FITCH AFFIRMS TELEFONICA DEUTSCHLAND AT 'BBB'; OUTLOOK STABLE

Fitch Ratings-London-21 December 2015: Fitch Ratings has affirmed Telefonica Deutschland Holdings AG's (TEF DE) Long-term Issuer Default Rating (IDR) at 'BBB'. The Outlook on the IDR is Stable. A full list of rating actions is available at the end of this commentary.

The ratings reflect TEF DE's solid position in the German telecoms market (Fitch estimate: 30% of mobile service revenue), good integration progress since the acquisition of E-Plus, a competitive but rational market environment and a disciplined financial policy. So far its year- one integration is ahead of plan, allowing management to upgrade its public guidance for EBITDA and reduce capex for 2015.

Guidance for a flat dividend in 2015 suggests management remains committed to progressive distributions over time but also to its financial leverage target of reported net debt-to-EBITDA of up to 1.0x (0.9x at 9M15). This target currently corresponds to funds from operations (FFO) adjusted net leverage of 2.9x-3.0x; with 3.0x being our rating case estimate for end-2015.

KEY RATING DRIVERS

Integration Progressed, 2015 Guidance Upgraded

Despite the challenge of integrating two divergent brands, as well as amalgamating and rationalising two national infrastructures and retail channels, TEF DE has so far managed the process well. It has managed cost rationalisation cohesively while at the same time ensuring that customer experience has not been undermined. Operational trends, measured by customer base and market share stability, LTE penetration, data usage and average revenue per user (ARPU), indicate that consumer experience is being managed effectively.

Financial synergies are ahead of plan with the company achieving in year one 35% of the planned EUR800m synergies (over five years), versus an original target of 30%. EBITDA and capex guidance for 2015 were both upgraded at the 9M15 results announcement, with EBITDA growth revised from above 10% to 15% to 20%. Fitch expects the upgrade to lead to stronger near-term free cash flow (FCF) generation, although management has not revised its medium term expectations.

Stabilising and Rational Market

While it is too early to say how TEF DE's capacity off-take agreement with virtual mobile network operator (MVNO) partner, Drillisch, will affect market pricing over the medium term, Fitch considers the market environment as stable. We estimate total market revenues (excluding MVNO retail revenues) continue to decline at low single-digit rates, but that the pace of decline is slowing.

Market stabilisation is in Fitch's view likely to develop given the improving trends and the developments seen in other markets. In mobile, margin expansion across the market is reflecting a more rational approach to reduced handset subsidy, while smartphone and LTE penetration are driving data usage, which we expect to lead to mobile service revenue growth over time. Despite the challenges of the integration the enlarged TEF DE has maintained and moderately improved its market position at a time when the competition will have sought to take advantage of the disruption caused by the merger.

Financial Policy, Dividends & Operating Leases

Fitch views TEF DE's operating environment as competitive but rational and that following the merger and given the integration progress so far, its ratings are less constrained than in the past. Its ratings are also driven by financial policy and a high level of operating leases. Fitch views management as disciplined and consistent in its financial policies, with a stated leverage (reported net debt/EBITDA) target of below 1.0x (9M15: 0.9x).

Statements around dividend policy are clear with management committed to a progressive pay-out but which takes into account ongoing investment needs, including the likelihood of capex remaining high for the next two years. Fitch does though expect dividends to increase over the medium term, reflecting the growth of FCF.

Operating lease and handset receivable adjustments currently add an estimated 1.9x to 2.0x to the unadjusted (net debt / EBITDA) measure of leverage - our base case envisages FFO adjusted net leverage peaking at 3.0x in 2015 and that the metric will trend down as FCF expands and leases reduce given the benefit of network rationalisation. An evolving dividend policy will be a key determinant of FCF expansion and whether the company is likely to meet one of its key upgrade metrics of FFO net leverage of around 2.5x. Our rating case does not envisage this metric being met over the next two years.

Use of Factoring
As seen to varying degrees across the peer group TEF DE also makes use of factoring - to help manage working capital and as a source of liquidity in relation to handset receivables. Adjustments for factoring would add a further 0.2x to the forecast 3.0x FFO adjusted net leverage for 2015. The degree to which factoring becomes a core part of a company's liquidity is important given that in the absence of factoring these amounts would need to be financed by more traditional on-balance sheet means.

Spectrum Auctions Complete, License Visibility
Spectrum auctions that took place in 1H15 saw TEF DE secure a significant share of the spectrum on offer, including sizeable blocks of newly available frequencies and the renewal of its existing GSM license. Licenses are therefore largely secured for the next 17 years and close to EUR1bn of the EUR1.2bn spectrum payment already paid. The outcome of the auction was broadly within Fitch's working assumption in terms of cost - while the remaining instalments of EUR111m in 2016 and 2017 will not unduly pressure cash flow over the next two years. Fitch views clarity with respect to spectrum and license renewal as a positive factor.

Fixed Line & Content Strategy
With wholesale access to Deutsche Telekom's fibre network, TEF DE has convergent capabilities and approximately 2.1 million fixed broadband customers. While fixed line revenues are likely to remain a modest part of the revenue mix, fixed access trends are showing improvement and Fitch views the ability to offer convergent services as an important, if less critical, part of the overall consumer offer.

While there is a market for quad-play in Germany - Deutsche Telekom for instance, has 2.6m IPTV/satellite subscribers - Fitch does not view the German market like the UK where pay TV has become a compelling part of the telecoms offer. Data usage on mobile is being driven by content - music, social media and video. Fitch understands revenue share agreements with content providers are profitable, but takes the view these services are as important in terms of driving data usage and ultimately improving ARPU through upgrades to higher usage tariffs or usage fees outside agreed service tiers.

Parent Subsidiary Linkage
TEF DE's ratings are assigned broadly on a standalone basis, but with some ultimate linkage to its parent, Telefonica SA (BBB+/Stable). The company is established as a standalone entity, with

separate management, independent governance and its own financial policy. Given its scale and maturity, Fitch regards TEF DE as a sustainable independent business with a proven ability to finance itself.

KEY ASSUMPTIONS

Fitch's key assumptions within the rating case for TEF DE include:-
- EBITDA before restructuring around EUR1.7bn in 2015 (22.3% margin), exceeding EUR2bn in 2018
- Annual rent expense falling from EUR600m in 2015 to below EUR540m from 2018 as the network is integrated and rationalised
- No significant cash tax before 2020
- Neutral working capital in 2015, aggregate negative working capital flows of EUR400m 2016-2018, largely reflecting integration and restructuring effects
- Non-recurring cash integration costs of EUR577m incurred during 2015 to 2018
- Capex (excluding spectrum) above EUR1bn per year through to 2018
- Cash dividends slightly progressing from EUR714m in 2015, flat in cash terms in 2016; growth thereafter as FCF expands

RATING SENSITIVITIES

Future developments that may, individually or collectively, lead to positive rating action include:
- Continued evidence that the integration of E-Plus and network rationalisation is progressing; leading to sustainable improvements in the margin and cash flow profile,
- FFO adjusted net leverage trending consistently around 2.5x or below; with forecast expectations subject to visibility on capital allocation and shareholder remuneration as the integration progresses

Future developments that may, individually or collectively, lead to negative rating action include:
- A material weakening in the company's current financial profile, including FFO adjusted net leverage consistently expected to exceed 3.25x
- FFO fixed charge cover consistently below 4.0x

LIQUIDITY

TEF DE currently maintains cash and cash equivalents of EUR200m and benefits from an undrawn revolving credit facility of EUR710m with a maturity beyond 12 months. Pre-dividend FCF excluding spectrum for 9M15 was EUR292m (2015 cash dividends EUR714m, spectrum payment EUR977m). Debt maturities are well spread with EUR600m and EUR 500m bonds maturing in 2018 and 2021, respectively and inter-company loans from Telefonica S.A. totalling EUR500m maturing within two years, which are likely to be refinanced in 2016.

FULL LIST OF RATING ACTIONS

Telefonica Deutschland Holdings AG
--Issuer Default Rating: affirmed at 'BBB'; Outlook Stable

O2 Telefonica Deutschland Finanzierungs GmbH
--Senior unsecured rating: affirmed at 'BBB'

Telefonica Germany GmbH & Co OHG
--Senior unsecured rating: affirmed at 'BBB'

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362