FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Ceska telekomunikacni infrastruktura at 'BBB'/Stable

Mon 09 Jul, 2018 - 12:52 ET

Fitch Ratings-London-09 July 2018: Fitch Ratings has affirmed Prague-based Ceska telekomunikacni infrastruktura a.s.'s (CETIN) Long-Term Issuer Default Rating (IDR) at 'BBB'. The Outlook is Stable. A full list of rating actions is below.

CETIN's rating reflects the company's ownership of key mobile and fixed-network infrastructure in the Czech Republic and a wholesale-based business model that benefits from long-term contracts with significant levels of minimum revenue guarantees from its customers. This provides greater cash-flow visibility and reduces the company's operating risk profile compared to other fully integrated telecoms operators.

Cost inflation and investments in fixed-line infrastructure are likely to lead to some free cash flow (FCF) margin pressure over the next three to four years. Fitch expects pre-dividend FCF generation to remain robust and the company's financial policies are likely to lead to a leverage profile that is at the lower end for the company's 'BBB' rating.

The prospective acquisition of Telenor's assets in Central and Eastern Europe by CETIN's intermediate holding company parent, PPF Arena 1, will affect the relationship between the holding company parent and CETIN, although not to such a degree that it would change CETIN's standalone rating profile, in our opinion. Were PPF Arena 1 to become more dependent on CETIN's dividend stream, then this could lead to a change in our approach with negative implications for the rating.

KEY RATING DRIVERS

National Infrastructure, Limited Alternatives: CETIN owns and operates the incumbent national telecoms infrastructure in the Czech Republic, which it wholesales to all parties on a non-discriminatory basis. The structural separation of CETIN's network and a neutral wholesale-based business model lowers the regulatory burden compared to other EU incumbent operators. There are limited alternatives to CETIN's mobile and fixed-network infrastructure with equal depth of coverage and capacity. This is supported by cable coverage of around 33% of households by UPC, numerous local Wi-Fi operators that fragment the broadband market, and a mobile network-sharing agreement with T-Mobile.

Cash Flow Visibility and Generation: CETIN's most material contracts with O2, T-Mobile and other operators are based on long-term durations with guaranteed base-line revenue commitments. These commitments come with service and capex obligations for CETIN, but provide the company with revenue, opex and capex visibility and the capacity to generate strong EBITDA margins (around 64% excluding international transit). As a result of these agreements, CETIN is able to increase the stability and visibility of cash flows and reduce operational risk.

Manageable Customer Concentration Risk: Around 80% of CETIN's EBITDA is derived from O2, based on long-term agreements. The high dependency of sales on one party creates customer concentration risk. Fitch incorporates a low weighting to this risk in the rating due to O2's strong market position and high switching costs arising from financial and operational factors. O2's agreement with CETIN is on a 'take or pay' basis and lasts for an initial seven-year term. This is likely to make O2's business case for alternative suppliers or own-network investments prohibitive in all but niche areas.

FCF Margin Contraction: Fitch expects that CETIN's pre-dividend FCF margins will contract to 11%-12% over the next three to four years from 15% at end-2017 largely because of increased capital expenditure and EBITDA pressure arising from wage and energy price inflation in the Czech Republic. CETIN is increasing the pace and depth of its fibre and broadband technology roll-out and is experiencing greater network capacity demands from mobile customers that result in higher capex. While some of the expenditure has associated contracted revenues, investments in the broadband network are long-term and support the competitive capability of CETIN's fixed-line network.

Retained Flexibility Key: CETIN's funds from operations (FFO) adjusted net leverage at end-2017 was 3.4x and comfortably within its downgrade trigger of 4x. Our base case forecasts indicate that this is likely to remain between 3.3x and 3.5x over the next three to four years, reflecting the company's financial policy and incorporating lower FCF. CETIN has a financial policy to manage leverage below 3.5x net debt-to-EBITDA (based on its definition of the metric) in the long term, with a reduction towards a target of 2.5x after 2020 (a level achieved at end-2017). The company's dividend policy is based on a net income pay-out ratio of up to 100%.

Standalone Approach Unchanged: CETIN is 100% ultimately owned by PPF Group N.V., which also owns 83.4% of O2 Czech Republic. CETIN's rating is based on its standalone credit profile, which we believe is effectively ring-fenced from its parent or its holdings in other entities. The prospective, partially debt-funded acquisition by PPF Arena 1, an intermediary holding company between parent PPF Group N.V. and CETIN, of Telenor's CEE assets for EUR2.8 billion has not changed our approach, although a dependency on CETIN's dividend stream to service debt at PPF Arena 1 has been created. Fitch views this dependency as low and not affecting CETIN's standalone rating profile, which we view as sufficiently insulated from PPF Arena 1's financing.

Maintaining the standalone rating profile reflects a combination of factors that include 'silo' leverage covenants at the CETIN/O2 Czech Republic level of 2.5x net debt to EBITDA, contractual debt terms with no cross defaults or guarantees to any other part of the PPF Group, clear financial policies that allow for investment at CETIN and dividend payments of up to 100% of net income, the operating profile of PPF Arena 1's other assets and CETIN's dividend contributions to PPF Arena 1, which we expect will amount to around 20% of the FCF required to service debt at the PPF Arena 1 level.

Key Operating Risks Unlikely: Fitch has considered four main operational events, which could have an impact on CETIN's credit profile, and concluded that they either have a low risk of occurrence or manageable impact over the next five years. These are: the build-out of alternative infrastructures, a sustained increase in capex for network investments, a material loss of broadband market share by O2, and no contractual agreement between O2 and CETIN after the initial seven-year term. These risks form the basis of some of the rating sensitivities below.

DERIVATION SUMMARY

CETIN has a hybrid credit profile due to its focus on wholesale infrastructure provision. The combination of a lower regulatory burden, reduced exposure to retail competition and long-term underlying contracts with minimum revenue streams is unique and reduces the company's operating risks compared with typical, fully integrated telecom operators such as Royal KPN N.V. (BBB/Stable) or BT Group plc (BBB/Stable). This is reflected in CETIN's higher leverage thresholds for any given rating band.

CETIN's operating risk is, however, higher than mobile tower operators, such as Cellnex Telecom S.A (BBB-/Negative) in our opinion. Mobile tower operators benefit from higher cash-flow visibility and stability as a result of longer-term contracts, minimal technology obsolescence risk, greater visibility of capex investment returns, higher price indexation and, in many cases, energy cost pass-through. In comparison, CETIN's business model benefits from higher barriers to entry as its fixed-line network would be more costly to replicate, but overall, CETIN bears commercial risk for its investments particularly in fixed-line infrastructure that is more similar to traditional, fully vertically integrated telecom operators.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Revenue (excluding international transit) declining around 1% in 2018 and growing by around 1% thereafter until 2020;
- EBITDA margin (excluding international transit) declining by around 1pp to 63% in 2018 and a further 1pp to 62% in 2019;
- International transit EBITDA margin remaining broadly stable at 4%;
- A weighted-average operating lease multiple of 7.5x. This excludes short-term lease expenditure, such as vehicles, and represents a blended figure that implies a multiple of 8.0x for long-term leased assets, such as property and 5.0x for telecoms connectivity;
- Capex of around 18% of total revenue in 2018 and remaining broadly at this level thereafter (excluding international transit around 40%); and
- Shareholder distribution after prioritisation of strategic investment in infrastructure, debt reduction and maintaining net debt-to-EBITDA (as defined by company) below 3.5x.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Greater EBITDA diversification in its wholesale customer base and significant growth in broadband market share of CETIN's fibre and xDSL lines;
- Improved visibility of long-term cash-flow generation driven by a material increase of committed revenue; and
- FFO-adjusted net leverage falling below 3.5x on a sustained basis.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- A material and sustained decline in EBITDA or FCF driven by pressure in core national business segments;
- A deterioration in the credit quality of O2 Czech Republic driven by a material loss in market share particularly but not solely in the broadband segment;
- A roll-out of alternative network infrastructures that results in a loss of CETIN's market share of fibre and xDSL lines;
- A change in the financial policy of CETIN that results in reduced financial flexibility, higher long-term leverage targets or contractual debt obligations to other parts of the PPF Group. Lower financial disclosure at PPF Group and increased dependence by PPF Arena 1 on CETIN dividends to service debt obligations; and
- FFO-adjusted net leverage trending above 4.0x on a sustained basis.

LIQUIDITY

Comfortable Liquidity: CETIN had CZK805 million of unrestricted cash on its balance sheet at end-2017. The company generates strong pre-dividend FCF with no short-term maturities and senior unsecured bonds maturing in 2021 (Eurobonds) and 2023.

FULL LIST OF RATING ACTIONS

Ceska telekomunikacni infrastruktura a.s
- Long-tTerm IDR: affirmed at 'BBB', Outlook Stable;
- Senior unsecured debt: affirmed at 'BBB';
CETIN Finance B.V
- Senior unsecured notes: affirmed at 'BBB';

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Summary of Financial Statement Adjustments
- For the purposes of calculating leverage, Fitch has adjusted CETIN's cash position to include cash collateral held for derivative obligations: CZK155 million in 2016 and CZK306 million in 2017.

For the purposes of liquidity analysis, Fitch treats cash collateral as restricted cash and excludes it from cash and cash equivalents.

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 - Effective from 23 March 2018 to 19 February 2019 (pub. 23 Mar 2018)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Country-Specific Treatment of Recovery Ratings Criteria - Effective from 16 April 2018 to 18 January 2019 (pub. 16 Apr 2018)
Parent and Subsidiary Rating Linkage - Effective from 15 February 2018 to 16 July 2018 (pub. 15 Feb 2018)

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