FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Telefonica Deutschland at 'BBB', Outlook Stable

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Fitch Ratings - Frankfurt am Main - 15 Mar 2021: Fitch Ratings has affirmed Telefonica Deutschland Holdings AG's (TEF DE) Long-Term Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook and senior unsecured rating at 'BBB'.

The ratings reflect TEF DE's solid position in the German telecoms market, improved network quality and low leverage. We expect the company to maintain a prudent approach to its leverage policy, leaving healthy headroom below its target of 2.5x net debt/OIBDA (company definition; 1.4x in 2020) despite an increase in capex. We also expect competitive intensity in Germany to gradually increase in the medium term as one of TEF DE's main wholesale customers, 1&1 Drillisch, builds out its own network. We believe TEF DE has sufficient time and resources to address this risk and substantial flexibility to manage its leverage accordingly.

Feedback

TEF DE is the largest mobile network operator in Germany by subscriber and the second-largest by revenue, with 36% subscriber and 33% revenue market shares at end-4Q20.

KEY RATING DRIVERS

Low Leverage Sustainable: We expect TEF DE's funds from operations (FFO) net leverage to gradually increase to 1.0x by 2024 from 0.5x in 2021, driven primarily by accelerated investments in 5G roll-out. Despite this increase the company will retain comfortable headroom below Fitch's downgrade threshold of 2.3x FFO net leverage. The sale of 10,100 mobile sites to Telxius in 2020 has improved TEF DE's leverage headroom and provided substantial flexibility to accelerate investments in 5G roll-out.

FCF Margin to Remain Positive: Higher capex will put pressure on pre-dividend free cash flow (FCF) in 2021-2022. However, we expect FCF margin to remain positive in low single digits during this period before improving to mid-single digits from 2023 as capex decreases.

Competition to Increase: Fitch's base-case scenario assumes competition in the German telecoms market will gradually increase in the medium term as 1&1 Drillisch focuses on customer acquisition and porting its existing customer base to its own network to support the economics of deploying a mobile network. Defensive moves from other telecoms operators may increase overall competitive intensity, with a greater focus on fixed-mobile bundled offerings in particular, similar to what we have seen in other European markets following the entry of a new network player.

More visibility on TEF DE's competitive position in the long term and on the performance of its own brands in light of 1&1 Drillisch's network roll-out would be a prerequisite for a positive rating action.

Improved Network Quality: TEF DE was able to largely catch up in mobile network quality with its main peers Deutsche Telekom and Vodafone in the last several years, which positively impacts its perception by customers and its churn rates. Accelerated investments into 5G in the next two years, combined with active network-sharing agreements with other operators, should help TEF DE remain competitive in network quality and secure a cost-efficient fulfilment of coverage obligation attached to 5G licenses.

Rational Fixed-line Strategy: TEF DE's access to Deutsche Telekom's VDSL and fibre networks as well as to cable companies' networks strengthens the company's bundling capacity, which may be helpful if competition in fixed-mobile convergent products increases. TEF DE focuses primarily on the mobile segment and wholesale access to third-party networks allows it to remain competitive without having to make substantial investments in infrastructure.

New Leverage Thresholds: Fitch has changed its upgrade/downgrade thresholds to 1.5x/2.3x FFO net leverage from 2.5x/3.25x FFO-adjusted net leverage and added an additional upgrade trigger cash flow from operations (CFO)-capex/total debt. The change reflects Fitch's revised approach to leverage metrics following the introduction of IFRS 16 lease accounting and associated changes made to our Corporate Rating Criteria and recalibration of the telecoms Navigator leverage thresholds. The additional cash-flow-based metrics in response to the complexities of IFRS 16 adoption improve comparability across peers.

We forecast CFO-capex/total debt at 3.2% in 2021 due to high capex. This should improve to the teens from 2023.

No Rating Impact from Parent: 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 strong market positions in the German mobile market. Unlike its peers, the company derives a significant share of its wholesale revenue from MVNOs, which exposes it to some revenue volatility in the long term as its main wholesale partner, 1&1 Drillisch, rolls out its own network.

TEF DE's operating profile is weaker than that of its larger and more diversified European telecoms peers such as Deutsche Telekom AG (BBB+/Stable), Orange S.A. (BBB+/Stable) and Vodafone Group plc (BBB/Stable), which have greater scale and geographic diversification that can help mitigate potential weakness in domestic performance. Other peers focused on domestic markets, such as Royal KPN N.V. (BBB/Stable), NOS, S.G.P.S., S.A. (BBB/Stable) and BT Group (BBB/Stable), have higher leverage but benefit from strong domestic positions in both mobile and fixed line and from the ownership of substantial fixed-line infrastructure.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

-Flat revenue in 2021, as negative impact from Covid-19 and mobile termination-rate cuts mitigate roaming revenue growth from 2H21 and stronger revenue in fixed-line segment and handset sales. This is followed by low single-digit revenue growth per annum in 2022-2024

-Fitch-defined EBITDA margin to decline to 22.6% in 2021 from 23.1% in 2020, reflecting increase in lease costs for divested tower assets. EBITDA margin at around 23% in 2022 and modestly improving in 2023-2024

-Capex excluding spectrum at 18% of revenue in 2021, 16.5% in 2022 and 14%-15% in 2023-2024

-Dividends to increase by EUR0.1 per share per year in 2022-2024

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- FFO net leverage sustained at below 1.5x and accompanied by greater visibility on the company's long-term competitive position

- CFO-capex/total debt sustainably at or above 12%

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-FFO net leverage consistently expected to exceed 2.3x

-Higher-than-expected competitive pressure, in particular, from 1&1 Drillisch impacting TEF DE's market share and wholesale revenue

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity: TEF DE had EUR1.3 billion of cash and equivalents on its balance sheet and access to EUR2 billion of undrawn facilities as of end-2020. These, together with its EUR0.5 billion proceeds from the Telxius transaction expected in 2021, are sufficient to fund debt maturities and projected negative post-dividend FCF over the next four years.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
O2 Telefonica Deutschland Finanzierungs GmbH		

ENTITY/DEBT	RATING			PRIOR
• senior unsecured	LT	BBB	Affirmed	BBB
Telefonica Germany GmbH & Co. OHG				

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

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Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub. 26 Aug 2020)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Telefonica Deutschland Holding AG	EU Issued, UK Endorsed
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Technology, Media, and Telecom Corporate Finance Europe Germany

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