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Research Update:

PPF Arena 1 B.V., Parent Of O2 Czech Republic, CETIN, And Telenor CEE, Assigned 'BB+' Rating; Outlook Stable

Primary Credit Analyst:
Justine Miquee, Paris + 33 14 420 6794; justine.miquee@spglobal.com

Secondary Contact:
Xavier Buffon, Paris (33) 1-4420-6675; xavier.buffon@spglobal.com

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Rating Action Overview

- PPF Arena 1 B.V.--holding company of O2 Czech, CETIN, and Telenor CEE--is a well-established and diversified mobile telecommunications network operator in Central and Eastern Europe (CEE), with relatively stable markets, and sound mobile networks, and spectrum holdings.
- The company is a mobile-only player in five of the six countries in which it operates, with the exception of the Czech Republic where it is also the incumbent fixed operator and investing in a fiber network.
- We are assigning our 'BB+' long-term issuer credit rating to PPF Arena 1.
- The stable outlook reflects our anticipation of 1%-2% pro rata revenue growth and an adjusted EBITDA margin of more than 40% in 2019-2020, combined with adjusted debt to EBITDA of below 3.5x, and free operating cash flow (FOCF) to debt of close to 15%, excluding spectrum payments.

Rating Action Rationale

The rating reflects PPF Arena 1's leading positions in most of the mobile markets in which it operates, where the competitive environment has been relatively stable. It also factors in the company's position as a midsize European telecom operator, with presence in several CEE countries and an above-industry average adjusted EBITDA margin. We consider PPF Arena 1's sound mobile networks and capacity, as well as the ongoing upgrade of wholesale infrastructure provider CETIN's fixed network in the Czech Republic, a positive. In particular, we believe the company's investments in fiber technology will benefit CETIN's wholesale activities, and O2's subscriber mix, and retail fixed broadband market shares. The absence of fixed broadband activities in Slovakia and Telenor CEE's markets, as well as our view of a weaker fixed broadband position in the Czech Republic compared with other European incumbents, mitigate these strengths. Our ratings also factor in our expectation that PPF Arena 1's adjusted debt to EBITDA will be about 3.4x over the next two years. Growing capital expenditure (capex) for spectrum and a fixed network upgrade, combined with dividend payments, will hamper any material deleveraging prospects. In addition, we forecast the company's reported net leverage at about 3x, which is within management's financial policy guidelines.

Our assessment of PPF Arena 1's business risk is supported by its strong position in the mobile markets of most of its countries of operation. We also see the company's geographic diversification in six CEE countries, strong adjusted EBITDA margin exceeding 40%, sound mobile network and capacity, and the ongoing upgrade of its fixed broadband network in the Czech Republic as business strengths.

PPF Arena 1 became a midsize European mobile player following its acquisition of Telefonica O2 Czech--later split into O2 Czech and CETIN--in 2013 and Telenor CEE in 2018. Pro forma consolidated revenue reached €3.2 billion in 2018 and the group now operates in six countries. The Czech Republic accounts for about 50% of total EBITDA, followed by Hungary (14%), Bulgaria (13%), Serbia (12%), Slovakia (8%), and Montenegro (2%). PPF Arena 1 is the No. 1 mobile operator in three of these markets: Bulgaria, Serbia and Montenegro, with revenue market share of 37%-41% in 2018. The group is also co-leader with T-Mobile in the Czech Republic, at 37%-38% revenue market share each in 2018, as well as No. 3 in Slovakia (24%) and No. 2 in Hungary (28%). We believe PPF Arena 1's mobile markets are moderately competitive, based on the presence of three mobile network operators (MNO) in each country. So far, these markets have been characterized by relatively low churn rates, with monthly postpaid churn in the Czech Republic below 1%, and broadly stable or slightly improving average revenue per user (ARPU). This has limited market share declines in Serbia, Montenegro, and Hungary and improved PPF Arena 1's positioning in the Czech Republic, Slovakia, and Bulgaria.

We view positively CETIN's ongoing upgrade of its fixed network, which is set to provide next generation access (NGA) speeds for the majority of households passed by 2021, from less than half in 2017. We believe having access to CETIN's upgraded fixed network is positive from a wholesale perspective, because rivals Vodafone and T-Mobile recently focused on cross-selling their mobile subscriber base, and from a retail perspective as O2 managed to improve its subscriber mix toward higher-speed and higher-value packages. We believe the voluntary separation of CETIN (wholesale infrastructure provider) and O2 (retail and services) in 2015 streamlined both businesses, allowing CETIN to focus on improving and maximizing the utilization of its networks. Meanwhile, O2 was freed up from regulation linked to infrastructure ownership.

Our assessment also factors in PPF Arena 1's sound profitability, with an adjusted EBITDA margin above 40%. This is supported by CETIN's high infrastructure margin of about 65% on a reported basis, when excluding low-margin international transit business, and the sound profitability at Telenor CEE, which we expect to benefit from modest synergies in procurement.

Balancing the strengths listed above are O2 Czech's lower market share in fixed broadband compared with other European incumbents. The operator's Czech revenue market share was about 31% in 2018, significantly less than Telekom Austria's 56% fixed broadband market shares in Austria. PPF Arena 1 also lacks convergence in five of its six countries of operations.

The late and slow rollout of asymmetric digital subscriber line (ADSL) technology in the Czech Republic has favored the emergence of multiple local

Wi-Fi and fiber providers, resulting in a relatively fragmented fixed broadband market. This has been at the expense of O2, which registered subscriber net losses until third-quarter 2018. Similarly, CETIN's total DSL lines declined until third-quarter 2018, with subscriber market share contracting to about 28% in 2017 from about 37% in 2012, according to the Czech Telecommunications Office. However, CETIN's total DSL lines grew 0.9% in fourth-quarter 2018 compared with the same period in 2017 and O2's fixed broadband net additions stabilized, following ongoing fixed network modernization and the gaining of a better mix of higher-speed and higher-value fixed subscribers. Therefore, we believe that CETIN's capacity to monetize its fixed network upgrade and O2 Czech's capacity to ramp-up its fixed broadband and pay-TV market share, if realized, could strengthen the group's business risk profile in the medium term. Although this in turn could be offset should the pending combination of Vodafone and UPC lead to fiercer competition. However, we believe fiercer competition from the merger may partly be mitigated by the opportunity for PPF Arena 1 to access UPC's network should the regulator require it to be made available to other market participants.

In Slovakia and Telenor CEE's geographies, PPF Arena 1 is a mobile-only player with no fixed broadband operations, also constraining our assessment of the group's business risk profile. We believe that a push toward convergence from existing fixed-mobile local competitors in these countries would be detrimental to PPF Arena 1, although we have not seen it to date because churn rates are relatively low in markets with three MNOs.

Our view of PPF Arena 1's financial risk profile is supported by our expectation that pro rata adjusted debt to EBITDA will remain slightly below 3.5x and FOCF to debt will approach 15% in 2019 and 2020 excluding spectrum payments, and 10%-15% including payments. The company's investments to upgrade the fixed network and acquire spectrum bands will limit FOCF at €445 million-€465 million in 2019-2020, compared with about €580 million in 2018. This, combined with dividend returns to shareholders, will hamper discretionary cash flow and limit deleveraging prospects over the next 12-24 months. In our base case, we assume shareholder returns at the higher end of the expected range. Although we understand the group's dividend policy is flexible, we forecast that reported leverage will be in the middle of its net consolidated leverage target of 2.8x-3.2x, with our adjustments adding about 0.4x. It remains to be seen if, and when, management would want to utilize dividend flexibility to drive reported leverage toward the lower end of its policy range. We haven't factored such an assumption into our base case at this stage.

We deconsolidate from reported figures, including debt, revenue, and EBITDA, 32.31% of O2's and 10.27% of CETIN's corresponding figures, to reflect the existence of meaningful minority shareholders.

Our adjustments to debt also include the addition of operating leases of €380 million, and asset-retirement obligations of about €25 million. We also exclude 85%-90% of consolidated cash. We do not net €1.5 million of restricted cash at CETIN and about €40 million of cash reserves maintained at Telenor CEE for operating purposes because this may not be immediately accessible to PPF Arena 1 to repay debt. Our adjustments to EBITDA primarily include the addition of €80 million-€90 million corresponding to rent costs.

Outlook

The stable outlook reflects our expectation that PPF Arena 1 will successfully integrate Telenor CEE, expand its organic pro rata revenue by 1%-2% per year in 2019-2020, and maintain an adjusted EBITDA margin slightly above 40% over the same period. We expect the company to monetize its network upgrade and TV-content investments, while maintaining its current mobile market shares and ARPU in all countries of operations. We also forecast adjusted pro rata leverage will remain below 3.75x and FOCF to debt will approach 15% when excluding spectrum payments.

Upside scenario

We could raise the rating over the medium term if PPF Arena 1 builds a favorable track record of fixed broadband and pay-TV market share gains, maintains or further improves its mobile positioning, and sustains an adjusted EBITDA margin of more than 40%. We could also upgrade PPF Arena 1 if management aimed to maintain reported leverage at the very low end of its financial guideline, translating into adjusted debt to EBITDA sustained at less than 3.25x, with FOCF to debt at more than 15%, excluding spectrum.

Downside scenario

Rating downside is currently remote given PPF Arena 1's financial policy, but we could lower the rating if adjusted debt to EBITDA sustainably increases above 3.75x, together with FOCF to debt declining to less than 10%. This could result from a more competitive Czech mobile market following the potential entry of a fourth mobile player, or a push toward convergence in markets where PPF Arena 1 is a mobile-only operator.

Company Description

PPF Arena 1 B.V. is a European telecom group operating in six markets: the Czech Republic (through O2 for retail activities and CETIN as an independent wholesale fixed and mobile infrastructure provider), Slovakia (through the O2 brand), and Hungary, Bulgaria, Serbia, and Montenegro (through the Telenor brand). PPF Arena 1 offers mobile, fixed broadband, internet protocol television (IPTV), and wholesale services in the Czech Republic, and mobile services only in its other five operating countries. In 2018, PPF Arena 1 generated about €3.2 billion of pro forma consolidated revenue, 25% of which was contributed by CETIN, 33% by O2 Czech (including Slovakian operations), and 41% from Telenor CEE. In the same year, PPF Arena 1 had 16.4 million mobile customers--including 5 million in the Czech Republic, 3.1 million each in Hungary and Bulgaria, 2.8 million in Serbia, 2 million in Slovakia, and 0.4 million in Montenegro. PPF Arena 1 is part of PPF Group N.V., an international investment conglomerate with three pillars: telecom, financial services, and real estate.

Our Base-Case Scenario

In our base case, we assume:

- PPF Arena 1's mobile markets will remain modestly competitive, with relatively stable ARPU and market shares, because most are structured around three MNOs. However, we are mindful that the potential arrival of a fourth player on the Czech mobile market, or a push toward convergence in Telenor CEE's markets, could increase competition.
- Consolidated pro rata revenue growth of 1%-2% in 2019, mainly driven by Telenor CEE and O2 Czech. This growth reflects continued data monetization, migration from prepaid to postpaid customer contracts, and slowly growing ARPU in most countries. Conversely, we expect CETIN's revenue to decline 0.6% in 2019 due to weaker performance in the international transit segment, before improving to 2% in 2020, and stabilizing to 1.0%-1.5% thereafter, supported by CETIN's wholesale contracts.
- A rise in adjusted pro rata EBITDA margin to about 44.5% in 2019 from 42.6% pro forma in 2018. The cost benefits from renewal of IT systems and modest net synergies from the Telenor CEE acquisition will allow PPF Arena 1 to reduce its cost base as a proportion of revenue, and thus slightly increase its margins.
- Total capex increases to 22%-23% of pro rata sales (18%-19% of consolidated sales) over the 2019-2021 period, from about 18% (15%) pro forma in 2018. This growth will be mainly fueled by spectrum and brand license payments, in addition to continued investments to upgrade O2 Czech's fixed network.
- Dividends of €687 million in 2019 and €493 million in 2020, including dividends to minority shareholders of O2 Czech and CETIN

Based on these assumptions, we obtain the following credit measures:

- Stable pro rata debt to EBITDA at about 3.4x in 2019-2020.
- Funds from operations (FFO) to debt slightly declining to about 23% in 2019-2020 from 24.3% pro forma in 2018 on higher interest payments, including the full-year contribution of debt raised to fund the acquisition of Telenor CEE.
- FOCF to debt declining to about 11% in 2019-2020 from 15% pro forma in 2018, because of a steep increase in capex, including spectrum payments.

Liquidity

We view PPF Arena 1's liquidity as adequate, based on our expectation that the ratio of liquidity sources to uses will be approximately 1.25x in the 12 months from Jan. 1, 2019. Although we expect uses of cash would slightly exceed sources of liquidity if EBITDA were to decline by 15% in 2019, we believe PPF Arena 1 has sufficient flexibility to reduce its dividend distributions and capex, and has access to undrawn long-term facilities. In addition, PPF Arena 1 has large headroom vis-à-vis its covenants, good relationships with banks, and a satisfactory standing in capital markets.

As of Jan. 1, 2019, we estimate principal liquidity sources include:

- Cash and liquid investments of about €435 million as of Dec. 31, 2018.
- An undrawn €200 million revolving credit facility (RCF) maturing in 2023.
- Sizable cash FFO of €1.00 billion-€1.05 billion.

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

- Working capital outflows of €45 million-€50 million.
- Capex of about €600 million.
- Dividends of about €685 million.

Covenants

We expect adequate headroom under PPF Arena 1's net leverage ratio, set at 4.5x, and its interest coverage ratio of 2.5x in 2019 and 3.0x from 2020. In addition, we expect the group will comply with its net proportionate leverage covenant of 2.5x at CETIN and O2, as well as its net proportionate leverage covenant of 1.0x at Telenor CEE, with comfortable headroom.

Issue Ratings - Recovery Analysis

Key analytical factors

- We are assigning our 'BB+' issue rating to the proposed secured bond to be issued by PPF Arena 1, which will repay the bank debt taken by the company. The recovery rating is '3', indicating our expectation of a meaningful recovery (rounded estimate: 50%) in an event of payment default. The recovery prospects are supported by our valuation of PPF Arena as a going concern and the secured nature of the debt at the PPF Arena 1 level. They are constrained, however, by the structural subordination of PPF Arena's secured debt to O2 and CETIN's unsecured debt.
- We consider the security package limited. It comprises pledges over shares in PPF Arena 1 and in the holding companies owning 65.79% of O2 Czech, 89.73% of CETIN, and 100% of Telenor, as well as pledges from the holding company's bank accounts. There are no direct pledges of CETIN and O2 Czech shares and we understand securities assigned to the proposed bond will be released once secured debt at PPF Arena 1 is paid off.

- The debt documentation offers borrowers operational flexibility, and protection to creditors. For example, we note the presence of a net consolidated leverage ratio of 4.0x at group level. In addition, incurrence of debt at the subsidiary level is limited to 2.5x the net consolidated maximum leverage at CETIN and O2 Czech, and 1.0x at Telenor.
- Our hypothetical default scenario envisions a combination of increased competition between telecom providers, and a push toward convergence in markets where the group is a mobile-only operator, resulting in subscriber losses, lower profit, and cash burn.
- We value PPF Arena 1 as a going concern because it is a midsize European telecom operator with strong mobile market positions, low churn, and an established network asset base in several CEE countries.

Simulated default assumptions

- Year of default: 2024
- Jurisdiction: Czech Republic
- Minimum capex (percentage of 2018 pro forma revenue): 6%
- Cyclicality adjustment factor: 0% (standard sector assumption for telecom and cable)
- Operational adjustment: 35% (reflecting our assumptions that on a hypothetical path to default, minimum capex will be in excess of 6%)
- Emergence EBITDA after recovery adjustments: about €545 million
- Implied enterprise value multiple: 6.0x

Simplified waterfall

- Gross recovery value: about €3,275 million
- Net recovery value for waterfall after administrative expenses: about €3,110 million
- Estimated senior secured debt claims [1]: about €1,730 million

-- Recovery expectation [2]: 50%-70% (rounded estimate: 50%)

[1] All debt amounts include six months of prepetition interest. RCF assumed 85% drawn.
[2] Rounded down to the nearest 5%.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Stable/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Intermediate

- Competitive position: Satisfactory

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers:
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

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New Rating

PPF Arena 1 BV
 Issuer Credit Rating                   BB+/Stable/--
 Senior Secured                         BB+
   Recovery Rating                      3(50%)
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Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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.