Research Update:

DKT Holdings Outlook Revised To Negative On High Investments And Financial Policy Concerns; 'B+' Ratings Affirmed

December 11, 2019

Rating Action Overview

- We forecast that DKT Holdings ApS, parent of Danish telecom operator TDC A/S, will invest more heavily than we previously expected in order to cope with fierce domestic competition.
- We therefore think free operating cash flow (FOCF) may remain negative in 2020, compared with our previous forecast of a rebound to positive territory after its non-recurring outlay on spectrum in 2019.
- S&P Global Ratings-adjusted EBITDA may slightly recover in 2020 on the back of cost savings and any content monetization, but hefty restructuring and transformation costs are a likely constraint, and may weigh on senior leverage after continuing dividend payments.
- We are revising our outlook on DKT Holdings to negative from stable, and affirming the ratings at 'B+'.
- The negative outlook reflects the risk of a one-notch downgrade within six to 12 months, should we continue to expect muted EBITDA recovery or steadily negative discretionary cash flows after investments and dividends.

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Rating Action Rationale

We expect TDC to maintain 2019's capital intensity in coming years, as it remains focused on building a superior 5G network. In our view, Danish telecommunications network operator TDC's capital expenditure (capex; excluding spectrum payments) will be about Danish krone (DKK) 4.6 billion to DKK4.8 billion for full-year 2019, representing 26% to 27% of sales as the company continues to expand its fiber network and build its fifth-generation (5G) network. In addition, the company invested DKK1.3 billion in spectrum in 2019, winning key spectrums required to build 5G network. Owing to significant network investment, we expect TDC will report negative FOCF in 2019. Our expectation is that TDC will maintain reported capex to sales above 25% in 2020, to confront fierce domestic competition and alternative infrastructure operators. FOCF should improve in 2020, after 2019's one-off spectrum outlays, but it could remain negative compared with our previous expectation of positive FOCF in 2020. While we expect incremental benefits on operating performance from the high network investment in the longer term, we believe it does not offset the short-term effect on cash flows.

High capex coupled with shareholder remuneration will likely weigh on debt. In addition to the high capex, we assume TDC will continue to pay dividends of about DKK500 million-DKK800 million each year. As such, we expect the combination of high capex and continued dividends to burn cash and consequentially increase S&P Global Ratings-adjusted debt.

Conflicting effects are expected on the EBITDA trend. Cost savings and potential commercial traction from sports-content investments will likely be offset by ongoing separation and restructuring costs, and higher content costs. This could compromise our expected improvement in adjusted senior leverage toward 5.5x from 5.8x in 2018.

Outlook

The negative outlook on DKT Holdings reflects our expectation that the company will maintain heavy network- and content-investment efforts, while at the same time bearing the costs of its ongoing transformation and optimization initiatives. This could more than offset the benefits from potentially better pricing in the consumer segment, content monetization, and cost savings.

Downside scenario

We could downgrade DKT Holdings if:

- Fierce competition and challenging monetization of content costs or protracted transformation costs result in continued EBITDA decline;
- We continue to foresee negative discretionary cash flow (DCF) in 2020; and
- Adjusted debt to EBITDA fails to decline toward 5.5x (excluding shareholder loans) from 2020, or adjusted leverage including shareholder loans shoots to above 8.5x.

Upside scenario

We could revise the outlook to stable if stronger-than-expected EBITDA or DCF supported an improvement in our adjusted senior debt leverage toward 5.5x (sustainably below 8.5x including shareholder loans) over time.

Company Description

TDC is the incumbent operator and a provider of integrated communications and entertainment solutions in Denmark, with a leading market position across fixed broadband (51% market share), pay TV (55% market share), mobile (44% market share) and landline voice services (65% market share), based on end-user subscriptions to consumer, business, and wholesale customers. At the end of the third quarter 2019, TDC had approximately 3.6 million revenue-generating units (RGUs), about 1.25 million broadband subscribers, and 0.5 million fixed-line telephony subscribers, as well as 1.2 million TV customers.

Our view of DKT Holdings' business risk profile is supported by TDC's position as the leading telecom operator in Denmark, its well-invested mobile network, and its sound, yet temporarily weakened EBITDA margins. At the same time, we consider intense competition in the Danish telecoms market, partly fostered by regulation, and moderate scale to be the main constraints.

Thanks to investments in recent years, TDC's 4G coverage extended to more than 99.5% of the Danish population at the end of 2018. Furthermore, 100% of its own cable network has been upgraded recently to 1GB broadband speeds. That said, the group has a long-term investment horizon and is looking to increase its investments in digital infrastructure, including fiber-rollout and the 5G mobile network. We also note that as part of the long-term strategy for the Opco division, the group has invested in content as means of differentiating itself from competition and lowering churn.

TDC invested heavily in the Danish spectrum auction held in February 2019, winning 14 of the 20 lots. Its investment was tangibly higher than Danish mobile peers, and it acquired key spectrum bands such as 2300 megahertz (Mhz), which peers did not acquire. As a result, we expect these investments should help TDC develop a differentiated 5G network and strengthen the capacity of its 4G network, which in turn should help it maintain its market share in the competitive mobile market.

In our assessment of its business risk, TDC's exposure to the tough market conditions in Denmark represents a key weakness. The company continues to face fierce competition in the Danish telecoms market. In the first nine months of 2019, TDC's EBITDA decline was 3% organically, but about 8% after heavy transformation costs for the network separation.

Our Base-Case Scenario

In our base case, we assume:

- Real GDP growth in Denmark of 1.1% in 2019 and 1.5% in 2020, following 0.7% in 2018, paired with a relatively low unemployment rate of about 5%. We think these macroeconomic fundamentals support upselling of broadband and mobile to some extent, despite a limited link between business cycles and telecom spending.
- Organic revenue decline of about 1%-2% in 2019, before stabilizing in 2020, versus about 0.5% organic revenue decline in 2018. We expect the gradual stabilization to relate to average revenue per user (ARPU) increases, stemming from the monetization of network and content investments, and balanced in part by lower revenue in the business-to-business segment and landline.
- We expect adjusted EBITDA margin (including International Financial Reporting Standards [IFRS] 16 impact) to decline to about 38% in 2019, from over 40% in 2018. The decline stems primarily from increased content costs and separation costs of about DKK300 million-DKK400 million, but also from higher fiber investments and the divestment of the higher-margin Norwegian Get business. Thereafter, we expect a gradual improvement in the margin, with adjusted EBITDA margin reaching just over 39% by 2020.
- Absolute adjusted EBITDA progressing 2% annually in 2020 and 2021.
- Capex to sales (excluding license payment) peaking at about 27% in 2019, from about 24% in 2018 (and 22% in 2017), after spectrum outlays, and 25% of sales in 2020.
- DKK700 million-DKK800 million annual shareholder distributions.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted debt to EBITDA at 8.5x in 2019-2020, including shareholder loans.
- Adjusted debt to EBITDA excluding shareholder loans only gradually declining from 5.8x in 2019 to 5.7x in 2021.
- Reported FOCF heavily negative on spectrum payments in 2019 to slightly negative in 2020 and materially stronger thereafter.
- Negative discretionary cash flows in 2019-2020, assuming steady dividend payments, and neutral to positive thereafter.

Liquidity

We assess DKT Holdings' liquidity as adequate, since we expect the ratio of liquidity sources to liquidity uses will comfortably exceed 1.2x in the 12 months from Oct. 1, 2019. We think that DKT Holdings' risk management aims to maintain adequate, though not necessarily strong, liquidity.

As of Oct. 1, 2019, we estimate that principal liquidity sources over the ensuing 12 months include:

- Estimated cash balances of about DKK1.8 billion;
- Committed revolving credit facilities (RCFs) totaling €600 million (about DKK4.5 billion), of which €500 million at TDC and €100 million at DKT Finance; and
- FFO of DKK4.7 billion–DKK4.9 billion.

For the same period, we estimate that principal liquidity uses include:

- Minimal debt amortizations of around DKK600 million;
- Annual capex of about DKK4.6 billion;
- Moderate regular shareholder distributions in 2019 and 2020; and
- Seasonal negative working capital of around DKK250 million-DKK350 million annually.

Covenants

The RCFs issued by TDC and DKT Finance ApS stipulate springing maintenance covenants subject to net debt to EBITDA remaining below 7.3x, as defined in the covenants (net debt excludes shareholder loans and debt at DKT Finance). We forecast comfortable headroom of more than 30% under these covenants in the next 24 months.

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating on the senior secured term loan, the €1.0 billion unsecured notes, and the €500 million RCF at TDC is rated 'BB-', with a '2' recovery rating.
- We expect substantial recovery prospects of about 85% for the senior debt (notes and term loans), reflecting its structural seniority to debt issued at DKT Finance.
- The senior secured nature of the term loan and the pledge of shares in TDC offer creditors

almost no advantage over unsecured noteholders with respect to their ability to extract value from operating assets at TDC. This is because the senior secured term loan and the unsecured notes will not be part of the same intercreditor agreement. Therefore, we assume that term loan lenders will not be able to enforce a priority claim over unsecured creditors in a default scenario. At the same time, we estimate that the residual value for equity holders at TDC will be zero and the share pledges over TDC will not produce additional recovery value.

- The subordinated notes issued by DKT Finance are rated 'B-', with a '6' recovery rating. We expect recovery prospects to be negligible (at 0%), reflecting the notes' structural subordination to debt issued at TDC and to the €100 million super senior RCF at DKT Finance.
- In our simulated default scenario, we assume that tough competition from other telecom operators in the broadband and mobile segments, paired with loss of TV customers to over-the-top services, would result in substantial pressure on EBITDA. Together with continued high capex, this would lead to a hypothetical payment default in 2023.
- We value DKT Holdings, the ultimate parent of the group, as a going concern because it is the incumbent network operator in Denmark, with ownership of the leading mobile, fixed-line broadband, and cable-TV networks, and has an established position across all subsegments of the telecom services market.

Simulated default assumptions

- Year of default: 2023
- Minimum capex (share of sales): 6% (9%-10% including the operational adjustment, based on our view of minimum capex requirements for cable and telecom operators)
- No cyclicality adjustment, in line with our standard assumption for the telecom and cable industry
- Operational adjustment: +15% (to reflect minimum capex higher than 6% of sales)
- EBITDA at emergence: about DKK3.96 billion
- Enterprise value (EV) multiple: 6.0x
- Jurisdiction: Denmark

Simplified waterfall

- Gross EV at default: about DKK23.8 billion
- Net EV after administrative costs (5%): DKK22.6 billion
- Priority claims: zero
- Estimated senior debt claims at TDC: DKK25.92 billion [1][2]
- Value available for secured claims: DKK22.6 billion
- --Recovery prospects: 70%-90% (rounded estimate 85%)
- Recovery rating: 2
- Estimated senior debt claims at DKT Finance: DKK10.9 billion
- Value available for senior claims: Nil.

- --Recovery prospects: 0%-10% (rounded estimate 0%)
- Recovery rating: 6

[1] All debt amounts include six months of prepetition interest. [2] Revolving facilities assumed to be 85% drawn at default.

Ratings Score Snapshot

Issuer Credit Rating: B+/Negative/--

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: b+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- 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: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
DKT Holdings ApS		
Issuer Credit Rating	B+/Negative/--	B+/Stable/--
DKT Finance ApS		
Issuer Credit Rating	B+/Negative/--	B+/Stable/--
Subordinated	B-	
Recovery Rating	6(0%)	
TDC A/S		
Issuer Credit Rating	B+/Negative/B	B+/Stable/B
Senior Secured	BB-	
Senior Unsecured	BB-	
Recovery Rating	2(85%)	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.