FitchRatings

Fitch Revises Telefonica Deutschland's Outlook to Positive; Affirms at 'BBB'

Fitch Ratings-Moscow/London-31 March 2017: Fitch Ratings has revised Telefonica Deutschland Holdings AG's (TEF DE) Outlook to Positive from Stable, while affirming its Long-Term Issuer Default Rating (IDR) at 'BBB'. A full list of rating actions is available at the end of this commentary.

TEF DE is the largest mobile network operator in Germany by subscribers and the third-largest by revenues, with 38% subscriber and 30% revenue market shares at end-2016. The company is continuing with operational integration following its merger with E-Plus in 2014, and,in terms of network quality aims to catch up with its domestic competitors. TEF DE is managing its leverage at or below 1x net debt/OIBDA (company definition), but heavily relies on operating leases resulting in substantial off-balance-sheet debt and significantly higher funds from operations (FFO) adjusted net leverage (as defined by Fitch, 2.0x at end-2016).

KEY RATING DRIVERS

Low Leverage: We expect TEF DE's leverage to remain below 2.5x FFO adjusted net leverage. We estimate FFO adjusted net leverage at 2.0x at end-2016, corresponding to 0.4x net debt/OIBDA (company definition) and significantly below TEF DE's targeted level of at or below 1x. With low leverage and strong FCF generation, we expect moderate dividend growth in 2017 and 2018.

We estimate that organic development or reasonably growing shareholder distributions are unlikely to significantly stress leverage. Continuing generous shareholder distributions not supported by free cash flow may be more onerous for the ratings. FFO adjusted net leverage may come under pressure from rising taxes in the medium to long term, after depreciation of 3G licenses declines from 2020. However, a large tax loss carry forward will continue to shield TEF DE from excessive tax payments.

Substantial Integration Synergies: TEF DE's EBITDA and FFO generation is benefiting from substantial integration synergies following the merger with E-Plus in 2014. The company is targeting EUR900 million of synergies by 2019 on a run-rate basis, with opex synergies accounting for 65% of this target.

Robust FCF Generation: We expect TEF DE to generate strong FCF, with pre-dividend FCF margin likely to be in a high single-digit/low double-digit range in the medium term. This should be due to stronger integration synergies and capex discipline. 2017 FCF may be pressured by one-offs such as the last remaining EUR111 million spectrum payment, continuing restructuring costs, and utilisation of past restructuring provisions with a negative impact on working capital of around EUR100 million.

Revenue Headwinds: We believe the company is unlikely to achieve revenue stabilisation in 2017-2018 due to regulatory headwinds. TEF DE faces moderate revenue pressure from mobile termination rate cuts and the cancellation of European roaming charges in 2017, with the negative impact likely to extend to 2018. The company estimates the negative regulatory impact at around 3%-4% of revenues in 2017, on top of the guidance for slightly negative to flat organic mobile service revenue growth.

TEF DE's customer base is more skewed towards the pre-paid and the price-sensitive segments, and is likely to be more susceptible relative to its domestic competitors to changes in the roaming regulation and new ID registration requirements for pre-paid users, in our view.

Network Catch-Up: TEF DE's spectrum portfolio is on par with its competitors. Continuing capex investments should allow it to gradually catch up with its competitors in terms of network quality. The company has achieved almost 80% LTE population coverage at end-2016, closing the gap with other German mobile operators.

Significant Off-Balance-Sheet Debt: The ongoing network integration and synergies following the merger are likely to result in a gradual decline in lease payments (rationalisation of office space and retail shops) and lower off-balance-sheet debt, in our view. We do not expect this trend to be reversed by the increase in lease payments due to TEF DE's tower sale in 2017. We estimate incremental leases from this sale at EUR35 million per annum, translating into an additional EUR280 million of off-balance-sheet debt, using a 8x lease multiple.

The company heavily relies on operating leases, which leads to a significant amount of lease-equivalent debt under Fitch's approach. At end-2016, we estimate TEF DE had lease-equivalent debt of EUR3.7 billion, making up 70% of the company's total lease-adjusted debt.

Parent Subsidiary Linkage: TEF DE is broadly rated on a standalone basis, reflecting its status as a public company with independent management and its own financial policy. Even with cash pooling in place and no restrictions on dividend payments, links to its parent Telefonica S.A ('BBB') are viewed as weak to moderate.

DERIVATION SUMMARY

TEF DE has a sufficiently large subscriber base and spectrum portfolio, but it lags its domestic competitors in terms of network quality and revenue market share. The company derives a significant share of its wholesale revenues from MVNOs and its subscriber base is skewed towards pre-paid and the lower spending subscriber segments, with limited bundling opportunities on proprietary infrastructure. Its operating profile is weaker than its larger and more diversified European telecoms. However, its leverage is lower that at its key peers and pre-dividend free cash flow is improving.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- mid-single digit yoy decline in mobile service revenue in 2017 driven primarily by regulatory impact, largely stable mobile service revenue in 2018-2020;
- low single-digit revenue decline in fixed-line in 2017-2018 stabilising in 2019-2020;
- continuing improvement in EBITDA margin on the back of integration synergies;
- EUR1 billion capex per year in 2017-2018 gradually declining in 2019-2020;
- dividend payments growing at mid-single digits per year;
- average operating lease multiple of 7.0-7.3x in 2017-2020 reflecting TEF DE's mix of operating leases;
- no significant taxes before 2020.

RATING SENSITIVITIES

Future developments that may, individually or collectively, lead to positive rating action include:
- FFO-adjusted net leverage sustained at below 2.5x and accompanied by improvements in pre-dividend cash flow generation and a stronger operating profile may lead to an upgrade.

Future developments that may, individually or collectively, lead to negative rating action include:
- the Outlook may be changed to Stable if FFO adjusted net leverage trends to above 2.5x on the back of shareholder distributions, operating underperformance or a failure to achieve integration synergies and to improve EBITDA generation and cash flow;
- a downgrade may result from a material weakening in the company's current financial profile, including FFO adjusted net leverage consistently expected to exceed 3.25x;
- FFO fixed charge cover consistently below 4.0x may also lead to a downgrade.

LIQUIDITY

Ample Liquidity: TEF DE had EUR613 million of cash and equivalents on the balance sheet and access to EUR1,675 million of undrawn facilities as of end-2016. Available liquidity of EUR2,288 million more than comfortably covers its EUR797 million refinancing requirements until end-2020.

FULL LIST OF RATING ACTIONS

Telefonica Deutschland Holdings AG
--Issuer Default Rating: affirmed at 'BBB'; Outlook changed to Positive from Stable

O2 Telefonica Deutschland Finanzierungs GmbH
--Senior unsecured rating: affirmed at 'BBB'

Telefonica Germany GmbH & Co OHG
--Senior unsecured rating: affirmed at 'BBB'

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Summary of Financial Statement Adjustments - Financial statement adjustments that depart materially from those contained in the published financial statements of the relevant rated entity or obligor must be disclosed (in bullet points). Analysts should refer to the relevant section of the Data Control Form and discuss and agree the proposed disclosure at the rating committee. This disclosure should appear after the analyst contact information.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary

Applicable Criteria
Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017) (https://www.fitchratings.com/site/re/895493)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
(https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1021449&cft=0)
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