Research Update:

Deutsche Telekom AG Outlook Revised To Positive On Strong Operating Performance; 'BBB/A-2' Ratings Affirmed

April 22, 2022

Rating Action Overview

- After Deutsche Telekom AG's (DT) solid 2021 full-year results, including 3.5% organic growth in service revenue, S&P Global Ratings expects the company will deliver steady operational performance, underlined by EBITDA growth and robust free operating cash flow (FOCF), and driven by increased service revenue, synergies from the U.S. merger, and contained capital expenditure (capex).
- After $9.3 billion of spending on spectrum in the U.S. in 2021, deleveraging headwinds will persist in 2022 due to significant increases in lease liabilities, resulting from recent U.S. tower contract renewals, but will subside thereafter, paving the way for accelerated deleveraging from 2023.
- We therefore revised the outlook to positive on DT and its fully owned financing subsidiary Deutsche Telekom International Finance B.V. We affirmed our 'BBB/A-2' long- and short-term issuer credit ratings on the companies.
- The positive outlook reflects a potential one-notch upgrade within two years, if the S&P Global Ratings-adjusted ratio of debt to EBITDA improves to sustainably less than 3.5x, funds from operations (FFO) to debt improves to 25%, and FOCF to debt before spectrum payments improves to 10%. We view this as possible by end-2023.

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Rating Action Rationale

The outlook revision reflects our view that DT's credit metrics will reach upside triggers in full-year 2023. The group generates robust free cash flows (about €9 billion in 2021 before spectrum and after lease payments) and its sound operational performances translate into growing EBITDA (7.8% in reported adjusted core EBITDA after lease in 2021, and 4.8% outside the U.S.). This has not led to stronger credit metrics so far, due to heavy spectrum investment in the U.S. in 2021 and recent significant tower liabilities inflation. These headwinds will subside going forward. We believe that DT's steady operations and strong FOCF, combined with increasing cost synergies reaped in the U.S., will drive material deleveraging by 2023. Therefore, we foresee DT's S&P Global Ratings-adjusted debt to EBITDA likely falling to less than 3.5x by 2023, down from an average of 3.8x over 2020-2022. In our view, metrics could slightly deteriorate this year on higher lease liabilities, but should sharply improve thereafter, reaching upside triggers in 2023 and progressing further in 2024.

After 2023, DT's financial policies should lead to further strengthening of its credit profile. The company's reported leverage has been outside its policy parameters since 2020, due to the acquisition of Sprint in the U.S. and spectrum investments thereafter. At this stage, we believe that DT could return to the higher end of its leverage comfort zone, of 2.25x-2.75x, in 2024, and think this will translate into S&P Global adjusted metrics strengthening to comfortably less than 3.5x.

We think DT's business risk profile ranks ahead of its rated peers. We think DT exhibits the strongest business risk profile in the EMEA telecoms sector (see "EMEA Telecoms: Relative Strength Ranking 2022," published March 29, 2022, on RatingsDirect). We also believe competition in the German market is characterized by rational mobile network pricing and predictable conditions in fixed broadband, and is thus benign compared with other large European markets. Germany has three established mobile network operators and one emerging operator.

In addition, we believe DT's U.S. assets and its Central and Eastern European (CEE) assets provide a strong degree of additional credit protection.

We do not adjust pro rata for DT's effective economic interest in T-Mobile U.S. (TMUS). Although DT's economic interest in TMUS is limited to 48%, DT effectively controls the company and fully consolidates TMUS in its results. We do not adjust the credit metrics to reflect DT's economic interest as we estimate that the difference between the full consolidation figures, as opposed to the pro rata figures, is not material and doesn't meaningfully distort the key credit metrics. In addition, we note DT intends to take a majority economic stake, through various possible mechanisms, including by not selling its TMUS shares when the latter launches share buybacks, which we have assumed will start in 2023.

Costs of ongoing fiber layout in Germany are captured in our base case and we do not adjust pro rata for rural deployments via off-balance-sheet joint ventures as they aren't material. DT has already completed the transition of its core network to All-IP and deployed fiber in its backbone, down to street cabinets in urban areas. Ongoing broadband speed upgrades, including through the use of super-vectoring technology, has therefore likely contributed to the 6% fixed broadband revenue growth in 2021. That said, the fiber to the home (FttH) footprint in Germany remains among the lowest in Europe, at less than 10% of households, and DT is facing competition from cable infrastructure suppliers. DT is therefore seeking to accelerate the roll-out of fiber over the last mile to retail customers' premises, with the aim of connecting 10 million households with optical fiber by 2024. At this stage, we do not expect net investment will materially increase, due to savings generated by the shift to all IP and other optimization initiatives. We also note that DT is rolling out fiber investments in rural areas through off-balance-sheet joint ventures (JVs), but we think they are not material enough for us to adjust DT's metrics pro rata in the foreseeable future.

Outlook

The positive outlook reflects the assumption that from 2023 DT's EBITDA will sharply increase, leading to a significant reduction in leverage from 2023 onwards. In particular, we anticipate that the group's adjusted leverage will drop to less than 3.5x in 2023 and further thereafter.

Upside scenario

We could raise the rating within two years if credit metrics sufficiently strengthen, such that S&P Global Ratings-adjusted debt to EBITDA, FFO to debt, and FOCF to debt before spectrum payments improve to less than 3.5x, to 25%, and to 10%, respectively. We would also look for prospects of a further strengthening afterwards, as DT continues to move toward its financial policy parameters.

Downside scenario

Failure to sufficiently strengthen credit metrics could remove the upside potential. This could stem from a more aggressive financial policy than currently foreseen, or any material operational setbacks.

Company Description

Bonn, Germany-headquartered DT is one of the world's largest telecommunications operators. It mainly offers fixed and mobile telecommunication services, to retail and business customers. The company's geographical EBITDA split in 2021 was about 40% Europe (two-thirds in Germany), and about 60% U.S. DT's largest shareholder is the German state, which has a direct stake of 14% and an indirect stake of 17% held through the German government-owned bank KfW.

Our Base-Case Scenario

Assumptions

- A dollar appreciation against the euro in 2022 followed by a depreciation in 2023-2024, with an average exchange rate of $1.10 per euro in 2022, $1.13 in 2023, and $1.17 in 2024, compared with an average of $1.18 in 2021
- Group annual revenue growth of 1% on average over 2022-2024, after an around 2% negative scope impact in 2022 from the deconsolidation of the disposed T-Mobile Netherlands, and our assumption of the dollar depreciation over 2023-2024
- A S&P Global Ratings-adjusted EBITDA margin for DT of 34% in 2022, down from 35% in 2021 due to the temporary effect of lower handset leasing revenue in the U.S., then rebounding sharply toward 40% by 2024, as cost savings from the merger integration accelerate in the U.S., and assuming moderate margin progression in Germany and Europe
- Capex, excluding spectrum acquisitions, of about 16% of sales on average over 2022-2024, including still significant spectrum outlays that will drop sharply from 2023

- Cash dividends of about €3.5 billion-€3.8 billion per year
- No share buybacks in 2022, then progressively starting in 2023 at the U.S. subsidiary. The impact of this should be mitigated once DT has secured a controlling stake in TMUS, at which time, it could start to sell its TMUS shares, while keeping its controlling stake unchanged.
- About €1.7 billion of net cash proceeds in 2022 from the sale of T-Mobile Netherlands, net of the acquisition of additional shares in T-Mobile U.S.
- Lease liabilities increasing about 20% in 2022 following tower contract extensions

Key metrics

- S&P Global Ratings-adjusted debt to EBITDA about flat compared with 2021, at about 3.8x in 2022 (3.6x including the captive finance adjustment), then dropping to less than 3.5x in 2023 (under 3.4x including the captive adjustment)
- S&P Global-adjusted FFO to debt improving to about 25% by 2023, up from about 22% in 2021
- S&P Global Ratings-adjusted FOCF, excluding outlays on spectrum, of about 12% in 2022-2023, up from about 10% in 2021

Liquidity

We assess DT's liquidity as strong based on our expectation that liquidity sources will exceed uses 1.5x in the 12 months started Dec. 31, 2021 and by more than 1.0x in the subsequent 12 months. In addition, we think DT enjoys a high standing in capital markets and well-established, solid relationships with its banks, as demonstrated by frequent issuance of notes and credit facilities to a variety of investors and in multiple currencies.

As of Dec. 31, 2021, we estimate that principal liquidity sources over the ensuing 12 months include:

- Cash and liquid investments of about €3.6 billion at the parent, pro forma for $2.25 billion of intra-group loans recently repaid by TMUS
- €12 billion available under undrawn committed credit facilities maturing within two-to-three years and which do not contain covenants nor material adverse clauses
- Cash FFO (excluding the U.S.) of about €8 billion
- €3.8 billion proceeds from the sale of T-Mobile Netherlands

For the same period, we estimate that principal liquidity uses include:

- Debt maturities of about €4.2 billion
- Capex (excluding the U.S., and excluding spectrum payments) of about €8 billion
- Dividend payments of €3.5 billion
- €2.1 billion spent on TMUS share acquisitions from Softbank

Covenants

DT is not subject to any maintenance covenants in its outstanding bonds or existing credit facilities.

Issue Ratings - Subordination Risk Analysis

Capital structure

About half of consolidated external debt is at the U.S. level, and the rest mainly at the parent or fully owned subsidiary DT Finance. The latter is used as a finance vehicle and its issues are guaranteed by the parent. Based on the 48% existing economic stake of DT in U.S. subsidiary TMUS, the structural subordination ratio is about 40%.

Analytical conclusions

Although parent-level creditors will be structurally subordinated in respect to the U.S. assets, which carry a high level of debt, we continue to rate the unsecured debt at DT at the same level as the issuer credit rating. This considers that the pro rata structural subordination ratio remains lower than 50%. In addition, we note the liquid and considerable equity value of DT's stake in TMUS, which provides a strong cushion to the creditors at parent level. Conversely, in the situation of a default at TMUS, the equity value would likely remain substantial, given the value of spectrum and network assets. Moreover, a substantial proportion of cash flows come from outside the U.S., while DT's debt is not cross-defaulted with its U.S. subsidiary's debt and the latter does not benefit from any guarantee from the parent.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Positive/A-2

Business risk: Strong

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Strong

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: Strong (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

- Related government rating: AAA
- Likelihood of government support: Low (no impact)

ESG credit indicators: E-2, S-2, G-1

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Deutsche Telekom AG		
Issuer Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
Senior Unsecured	BBB	
Commercial Paper	A-2	
Deutsche Telekom International Finance B.V.		
Issuer Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
Senior Unsecured	BBB	