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Telekom Austria AG

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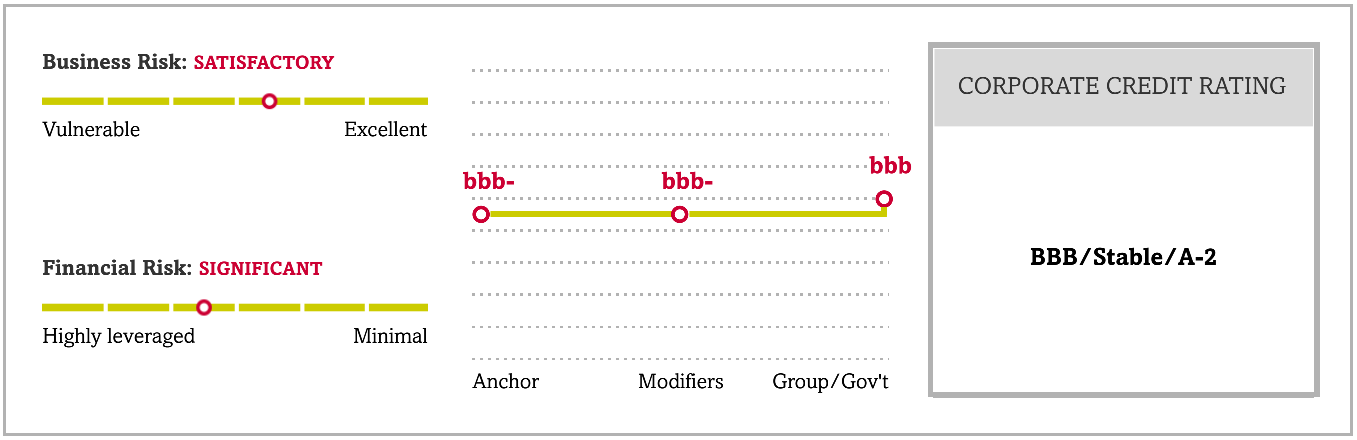

Rationale

Business Risk: Satisfactory	Financial Risk: Significant
• Leading telecommunications operator in Austria, supported by high fixed broadband market share and good spectrum holdings. • Profitable and cash-generative international mobile operations. • High competitive pressure in many service areas. • High exposure to country risk, especially in Belarus. • Rigid cost structure in Austria.	• Intermediate leverage. • Free operating cash flow (FOCF) generation constrained by large network investments and restructuring costs. • Marked foreign exchange exposure of cash flows from international operations in Belarus, Serbia, and Macedonia.

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Outlook: Stable

Standard & Poor's Ratings Services' outlook on Austrian telecommunications provider Telekom Austria AG is stable. This reflects our expectation that operating performance in Austria will continue to stabilize and that the company will maintain a Standard & Poor's-adjusted debt-to-EBITDA ratio of no higher than 3x.

The stable outlook further reflects steady improvement to adjusted debt to EBITDA and funds from operations (FFO) to debt, offset by uncertainty over the extent to which the €1 billion in proceeds from the November 2014 capital increase will be applied to debt repayment versus network investments, acquisitions, or—in the medium term—shareholder returns.

Upside scenario

We could consider an upgrade if we observed greater visibility on the use of the proceeds from the capital increase, reducing the risk the funds will be applied mainly for purposes other than debt reduction, and if, at the same time, Telekom Austria were to improve its revenues and profitability more quickly than we currently anticipate, leading to better FOCF generation. A positive rating action would depend on FOCF to debt sustainably improving toward 10% while not exceeding a debt-to-EBITDA ratio, after our adjustments, of 2.75x, and FFO to debt rising above 30%.

We could also raise the rating on Telekom Austria if we viewed its strategic importance to its majority shareholder, América Móvil S.A.B. de C.V. (AMX), as strengthening. This could happen if we were to witness more implicit support from AMX, for example, if AMX were to guarantee Telekom Austria's debt.

Downside scenario

Although not expected at this stage, we could consider a downgrade if the company's revenues continued to decline or margins weakened due to competitive pressure in Telekom Austria's domestic or international operations, leading leverage to rise to more than 3.25x and FFO to debt to fall to less than 25%. We could also lower the rating if Telekom Austria were to use the proceeds from the capital increase primarily for purposes other than debt reduction.

The ratings on Telekom Austria incorporate support from AMX, and could come under pressure if we assess Telekom Austria's strategic importance to AMX as weakening, for example, if Telekom Austria appeared likely to be sold over the near term, a scenario which we consider unlikely.

Standard & Poor's Base-Case Scenario

The €1 billion capital increase has strengthened the group's credit metrics and reduced adjusted debt to EBITDA to about 2.8x at year-end 2014 compared with 3.7x at year-end 2013. The future development of leverage will depend on the extent to which the resulting surplus cash balances will be used for debt repayment, acquisitions, network investments, or—in the medium term—shareholder returns.

Assumptions	Key Metrics

Assumptions

- Revenue growth of about negative 0.5% in 2015 and positive 0.5%-1% in 2016, compared with a 4% decline in 2014, supported by easing revenue pressure in Austria and select other markets.
- Stable to slightly higher EBITDA margin before restructuring costs and impairments of 32%-33% in 2015-2016, due to continued cost savings and somewhat better pricing in Austria.
- Capital expenditures (capex), excluding spectrum costs, of about €0.72 billion a year in 2015-2016, due to accelerated broadband rollout in Austria, plus moderate spectrum costs.
- Between €100 million and €110 million of annual restructuring-related cash outflows in 2015 and 2016.
- Acquisition spending of €150 million in 2015 and 2016 combined.
- Stable dividends of €0.05 per share in 2015 and 2016.

Key Metrics

	2014a	2015e	2016e
EBITDA margin (%)*	32.0	32.0–32.5	32.0–33.0
Debt/EBITDA (x)§	2.8	2.7–2.9	2.6–2.8
FFO/debt (%)§	28.9	28.0–30.0	29.0–31.0
FOCF/debt (%)§	4.8	5.0-7.0	6.0-8.0

*As adjusted by Telekom Austria. §Standard & Poor's-adjusted. a--Actual. e--Estimate. FFO--Funds from operations. FOCF--Free operation cash flow, defined as cash flow from operations after capital expenditures and spectrum costs.

Company Description

Headquartered in Vienna, Telekom Austria is the leading telecommunications provider in Austria and a leading mobile operator in Central and Eastern European countries like Bulgaria, Croatia, Belarus, Slovenia, Serbia, and Macedonia. As of March 31, 2015, the group had 2.8 million fixed access lines and 1.8 million retail broadband Internet customers in Austria, and a total of 20 million mobile subscribers.

As of March 31, 2015, AMX was the largest shareholder with a 59.7% stake, followed by the Österreichische Bundes- und Industriebeteiligungen GmbH, the national industry holding company of the Austrian government (28.4%).

Business Risk: Satisfactory

Our business risk assessment primarily reflects the group's established and solid position in the wealthy, but mature, competitive, and relatively small, Austrian telecommunications market. Following wireless market consolidation to three players from four in 2013 and a mobile market strategy that focuses on the premium segment, Telekom Austria has made progress with stabilizing mobile average revenue per user and reducing subscriber acquisition and retention costs. In our view, further support for Telekom Austria's competitive position in the high-value domestic mobile segment could result from its strong spectrum position, backed by the acquisition of one-half of the total available spectrum of 2 x 140 megahertz (MHz) in the last spectrum auction in 2013, including four blocks of 800 MHz spectrum.

As of the first quarter 2015, Telekom Austria had relatively high subscriber market shares for fixed-line broadband Internet (about 59%), mobile telephony (about 40%), and mobile broadband (31%), thanks to an extensive mobile and fixed-line network infrastructure in Austria and its strong brand. Furthermore, we think that plans to accelerate the upgrade of the fixed broadband network in connection with the Austrian national broadband rollout subsidy program could further enhance its domestic fixed-line value proposition. Additional support for our business risk profile assessment stems from Telekom Austria's market-leading and profitable international mobile operations, which help diversify its revenue base, in our view. The group's largest international operations are its Bulgarian mobile subsidiary, Mobiltel (which reported a 39% subscriber market share and an EBITDA margin, as adjusted by Telekom Austria, of about 40% in the first quarter of 2015), Croatia-based Vipnet (36% market share and 23% EBITDA margin), and Belarus-based Velcom (about 43% market share and 54% EBITDA margin). Furthermore, Telekom Austria is looking to expand the fixed-line coverage of its international businesses to improve its ability to make fixed-and-mobile convergence offers.

Nevertheless, competition among mobile operators is still fierce, and competitively priced mobile broadband products constrain prices and subscriber growth in fixed-line broadband Internet services, in our opinion. Also, new competitive pressure in Austria could derive from recent market entries by additional mobile virtual network operators, potentially forcing Telekom Austria to revert to more generous handset subsidy practices or other price/nonprice measures.

We also note that the group remains exposed to adverse regulatory developments, mainly on mobile-termination and roaming tariffs, which will continue to weigh on revenues, albeit to a lessening extent, in our view. The rigid domestic cost structure also constrains the group's business risk profile. Telekom Austria employs a significant share of civil servants in its workforce who cannot be laid off. The group is also exposed to country and foreign exchange risk through its international mobile operations, particularly in Belarus. Furthermore, 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.

S&P Base-Case Operating Scenario

In our base case, we assume further revenue decline of about 0.5% in 2015, compared with 4% in 2014. We expect revenues will return to growth in 2016, primarily as a result of the company's premium mobile strategy in Austria and modest revenue growth in Croatia and other additional markets. Additional tailwind may result from an improving economic outlook in some of the group's main service areas, possibly offset by difficult economic conditions in Belarus.

We expect stable to slightly rising group EBITDA margins, as adjusted by Telekom Austria, between 32%-33% in 2015 through 2017. Margins will primarily be supported by more stable pricing, improving revenue trends, and continued cost-cutting efforts in Austria, partly offset by weakening margins in Bulgaria and Croatia.

Peer comparison

Table 1

Telekom Austria AG -- Peer Comparison					
Industry Sector: Telecom					
	Telekom Austria AG	**Koninklijke KPN N.V.**	**TDC A/S**	**Telecom Italia SpA**	**EE Ltd.**
Rating as of May 18, 2015	BBB/Stable/A-2	BBB-/Stable/A-3	BBB/Negative/A-2	BB+/Stable/B	BBB/Stable/A-2
	--Fiscal year ended Dec. 31, 2014--				
(Mil. €)					
Revenues	4,018	7,999	3,135	21,974	8,152
EBITDA	1,238	2,773	1,324	9,213	2,029
Funds from operations (FFO)	1,005	2,017	1,043	6,606	1,796
Net income from continued operations	(186)	225	331	809	(280)
Cash flow from operations (CFO)	914	1,694	1,023	5,458	1,767
Capital expenditures	747	1,473	517	4,659	768
Free operating cash flow (FOCF)	167	221	506	799	999
Discretionary cash flow (DCF)	128	127	109	547	289
Cash and short-term investments	41	0	0	200	0
Debt	3,477	9,559	5,101	31,014	3,855
Equity	1,918	4,543	2,504	22,837	11,494
Adjusted ratios					
EBITDA margin (%)	30.8	34.7	42.2	41.9	25.0
Return on capital (%)	6.3	4.5	8.4	9.5	1.9
EBITDA interest coverage (x)	6.0	4.0	7.2	4.3	8.7
FFO cash interest coverage (x)	7.0	3.8	5.8	1.8	19.5
Debt/EBITDA (x)	2.8	3.4	3.9	3.4	1.9
FFO/debt (%)	28.9	21.1	20.5	21.3	46.8
CFO/debt (%)	26.3	17.7	20.1	17.6	46.0
FOCF/debt (%)	4.8	2.3	9.9	2.6	26.1
DCF/debt (%)	3.7	1.3	2.1	1.8	7.7

Financial Risk: Significant

The €1 billion capital increase has strengthened the group's credit metrics and reduced adjusted debt to EBITDA to about 2.8x at year-end 2014 compared with 3.7x at year-end 2013. Future leverage will depend on the extent to which the surplus cash balance is used for debt repayment.

The group so far demonstrates a transparent and moderately conservative financial policy, which targets a 'BBB' rating by focusing on deleveraging through free cash flow generation. The financial profile is constrained by uncertainty over the future use of the funds from the capital increase, coupled with modest FOCF generation. We expect only moderate annual FOCF (before Standard & Poor's adjustments) of about €0.2 billion in 2015 and 2016, including spectrum costs, held back by significant continued restructuring costs and sizable network investments. Following the recent deleveraging coupled with our expectation of modest EBITDA growth from 2016, we anticipate adjusted debt-to-EBITDA and FFO-to-debt ratios between 2.6x-2.8x and 29%-31%, respectively, at year-end 2016.

We note that there is currently a meaningful difference between the group's reported financial policy leverage and Standard & Poor's-adjusted leverage of about 0.7x, primarily because of our adjustments for the hybrid bond (which the company reports entirely as equity) and restructuring-related cash outflows, as well as our customary adjustments for unfunded employee benefit obligations, operating leases, and asset-retirement obligations.

S&P Base-Case Cash Flow And Capital Structure Scenario

- Capex, excluding spectrum costs, of about €0.72 billion a year in 2015-2016, due to accelerated broadband rollout in Austria, plus moderate spectrum costs.
- Between €100 million and €110 million of annual restructuring-related cash outflows in 2015 and 2016.
- Acquisition spending of €150 million in 2015 and 2016 combined, mainly for expanding the group's international operations.
- Stable dividends of €0.05 per share in 2015 and 2016.

Financial summary

Table 2

Telekom Austria AG -- Financial Summary

Industry Sector: Telecom

	--Fiscal year ended Dec. 31--				
(Mil. €)	**2014**	**2013**	**2012**	**2011**	**2010**
Revenues	4,018	4,184	4,330	4,455	4,651
EBITDA	1,238	1,217	1,399	1,467	1,628
Funds from operations (FFO)	1,005	998	1,176	1,241	1,386
Net income from continuing operations	(186)	52	104	(252)	195
Cash flow from operations	914	1,079	1,065	1,231	1,414
Capital expenditures	747	1,777	726	737	761
Free operating cash flow (FOCF)	167	(699)	338	494	653
Discretionary cash flow (DCF)	128	(721)	170	162	321
Cash and short-term investments	41	42	34	31	32
Debt	3,477	4,521	3,651	3,740	3,734
Equity	1,918	1,159	813	876	1,470
Adjusted ratios					
EBITDA margin (%)	30.8	29.1	32.3	32.9	35.0
Return on capital (%)	6.3	6.5	9.2	8.0	9.5
EBITDA interest coverage (x)	6.0	6.6	7.1	7.8	9.2
FFO cash interest coverage (x)	7.0	5.2	8.3	12.7	12.5

Table 2

Telekom Austria AG -- Financial Summary (cont.)					
Debt/EBITDA (x)	2.8	3.7	2.6	2.5	2.3
FFO/debt (%)	28.9	22.1	32.2	33.2	37.1
Cash flow from operations/debt (%)	26.3	23.9	29.2	32.9	37.9
FOCF/debt (%)	4.8	(15.5)	9.3	13.2	17.5
DCF/debt (%)	3.7	(15.9)	4.7	4.3	8.6

Liquidity: Strong

The short-term rating is 'A-2', reflecting the long-term rating of 'BBB' and our assessment of the group's liquidity as "strong" under our criteria.

Under our base case, the ratio of liquidity sources to uses will exceed 1.5x in 2015 and 2016.

Principal Liquidity Sources

Our estimate of principal liquidity sources in the 12 months from April 1, 2015, includes:

- About €1.1 billion of balance sheet cash and liquid investments, bolstered by the €1 billion capital increase in 2014.
- €1 billion of borrowing capacity under the company's new revolving credit facility due 2019.
- Cash FFO exceeding €1 billion.

Principal Liquidity Uses

Our estimate of principal liquidity uses in the 12 months from April 1, 2015, includes:

- About €245 million of scheduled debt amortization.
- Approximately €110 million of cash outflows for restructuring costs.
- Capex of close to €0.8 billion including spectrum costs.
- Modest annual shareholder dividends of €33 million and €34 million coupon payments on the group's hybrid bond.
- Up to €50 million for smaller acquisitions.

Debt maturities

Table 3

Telekom Austria AG -- Debt Maturities	
(Mil. €)	**Maturities***
2015	245
2016	805
2017	547
2018	205
2019	47
Thereafter	1,800

*Excluding the €600 million hybrid bond.

Other Credit Considerations

There is no impact from the modifiers on the rating. Still, the group faces marked foreign exchange exposure, primarily due to its international mobile operations in Belarus, Croatia, Serbia, and Macedonia. Nevertheless, the group is taking measures to limit any exchange rate impact, in particular from its operations in Belarus. The Bulgarian lev is pegged to the euro.

Group Influence

The 'BBB' rating benefits, in our view, from Telekom Austria's strategic importance to AMX since it acquired a controlling stake.

The assessment of Telekom Austria's group status primarily reflects our view that Telekom Austria is unlikely to be sold over the medium term. We understand that AMX intends to use Telekom Austria as a vehicle for expansion into Europe, particularly into Central and Eastern Europe. Therefore, we anticipate that Telekom Austria will be important to the group's long-term strategy and that AMX is likely to support it if it should fall into financial difficulty.

Government Influence

We continue to regard Telekom Austria as a government-related entity (GRE) under our criteria. Our 'BBB' rating on Telekom Austria, including group support, is not enhanced further for potential government support, as we see a "low" likelihood of timely and sufficient extraordinary support in the event of financial distress from the group's 28.4% shareholder, the Republic of Austria (AA+/Stable/A-1+).

Ratings Score Snapshot

Corporate Credit Rating

BBB/Stable/A-2

Business risk: Satisfactory

- **Country risk:** Intermediate
- **Industry risk:** Intermediate
- **Competitive position:** Satisfactory

Financial risk: Significant

- **Cash flow/Leverage:** Significant

Anchor: bbb-

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)

- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : bbb-

- **Group credit profile:** a-
- **Entity status within group:** Moderately strategic (+1 notch from SACP)
- **Related government rating:** AA+
- **Likelihood of government support:** Low (no impact)

Reconciliation

We assess the group's hybrid bonds, which the group reports as equity in its accounts, as having "intermediate" equity content under our criteria. As a result, we allocate 50% of bond's principal amount to debt and 50% to equity. In addition, we treat 50% of the related payments on these securities as a fixed-interest charge and 50% as equivalent to a common dividend, in line with our hybrid capital criteria.

As a result of its restructuring programs, Telekom Austria recorded an €810 million provision at year-end 2014. This figure reflects the net present value of social plans for employees, the estimated future personnel expenses of redundant civil servants until their retirement, and salary expenses for civil servants transferred to the government. The provision incurs interest, but we don't treat it as debt. Rather, we added newly recorded provisions back to reported EBITDA (€90 million) and reduced EBITDA by €107 million for restructuring-related cash outflows in 2014.

In our base case, we estimate restructuring-related cash outflows at about €100 million to €110 million in 2015 and 2016 and further moderate new restructuring provisions.

Table 4

Reconciliation Of Telekom Austria AG Reported Amounts With Standard & Poor's Adjusted Amounts

(Mil. €)	--Fiscal year ended Dec. 31, 2014--									
Telekom Austria AG reported amounts										
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Reported	3,726	2,217	4,018	1,197	(3)	163	1,197	901	56	757
Standard & Poor's adjustments										
Interest expense (reported)	--	--	--	--	--	--	(163)	--	--	--
Interest income (reported)	--	--	--	--	--	--	15	--	--	--
Current tax expense (reported)	--	--	--	--	--	--	(43)	--	--	--

Table 4

Reconciliation Of Telekom Austria AG Reported Amounts With Standard & Poor's Adjusted Amounts (cont.)										
Operating leases	113	--	--	50	8	8	42	42	--	--
Intermediate hybrids reported as equity	300	(300)	--	--	--	17	(17)	(17)	(17)	--
Postretirement benefit obligations/deferred compensation	181	--	--	8	8	6	2	(2)	--	--
Surplus cash	(991)	--	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	10	(10)	(10)	--	(10)
Share-based compensation expense	--	--	--	1	--	--	1	--	--	--
Asset retirement obligations	148	--	--	--	--	--	--	--	--	--
Nonoperating income (expense)	--	--	--	--	15	--	--	--	--	--
Noncontrolling interest/minority interest	--	1	--	--	--	--	--	--	--	--
EBITDA--Other	--	--	--	(18)	(18)	--	(18)	--	--	--
D&A--Reverse goodwill amortization	--	--	--	--	346	--	--	--	--	--
Total adjustments	(249)	(299)	0	41	360	41	(192)	13	(17)	(10)

Standard & Poor's adjusted amounts

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Dividends paid	Capital expenditures
Adjusted	3,477	1,918	4,018	1,238	357	205	1,005	914	39	747

D&A--Depreciation and amortization.

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- Rating Each Issue, April 15, 2008

Business And Financial Risk Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	**bbb-/bb+**	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of May 22, 2015)

Telekom Austria AG	
Corporate Credit Rating	BBB/Stable/A-2
Commercial Paper	
Local Currency	A-2
Junior Subordinated	BB+
Senior Unsecured	BBB
Corporate Credit Ratings History	
11-Aug-2014	BBB/Stable/A-2
02-May-2014	BBB-/Watch Pos/A-3
23-Oct-2013	BBB-/Stable/A-3

*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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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