FITCH AFFIRMS DEUTSCHE TELEKOM AT 'BBB+'/STABLE ON SPRINT US ACQUISITION

Fitch Ratings-London-30 April 2018: Fitch Ratings has affirmed Deutsche Telekom's (DT) Long-Term Issuer Default Rating (IDR) at 'BBB+' with a Stable Outlook and Short-Term IDR at 'F2'. Fitch has also affirmed DT's senior unsecured ratings at 'BBB+' and 'F2'. The affirmation also applies to the debt issued by Deutsche Telekom International Finance B.V. and guaranteed by DT.

The affirmation follows DT's agreement with Softbank to merge T-Mobile US (TMUS) with Sprint in an all-share transaction. Under the terms of the agreement DT would have a 42% economic stake in the newly merged entity, control of 69% of the voting rights and the ability to appoint nine out of 14 members of the board, including CEO and Chairman. These factors will enable DT to fully consolidate the newly merged entity. As part of the agreement, DT will also reduce its intercompany loans exposure to TMUS to USD6.6 billion from USD17.1 billion. The agreement is subject to approval by the antitrust and regulatory authorities in the US.

If the transaction is completed successfully as envisaged, Fitch would rate DT on a deconsolidated basis excluding its US operations. This reflects the potential minority economic holding of the newly merged entity, the intended standalone funding and operational structure of the newly merged entity. The affirmation of the ratings reflects the strong industrial logic of the merger and that following deconsolidation, the operating profile of DT's remaining European assets, their free cash flow (FCF) capability and the company's leverage profile will remain robust and consistent with a 'BBB+' rating.

Fitch expects that following transaction completion and deconsolidation of TMUS, DT's leverage is likely to temporarily exceed its downgrade threshold of 3.5x funds from operations (FFO) adjusted net leverage in 2019, rising to 3.7x from an estimated 3.5x at end-2018 before declining to 3.5x by 2021 (assuming deconsolidation from 1 January 2019). The extent of the leverage spike and pace of deleveraging will be impacted by potential spectrum expenditure in Europe. During this period, DT would have limited rating headroom and the ratings would be more susceptible to operational risks, especially in its domestic market

KEY RATING DRIVERS

Strong Industrial Logic: The merger of TMUS and Sprint carries strong industrial logic. Combining the two assets would create a scaled operator, with a number three position in their market that would have an improved competitive position from both a market and cost perspective, making it better placed to manage future technology change and network investments. The merger would allow the release of sizeable synergies, which DT estimates at USD6 billion a year by 2024, from operational and capital expenditure that we believe could be achieved with manageable risk and good execution.

Deconsolidated Rating Profile: Fitch would deconsolidate TMUS from the overall group and assess the company's ability to meet debt obligations based on the cash generation capacity of the company's remaining European operations. This reflects a combination of factors, which include DT's minority equity holding in the newly merged entity, a combination of weak legal ties and limited operational ties between DT and the newly merged entity, an intended standalone funding structure for the merged operations and voting control that will not provide DT with sufficient cash fungibility between itself and the newly merged operations.

Strong Remaining European Profile: Following the deconsolidation of DT's US operations, the credit profile of DT would be anchored around its domestic operations, which would account for around 70% of EBITDA with DT's other European operations accounting for the remaining proportion. Fitch's views DT as well-positioned in its domestic market, which benefits from a sound market structure. Combined with the product and geographic diversification of DT's other European operations, we believe DT excluding US would have a sufficiently strong operating profile so as not to affect the leverage capacity that the company must maintain for its ratings.

Undiluted Cashflow Margins: DT's likely leverage profile, following the deconsolidation of TMUS and the company's organic deleveraging capacity thereafter, have been core elements of the rating affirmation. We expect DT's FCF generation, excluding TMUS, to remain robust, demonstrated by a strong FCF margin. Based on our scenario analysis, DT's FCF margin following the transaction (excluding spectrum costs) is likely to remain broadly similar to Fitch's current base case (prior to the transaction) at 2%-3% between 2019 and 2022. This assumes a prudent cash dividend policy and no changes to investment plans in Europe.

Reduced Gross and Adjusted Debt: A reduction in EBITDA as a result of the deconsolidation of TMUS will be accompanied by a significant decrease in gross and adjusted debt due to sizeably lower operating lease obligations. A self-funding structure of any new US operations will also result in a significant reduction in DT's intercompany loans exposure between itself and TMUS to USD6.6 billion from USD17.1 billion. The potential debt reduction will partially offset some of the impact on DT's post-transaction leverage increase.

Post-transaction Leverage Spike: The combination of remaining levels of gross and adjusted debt, reduced EBITDA through deconsolidation and prospects of spectrum payments in Europe over 2018 and 2019, is likely to lead to a leverage spike that would exceed DT's current downgrade sensitivity of 3.5x for the 'BBB+' rating. Fitch projects DT's FFO-adjusted net leverage to increase to 3.7x in 2019 from an estimated 3.5x in 2018.

The spike in leverage is, however, temporary and can be tolerated within the ratings due to the sufficiently strong organic FCF generation of DT's remaining European operations. Fitch's scenario analysis indicates DT's leverage is likely to reduce to 3.5x within 24 months following the transaction's close. However, during this period, DT would have limited rating headroom and the ratings would be more susceptible to operational risks, especially in its domestic market.

DERIVATION SUMMARY

DT has a strong operating profile that is driven by a combination of a strong domestic position in Germany and the growing scale and profitability of TMUS. The company is rated in line with other western European diversified telecoms operators that have similar strong domestic operations and a geographically diversified portfolio of international businesses such as Orange SA (BBB+ / Stable), Vodafone Group Plc. (BBB+ / Stable) and Telefonica SA (BBB / Stable). The combination of a strong domestic position and diversified businesses portfolio enables slightly higher leverage capacity for the ratings compared with operators with limited scale such as BT Group Plc (BBB+ / Stable) and Royal KPN NV (BBB / Stable). No country-ceiling, parent / subsidiary or operating environment aspects impact the ratings.

KEY ASSUMPTIONS

Fitch's Key Assumptions within our Rating Case for the Issuer (Assuming no Sprint Acquisition)
- Largely stable domestic revenue and modestly improving EBITDA margins
- Mid-single digit revenue growth in the US and modestly improving EBITDA margins
- Moderate revenue pressures on the European franchise

- Capex as a percentage of revenue (excluding spectrum) around 17% in 2018, declining to 16.5% in 2019 and remaining stable thereafter

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Maintaining lower leverage targets and stabilisation of operating performance across most of DT's operations

Developments that May, Individually or Collectively, Lead to Negative Rating Action
- An increase in FFO-adjusted net leverage to above 3.5x (3.3x at end-2017) on a sustained basis. Spikes in leverage may be consistent with the current ratings if the company has a credible plan to reduce leverage within 18-24 months.

- Pressure on FCF driven by EBITDA margin erosion, consistently higher capex and shareholder distributions, or significant underperformance in the core domestic market and at other key subsidiaries.

LIQUIDITY

Robust Liquidity, Well-Spread Maturity: DT's public treasury policy is to maintain sufficient liquidity to cover 24 months of coming debt maturities. Available liquidity at end--2017 exceeded this guidance. DT also has a well-spread debt maturity profile.

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Summary of Financial Statement Adjustments
- Adjustments for factoring, de-recognition of leased handsets and outstanding handset receivables related to financial services operations (assessed using a debt-to-equity ratio of 3x) resulted in a reduction of the level of debt used in calculating our leverage metrics by around EUR2.5 billion.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018)

https://www.fitchratings.com/site/re/10023785

Parent and Subsidiary Rating Linkage (pub. 15 Feb 2018)

https://www.fitchratings.com/site/re/10019836

Sector Navigators (pub. 23 Mar 2018)

https://www.fitchratings.com/site/re/10023790

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