Fitch Ratings

Fitch Downgrades DKT's IDR to 'B+'; Outlook Stable

Fitch Ratings - Frankfurt am Main - 05 July 2019:

Fitch Ratings has downgraded DKT Holdings ApS (DKT), the owner of Danish telecoms company TDC A/S (TDC), to Long-Term Issuer Default Rating (IDR) 'B+' from 'BB-'. The Outlook on the IDR is Stable. We have also upgraded TDC's senior secured debt ratings.

The downgrade reflects our view that the company's strategy to increase network investment and to separate TDC into two operating subsidiaries will increase capex and operating expenses. We expect this will increase DKT's leverage to a level sustainably higher than our downgrade threshold for a 'BB-' rating. Our base case envisages funds from operations (FFO) adjusted net leverage to stabilise at around 6.2x-6.3x in 2020-2022. This high leverage, taken into consideration with the strong operating profile of an incumbent telecoms operator, is more consistent with a 'B+' rating.

Key Rating Drivers

Higher Capex and Leverage: We forecast DKT's Fitch-defined FFO lease-adjusted net leverage to rise to 5.8x by end-2019 and to remain at around 6.2x-6.3x in 2020-2022. DKT plans to invest more on its FTTH and 5G network, and develop its TV platform. We expect this higher capex starting in 2019 to continue over the next four years. The demerger of TDC into two operating subsidiaries (a NetCo focused on operating its fixed and mobile networks and an OpCo focusing on delivering customer experience) should also contribute to higher operational expenses and capex in 2019-2020. However, we believe DKT has a strong ability to manage its leverage via flexible dividends and phasing of its capex programme.

Fibre Network Investment: DKT's strategy to increase fibre network investment and FTTH coverage, in Fitch's view, should help to address growing demand for high-speed broadband connectivity and place DKT in a better competitive position relative to its infrastructure competitors. We believe DKT is likely to focus its FTTH investments initially in areas where it has a fixed broadband market share, but where there is little alternative fibre deployment.

In Denmark, FTTH network has been predominantly deployed and is owned by local utility companies. They have passed 1.2 million homes with fibre, which covers half of the country's households. Where fibre connections are not available, consumers rely on upgraded cable networks or TDC's copper-based network for their broadband service.

Competitive Market: The mature Danish telecom market remains competitive with limited subscriber growth potential. DKT's 1Q19 results show some signs of stabilisation. Its business segment has delivered for the first time revenue growth of 0.9% yoy, reversing high single-digit declines in past years. The consumer segment's revenue dipped 0.2%. Based on DKT's solid market position as the incumbent operator in Denmark, we expect overall revenue growth to turn positive starting from 2021.

NetCo-OpCo Legal Separation: The legal separation of OpCo and NetCo has now been completed with these two business units transferred to 100%-owned TDC subsidiaries, Nuuday A/S and TDC NetCo A/S respectively. This demerger is still partial as certain headquarter functions and the primary part of TDC's external debt financing still remain at TDC. We do not expect a full operational separation to be completed before 2021-2022 as complex issues, including IT systems, are still being worked through. However, changes to the security and guarantee package for the senior secured debt issued by TDC have now been put in place, in line with terms outlined during TDC's term loan B (TLB) euro tranche repricing in November 2018.

Instrument Ratings Change: We have updated our ratings on DKT's instrument ratings, as we now have further clarity on the impact of TDC's planned network separation, with the legal separation being the first step.

TDC's Senior Secured Upgraded: Recovery prospects for the debt issued by TDC remain good, even though we expect 2019 EBITDA to be lower than 2018's. With the legal separation complete, the TLB (senior secured facilities issued by TDC) now has significant security advantages over TDC's senior unsecured notes. This includes the share pledge over TDC and its two new subsidiaries, TDC NetCo A/S and Nuuday A/S, as well as guarantees from the two new subsidiaries and TDC's immediate parent, DK Telekommunikation ApS. Therefore we have upgraded TDC's senior secured instrument rating to 'BB+'/'RR1'/100%.

TDC's Senior Unsecured Upgraded: Recovery prospects for TDC's senior unsecured noteholders are also good. While these noteholders do not benefit from any guarantee or security package, TDC's two new subsidiaries, due to the demerger under Danish law, will be liable on a statutory basis to satisfy existing noteholders' claims if TDC defaults on these notes. These notes mature in 2022 and 2023, before the TLB is due in 2025. Therefore we have upgraded TDC's senior unsecured instrument rating to 'BB'/'RR2'/90%.

DKT Holdco Rating Downgraded: The debt issued by DKT Finance ApS, a holding company that ultimately owns TDC, is structurally subordinated to the debt issued by TDC. Underlying recovery of the instrument remains weak given a substantial amount of prior-ranking debt totalling over 2x EBITDA. Hence we downgraded the rating of the notes by DKT to 'B-'/'RR6'/10%, following DKT's IDR downgrade.

No Impact from IFRS 16 Adoption: Our leverage metrics under our current methodology do not factor in the transition to IFRS16 accounting standards. We continue to treat operating lease payments as part of operating costs and capitalise them for our total adjusted debt calculation.

Derivation Summary

DKT's ratings reflect the company's leading position within the Danish telecoms market. The company has strong in-market scale and market shares that span both fixed and mobile segments. Ownership of both cable and copper-based local access network infrastructure partly reduces the company's operating risk profile, even though TDC faces network competition from FTTH fibres deployed by Danish electricity companies in parts of the country. Domestic European incumbent peers typically face infrastructure-based competition from cable network operators.

DKT is rated lower than other peer incumbents, such as Royal KPN N.V (BBB/Stable), due to notably higher leverage, which puts it more in line with cable operators with similarly high leverage, such as VodafoneZiggo Group B.V. (B+/Stable), Unitymedia GmbH (B+/RWP), Telenet Group Holding N.V. (BB-/Stable) and Virgin Media Inc. (BB-/Stable). TDC's incumbent status, leading positions in both fixed and mobile markets, and unique infrastructure ownership justify higher leverage thresholds than cable peers.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

- Slightly declining revenue in 2019 and 2020, before stabilising and growing in the following two years

- EBITDA margin of around 36%-37% in 2019-2020, reflecting investment in FTTH rollout as well as TV content costs. Improvement starts from 2021 onwards

- Capex (excluding spectrum) of around 26% of revenue in 2019-2020 before declining in 2021-2022

- Dividends of around DKK800 million per year

- Capex and dividend policy to keep leverage high but at stable levels after 2020

KEY RECOVERY RATING ASSUMPTIONS

-The recovery analysis assumes that the company would be considered a going concern in bankruptcy and that it would be reorganised rather than liquidated

- A 10% administrative claim

-Our going-concern EBITDA estimate of DKK5 billion reflects Fitch's view of a sustainable, post-reorganisation EBITDA level upon which we base the valuation of the company

-Our going-concern EBITDA estimate is 20% below our 2019 forecast EBITDA, which taking into account the operational expenses related to demerger in 2019.

- An enterprise value (EV) multiple of 6x is used to calculate a post-reorganisation valuation and reflects a distressed multiple. The multiple reflects TDC's incumbent position in Denmark and is also in line with that used for large European cable operators like VodafoneZiggo and Unitymedia, which also have solid market position and own significant network assets

- We estimate the total amount of debt for claims at EUR4.9 billion (DKK36.4 billion), which includes debt instruments at the OpCo and HoldCo levels, as well as full drawings on available credit facilities, comprising EUR500 million facilities at TDC and a EUR100 million revolving credit facility (RCF) at DKT.

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action

- Expectation that FFO adjusted net leverage will fall below 5.7x on a sustained basis

- Neutral-to-positive FCF generation reflecting a stable competitive market position and a capex profile normalising at lower levels than in 2019

Developments that May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 6.5x on a sustained basis

- Increased competitive intensity in the Danish telecoms market, resulting in declining EBITDA margin and weak pre-dividend free cash flow (FCF) generation.

Liquidity and Debt Structure

Satisfactory Liquidity: At end-2018, DKT had a consolidated cash balance of DKK2.4 billion. We expect the business to see negative FCF of over DKK 1 billion in both 2019 and 2020 due to higher capex and dividend payments. It has sufficient liquidity provided by the EUR500 million RCF at TDC and a EUR100 million RCF at DKT Finance ApS. Both facilities are undrawn and expire in 2024 and 2025 respectively. The debt maturity profile is comfortable with the first large debt repayment in 2022.

RATING ACTIONS

ENTITY/DEBT	RATING	RECOVERY	PRIOR
TDC A/S			
senior unsecured	LT BB Upgrade	RR2	BB-
senior secured	LT BB+ Upgrade	RR1	BB
DKT Holdings ApS	LT IDR B+ ⭘ Downgrade		BB- ⭘
DKT Finance ApS			
senior secured	LT B- Downgrade	RR6	B+

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Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)

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