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Research Update:

PPF Telecom Group 'BB+' Rating Affirmed Following Ownership Changes At Subsidiaries; Outlook Stable

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Rating Action Overview

- In March 2022, PPF Telecom Group sold a 30% minority stake of its infrastructure subsidiary CETIN Group. Meanwhile, over the past two years, PPF has consolidated its operating subsidiaries, leading to full ownership and consolidation of O2 Czechia and O2 Slovakia.
- While we expect our key adjusted credit ratios to remain largely intact, with S&P Global Ratings-adjusted leverage of about 3x, we view the minority interest sale of the strategic infrastructure asset as slightly negative for the group's overall creditworthiness.
- We affirmed our 'BB+' long-term issuer credit rating on PPF.
- The stable outlook reflects our expectation that the group will continue to increase its revenue and EBITDA at a mid-single-digit rate and the pro rata S&P Global Ratings-adjusted leverage will remain at about 3x in 2022 and 2023.

Rating Action Rationale

We view the sale of the 30% stake in CETIN Group as credit negative, although somewhat balanced by the consolidation of operating assets. We view CETIN Group as a strategic asset for PPF, owning the mobile networks in the group's countries and its fixed network in the Czech Republic. Although the pro rata deconsolidation has a slightly positive effect on our credit metrics, due to the debt that sits at the CETIN level, the overall impact is slightly negative for metrics due to our adjustment of the master service agreement (MSA) between O2/Yettel and CETIN as well as the shareholder distribution of the majority of sale proceeds. At the same time, PPF spent about €1.0 billion to buy out and squeeze out O2 Czechia's remaining minority interests in 2021 and 2022 and used €325 million of proceeds from the sale of its minority stake in CETIN to repay debt at O2, which it now fully owns. As a result, we expect that S&P Global Ratings-adjusted leverage will remain at about 3x in 2022, similar to 2021. However, we regard the overall corporate restructuring as slightly negative, as we regard the cash flow stemming from the infrastructure arm as more stable and predictable than those streaming from the commercial arm, so we have tightened our leverage threshold for the rating by 0.25x.

High inflation is likely to put pressure on EBITDA margin expansion. We expect Czech inflation of 15%-20% in 2022 and close to 10% in 2023. This will likely strain the group's EBITDA margin, in particular through increasing labor costs and higher energy prices. In first-half 2022, PPF's energy costs rose by 60% compared with the same period a year earlier (to €48 million from €30 million) and its labor costs by 9% (to €176 million from €162 million). Still, we expect inflationary pressure will be balanced by higher growth in the higher-margin fixed segment (CETIN) than in the rest of the group. In addition, we expect that inflationary pressure will lead to an increased ability to raise prices and therefore support revenue growth. We therefore expect growing EBITDA while we expect the reported margin to remain at 46%-47%.

We forecast S&P Global Ratings-adjusted debt to EBITDA to remain at about 3.0x in 2022-2023. Although we expect mid-single-digit revenue and EBITDA growth, we also expect that leverage will remain at about 3.0x because we forecast operating cash flow will cover network investments and shareholder distributions rather than deleveraging. We expect a peak in capital expenditure (capex) in 2022 and 2023, stemming from ongoing upgrades of the fixed infrastructure in the Czech Republic and mobile network upgrades in other areas. Furthermore, PPF spent about €160 million on spectrum renewals in Hungary in first-half 2022, and in 2023, we expect PPF to participate in upcoming spectrum auctions in Bulgaria and Serbia. As well, we anticipate dividend payments will hamper any material deleveraging prospects. Still, we expect PPF to continue adhering to its financial policy, stating a maximum net leverage of 3.2x, a threshold it has been comfortably below in recent quarters.

Relatively stable competitive markets support the group's sound market position in mobile telecommunications. PPF is the No. 1 mobile operator (in terms of revenue share) in two of its markets (Bulgaria and Serbia), shares the leading position with T-Mobile in the Czech Republic, and holds the No. 2 position in Hungary and No. 3 in Slovakia. We believe the mobile markets in which the group operates are moderately competitive, based on the presence of three mobile network operators (MNO) in each country and relatively stable market share distribution.

O2 Czechia's fixed broadband and pay-TV subscriber base is growing as CETIN Czechia continues to invest and upgrade its network. The Czech Republic remains the group's largest market, representing around 49% of its EBITDA during first-half 2022 (O2 and CETIN Czechia). Ongoing fixed network modernization at CETIN Czechia will continue supporting the group's market position, growth, and pay-TV penetration, while improving its mix of higher-speed and higher-value fixed subscribers. O2 provides connection speeds of 50 megabits per second (Mbps) or more to 87% of its connections, up from about 30% in 2015, and 100 Mbps to 71% of its connections, achieved through DSL upgrades via fiber-to-the-cabinet and now fiber-to-the-home deployment--and a better mix of higher-speed and higher-value fixed subscribers at O2 Czechia.

Outlook

The stable outlook reflects our expectation that PPF will continue to increase revenue and EBITDA at a mid-single-digit rate because we expect the group to continue monetizing its network upgrades and TV-content investments, while maintaining its mobile market shares and average revenue per unit in all countries of operations. We expect that pro rata adjusted leverage basis will remain at about 3x and free operating cash flow (FOCF) to debt above 10%, excluding spectrum payments.

Downside scenario

A negative rating action is unlikely given PPF's sound profitability, cash flow, and financial policy, but we could lower the rating if adjusted debt to EBITDA sustainably increases above 3.5x, along with FOCF to debt declining to sustainably below 10%. This could result from a more competitive market environment, a push toward convergence in markets where the group is a mobile-only operator, or unexpected and more aggressive return to shareholders.

Upside scenario

Although unlikely in the next 12 months, we could raise the rating if PPF builds a favorable track record of steady fixed broadband and pay-TV market share gains--narrowing the fixed broadband market share gap with other European incumbents--maintains or further improves its mobile positioning, and sustains an adjusted EBITDA margin of more than 40%. We could also upgrade PPF if management aimed to adapt its reported leverage target so that it sustains the S&P Global Ratings-adjusted debt to EBITDA at less than 3x, with FOCF to debt at more than 15%, excluding spectrum, and this stronger credit profile would not be constrained by our view of the group's credit quality.

Company Description

PPF is a European telecom group operating in five markets: the Czech Republic (through O2 for retail activities and CETIN Czechia as an independent wholesale fixed and mobile infrastructure provider); Slovakia (through the O2 brand); and Hungary, Bulgaria, and Serbia (through the Yettel brand for retail activities and CETIN Group as an independent wholesale mobile infrastructure provider in all areas). The group offers mobile, fixed broadband, and internet protocol television in the Czech Republic, as well as mobile services only in its four other operating countries. It also offers wholesale fixed and mobile services in the Czech Republic, and wholesale mobile services in Hungary, Bulgaria, and Serbia after it voluntarily separated its network from commercial activities in 2020 in these countries.

In 2021, PPF generated about €3.6 billion of consolidated revenue, and €1.5 billion of consolidated reported EBITDA after leases, 37% of which comes from CETIN Group (including Slovakia, Hungary, Bulgaria, and Serbia), 36% by O2 Group (Czech and Slovak operations), and 27% from Telenor CEE/Yettel. In the same year, PPF had 18.3 million mobile customers--including 6.0 million in the Czech Republic, 3.5 million-3.6 million each in Hungary and Bulgaria, 3.0 million in Serbia, and 2.3 million in Slovakia.

PPF Telecom is part of PPF Group N.V., an international investment conglomerate with four pillars: telecom, financial services, real estate, and media.

Our Base-Case Scenario

Assumptions

- Czech Republic GDP to expand by 2.5% in 2022, with close to stagnate levels in 2023, at 0.2%. For the eurozone, we expect 3.1% growth in 2022 and about 0.3% in 2023.

- Czech consumer price index (CPI) to rise by 16.8% in 2022 and about 8% in 2023. Eurozone CPI will rise by 8.0% and 5.2%, respectively.

- Pro rata revenue decline of about 5% in 2022 due to the deconsolidation of 30% of CETIN. Reported consolidated revenue growth will be 3%-4% in 2022 and 2023.
- EBITDA margin of 46%-48% in 2022-2023, supported by increasing scale in several markets but constrained by inflationary pressure and rising energy prices.
- S&P Global Ratings-adjusted EBITDA margin of about 52% in 2022 compared with 47% in 2021. The increase relates to our master service agreement adjustment.
- Pro rata capex of 16%-17% of sales, mainly fueled by continued investments to upgrade CETIN Czechia's fixed network.
- Annual spectrum payments of €100 million-€200 million per year.
- Dividends of about €600 million per year in 2023-2024, after €1 billion in 2022.

Key metrics

- S&P Global Ratings-adjusted debt to EBITDA of about 3.0x in 2022-2024 (similar to 3.0x in 2021).
- S&P Global Ratings-adjusted FFO to debt of 26%-28% in 2022-2024 (similar to 27.8% in 2021).
- S&P Global Ratings-adjusted FOCF, excluding outlays on spectrum, of 12%-14% in 2022-2024 (similar to 14% in 2021).

Liquidity

We view PPF's liquidity as adequate, based on our expectation that the ratio of liquidity sources to uses will be comfortably above 1.2x in the 12 months from June 30, 2022. In addition, the group has sound headroom vis-a-vis its covenants, good relationships with banks, and a satisfactory standing in capital markets. We also believe PPF can absorb high-impact, low-probability events with limited need for refinancing as we understand it has flexibility to adjust its capex and reduce its dividend distributions.

Principal liquidity sources include:

- Cash and liquid investments of €501 million as of June 30, 2022.
- An undrawn €200 million revolving credit facility (RCF) maturing in 2026.
- Cash FFO of €1.2 billion-€1.4 billion.

Principal liquidity sources include:

- Capex of €650 million-€700 million, including our assumptions for spectrum payments.
- Minor working capital outflow.
- Dividends of about €600 million.

Covenants

We expect adequate headroom under PPF's financial covenant of a net leverage ratio, set at 4.0x. Furthermore, subsidiaries CETIN Group and O2 Group are subject to a net total leverage of maximum 2.2x and other group entities (Yettel) are subject to a max net total leverage of 1.0x.

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating assigned to the €550 million due 2026, and €600 million unsecured bonds due 2024 and 2025, as well as the €500 million due 2027 tap issued by PPF Telecom Group B.V.is 'BB+'. The recovery rating is '3', indicating our expectation of a meaningful recovery (rounded estimate: 50%) in an event of default.
- The recovery prospects are supported by our valuation of PPF Telecom as a going concern. It is constrained by the bonds' unsecured and unguaranteed nature and the structural subordination of unsecured debt at subsidiaries O2 and CETIN.
- The debt documentation offers borrowers operational flexibility, as well as creditor protection. For example, there is a net consolidated leverage ratio at 4.0x at group level. What's more, incurrence of debt at the subsidiary level is limited by a 2.2x net proportionate maximum leverage at CETIN and O2 Czechia and a 1.0x net proportionate maximum leverage at Yettel.
- Our hypothetical default scenario envisions increased competition between telecom providers and a push toward convergence, where the group operates as mobile-only, resulting in subscriber loss, lower profitability, and cash burn.
- We value PPF as a going concern, being a midsize European telecom operator with strong mobile market positions, low churn, and established network asset base in several Central and Eastern European countries.

Simulated default assumptions

- Year of default: 2027
- Jurisdiction: Czech Republic
- Minimum capex: 6%
- Cyclicality adjustment factor: 0% (standard sector assumption for telecom and cable)
- Operational adjustment: 50% (reflecting our assumptions that on a hypothetical path to default, minimum capex will exceed 6%)
- Emergence EBITDA after recovery adjustments: about €507 million
- Implied enterprise value multiple: 5.5x

Simplified waterfall

- Gross recovery value: about €2.8 billion
- Net recovery value for waterfall after 5% administrative expenses: about €2.69 billion
- Value available to unsecured claims: €1.24 billion
- Estimated senior unsecured debt claims: about €2.28 billion

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)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bb+

ESG credit indicators: E2,S2,G2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 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 23, 2014

- General Criteria: Methodology: Industry Risk, 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: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed	
PPF Telecom Group B.V.	
Issuer Credit Rating	BB+/Stable/--
Senior Unsecured	BB+
Recovery Rating	3(50%)

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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; or Stockholm (46) 8-440-5914