

Research Update:

Telekom Austria AG Downgraded To 'BBB' On Likely Weaker Credit Measures; 'A-2' Rating Affirmed; Outlook Stable

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Overview

- We expect Telekom Austria to face strong operating pressures over the next two years.
- In our view, this is likely to result in a marked deterioration of the company's credit measures.
- We are lowering our long-term credit rating on the group to 'BBB' and affirming the 'A-2' short-term credit rating. We are removing the ratings from CreditWatch where they were placed with negative implications on Dec. 11, 2009.
- The stable outlook reflects our expectation that the group will continue to generate positive free cash flow and maintain a ratio of adjusted net debt to EBITDA of less than 3x.

Rating Action

On March 30, 2010, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on Austrian telecommunications operator Telekom Austria AG to 'BBB' from 'BBB+'. The 'A-2' short-term corporate credit rating was affirmed. At the same time, the ratings were removed from CreditWatch where they were placed with negative implications on Dec. 11, 2009. The outlook is stable.

Rationale

The downgrade reflects our view that Telekom Austria would be unlikely to stabilize its operational performance by 2011, particularly at its domestic fixed-line business. This we believe could weaken the group's credit ratios over the next two years to levels that we consider inconsistent with a 'BBB+' rating. We expect the ratio of adjusted net debt to EBITDA to deteriorate to about 2.6x and funds from operations to adjusted net debt to fall to about 33% by year-end 2010 from 2.3x and 39% at year-end 2009, respectively. We don't expect these credit measures to improve in 2011.

Our EBITDA forecast (excluding expenses from the announced merger of Telekom Austria's domestic fixed-line and mobile operations) is about in line with Telekom Austria's financial guidance for 2010 and assumes a further modest EBITDA decline in 2011. In our opinion, the difficult business environment in Austria and for the group's international mobile operations in 2009 is likely to prevail over the next few years. Moreover, we expect the group's

cost-cutting measures to be insufficient to offset fierce price pressure, continued fixed-to-mobile substitution, and lower mobile termination and roaming tariffs.

Telekom Austria's operating flexibility is hampered by a fairly rigid cost structure, primarily at its fixed-line division. This, in our view, poses considerable challenges for the group to sustain its domestic EBITDA generation in light of continued revenue and margin erosion. In addition, we don't expect Telekom Austria's free cash flow generations to be meaningfully supported by the planned merger of its domestic operations before 2013. We also assume that Telekom Austria will not alter its financial policy of paying at least stable dividends in the medium term, which we believe would limit the group's flexibility to reduce debt.

Compared with fiscal year ended Dec. 31, 2009, and on a constant currency basis, Telekom Austria has forecast a year-on-year revenue decline of about 2% to €4.7 billion and an EBITDA decline of about 11% to €1.6 billion in 2010. As a result, its EBITDA margin is likely to drop to about 34% in 2010 from 37.4% in 2009, which we see as somewhat weak compared with its peer companies. Furthermore, Telekom Austria expects cash flow to decrease by about €80 million owing to the merger of its domestic operations in 2010, which is not reflected in its EBITDA guidance.

The ratings on Telekom Austria, however, are supported by the group's sustainable leading market position in all main segments of the Austrian telecoms market. Despite the near-term economic challenges, Telekom Austria's profitable international mobile operations help diversify its revenue base and partly mitigate domestic pressure. We expect the mobile operations to keep generating meaningful, albeit somewhat lower, free cash flow, which is likely to support the group's so far solid free operating cash flow (FOCF) generation: €674 million in 2009 and €756 million in 2008. In addition, the group's adjusted net-debt-to EBITDA ratio is likely to remain at less than 3x in the medium term, in our opinion, providing adequate headroom for any operating underperformance or currency fluctuations.

Short-term credit factors

The 'A-2' short-term rating reflects that Telekom Austria had adequate liquidity on Dec. 31, 2009. Our assessment is based on:

- €946 million in reported consolidated cash and short-term investments;
- Access to €1.1 billion in undrawn committed credit lines, of which €1.0 billion (undrawn) mature beyond 2010; and
- Our expectation of continued positive, albeit declining, discretionary cash flow (defined as FOCF after dividends), which amounted to €342 million in 2009.

Telekom Austria has sizable short-term debt of €1.5 billion (including the amount required to purchase the remaining 30% stake in its Belarussian mobile subsidiary Velcom in the fourth quarter of 2010) and €215 million of debt

maturities in 2011. In our view, these short-term obligations should broadly be covered by Telekom Austria's existing liquidity sources and expected discretionary cash flow generation.

We believe that Telekom Austria will continue to manage its debt and its liquidity profile proactively by refinancing upcoming debt maturities and extending maturing committed credit lines.

Outlook

The stable outlook reflects our expectation that, despite the likely continuation of strong competitive and regulatory pressures in its main markets, Telekom Austria should be able to generate moderately positive discretionary free cash flow and maintain a ratio of adjusted net debt to EBITDA of less than 3x. This, in turn, should provide adequate rating headroom for the group over the next two years. In addition, despite the operating pressures, we expect the group to defend its solid domestic market positions and those of its international mobile operations.

We would consider an upgrade or a revision of the outlook to positive if we see signs that the group is able to stabilize or improve its revenue and EBITDA trends (including amortization of restructuring provisions) at its fixed-line division and at its international mobile operations. Furthermore, we would need to see solid positive discretionary cash flow generation and an adjusted net debt-to-EBITDA ratio consistently lower than 2.5x.

A downgrade would be possible if the group's operating performance were to deteriorate beyond our expectations. This would be the case if Telekom Austria's EBITDA were to decline by more than 25% over the next two years or if discretionary cash flow were to turn negative for several years. Financial policy initiatives could also trigger a negative rating action. However, we view this as unlikely in the near term, given that Telekom Austria has meaningful headroom at the new rating level.

Related Criteria And Research

- Principles Of Corporate And Government Ratings, June 26, 2007
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Key Credit Factors: Business And Financial Risks In The Global Telecommunication, Cable, And Satellite Broadcast Industry, Jan. 27, 2009

Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Telekom Austria AG Corporate Credit Rating	BBB/Stable/A-2	BBB+/Watch Neg/A-2

Ratings Affirmed

Telekom Finanzmanagement GmbH Commercial Paper	A-2
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NB: This list does not include all the ratings affected.

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