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Fitch Affirms Telefonica Deutschland at 'BBB'; Outlook Stable

Fitch Ratings - Frankfurt am Main - 25 Oct 2022: 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 German mobile telecommunications market and scaled operations that drive strong pre-dividend free cash flow (FCF) generation. The company's low leverage and sizeable leverage headroom for the rating provide financial flexibility and position the rating strongly at the 'BBB' level. This is balanced by the gradual deployment of 1&1's own mobile network, which could lead to increasing competition and a potential loss of wholesale revenues. This creates uncertainties about medium-term free cash-flow generation and leads us to take a more cautious stance on the rating's progression.

Key Rating Drivers

Rational German Market: TEF DE has about 33% mobile network service revenue market share in Germany and is one of three main mobile network operators in the country. The company's partnership approach with mobile virtual network operator (MVNO) wholesale customers enables TEF DE to effectively reach complementary market segments. While the MVNO strategy carries some risk with some wholesale customers, when managed effectively it helps improve network utilisation and scale economics. The company's network sharing approach in rural and low-dense urban areas with competitors Vodafone and T-Mobile will support capex reduction while improving coverage.

Strong Execution Driving Growth: At 1H22, TEF DE had grown revenues by 5.5% and EBITDA by 5.0% yoy. Growth was driven by improving average revenue per user due to data monetisation and more-for-more offers, increasing second SIM card penetration and increasing market share in B2B and rural areas supported by continued network infrastructure roll-out and upgrades. We expect these growth drivers will remain supportive for the company over the next two to three years, given the current market structure and business mix.

1&1 Network Build Risks: 1&1 is an MVNO in the German telecoms market with 11.4 million mobile subscribers. The company is both a competitor and a wholesale customer of TEF DE. 1&1 is gradually building its own mobile network, which over time will see the company port customers to its own mobile network. This will have an impact on TEF DE's wholesale revenues and potentially raise competitive intensity as 1&1 strives to improve its own network utilisation and scale economics. A significant loss of wholesale revenues would be a downside to our current base case forecasts.

Wholesale revenues typically carry strong EBITDA margins and the loss of these revenues can have pronounced, disproportionate effect on FCF. As a result, more visibility of TEF DE's competitive position in the long term and of the performance of its own brands in light of 1&1 Drillisch's network roll-out would be a prerequisite for positive rating action.

Supportive Fixed-line Strategy: TEF DE's fixed line strategy is geared to support the company's 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 Vodafone's fixed-line networks and a growing number of alternative fixed-line providers. This provides TEF DE with the scope to provide customers with technology agnostic broadband proposition and purchasing power in wholesale contract negotiations.

Low Leverage, Financial Flexibility: Fitch's base case forecasts project that TEF DE will have funds from operations net leverage of 0.3x by end-2022, gradually increasing to about 0.6x-0.8x by 2025 as a result of increasing dividends, cash taxes and continued capex investments. This gives the company 1 to 2 turns of leverage headroom and provides sizeable financial flexibility. The company's financial policy is to target leverage at or below 2.5x net debt to EBITDA (company definition) in the medium term. Leverage sustained at the upper end of this target would benchmark comfortably at the current 'BBB' rating level.

No Rating Impact from Parent: Telefonica S.A. and TEF DE are both rated 'BBB' 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. Based on Fitch's Parent Subsidiary Linkage Criteria, the ratings could be linked if the ratings of either TEF DE or Telefonica S.A. differ from each other.

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 in the long term, as its main wholesale partner 1&1 rolls out its own network.

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/Stable), 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 strong domestic positions in both mobile and fixed line and the ownership of substantial fixed-line infrastructure.

Key Assumptions

Fitch's Key Assumptions Within its Rating Case for the Issuer

- Revenue growth of around 4% in 2022 and low single-digit between 2023-2025;

- Fitch-defined EBITDA margin of 22.6% in 2022 remaining broadly stable between 2023-2025;

- Capex-to-sales of around 16% in 2022 declining gradually to 15% by 2025;

- Cash dividends of EUR0.18 per share in 2022 and 2023 and gradually increasing thereafter.

RATING SENSITIVITIES

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

- FFO net leverage sustained below 1.5x (about 1.2x Fitch defined net debt to EBITDA) and accompanied by greater visibility of the company's long-term competitive position and wholesale revenues;

- Cash from operations-capex/total debt sustained at or above 12%.

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

- FFO net leverage consistently expected to exceed 2.3x (about 2.0x Fitch defined net debt to EBITDA);

- Higher-than-expected competitive pressure, in particular, from 1&1 impacting TEF DE's market share and wholesale revenue.

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Comfortable Liquidity: TEF DE had just over EUR427 million of cash and equivalents on its balance sheet and access to EUR1.4 billion of undrawn facilities as of 2Q22. These are sufficient to fund debt maturities and projected negative post-dividend FCF over the next three to four 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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
O2 Telefonica Deutschland Finanzierungs GmbH					
• senior	LT	BBB	Affirmed		BBB

ENTITY/DEBT	RATING			RECOVERY	PRIOR
unsecured					
Telefonica Germany GmbH & Co. OHG					
• senior unsecured	LT	BBB	Affirmed		BBB
Telefonica Deutschland Holding AG	LT IDR	BBB	Affirmed		BBB

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Rating Criteria (pub.15 Oct 2021) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub.09 Apr 2021) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub.01 Dec 2021)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.3 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

O2 Telefonica Deutschland Finanzierungs GmbH	EU Issued, UK Endorsed
Telefonica Deutschland Holding AG	EU Issued, UK Endorsed
Telefonica Germany GmbH & Co. OHG	EU Issued, UK Endorsed

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