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Research Update:

Deutsche Telekom AG 'BBB+' Ratings Placed On CreditWatch Negative On Agreement To Buy Sprint Corp.

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Overview

- On April 29, 2018, German incumbent telecom operator Deutsche Telekom AG (DT) announced that its subsidiary T-Mobile U.S. had agreed to acquire U.S. mobile operator Sprint Corp. in a stock-for-stock transaction.
- Although we predict long-term benefits for DT's market and spectrum positions in the U.S., we see integration risk and substantial integration costs that will result in subdued free operating cash flow and materially higher leverage in the first two years after closing.
- We are therefore placing our 'BBB+' long-term ratings on DT on CreditWatch negative.
- The CreditWatch placement indicates that a one-notch downgrade is likely if the acquisition closes in the absence of operating performance significantly ahead of our base case and other material leverage-reduction measures.

Rating Action

On April 29, 2018, S&P Global Ratings placed on CreditWatch with negative implications its 'BBB+' long-term issuer credit rating on German incumbent telecommunications network operator Deutsche Telekom AG (DT) and its fully owned financing subsidiary Deutsche Telekom International Finance B.V.

We also placed on CreditWatch negative our 'BBB+' issue ratings on DT's senior unsecured debt.

At the same time, we affirmed our 'A-2' short-term issuer credit and commercial paper program ratings on DT.

Rationale

The CreditWatch placement reflects DT's announcement, on April 29, 2018, that its subsidiary T-Mobile U.S. (TMUS) has agreed to acquire U.S. mobile operator Sprint Corp. in a stock-for-stock transaction. We expect the acquisition will result in weaker free operating cash flow (FOCF) and higher leverage for at least two years after closing. We also take into account execution risk during the multiyear integration process.

We forecast that total integration costs of about $15 billion incurred over the first five years and higher debt at Sprint will increase S&P Global Ratings-adjusted debt to EBITDA for the DT group to 3.6x-3.9x in 2019 (assuming the transaction closes at the start of 2019). Similarly, we forecast that leverage will not revert to less than 3.5x before 2021, compared with our assumption of 3.1x-3.3x over this period without the transaction. Moreover, we project integration spending will depress cumulative FOCF (excluding spectrum costs) to about €11 billion-€13 billion during 2019-2021, compared with €20 billion-22 billion without the deal.

As a result, we expect our adjusted FOCF-to-debt ratio, excluding spectrum, will decline to about 3%-8% during 2019-2021, significantly below our forecast of 10%-13% over this period without the transaction. We think that integration is likely to take more than three years because T-Mobile and Sprint operate in different spectrum bands and partly use different wireless technologies. In addition, the migration of customers to T-Mobile's network from Sprint could be accompanied by customer service issues and higher churn. We also expect the consolidation of sales, service, marketing, and back-office functions, to be time-consuming, given the sheer size of the two companies.

In the short term, the acquisition would weaken our view of DT's business risk profile, in light of execution and integration risks, as well as our view that the enlarged U.S. operations would still have a less-established market position than DT's domestic business, but would contribute more than 60% of group EBITDA. However, over time, we believe these factors would be offset by the substantial benefits of the combination in terms of market share, spectrum holdings, synergies, and reduced competition in the U.S. wireless market due to industry consolidation.

We estimate that T-Mobile and Sprint would together hold about 26% of the U.S. postpaid market, compared with 30% for AT&T and 42% for Verizon, and that the entity would lead in prepaid with a share of about 40%. At the same time, both entities would jointly own about 50% of all spectrum available across different bands in the U.S., about the same amount as Verizon and AT&T together. We view this as a strategic advantage, as it would enable the company to remain aggressive on pricing while offering unlimited data plans, although we anticipate that Verizon and AT&T might try to take market share initially.

Importantly, we think removing a fourth network operator from the market will result in a better pricing environment over time. In addition, DT expects the combination to yield substantial run-rate synergies of more than $6 billion per year, of which about 65% will result from network consolidation, about 20% from sales and marketing functions, and the remainder from merging back-office functions. We estimate this will translate into EBITDA margin expansion of 8 percentage points or more over five years from about 29%-30% on a pro forma basis in 2018.

Our view of DT's financial risk after closing would be determined by the

group's increased leverage, and near- to medium-term pressure on FOCF for the first three to four years of the combination. In order to mitigate the build-up of S&P Global Ratings-adjusted leverage, DT has transferred its €3.2 billion stake in U.K. incumbent telecom operator British Telecommunications Group plc to its pension trust. However, this measure would not be sufficient to prevent our calculation of adjusted debt to EBITDA from rising to 3.5x or above for at least two years, from 3.0x at year-end 2017.

At the same time, DT expects its company-adjusted leverage to increase above its net debt to EBITDA target band of 2.0x-2.5x after closing before returning to the same band in 2021, marking a departure from its existing financial policy for at least two years. Furthermore, leverage metrics are diluted, in our view, by the favorable impact of handset leasing, mainly at Sprint, which boosts EBITDA. Without the capitalization of handset costs due to the handset leasing, our adjusted leverage would be about 0.3x-0.4x higher. We estimate that continued high network investments coupled with integration spending would reduce cumulative FOCF by about €8 billion-€10 billion over 2019-2021.

We fully consolidate the combined U.S. entity into the wider DT group in our analysis. Although we acknowledge that DT's economic interest would be limited to 42%, DT would effectively control 69% of the total voting rights (slightly higher than DT's current voting share in T-Mobile) through a proxy agreement with Softbank, and therefore retain control of the asset, including the ability to determine key operating decisions and dictate financial policy. We further understand that DT would continue to define its public financial policy targets for the group on a consolidated basis, including the U.S. operations. Moreover, given the sheer size of the asset's contribution to group EBITDA and FOCF, we believe DT would consider providing some support to TMUS in a financial distress scenario, depending on the circumstances and within the limits set by its own credit documentation and the shareholder and governance structure.

In our base case, we assume:

- Real GDP growth of 2.9% in the U.S. and 2.4% in Germany in 2018 and 2.6% and 1.9%, respectively, in 2019, accompanied by low unemployment rates of 3.4%-3.5% in Germany and U.S. unemployment rates declining further to 3.6% in 2019 from 4.4% in 2017. We think these robust macroeconomic fundamentals will provide a favorable environment for up-selling of broadband and mobile, despite a limited link between business cycles and telecom spending.
- A dollar-to-euro exchange rate of 1.20/1, compared with an average of 1.13/1 in 2017.
- Closing of the acquisition on Jan. 1, 2019. Our assumptions for 2018 are based on DT on a stand-alone basis excluding Sprint.
- Net retail postpaid customer gains of 2.5 million-3.0 million at TMUS, and a stable to modestly rising mobile market share in Germany, but small incremental losses of broadband retail market share to cable and other broadband providers.

- Group revenue growth, excluding the negative effects of International Financial Reporting Standards rule 15, of up to 1.5% in 2018, based on strong customer and service revenue growth at TMUS, and about flat revenues in Germany and Europe, partly offset by the depreciation of the U.S. dollar against the euro.
- Pro forma revenue growth for the DT group, including Sprint, of 1%-2% in 2019 and negative 0.5% to positive 1% in 2020, compared with 0% to negative 1% in 2018. We expect revenue from 2019 through 2021 to be reduced by the disruption caused by the integration process and migration of Sprint customers to the T-Mobile network.
- Pro forma reported EBITDA margins for DT of 27%-29% in 2019, increasing to 29%-31% in 2020, after 28%-30% in 2018. Margin degradation in 2019 is due to our expectation of margin compression at Sprint, coupled with high integration expense, which would be offset over time by cost synergies.
- Pro forma S&P Global Ratings-adjusted EBITDA margins for DT of 32%-34% in 2019, expanding to 34%-36% in 2020, after 33%-34% in 2018, reflecting some margin expansion in Germany and Europe, which cushions the integration-related margin compression in the U.S.
- Pro forma capital expenditures (capex) as a percentage of sales, excluding spectrum acquisitions, of 17%-19% in 2019 and 15%-17% in 2020, after 17%-18% in 2018, reflecting high investments in fixed networks in Germany and in TMUS' and Sprint's mobile networks, plus integration capex.
- $5 billion-$6 billion annual working capital requirements at the combined U.S. operations in 2019 and 2020, mostly in connection with handset leasing.
- Cash dividends, including dividends at DT's Greek subsidiary OTE, of about €3.2 billion in 2018, and moving broadly in line with DT's free cash flow in 2019-2020.
- Share buybacks at TMUS and OTE and recent small purchases of TMUS shares by DT totaling €1.0 billion-€1.5 billion in 2018-2019 combined.

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

- S&P Global Ratings-adjusted debt to EBITDA, pro forma Sprint, of 3.6x-3.9x in 2019 and 3.5x-3.7x in 2020, following our projection of 3.2x-3.4x in 2018 for DT excluding Sprint, and 3.0x in 2017. The expected leverage increase in 2018 primarily stems from contracted acquisition spending and planned share buybacks at TMUS and OTE.
- Adjusted funds from operations (FFO) to debt of 20%-22% in 2019 and 22%-24% in 2020, following our projection of 25%-27% in 2018 for DT excluding Sprint, and 27.6% in 2017.
- Adjusted FOCF, excluding spectrum, of 3%-5% in 2019 and 5%-8% in 2020, compared with about 10% in 2017 and 9%-11% expected in 2018.
- Adjusted FOCF, including spectrum, of 0%-2% in 2019 and 3%-6% in 2020, after about 0% in 2017 and our forecast of 7%-8% for 2018.

Liquidity

We assess DT's liquidity as adequate based on our expectation that the ratio of liquidity sources to uses will exceed 1.2x in the 12 months started Jan. 1, 2018. 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 Jan. 1, 2018, we estimate that principal liquidity sources over the ensuing 12 months include:

- Cash and liquid investments of about €3.3 billion.
- An unused portion of €12.7 billion under available committed credit facilities totaling €12.9 billion, with an initial term of 36 months. After 12 months, the agreements can be extended by a further 12 months to restore the maturity of 36 months.
- Sizable FFO of about €18.5 billion-€19.5 billion.

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

- Debt maturities, including bonds called by TMUS, commercial paper, and finance leases, of about €4.6 billion.
- Capex, including spectrum payments, of €14 billion-€15.5 billion.
- Dividend payments, including dividends at OTE, of about €3.2 billion.
- Payments for contracted acquisitions, including UPC Austria, the 5% increase of DT's stake in OTE, Tele2 Netherlands, and Layer3 in the U.S., of about €2.7 billion.
- Share repurchases at TMUS and OTE of about €1 billion.
- Working capital needs of about €1 billion.

CreditWatch

We aim to resolve the CreditWatch after completion of the acquisition, which we expect to occur between the end of 2018 and mid-2019.

Provided that the acquisition closes without significant regulatory concessions, and that performance at T-Mobile and Sprint remains in line with our base case for 2018, we would likely lower our issuer credit rating on DT by one notch upon completion of the acquisition. This reflects our expectation of materially weaker FOCF and higher S&P Global Ratings-adjusted leverage during the first years after closing, as well as execution risks related to the multiyear integration process.

We would likely also lower the issue ratings on DT's senior unsecured debt by one notch in line with the issuer credit rating, but we don't expect to notch down the issue rating further. Although group-level creditors would be structurally subordinated in respect of the U.S. assets, which would carry a

high amount of debt, we expect that more than 30% of group EBITDA and an even higher portion of FOCF would still be generated by entities outside the U.S., thus providing sufficient asset coverage for group-level creditors.

We could affirm the rating if the transaction was abandoned, or if the expected weakening of credit metrics as a result of the acquisition was offset by materially stronger operating performance, combined with other material leverage reduction measures, such as asset disposals.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Watch Neg/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: Positive (+1 notch)

Stand-alone credit profile: bbb+
- Sovereign rating: AAA
- Likelihood of government support: Low (no impact)

Issue Ratings--Subordination Risk Analysis

Under DT's current structure excluding Sprint, we rate the group's senior unsecured debt at the same level as the issuer credit rating. This is because, out of about €58 billion of reported debt for the group at year-end 2017, secured debt and unsecured third-party liabilities at subsidiaries, notably TMUS and OTE, accounted for less than 25% of total debt. Therefore, we assess that subordination risk for group-level creditors is limited.

Related Criteria

- 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: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

CreditWatch Action

	To	From
Deutsche Telekom AG		
Deutsche Telekom International Finance B.V.		
Long-Term Issuer Credit Rating	BBB+/Watch Neg	BBB+/Stable
Senior Unsecured	BBB+/Watch Neg	BBB+

Ratings Affirmed

Deutsche Telekom AG	
Short-Term Issuer Credit Rating	--/--/A-2
Commercial Paper	A-2

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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