S&P Global Ratings

RatingsDirect®

Research Update:

Telecom Operator Telekom Austria Outlook Revised To Positive On Improving Operating Trends And Cash Flow Prospects

Primary Credit Analyst:
Lukas Paul, Frankfurt (49) 69-33-999-132; lukas.paul@spglobal.com

Secondary Contact:
Osnat Jaeger, London (44) 20-7176-7066; osnat.jaeger@spglobal.com

Table Of Contents

Research Update:

Telecom Operator Telekom Austria Outlook Revised To Positive On Improving Operating Trends And Cash Flow Prospects

Overview

- Austrian incumbent telecom services provider Telekom Austria is experiencing a gradual stabilization of operating trends in its domestic market and continues to successfully trim its cost base.
- We think these developments will likely support improving and less volatile free cash flow generation over time, offsetting somewhat the risks from the company's flexible financial and mergers and acquisitions policies, as the growing cash flows provide more capacity to reduce debt.
- We are therefore revising our outlook on Telekom Austria to positive from stable, and affirming our 'BBB/A-2' corporate credit ratings and our issue ratings on Telekom Austria's debt.
- The positive outlook reflects our view that improving service revenue trends and continued cost savings in Austria may strengthen free operating cash flow to sustainably more than 10% of adjusted debt in the next two years and support Telekom Austria's longer term maintenance of adjusted debt to EBITDA of less than 3x.

Rating Action

On May 23, 2017, S&P Global Ratings revised its outlook on Austrian telecommunications network operator Telekom Austria AG and its fully owned finance subsidiary Telekom Finanzmanagement GmbH to positive from stable. At the same time, we affirmed our 'BBB/A-2' long- and short-term corporate credit ratings on both entities.

We also affirmed our 'BBB' issue ratings on the group's senior unsecured debt, our 'BB+' issue rating on its hybrid debt, and our 'A-2' rating on its commercial paper.

Rationale

The outlook revision is driven by our view that competitive conditions in Austria are showing some signs of stabilization and our expectation that this could lead to stronger and more predictable free cash flow generation at Telekom Austria.

Following some loss of market share to other mobile network operators and new mobile virtual network operators in 2015, Telekom Austria has defended its stable mobile subscriber market share of about 39.5% since the end of 2015. The company also achieved relatively stable mobile service revenues, excluding the negative impact of the new EU roaming rules, in recent quarters. We think that the more stable performance in Austria, together with continued cost saving efforts, cash interest savings from recent refinancing, and limited risk of spikes in capital expenditures, could support an increase of free operating cash flow (FOCF) to sustainably more than 10% of our adjusted debt. This FOCF improvement would balance our expectation that the company will continue to pursue merger and acquisition (M&A) opportunities and that potential transactions may weaken its credit metrics relative to our forecast, as it should enable the company to reduce debt and quickly restrengthen adjusted debt to EBITDA to below 3x and funds from operations (FFO) to debt to more than 30% in such cases.

A key factor in our assessment of Telekom Austria's business risk is the company's leading position in fixed and mobile telecom markets in Austria, which is supported by more than 90% coverage of the population with fourth-generation mobile networks, progress with upgrading to higher fixed broadband speeds, the presence of competing fixed broadband networks for less than 40% of Austrian households, and comfortable spectrum holdings.

In addition, Telekom Austria is a major player in six Central and Eastern European (CEE) mobile markets where it holds mostly No. 1 or No. 2 positions, and it has enhanced its ability to make fixed-mobile convergence offers with the acquisitions of additional fixed-line operations in Bulgaria, Slovenia, Belarus, and Croatia in the last two years. Nevertheless, competition in the domestic mobile market remains intense and is likely to constrain pricing and upselling opportunities in the near to medium term.

Moreover, competitively priced mobile broadband products such as mobile WiFi routers may also limit room for subscriber growth in fixed broadband, in our opinion. Equally, Telekom Austria's foreign mobile operations continue to face fierce competition in many markets, for example in Bulgaria, Slovenia, and Serbia, and its subsidiary in Belarus remains subject to high country and foreign exchange risks. We also note that Telekom Austria's domestic cost structure exhibits some rigidity with respect to certain items, such as staff costs, with 48% of domestic employees being civil servants at the end of 2016.

Telekom Austria's financial risk primarily reflects our view of meaningful M&A event risk and that FOCF is currently constrained by significant network investments and restructuring payments. In our view, Telekom Austria remains determined to pursue acquisitions to consolidate its operations within the current footprint and, prospectively, to expand opportunistically into new markets. Although the company's financial policy defines a 'BBB' rating target, it sets no quantitative caps on leverage. In our view, this implies a potential risk of incremental debt to fund M&A activity. As a result, we think the debt-to-EBITDA ratio could rise to or moderately exceed 3.0x in the event of large acquisitions. This is higher than the 2.3x–2.6x range we forecast over the next three years without such deals. We consider it increasingly likely, however, that the material headroom within Telekom Austria's current leverage and our expectation of improving FOCF generation could help Telekom Austria reduce its adjusted leverage to less than 3.0x sufficiently quickly after making a significant acquisition. We also note that the company's main shareholders supported a €1 billion capital increase in the past to strengthen the balance sheet and create leeway for investments and M&A. At the same time, we expect that FOCF will remain burdened by high cash outflows of €90 million-€110 million per year for restructuring and substantial capital expenditures (excluding spectrum) of 16%-18% of sales in the next two years.

We note that our debt to EBITDA and FFO to debt for 2016 and in our forecast are enhanced by about 0.1x and one percentage point, respectively, by our adjustments for captive finance operations (see "The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers," Dec. 14, 2015) that we apply to Telekom Austria's equipment installment plans.

The 'BBB' rating benefits from our view of Telekom Austria's strategic importance to América Móvil S.A.B. de C.V. (AMX), primarily because we believe Telekom Austria is unlikely to be sold over the medium term. We understand that AMX intends to use Telekom Austria as a vehicle for expansion in Europe, particularly in CEE. Therefore, we anticipate that Telekom Austria will be important to the group's long-term strategy and that AMX is likely to support it if it should fall into financial difficulty.

We continue to regard Telekom Austria as a government-related entity (GRE). Our 'BBB' rating on Telekom Austria, which includes group support, is not enhanced further for potential government support, however. This is because we see a low likelihood of timely and sufficient extraordinary support for Telekom Austria from its 28.4% shareholder, the Republic of Austria (AA+/Stable/A-1+), in the event of financial distress.

In our base case, we assume:

- Organic revenue growth of 0%-1% in 2017 and 0.5%-1.5% in 2018, supported by improving service revenue trends in Austria and increased fixed-mobile cross- and upselling in some other markets.
- Approximately stable EBITDA margins, as adjusted by S&P Global Ratings, of 30.5%–32.0% in 2017 and 2018, after about 31% in 2016, as cost savings in Austria and some M&A synergies in other markets offset the impact of the new EU roaming rules in 2017 and higher commercial costs in some CEE markets.
- Cash outflows for restructuring of €90 million-€110 million in 2017-2018.
- Capital expenditures, excluding spectrum, of €700 million-€750 million in 2017 and 2018, driven by fixed broadband investments in Austria and fourth-generation mobile rollout in CEE, plus moderate spectrum costs.
- Dividend and hybrid coupon payments of €133 million and €34 million in 2017, respectively, and an increase in dividends of up to 50% in 2018.
- Acquisition spending of up to €300 million in 2017 and 2018 combined, plus significant cash outflows in 2017 in connection with the put option held by minority shareholders in Telekom Austria's Macedonian mobile subsidiary.

Based on these assumptions, we arrive at the following credit measures:

- Debt to EBITDA, as adjusted by S&P Global Ratings, of 2.4x–2.6x in 2017, decreasing to 2.3x–2.5x in 2018 as a result of EBITDA growth and improved free cash flows, after 2.5x in 2016.
- Adjusted FFO to debt of 33%-35% in 2017 and 35%-37% in 2018, further supported by declining interest expenses, compared with about 34% in 2016.
- Adjusted FOCF to debt of 9%-11% in 2017 and 10%-13% in 2018, after about 7% in 2016.

Liquidity

We assess Telekom Austria's liquidity as strong, based on our expectation that the ratio of liquidity sources to uses will be approximately 1.5x in the 12 months started March 31, 2017. In addition, we assess Telekom Austria's financial risk management as prudent, and we think that the company has well-established, solid relationships with its banks.

As of March 31, 2017, we estimate that the principal liquidity sources over the ensuing 12 months include:

- Cash and liquid investments of about €61 million.
- Availability of a €1 billion committed revolving credit facility due 2019.
- Sizable FFO of €1.2 billion–€1.3 billion.

For the same time period, we estimate that principal liquidity uses include:

- Short-term debt and commercial paper maturities of about €165 million.
- Restructuring-related cash outflows and modest other working capital needs totaling €110 million to €125 million.
- Capital expenditures (including spectrum payments) of €750 million-€830 million.
- Dividends of €133 million and €34 million in coupon payments on hybrid debt.
- Significant payments to acquire the remaining 45% minority stake in ONE Macedonia.

Outlook

The positive outlook reflects our expectation that service revenue trends in Telekom Austria's domestic and other international markets, excluding the impact of regulation, will stabilize further, and that successful cost management in Austria will continue to cushion the adverse EBITDA impact from the phase-out of retail roaming fees in the EU in 2017 and increases in certain cost items. We think this will enable the company to report organic revenue growth of 0%-1.5% in the next two years and stable adjusted EBITDA margins of 30%-32%, which may help strengthen adjusted FOCF to debt to more than 10% and could support an upgrade with the next 12–18 months. In addition, we expect that Telekom Austria will maintain adjusted debt to EBITDA of below 3x and FFO to debt of at least 30% on a sustainable basis.

Upside scenario

We could raise the rating if we see further stabilization of operating trends in Austria and across Telekom Austria's foreign subsidiaries, along with stable or increasing adjusted EBITDA margins, supporting FOCF to debt comfortably between 10%-15%, in addition to maintaining debt to EBITDA of below 3x and FFO to debt of at least 30%.

We could also raise the rating on Telekom Austria if we viewed its strategic importance to its majority shareholder, AMX, as strengthening. This could happen if we were to witness more implicit support from AMX, for example, if AMX were to guarantee Telekom Austria's debt or AMX were to refinance Telekom Austria's debt at the parent level.

Downside scenario

We could revise the outlook to stable if continued fierce competition in Austria and other markets, paired with higher-than-expected capital expenditures or spectrum spending, prevented FOCF from increasing to sustainably more than 10% of adjusted debt in the next two years, or if debt to EBITDA weakened to more than 3x or FFO to debt weakened to less than 30% for more than a temporary period.

Although we do not expect it at this stage, we could consider a downgrade if we were to observe a combination of large debt-funded acquisitions and revenues and EBITDA underperforming our projections materially, for example due to worsening competitive conditions in Telekom Austria's domestic or international operations, causing leverage to rise to more than 3.25x and FFO to debt to fall to less than 25% on a prolonged basis.

We could also revise the outlook to stable if we downgraded AMX to 'BBB+', which we do not currently expect given our stable outlook on AMX. The ratings on Telekom Austria could come under pressure if we assessed that its strategic importance to AMX had weakened, for example, if Telekom Austria appeared likely to be sold over the near term, a scenario which we currently consider unlikely.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Positive/A-2

Business risk: Satisfactory
- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Negative (-1 notch)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

- Group credit profile: a-
- Entity status within group: Moderately strategic (+1 notch from SACP)
- Sovereign rating: AA+
- Likelihood of government support: Low (no impact)

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Telekom Austria AG		
Corporate Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
Junior Subordinated	BB+	BB+
Telekom Finanzmanagement GmbH		
Corporate Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
Senior Unsecured	BBB	BBB
Commercial Paper	A-2	A-2

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com