S&P Global
Ratings

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Research Update:

Deutsche Telekom Upgraded To 'BBB+/A-2' On Solid Deleveraging Trajectory; Outlook Stable

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Rating Action Overview

- Deutsche Telekom AG (DT) outperformed its 2022 guidance, and with the first-quarter 2023 results also raised its EBITDA guidance for the year. We expect the S&P Global Ratings-adjusted EBITDA margin to expand further as merger costs related to Sprint will decline, leading to a gradual improvement in the margin toward 40% by 2024, versus 34.7% in 2022.
- In addition, we anticipate a slowdown in capex at TMUS, which, in combination with an expanding EBITDA margin, leads us to expect that the company's adjusted FOCF will approach €20 billion annually in 2023-2024, compared with €12 billion in 2022.
- Furthermore, we expect leverage to gradually decline toward an adjusted leverage of 3.0x by year-end 2024, from 3.5x in 2022, based on DT's financial policy framework and further deleveraging priority, as well as its strong financial flexibility, including the remaining value of its 49% stake in GD Towers.
- We therefore raised our long-term issuer and issue credit ratings on DT and its fully owned financing subsidiary Deutsche Telekom International Finance B.V. to 'BBB+' from 'BBB'. The short-term ratings on both entities are affirmed at 'A-2'.
- The stable outlook indicates that DT will expand its adjusted EBITDA margin toward 40%, while capex to sales will decline toward 15% of sales, which in our view should lead to an annual FOCF approaching €20 billion and leverage comfortably below 3.5x.

Rating Action Rationale

Synergies and fewer one-off costs at TMUS will drive strong improvement in the S&P Global Ratings-adjusted EBITDA margin. We expect DT's adjusted EBITDA margin to approach 40% during 2023, a sharp improvement from 34.7% in 2022. The improvement is primarily driven by TMUS, which posted an improvement in its adjusted EBITDA margin during first-quarter 2023 to about 42.0%, compared with 34.0% during first-quarter 2022. The improvement stems from DT's solid progress toward the targeted $8.0 billion of annualized synergies by 2024 following the

Sprint merger, as well as a decline in related costs. In addition, we expect the healthy growth in service revenue across geographies to be able to mitigate any cost pressure from inflation.

We expect capex to slow down and DT to shift its focus from the 5G rollout in the U.S. to the fiber to the home (FTTH) rollout in Europe. We think capex will drop to about 14%-16% of sales in 2023 from 18.4% in 2022. This primarily relates to a drop in capex in the U.S., from about $13 billion in 2022 to $9.5 billion, following years of heavy investments in its 5G network, which now covers 98% of the American population. However, we expect the fiber rollout in Germany to intensify because the company has targeted FTTH coverage to increase by 2.5 million homes in 2023. We also expect FTTH investments in the European portfolio, because the company targets 10 million homes passed by 2024, up from 8.2 million in first-quarter 2023. That said, we expect the normalization in capex and strong improvement in the adjusted EBITDA margin to drive an equally strong improvement in FOCF approaching €20 billion on an S&P Global Ratings-adjusted basis (and excluding spectrum payments), from €11.7 billion in 2022 and €5.9 billion in 2021. In addition, DT is rolling out fiber investments in rural areas through off-balance-sheet joint ventures, but we think they are insufficiently material for us to adjust DT's metrics pro rata in the foreseeable future.

During the first quarter of 2023, DT accomplished two milestones: it reached a 50% ownership in TMUS and completed the sale of a 51% stake in GD Towers. DT passed the 50% ownership mark in TMUS primarily by abstaining from participating at the share buybacks conducted at the U.S. entity in recent quarters. However, like DT, we already fully consolidate TMUS, so the majority stake has a limited impact on our credit metric. That said we expect the company to continue increasing its ownership during 2023, to allow for a majority cushion. DT has authorized a $14 billion share buyback program, of which about $7.8 billion was utilized at the end of first-quarter 2023. The 51% sale of GD Towers resulted in cash inflow of €10.7 billion during first-quarter 2023, but also led to an increase in reported operating lease liabilities of about €5.0 billion (a net increase of €3.0 billion as ground leases would be lost). In addition, the remaining 49% stake will be deconsolidated but over time will likely generate dividends, which we expect to add to our adjusted EBITDA.

We expect DT to reach its financial leverage corridor of 2.25x-2.75x by late 2024 or early 2025. In our view, given the improved free cash flow profile, which we expect will lead to adjusted free cash flow approaching €20 billion over the forecast period and several milestones completed, DT has, in our view, the capacity and flexibility to be back in the upper end of its leverage corridor during 2024 of net debt to EBITDA of 2.25x-2.75x (2.5x-3.0x adjusted).

Outlook

The stable outlook indicates our expectation that DT will expand its adjusted EBITDA margin toward 40%, while capex to sales will decline toward 15% of sales, which in our view should lead to an annual FOCF approaching €20 billion and leverage comfortably below 3.5x.

Downside scenario

We could lower the rating if DT fails to sufficiently strengthen credit metrics so leverage rebounds above 3.5x. This could stem from a more aggressive financial policy than we currently foresee, or any material operational setbacks.

Upside scenario

We could raise the rating if DT's cash flow metric improved to the extent that FFO-to-debt exceeds 30% of debt and free cash flow exceeds 15% of debt, while at the same time deleveraging to below 3.0x.

Company Description

DT is one of the world's largest telecommunications operators, with headquarters in Bonn, Germany. It mainly offers fixed and mobile telecommunication services to retail and business customers, as well as IT services. The company's geographic EBITDA split in 2022 was about 36% Europe (two-thirds in Germany) and about 64% 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

- In the U.S. we expect real GDP growth of 0.7% in 2023 and 1.2% 2024, compared with 2.1% 2022, and consumer price index (CPI) growth of 4.2% in 2023 and 2.4% 2024, compared with 8.0% in 2022.
- In the eurozone, we expect real GDP growth of 0.3% in 2023 and 1.0% in 2024, compared with 3.5% in 2022; and CPI growth of 6.0% in 2023 and 2.7% 2024, compared with 8.4% in 2022.
- Revenue growth of about 2%-3% over the forecast period on a currency-adjusted basis, stemming primarily from strong service revenue growth in the U.S. and fixed broadband growth in Germany.
- A gradual strengthening of the adjusted EBITDA margin to over 40% by year-end 2024, compared with 34.9% in 2022. Growth in EBITDA will be primarily driven by strong momentum in the U.S., synergies from the merger with Sprint, and growing service revenue.
- Capex (excluding spectrum) at 14%-16% of sales in 2023-2025, following 18.4% in 2022.
- In 2023, we expect spectrum outlays of €3.5 billion for the 600 megahertz license in the U.S. Although the amount is uncertain, there are also upcoming spectrum auctions in Poland, the Czech Republic, and Romania.
- As of April 2023, DT held 50% of shares in TMUS. We expect DT will continue to increase its share of ownership over the next two years. DT has authorized a $14 billion share buyback program, of which about $7.8 billion was utilized at the end of first-quarter 2023.
- Annual dividends of €3.5 billion-€4.2 billion in 2023-2025.
- Like DT, we fully consolidate TMUS in our credit metrics.

Deutsche Telekom AG--Key Metrics*

Bil. €	2021a	2022a	2023f	2024f	2025f
USD exchange rate (annual average)	1.18	1.04	1.07	1.12	1.17
USD exchange rate (year end, Q4 avg.)	1.14	0.99	1.08	1.14	1.15
Revenue	108.4	113.7	110.0-115.0	108.0-115.0	108.0-116.0
Revenue growth (%)	7.7	4.9	(2)-2	(3)-0	0-1
Revenue growth in constant currency (%)	N/A	N/A	2.0-3.0	2.0-3.0	2.0-3.0
EBITDA	38	39.4	43.0-44.0	45.0-47.0	47.0-49.0
EBITDA margin (%)	35	34.7	38.0-38.5	40.0-42.0	40.0-43.0
Capital expenditure (% of revenue)	16.5	18.4	15.0-16.0	14.0-16.0	14.0-16.0
Dividends	3.1	3.4	3.6-3.8	3.9-4.0	4.0-4.2
Operating lease liabilities	33.1	38.8	42.0-43.0	39.0-40.0	39.0-40.0
Adjusted net debt	143.7	145	140-145	137-142	138-143
Debt to EBITDA (x)	3.8	3.6	3.1-3.3	2.9-3.1	2.8-3.0
Debt to EBITDA excluding debt at captive finance operations	3.6	3.5	3.0-3.2	2.8-3.0	2.7-2.9
Funds from operations to debt (%)	21.6	22.1	23.0-25.0	25.0-26.0	26.0-27.0
Funds from operations to debt (excluding debt at captive finance) (%)	22.5	23.3	25.0-26.0	27.0-28.0	28.0-29.0
Free operating cash flow to debt (%)§	4	8.3	11.0-13.0	12.0-14.0	13.0-15.0
Free operating cash flow to debt (excluding debt at captive finance) (%)	4.2	8.8	12.0-14.0	13.0-15.0	14.0-16.0

*All figures adjusted by S&P Global Ratings. §Excluding Spectrum Payments a--Actual. f--Forecast. N/A--Not available.

Liquidity

We assess DT's liquidity as strong based on our expectation that liquidity sources will exceed uses by 1.5x in the 12 months from March 31, 2023, 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.

Principal liquidity sources

- Cash and liquid investments of about €6.1 billion (excluding the U.S.).
- €12.0 billion available under undrawn committed credit facilities which do not contain covenants nor material adverse clauses.
- Cash funds from operations (excluding the U.S.) of about €10.5 billion.

Principal liquidity uses

- Debt maturities of about €3.3 billion.
- Capex (excluding the U.S. and spectrum payments) of about €8.5 billion.
- Dividend payments of €3.8 billion.

Covenants

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

Environmental, Social, And Governance

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

Governance factors are a moderately positive consideration in our credit rating analysis of DT. This reflects DT's deep and broad management expertise and its strong operational track record, as illustrated by the company's successful diversification into the U.S. and the ongoing integration of Sprint within TMUS, which has gone smoothly so far.

That said, cyber-attacks among U.S. telecommunication providers have increased in frequency, and T-Mobile has been hit by three such data breaches since 2021. The first occurred in August 2021 and as a result, the company agreed to settle a class action lawsuit for $350 million in addition to incurring significant expenses to improve its cybersecurity. The latter two were smaller in scale and more-sensitive information, such as customer payment data, social security numbers, and government identification numbers, was not exposed. Nonetheless, it raises concerns around T-Mobile's ability to address these ongoing cyber-attacks, even though it had developed a more comprehensive strategy following its 2021 data breach.

Issue Ratings - Subordination Risk Analysis

Capital structure

At year-end 2022, about 63% 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 50% existing economic stake of DT in U.S. subsidiary TMUS, the structural subordination ratio is about 48%.

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. Our analysis includes the pro rata structural subordination ratio of below 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 flow comes 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+/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
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Strong
Management and governance	Strong
Comparable rating analysis	Positive (+1 notch)
Stand-alone credit profile:	bbb+
Related government rating	AAA/A-1+
Likelihood of government support	Low

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
- 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 | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

Upgraded

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