FITCH AFFIRMS DEUTSCHE TELEKOM AT 'BBB+'; OUTLOOK STABLE

Fitch Ratings-Moscow/London-14 August 2015: Fitch Ratings has affirmed Deutsche Telekom's (DT) Long-term Issuer Default Rating (IDR) at 'BBB+' with a Stable Outlook. Fitch has also affirmed DT's senior unsecured rating at 'BBB+' and Short-term IDR at 'F2' The affirmation also applies to the debt issued by Deutsche Telekom International Finance B.V. and guaranteed by DT.

DT is the incumbent telecoms operator in Germany. Its high leverage provides little headroom within the 'BBB+' rating level. DT's strong deleveraging capability is supported by robust internal cash flow generation, although this may come under pressure in 2016 from US spectrum investments.

The German market has been notably more resilient than most other European countries, benefiting all operators including DT. The company has been able to maintain and grow its market shares in key domestic segments on the back of substantial investments in spectrum and network. Extensive geographic diversification across Europe and in the US exposes DT to significantly higher operating challenges compared with its home market.

KEY RATING DRIVERS

Strong Incumbent Position in Germany

As an incumbent operator, DT holds strong domestic market shares in both wired and wireless segments. Substantial investments, consummated and ongoing, in the mobile spectrum and a faster fixed network including fibre will support DT's leading position in Germany. Mobile consolidation in Germany with Telefonica Deutschland's (BBB/Stable) acquisition of KPN's (BBB-/Stable) E-Plus has refocused competition on quality with less emphasis on pricing. This will benefit DT as it is focused on maintaining high quality infrastructure.

The German telecoms market has experienced much less downward pressure than in most other European countries, supported by robust macroeconomic fundamentals, and is likely to remain resilient, in our view. DT's domestic revenues reached a turning point in 2Q15, with a 2.1% yoy growth. We expect revenues to remain largely stable in the medium-term while on-going cost-cutting and optimisation efforts will support profitability. Once its investments in all-IP transformation in Germany peak at end-2016, DT's margins may further benefit from additional efficiencies.

Regulatory approval for wholesale access by telecom operators to DT's high-speed broadband lines under the Kontingent model protects the company from small disruptive operators. The Kontingent model allows price differentiation for volume including advance commitments.

US Operating Turnaround Positive

DT's majority-controlled subsidiary T-Mobile US has achieved significant operating improvements, which would likely lead to stronger EBITDA, cash flow generation, and deleveraging. Although this company continues to suffer from smaller scale than its larger US peers, T-Mobile US is no longer a cash drag for the group. The risk of overinvesting in spectrum in the broadcast incentive auction scheduled for 2016 is mitigated by DT's intention to keep this subsidiary self-funded with its debt being non-recourse to the parent.

T-Mobile USA's aggressive 'un-carrier' strategy has paid off with a sustained positive trend of adding new post-paid customers since 2013, reversing earlier losses. The company became the third-largest US operator by subscriber base, surpassing Sprint in 2Q15.

Improving scale and synergies from consolidation with Metro PCS have so far allowed T-Mobile US to grow its EBITDA margins in spite of significant investments in customer additions and subscriber equipment replacement options. We believe further gains are likely after the company successfully shut down the MetroPCS CDMA network and migrated all customers onto the T-Mobile network in 2Q15.

T-Mobile US is facing a large spectrum investment that would require external funding and as a result significantly increase the company's leverage. The company is likely to participate in an auction for 600 MHz bandwidth frequencies (broadcast incentive auction), scheduled for early 2016. By our estimates, this auction may require USD5bn or more, which we view as event risk. DT has guided that T-Mobile US would remain self-funded, which somewhat mitigates the risk of overinvestment to the group.

DT remains open to deals in the US, and views T-Mobile US as an asset that may contribute to creating a strong diversified operator in the US. Taking into account T-Mobile US's improving EBITDA generation and expected stronger organic cash flow generation (barring spectrum investments), a potential deconsolidation of T-Mobile US would no longer lead to an immediate improvement in DT's leverage. Fitch expects that post any deal involving T-Mobile US DT would maintain its current leverage targets.

Contained Pressures in Europe
DT's European markets have experienced a slowdown in revenue and downward pressures on EBITDA to a varying degree. Full stabilisation is unlikely in the short-term; however, we believe the revenue and EBITDA have bottomed out, with any further losses likely to be contained in the medium term.

Mobile-only operators are typically under more pressure than incumbent companies and are facing a strategic disadvantage of not being able to offer a full range of bundled services. DT will likely explore strategic options for its mobile-only subsidiaries although M&A spend may not necessarily increase. DT's wide geographical diversification provides the company with the flexibility to dispose of certain assets or seek strategic alliance with other operators in a joint search of operating turnaround, as was the case in the UK. Diversification also leads to a less volatile performance of its consolidated European segment compared with individual country markets.

The performance of OTE - a DT subsidiary - has notably strengthened such that we no longer expect this subsidiary to be a financial outlier, with positive implications for the group results. We expect OTE to remain self-funded and it will therefore not require any support from the parent.

Capex Drive Leverage Higher
DT's funds from operations (FFO) adjusted net leverage is likely to remain above 3.5x for both 2015 and 2016, driven by high capex including into spectrum. DT continues to invest in vectoring and fibre upgrades and all-IP transformation in Germany and across Europe. It has already made substantial investment into spectrum in Germany and the US so far in 2015, and we expect it to make significant further investment in the US 'broadcast incentive' auction in 2016.

We project DT's free cash flow (FCF) generation to remain negative in both 2015 and 2016, primarily due to spectrum purchases. Cash flow for this year will be helped by a high, almost 50% sign-up for scrip dividends, which may not be replicated in future. Deleveraging will be supported by growing EBITDA and improving cash flow generation at T-Mobile US.

A spike in leverage driven by spectrum investment need not result in negative rating action if the company remains on the deleveraging path. DT's underlying cash flow generation remains strong, supporting the company's deleveraging flexibility.

KEY ASSUMPTIONS

Fitch's key assumptions within the rating case for DT include the following:

- Largely stable domestic revenues on the back of modestly improving EBITDA margins;
- Moderate revenue pressures on the European franchise;
- Improving operating and financial performance in the US, with 2015 double-digit revenue growth tapering off to mid-single digits thereafter
- Above USD5bn spectrum investments in the US in 2016
- Continuing high organic capex of approximately EUR10bn per annum in the medium-term
- T-Mobile US's USD1bn hybrid instrument converting into equity in 2017

RATING SENSITIVITIES

Negative: Future developments that may, individually or collectively, result in negative rating action include

-Failure to reduce FFO adjusted net leverage, on a sustained basis, to 3.5x (3.7x in 2014). We expect leverage to stabilise at below this level by end 2017. However, spikes in leverage driven by spectrum investment may be consistent with the current rating level if the company continues to make efforts to substantially reduce debt.

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

Positive: Future developments that may, individually or collectively, result in positive rating action include

-Maintenance of lower leverage targets and stabilisation of operating performance across the entire franchise.

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