

## **RATING ACTION COMMENTARY**

## Fitch Affirms Telefonica Deutschland at 'BBB'; Outlook Stable

Thu 19 Oct. 2023 - 11:33 ET

Fitch Ratings - Frankfurt am Main - 19 Oct 2023: Fitch Ratings has affirmed Telefonica Deutschland Holding AG's (TEF DE) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. The Outlook on the IDR is Stable.

The ratings reflect TEF DE's solid position in the rational German mobile telecommunications market, well-invested networks, low leverage and conservative financial policy. The ratings also consider relatively low profitability and expected in the next two to three years loss of revenues from TEF DE's major customer, 1&1 Mobilfunk GmbH.

The risk of loss of 1&1 revenues has already been incorporated into the rating. The company's low leverage and sizeable leverage headroom for the rating provide financial flexibility to withstand situations like this.

## **KEY RATING DRIVERS**

Continued Organic Growth: TEF DE has demonstrated relatively good results with revenue and company-defined EBITDA growing by 5.9% and 5.4% in 2022 and 6.2% and 2.1% in 1H23, respectively. Growth was supported by 4.6% mobile service revenue (MSR) growth in 2022 and 4.3% in 1H23 as well as handset sales. The MSR growth was driven by improving average revenue per user due to data monetisation and more-formore offers, increasing second SIM card penetration and increasing market share in B2B and rural areas supported by continued network infrastructure roll-out and upgrades.

**1&1** Loss Significant, but Manageable: 1&1's new partnership with Vodafone Germany (VOD) will result in a gradual but significant loss of wholesale revenue for TEF DE. Fitch has adjusted its base-case forecasts to incorporate the loss of the 1&1 contract. We estimate the full-year negative impact on EBITDA to be EUR500 million. The migration of customers to Vodafone's network will take two to three years. Our base case assumes a limited impact on TEF DE's revenue and EBITDA in 2024, 70% impact in 2025 and 100% from 2026.

We expect the loss of 1&1 revenue to be partially compensated by continued underlying revenue growth and expansion of its wholesale business through new and existing partnerships that include mobile virtual network operators (MVNO). TEF DE will have considerable freed-up network capacity for this after relocation of 1&1 subscribers to VOD.

Comfortable Leverage Headroom: The company's EBITDA net leverage (Fitch-defined) was 0.3x at end-2022. Our base case forecasts leverage of 0.5x at end-2023 and 2024 mainly due to continued network investments, higher interest expenses and tax payments. We expect the leverage to increase to 0.9x by end-2027 driven by the EBITDA loss from 1&1. This would still leave the company more than one turn of headroom below the 2.0x downgrade threshold.

**Pressured Profitability:** Wholesale revenues typically carry strong EBITDA margins and the loss of 1&1 revenues will likely have a more pronounced, disproportionate effect on free cash flow (FCF). TEF DE's EBITDA margin, which has already been reduced by higher lease costs following sales of towers, will be further affected by the loss of wholesale revenues. Our base case envisages Fitch-defined EBITDA margin declining to around 19% in 2026-2027 from around 23% in 2021-2022.

Rational Market: TEF DE is one of three main mobile network operators (MNO) in Germany, with about a 34% mobile network service revenue market share (including 1&1 subscribers). The German mobile market remains rational, evidenced by service revenue growth of around 3% in 2022 and 6M23 and relatively low churn. The deployment of a fourth mobile network by 1&1 is likely to be more gradual, given the national roaming cooperation with VOD, and is unlikely to significantly destabilise the market growth profile considering its existing mobile customer base.

**Spectrum Licenses Extension Likely:** The German regulator recently flagged that it is considering extending MNOs' existing spectrum licenses expiring at end-2025 to 2030. A final decision is expected in 2024. Our base case assumes no spectrum auction in 2025. However, should the auction unexpectedly proceed, a EUR500 million spectrum payment in 2026 would raise leverage by 0.3x in 2026 and 2027.

**5G Roll-out Near Completion:** TEF DE has been investing significantly in 5G networks in the last few years, achieving 90% of population 5G coverage in mid-2023. The company expects to have nationwide 5G coverage by the end-2024. As a result, we expect cash capex (excluding spectrum) to decline to 14-15% in 2023-2024 from 17% in 2022 and to gradually decline further to 12% by 2027.

Supportive Fixed-line Strategy: TEF DE's fixed-line strategy is geared to support its core mobile product portfolio by providing cross-selling opportunities and a fixed mobile convergent product proposition capability. The company has good access to fixed-line networks on a wholesale basis in Germany with access to Deutsche Telekom's and VOD's fixed-line networks and a growing number of alternative fixed-line providers. This provides TEF DE with the scope to provide customers with a technology agnostic broadband proposition and purchasing power in wholesale contract negotiations.

No Rating Impact from Parent: TEF DE is rated on a standalone basis, based on Fitch's Parent Subsidiary Linkage (PSL) Criteria. This reflects that both parent Telefonica S.A. and TEF DE are rated at the same 'BBB' level. TEF DE is a listed company with independent management and its own financial policy. There is cash pooling in place and TEF DE has no formal restrictions on dividend payments.

Based on Fitch's PSL Criteria, TEF DE's ratings would be linked to Telefonica S.A.'s rating, if the parent's and TEF DE's standalone rating profile differed from each other. In the event of a downward revision of TEF DE's Standalone Credit Profile (SCP), the company would receive a one-notch uplift support to its IDR from Telefonica S.A. In a scenario, where Telefonica S.A.'s rating was lower than TEF DE's, TEF DE would be linked to Telefonica S.A. on a consolidated basis plus one notch. The rating sensitivities below reflect the standalone profile, which in our opinion is the most probable scenario in the rating horizon.

## **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 MVNO, which exposes it to some revenue volatility, as its main wholesale partner 1&1 will move to another MNO in the next two years.

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/Positive), which have greater scale and geographic diversification that can help mitigate potential weakness in domestic performance. Other peers that focus on domestic markets, such as Royal KPN N.V. (BBB/Stable), NOS, S.G.P.S., S.A. (BBB/Stable) and BT Group plc (BBB/Stable), have higher leverage but benefit from higher EBITDA margins and strong domestic positions in both mobile and fixed line and the ownership of substantial fixed-line infrastructure.

## **KEY ASSUMPTIONS**

- Revenue growth of 3.9% in 2023, decelerating to 1.1% in 2024 and 2.6% decline in 2025 on the back of loss of wholesale revenue from 1&1 before getting back to 0.6%

growth in 2026 and 3.5% in 2027;

- Fitch-defined EBITDA margin of 22.1% in 2023 gradually declining to 19.2%-19.3% in 2026-2027;
- Cash capex-to-sales (including spectrum) of around 16% in 2023 declining gradually to 14% by 2027;
- Cash dividends of EUR0.18 per share in 2023-2024, declining to EUR0.15 per share in 2025-2027.

## **RATING SENSITIVITIES**

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

- Fitch-defined EBITDA net leverage sustained below 1.2x and accompanied by greater visibility of the company's long-term competitive position and improvement in EBITDA margin;
- Cash flow from operations (CFO) less capex/gross debt sustained at or above 16% (excluding one-off spectrum costs)

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

- Fitch-defined EBITDA net leverage consistently expected to exceed 2.0x;
- Higher-than-expected competitive pressure, in particular, from 1&1 impacting TEF DE's market share;
- CFO less capex/gross debt sustained at or below 14% (excluding one-off spectrum costs);
- Inability to sufficiently compensate for the loss of 1&1 revenues and EBITDA in the medium term either through organic growth or through increased wholesale revenues from other MVNOs.

## LIQUIDITY AND DEBT STRUCTURE

**Comfortable Liquidity:** TEF DE had a comfortable liquidity position at mid-2023 supported by EUR0.3 billion of cash and equivalents on its balance sheet and access to around EUR1.7 billion of undrawn facilities as of 2Q23. These are sufficient to fund debt maturities and projected negative post-dividend FCF over the next three 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**

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit <a href="https://www.fitchratings.com/topics/esg/products#esg-relevance-scores">https://www.fitchratings.com/topics/esg/products#esg-relevance-scores</a>.

## **RATING ACTIONS**

ENTITY/DEBT \$	RATING <b>♦</b>	PRIOR <b>♦</b>
O2 Telefonica		
Deutschland		
Finanzierungs GmbH		
senior unsecured	LT BBB Affirmed	BBB
Telefonica Germany GmbH & Co. OHG		
senior unsecured	LT BBB Affirmed	BBB
Telefonica Deutschland Holding AG	LT IDR BBB Rating Outlook Stable	BBB Rating Outlook Stable
	Affirmed	

#### **VIEW ADDITIONAL RATING DETAILS**

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## **APPLICABLE CRITERIA**

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub. 16 Jun 2023)

Climate Vulnerability in Corporate Ratings Criteria (pub. 21 Jul 2023) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 13 Oct 2023) (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), v8.1.0 (1)

## **ADDITIONAL DISCLOSURES**

Dodd-Frank Rating Information Disclosure Form

**Solicitation Status** 

**Endorsement Policy** 

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