

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 than 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'

Contact:

Principal Analyst

Slava Bunkov

Director

+7 495 956 9931

Supervisory Analyst

Nikolai Lukashevich, CFA

Senior Director
+7 495 956 9968
Fitch Ratings CIS Ltd
26 Valovaya Street
Moscow 115054

Committee Chair
Damien Chew, CFA
Senior Director
+44 20 3530 1424

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.

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

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)

Solicitation Status (https://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=1021449)

Endorsement Policy (<https://www.fitchratings.com/regulatory>)

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK:

[HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings)

(<https://www.fitchratings.com/understandingcreditratings>). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM.

(<https://www.fitchratings.com>). PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory) (<https://www.fitchratings.com/site/regulatory>).

FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE. Copyright © 2017 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody

assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Solicitation Status

Fitch Ratings was paid to determine each credit rating announced in this Rating Action Commentary (RAC) by the obligatory being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated, except for the following:

Endorsement Policy - Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures (<https://www.fitchratings.com/regulatory>) page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.