FitchRatings

Fitch Downgrades TDC to 'B+'; Assigns DKT 'B+(EXP)'

Fitch Ratings-Moscow/London-07 May 2018: Fitch Ratings has downgraded TDC A/S's (TDC) Long-Term Issuer Default Rating (IDR) to 'B+' from 'BBB-' with a Stable Outlook following the company's acquisition by Denmark-based DKT Holdings ApS (DKT). We have also assigned DKT an expected IDR of 'B+(EXP)' with a Stable Outlook. The final IDR is contingent on the successful completion of the refinancing of acquisition financing and confirmation of DKT's capital structure. We expect to withdraw TDC's Long-Term and Short-Term IDRs when the transaction is completed. A full list of rating actions is at the end of this release.

DKT's acquisition of TDC has been funded with a mix of debt and equity. The debt component was substantial and added DKK20.9 billion to TDC's existing net debt of DKK23 billion at end-2017. We expect DKT should end 2018 with funds from operations (FFO) adjusted net leverage of 6.7x. DKT's ability to delever over the next 18-24 months and the new shareholders' financial strategy will be key factors for the company's ratings in the medium term.

KEY RATING DRIVERS

Takeover by Consortium: DKT is controlled by a consortium comprising Macquarie Infrastructure and Real Assets, and three Danish pension funds (PFA, PKA, and ATP). It has acquired more than a 90% share in TDC A/S via a voluntary buyout offer. The remaining shares will be purchased via a squeeze out mechanism to achieve 100% ownership. We expect the deal to be funded with EUR2.7 billion (DKK20.5 billion) of equity together with EUR2.8 billion (DKK20.9 billion) of debt.

Capital Structure: Following the change in ownership, TDC's new owners plan to refinance the acquisition debt initially raised by DKT and its intermediate holding companies (collective known as HoldCo), as well as existing debt at TDC, the operating entity (OpCo). We expect total OpCo debt to amount to EUR4.9 billion, including a new EUR3.9 billion senior secured term loan B. We expect a significant portion of existing senior unsecured debt at TDC to be refinanced. If not all existing TDC senior unsecured bondholders decide to exercise their change of control put options, we expect these bonds will become subordinated to the new senior secured debt, which would also include revolving credit and capex facilities. This would reduce the recovery prospects of existing bonds if TDC went into financial distress.

We intend to analyse any HoldCo debt together with debt at TDC, the OpCo level, as we see both the OpCo and HoldCo tied together from a credit perspective. We do not expect to see significant barriers to prevent cash flow being upstreamed from the OpCo to the HoldCo. Any HoldCo debt would be structurally subordinated to both senior secured and unsecured debt at the OpCo. We have downgraded TDC's existing senior unsecured debt to 'BB-', and put the instrument rating on Rating Watch Evolving (RWE). The recovery prospects, and hence the ratings of the instruments, may change subject to the final mix of secured and unsecured debt at the OpCo level.

Spike in Leverage: Fitch expects the group's FFO adjusted net leverage to increase to 6.7x by end-2018 from 3.6x at end-2017 following the acquisition. TDC's leverage previously benefited from 50% equity credit from DKK5.6 billion of hybrid instruments. The planned refinancing of these hybrids will remove this equity credit. We believe that the company should be able to decrease leverage below 6.5x within the next 18-24 months with a combination of stable EBITDA generation, lower capex and potentially reduced dividends.

Leverage Management: We believe that the company retains substantial flexibility in managing its leverage. We estimate its pre-dividend free cash flow (FCF) margin will remain strong, at high single-digits in 2018-2021. The increase in interest expenses on the back of higher debt will be mitigated by lower capex intensity, which we estimate at around 17%-18% in 2018-2021 compared with 20%-22% in 2015-2017. Shareholder remuneration is another way for the new owners of TDC to manage leverage and FCF as they should have more flexibility with dividend policy.

Fixed-Line Supportive: TDC owns both the incumbent copper network and around half of the cable infrastructure in Denmark. This gives it a stronger domestic fixed-line position than its European peers. We view the position as structurally supportive for the company's long-term credit profile due to the lack of a competing fixed-line infrastructure. Combined with its number one domestic market position, this enables TDC to sustain slightly higher leverage than peers. Current competitive pressures are more prevalent in the mobile and business segments.

Progress on Reducing Declines: TDC's domestic EBITDA declined by 4.6% yoy in 2017 after 12.7% and 10.5% yoy declines in 2016 and 2015, respectively, indicating that its strategy to reduce costs and focus on bundled product value and quality-based differentiation in conjunction with price increases is working. We expect that the new shareholders will not dramatically change the company's operating strategy in the short to medium term and TDC's EBITDA should continue to benefit from operating cost reduction programme in 2018. Consistently strong performance in Norway should also contribute to improving EBITDA for the group.

Network Separation Plan: The shareholders intend to split the company into two, creating a customer-facing service unit and a wholesale network company. The latter should become a utility-like regulated wholesale telecom operator generating stable long-term returns. We anticipate these changes are likely to take a few years. We have not incorporated these long-term changes into our rating and treat such a development as event risk, due to a large number of uncertainties including regulation, the terms of any network separation and impact on capital structure.

DERIVATION SUMMARY

DKT's ratings reflect its leading position within the Danish telecoms market. The company has strong in-market scale and share that spans both fixed and mobile segments. Ownership of both cable and copper-based local access network infrastructure reduces the company's operating risk profile relative to domestic European incumbent peers, which typically face infrastructure-based competition from cable network operators.

DKT is rated lower than other peer incumbents like 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 (B+/Stable), UnityMedia (B+/Stable), Telenet (BB-/Stable) and Virgin Media (BB-/Stable). DKT's incumbent status, leading positions in both fixed and mobile markets and its unique infrastructure ownership justify higher leverage thresholds compared to the cable peers.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Stabilisation of revenue in 2018 with a largely flat dynamics onwards
- Broadly stable EBITDA margin at around 40-41% in 2018-2021
- Capex at around 17% of revenue in 2018-2021 (including spectrum)
- Conservative dividend policy to support the initial deleveraging
- No M&A

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.
- We have assumed a 10% administrative claim.
- The going-concern EBITDA estimate of DKK6.6 billion reflects Fitch's view of a sustainable, post-reorganisation EBITDA level upon which we base the valuation of the company.

- The going-concern EBITDA is 20% below LTM 2017 EBITDA, assuming likely operating challenges at the time of distress.
- An enterprise value (EV) multiple of 6x is used to calculate a post-reorganisation valuation and reflects a conservative mid-cycle multiple.
- We estimate the total amount of debt for claims at EUR6.8 billion, which includes debt instruments at OpCo and HoldCo level as well as drawings on available credit facilities.
- We incorporate EUR3.9 billion of prior ranking debt (term loan B) and assume EUR1.0 billion of remaining senior unsecured debt at OpCo. Fitch calculates the recovery prospects for the senior unsecured debt at 'RR3/51%' which implies a one-notch uplift from the IDR for a 'BB-' instrument rating. We have placed the senior unsecured debt on RWE because the proportion between secured and unsecured debt could change, subject to a share of existing unsecured bondholders exercising their change of control put option. Senior unsecured notes at OpCo level have priority over instruments at HoldCo due to structural subordination.

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
- A strong and stable FCF generation, reflecting a stable competitive and regulatory environment

Developments that May, Individually or Collectively, Lead to Negative Rating Action
- FFO-adjusted net leverage above 6.5x on a sustained basis
- Further declines in the Danish business putting FCF margins under pressure into mid to low single digits

LIQUIDITY

Comfortable Liquidity: We expect DKT and its subsidiaries to have a comfort liquidity position upon deal completion, which will be supported by EUR600 million of credit facilities (RCF and capex). The maturity profile is yet to be established, but given the major refinancing of the existing instruments, we expect the first large debt payout to be only in three to five years. The company's liquidity profile is also supported by strong pre-dividend FCF generation.

FULL LIST OF RATING ACTIONS

TDC A/S
- Long-Term IDR downgraded to 'B+' from 'BBB-'; off RWN; Outlook Stable;

- Short-Term IDR downgraded to 'B' from 'F3'; off RWN;
- Senior unsecured rating downgraded to 'BB-/RR3' from 'BBB-; Rating Watch revised from Negative to Evolving
- Subordinated hybrid securities rating withdrawn at 'BB', RWN. The rating is no longer considered by Fitch to be relevant to the agency's coverage as the instruments are expected to be called.

DKT Holdings ApS
- Long-Term IDR assigned at 'B+(EXP)'; Outlook Stable.

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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 Hybrids Treatment and Notching Criteria (pub. 27 Mar 2018) (https://www.fitchratings.com/site/re/10024296)
Corporate Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023785)

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
(https://www.fitchratings.com/site/re/10024585)
Country-Specific Treatment of Recovery Ratings Criteria (pub. 16 Apr 2018)
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