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Research Update:

KPN Upgraded To 'BBB/A-2' On Lower Leverage; Outlook Stable

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Rating Action Overview

- Dutch telecoms incumbent operator Koninklijke KPN has posted 2018 operating performances in line with our expectations.
- Competition remains elevated in the Dutch market, but we see revenue stabilizing over the next two years.
- We expect KPN's efficiency program will continue to drive organic margin growth. Resulting EBITDA and retained cash flow will likely drive deleveraging below 3x, and TEFD proceeds provide further financial flexibility.
- We are therefore upgrading KPN to 'BBB/A-2' from 'BBB-/A-3'.
- The stable outlook reflects our view that management will continue to deleverage to below 3x on the back of stronger EBITDA and positive discretionary cash flows.

Rating Action Rationale

KPN has deleveraging capacity to strengthen credit ratios sustainably in line with our 'BBB' rating. Under our forecast, KPN crosses our upgrade thresholds in 2019 despite accounting distortion and elevated restructuring charge assumptions that will depress EBITDA and builds a substantial cushion from 2020. KPN's prior efficiency program realized €225 million in run-rate savings, in line with its original targets. This helped drive positive organic EBITDA growth in 2018, leading us to believe that KPN will meet the target of its new program--an additional €350 million in net indirect opex savings by end-2021. This supports our forecast rise in S&P Global Ratings-adjusted EBITDA margins to 44% in 2020 and 46% in 2021, from 42% in 2018, and anticipated cash flow for deleveraging.

Management is committed to deleveraging and has articulated a mid-term objective of reported net leverage below 2.5x. This equates to less than 3x S&P Global Ratings-adjusted debt to EBITDA and supports our assumption that the company will use free cash flow to reduce debt. We believe management's financial policy has become more conservative since the 2017 share buyback, reflecting prioritization of a strong balance sheet to weather industry headwinds and fund its fiber investment programs. We also expect KPN to monetize its remaining 4.4% stake in Telefonica Deutschland over the short term and retain proceeds to strengthen the balance sheet, giving it further financial flexibility.

Competition remains challenging in the Dutch market, with revenue declines expected to continue in 2019. We assume KPN will be able to execute its stabilization plans over the next two years, thanks to the company's premium positioning, increasing penetration of convergent offers, and a more ambitious fiber to the home (FTTH) program. While we do not assume material market repair, the merger of TMobile and Tele2 is likely to moderate unsustainable price competition, further supporting market stabilization.

In our opinion, the potential impact of reported interest from Brookfield Asset Management on KPN's creditworthiness is sufficiently remote at this point. We understand that Brookfield has yet to directly approach KPN with a potential bid. We think the telecom company is committed to an integrated operational model and that its independent foundation would likely use its voting control to block any offer contrary to that view, or that is detrimental to lenders. In addition, recently proposed legislation in the Netherlands would allow the government to act in the national interest and intervene in an attempted takeover of a Dutch telecom firm.

Outlook

The stable outlook on KPN reflects our view that management will continue to reduce debt through a mix of positive discretionary cash flows and proceeds from the monetization of group financial assets. We forecast that adjusted leverage will fall below 3x in 2019, with an increasing cushion thereafter. We also project that, over 2019, KPN's funds from operations (FFO)-to-debt ratio will remain near 30% (29% in 2018) and free operating cash flow (FOCF) to debt will remain above 10%, excluding spectrum costs (14% in 2018). The outlook also incorporates our opinion that group EBITDA has stabilized on a sustainable basis and should rise from 2020 as KPN benefits from a new round of cost-saving measures.

Downside scenario

We could lower our rating on KPN if its adjusted debt to EBITDA remained above 3.0x due to financial policy measures, such as larger-than-anticipated shareholder distributions or weaker-than-expected operating performance. These could stem from an unabated decline in B2B or consumer mobile as a result of renewed pricing pressures in the market. We could also consider a downgrade if our view of transactional credit risk increased.

Upside scenario

While unlikely at this point, we could raise our rating if KPN materially reduced debt such that its adjusted leverage stayed below 2x. This could occur on a much stronger-than-expected operational rebound, possibly driven by market repair in mobile following consolidation to a three-player market. A shift to more a conservative financial policy, including a commitment to maintain such levels rather than increase dividends, would also likely be needed to support ratings upside.

Company Description

KPN is the incumbent and leading integrated telecommunications and IT services provider in the Netherlands, offering fixed-line and mobile telephony and broadband to business and retail customers, and TV to retail consumers. As of Dec. 31, 2018, the company generated about €5.6 billion in revenues and approximately €2.3 billion in adjusted EBITDA.

Our Base-Case Scenario

We believe that KPN will sustain its EBITDA turnaround, thanks to stabilizing revenue and aggressive cost-cutting, including process simplification and progress toward a full internet protocol (IP) network that is less expensive to maintain. Despite continued headwinds and negative growth in the B2B and consumer mobile segments, we expect the company's topline will stabilize over the next two years driven by fixed-line consumer broadband.

Our base-case assumptions for the coming two years include:

- Organic revenue decline of about 2% in 2019 (in line with the organic drop of 2% in 2018, excluding the effect of the iBasis sale). This reflects the tough competitive environment, particularly in B2B and consumer mobile. We think KPN's focus on premium service offerings and converged bundles will improve trends, and that consumer mobile should approach breakeven in 2020, and B2B should improve to low single digit declines by 2021.
- Consolidated revenue stabilization in 2020 and modest growth approaching 1% thereafter. Consumer residential broadband will lead with growth of 2%-3% as KPN executes on plans to cover over 40% of Dutch households with its FTTH network over the next three years.
- Adjusted EBITDA margin to remain flat in 2019, after jumping to 42% in 2018 with the disposal of KPN's low margin iBasis business, on heightened restructuring costs associated with KPN's new three-year efficiency program. This will depress adjusted EBITDA and temporarily slow deleveraging in 2019, despite slight organic growth. Adjusted margins should resume climbing thereafter--to 44% in 2020 and 46% in 2021--as the program's benefits accrue to the second half of the three-year efficiency project. This should support EBITDA growth until topline growth kicks in. Adoption of the new lease accounting standard (International Financial Reporting Standards 16) would add another 1% to this margin forecast.
- Capital expenditure (capex) to remain high at about €1.1 billion per year, about 20% of revenue, through our forecast as the company accelerates its FTTH rollout. We also assume annual spectrum auction costs of about €300 million-€350 million in 2020 and 2021. This is incremental to our capex forecast.
- Dividends of €500 million-€550 million in 2019 and 2020.

- We exclude potential benefit from sale of KPN's remaining stake in TEFD, since the timing and valuation are uncertain. However, we expect proceeds will be retained for debt reduction, which could yield an additional €400 million-€450 million of financial flexibility.
- Our forecast also excludes the change to IFRS16 accounting. Based on KPN's public guidance, we expect the new standard could result in about 0.15x higher adjusted leverage, though at this time we do not expect the accounting change will impact our view of underlying credit quality.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures:

- Debt to EBITDA of just below 3.0x in 2019, a marginal improvement from 3.0x in 2018 due to high restructuring costs and lower revenue weighing on EBITDA in 2019. We expect more pronounced strengthening to about 2.8x in 2020 and 2.6x in 2021, as EBITDA begins to expand on cash-flow-led deleveraging. Monetization of KPN's TEFD stake could further reduce leverage by about 0.2x.
- FFO to debt of about 28% in 2019 and 31%-33% in 2020-2021, after about 29% in 2018.
- Adjusted FOCF to debt, excluding spectrum, of 12% in 2018, rising to 16%-18% in 2020-2021, after about 14% in 2018.

Liquidity

We assess KPN's liquidity as strong, with sources of liquidity to cover uses by more than 1.5x over the next 12 months and at least 1.0x in the following 12 months. This assessment also reflects our view that KPN maintains a high credit standing in the capital markets and solid relationships with banks.

As of Jan. 1, 2019, we estimate liquidity sources of about €3.7 billion in the following 12 months, including:

- Cash and liquid investments of about €650 million;
- Undrawn long-term committed credit lines of €1.25 billion, with maturity up to 2023;
- Positive FFO of about €1.8 billion; and
- Marginal working capital inflows.

For the same period, we estimate KPN's liquidity needs at about €2.2 billion, including:

- Annual capex of about €1.1 billion;
- Annual ordinary dividends of €500 million-€550 million; and
- About €600 million of debt redemption.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/A-2

Business risk: Satisfactory
- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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
- 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: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related Research

- Credit FAQ: Will Changes To Lease Accounting Standards Affect Telco Ratings?, Feb. 13, 2019

Ratings List

Upgraded

	To	From
Koninklijke KPN N.V.		
Issuer Credit Rating	BBB/Stable/A-2	BBB-/Positive/A-3
Senior Unsecured	BBB	BBB-
Junior Subordinated	BB+	BB

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.