FitchRatings

RATING ACTION COMMENTARY

Fitch Rates CETIN at 'BBB'; Outlook Stable

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Fitch Ratings-London-17 October 2016: Fitch Ratings has assigned Prague based Ceska telekomunikacni infrastructura a.s. (CETIN) a Long-Term Issuer Default Rating (IDR) of 'BBB'. The Outlook is Stable.

The rating reflects CETIN's ownership of core national network infrastructure in the Czech Republic, long-term contracts that reduce operating risks and drive improved visibility and stability of cash flows, strong cash generating capability and a measured financial policy that is supported by a flexible shareholder remuneration policy. Fitch deems risks related to customer concentration and contract renewal with its main wholesale customer, O2 Czech Republic (O2) as manageable for the rating.

KEY RATING DRIVERS

Core National Infrastructure

CETIN was created following a voluntary structural separation from O2 in 2015. The company owns and operates the incumbent national telecoms infrastructure, including the fixed local access loop, back bone and mobile. Structural separation enables CETIN to provide wholesale services to all telecoms operators in the Czech Republic on an equal footing. This enables the company to reduce its regulatory exposure to a few core areas.

Outside of Prague and Brno, mobile network access is provided through a 50:50 network sharing agreement with T-Mobile, enabling both parties to efficiently deliver faster mobile network with better coverage. The only alternative mobile infrastructure on a truly national scale is operated by Vodafone Czech Republic. In fixed access, the largest available alternative is cable operator UPC, covering 33% of households. This leaves limited alternative wholesale infrastructures to CETIN with an equal depth of coverage and capacity.

Manageable Customer Concentration Risk

CETIN derives around 80% of its EBITDA from O2 through long-term agreements. The high dependency of sales on one party creates customer concentration risk. Fitch incorporates a low weighting to this risk in the rating due to O2's strong market position and high switching costs.

O2's strong position in the Czech telecoms market also benefits from some structural support when compared with other EU incumbents. Fitch estimates the operator has a 39% share of mobile voice and data service revenues and 42% share of fixed voice and broadband revenues. Investments in pay-tv are likely to support further growth and maintain O2's competitive position. Structural support is derived from a three member mobile operator market, a lack of significant competition from local loop unbundling operators in broadband (around 3% of lines) and low cable coverage.

Switching costs for O2 are extremely high due to financial and operational reasons. CETIN's agreement is based on significant financial commitments from O2 on a 'take or pay' basis, which initially last for seven years from June 2015. This makes O2's business case for alternative suppliers or own network investments prohibitive in all but niche areas. O2 owns the customers, retail distribution, mobile spectrum and certain technical platforms while CETIN owns the network infrastructure.

Cash Flow Visibility and Generation

CETIN's most material contracts with O2, T-Mobile and other operators are based on long-term durations with guaranteed base line revenue commitments. These commitments come with service and capex obligations for CETIN, but provide the company with revenue, opex and capex visibility and the capacity to generate strong EBITDA margins (64% excluding international transit). As a result of these agreements, CETIN is able to increase the stability and visibility of cash flows and reduce operational risk.

The revenue commitments reduce the proportion of variable revenue and costs for CETIN and provides greater planning certainty than typical European telecoms operators. This improves the stability of CETIN's cash flows.

Measured Financial Policy

CETIN has a long-term policy to manage leverage below 3.5x net debt to EBITDA based on its definition of the metric, with gradual reduction towards a target of 2.5x after 2020. The company has a strong underlying pre-dividend free cash flow margin (around 25%-28% excluding international transit) which provides flexibility for increased investment and deleveraging if required. Fitch expects CETIN will progressively increase its dividend to a pay-out ratio of 100% of net income by 2018 from zero in 2016. This should enable the company to reduce its funds from operations (FFO) adjusted net leverage to 3.6x by 2019 from 4.5x in 2016. On an underlying basis, normalised for tax and interests costs, CETIN's 2016 FFO adjusted net leverage would be around 4.1x.

Standalone Rating
CETIN is 100% owned by PPF Group N.V., which also owns 84% of O2. CETIN's rating is based on its standalone credit profile and is not affected by its parent or its holdings in other entities. This reflects contractual debt terms such as CETIN having no cross defaults or guarantees to any other part of the PPF group.

PPF considers CETIN a strategic investment. The group views its investment in CETIN as long term. PPF plays an advisory role in areas such as corporate funding, procurement and real estate. PPF holds minimal debt at the holding company level and has no obligation to provide bail-out support for any of its subsidiaries.

Key Operating Risks to Rating
Fitch has considered four main operational events that could have an impact on CETIN's credit profile for which it is attributing either a low risk of occurrence or minimal impact within the rating horizon. These risks are reflected in the rating sensitivities and include firstly, the build out of alternative infrastructures (e.g. cable or government backed fibre) where the current pace of development is slow and in our opinion unlikely to have a significant impact on CETIN's fixed line local access share.

Secondly, sustained increase in capex for network investments, for which the company has some headroom within its rating and flexibility in terms of shareholder remuneration. Thirdly, a material loss of broadband market share at O2, and finally no contractual agreement between O2 and CETIN following the initial seven-year contractual period. Switching costs, limited alternative national wholesale networks and the contractual relationship for O2 and CETIN make this unlikely.

Hybrid Credit Profile
Fitch views CETIN's operating risk profile as relatively lower than typical, fully integrated telecom operators, which we reflect in the credit metrics that we incorporate in our rating

sensitivities for CETIN. The lower risk profile reflects a combination of long-term contracts, flat fees and volume commitments, higher visibility on capex investment return, potential for improved scale economics (supplying all market participants) and a greater proportion of revenues derived from ownership of the local loop.

We view CETIN's profile as having relatively higher risk than mobile tower operators, which benefit from higher cash flow visibility and stability as a result of longer-term contracts, minimal technology obsolescence risk, greater visibility of capex investment returns, higher price indexation and energy cost pass through (in many cases). In comparison, CETIN's business model benefits from higher barriers to entry as its fixed line network would be more costly to replicate, but overall, CETIN bears commercial risk to its investments in fixed line infrastructure that is more similar to traditional, vertically integrated telecom operators.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer are:

- Revenue (excluding international transit) decline of around 4% in 2016 and broadly stable to marginally declining thereafter.
- EBITDA margin (excluding international transit) improving by one percentage point between 2016 and 2018 to 65% from 64% in 2015, reflecting operational efficiencies.
- International transit revenue and EBITDA to grow at mid-single digit percentage from 2016 to 2018.
- Capex to total revenue at 15%-17% in 2016-2018 and declining thereafter (capex to revenue excluding international transit around 31% in 2017 and 2018).
- Profit distribution subordinated to strategic investment in infrastructure, debt reduction and maintaining net debt to EBITDA (as defined by company) below 3.5x.

RATING SENSITIVITIES

Positive: Developments that may, individually or collectively, lead to positive rating action include:

- Greater EBITDA diversification in its wholesale customer base and a significant growth in broadband market share of CETIN fibre and xDSL lines.
- Improved visibility of long-term cash flow generation driven by a material increase of committed revenues.
- FFO adjusted net leverage falling sustainably below 3.5x.

Negative: Developments that may, individually or collectively, lead to negative rating action include:

- A material and sustained decline in EBITDA or free cash flow driven by pressure in core

national business segments.
- A deterioration in the credit quality of O2 Czech Republic driven by a material loss in market share particularly but not solely in the broadband segment.
- A roll out of alternative network infrastructures that result in a loss of CETIN's market share of fibre and xDSL lines.
- A change in the financial policy of CETIN that results in reduced financial flexibility, higher long-term leverage targets or contractual debt obligations to other parts of the PPF group.
- FFO-adjusted net leverage trending above 4.0x on a sustained basis.

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Applicable Criteria
Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016)
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)

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