FITCH AFFIRMS TELEFONICA DEUTSCHLAND AT 'BBB', OUTLOOK POSITIVE

Fitch Ratings-Moscow/London-18 April 2018: Fitch Ratings has affirmed Telefonica Deutschland Holdings AG's (TEF DE) Long-Term Issuer Default Rating (IDR) at 'BBB' with Positive Outlook. A full list of rating actions is 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 37% subscriber and 29% revenue market shares at end-2017. The company is continuing with operational integration and transformation following its merger with E-Plus in 2014, and is aiming to grow in line with the market, although it slightly lagged its peers in terms of subscriber and revenue performance throughout 2016-2017.

TEF DE is managing its leverage at or below 1x net debt/OIBDA (company definition), but relies heavily on operating leases, resulting in substantial off-balance-sheet debt and significantly higher funds from operations (FFO) adjusted net leverage (as defined by Fitch, 2.3x at end-2017) and tight FFO fixed charge coverage (3.6x at end-2017). Network integration has not yet resulted in substantial lease synergies on a net basis, leading to weaker coverage and higher leverage vs. Fitch's earlier expectations.

KEY RATING DRIVERS
Supportive Market Structure: We view the structure of the German telecoms market as supportive of revenue and EBITDA stabilisation, and ultimately growth in the long term, with only three facilities-based mobile network operators (MNOs). The 2017 merger of Drillish and United Internet, two large non-MNOs, should help rationliase pricing competition, particularly in the most price-sensitive customer segment where TEF DE's positions are strong. TEF DE estimated that non-MNO post-paid market pricing had significantly recovered by early 2018, supporting bundled offers in the EUR15-EUR30 range, compared with EUR8-EUR12 offers prevalent in mid-2016.

Operating Underperformance: TEF DE slightly underperformed its peers in terms of mobile service revenues in 2016-2017, shedding approximately 1% market share. It remains a challenge to start growing in line with the market, as outlined in the company's mid-term strategy. However, the dynamics improved during 2017. The company estimated the underlying yoy quarterly mobile service revenue trend turned positive in 4Q17.

Integration Benefits Delayed: We expect that the net positive impact of merger synergies is likely to be delayed, as the company has reinvested a significant share of its gross integration synergies into the market and initiated a transformation programme in March 2018. The company expects the transformation restructuring costs to be front-loaded while any substantial benefits from the new initiative are unlikely earlier than 2019. TEF DE is targeting a EUR600 million positive gross OIBDA (company definition) transformation effect by 2022 and increased its expected cumulative integration synergies by EUR100 million to EUR900 million by end-2019. However, it does not provide guidance on the net impact of these initiatives.

Regulation Bites: We estimate the negative impact of mobile termination rates (MTR) cuts and roam-like-home regulation to be significant and likely to wipe up to 7%-8% of 2016 EBITDA over the three years to end-2019. Roam-like-home regulation is most painful, as it primarily hits EBITDA and is likely to have a lingering effect. TEF DE is more sensitive to this regulation than its peers because of its larger focus on ethnic communities and a higher proportion of within-EU migrant workers in its subscriber base.

Roam-like-home regulation was introduced on 15 June 2017, and, along with MTR cuts, resulted in a negative OIBDA impact of EUR51 million in 2017. MTR cuts have a more significant negative impact on revenues, but are typically accompanied by similar interconnect savings, with an almost negligible impact on EBITDA.

Stable Revenue: We expect TEF DE's revenues to remain largely stable. The company's strategy of searching for new growth opportunities such as from monetisation of internet-of-things and big data remains subject to significant execution risks, in our view, as it suggests entry into effectively new segments with low financial visibility. Pockets of growth are likely to be accompanied by continuing pressures in the traditional voice segment.

Gradually Improving Margins: TEF DE's EBITDA generation will be supported by ambitious cost-cutting initiatives but pulled down by a negative regulatory impact in the medium term. We expect the overall trend to be positive, with up to 1.5p.p. EBITDA margin improvement in the medium term.

Modest Leverage, Tight Coverage: We expect TEF DE's FFO adjusted net leverage to remain modest at or below 2.5x. We estimate it at 2.3x at end-2017, corresponding to 0.6x net debt/ OIBDA (company definition) and significantly below TEF DE's targeted level of at or below 1x. However, FFO fixed charge coverage is relatively weak, at 3.6x at end-2017, reflecting significant lease payments.

With more than 70% of total adjusted debt stemming from capitalised leases at end-2017, leverage metrics are sensitive to even small variations in the operating lease assumptions. The introduction of IFRS 16 requiring all leases to be capitalised on the balance sheet will likely lead to a review of the targeted leverage, currently stated as 1x net debt/OIBDA (company definition). However, we expect the updated leverage targets to remain reasonably conservative. The planned 5G spectrum auction in Germany, which we expect TEF DE to participate in, is unlikely to trigger higher than 0.5x increase in leverage by our estimates, which is manageable.

Strong Pre-Dividend FCF Generation: We expect TEF DE's pre-dividend FCF generation to remain robust, in the low double-digit territory as percentage of revenues in the medium term (excluding potential spectrum investments). The company is committed to dividend growth until 2019 (with the last pay-out based on 2018 earnings), which under our estimates, suggests that the entire FCF will be paid out to shareholders. The company will have more dividend flexibility after this deadline, which may be required as cash flow could be drained by higher taxes after full utilisation of tax-loss-carry-forward provisions, likely after 2020.

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 formal restrictions on dividend payments, links to its parent Telefonica S.A (BBB/Stable) 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 Deutsche Telekom (BBB+/Stable) and Vodafone (BBB+/Stable) in terms of network quality and revenue market share. Unlike its peers, the company derives a significant share of its wholesale revenues from MVNOs, with limited bundling opportunities on proprietary infrastructure. Its subscriber base is skewed towards pre-paid and the lower spending subscriber segments, which are more vulnerable to regulatory changes such as roam-like-home. Its operating profile is weaker than its larger and more diversified European telecoms peers such as Orange (BBB+/Stable). However, its leverage is lower than its key peers and pre-dividend FCF is strong in a low double-digit territory as a percentage of revenues.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Largely stable revenues, with a slight 2018 yoy decline driven by discontinuation of wholesale fixed-line service;
- Gradually improving EBITDA margins on the back of integration and transformation synergies but dampened by a negative regulatory impact;
- Capex at approximately 13% of revenues in the medium term;
- Annual dividend growth of EUR0.01 per share;
- Average operating lease multiple of 6.7x-6.9x in 2018-2021 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 revised 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 net 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

Comfortable Liquidity: TEF DE had EUR587 million of cash and equivalents on the balance sheet and access to EUR2,015 million of undrawn facilities with over one year maturity as of end-2017. This compares with only EUR829 million refinancing requirements until end-2020.

FULL LIST OF RATING ACTIONS

Telefonica Deutschland Holdings AG

--Long-Term IDR: affirmed at 'BBB'; Outlook Positive

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
- 4 to 1 debt to equity ratio for TEF DE handsets receivables under financial services adjustments
- Adjustments for sold handset receivables in line with Fitch's methodology

Media Relations: Adrian Simpson, London, Tel: +44 203 530 1010, Email: adrian.simpson@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
Corporate Rating Criteria (pub. 23 Mar 2018)
https://www.fitchratings.com/site/re/10023785
Parent and Subsidiary Rating Linkage (pub. 15 Feb 2018)
https://www.fitchratings.com/site/re/10019836
Sector Navigators (pub. 23 Mar 2018)
https://www.fitchratings.com/site/re/10023790