Telefonica Deutschland Holding AG

Update

Ratings

Long-Term IDR	BBB

O2 Telefonica Deutschland Finanzierungs GmbH

Senior unsecured	BBB

Outlook

Foreign-Currency Long-Term IDR	Stable

Financial Data

Telefonica Deutschland Holding AG

	31 Dec 2013	31 Dec 2012
Revenues (EURm)	4,914	5,213
Revenue Growth (%)	-5.7	3.5
EBITDA (EURm)	1,237	1,279
EBITDA Margin (%)	25.2	24.5
Funds from Operations (EURm)	1,142	1,792
Pre-Free Cash Flow (EURm)	592	1,023
Free Cash Flow Margin (%)	12	19.6
Net Debt/EBITDA (x)	0.6	0.73
FFO Net Adjusted Leverage (x)	2.31	1.63
FFO Fixed-Charge Cover (x)	4.07	6.45

Analysts

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Key Rating Drivers

E-Plus Adds Scale, Synergies: The E-Plus acquisition received EU clearance in September – with Fitch Ratings' base case being that the transaction closes with effect from 4Q14. The transaction boosts Telefonica Deutchland Holding AG's (TEF DE) market position – Fitch estimates it will be the number two by mobile service revenues. E-Plus currently reports stronger margins which should in Fitch's view enhance the overall profile. A well-managed and effective integration will however be important if commercial momentum is not to be interrupted.

Ratings Less Constrained: Fitch had previously guided that upside to the ratings was limited by TEF DE's single market and scale. Given the structure of the E-Plus deal – adding significant incremental cash flows with no additional debt (given the rights issue and equity component), the company's enhanced operating profile and better economies of scale, the ratings are less constrained. While our base case envisages it taking time for margins to expand dramatically, ratings upside is possible at some point.

Financial Policy, High Operating Leases: TEF DE's revenues and cash flow are mature and highly visible. Fitch expects operating conditions to remain tough, but the ratings are as much a function of stated financial policy and a high level of operating leases. Dividend policy subject to a stated leverage (net debt/EBITDA) target of below 1.0x, is expected by Fitch to drive progressive distributions, while operating leases add approximately 1.7x of leverage (FYE2013) to the FFO net adjusted metric.

Operating Conditions: Despite operating in Europe's largest telecom market and in an economy that has remained consistently strong, revenue and EBITDA pressures have been driven by naturally prudent consumption trends and a competitive environment that should ease following the closing of the acquisition. A well-developed reseller (MVNO) market and regulatory remedies which require TEF DE to preserve 20% of its network capacity for up to three MVNOs are likely to maintain competition, but in Fitch's view with less intensity.

Parent-Subsidiary Linkage: TEF DE's ratings are assigned broadly on a standalone basis, but with some ultimate linkage to the parent. The company has been established as a standalone entity, with separate management, independent governance and its own financial policy. Given its scale and maturity, Fitch regards TEF DE as a sustainable independent business with a proven ability to finance itself and guides that TEF DE could be rated up to two notches higher than the parent. This linkage was more important during the Eurozone crisis.

Rating Sensitivities

Leverage and Operations: A material weakening in the company's current financial profile would put pressure on the ratings. Financial pressure likely to exert ratings pressure includes funds from operations (FFO) net adjusted leverage exceeding 3.0x, and FFO fixed charge cover falling below 4.0x.

Any upside in the rating is unlikely to materialise for some time following closing of the E-Plus acquisition. However, the positive leverage approach to funding the acquisition combined with the scale and operational benefits of the deal does pave the way for the possibility of a higher rating over time. Any upgrade guideline will be discussed more fully once the transaction has closed. A material and sustained improvement in the margin profile would be likely to form a key part of this discussion.

Peer Group

Issuer	Country
BBB	
BT Group plc	United Kingdom
TDC A/S	Denmark
BBB−	
Royal KPN N.V.	Netherlands
Telecom Italia SpA	Italy
BB+	
Portugal Telecom SGPS SA	Portugal

Issuer Rating History

Date	LT IDR (FC)	Outlook/ Watch
14 Jan 14	BBB	Stable
23 Jul 13	BBB	Stable
13 Mar 13	BBB	Stable
16 Jan 13	BBB	Stable
9 Jan 13	BBB	Stable
18 Dec 12	BBB	Stable
31 Aug 12	RAS	

Snapshot Profile: Major Issuer-Specific Rating Factors and Trends

Rating Factor	Status[a]	Trend
Operations	Average	Improving
Market Position	Weak	Improving
Finances	Strong	Improving
Governance	Average	Neutral
Geography	Average	Neutral

[a] Relative to [peer group

Related Criteria

Corporate Rating Methodology (May 2014)

Rating Telecom Companies (August 2012)

Immediate Peer Group – Comparative Analysis

Sector Characteristics

Operating Risks

Incumbent telecom operators have mature but relatively stable cash flows in their home markets. In most cases this is complemented by a degree of diversification, developed either in adjacent or emerging markets. Domestic market growth is mature, both in fixed and mobile segments, where market saturation and competition make further subscriber growth difficult. There has been a marked decoupling between northern and southern European markets, with southern European revenue appearing under greater pressure.

Financial Risks

In fixed line, maturing broadband markets and continued competition from alternative networks and cable TV providers across western Europe are putting pressure on top-line growth. Incumbents have been investing in their networks so that they can offer high-speed broadband and IPTV (internet protocol TV) products.

Mobile revenue is proving more susceptible to the economic downturn than previously expected. Convergence and multimedia services will continue to keep capex and investments in subscriber acquisition and retention high. Over the longer term, the industry needs to find ways to monetise the strong growth in data traffic to avoid erosion of revenue and margins, while keeping investment in new technologies high.

Peer Group Analysis

LTM June 2014	TDC BBB/Stable	Telefonica Deutschland BBB/Stable	BT Group plc BBB/Positive	KPN BBB−/Stable
Revenue growth (%)	-5.5	-6.9	-0.5	-8.1
EBITDA (EURm)	1,327	1,150	7,639	2,564
EBITDA margin (%)	42.4	24.2	33.6	31.5
Net Debt / EBITDA (x)	2.1	0.7	1.2	2.8

KPN figures reflect continuing operations; FX rates DKR 7.4556; GBP: 0.800 to EUR1.0

Source: Fitch, companies

Key Credit Characteristics

Fitch expects anaemic revenue growth in the mature western markets, but growth from international assets combined with cost-cutting measures should minimise the decline in profitability. Cash flow growth remains limited, and Fitch expects most incumbents to remain cautious on dividend distributions, while seeking to keep leverage at the current levels.

Overview of Companies

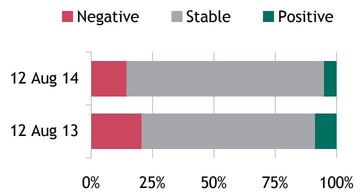
TDC A/S (BBB/Stable) – is the Danish incumbent, with a strong domestic position in a mature market, despite facing intense competitive pressure in its mobile business. Top-line pressures are currently offset by a strong margin profile.

Telefonica Deutschland (BBB/Stable) – will be Germany's mobile market number one by customers/number two by service revenues, following the E-Plus merger. Closing of this transaction, expected in 4Q14 materially improves the company's scale and market position.

BT Group plc (BBB/Positive) – is the UK incumbent telecom. Operating in a highly competitive market, the company's investment in fibre and TV content (primarily sport) supports the company's market number one broadband position. Strong cost management, good cash flow and low leverage support its ratings and Outlook.

Royal KPN N.V. (BBB−/Stable) – is the Dutch incumbent and currently in the process of selling its German mobile business to TEF DE. Competitive conditions in both fixed and mobile, along with high spectrum acquisition costs, have weighed on domestic performance and leverage.

Distribution of Sector Outlooks
Directional Outlooks and Rating Watches



Fitch's expectations are based on the agency's internally produced, conservative rating case forecasts. They do not represent the forecasts of rated issuers individually or in aggregate. Key Fitch forecast assumptions include:

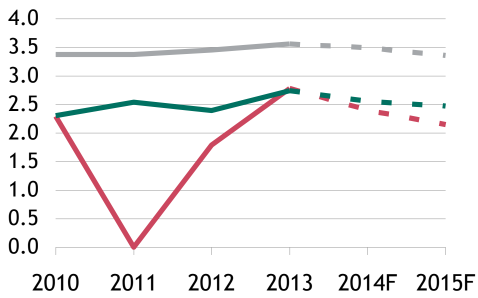
- The E-Plus acquisition closes in the 4Q14, with the first full year of revenues recorded in 2015;
- on a combined basis revenue pressures ease given the stronger operating profile and improved competitive environment;
- EBITDA margin rises to the high twenties in 2015 reflecting the stronger mobile only margins from E-Plus;
- capex to sales in the mid-teens;
- distributions to be managed well within a 1.0x leverage target/cap;
- upside potential to the rating case from synergies – although this is not factored into our forecasts.

Definitions

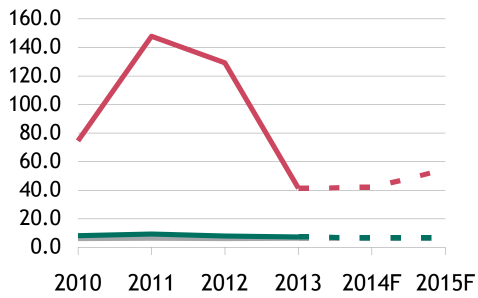
- Leverage: Gross debt plus lease adjustment minus equity credit for hybrid instruments plus preferred stock divided by FFO plus gross interest paid minus interest received plus preferred dividends plus rental expense.
- Interest cover: FFO plus gross interest paid minus interest received plus preferred dividends divided by gross interest paid plus preferred dividends.
- FCF/revenue: FCF after dividends divided by revenue.
- FFO profitability: FFO divided by revenue.
- For further discussion of the interpretation of the tables and graphs in this report see Fitch's "*Interpreting the New EMEA and Asia-Pacific Corporates Credit Update Format*" Special Report, dated 25 November 2009 and available at www.fitchratings.com.

Telefonica Deutschland Holding AG — Telecommunications Median — Developed BBB Median
Source: Company data; Fitch.

Leverage
including Fitch expectations



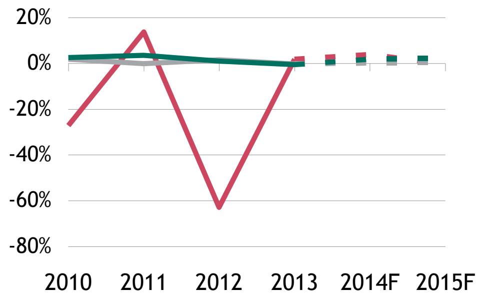
Interest Cover
including Fitch expectations



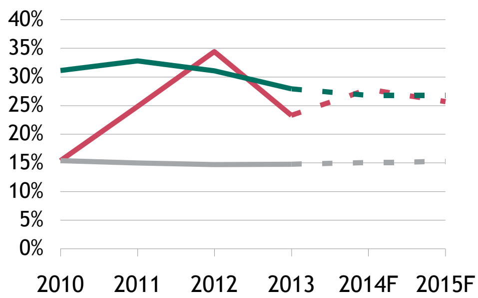
Debt Maturities and Liquidity at Dec 2013

Debt maturities	**(EURm)**
2014	100
2015	250
2016	250
2017	250
After 2017	600
Cash and equivalents	**708.5**
Undrawn Committed Facilities	
Bilateral bank lines totalling EUR710m	710

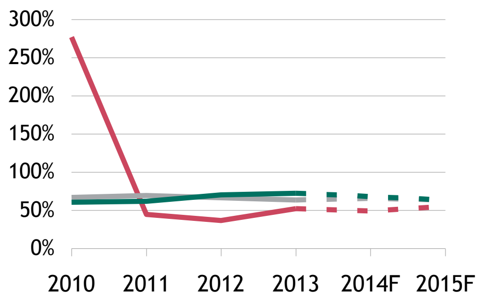
FCF/Revenues
including Fitch expectations



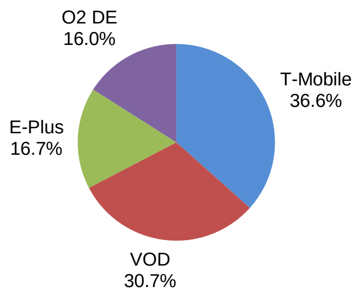
FFO Profitability
including Fitch expectations



Capex/CFO
including Fitch expectations

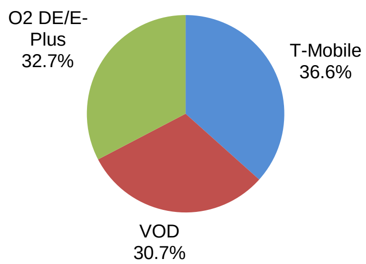


German Mobile Service Revenue Market Share - 2Q14



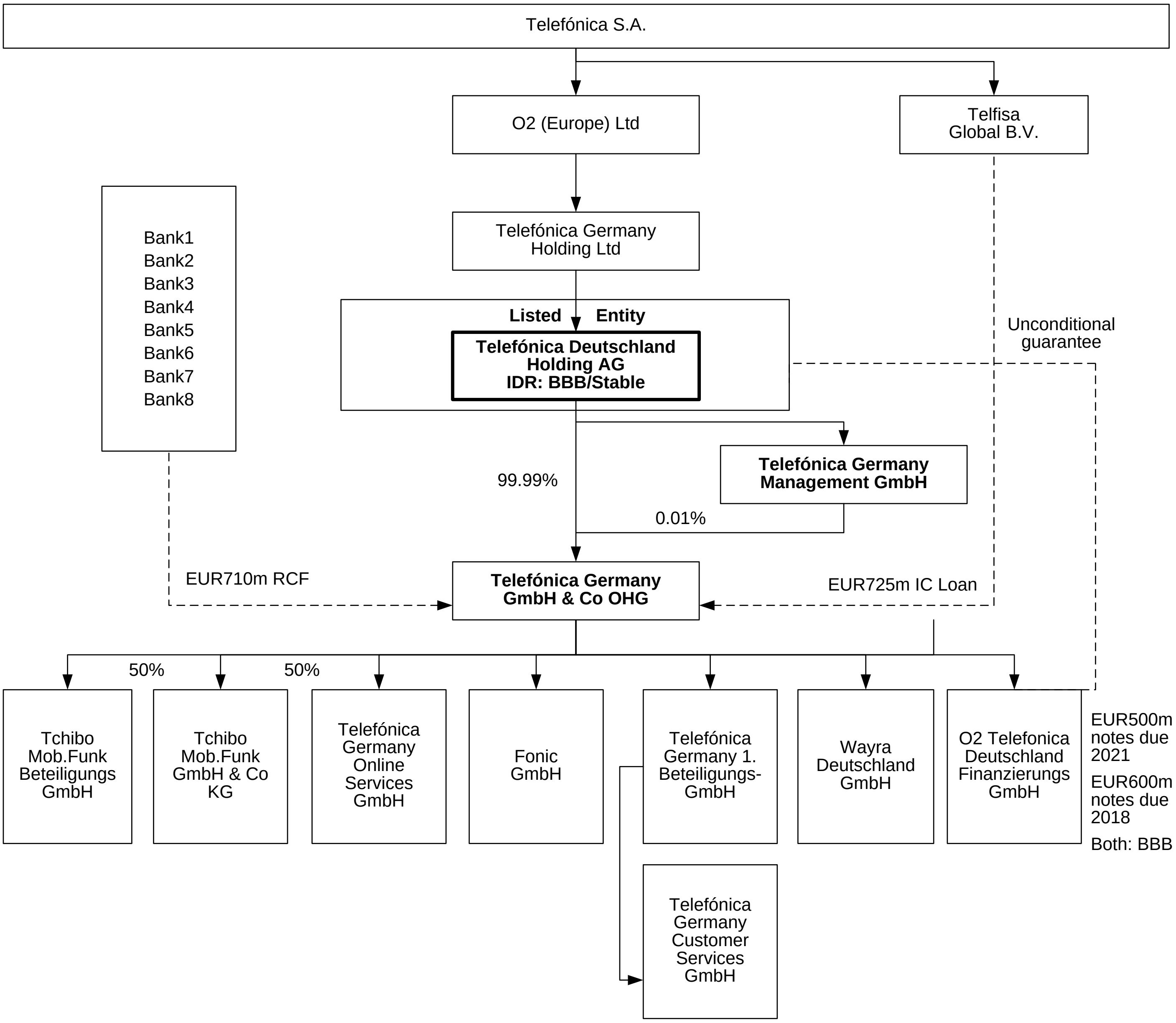
Source: company earnings releases, Fitch

German Mobile Service Revenue Market Share - 2Q14
pro-forma for O2/ E-Plus merger



Source: company earnings releases, Fitch

Simplified Group Structure Diagram



Source: Transaction documents

Building Blocks - Telecoms Sector - TEF DE (BBB/Stable)

	Sector Risk Profile	Company-Specific Traits				Financial Profile (Historical where relevant and forecast, mid-points)				
		Competitive position	Diversity of service platforms	Technology leadership/ infrastructure quality	Regulatory risk	FFO adj.net leverage (x)	FFO fixed charged cover (x)	OP.EBITDAR (USD)	OP.EBITDAR margin (%)	Pre div FCF/ sales (%)
AA										
A	• Incumbent operators	• Large scale, dominant market position, • Diversified service portfolio, good geographical footprint	• Operates multiple established platforms for providing service. Commonly wired and wireless	• Infrastructure of high quality. Leading edge technology deployed widely in a timely manner	• Regulatory risk is benign or low	2.0	7	>5bn	35	15
BBB		• Medium Scale, Strong Market Position, Average geographical footprint, Service Portfolio may be heavily weighted to one service	• May operate multiple platforms, but one may be developing with one established	• Infrastructure quality is solid. Leading edge technology deployed more narrowly or at a slower pace	• Regulatory risk is moderate	3.0	4	>3bn	30	10
BB	• Emerging or "niche" provider	• Small scale, market challenger, lack of service diversity, weak geographical footprint	• Operates one established platform	• Infrastructure is questionable. Leading edge technology not deployed	• Regulatory risk is medium, or trending higher	4.0	3	>800m	20	7
B		• Little to no scale, market challenger, lack of service diversity, weak geographical footprint	• May be developing a single platform or may not own platform	• Limited infrastructure deployment or quality is out-dated	• Regulatory environment is clearly unfavorable	5.0	3	<800m	15	Negative

General
- Essential service
- Broadly constant demand
- Technology risk
- High barriers to entry
- Regulated or franchised services
- Economies of scale

Current Forecast

Indicative factors observed or extrapolated for rated issuers in developed markets. Ratio levels refer to the mid-point of a through-the-cycle range; actual observations are likely to vary from these. Certain sub-sectors may contain a small number of observations; where no observations currently exist, guidelines for a category are extrapolated based on Fitch judgement. The factors give a high-level overview and are neither exhaustive in scope nor uniformly applicable. Additional factors will influence ratings, particularly in emerging markets and where group relationships constrain or enhance a rating level.

Telefonica Deutschland Holding AG
FINANCIAL SUMMARY

	31 Dec 2013 EURm Year End	31 Dec 2012 EURm Year End	31 Dec 2011 EURm Year End	31 Dec 2010 EURm Year End	31 Dec 2009 EURm Year End
Profitability					
Revenue	4,914	5,213	5,036	4,826	3,746
Revenue Growth (%)	(5.74)	3.52	4.34	28.85	n.a.
Operating EBIT	105	143	67	(95)	(32)
Operating EBITDA	1,237	1,279	1,149	893	891
Operating EBITDA Margin (%)	25.17	24.54	22.82	18.50	23.79
FFO Return on Adjusted Capital (%)	14.86	20.79	10.69	7.60	8.60
Free Cash Flow Margin (%)	1.82	(62.87)	13.72	(27.23)	(2.82)
Coverages (x)					
FFO Gross Interest Coverage	41.26	129.06	147.65	74.36	127.58
Operating EBITDA/Gross Interest Expense	43.86	92.22	136.99	89.89	164.27
FFO Fixed Charge Coverage (inc. Rents)	4.07	6.45	147.65	3.38	3.18
FCF Debt-Service Coverage	0.89	(12.14)	83.34	(131.33)	(18.46)
Cash Flow from Operations/Capital Expenditures	1.91	2.75	2.24	0.36	0.87
Debt Leverage of Cash Flow (x)					
Total Debt with Equity Credit/Operating EBITDA	1.17	0.99	n.a.	n.a.	n.a.
Total Debt Less Unrestricted Cash/Operating EBITDA	0.60	0.73	(1.00)	(0.21)	(0.04)
Debt Leverage Including Rentals (x)					
Annual hire lease rent costs for long-term assets (reported and/or estimate)	341	312	n.a.	296	309
Gross Lease Adjusted Debt/Operating EBITDAR	2.65	2.36	n.a.	2.00	2.06
Gross Lease Adjusted Debt /FFO+Int+Rentals	2.78	1.79	n.a.	2.29	2.47
FFO Adjusted Net Leverage	2.31	1.63	(0.93)	2.11	2.43
FCF/Lease Adjusted Debt (%)	2.14	(87.20)	n.a.	(55.41)	(4.27)
Debt Leverage Including Leases and Pension Adjustment (x)					
Pension and Lease Adjusted Debt /EBITDAR + Pension Cost	2.64	2.36	n.a.	2.00	2.06
Balance Sheet Summary					
Readily Available Cash	709	324	1,149	189	38
Restricted/Not Readily Available Cash	n.a.	n.a.	n.a.	n.a.	n.a.
Short-Term Debt	104	255	n.a.	n.a.	n.a.
Long-Term Senior Debt	1,344	1,005	n.a.	n.a.	n.a.
Subordinated debt	n.a.	n.a.	n.a.	n.a.	n.a.
Equity Credit	n.a.	n.a.	n.a.	n.a.	n.a.
Total Debt with Equity Credit	1,448	1,260	n.a.	n.a.	n.a.
Off-Balance-Sheet Debt	2,730	2,498	n.a.	2,372	2,472
Lease-Adjusted Debt	4,178	3,758	n.a.	2,372	2,472
Fitch- identified Pension Deficit	n.a.	n.a.	n.a.	n.a.	n.a.
Pension Adjusted Debt	4,178	3,758	n.a.	2,372	2,472
Cash Flow Summary					
Operating EBITDA	1,237	1,279	1,149	893	891
Gross Cash Interest Expense	(28)	(14)	(8)	(10)	(5)
Cash Tax	n.a.	n.a.	(5)	7	(0)
Associate Dividends	n.a.	n.a.	n.a.	n.a.	n.a.
Other Items before FFO (incl. interest receivable)	(66)	527	113	(147)	(194)
Funds from Operations	**1,142**	**1,792**	**1,248**	**742**	**692**
Change in Working Capital	128	(160)	n.a.	n.a.	n.a.
Cash Flow from Operations	**1,270**	**1,632**	**1,248**	**742**	**692**
Total Non-Operating/Non-Recurring Cash Flow	(14)	(15)	n.a.	n.a.	n.a.
Capital Expenditures	(664)	(594)	(558)	(2,056)	(797)
Dividends Paid	(503)	(4,300)	n.a.	n.a.	n.a.
Free Cash Flow	**89**	**(3,277)**	**691**	**(1,314)**	**(106)**
Net (Acquisitions)/Divestitures	0	557	0	(844)	n.a.
Net Equity Proceeds/(Buyback)	0	0	266	2,307	(1)
Other Cash Flow Items	108	445	2	3	2
Total Change in Net Debt	197	(2,275)	959	152	(105)
Working Capital					
Accounts Receivable Days	63	67	84	83	45
Inventory Days	18	14	13	15	8
Accounts Payable Days	85	63	143	141	70

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.