Research Update:

Deutsche Telekom AG Downgraded To 'BBB' From 'BBB+' On Sprint Acquisition's Completion; Off Watch

April 1, 2020

Rating Action Overview

- On April 1, 2020, German telecom operator Deutsche Telekom AG's (DT's) subsidiary, U.S. wireless carrier T-Mobile U.S., closed its acquisition of Sprint Corp. in an all-stock transaction for $26 billion.
- Although we predict long-term benefits for DT's market and spectrum positions in the U.S., we see integration risks, subdued free operating cash flow (FOCF) from heavy integration costs, and materially higher leverage for the foreseeable future.
- We foresee credits metrics materially weakening in 2020 and only gradually recovering thereafter, including pro forma S&P Global Ratings-adjusted debt to EBITDA shooting up to about 3.8x in 2020, from about 3.0x in 2019.
- We are therefore lowering our long-term issuer credit ratings on DT, and its fully owned financing subsidiary Deutsche Telekom International Finance B.V., and the issue ratings on the company, to 'BBB' from 'BBB+' and removing them from CreditWatch, where they were placed with negative implications April 29, 2018.
- The stable outlook reflects our assumption that adjusted leverage will progressively fall back after a spike in 2020, and remain sustainably below a commensurate 4x maximum level for the rating; and that FOCF to debt, excluding spectrum, will progressively bounce back from a trough of 5%-6% in 2020.

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Rating Action Rationale

The downgrade reflects DT's weaker credit metrics following the Sprint acquisition, with only modest near-term improvements. The higher overall leverage stems from the higher leverage at Sprint, as well as heavy integration costs of about $15-$16 billion over several years. We foresee DT's S&P Global-adjusted pro forma leverage rising to about 3.8x in 2020, before gradually receding over 2021-2022, but we do not see the ratio falling back to comfortably 3.5x before 2023.

We also foresee FOCF being constrained by hefty integration costs and capital expenditures of about $3.6 billion per year on average over 2020-2022. This leads to weak pro forma adjusted FOCF (before spectrum outlays) to debt at 5%-7% over 2020-2022, before a potential material rebound toward 10% from 2023 onwards.

In our view, DT's business risk profile will temporarily weaken somewhat, due to the integration's complexity. In the near term, the acquisition, and integration risks, will weaken our view of the company's business risk profile. We expect integration to take at least three years, given the sheer scale of the merger and because, in particular, T-Mobile and Sprint operate in different spectrum bands and use some different wireless technologies. In addition, we believe that the enlarged U.S. operations, which would contribute about 60% of group EBITDA compared with 45% in 2019, would still have a less-established market position, with about 29% postpaid market share, relative to DT's strong incumbent position in Germany, where the group enjoys about 39% subscriber market share in fixed broadband and a service revenue share of about 37% in wireless. Post-integration, however, we believe these factors would be offset by the combination's substantial benefits in terms of market share, spectrum holdings, and about $6 billion of cost synergies; and likely reduced competition in the U.S. wireless market in the near term due to industry consolidation.

Post-integration, we think DT's business risk profile will rank ahead of its rated peers. Assuming the integration's smooth completion, we think the company's business risk profile would be somewhat stronger than that of France-based Orange and U.K.-based Vodafone. In particular, we believe the German market, with three established and an emerging fourth mobile network operator and rational pricing and predictable conditions in fixed broadband, is somewhat more benign than the French market, where four fixed and mobile integrated players compete. In addition, we view DT's U.S. assets and its Central and Eastern European assets as providing a stronger degree of additional credit protection than Orange's portfolio of assets in Europe and emerging markets in Africa and the Middle East. We also see Telefonica's profile as the weaker of the latter profiles, given the group's significant exposure to several volatile markets and currencies in Latin America.

We fully consolidate the combined U.S. entity into the wider DT group in our analysis. Although DT's economic interest is limited to 43%, the company will effectively control 67% of the total voting rights (slightly higher than its current voting share in T-Mobile) through a proxy agreement with Softbank. Therefore, it will retain control of the asset, including the ability to determine key operating decisions and dictate financial policy. We further understand that DT will continue to define its public financial policy targets for the consolidated group, including the U.S. operations. Moreover, we estimate that the divergence between leverage computed fully consolidated, compared with pro rata, is not material. Therefore, we do not believe that the full consolidation view, as opposed to the pro rata view, meaningfully distorts the economic reality of key credit metrics.

Outlook

The stable outlook reflects the assumption that the integration of T-Mobile and Sprint will progress without major setbacks, but at the same time that cost synergies will be offset by near-term integration expense. The outlook also reflects our belief that DT will defend its domestic market positions in mobile and fixed broadband, and manage its domestic cost base effectively, supporting moderately increasing EBITDA in Germany. We anticipate the group's pro forma adjusted leverage will peak at about 3.8x in 2020 and progressively recede thereafter, and that its pro forma funds from operations (FFO) to debt and FOCF to debt, before spectrum, will gradually strengthen from the low 20% range and 5%-6% foreseen in 2020, respectively.

Upside scenario

We could raise the rating if these occur:

- The integration succeeds, with synergies at the combined U.S. operations, accompanied by continued solid performance in Germany; and
- Significantly strengthened credit metrics, such that S&P Global Ratings-adjusted debt to EBITDA, FFO to debt, and FOCF to debt before lease and spectrum payments, improved to comfortably less than 3.5x and to 25% and 10%, respectively.

In our base-case scenario, we think potential for this upside could exist in 2023.

Downside scenario

We could lower the rating if difficulties with the integration resulted in considerably weaker operating performance in the U.S. market than we expect, causing S&P Global Ratings-adjusted debt to EBITDA to durably exceed 4x; FFO to debt to weaken to less than 20%; or FOCF to debt, before spectrum and leases, to drop and remain sustainably below 5%.

Company Description

Germany-headquartered DT is one of the world's largest telecommunications operators. It mainly offers fixed and mobile telecommunication services. Pro forma the Sprint acquisition, we foresee the following geographical EBITDA split in 2020: about 40% Europe, two-thirds of this in Germany; and about 60% in the U.S. DT's largest shareholder is Germany, which holds a 14.5% direct stake and a further 17.4% indirect stake through the German government-owned bank KfW.

Our Base-Case Scenario

In our base-case scenario, we assume:

- A recession in the wake of the COVID-19 pandemic, with eurozone real GDP declining by 2% in 2020 from about 1.2% in 2019A and U.S real GDP declining 1.3% in 2020 from 2.3% growth in 2019. We do not envisage material near-term adverse effects of the recession, however, given the recurring, subscription-based business models and the fundamental, recession-resistant nature of the telecommunication services
- A dollar appreciation against the euro in 2020 followed by a depreciation in 2021-2022, with an exchange rate of $1.09 per euro in 2020, $1.12 in 2021, and $1.15 in 2022, compared with an average of $1.12 in 2019
- Group (excluding Sprint) annual revenue growth of 2% on average over 2020-2022, as the stronger growth rate at TMUS is partially offset by the depreciation of the U.S. dollar against the euro, and including about 0.5% growth in Europe on average
- Revenue growth for the DT group, including Sprint, of about 40% in 2020 pro forma a twelve month consolidation of Sprint, and negative 1.1% on average in 2021-2022, with flat service

revenue growth in the U.S., as growth on the legacy T-Mobile network will be offset by higher customer churn from Sprint's business through the integration, and after our assumed dollar depreciation in 2021-2022

- Pro forma S&P Global Ratings-adjusted EBITDA margins for DT of 28% in 2020, 29% in 2021, and 31% in 2022, down from 33% in 2019, based on IFRS 16 and including our handset leasing adjustment, constrained by the integration-related costs in the U.S., and mitigated by margin resilience in Germany and Europe
- Pro forma capital expenditures (capex), excluding spectrum acquisitions, of about 17%-18% of sales on average over 2020-2022, including integration outlays in the U.S., up from 16% in 2019
- $5 billion annual working capital requirements at the combined U.S. operations in 2019 and 2020, mostly in connection with handset leasing
- Cash dividends of about €3.1 billion annually, based on a level of 60 cents per share
- No share buybacks
- About €1.2 billion and €3.1 billion of cash proceeds in 2020 and 2023 from the disposal of Sprint's prepaid business, Boost

Based on these assumptions, we arrive at the following credit measures:

- S&P Global Ratings-adjusted debt to EBITDA, pro forma the Sprint integration, rising to about 3.8x in 2020, from about 3.0x in 2019. This is based on an IFRS16 basis and including the handset-leasing and captive adjustments, the increase stems from the higher leverage at Sprint level, and the net integration costs. We then anticipate the ratio to progressively recede, to 3.7x in 2021, and 3.5x in 2022, on somewhat increasing EBITDA and slightly lower debt
- S&P Global-adjusted FFO to debt weakening to 22% through 2020-2021, and improving to 24% in 2022
- S&P Global-adjusted FOCF, excluding outlays on frequencies, weakening to 5%-6% in 2020 before rebounding to 7% in 2021-2022

Liquidity

We assess DT's liquidity as adequate based on our expectation that liquidity sources will exceed uses 1.2x in the 12 months started Dec. 31, 2019. 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, 2019, we estimate that principal liquidity sources over the ensuing 12 months include:

- Cash and liquid investments of about €5.4 billion at the parent
- €12 billion available under undrawn committed credit facilities maturing within two-to-three years and which do not contain covenants nor material adverse clauses
- Sizable pro forma FFO of about €11 billion

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

- Debt maturities of about €6.2 billion
- Pro forma capex, excluding spectrum payments, of €19 billion

- Dividend payments of about €3.1 billion

Covenants

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

Issue Ratings--Subordination Risk Analysis

Capital structure

We foresee somewhat more than 60% of pro forma consolidated reported debt to be 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 43% existing economic stake of DT in U.S. subsidiary TMUS, we foresee pro forma structural subordination ratio of about 45%.

Analytical conclusions

Although parent-level creditors will be structurally subordinated in respect to the U.S. assets, which will carry a high amount of debt, we continue to rate the unsecured debt at DT at the same level as the issuer credit rating. This is considering 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 T-Mobile U.S., providing a strong cushion to the creditors at parent level. Conversely, in the situation of a default at T-Mobile U.S., 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 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/Stable/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)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Strong (no impact)
- Comparable ratings analysis: Neutral (no impact)

Stand-alone credit profile: bbb

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

Related Criteria

- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Deutsche Telekom AG		
Deutsche Telekom International Finance B.V.		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Watch Neg/A-2
Senior Unsecured	BBB	BBB+/Watch Neg
Ratings Affirmed		
Deutsche Telekom AG		
Deutsche Telekom International Finance B.V.		
Commercial Paper	A-2	