FitchRatings

Fitch Downgrades DKT Holdings IDR to ‘B-‘, Outlook Negative

06 JUL 2022 1:07 PM

Fitch Ratings - Stockholm - [publication date will be automatically inserted]
Fitch Ratings has downgraded DKT Holdings ApS’s (DKT) Long-Term Issuer Default Rating (IDR) to ‘B-’ from ‘B+’ and removed it from Rating Watch Negative (RWN). The Outlook is Negative. DKT is the owner of Danish telecoms companies Nuuday A/S and TDC NET Holding A/S.

Fitch has also affirmed DKT Finance’s instrument ratings and removed them from Rating Watch Evolving (RWE).

The rating action follows separation of and ringfencing around TDC NET earlier this year. DKT creditors will have limited access to TDC NET’s assets and cashflows, and rely mainly on assets and cash flow from Nuuday. The Negative Outlook on DKT reflects increased refinancing risk, with DKT Finance’s approaching maturities on its outstanding EUR1,050 million and USD410 million notes in mid-2023.

KEY RATING DRIVERS

IDR Construction Change: Separation of and ringfencing around operating subsidiary TDC NET has led to a change in our rating approach from a consolidated profile to rating DKT under the Nuuday perimeter. With the new ringfenced debt at TDC NET in place, DKT creditors will rely mainly on assets and cash flow from Nuuday to service DKT Finance’s debt. DKT may also receive dividends payments from TDC NET within the limitations of the ringfence. We forecast limited dividend payments from TDC NET over the next three years.

Under our previously consolidated profile analysis, there were no constraints on cash being upstreamed from its operating subsidiaries TDC NET and Nuuday.

High Leverage: Under the existing capital structure, we forecast DKT /Nuuday’sfunds from operations (FFO) leverage of 7.9x-8.0x in FY22-FY24 (financial year end December). We expect cash flow from operations (CFO) minus capex/total debt, to remain negative in FY22-FY25, due to high cash interest under the existing DKT Finance notes and significant capex, which is a key rating constraint.

High Capex Drives Negative FCF: We expect DKT/Nuuday’s free cash flow (FCF) to remain negative in FY22-FY24, primarily due to investments in streamlining its product portfolio and organisational structure and in a new IT transformation programme. The DKK1.1 billion IT programme (capex and operating expenditure) is spread across FY22-FY24, and is part-funded by DKK600 million of net cash on balance from cancellation of the cash pool in TDC holding. In addition, we expect excess proceeds around DKK867 million in FY22 from the TDC Pension Fund and DKK150 million per year thereafter. We also forecast total drawings of around DKK1.175 billion under its revolving credit facility (RCF) in FY23-FY24 to fund cash outflows.

Capex to Fall from FY25: DKT/Nuuday maintains flexibility in capex, which can help mitigate pressures on cash flow in case of operational underperformance. Capex should start to decrease materially from FY25 as a result of improved efficiencies and completion of the IT transformation programme.

Increased Refinancing Risk: DKT Finance’s outstanding EUR1,050 million 7% 2023 and USD410 million 9.37% 2023 fixed-rate notes mature in June 2023. The combination of high leverage, approaching maturities and increased interest rates increase refinancing risk and explains the Negative Outlook.

We expect DKT to address refinancing of the DKT Finance notes post evaluation of different financing alternatives including standalone financing of Nuuday to fund partial debt repayments in DKT.

Leading Market Positions: Nuuday is the leader in the end-user market for mobile, broadband and pay-TV services in Denmark with a strong portfolio of brands in both B2C and B2B segments. It is further supported by the leadership in infrastructure quality and coverage of TDC NET, its main network partner. We believe that the structural separation of TDC NET will not affect Nuuday's market position and expect it to continue benefitting from its long-term partnership with TDC NET. At the same time, Nuuday's partnerships with utility companies that offer wholesale fibre should provide it with additional flexibility for its broadband expansion.

Access to Best Infrastructure: Long-term contracts and established relationships with TDC NET allow Nuuday to maintain its competitive advantage in infrastructure despite structural separation from TDC NET. We expect TDC NET's quality leadership to remain a major strength for Nuuday over its competitors. This is particularly true in the mobile segment, where Nuuday benefits from being ahead of competition in 5G. In broadband, competition is likely to be stronger due to the ability of all service providers to have non-discriminatory access to TDC NET's and utilities' fibre networks.

Commercial Risks Increase: The separation of network infrastructure effectively passes the risks of increasing competition to service companies, such as Nuuday. Intense competition may put pressure on prices and increase churn, which, combined with a high share of fixed costs for wholesale network services, may squeeze margins. Positively, the separation of networks can help operators increase focus on customer satisfaction and operational efficiency. It also removes the risks associated with investing in new technologies, passing them to wholesale network providers.

Margin Improvement: We expect Nuuday to remain cost-efficient and ongoing cost-optimisation initiatives should continue to support margin improvement. The TDC Group has a strong record of a disciplined approach to cost, evident in a history of operating margin growth, and we expect Nuuday to inherit this approach. Fitch-defined EBITDA margin is affected by DKK40 million-DKK80 million of annual operating expense from the IT transformation programme, which should reduce significantly by FY25. Low margins typical of the asset-lite business model leave little room for manoeuvre and make continued strong operational delivery essential.

DERIVATION SUMMARY

The operating profiles of asset-light operators are weaker than integrated telecoms' due to the former's dependence on third-party infrastructure, higher exposure to the risk of high competition and operational underperformance, and lower margins. Nuuday's closest peer is UK fixed-line operator TalkTalk Telecom Group Plc (B+/Negative). Compared with TalkTalk, Nuuday benefits from notably stronger market positions and a diversification across telecom segments. DKT/Nuuday's FFO gross leverage of around 8x is higher than TalkTalk's expected 5x in FY22, resulting in the rating differential.

Nuuday's peer group includes small and medium-sized domestically focused telecom operators Lorca Holdco Limited (B+/Stable), PLT VII Finance S.a r.l. (Bite; B/Stable), Melita BidCo Limited (B+/Stable) and eircom Holdings (Ireland) Limited (B+/Stable). Different leverage thresholds for this peer group reflect differences in domestic market competitive intensity, strength of market positions, margins and cash flow generation. We see significant leverage, lower margins and negative FCF as rating constraints for DKT/Nuuday.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Revenue to decline 0.5% in FY22 and 1.1% in FY23 before growing less than 1% in FY24

- Fitch-defined EBITDA margin to decline to 9.2% in FY22, on the back of the increased costs associated with the IT transformation programme, increasing towards 10.6% in FY25

-Capex at DKK1.6 billion in FY22 (including IT capex), gradually reducing to DKK930 million in FY25

- Working -capital outflows of 1.2%-0.3% of revenues in FY22-FY25 (excluding impact from IT programme)

- Negative FCF in FY22-FY24

Key Recovery Rating Assumptions

We have not applied the standard bespoke approach for determining recovery ratings for issuers with IDRs of 'B+' and below, as detailed in our Corporates Recovery Ratings and Instrument Ratings Criteria Given the wide range of outcomes in debt recovery depending on the potential opco and holdco default scenarios, we have applied an average recovery of 40% equivalent to 'RR4' to DKT's debt and not applied any uplift despite it being nominally secured.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to an upgrade:

- Total debt/EBITDA below 5.5x and FFO gross leverage below 6.0x, both on a sustained basis

- Neutral to positive CFO minus capex/total debt, reflecting a stable competitive market position and a normalising capex profile

Factors that could, individually or collectively, lead to a revision of Outlook to Stable

- Successful refinancing of DKT Finance debt, with an improved FCF profile and reduced reliance on RCF to fund negative FCF

Factors that could, individually or collectively, lead to a downgrade:

- Total debt/EBITDA above 7.5x and FFO gross leverage above 8.0x, both on a sustained basis

- Increased competitive intensity in the Danish telecoms market, resulting in declining EBITDA and sustainably negative FCF

- Weak liquidity with off-market refinancing options

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Satisfactory Operating Liquidity: We forecast negative FCF in Nuuday of around DKK2.67 billion in FY22-FY24, owing to initial high capex and the IT transformation programme. We expect outflows to be funded by DKK604 million of cash from cancellation of the TDC holding cash pool and DKK867 million of cash inflows from the TDC Pension Fund (both in FY22), and around DKK1.175 billion of drawings under Nuuday’s committed EUR200 million RCF (DKK1.48 billion) in FY23-FY25.

Approaching Maturities: DKT’s outstanding EUR1,050 million 7% 2023 and USD410 million 9.37% 2023 fixed-rate notes mature in June 2023. This leads to weak liquidity metrics, including cash on balance and FCF/debt maturities.

ISSUER PROFILE

In 2019, DKT separated TDC Group, the Danish incumbent telecoms operator, into a network company (TDC NET) and a services company (Nuuday) with the goal to attract other telecom operators onto its infrastructure while maintaining its leadership in digital services.

Criteria Variation

In our Corporates Recovery Ratings and Instrument Ratings Criteria, the bespoke approach that applies to issuers with IDRs in the ‘B+’ and below is not appropriate for DKT as a holding company that owns two operating companies (opcos). The standard approach of applying an enterprise value (EV) multiple to post-restructuring EBITDA and distributing the value using a waterfall cannot be applied as a default of the holding company can happen without the opcos defaulting. Given the wide range of outcomes in debt recovery depending on the potential opco and holdco default scenarios, we have applied an average recovery of ‘RR4’ to the holdco debt and not applied any notch uplift despite it being nominally secured. Conversely, the debt is not notched down from the holdco IDR as the latter already reflects structural subordination to the opco debt, also in terms of access to the opco’s cash flows.

SUMMARY OF FINANCIAL ADJUSTMENTS

We rate DKT on a consolidated basis with Nuuday, including DKT Finance debt, but excluding TDC Holding debt that we rate as a liability of TDC NET.

Due to the Danish statutory demerger law, TDC Holding’s GBP425 million 2023 EMTN noteholders could, in a default scenario, forward their claims on both TDC NET and Nuuday. While Nuuday is partly responsible for this debt legally, we expect TDC NET to take full responsibility for the TDC Holding notes and upstream cash to repay them in February 2023. This debt is included in our calculations of TDC NET’s credit metrics.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of ‘3’. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch’s ESG Relevance Scores, visit www.fitchratings.com/esg

(http://www.fitchratings.com/esg)

RATING ACTIONS

ENTITY	RATING			RECOVERY	PRIOR
DKT Holdings ApS	LT IDR	B-	Downgrade		B+
DKT Finance ApS					
senior secured	LT	B-	Affirmed	RR4	B-

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Applicable Criteria
Corporate Rating Criteria (pub.15-Oct-2021)(includes rating assumption sensitivity)
Corporates Recovery Ratings and Instrument Ratings Criteria (pub.09-Apr-2021)(includes rating assumption sensitivity)
Sector Navigators - Addendum to the Corporate Rating Criteria (pub.15-Oct-2021)

Applicable Models
Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.2 (1 (https://www.fitchratings.com/site/re/1003019))

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