



RATING ACTION COMMENTARY

Fitch Affirms Telefonica Deutschland at 'BBB', Outlook Stable

Mon 15 Mar, 2021 - 5:35 AM ET

Fitch Ratings - Frankfurt am Main - 15 Mar 2021: Fitch Ratings has affirmed Telefonica Deutschland Holdings AG's (TEF DE) Long-Term Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook and senior unsecured rating at 'BBB'.

The ratings reflect TEF DE's solid position in the German telecoms market, improved network quality and low leverage. We expect the company to maintain a prudent approach to its leverage policy, leaving healthy headroom below its target of 2.5x net debt/OIBDA (company definition; 1.4x in 2020) despite an increase in capex. We also expect competitive intensity in Germany to gradually increase in the medium term as one of TEF DE's main wholesale customers, 1&1 Drillisch, builds out its own network. We believe TEF DE has sufficient time and resources to address this risk and substantial flexibility to manage its leverage accordingly.

TEF DE is the largest mobile network operator in Germany by subscriber and the second-largest by revenue, with 36% subscriber and 33% revenue market shares at end-4Q20.

KEY RATING DRIVERS

Feedback

Low Leverage Sustainable: We expect TEF DE's funds from operations (FFO) net leverage to gradually increase to 1.0x by 2024 from 0.5x in 2021, driven primarily by accelerated investments in 5G roll-out. Despite this increase the company will retain comfortable headroom below Fitch's downgrade threshold of 2.3x FFO net leverage. The sale of 10,100 mobile sites to Telxius in 2020 has improved TEF DE's leverage headroom and provided substantial flexibility to accelerate investments in 5G roll-out.

FCF Margin to Remain Positive: Higher capex will put pressure on pre-dividend free cash flow (FCF) in 2021-2022. However, we expect FCF margin to remain positive in low single digits during this period before improving to mid-single digits from 2023 as capex decreases.

Competition to Increase: Fitch's base-case scenario assumes competition in the German telecoms market will gradually increase in the medium term as 1&1 Drillisch focuses on customer acquisition and porting its existing customer base to its own network to support the economics of deploying a mobile network. Defensive moves from other telecoms operators may increase overall competitive intensity, with a greater focus on fixed-mobile bundled offerings in particular, similar to what we have seen in other European markets following the entry of a new network player.

More visibility on TEF DE's competitive position in the long term and on the performance of its own brands in light of 1&1 Drillisch's network roll-out would be a prerequisite for a positive rating action.

Improved Network Quality: TEF DE was able to largely catch up in mobile network quality with its main peers Deutsche Telekom and Vodafone in the last several years, which positively impacts its perception by customers and its churn rates. Accelerated investments into 5G in the next two years, combined with active network-sharing agreements with other operators, should help TEF DE remain competitive in network quality and secure a cost-efficient fulfilment of coverage obligation attached to 5G licenses.

Rational Fixed-line Strategy: TEF DE's access to Deutsche Telekom's VDSL and fibre networks as well as to cable companies' networks strengthens the company's bundling capacity, which may be helpful if competition in fixed-mobile convergent products increases. TEF DE focuses primarily on the mobile segment and wholesale access to third-party networks allows it to remain competitive without having to make substantial investments in infrastructure.

New Leverage Thresholds: Fitch has changed its upgrade/downgrade thresholds to 1.5x/2.3x FFO net leverage from 2.5x/3.25x FFO-adjusted net leverage and added an additional upgrade trigger cash flow from operations (CFO)-capex/total debt. The change reflects Fitch's revised approach to leverage metrics following the introduction of IFRS 16 lease accounting and associated changes made to our Corporate Rating Criteria and recalibration of the telecoms Navigator leverage thresholds. The additional cash-flow-based metrics in response to the complexities of IFRS 16 adoption improve comparability across peers.

We forecast CFO-capex/total debt at 3.2% in 2021 due to high capex. This should improve to the teens from 2023.

No Rating Impact from Parent: TEF DE is broadly rated on a standalone basis, reflecting its status as a public company with independent management and its own financial policy. Even with cash pooling in place and no formal restrictions on dividend payments, links to its parent Telefonica S.A (BBB/Stable) are viewed as weak to moderate.

DERIVATION SUMMARY

TEF DE has strong market positions in the German mobile market. Unlike its peers, the company derives a significant share of its wholesale revenue from MVNOs, which exposes it to some revenue volatility in the long term as its main wholesale partner, 1&1 Drillisch, rolls out its own network.

TEF DE's operating profile is weaker than that of its larger and more diversified European telecoms peers such as Deutsche Telekom AG (BBB+/Stable), Orange S.A. (BBB+/Stable) and Vodafone Group plc (BBB/Stable), which have greater scale and geographic diversification that can help mitigate potential weakness in domestic performance. Other peers focused on domestic markets, such as Royal KPN N.V. (BBB/Stable), NOS, S.G.P.S., S.A. (BBB/Stable) and BT Group (BBB/Stable), have higher leverage but benefit from strong domestic positions in both mobile and fixed line and from the ownership of substantial fixed-line infrastructure.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

-Flat revenue in 2021, as negative impact from Covid-19 and mobile termination-rate cuts mitigate roaming revenue growth from 2H21 and stronger revenue in fixed-line segment and handset sales. This is followed by low single-digit revenue growth per annum in 2022-2024

-Fitch-defined EBITDA margin to decline to 22.6% in 2021 from 23.1% in 2020, reflecting increase in lease costs for divested tower assets. EBITDA margin at around 23% in 2022 and modestly improving in 2023-2024

-Capex excluding spectrum at 18% of revenue in 2021, 16.5% in 2022 and 14%-15% in 2023-2024

-Dividends to increase by EUR0.1 per share per year in 2022-2024

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- FFO net leverage sustained at below 1.5x and accompanied by greater visibility on the company's long-term competitive position

- CFO-capex/total debt sustainably at or above 12%

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-FFO net leverage consistently expected to exceed 2.3x

-Higher-than-expected competitive pressure, in particular, from 1&1 Drillisch impacting TEF DE's market share and wholesale revenue

Feedback

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and

worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity: TEF DE had EUR1.3 billion of cash and equivalents on its balance sheet and access to EUR2 billion of undrawn facilities as of end-2020. These, together with its EUR0.5 billion proceeds from the Telxius transaction expected in 2021, are sufficient to fund debt maturities and projected negative post-dividend FCF over the next four years.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
O2 Telefonica Deutschland Finanzierungs GmbH		

ENTITY/DEBT	RATING			PRIOR
● senior unsecured	LT	BBB	Affirmed	BBB
Telefonica Germany GmbH & Co. OHG				

[VIEW ADDITIONAL RATING DETAILS](#)

FITCH RATINGS ANALYSTS

Evgeniya Chernyaeva

Associate Director

Primary Rating Analyst

+49 69 768076 138

Fitch Ratings – a branch of Fitch Ratings Ireland Limited

Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

Slava Bunkov

Senior Director

Secondary Rating Analyst

+7 495 956 9931

Damien Chew, CFA

Senior Director

Committee Chairperson

+44 20 3530 1424

MEDIA CONTACTS

Adrian Simpson

London

+44 20 3530 1010

adrian.simpson@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Feedback

[Corporates Notching and Recovery Ratings Criteria \(pub. 14 Oct 2019\) \(including rating assumption sensitivity\)](#)

[Parent and Subsidiary Linkage Rating Criteria \(pub. 26 Aug 2020\)](#)

[Corporate Rating Criteria \(pub. 21 Dec 2020\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

[Dodd-Frank Rating Information Disclosure Form](#)

[Solicitation Status](#)

[Endorsement Policy](#)

ENDORSEMENT STATUS

O2 Telefonica Deutschland Finanzierungs GmbH
 Telefonica Deutschland Holding AG
 Telefonica Germany GmbH & Co. OHG

EU Issued, UK Endorsed
 EU Issued, UK Endorsed
 EU Issued, UK Endorsed

DISCLAIMER

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, THE FOLLOWING [HTTPS://WWW.FITCHRATINGS.COM/RATING-DEFINITIONS-DOCUMENT](https://www.fitchratings.com/rating-definitions-document) DETAILS FITCH'S RATING DEFINITIONS FOR EACH RATING SCALE AND RATING CATEGORIES, INCLUDING DEFINITIONS RELATING TO DEFAULT. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS

RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR WHICH THE LEAD ANALYST IS BASED IN AN ESMA- OR FCA-REGISTERED FITCH RATINGS COMPANY (OR BRANCH OF SUCH A COMPANY) CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH RATINGS WEBSITE.

[READ LESS](#)

COPYRIGHT

Copyright © 2021 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed. The information in this report is provided "as is" without any representation or warranty of

any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see <https://www.fitchratings.com/site/regulatory>), other credit rating subsidiaries are not listed

on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

[READ LESS](#)

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's [Regulatory Affairs](#) page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

[Technology, Media, and Telecom](#) [Corporate Finance](#) [Europe](#) [Germany](#)

Feedback