02 May 2019 | Affirmation

Fitch Affirms KPN at 'BBB'; Outlook Stable

Fitch Ratings-Frankfurt am Main-02 May 2019:

Fitch Ratings has affirmed Netherlands-based Royal KPN N.V.'s (KPN) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. The Outlook on the IDR is Stable. A full list of rating actions is at the end of this commentary.

KPN is the Dutch incumbent telecoms operator offering fixed-line/broadband, mobile and pay-TV services with strong market positions in both consumer and B2B (business-to-business) segments. We project KPN's FFO adjusted net leverage to remain comfortable for its rating level and significantly below its downgrade threshold supported by capex discipline and improving financial performance on the back of its EUR 350 million cost-cutting program. Additional financial flexibility is provided by a 3.5% minority stake it holds in Telefonica Deutschland (BBB/Positive) (as of end-1Q19).

Key Rating Drivers

Strong Market Positions: We expect KPN to maintain its strong market positions in both the mobile and fixed-line/broadband segments, supported by its strategy to accelerate fiber deployment , and to continue with infrastructure upgrades. KPN has maintained its wired broadband market share at close to 40%. It is the largest mobile operator in the country with a subscriber retail market share at above 30% at end-1H18, as estimated by Telecommonitor.

Premium Strategy: KPN is keen to position itself as a premium operator, which may allow it to command stronger pricing power and lead to growth in average revenue per user (ARPU). The company is making significant investments to ensure high quality of its network that is capable of provid ing premium services. KPN is going to make its mobile network fully 5G -ready by end-2021. The company plans to build an additional 1 million fiber-to-the-home (FTTH) household connections by end-2021 , taking the total to 3.4 million, and covering more than 40% of households in the Netherlands.

Unbundled, Mobile-Only Services Vulnerable: We project KPN's retail revenue to remain in the modestly negative territory, due to pressure from declining fixed-line unbundled and mobile-only services. While the company is making good progress in migrating its customer base to bundled offers with higher ARPU, the total number of serviced households in 1Q19 declined 4% yoy and the total count of revenue generating units (RGUs) shrank by 3.4% yoy.

Non-bundled customers accounted for a quarter of KPN's total household base at end-1Q19, and are likely to continue churning away. The company's consumer mobile subscriber base declined 6% yoy at end-1Q19, with post-paid customers demonstrating higher loyalty as their numbers shrank only 1.3% yoy.

B2B Under Pressure: The business-to-business (B2B) segment is likely to remain under moderate pressure over the next couple of years, hit by declining revenue from legacy products. Strong growth in IT and other services is likely to be insufficient to compensate for weakness in communication revenue (down 7.6% yoy in 1Q19). Business customers are migrating en-masse to IP-based solutions, with voice-over-IP ARPU only a fraction of traditional fixed-voice ARPU (EUR11 vs. EUR49 respectively in 1Q19).

Margins Sustainably Higher: We expect KPN's profitability to become sustainably stronger, supported by an ambitious cost-cutting programme to reduce net indirect operating costs by EUR350 million at end-2021. The company is going to significantly reduce its workforce and has identified a few legacy platforms that can be discontinued or simplified. The targeted savings are substantial at 6 .2% of 2018 revenue. The net impact on EBITDA growth is likely to be more moderate, due to continuing revenue challenges.

More Cost-Cutting Likely: We believe the company retains a potential to continue with the second wave of additional cost savings in the more distant future, which would be margin -accretive. KPN has received regulatory clearance to start switching off its legacy PSTN network, which may pave the way for further network simplification and a leaner operating model.

Capex Discipline: KPN's plans to increase the share of capex on infrastructure upgrades within a constant capex amount support the company's longer-term competitiveness, in our view. The company committed itself to EUR 1.1 billion of annual capex till end-2021.

Strong Cash Flow: We expect KPN to be able to maintain strong cash flow generation, with a pre-dividend free cash flow (FCF) margin in the low single-digit territory on average in the medium-term. This will be under temporar y pressure from restructuring expenses that are likely to be front-loaded, leading to lower FCF generation in 2019 and , to a lesser extent , in 2020.

Moderate Leverage: We expect KPN's leverage to remain comfortable, at slightly above 3x funds from operations (FFO) adjusted net leverage (3x at end-2018) , providing sufficient headroom within the current rating level. We project the company's deleveraging flexibility to be supported by improving EBITDA generation on the back of ongoing cost-cutting and healthy organic cash flow.

One-off Offset: Leverage will be modestly pushed up by two rounds of spectrum payments that we expect in 2020 and 2021. However, this may be mitigated by if the company retains proceeds from the sale of its remaining shares in Telefonica Deutschland (BBB/Positive). The company held a 3.5% stake in the latter operator at end-1Q19.

Taxes to Rise: KPN's FFO and FFO-based metrics are likely to be modestly weakened once the company begins paying higher income taxes. KPN continues to benefit from a tax shield created by the divestment of its mobile operations in Germany - the company only paid EUR 9 million of cash income taxes in 2018. The deferred tax asset from netted tax losses and other carry forwards including unrealised liquidation losses was reported at EUR594 million at end-2018, a reduction from the EUR902 million reported at end-2017.

Derivation Summary

The ratings of KPN reflect its strong domestic market positions, but also intense infrastructure-based competition in the Netherlands in the face of a full bundle-enabled operator, VodafoneZiggo Group B.V. (B+/Stable) , on a cable network with a significant revenue market share. KPN's domestic market is more competitive than certain other European markets with limited or regional cable competition such as Italy or Germany. The company is rated one notch lower than its larger peers such as Orange S.A. (BBB+/Stable) and Deutsche Telekom AG (BBB+/Stable) with comparable leverage , due to its smaller scale, lower geographic diversification and a more challenging competitive environment. KPN can sustain higher leverage within its rating compared with equally-rated but operationally weaker or less diversified operators such as NOS, S.G.P.S., S.A. (BBB/Stable) or Telefonica Deutschland Holding AG (BBB/Positive).

Key Assumptions

-Revenue i n the consumer and B2B segments to decline 2% or less in 2019, before stabilising in the medium-term but with B2B lagging

-Improving EBITDA margin supported by the EUR350 million cost-cutting programme

-Significant front-loaded restructuring charges in 2019-2021, cumulatively equal to slightly above one year of expected annual cost savings of EUR350 million

-Recurring capex (excluding spectrum) in line with company guidance of EUR 1.1 billion per annum

-Spectrum investments in 2020 and 2021

-Modestly growing dividends

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

-Revenue and EBITDA growth across all divisions combined with a strengthened operating profile and competitive capability

-Expectations of FFO-adjusted net leverage sustainably below 3.0x

Developments That May, Individually or Collectively, Lead to Negative Rating Action

-Deterioration in KPN's operations that result in declining EBITDA

-Expectations of FFO-adjusted net leverage remaining above 3.5x on a sustained basis

-Aggressive shareholder remuneration policy that is perceived by Fitch not to be in line with the company's operating risk profile

Liquidity and Debt Structure

Sufficient Liquidity: KPN had EUR644 million of cash and cash-like assets at end-2018, excluding EUR24 million relating to the contracted sale of iBasis. This is supported by an untapped EUR 1.25 billion revolving credit facility with a maturity in July 2023. Additionally, in early 2Q19 the company signed a European Investment Bank facility of EUR300 million available for mobile network investments. KPN's debt maturity profile is well-spread out with annual redemptions at or below EUR1 billion per annum.

Royal KPN N.V.; Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
----senior unsecured; Long Term Rating; Affirmed; BBB
----subordinated; Long Term Rating; Affirmed; BB+

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Applicable Criteria

Corporate Hybrids Treatment and Notching Criteria (pub. 09 Nov 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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