

Research Update:

Telekom Austria Upgraded To 'BBB+' On Solid Performance And Expectation Of Deleveraging; Outlook Stable

August 12, 2019

Rating Action Overview

- Telekom Austria has posted a sound operating track record over the past two years, both in Austria and increasingly also in many of its Central and Eastern European (CEE) markets.
- We believe that the company's increasingly robust free operating cash flows (FOCF) and financial policy track record will translate into steady organic deleveraging in the next two years.
- We consider that the risk of material debt-funded acquisitions has decreased, and that management is prioritizing strengthening its balance sheet.
- We are therefore raising our long-term issuer credit rating on Telekom Austria to 'BBB+' from 'BBB' and affirming our 'A-2' short-term rating.
- The stable outlook reflects our view that the company's S&P Global Ratings-adjusted ratio of debt to EBITDA will fall comfortably below 2.5x by 2021, while funds from operations (FFO) to debt and FOCF (excluding spectrum investments) to debt will strengthen to 35%-40% and toward 15%, respectively.

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Rating Action Rationale

The upgrade reflects the company's solid operational and deleveraging track record through the second quarter of this year, as well as our view of diminishing financial policy event risk related to sizeable acquisitions compared with our previous forecasts. We therefore anticipate that Telekom Austria's financial risk profile will strengthen further in the next two years, with pre International Financial Reporting Standard (IFRS) 16 reported leverage of close to 1.5x down from 2.0x currently, and our IFRS16-based S&P Global Ratings-adjusted debt to EBITDA at comfortably to less than 2.5x down from about 2.7x pro forma for IFRS16 in 2018. At the same time, we think the predictability of the company's FOCF has increased, and we foresee our adjusted FOCF to debt ratio (excluding spectrum investments) gradually improving toward 15% from 10%-12% currently.

Telekom Austria has effectively defended its domestic position in the high-value mobile segment and in fixed retail broadband in recent years, with a limited decline in its subscriber market shares since the end of 2015, which remained at about 37% in mobile and about 55% in fixed broadband (company data as of second-quarter 2019). The company has also consistently achieved positive service revenues for a number of quarters, including positive mobile service revenue growth. This has been supported by good traction from mobile Wi-Fi routers as well as an improving customer mix on the fixed side--driven by TV and fiber upselling success and by the enterprise segment--mitigating the negative trend in retail fixed voice and some modest pressure on the fixed broadband subscriber base.

We think that the good performance in Austria is likely to be sustained, as higher-value products are supported by increasing data traffic and demand for high-speed fixed and mobile connectivity, as well Telekom Austria's positioning as a quality player. We also think that the company's operating trends in some of its CEE operations have steadily improved, partly aided by earlier bolt-on acquisitions in fixed broadband and TV, or business-to-business services. In the first half of 2019, mobile and fixed service revenues increased by more than 2% in five out of the company's six CEE markets, with solid performance in key countries like Bulgaria, Croatia, and Belarus.

These developments, together with continued cost-saving efforts and limited risk of spikes in capital expenditures (capex), will likely contribute to reducing adjusted leverage through steadily increasing EBITDA. Furthermore, from 2021, we expect to see net debt decline on account of annual reported FOCF of €400 million-€500 million (before spectrum costs).

We acknowledge that competition in Austria remains intense. The recent merger between T-Mobile with cable company UPC will likely intensify competition in the high-price converged segment, and may enable T-Mobile to make modest gains in its mobile subscriber market share from upselling into the UPC customer base. However, we anticipate T-Mobile will behave rationally with respect to pricing. Moreover, without the merger with T-Mobile, UPC would have continued to operate as a mobile virtual network operator, with potentially stronger incentives to be aggressive on price.

We think Telekom Austria may face some pressure to scale up its fixed network investments in Austria, given that fixed broadband coverage with speeds of at least 50 megabytes per second is limited to 40% today. That said, we believe investments will be incremental and take place over an extended period. Moreover, we don't see a big risk of materially higher mobile capex, since 5G investments will be staggered over time and offset by declining spending on 3G and 4G networks.

We rate Telekom Austria at the same level as peers like Telia and Elisa. Although it is larger and more diversified than Elisa, Elisa has significantly lower leverage. Conversely, Telekom Austria has a smaller scale than Telia and its geographic portfolio is exposed to higher volatility risks, but we foresee Telekom Austria having lower leverage. We think Telekom Austria's business risk is similar to that of Proximus, with some more geographic diversity mitigated by related country risks. Our rating on Proximus is higher, however, due to very low leverage and a one-notch uplift stemming from potential government support.

We continue to regard Telekom Austria as a moderately strategic subsidiary for its 51% shareholder, America Movil S.A.B. de C.V. (AMX; A-/Negative/--), and as a government-related entity (GRE). That said, our 'BBB+' rating on Telekom Austria is based on our stand-alone view of Telekom Austria's credit quality, and does not include any uplift from potential extraordinary group or government support. Any uplift for potential group support is capped at one notch below the parent rating, which is 'A-', whereas our view of Telekom Austria's stand-alone credit quality is 'bbb+'. Still, we understand that AMX is regularly involved in the company's strategic decisions and day-to-day management, and also supportive of Telekom Austria's financial policy, which is a positive factor captured in our stand-alone assessment of the company. As for the 28.4% stake

held by Austria (AA+/Stable/A-1+), we see a low likelihood of timely and sufficient extraordinary support for Telekom Austria in the event of financial distress.

Outlook

The stable outlook reflects our expectation that Telekom Austria will continue to increase its service revenues in Austria and CEE markets and successfully manage its cost base. We expect that management will remain focused on further improving credit metrics.

We therefore foresee credit metrics steadily and sustainably strengthening to levels commensurate with the rating in 2020-2021, namely adjusted debt to EBITDA of below 2.5x, FFO to debt of 35%-40%, and FOCF (before spectrum outlays) to debt increasing toward 15%.

Downside scenario

Rating downside could occur if the company's operating performance or deleveraging path failed to live up to our forecasts, preventing adjusted debt to EBITDA from strengthening sustainably below 2.5x and FOCF to debt toward 15%. This could result from its financial policy becoming less conservative than we anticipate, and or from fiercer competition and lower prices than expected, or higher-than-expected capex. In addition, if we lower our rating on the majority shareholder AMX to 'BBB' or below, this could prompt a downgrade.

Upside scenario

Rating upside is unlikely, since this would require a financial policy geared toward materially lower leverage than we currently foresee.

Company Description

Headquartered in Vienna, Telekom Austria is the leading telecommunications operator in Austria and a mobile operator in Bulgaria, Croatia, Belarus, Slovenia, Serbia, and Macedonia. It also provides fixed-line broadband, telephony, and TV services in all the abovementioned countries except Serbia. In 2018, the domestic market contributed about 60% of the group's €4.4 billion in revenue and of its €1.5 billion EBITDA.

Our Base-Case Scenario

- Organic annual revenue growth of 1%-2% in 2019-2021, compared with 1.8% in 2018, supported by positive service revenue trends in Austria and growth in mobile, fixed broadband, and TV in other markets.
- Approximately stable or very slightly progressing S&P Global Ratings-adjusted EBITDA margins, at about 33% in 2019-2021, based on IFRS16 accounting.
- Cash outflows for restructuring of €100 million annually.
- Capex, excluding spectrum costs, of around €800 million, due to fixed broadband investments in Austria and mobile network upgrades in all markets, plus moderate spectrum costs.
- Annual dividends of around €140 million.

- Small bolt-on acquisition spending of €20 million annually.
- Our assumption of around €400 million spectrum total cash outs in 2019-2021.

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

- Debt to EBITDA, as adjusted by S&P Global Ratings and based on reported IFRS16 figures, of 2.6x in 2019, decreasing to 2.5x in 2020 and 2.3x in 2021, compared with 2.4x in 2018 (excluding IFRS16, and 2.7x pro forma IFRS16 as by our estimate).
- Adjusted FFO to debt increasing toward 37%-39% by 2021.
- Adjusted FOCF (excluding spectrum outlays) to debt of 11%-12% in 2019, progressing toward 13%-15% thereafter.

Liquidity

We assess Telekom Austria's liquidity as strong, based on our expectation that the ratio of liquidity sources to uses will be higher than 1.5x in the 12 months started July 1, 2019. 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, underpinned by repeated issuance of bank facilities at highly favorable terms and with a variety of lenders

As of July 1, 2019, we estimate that the principal liquidity sources over the ensuing 12 months include:

- Cash and liquid investments of about €44 million.
- Availability of a €1 billion committed revolving credit facility (RCF) due 2024.
- Sizable FFO of €1.2 billion.

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

- Short-term debt and commercial paper maturities of about €0.3 billion including licences.
- Capex (including spectrum payments) of €0.8 billion.
- Dividends of €0.1 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

The vast majority of debt is senior unsecured debt located at the group's financing entity, Telekom Finanzmanagement GmbH.

Analytical conclusions

The long-term issue rating on the company's senior unsecured debt is 'BBB+', in line with the issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/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: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

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

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded

	To	From
Telekom Austria AG		
Telekom Finanzmanagement GmbH		
Issuer Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2
Senior Unsecured	BBB+	BBB

Ratings Affirmed

Telekom Finanzmanagement GmbH		
Commercial Paper	A-2	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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