STANDARD & POOR'S

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Telekom Austria AG

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Table Of Contents

Telekom Austria AG

Major Rating Factors

Corporate Credit Rating
BBB/Stable/A-2

Strengths:

- Leading telecommunications operator in Austria.
- Profitable and cash-generative international mobile operations.
- Solid free operating cash flow generation.
- Moderately conservative and transparent financial policy.

Weaknesses:

- Very competitive, mature, and regulated domestic marketplace.
- Limited flexibility to cut costs quickly because the majority of Austrian employees are civil servants.
- High exposure to country risk, notably in Belarus.
- Meaningful competitive and regulatory pressure on international mobile operations.

Rationale

The ratings on Telekom Austria AG reflect Standard & Poor's Ratings Services' view of the group's sustainable, leading market positions in Austria. Telekom Austria's international mobile operations help diversify its revenue base and generate meaningful profit margins, which we consider likely to support the group's so far solid consolidated free operating cash flow (FOCF) generation. In addition, in our opinion, the group follows a transparent and moderately conservative financial policy.

These factors are tempered by the saturation of, and fierce competition in, Austria's declining fixed-line and mobile telecommunications services market, in our opinion. The group has a rigid cost structure because of the high number of civil servants working at its domestic fixed-line business. Furthermore, we consider that its international mobile operations continue to face meaningful competitive and regulatory pressure and pose significant country risks, notably in Belarus.

Key business and profitability developments

In 2010, Telekom Austria's operating results were not as weak as we had expected. This was primarily due to lower integration costs from the merger of the group's domestic operations and better-than-expected operating results at the group's mobile operations in Belarus and Serbia. Nevertheless, the group's revenues decreased by 3.1% and comparable EBITDA (defined as EBITDA before restructuring costs and impairments) fell by 9.1%, year on year. Consequently, the group's EBITDA margin declined to 35.4% from 37.7% a year earlier. This performance was primarily the result of continued fixed-to-mobile substitution, fierce competitive price pressure, a challenging economic environment, declining mobile termination and roaming tariffs, and the fairly inflexible cost structure of the group's domestic fixed-line operations. In our view, the group could find it difficult to sustain its domestic EBITDA generation in the face of continued revenue erosion.

In our base-case assessment, we expect group revenues to decline slightly compared with 2010 and comparable EBITDA to decrease by about 4%, before revenues and comparable EBITDA stabilize in 2012. Although we expect the economic environment in the company's service areas to improve, we forecast that the negative factors that impeded the company's revenues and margins in 2010, such as declining mobile termination and roaming tariffs and fierce competition, will persist in 2011. In addition, revenues at the group's Belarusian mobile operations could decline significantly in euro terms if the steep devaluation of the Belarusian ruble against the euro continues. The official exchange rate weakened considerably in May 2011 to more than Belarusian ruble (BYR) 7,000 for one euro, from about BYR4,000 at year-end 2010. Furthermore, Belarus-based companies are currently unable to exchange Belarusian rubles into euros. In our view, these pressures on Telekom Austria's revenues will be only partly offset by the first-time consolidation of two Bulgarian fixed-line operators in the first quarter of 2011 and the recently announced acquisition of B.net, the largest cable operator in Croatia. The acquisition of B.net is expected to close in the second half of 2011.

Key cash flow and capital-structure developments

In 2010, Telekom Austria's FOCF of €634 million was better than we expected and only slightly down from €674 million in 2009. This was primarily because lower working capital requirements partly compensated for the decline in EBITDA and higher capital expenditures. In our base-case assessment for 2011, we expect FOCF to decline to about €400 million-€450 million, mainly due to lower EBITDA generation, meaningful restructuring cash outflows, and modestly higher capital expenditures.

Telekom Austria's financial policy targets a net debt-to-comparable-EBITDA ratio of 2.0x-2.5x, but also at least stable dividend distributions. As a result, we expect discretionary cash flow to decline to about €0.1 billion in 2011 and, together with Telekom Austria's recent acquisitions in Bulgaria and Croatia, discretionary cash flow after acquisitions could be negative. Consequently, due to our forecast of lower EBITDA generation, we expect the group's net debt-to-EBITDA ratio, as adjusted by Standard & Poor's, to deteriorate to about 2.5x-2.6x by year-end 2011, from 2.4x as of March 31, 2011.

Liquidity

Our short-term rating on Telekom Austria is 'A-2'. In our opinion, the company has an adequate liquidity profile that can more than cover its needs over the next 12 months, even if EBITDA declines sharply. However, since the group generates about one-third of its EBITDA in noneuro currencies, we do not consider its liquidity to be strong.

Our liquidity assessment is based on the following factors and assumptions:

- We expect the company's liquidity sources in 2011 and 2012 to exceed its uses by 1.7x and 1.0x respectively. For our analysis, we assume Telekom Austria to have about €3.0 billion of liquidity sources in 2011 and €2.1 billion in 2012. Liquidity sources include surplus cash, positive funds from operations, and availability under the credit facilities.
- As of March 31, 2011, Telekom Austria reported consolidated cash and short-term investments of €527 million and had access to €1.0 billion in undrawn committed credit lines, €0.8 billion (undrawn) of which mature after 2011.
- The company has good relationships with its banks and has a solid standing in the credit markets, in our view.
- We expect the company to proactively refinance its upcoming debt maturities, totaling €0.3 billion in the remainder of 2011, €0.9 billion in 2012, and €0.9 billion in 2013. In the first quarter of 2011, Telekom Austria raised a long-term €500 million bank loan through which it addressed its 2011 maturities.
- Apart from the large debt maturities, other uses of liquidity chiefly include capital expenditures of about €0.8 billion per year, annual shareholder dividends of €0.3 billion, modest working capital needs, and moderate deferred payments.

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 keep leverage at the lower end of its financial policy target range of 2.0x-2.5x net debt to comparable EBITDA. In addition, we expect the group to defend its solid domestic market positions and those of its international mobile operations.

Pressure on the rating could build 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 15% over the next two years or if discretionary cash flow were to turn negative for several years. In addition, large debt-financed acquisitions that resulted in a pro forma leverage ratio at the upper end of the group's target range could trigger a negative rating action.

We would consider an upgrade if we saw signs that the group were able to stabilize revenues and improve its EBITDA margins from the current levels. Nevertheless, a positive rating action would have to be supported by significant positive discretionary cash flow generation and a net debt-to-EBITDA ratio, after our adjustments, of about 2x.

Business Description

Headquartered in Vienna, Telekom Austria is the leading telecom provider in Austria and a leading mobile operator in Bulgaria, Croatia, Belarus, Slovenia, Serbia, Macedonia, and Liechtenstein. As of March 31, 2011, the group had 1,123 million fixed-line customers and 1,155 million retail broadband Internet customers in Austria and, in total, 20.1 million mobile subscribers.

As of Dec. 31, 2010, Telekom Austria's largest shareholder was the Republic of Austria (AAA/Stable/A-1+), which has an indirect 28.4% stake through its fully-owned state holding company Oesterreichische Industrie Holding AG (OIAG). In addition, on Jan. 20, 2010, investment company Capital Research & Management (California) announced that it owned a 15.1% stake in Telekom Austria.

Government Support And GRE Methodology Impact

Under our criteria, Telekom Austria is a government-related entity (GRE). We assess the group's stand-alone credit profile (SACP) as 'bbb' and have not factored any state support into the current rating on Telekom Austria, which is therefore the same as the SACP classification.

In accordance with our criteria for GREs, our rating approach is based on our view of Telekom Austria's:

- "Limited" role for the Republic of Austria, due to the existence of viable alternative telecom operators in Austria. In addition, in our opinion, the Austrian government is more interested in the stability of the group's operations than the group's credit standing; and
- "Limited" link with the state, based on our view that the Austrian government is unlikely to be a long-term owner. OIAG pursues a dual strategy in carrying out its role as Austria's investment and privatization agency. It aims to increase the value of its holdings, but also to monitor its investments for exit scenarios and--depending on

its mandate from the Austrian government--to partly or fully privatize its companies.

As a result, we consider that there is a "low" likelihood that the Republic of Austria would provide timely and sufficient extraordinary support to Telekom Austria in the event of financial distress.

Business Risk Profile: Weak Growth Prospects Offset Good Market Positions

The main strengths of Telekom Austria's "satisfactory" business risk profile, according to our terminology, are:

- An established and solid domestic position for the full range of telecom services to business and residential customers. As of year-end 2010, Telekom Austria had relatively high and sustainable market shares for fixed-line broadband Internet (57%), mobile telephony (41%), and mobile broadband subscriptions (39%).
- Market-leading and profitable international mobile operations. The group's most important international operations are its Bulgarian mobile subsidiary Mobiltel (which had a 50% subscriber market share and a 53% EBITDA margin in 2010), Croatia-based Vipnet (43% market share and a 33% EBITDA margin), and Belarus-based Velcom (42% market share and a 45% EBITDA margin).
- An extensive mobile and fixed-line network infrastructure in Austria, coupled with a strong brand and sound technology skills.
- Telekom Austria's profitable international mobile operations, which help diversify its revenue base and mitigate domestic pressure in the medium term, in our view.

These strengths are partly offset by:

- Weak growth prospects in the wealthy, but mature and relatively small, Austrian telecom market that encompasses about 8.3 million inhabitants and 3.5 million households. This is primarily due to strong competition among the four existing facility-based mobile operators. Mobile telephony penetration--the number of active mobile phone numbers within a population--was at about 147% at year-end 2010, while mobile broadband penetration is among the highest in Europe at about 21% per capita. Furthermore, very competitively priced mobile broadband products depress prices and subscriber growth of fixed-line broadband Internet services, in our opinion.
- Strong regulatory pressure, mainly on mobile termination and roaming tariffs. This is likely to result in further pressure on mobile prices, in our view. In addition, the group does not yet have approval to offer flat rates for fixed-line voice services in Austria, which increases fixed-to-mobile substitution because of competitive flat-rate mobile voice offers.
- Rigid domestic cost structure because of the high number of civil servants, who cannot be laid off. As of year-end 2010, about 57% of Telekom Austria's domestic workforce (about 5,500 employees) had civil servant status.
- The group's country risk exposure through its international mobile operations, particularly in Belarus. In our opinion, the revenues and earnings of Telekom Austria's international mobile operations are likely to be more volatile than those of its domestic operations. The group's international mobile operations accounted for about 35% of group revenues and 38% of EBITDA in 2010.

Financial Risk Profile: The Sound Free Cash Flow Generation And Solid Credit Measures Of 2010 Are Likely To Decline in 2011

The main strengths of Telekom Austria's "intermediate" financial risk profile, according to our classifications, are:

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- The group's sound FOCF generation and track record of maintaining solid credit measures.
- A transparent and moderately conservative financial policy. This currently targets a leverage ratio (net debt to comparable EBITDA) of 2.0x-2.5x, share buybacks with free cash flows if there are no profitable growth projects or if the leverage ratio falls to less than 2.0x, and a solid investment-grade rating with an absolute rating floor of 'BBB' with a stable outlook.

These strengths are offset by:

- Our expectation of lower discretionary cash flow generation in 2011 and 2012, in light of the group's policy of paying at least stable dividends and our forecast of lower EBITDA generation, high restructuring costs, and at least stable capital expenditures. Discretionary cash flow was €302 million in 2010, down from €342 million in 2009 and €424 million in 2008.
- The group's foreign exchange exposure, primarily due to its international mobile operations in Belarus, Serbia, and Macedonia. Nevertheless, unlike the Belarusian ruble, the exchange rates of the Bulgarian lev and the Croatian kuna have been fairly stable against the euro in past years.

Financial Statistics/Adjustments

Telekom Austria produces consolidated financial statements in accordance with International Financial Reporting Standards.

In its assessment of the company's financial leverage, Standard & Poor's has made adjustments to Telekom Austria's reported figures (see table 1). Financial debt was adjusted by adding operating-lease and asset-retirement obligations and unfunded pension liabilities. Furthermore, we added the present value of the outstanding performance-based deferred consideration related to the acquisition of Telekom Austria's Belarusian mobile operation. We excluded defeased lease obligations (those backed by financial assets placed in trusts) from our debt calculations, however.

Given the group's sizable amount of undrawn credit facilities and solid FOCF generation, we view the majority of cash and unrestricted short-term investments as surplus cash. We deduct €50 million from cash and short-term investments to reflect funding needs for working capital purposes and that Telekom Austria is currently unable to convert Belarusian rubles into hard currencies and repatriate cash from its Belarusian operations.

As a result of a restructuring program in 2008, Telekom Austria recorded a provision of €673 million at year-end 2010 for the net present value of the estimated future personnel expenses of redundant civil servants until their retirement. Following the announcement of additional social plans in January 2011, Telekom Austria increased the provision to €836 million as of March 31, 2011. The provision incurs interest charges, but we do not treat it as debt. Rather, we reduced the group's EBITDA for the cash outflows related to the redundant, but not laid-off employees (€51 million in 2010), and added back newly recorded provisions to reported EBITDA (€124 million). Telekom Austria expects the cash outflows for both programs to increase to about €100 million-€110 million in 2011.

Table 1

Reconciliation Of Telekom Austria AG Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €)

	--Fiscal year ended Dec. 31, 2010--					
Telekom Austria AG reported amounts						
	Debt	**Shareholders' equity**	**EBITDA**	**Interest expense**	**Cash flow from operations**	**Capital expenditures**
Reported	3,583.9	1,474.4	1,521.8	161.9	1,397.5	763.6
Standard & Poor's adjustments						
Operating leases	93.3	--	5.9	5.9	23.6	12.6
Postretirement benefit obligations	131.4	(6.8)	3.2	6.5	(4.0)	--
Surplus cash and near cash investments	(191.1)	--	--	--	--	--
Capitalized interest	--	--	--	2.3	(2.3)	(2.3)
Share-based compensation expense	--	--	0.7	--	--	--
Asset retirement obligations	99.8	--	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	36.0	--
Minority interests	--	2.5	--	--	--	--
Deferred purchase price payment and finance lease obligations	55.9	--	--	--	--	--
Defeased cross-border leases	(12.2)					
Net of restructuring costs less cash outflows for redundant, but not laid-off employees.	--	--	72.7	--	--	--
Total adjustments	177.1	(4.2)	82.5	14.8	53.2	10.3
Standard & Poor's adjusted amounts						
	Debt	**Equity**	**EBITDA**	**Interest expense**	**Funds from operations**	**Capital expenditures**
Adjusted	3,761.0	1,470.2	1,604.3	176.7	1,450.8	773.8

Table 2

Telekom Austria AG--Peer Comparison*

	Telekom Austria AG	**Telekomunikacja Polska S.A.**	**Elisa Corp.**	**Portugal Telecom SGPS S.A.**	**Polkomtel S.A.**
Corporate credit ratinga as of June 13, 2011	BBB/Stable/A-2	BBB+/Stable/--	BBB/Stable/A-2	BBB-/Negative/A-3	BBB+/Stable/A-2
(Mil. €)	--Fiscal year ended Dec. 31, 2010--				
Revenues	4,650.8	3,965.3	1,463.2	3,742.3	1,936.1
EBITDA	1,604.3	1,199.1	493.8	1,311.5	751.0
Net income from continuing operations	195.4	27.0	149.7	106.8	282.3
Funds from operations (FFO)	1,450.8	1,283.4	380.6	997.3	680.5
Capital expenditures	773.8	555.4	190.6	1,154.8	283.7
Free operating cash flow	641.0	631.1	196.8	(298.0)	404.9
Discretionary cash flow	309.1	125.5	(24.5)	(1,749.9)	251.4
Debt	3,761.0	1,498.3	829.4	3,003.9	803.2
Equity	1,470.2	3,692.5	831.0	4,622.4	938.1

Table 2

Telekom Austria AG--Peer Comparison* (cont.)

Adjusted ratios					
Annual revenue growth (%)	(3.1)	(5.1)	2.3	0.2	(1.3)
EBITDA margin (%)	34.5	30.2	33.7	35.0	38.8
EBITDA interest coverage (x)	9.1	11.6	11.6	3.6	14.0
Return on capital (%)	9.5	4.3	16.0	8.6	22.2
FFO/debt (%)	38.6	85.7	45.9	33.2	84.8
Free operating cash flow/debt (%)	17.0	42.4	23.7	(9.9)	51.5
Discretionary cash flow/debt (%)	8.2	8.7	(2.9)	(58.3)	32.4
Debt/EBITDA (x)	2.3	1.2	1.7	2.3	1.1
Total debt/debt plus equity (%)	71.9	28.9	50.0	39.4	46.1

*Fully adjusted.

Table 3

Telekom Austria AG--Financial Summary*

	--Fiscal year ended Dec. 31--				
(Mil. €)	**2010**	**2009**	**2008**	**2007**	**2006**
Revenues	4,650.8	4,802.0	5,170.3	4,919.0	4,759.6
EBITDA	1,604.3	1,762.0	1,898.2	1,871.2	1,949.5
Net income from continuing operations	195.4	95.1	(48.8)	492.5	561.8
Funds from operations (FFO)	1,450.8	1,525.8	1,702.0	1,679.4	1,795.2
Capital expenditures	773.8	725.7	840.0	851.3	1,021.3
Free operating cash flow	641.0	675.9	739.2	913.9	596.1
Discretionary cash flow	309.1	344.1	407.6	570.9	334.9
Cash and short-term investments	56.6	8.8	80.6	0.0	0.0
Debt	3,761.0	4,061.4	4,416.0	4,671.9	3,513.6
Equity	1,470.2	1,620.8	2,167.9	2,563.7	2,810.8
Adjusted ratios					
Annual revenue growth (%)	(3.1)	(7.1)	5.1	3.3	9.0
EBITDA margin (%)	34.5	36.7	36.7	38.0	41.0
EBITDA interest coverage (x)	9.1	8.2	8.2	10.4	13.0
Return on capital (%)	9.5	5.4	10.8	11.5	12.7
FFO/debt (%)	38.6	37.6	38.5	35.9	51.1
Free operating cash flow/debt (%)	17.0	16.6	16.7	19.6	17.0
Discretionary cash flow/debt (%)	8.2	8.5	9.2	12.2	9.5
Debt/EBITDA (x)	2.3	2.3	2.3	2.5	1.8
Debt/debt and equity (%)	71.9	71.5	67.1	64.6	55.6

*Fully adjusted.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Principles Of Credit Ratings, Feb. 16, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 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 Detail (As Of June 14, 2011)*	
Telekom Austria AG	
Corporate Credit Rating	BBB/Stable/A-2
Commercial Paper	
Local Currency	A-2
Senior Unsecured (3 Issues)	BBB
Corporate Credit Ratings History	
30-Mar-2010	BBB/Stable/A-2
11-Dec-2009	BBB+/Watch Neg/A-2
25-Nov-2008	BBB+/Negative/A-2
20-Jun-2007	BBB+/Stable/A-2
01-Aug-2006	BBB+/Positive/A-2
Business Risk Profile	Satisfactory
Financial Risk Profile	Intermediate
Debt Maturities	
(As of March 31, 2011) 2011: €267 mil. 2012: €938 mil. 2013: €937 mil. 2014: €78 mil. Thereafter: €1,692 mil.	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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