# FITCH AFFIRMS TELEFONICA DEUTSCHLAND AT 'BBB'; STABLE OUTLOOK

Fitch Ratings-London-01 December 2014: Fitch Ratings has affirmed Telefonica Deutschland Holding AG's (TEF DE) Long-term Issuer Default Rating (IDR) of 'BBB'. The Outlook is Stable. A full list of rating actions is at the end of this comment.

Despite the company's considerably improved scale following its E-Plus acquisition, TEF DE's margin profile remains sub-optimal and its financial profile driven by high operating leases, a progressive dividend policy and upcoming spectrum auctions, which are all likely to weigh on adjusted leverage metrics for the next two to three years. The company faces integration challenges related to the acquisition, although scale economies can be expected to arise naturally and targeted synergies should be achievable. Fitch's base case assumes an EBITDA margin trending towards the mid-twenties by 2016.

TEF DE is now the largest mobile network operator (MNO) by subscribers in the German market, a market that should benefit from a four to three player consolidation and regulatory remedies that cedes power to a fragmented virtual mobile network operator (MVNO) market but is not intent necessarily on further facilities-based competition.

KEY RATING DRIVERS

E-Plus Adds Scale and Synergies

The E-Plus acquisition received EU clearance on 29 August and completed 1 October 2014. The transaction boosts TEF DE's market position considerably, making it the largest operator by subscriber numbers and the number two/three by mobile service revenues. After the application of TEF DE's accounting policies, with notable differences employed by E-Plus in relation to handset sales, a pro-forma EBITDA margin of 20.5% (1H14) is low despite the combined company's scale. Planned synergies, natural scale economies, and the potential for a more rational pricing environment, should lead to margin expansion, which in Fitch's view could realistically rise to the mid-20s over the next two to three years.

Financial Policy, Dividends & Operating Leases

TEF DE's revenues and cash flow are mature and visible. Fitch expects operating conditions to remain tough albeit with some easing given MNO market consolidation. However, the ratings are also driven by financial policy and a high level of operating leases. In Fitch's view, dividend policy, framed by a stated leverage (net debt/EBITDA) target of below 1.0x (2013A: 0.6x according to Fitch calculations), will drive progressive distributions.

Operating leases currently add approximately 1.7x of leverage (FYE2013) to arrive at the FFO net adjusted metric (2013A: 2.3x). Network rationalisation should have a positive effect on lease expenses over the next three years, which would improve the gap between net debt/EBITDA and lease adjusted leverage. Our base case assumes a metric trending up towards 2.6x by FYE15 before it reduces more materially by FYE17 as the benefits of the integration materialise - noting that at this stage Fitch has not adjusted its leverage calculations for E-Plus' handsets related finance leases. At 1H14 these amounted to EUR452m on a pro-forma basis, and Fitch estimates would add approximately 0.2x to 0.3x to lease adjusted leverage based on management's estimate of their anticipated value at FYE14.

Ratings Less Constrained

Fitch previously guided that upside to the ratings was limited by TEF DE's single market presence and scale. The leverage neutral structure of the E-Plus deal, the company's enhanced operating profile and better economies of scale, reduce these constraints. While our base case envisages that it will take time for margins to expand significantly, ratings upside is possible at some point. The cell-site integration plan and the impact this will have on operating leases, a progressive dividend policy and upcoming spectrum auctions will all influence adjusted leverage. However, it will take time to understand how these features affect the metrics and for a more natural leverage profile to be established.

Fitch considers the stated EUR700m 2015 dividend establishes a floor for distributions. While spectrum acquisition/renewal is viewed to some extent as an exceptional cash cost, the potential for sizeable spectrum payments between 2015 and 2017 (2G license renewal and the prospect of a second digital dividend) have the potential to add to debt and keep leverage at heightened levels over the next two to three years. The cash costs of restructuring will similarly weigh on debt, albeit these are also treated by Fitch as an exceptional cost in terms of measuring cash flow performance. This combination and the time envisaged for a more optimal margin profile to be established are expected to limit ratings upside in the near term.

Operating Conditions
Despite operating in Europe's largest telecom market and in an economy that has remained strong, revenue and EBITDA pressures have been driven by naturally prudent consumption trends and a competitive market environment. A well-developed reseller market and a capacity off-take agreement with MVNO, Drillisch (required to meet regulatory remedies to the merger), are likely to maintain competitive pressures. The Drilisch deal has the potential to increase pricing pressure in the short term given the sunk costs associated with the contract and the approximately 2 million incremental customers that Drillisch has stated as necessary to fill the initial 20% capacity off-take.

In Fitch's view, competitors will also seek to take advantage of the integration challenges facing TEF DE. These include merging a significantly overlapping network grid, rationalising overlapping retails channels and managing a high number and fragmented level of pricing tiers.

Parent-Subsidiary Linkage
TEF DE's ratings are assigned broadly on a standalone basis, but with some ultimate linkage to its parent, Telefonica SA (BBB+/Negative). The company has been established as a standalone entity, with separate management, independent governance and its own financial policy. Given its scale and maturity, Fitch regards TEF DE as a sustainable independent business with a proven ability to finance itself and guides that TEF DE could be rated up to two notches higher than the parent. This linkage was more important during the eurozone crisis.

RATING SENSITIVITIES
Negative:
- A material weakening in the company's current financial profile would put pressure on the ratings; including funds from operations (FFO) net adjusted leverage consistently expected to exceed 3.25x
- FFO fixed charge cover consistently below 4.0x

Positive:
- Tangible evidence that the integration of E-Plus and network rationalisation is progressing; leading to sustainable improvements in the margin and cash flow profile,
- FFO net leverage trending consistently around 2.5x or below; with forecast expectations subject to visibility on the impact of upcoming spectrum auctions

LIQUIDITY AND DEBT STRUCTURE
TEF DE has raised a total of EUR1.1bn in the bond markets since its IPO in 2012, with maturities of 2018 and 2021. Funding is additionally provided via intercompany loans from parent company. Liquidity is provided by underlying cash flow and standby lines from relationship banks totalling

EUR710m. 2013A pre-dividend free cash flow amounted to EUR592m, although Fitch considers a dividend floor of EUR700m, along with sizeable spectrum costs expected over the next two to three years, are likely to require additional liquidity/funding to be put in place.

The rating actions are as follows:

Telefonica Deutschland Holding AG
Long-term IDR: affirmed at 'BBB', Outlook Stable

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

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

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Additional information is available at 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 Methodology', dated 28 May 2014 is available at www.fitchratings.com.

Applicable Criteria and Related Research:
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=749393