



## Fitch Revises Telefonica Deutschland's Outlook to Stable; Affirms at 'BBB'

Fitch Ratings - Frankfurt am Main - 26 June 2019:

Fitch Ratings has revised Telefonica Deutschland Holdings AG's (TEF DE) Outlook to Stable from Positive, while affirming the telco's Long-Term Issuer Default Rating (IDR) at 'BBB'. The Outlook change reflects Fitch's expectation that TEF DE's funds from operations (FFO) adjusted net leverage will remain above our upgrade threshold of 2.5x in the medium term following a 0.5x increase in 2019 due to 5G spectrum payments.

We expect the company to maintain a prudent approach to its leverage policy. However, deleveraging is unlikely due to the company's commitment to pay dividends at a high pay-out ratio relative to pre-dividend free cash flow (FCF). Fitch also expects competitive intensity in Germany to gradually increase in the medium-term as competitor Drillisch builds out its network and enters the German mobile market as the fourth network operator.

TEF DE is the largest mobile network operator in Germany by subscriber and the third-largest by revenue with respectively 37% and 31% market shares at end-1Q19.

### Key Rating Drivers

**Spectrum Costs Drive Leverage:** Fitch expects TEF DE's FFO adjusted net leverage to increase to 2.7x in 2019 from 2.2x in 2018, driven by spectrum payments. The ratio is likely to remain stable at around 2.7x-2.8x in 2019-2022 and deleveraging to below our upgrade threshold of 2.5x is unlikely as the company is committed to a high dividend pay-out relative to its pre-dividend FCF. In our projections we assume that all of pre-dividend FCF will be paid out to shareholders as the company has a track record of shareholder-friendly remuneration policy and has historically targeted progressive dividend pay-outs.

Germany's 5G spectrum auctions raised over EUR6.5 billion - double our original expectation - from four winning bidders. TEF DE acquired 90MHz of spectrum in the 2.1GHz and 3.6GHz bands for a total consideration of EUR1.43 billion, of which EUR1.26 billion is payable in 2H19 and the remaining EUR0.17 billion is due in 2024.

**Stable Underlying Performance:** Fitch expects TEF DE's revenue to remain largely stable in 2020-2022 as regulatory effects fade away while underlying service revenue is supported by rational competition and growing demand for mobile data. EBITDA margin is likely to continue gradually improving as the company will see more benefits from the implementation of its transformation programme, which targets EUR600 million of gross EBITDA gains in 2019-2022. TEF DE reported 0.3% yoy increase in underlying mobile service revenue and 1% yoy growth in underlying EBITDA in 1Q19.

**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 over the medium term. The 5G network rollout should not lead to a material expansion of the company's investment as 4G capex will gradually wind down in the next several years. Hence we expect capex to remain at around 13%-14% of revenue in 2020-2022, translating into around

EUR1 billion of spending per year. FFO is expected to come under moderate pressure from rising taxes after depreciation of 3G licences declines from 2020.

**Drillisch Strategy Adds Uncertainty:** Drillisch's participation in the 5G spectrum auction demonstrates the company's determination to move from being mobile virtual network operator (MVNO) to a fully-fledged MNO in the German market. We believe Drillisch may be seeking to develop or deploy a hybrid mobile network using its own network in urban and metropolitan areas and relying on existing or new commercial or national roaming agreements for coverage in less dense areas and intercity transport routes. However, there are no clear, mandated regulatory pricing mechanisms in Germany and we have limited visibility on how Drillisch will establish its business model.

**Competition to Increase:** Fitch's base case scenario assumes competition in the German market may gradually increase in the medium term as Drillisch focuses on customer acquisition and porting its existing customer base to its own network to support the economics of deploying a mobile network. A downside scenario would be Drillisch making a more aggressive move in the next two years, which we believe is unlikely. Active network rollout by Drillisch may also put pressure on TEF DE's wholesale revenue as Drillisch is one of its core MVNO customers.

**Vodafone/Unitymedia Deal Impact:** TEF DE signed a wholesale agreement with Vodafone to gain access to the latter's cable infrastructure, subject to the completion of Unitymedia acquisition by Vodafone. This implies that TEF DE will have access to both Deutsche Telekom's DSL infrastructure and Vodafone's cable infrastructure. The effect of access to larger infrastructure footprint on fixed-line performance is yet to be seen as better coverage and potential increase in subscriber numbers may be offset by heightened competition. The agreement strengthens TEF DE's bundling capacity, which may be helpful if competition in fixed-mobile convergent products increases.

**Network Catch-Up:** The completion of network integration in 2018 and gradual improvements of its network quality and coverage compared with peers Deutsche Telekom and Vodafone, should help TEF DE to further improve customer perception of its brands and reduce churn. The company achieved approximately 90% LTE population coverage at end-1Q19 and 95% combined 3G and 4G coverage, slightly behind its main competitors. TEF DE's spectrum portfolio is on a par with that of its competitors.

**No Impact from IFRS 16 Adoption:** Our leverage metrics under our current methodology do not factor in the transition to IFRS16 accounting standards. We continue to treat operating lease payments as part of operating costs and capitalise them for our total adjusted debt calculation. With more than 60% of total adjusted debt stemming from capitalised leases at end-2018, TEF DE's leverage metrics are particularly sensitive to the treatment of operating leases.

**No Rating Impact from Parent:** Both Telefonica S.A. and TEF DE are rated at the same level of 'BBB', with both rated on a standalone basis. 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.

## **Derivation Summary**

TEF DE has a sufficiently large subscriber base and spectrum portfolio, but it lags behind its domestic competitors Deutsche Telekom AG (BBB+/Stable) and Vodafone Group plc (BBB+/RWN) in network coverage and revenue market share in Germany and geographical diversification. Unlike its peers, the company derives a significant share of its wholesale revenue from MVNOs, with limited bundling opportunities on proprietary fixed network 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 S.A. (BBB+/Stable). However, its leverage is lower than its key peers' and pre-dividend FCF, excluding spectrum payments, is strong in the high-single to- low double-digit territory as a percentage of revenue.

## Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

- Broadly stable revenue over the next four years
- EBITDA margin growth resulting in 2% to 3% CAGR in absolute EBITDA over the next four years with finalisation of synergies from E-plus integration partly offset by one-off regulatory impact of roam like home in 2019
- Capex excluding spectrum at 13% to 14% of revenue
- 5G spectrum payments at EUR1.3 billion in 2H19 with the remaining EUR170 million due by end-1H24
- Dividends of EUR803 million in 2019, stabilising at EUR833 million p.a. thereafter.

## RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- FFO-adjusted net leverage sustained at below 2.5x and accompanied by improvements in pre-dividend FCF generation and a stronger operating profile

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage consistently expected to exceed 3.25x
- FFO fixed charge cover consistently below 4.0x (2018: 3.9x), or consistently negative FCF driven by dividends
- Higher-than-expected competitive pressure, in particular, from Drillisch impacting TEF DE's market share and wholesale revenue

## Liquidity and Debt Structure

Comfortable Liquidity: TEF DE had EUR764 million of cash and equivalents on its balance sheet and access to EUR1.5 billion of undrawn facilities with over one year maturity as of end-1Q19. These, together with its EUR360 million promissory notes issued in April 2019, are sufficient to fund debt maturities and expected negative FCF over the next two years.

## Summary of Financial Adjustments

- Debt to equity ratio at 4x for TEF DE handset receivables under financial services adjustments
- Adjustments for sold handset receivables in line with Fitch's methodology

## Sources of Information

RATING ACTIONS		
ENTITY/DEBT	RATING	PRIOR
Telefonica Deutschland Holding AG	LT IDR BBB ● Affirmed	BBB +
Telefonica Germany GmbH & Co. OHG		
senior unsecured	LT BBB Affirmed	BBB
O2 Telefonica Deutschland Finanzierungs GmbH		
senior unsecured	LT BBB Affirmed	BBB

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## Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)  
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)  
Corporate Rating Criteria (pub. 19 Feb 2019)

## Additional Disclosures

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