MOODY'S INVESTORS SERVICE

Credit Opinion: Telekom Austria AG

Global Credit Research - 12 Jul 2010

Austria

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A3
Senior Unsecured MTN -Dom Curr	A3
ST Issuer Rating	P-2
Telekom Finanzmanagement GmbH	
Outlook	Stable
Bkd Senior Unsecured -Dom Curr	A3
Bkd Other Short Term -Dom Curr	P-2

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Key Indicators

Telekom Austria AG

	2007	2008	2009
RCF/Adjusted Debt	**28.55%**	**30.12%**	**26.55%**
FCF/Adjusted Debt	**12.03%**	**9.43%**	**7.28%**
Total Debt/EBITDA	**2.4x**	**2.3x**	**2.54**
(FFO+Interest Exp)/Interest Expense	**9.2x**	**7.3x**	**7.3x**
(EBITDA-Capex)/Interest Expense	**5.2x**	**4.4x**	**4.5x**

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

Opinion

Corporate Profile

Telekom Austria (TA; rated A3 stable) is the leading integrated telecommunications provider in Austria, serving 2.3 million fixed voice lines, almost 1.1 million fixed-line broadband connections and 4.8 million mobile customers as of fiscal year-end (FYE) 2009. TA has a nationwide presence, delivering a full range of services and products, including telephony, data exchange, interactive contents, TV and ICT solutions. Like those peers most comparable to TA, the group is having to adapt to an environment where market shares, revenues and margins on traditional fixed-line voice telephony services are facing intense competition and strong regulatory pressure. To offset this, TA continues to reduce opex and capex. TA has also expanded its mobile operations outside Austria, where its customer base accounts for more than 14 million subscribers. TA 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 (Mobilkom). Despite revenue declining by almost 6% in Q1 2010 driven by lower revenues from domestic operations and Bulgaria, like other telecoms companies, TA's cash flow has proved resilient to the global downturn. The group is seeing the first signs of a positive economic impact on its consumer service, with just 0.8% lines lost in the fixed line business and mobile customers increasing by 6% to almost 19 million customers.

Rating Rationale

Given its 28.42% ownership by the Austrian government and our expectation of no change, TA qualifies as a government-related issuer (GRI) under Moody's methodology for such entities This methodology formally disaggregates the rating of a GRI into four components: (i) the GRI's baseline credit risk; (ii) the credit risk of the supporting government; (iii) the default dependence between the GRI and the government; and (iv) the likelihood of government support for the GRI. In accordance with this methodology, TA's A3 rating reflects the combination of the following inputs:

A Baseline Credit Assessment (BCA) of 8 (on a scale of 1 to 21, where 1 represents the lowest level of credit risk), reflecting TA's leading positions in the Austrian market for wireline and wireless services, despite the significant penetration of the country's fixed-line market and the highly competitive domestic mobile market.

The Aaa local currency rating of Austria, whose government supports the group.

The low default dependence between TA and the government, reflecting the weak correlation between the strength of the group's credit profile and Austrian economic trends - despite TA's importance to the national economy.

A medium level of government support, reflecting the government's 28.42% ownership of TA. The group's strategic importance is diminished by the presence of viable, privately owned competitors with significant market shares. Further reduction of the government's stake is possible over the medium term, but is not yet reflected or assumed by the current support assessment. Further privatisation is a politically sensitive issue for which there is no political consensus. Moody's believes that the SPÖ-led grand coalition (SPÖ-ÖVP) has reduced the probability of TA's full privatisation given SPÖ's pre-election objection to further sales of state-owned assets. Moody's sees the Austrian government as moderately interventionist and able and willing to act as a large shareholder. Furthermore, given its large workforce, the economic and social importance of TA also appears to be high.

The A3 rating of TA has a stable outlook: it is most sensitive to changes in the BCA, followed by changes in the probability of government support, while Austria's Aaa rating and the default dependence are less likely to change. Moody's would revise its support assessment upwards in the event of concrete indications that the Austrian government intended to substantially increase its stake in the group or strongly intervene in TA matters, which would signal increasing government and reputational concerns. We would revise downwards the level of support currently assigned to TA in the event of concrete indications of a substantial further reduction in the government's stake in the group. If the government's stake were to be reduced below 20%, we would remove TA from the GRI methodology resulting in a probable one notch downgrade.

Under the telecoms methodology grid, the suggested theoretical rating output for TA is A3 based on the group's 2009 financial statements. The difference between the BCA of Baa1 and the suggested rating under the methodology, A3, reflects TA's exposure to emerging markets as well as a degree of perceived event risk pressure derived from macro economy, competition and regulation.

Telekom Austria's BCA of Baa1 reflects: (i) its integrated telecoms business model, which allows it to adapt to the developments in the telecoms industry; (ii) its management strategy and tolerance for financial risk, which directly influence debt levels and credit quality; and (iii) its operating margins and liquidity. In Moody's view, TA's future cash flow generation may be limited by: (i) the current economic environment; (ii) sustained price pressure; and (iii) the effect from regulatory-induced lower roaming tariffs and mobile termination charges in Austria, Bulgaria, Croatia and Slovenia. Moody´s has taken the following factors into consideration in applying its global telecoms methodology:

Size and Scale (Baa): A key determinant of a company's credit quality is its size and total annual revenues. Specifically, larger companies are generally more broadly diversified, which allows them to reduce volatility and provide flexibility to generate cash from the divestiture of certain operations, if needed. Larger companies also benefit from greater financial resources and economies of scale. In light of TA's annual revenues of around EUR 4.8 billion ($6.8 billion), Moody's ranks the group in the Baa category, which is afforded the single heaviest weighting in the methodology grid, at 15%.

Business Model and Competitive Environment (Aa): Moody's views an integrated telecoms business model as more robust than either a stand-alone fixed-line operation or a wireless business because of the ongoing pace of technological change. TA follows an integrated business model, with its wireless business contributing more than 50% of total revenue. We assess the competitive environment for a particular telecoms market by examining the industry structure and number of players. Although TA has recovered the market share that it lost after the deregulation of the wireline market in 1999, the Austrian fixed-line market is characterised by intense competition resulting from the existence of 38 operators. TA's most important competitors are Tele2 UTA and Tele.ring. Other important players in the fixed market are cable providers. The Austrian mobile market, which has virtually reached saturation point with a mobile penetration rate of 137.4% (well above the Western European average of 130.1%), is characterised by TA's leading position. With four mobile operators - Mobilkom, T-Mobile, Hutchison and One (rebranded to Orange One in September 2008) - and several service providers (such as Yesss!), the Austrian mobile market is extremely dynamic. Moody's believes that mobile virtual network operators (MVNOs) are not a threat to TA because price levels are so low that it is not a viable business model. In the Bulgarian mobile market, during the process of the privatisation of the Bulgarian Telecommunications Company (BTC), Bulgaria's fixed-line telephony operator, the Bulgarian Communications Regulation Commission, granted a third mobile telephony licence in Bulgaria to BTC. The Bulgarian regulator is considering a fourth GSM licence in Bulgaria. The Belarusian mobile market is still under-penetrated; according to the Belarusian Ministry of Telecommunication, the penetration rate will reach 105.3% as of March 2010. The development will very much depend on how aggressively the third player, BeST, operates in the market. The fast-growing Slovenian market is characterised by intense competition between five market participants. The mobile penetration rate remained virtually unchanged at 101.7%. In light of the above, Moody's has awarded TA a Aa score for this factor.

Regulatory and Political Framework (A): Moody's scores TA a score of A for this factor, reflecting the predictable regulatory environment and the established political environment. According to the new draft proposals from the Austrian regulatory authority (the Telecom Control Commission), fixed-line broadband connections for residential customers will in future be excluded from regulation at the wholesale level due to their widespread substitution by mobile broadband services. Although the European Commission had initially expressed doubts about this planned redefinition of the market, it eventually gave the Austrian regulator the go-ahead on 9 December 2009 after further facts had been submitted. The recognition by the regulator of the marked extent to which fixed net lines are being replaced by mobile communication in Austria will allow the partial deregulation of the wholesale broadband market for residential customers, which is unparalleled in Europe in this form. A new recent legal framework for the regulation of telecommunications services was adopted in Brussels, which among other things requires operators to commit to investing in new networks. On the basis of an amendment to the Austrian Telecommunications Act, the new legal framework must be implemented in Austria by mid-2011. TA'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, Bulgaria and Liechtenstein 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, the Republic of Serbia and the Republic of Macedonia are at various stages of development and in certain areas are successively coming into line with the EU's directives. In May 2009, the European Commission also published a recommendation concerning the calculation of termination rates, with the aim of harmonising the cost-based methods used within the EU and, consequently, termination charges. A further objective is to reduce termination charges for mobile communication to a very low uniform level. 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. The implementation of number portability is planned for the end of 2011. In Bulgaria, the gradual lowering of termination charges was initiated and number portability introduced in 2009. The national termination charge in Croatia was reduced from 10.8 to 9.2 euro cents for Vipnet and one other domestic operator, with a gliding path model agreed for further reductions to be made over the next three years. In Serbia, efforts to deregulate the telecommunications market and align framework conditions to those of the EU are still in their infancy. In Liechtenstein, which is a member of the European Economic Area, the old EU roaming rules remain in force; the new regulation is expected to become effective by the end of June 2010. Finally, in Slovenia, a decision was made in September 2009 to harmonise termination charges for all mobile operators at 3.24 euro cents by January 2013.

Technology Risk (A): Moody's ratings consider how exposed a company may be to technological advancement and how well positioned it may be to handle such developments. TA is developing an attractive broadband product portfolio by gradually combining its hitherto separate network infrastructures for voice, data and internet into an integrated next-generation all-IP-based network. In 2009, TA began the roll-out of the glass fibre-based Next Generation Network (NGN). Austria's position at the forefront of the development of mobile broadband has undoubtedly been driven by the extremely bullish approach of operators to High Speed Packett Access (HSPA). Mobilkom Austria was the first major European operator to launch HSDPA, which permits transmission speeds of up to 3.6 Mbit/s. TA has heavily invested in rolling out HSDPA to cover the country's major cities. The group has also become the first operator to launch an HSDPA network in Croatia and Bulgaria (with more than 50% of the population covered). While this assessment is largely qualitative, a quantitative measure that can prove helpful is capital expenditure (capex)/revenues, which was 15.5% in the wireline business and 12.9% in the wireless business as of December 2009. Therefore, Moody's has awarded TA a score of A for this factor.

Market Share (Aa): The relative positioning of a telecoms operator within any given segment is important to its rating outcome as it is indicative of the likely sustainability of its operating position and ability to exercise control over the nature and pace of development. Moody's has scored TA Aa for this factor, based on its leading positions in the fixed-line and wireless markets (Austria, Bulgaria, Belarus and Croatia).TA was poorly prepared for deregulation in 1999 and, consequently, the group rapidly lost market share in 1999-2002. This trend was reversed in 2002 and since then TA has increased its market share, reaching its publicly stated objective of 57%-58% market share of voice traffic. As of March 2010, TA, which dominates the market as the incumbent provider, reported a voice traffic market share of more than 60%. Thanks to mobile broadband, Mobilkom Austria increased its subscriber market share to approximately 42.4% as of March 2010. In Bulgaria, Mobiltel's estimated market share was approximately 50.1% (Q1 2010). Additionally, TA is the second-largest player in the Croatian mobile market, where it holds a market share of 43.7%, and in the underpenetrated mobile markets of Slovenia and Belarus, where it holds market shares of 28.2% and 41.2%, respectively as of Q1 2010. Overall, in Moody's view, there is still potential for further growth in the Slovenian and Belarusian markets, where the penetration rates of the population are only 101.7% and 105.3%, respectively. Moody's expects TA to continue to pursue the acquisition and retention of profitable customers, rather than to focus strictly on market share growth. We do not view the entry of MVNOs - which buy access to operators' networks and resell mobile phone services under their own brands - as a threat in the short term in a market where service quality (rather than price) plays the major role.

Management's Financial Strategy (A): Management's financial strategy and tolerance to financial risk will directly affect TA's debt levels and credit quality, and hence is a key rating determinant. Moody's has awarded TA a score of A for this factor, based on its predictable financial policy balanced between stockholders and creditors - in other words, the absence of major shifts in public commitments to a strong investment-grade rating. In 2009, TA announced that it expects to generate FCF of approximately EUR 3.2 billion for the period 2009-12 (EUR 0.8 billion expected for 2010). Based on a stable dividend payout ratio of 65% of net income, Moody's expects the group to distribute some EUR 1.4 billion to shareholders. In addition, approximately EUR 1.75 billion will be earmarked for acquisitions in Eastern and South-Eastern Europe during this period. If acquisition targets are not met, we would then expect TA to increase its shareholder remuneration. Going forward, TA is committed to a prudent financial policy based on: An attractive and balanced dividend policy; The consideration of any share buyback, depending on the condition of financial markets and sustainability of operating performance (not expected for 2010); Cash allocated to sustain profitable growth; Capex of approximately EUR 0.8 billion for 2010, moving towards 13% of sales in 2012; Selective and attractive acquisitions: (i) a preference for in-market consolidation; and (ii) a focus on targets with clear growth potential (limited to Eastern and South-Eastern Europe); A net debt/EBITDA ratio of 1.8x-2.0x.

Operating Performance (Baa): The level and stability of operating margins is a key consideration in assessing risk to debt holders. When considering the scores for this factor, Moody's reviews the EBITDA margin trend, as well as the absolute level of EBITDA. Moody's has scored TA Baa for this factor, based on its slight EBITDA decline in recent years, to below 40%. The group has been able to maintain its EBITDA margin despite some pressure from higher subscriber acquisition costs (SACs) as revenue growth is driven by low-margin services (TV, international carriers). The measurement of trends in the EBITDA margins reveals the trajectory of a company's earnings, and so is a leading indicator of business performance. Moody's believes that revenues in TA's wireline business will continue to decline in the current environment, with lower traffic volumes more than offsetting the asymmetric digital subscriber line (ADSL) contribution. Nevertheless, we also believe that the TA's trend for line losses has slowed to 1%, from the 6%-9% that we have seen in previous years. The group is implementing several strategies with a view to seeking further growth in its wireline business, including: Increased customer loyalty and retention through attractively priced packages and innovative products (2/3 and 4-Play bundle offers with significantly higher speeds launched, such as aonkombi and aonSuperkombi, which helped TA to gain fixed lines in Q4 2009 and Q1 2010); Efficiency improvements and streamlined operating costs (a reduction in the annual overhead expenditure). TA saved EUR 213 million in 2008-2009; The convergence of the wireline and wireless businesses: alignment of domestic operations to build a convergent player scheduled for summer 2010.

In Moody's view, increased subscription to packages and broadband growth should help to offset the negative pressure on TA's fixed-line revenues going forward. The Austrian mobile market is severely affected by price declines caused by the fierce competition and regulatory measures (MTRs and roaming), which are exerting pressure on operators' revenues. TA's objective is to preserve its customer base through: (i) value-added products with new content and data services; (ii) special low price offers; and (iii) increasing the use of mobile data services. Additionally, TA seeks to achieve further growth through its current international operations and by exploring further value-enhancing acquisitions in Eastern and South-Eastern Europe.

Financial Strength : TA displays a strong operating cash flow and business profile. Moody's has a stable outlook on TA's rating based on the strength of those credit metrics, the group's cash-usage policy until 2012 and its commitment to financial performance targets.

Liquidity

TA's liquidity profile is more than sufficient to cover its remaining debt maturities and other cash demands, including capex and dividend payments. Over the next 12 months, Moody's expects TA to generate more than EUR 1.6 billion of funds from operations (after tax and interest payments). The main uses of such cash include dividends of around EUR 300 million and capex of approximately EUR 700 million, as well as debt repayments of around EUR 1.4 billion. At the end of March 2010, TA had around EUR 230 million in cash and cash equivalents. External liquidity sources are robust, including EUR 1 billion worth of bank facilities, which are currently unutilised and can be drawn at any time. The group is not subject to material adverse change clauses or financial covenants.

Rating Outlook

The A3 rating of Telekom Austria has a stable outlook based on the strength of Telekom Austria's operations, the implicit support from the government and the expectation that the company will remain prudent in terms of making use of its financial flexibility. TA is most sensitive to changes in the BCA, followed by changes in the probability of government support, whilst Austria's Aaa rating and the default dependence are less likely to change. An increase in the support factor would occur if there were concrete indications of a substantial increase in the government's stake in the company or strong verbal intervention in TA matters, which would signal increasing government and reputational concerns. A decrease in support levels would occur if there were concrete indications of a substantial further reduction of the government's stake in the company. An increase in the support assumption from medium to high could result in a rating upgrade of up to two notches. Reduction of support from medium to low would result in a rating downgrade of one notch.

What Could Change the Rating - Up

Strengthening of debt protection ratios resulting from improving operational cash flows and prudent financial policies. Assuming no change in levels of government support and dependence, the rating would have positive pressure if no further substantial cross border investments were to be made and if, for example, it was clear that RCF to Debt was going to exceed 35% and debt to Ebitda to be lower than 1.5x on a sustainable basis.

What Could Change the Rating - Down

The company has some financial flexibility at the current rating level. Additional acquisitions, well in excess of free cash flow available, or deteriorating operating performance leading to additional debt and deterioration of the debt protection ratios could put pressure on the rating. For example if RCF to Debt were to drop to about 25% or debt to Ebitda to exceed 2.5x. In addition to the factors listed above affecting the baseline credit assessment, the ratings may also be impacted by changes in the ratings of the supporting government, or by changes in the other GRI factors.

Recent Developments

Following the approval of the budget by the Supervisory Board on December 9 2009, TA announced its performance expectations for the financial year 2010. Management expects the difficult environment during 2009 to prevail also in 2010. Negative factors include ongoing fixed-to-mobile substitution in Austria, continued price pressure in TA's major markets and the effect from regulatory induced lower roaming prices as well as mobile termination rates in Austria, Bulgaria, Croatia and Slovenia. Furthermore, the introduction of taxes levied on selected mobile communication services in Croatia and the Republic of Serbia poses an additional burden. Revenue for 2010 is expected to amount to about euro 4.7billion. TA has initiated significant cost reduction programs addressing both staff and non-staff related expenses to mitigate the impact from lower revenues. Including the expected cost savings, EBITDA should reach about euro 1.6 billion. Depending on the speed of migration to an All-IP based voice network in the Fixed Net segment, capx are forecasted to reach up to euro 800million. This amount does not reflect a material roll out of fiber, which is not expected to start in 2010. TA confirmed its shareholder distribution policy through 2012. Management remains committed to its capital allocation policy within the 2.0 to 2.5 x Moody´s adjusted net debt/EBITDA target balance sheet structure and provided stability in its main foreign currencies and operations. In light of the ongoing challenging operating environment, management has excluded any share buyback in 2010.

Rating Factors

Telekom Austria AG

Rating factors	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Size, Scale and Business Model							
a) Size and scale				X			
b) Business model and Competitive Environment		X					
Factor 2: Operating Environment							
a) Regulatory and Political			X				
b) Technology Risk			X				
c) Market Share		X					
Factor 3: Strategy and Financial Policies							
a) Management's Financial Strategy			X				
Factor 4: Operating Performance							
a) EBITDA Margin				X			
b) EBITDA Trends				X			
Factor 5: Financial Strength							
a) Total Debt / EBITDA				2.5x			
b) RCF / Adjusted Debt				26.55%			
c) FCF / Adjusted Debt					7.28%		
d) (FFO + Interest Expense) / Gross Interest Expense			7.3x				
e) (EBITDA - Capex) / Gross Interest Expense				4.5x			