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## Research Update:

# Dutch Telcoms Incumbent Koninklijke KPN Downgraded To 'BBB-/A-3' On Falling Operating Margins; Off Watch; Outlook Stable

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## Research Update:

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## Overview

- Dutch telecommunications group Koninklijke KPN (KPN) reported weaker-than-expected operating margins in the fourth quarter of 2012, and we expect no recovery in margins for the next two years under our base-case scenario.
- As a result, we are lowering our assessment of the group's business risk profile to "satisfactory" from "strong."
- We are lowering our long- and short-term ratings on KPN to 'BBB-/A-3' from 'BBB/A-2' and taking them off CreditWatch negative.
- The stable outlook reflects KPN's commitment to protecting its investment-grade rating, as demonstrated by the recently announced €4 billion rights issue, and our expectation that over the next 24 months the group's reported EBITDA margins will remain below 35%, and our Standard & Poor's adjusted debt-to-EBITDA ratio at the higher end of the 3.0-3.5x range.

## Rating Action

On Feb. 8, 2013, Standard & Poor's Ratings Services lowered its long- and short-term corporate credit ratings on Dutch telecoms incumbent Koninklijke KPN N.V. (KPN) to 'BBB-/A-3' from 'BBB/A-2'. At the same time we removed the ratings from CreditWatch with negative implications, where we placed them on Dec. 18, 2012. The outlook is stable.

## Rationale

The downgrade primarily reflects the group's significantly weaker-than-expected profitability in the fourth quarter of 2012 and our expectation that KPN's EBITDA margins, which declined by five percentage points year-on-year to about 34%, will not significantly recover over the next two years, primarily due to continued fierce competitive pressure on revenues and higher commercial investments in The Netherlands, Germany, and Belgium. As a result, we are lowering our operating cash flow assumptions and our assessment of the group's business risk profile to "satisfactory" from "strong," as our criteria define the terms. At the same time, we expect the group's financial risk profile to remain "significant," including a Standard & Poor's-adjusted debt-to-EBITDA ratio at the higher end of the 3.0-3.5x range, despite the anticipated significant debt reduction from the recently announced

€4 billion fully underwritten rights issue.

The rights issue is subject to shareholder approval at an extraordinary general meeting on March 19, 2013.

Under our updated base-case scenario, we expect reported group EBITDA to fall significantly in 2013--albeit to a lesser extent than in the fourth quarter of 2012--, but to modestly grow thereafter because of an improved competitive position following the announced fourth generation mobile network and commercial investments, which we expect to help stabilize revenues from 2014. Nevertheless, we are mindful of a quite high level of uncertainty regarding the development of competitive dynamics in the Dutch mobile market following the acquisition of long-term evolution (LTE) spectrum by telecom operator Tele2, which so far does not operate an own mobile network. In the fourth quarter of 2012, the group's underlying EBITDA, as adjusted by KPN, dropped by 16% year-on-year to €1.1 billion.

We continue to assess the group's financial risk profile as significant. This primarily reflects our expectations that the positive impact on the group's credit metrics from the rights issue is largely offset by the decline in EBITDA, the €1.35 billion spectrum costs, higher operating lease obligations following the disposal of parts of its German and Dutch mobile tower portfolio, and potentially higher unfunded pension obligations in light of declining discount rates. Including the rights issue and spectrum payment, we expect the group's Standard & Poor's adjusted debt-to-EBITDA ratio at year-end 2012 to decline only moderately below the level of 3.7x as of Sept. 30, 2012. In addition, we expect leverage to improve only mildly in 2013 and 2014 and remain at the higher end of the 3.0-3.5x range. In our view, debt reduction through positive discretionary annual cash flow generation of about €1 billion, compared with negative €239 million in 2012, will be largely offset by lower EBITDA in 2013 and significant outflows and higher debt adjustments in 2014 related to the expected ownership increase and consolidation of the group's currently 51%-owned joint venture Reggefiber.

## **Liquidity**

The short-term rating is 'A-3', reflecting the long-term rating of 'BBB-' and our assessment of KPN's liquidity as "strong" under our criteria. We raised our assessment of KPN's liquidity primarily because of the positive liquidity impact from the announced rights issue.

Under our base case, we calculate that the ratio of sources to uses is above 1.5x for the years 2013 and 2014, including the fully underwritten €4 billion rights issue in the first quarter of 2013. Even if a substantial share of the proceeds was used to repay medium-term debt--thereby weakening KPN's liquidity--we expect it would remain at least adequate under our assessment, based on the current significant liquidity buffer and the group's solid and proactive liquidity management track record.

As of Dec. 31, 2012, liquidity sources mainly comprised:

- A €2 billion committed line maturing in July 2017, without any financial maintenance covenants, which was fully undrawn at year-end 2013. KPN also had an undrawn €500 million stand-by credit facility, which is available for drawdown until March 31, 2013, and has a final maturity of 364 days after drawdown;
- €1 billion in surplus cash. At year-end 2012, KPN reported cash of €1,286 million;
- Our anticipation of about €3 billion in annual funds from operations (FFO); and
- €4 billion in proceeds from the announced rights issue in 2013.

As of Dec. 31, 2012, liquidity uses included:

- About €2.2 billion in annual capital expenditure;
- A €1.35 billion cash outflow from the spectrum investment in January 2013;
- Annual debt maturities of about €1.5 billion in 2013 and 2014; and
- Modest dividend payments, following the announced dividend cut to 3 eurocent per share in the years 2013 and 2014.

We think KPN has well-established and solid relationships with banks, and that it will continue to have good access to capital markets, partly owing to its domicile in The Netherlands, in the absence of any exposure to more risky emerging or peripheral economies.

## Outlook

The stable outlook reflects our expectation that the group's revenues will stabilize from 2014, following a further moderate decline in 2013, and that reported EBITDA margins will remain below 35%. It also reflects KPN's commitment to protecting its investment-grade rating as demonstrated through the recently announced €4 billion rights issue. Furthermore, we expect the group's Standard & Poor's adjusted debt-to-EBITDA and FFO-to-debt ratios to remain at or below 3.5x and in the mid-twenties, respectively.

We might lower the rating if we saw a clear trajectory that group revenues and EBITDA would continue to decline significantly in 2014 and thereafter, resulting in an adjusted debt-to-EBITDA ratio significantly above 3.5x, with limited prospects to improve in 2015. This could be the case, for example, if a significant LTE network roll out by a new entrant further increased competition in The Netherlands, or if the company's commercial and network investments in Germany did not translate into revenue growth and higher margins.

Although we do not expect it in 2013, ratings upside could build up in the medium term, if the group was able to defend its domestic and international market shares and if, at the same time, its reported EBITDA margins improved towards the high thirties, which we would view as commensurate with a "strong" business risk profile. Furthermore, maintenance of Standard & Poor's-adjusted debt to EBITDA at or below 3x and an FFO-to-debt ratio at or above 30% could support a higher rating.

Ratings List

Downgraded; CreditWatch/Outlook Action		
	To	From
Koninklijke KPN N.V.		
Corporate Credit Rating	BBB-/Stable/A-3	BBB/Watch Neg/A-2
Senior Unsecured	BBB-	BBB/Watch Neg

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