MOODY'S
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Credit Opinion: Telekom Austria AG

Global Credit Research - 30 Oct 2015

Austria

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa2
Senior Unsecured MTN -Dom Curr	(P)Baa2
Jr Subordinate -Dom Curr	Ba1
Other Short Term -Dom Curr	(P)P-2
Telekom Finanzmanagement GmbH	
Outlook	Stable
Bkd Senior Unsecured -Dom Curr	Baa2
Bkd Other Short Term -Dom Curr	(P)P-2

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Key Indicators

[1]**Telekom Austria AG**

	12/31/2014	12/31/2013	12/31/2012	12/31/2011
Scale (USD Billion)	$5.3	$5.6	$5.6	$6.2
EBITDA Margin	36.3%	32.3%	35.8%	36.9%
Debt / EBITDA	3.1x	3.5x	2.8x	2.6x
FCF / Debt	1.9%	-15.8%	3.5%	3.3%
RCF / Debt	27.9%	24.3%	27.4%	26.1%
(FFO + Interest Expense) / Interest Expense	7.1x	6.6x	7.4x	7.7x
(EBITDA - Capex) / Interest Expense	2.6x	-2.3x	3.6x	3.6x

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Continued commitment to an investment-grade rating

- Leading market positions, albeit in a challenging operating environment

- Regulatory headwinds and further mobile termination rate cuts to continue in Eastern European countries

- High capital intensity as a result of investments in fibre and 4G, but strategic advantage over competitors

- Early signs of stabilisation in operating performance

- Adequate liquidity profile

Corporate Profile

Telekom Austria AG (Baa2 stable) is the leading integrated telecommunications provider in Austria, providing 2.3 million fixed-line voice connections, over 1.5 million fixed-line broadband connections and serving 5.4 million mobile customers (as of 30 September 2015). The group has a nationwide presence, delivering a full range of services and products, including telephony, data exchange, interactive content, TV and information and communications technology (ICT) solutions. The group has also expanded its mobile operations into Central and Eastern Europe (CEE), where its customer base accounts for more than 14.8 million subscribers. Telekom Austria is one of the leading mobile operators in Bulgaria (through its subsidiary Mobiltel), Belarus (Velcom) and Croatia (Vipnet), and is also present in Slovenia (Si.mobil), Macedonia (Vip operator), Serbia (Vip mobile) and Liechtenstein (Telecom Liechtenstein). Telekom Austria's main shareholders are América Móvil (A2 stable), with a 59.7% holding (fully consolidating Telekom Austria) and the Austrian government, with a 28.42% holding.

Rating Rationale

Telekom Austria's Baa2 rating is supported by the group's (1) medium scale; (2) position as a strong, integrated player in its highly competitive domestic market and as a geographically diversified leading mobile operator in Austria as well as certain Eastern European countries; and (3) strategic advantage after the spectrum acquisition, which enhances the groups' position in terms of 4G network coverage, although high capital intensity is needed for both 4G and fibre roll out.

Although the rating takes into consideration Telekom Austria's stabilising operating performance, it also reflects that fierce competition persists in the company's domestic market, as well as adverse macroeconomic conditions and regulatory headwinds in CEE countries.

The rating also factors management's willingness to preserve the group's financial strength and public commitment to an investment grade rating, as well as the credit quality improvement as a result of American Movil being a major shareholder of Telekom Austria, the use of a hybrid instrument in its funding arrangements, and the capital increase of EUR1 billion in November 2014.

Telekom Austria is a government-related issuer (GRI) and its Baa2 rating currently benefits from one notch of uplift as a result of (1) the group being 28.42% government-owned; (2) its moderate level of default dependence; and (3) our moderate support assumptions for the group. Telekom Austria's baseline credit assessment (BCA), a measure of its standalone credit quality, is baa3.

DETAILED RATING CONSIDERATIONS

CONTINUED COMMITMENT TO AN INVESTMENT-GRADE RATING AND STRONGER FINANCIAL PROFILE FOLLOWING AMERICA MOVIL'S TAKE OVER

Telekom Austria has publicly stated that maintaining a Baa rating remains the first priority of the group's cash use policy, which we expect to focus on deleveraging. Management has implemented a number of actions to enhance its financial flexibility, including (1) accelerated cost-cutting initiatives; (2) a moderate shareholder remuneration policy; and (3) capital structure strengthening. However, the debt-financed acquisition of mobile spectrum in October 2013 coupled with higher capex has had a negative effect on the group's credit metrics, increasing its financial risk.

As a result of the acquisition, for which the group paid more than twice the amount we had expected (around EUR1 billion), Telekom Austria's leverage ratio, measured by gross debt/EBITDA, deteriorated in 2013 to around 3.8x, from 3.0x in 2012. However, we expect the group to manage its strategic investments, as well as shareholder remuneration, within our financial ratio guidance for the Baa2 rating level. We also expect stable leverage at 3.1x in 2015, with that figure coming down to below 3.0x in 2016.

In addition, the telecommunications company América Móvil became the major shareholder of Telekom Austria with a 59.7% share from 20 October 2014. As part of the takeover agreement, Telekom Austria successfully completed its capital increase back in November 2014, which amounted to EUR1 billion. This has strengthened Telekom Austria's capital structure and financial position as well as providing additional financial flexibility for investments. However, Telekom Austria will use part of the additional capital to increase its capex and pursue investment opportunities in countries in which it currently operates, as well as in emerging markets in CEE; we expect that Telekom Austria's M&A strategy will remain disciplined and prudent.

LEADING MARKET POSITIONS, ALBEIT IN A CHALLENGING COMPETITIVE ENVIRONMENT

As of September 2015, Telekom Austria holds a stable leading market position (1) in the mobile domestic market, with a reported market share in excess of 40.0%; (2) in the domestic wireline market, with a reported 60.9% fixed-line voice market share; and (3) with a 31.3% fixed-line broadband market .

However, the Austrian mobile market is experiencing overcapacity and has passed saturation point, with a mobile penetration rate of 157.9%, as of September 2015. After some early signs of market repair following the merger (Hutchison 3G acquired Orange Austria in January 2013) from 4 to 3 main players (Telekom Austria, T-Mobile and Hutchison 3G), renewed pressures have appeared, driven by mobile virtual network operators (MVNOs), such as UPC, HoT, and Mass Response with aggressive prices. The group is mitigating price and revenue pressures by introducing cost efficiency activities, and protecting existing tariff structures.

Telekom Austria is also one of the leading mobile operators in Bulgaria, with a reported 38.6% market share, in Croatia with a reported 36.3% market share, and in Belarus with a reported 42.5% market share as of September 2015. Nonetheless, the group has shown a weaker performance in international markets owing to macroeconomic headwinds in CEE, currency depreciation in Belarus, and fierce competition in Bulgaria, Slovenia, and Serbia.

REGULATORY HEADWINDS AND FURTHER MOBILE TERMINATION RATE CUTS TO CONTINUE IN EASTERN EUROPEAN COUNTRIES

Telekom Austria's mobile communication markets are governed by differing regulatory systems. Because of their membership of the European Union and the European Economic Area, Austria, Slovenia and Bulgaria are subject to the regulations of these bodies. They influence roaming tariffs and termination charges between the individual market players. The regulatory frameworks in Croatia, Belarus, Serbia and Macedonia are at various stages of development and in certain areas are successively coming into line with the EU's directives.

In Belarus, interconnection will continue to be carried out via the state-owned fixed net company BelTelekom. It remains unclear when the market will be deregulated. In Serbia, efforts to deregulate the telecommunications market and align framework conditions to those of the EU are still in their infancy. In addition, we expect further mobile termination rates (MTRs) cuts in Belarus.

HIGH CAPITAL INTENSITY AS A RESULT OF INVESTMENTS IN FIBRE AND 4G, BUT STRATEGIC ADVANTAGE OVER COMPETITORS

The company's key areas of investment include the expansion of the group's long term evolution (LTE) mobile network, taking advantage of the 800Mhz spectrum acquired back in 2013, and the further rollout of high bandwidth broadband in Austria.

The company is developing the 4G of mobile telecommunications technology towards LTE Advanced with the implementation of LTE carrier aggregation (which can double the speeds up to 300Mbps from 150Mbps) in selected conurbations since November 2014.

Telekom Austria is also adapting its fixed network infrastructure to meet the growing demand for fixed high-bandwidth broadband solutions; while the current standard product offers data speeds of 8 or 16 Mbps, the standard product in Austria is set to be several times higher by 2018. The company aims to increase the product coverage A1 Fibre Power 30 from 28% to more than 37% homes passed by the end of this year. Telekom Austria plans to increase the investment by EUR400 million in order to accelerate the roll out of fibre, although this plan is subject to the annual budget approvals by the Supervisory Board as well as the announced government broadband subsidy programme as a prerequisite. After the mobile spectrum auctions that exceeded all expectations, the industry is expecting up to EUR1billion to be redistributed in the form of subsidies for the roll-out of fixed broadband; as such, we expect Telekom Austria to be one of the main beneficiaries.

We believe Telekom Austria's capex will remain high at around 18%-19% over sales (EUR700-800 million per year) during the next 2 years, linked to the ramp-up of the Austrian 4G-LTE market and fibre rollout.

EARLY SIGNS OF STABILISATION IN OPERATING PERFORMANCE

Although in the first nine months to September 2015, reported revenues declined by 1.2% to EUR2.9 billion, excluding one-off effects, as well as negative FX translation effects of EUR 72 million, clean revenues were stable in that period (slight improvement of 0.2%). The clean growth was driven by growth in the Belarusian segment and a stabilisation in the Austrian segment. We expect that Telekom Austria's operating performance will remain challenged by (1) fierce competition in the domestic market; (2) adverse macroeconomic conditions in other countries in which the group operates; and (3) foreign exposure risks, which we expect to be offset by the focus on high value gross customers in the domestic market and revenue growth in Belarus. We expect revenue to remain stable in 2015 and some overall revenue recovery in 2016.

In the first nine months to September 2015, comparable EBITDA also grew by 1.7% to EUR1.1 billion on the back of strict cost control (clean EBITDA growth of some 3.1% excluding the above mentioned extraordinary effects as well as negative FX translation). Telekom Austria's range of measures implemented in the past, such as cut of operating expenses, lower marketing and sales costs as well as lower expenses in roaming and interconnection will drive an improvement in the EBITDA margin in 2015 and 2016.

Liquidity Profile

Telekom Austria's liquidity profile is more than sufficient to cover its debt maturities throughout 2017, as well as other cash demands. Over the next 12 months, we expect that the company will generate around EUR1 billion of cash from operations (after tax and interest payments). In addition, Telekom Austria has around EUR1.1 million in cash (as of September 2015) and external liquidity sources that include around EUR1.0 billion of committed long-term bank facilities that are unutilised and can be drawn at any time, not being subject to material adverse change clauses or financial covenants. In November 2014, Telekom Austria successfully launched the first capital increase in the company's history, at EUR1 billion, which was partly used to reduce debt.

Rating Outlook

The stable rating outlook reflects our expectation that Telekom Austria will gradually improve its future operating performance, despite an increasingly tough market in which the company will have to continue to weather macroeconomic, regulatory and competitive pressures. The outlook also factors in our expectation that management will preserve the company's financial strength within the publicly stated ratio guidance.

What Could Change the Rating - Down

The ratings could come under downward pressure if (1) Telekom Austria's underlying operating performance were to weaken beyond our current expectations as a result of more adverse macroeconomic, regulatory or competitive developments; or (2) the group were to make additional material debt-financed acquisitions and/or increase shareholder remuneration, such that its credit metrics were to deteriorate (reflected in adjusted RCF/adjusted gross debt sustainably below 20% and adjusted gross debt/EBITDA sustainably above 3.3x). Downward pressure could also be exerted on the rating if the group's liquidity profile were to weaken further.

In addition, we would most likely no longer apply our GRI methodology to Telekom Austria or incorporate uplift in its final rating if (1) the government were to reduce its stake in the group to below 20%; or (2) we were to lower our support assumptions for the group. While either one of these factors would likely result in a one-notch downgrade, there is currently no indication that either will occur.

What Could Change the Rating - Up

Although not currently expected, we could consider upgrading Telekom Austria's rating if the group's debt protection ratios were to strengthen as a result of improvements in its operational cash flows, assuming no change in the sovereign rating or the levels of government support and default dependence. This would be reflected by, for example, an adjusted retained cash flow (RCF)/gross adjusted debt ratio trending towards 30% and a gross adjusted debt/EBITDA ratio that is lower than 2.8x on a sustainable basis.

Other Considerations

JUNIOR SUBORDINATED INSTRUMENT RATING

The Ba1 rating of Telekom Austria's hybrid debt is two notches below the company's senior unsecured rating of Baa2. This rating differential reflects the fact that it (1) is a perpetual instrument; (2) is very deeply subordinated; (3) provides Telekom Austria with the option to defer coupons on a cumulative basis; (4) has no step-up prior to year 10 and none beyond 100 basis points (bps) thereafter; and (5) has a 500 bps step-up upon a change of control, in which event all senior creditors will be repaid first.

METHODOLOGY GRID

The Baa2 grid outcome (on the basis of Moody's adjusted audited figures for financial year 2014) is in line with the final rating assigned, and one notch higher than the underlying BCA equivalent (baa3), which is prospective in nature and reflects the competitive operating environment and the outcome of the spectrum auction, affecting its financial metrics. The final rating benefits from one notch uplift given the GRI considerations.

We expect Telekom Austria's revenues and EBITDA to remain stable in 2015, and improving in 2016. We expect that Telekom Austria will exhibit stabilising credit metrics, with a Moody's-estimated adjusted retained cash flow/ debt of over 26% and an estimated adjusted debt/EBITDA around 3.1x by the end of 2015. We expect adjusted FCF/ debt between 4%/6%. We also anticipate FFO coverage in the 6x-8x range and (EBITDA-capex)/gross interest expense around 3.0x.

DISCUSSION OF GOVERNMENT-RELATED ISSUER (GRI) INPUTS

Given Telekom Austria's 28.42% ownership by the Austrian government and our expectation that there will be no change in ownership over the next two to three years, the group qualifies as a government-related issuer (GRI) under our methodology for such entities. As such we include the following factors pertaining to our GRI methodology:

1) A BCA of baa3 reflects Telekom Austria's underlying strength, as defined above

2) The local currency rating of Austria, whose government supports the group, is Aaa negative

3) The moderate default dependence (recently changed from low) assessment reflects a degree of correlation between Telekom Austria and the Austrian government taking into consideration the strength of Telekom Austria's credit profile and Austrian economic trends, in light of the group's importance to the national economy. More specifically, the moderate default dependence assessment reflects the financial and operational links between the group and the Austrian economy.

We have factored into Telekom Austria's rating a moderate level of government support based on the following observations:

1) There is no explicit expression of support by the government, i.e., the government does not guarantee the debt of the GRI. In addition, we are not aware of any formal verbal or written confirmation that the government will support this GRI in the event of it defaulting on its financial debt.

2) The government's 28.42% ownership of Telekom Austria and its willingness to behave as a rational shareholder might suggest that the government would be unlikely to be the sole provider of support. Instead, it would only consider providing support jointly with other shareholders in the form of a capital increase.

3) There are EU policy barriers to the provision of direct financial support and the government is likely to obey these rules.

4) We consider the Austrian government's historical approach to be moderately interventionist. The government reviews and supervises Telekom Austria's business and funding plans, which we consider positive relative to support assumptions, and appoints a number of board members.

5) In our view, it is unlikely that the Austrian government's good reputation would be damaged in the event of a default by Telekom Austria.

6) Given its large workforce, the group's level of economic and social importance to Austria appears to be high, despite its strategic importance having diminished over recent years owing to the increasing presence of viable, privately owned competitors with significant market share.

Rating Factors

Telekom Austria AG

Global Telecommunications Industry Grid [1][2]	**12/31/2014**			[3]**Moody's 12-18 Month**	

			Forward ViewAs of October 2015	
Factor 1: Scale And Business Model, Competitive Environment And Technical Positioning (27%)	**Measure**	**Score**	**Measure**	**Score**
a) Scale (USD Billion)	$5.3	Baa	$4.5/$6.0	Baa/Ba
b) Business Model, Competitive Environment and Tec.Positioning	A	A	A	A
Factor 2: Operation Environment (16%)				
a) Regulatory and Political	Baa	Baa	Baa	Baa
b) Market Share	A	A	A	A
Factor 3: Financial Policy (5%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 4:Operating Performance (5%)				
a) EBITDA Margin	36.3%	Baa	34%-36%	Baa
Factor 5: Financial Strength (47%)				
a) Debt / EBITDA	3.1x	Ba	3.0x-3.3x	Ba
b) FCF / Debt	1.9%	Caa	4.0%-6.0%	B
c) RCF / Debt	27.9%	Baa	>26%	Baa
d) (FFO + Interest Expense) / Interest Expense	7.1x	A	6.0x-8.0x	A/Baa
e) (EBITDA - Capex) / Interest Expense	2.6x	Ba	3.0x	Ba
Rating:				
a) Indicated Rating from Grid		Baa2		Baa2/Baa3
b) Actual Rating Assigned				Baa2

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	baa3
b) Government Local Currency Rating	Aaa
c) Default Dependence	Moderate
d) Support	Moderate
e) Final Rating Outcome	Baa2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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