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Research Update:

DKT Holdings ApS Rated 'B+' On Completion Of Leveraged Buyout Of Danish Telecom Operator TDC; Outlook Stable

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Overview

- On May 4, 2018, DKT Holdings ApS, owned by a consortium comprising Macquarie Infrastructure and Real Assets (MIRA) and Danish pension funds PFA, PKA, and ATP completed the leveraged buyout of a 91% stake in Danish incumbent telecom operator TDC A/S.
- We expect no material changes to TDC's business and strategy in the near term, but a highly leveraged new capital structure with adjusted debt to EBITDA of 7.5x–8.0x, including shareholder loans (5.5x–6.0x excluding shareholder loans), compared with 3.2x for TDC in 2017.
- We are therefore assigning our 'B+' long-term issuer credit rating to DKT Holdings ApS and its subsidiary DKT Finance ApS.
- The stable outlook reflects our expectation that further improvements in domestic operating performance will enable the company to stabilize its EBITDA, resulting in adjusted debt to EBITDA of 7.5x–7.8x and free operating cash flow to debt of 3%-4% in 2018.

Rating Action

On May 9, 2018, S&P Global Ratings assigned its 'B+' long-term issuer credit rating to DKT Holdings ApS, the ultimate parent of Danish telecommunications network operator TDC A/S, and to DKT Finance ApS, an indirect subsidiary and intermediate holding company of DKT Holdings. The outlook on both entities is stable.

Rationale

The rating on DKT Holdings incorporates our view of TDC's robust market position as the incumbent telecom operator in Denmark, balanced by the high leverage of the group after completion of the leveraged buyout (LBO). Following the upcoming squeeze-out process, DKT Holdings will own 100% of TDC for a total purchase price of about €5.4 billion. This is funded by about €0.7 billion of equity, about €2.0 billion of shareholder loans, and €2.8 billion of new debt. As a result, we estimate that adjusted debt to EBITDA for the consolidated group headed by DKT Holdings, including shareholder loans, will be between 7.5x and 7.8x in 2018 and 2019, compared with 3.2x for TDC in 2017. In addition, we expect that high cash interest payments, together with continued high capital expenditure (capex) of 18%-21% of sales excluding spectrum, will constrain our adjusted free operating cash flow (FOCF) to debt ratio to 2%-4% over this timeframe. This is materially weaker than our previous forecast of 9%-11% for TDC on a stand-alone basis in 2018.

In our view, the LBO has little impact on our assessment of the existing business. We understand that the new owners are planning to carry on with TDC's current strategy, in particular ongoing cost-saving measures, planned upgrades of TDC's networks, and various initiatives to improve the product portfolio and digitize internal and customer-facing processes. Over the longer term, the new owners may decide to separate TDC's wholesale business from the retail activities and open up fixed and mobile networks to a greater extent for use by other operators and service providers, as well as pursue significant investments in fiber-to-the-home and fifth-generation (5G) networks. We think that network separation and a broader wholesale portfolio may somewhat reduce commercial flexibility of TDC's retail business, but we believe that could be offset by potentially less onerous regulatory access obligations. Furthermore, enlarged coverage with fiber technologies could reduce the risk of infrastructure overbuilding by other players, such as utility companies that have passed more than 40% of Danish homes with fiber (TDC's estimate). This could incrementally strengthen TDC's business, albeit being negative for FOCF for a certain period.

Our view of DKT's business risk profile is supported by TDC's position as the leading telecom operator in Denmark, its well-invested mobile network, its ownership of Norwegian cable operator Get, as well as its solid EBITDA margins. Although TDC is exposed to fierce competition, as of the first-quarter of 2018, the company enjoyed relatively high market shares in Denmark for fixed-line telephony services (63%), fixed-line broadband (51%), mobile services (41%), and pay TV (55%), according to company's estimates. In Norway, Get is the No.2 provider of high-speed broadband and TV to consumers, with market shares in broadband and TV of 18% and 19%, respectively, at end-2017. We also think that TDC's competitive positioning benefits from its well-invested fourth-generation (4G) mobile network, which covers more than 99.5% of the Danish population. Moreover, despite pressure on domestic EBITDA, continual efficiency initiatives have allowed TDC to maintain robust adjusted EBITDA margins of more than 40%. We expect continued high margins of 43%-45% in our forecast for the next three years.

TDC's exposure to the challenging market conditions in Denmark represents the key weakness in our assessment of its business. The company continues to face fierce competition in its business-to-business (B2B) division as well as in the business-to-consumer (B2C) segment, in particular for mobile and broadband services. In TDC's B2B segment, average revenue per user (ARPU) for mobile services has declined by about 26% over the last four years. In 2017, TDC managed to return to slight growth in B2C mobile ARPUs, and the decline is B2B ARPUs is flattening out. However, we think that the market structure with four mobile network operators and several mobile virtual network operators (MVNOs) will limit pricing upside. Also, TDC is increasingly confronted with the churn of TV customers to over-the-top (OTT) services, and continued customer attrition to competitors in broadband.

We derive our assessment of DKT Holdings' financial risk primarily from the high debt burden after completion of the LBO. We consider DKT's owners as infrastructure investors, since we expect them to follow a longer-term investment horizon of at least 10 years. However, DKT Holdings' capital structure, which includes €2 billion of shareholder loans, is highly leveraged, and we expect our adjusted debt to EBITDA to remain above 7.5x in the next few years (5.5x–6.0x excluding the shareholder loans). In the near-term, we expect the potential for leverage reduction to be limited, as we forecast only modest EBITDA growth and FOCF, our adjusted debt will increase due to interest accrual on the shareholder loans, and because we expect DKT Holdings' owners to pursue shareholder distributions, albeit at a moderate level. We understand that DKT Holdings would be willing to contemplate further value-accretive acquisitions, such as in the area of content or complementary infrastructure in Denmark, but we see only limited risk that any deals would materially impair credit metrics relative to our base case. We treat DKT Holdings' shareholder loans as debt, since they give the borrower a prepayment option, which is not sufficiently neutralized by other payment restrictions in the proposed senior debt documentation.

In our base case, we assume:

- Real GDP growth in Denmark of 2.1% in 2018 and 2% in 2019, paired with a relatively low unemployment rate of about 4%. We think these macroeconomic fundamentals are supportive to some extent to the up-selling of broadband and mobile, despite a limited link between business cycles and telecom spending.
- We expect TDC's mobile subscriber market share to remain broadly stable as the company reaps the benefits of its positioning as a quality player, but further modest churn of broadband customers mainly to resellers on TDC's infrastructure. We think TDC's market share in linear TV will remain approximately stable, but expect further decline of this segment due to customer attrition to OTT services.
- In 2018, the euro to Danish krone exchange rate being 7.44 and the Danish krone to Norwegian krone exchange rate being 0.75 (versus 0.80 in 2017).
- Organic revenue decline (excluding the divestment of TDC Hosting in April 2017) of 1.5%-2.5% in 2018 and 0%-1% in 2019, compared with about 2.2% in 2017, mainly driven by lower revenue in the Danish B2B segment, some decline in B2C TV and landline, and the depreciation of the Norwegian krone against the Danish krone.
- S&P Global Ratings-adjusted EBITDA margins of 43%-44% in 2018 and 43%-45% in 2019, after 42.6% in 2017, with margin expansion being supported mainly by cost savings and improved profitability of the B2C mobile segment.
- Capex to sales, excluding spectrum, of 19%-21% in 2018 and 18%-20% in 2019, compared with 21.5% in 2017, gradually declining as the company completes planned network upgrades and investments in other strategic

initiatives.

- Modest spectrum payments of up to Danish krone (DKK) 400 million (about €54 million) in 2018, including for the upcoming auction, and DKK200 million–DKK300 million in 2019.
- A final hybrid coupon payment of DKK195 million in 2018, and moderate shareholder distributions in 2019.

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

- S&P Global Ratings-adjusted debt to EBITDA of 7.5x-7.8x in 2018 and 2019 (5.7x–5.9x in 2018 and 5.6x–5.8x in 2019 excluding shareholder loans), compared with 3.2x for TDC in 2017.
- Adjusted funds from operations (FFO) to debt of 8%-10% in 2018 and 6%-8% in 2019 (11.5%-13.5% in 2018 and 10%-12% in 2019 excluding shareholder loans), after 25.4% in 2017.
- Adjusted FOCF to debt of 3%-4% in 2018 and 2%-4% in 2019 (4%-5% in 2018 and 3%-5% in 2019 excluding shareholder loans), compared with 10.7% in 2017.

We consider TDC a core subsidiary of its indirect parent DKT Holdings, since it encompasses all operating activities and generates virtually all of the group's EBITDA and FOCF.

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 April 1, 2018. We think that DKT Holdings' risk management aims at ensuring adequate, though not necessarily strong, liquidity at all times. In our view, DKT Holdings' resilience to withstand severe external shocks without refinancing is constrained by its high leverage after the TDC acquisition.

As of April 1, 2018, we estimate that principal liquidity sources over the ensuing 12 months include:

- Cash balance of about DKK1.4 billion.
- Committed revolving credit facilities (RCFs) and capex facilities totaling €600 million (about DKK4.5 billion), to be issued after closing.
- FFO of DKK5.8 billion–DKK6.2 billion.

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

- Capex of DKK4.0 billion–DKK4.3 billion.
- Repayments of TDC's existing RCF and finance leases of up to DKK0.6 billion.
- Net cash outflows in connection with the TDC acquisition of up to DKK1.6 billion.
- Moderate shareholder distributions.

The new RCFs to be taken out by TDC, and DKT Finance stipulate springing maintenance covenants relating to net debt to EBITDA, as per the covenant definition. We forecast sufficient headroom of more than 20% under these covenants in the next 24 months.

Outlook

The stable outlook on DKT Holdings reflects our view that the group's operating performance in Denmark will continue to improve in 2018 and 2019, particularly driven by better pricing in consumer mobile and further cost savings, contributing to gradually easing revenue decline and stable or modestly growing EBITDA. We think this will enable DKT Holdings to maintain adjusted debt to EBITDA, including shareholder loans, of 7.5x–7.8x and FOCF to debt of 3%-4% in 2018.

Downside scenario

We could lower the rating if intense competition, a surge in capex, or debt-funded shareholder distributions caused adjusted debt to EBITDA to increase above 8.5x, and FOCF to debt to weaken below 2% for a prolonged period.

Upside scenario

We could raise the rating if higher-than-expected EBITDA and FOCF growth, or the reduction of external debt through asset disposals or other measures, supported an improvement in our adjusted debt to EBITDA to below 5.5x and FOCF to debt of more than 5% on a sustainable basis.

Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/--

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 ratings analysis: Neutral (no impact)

Related Criteria

- General Criteria: Methodology And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018
- 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: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

New Rating

DKT Holdings ApS
DKT Finance ApS
Issuer Credit Rating B+/Stable/--

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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. 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.

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