FITCH AFFIRMS KPN AT 'BBB'; OUTLOOK STABLE

Fitch Ratings-London-08 August 2017: 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 the commentary.

KPN's rating reflects its leading position in the Dutch telecoms market. Competitive dynamics in the mobile and business segments are likely to remain challenging over the medium-term, but the combination of cost savings and modest growth in the consumer segment are likely to offset declines and drive a sustainable stabilisation in EBITDA and free cash-flow growth. KPN has to date maintained financial flexibility through sizeable financial investments and using proceeds from asset sales to improve leverage as well as equity returns. The flexibility provides KPN with sufficient scope to manage operational risks and is a core element in its credit profile and rating.

KEY RATING DRIVERS

Rational Fixed Market Structure: KPN generates about 30% of its revenues and probably a higher proportion of profits from the consumer fixed-line segment. We estimate that around 80% of the total Dutch market by revenues is generated broadly equally by KPN and VodafoneZiggo. This creates an effective duopoly in local fixed access and a structurally supportive environment. Given the maturity of the Dutch broadband market, we expect the market structure to instil rationality in the consumer broadband and fixed-line segments. KPN's early commercial agreements to allow wholesale access to its fibre (VULA) also limit the risk from increasing competition from virtual operators.

Sustainable Consumer Position: KPN's strategy to invest in broadband networks, value-added bundled products and service quality should enable the company to compete more effectively and sustainably in the consumer market. The strategy provides some points of differentiation in less price sensitive segments of the market and enables KPN to plough back savings from reduced churn into customer retention and product improvement. KPN's household penetration of fixed-mobile bundles has increased to 40% (1H17) from 33% (1H16), while mobile subscriber acquisition and retention costs have improved on per subscriber basis during 1H17.

Business Sector Decline to Persist: We expect KPN's revenue declines from the business segment to continue into the medium term, but expect the rate of annual decline (9% 2015, 7% 2016 and 6% 1H17) to continue improving. The declines are driven by a repricing of single-play mobile services, loss of traditional fixed-line voice revenues, migration to IP based products, and competition. Visibility on the point of inflection, when new services, multi-play growth and solutions offset the declines remains low. This is reflected in our base-case forecasts discussed below.

Mobile Market Pressure May Increase: The entry of Tele2 as a mobile network operator has so far had minimal impact on KPN as result of its segment focus and bundled strategy. This however may begin to change over the next 12 to 24 months as Tele2 seeks to increase scale and T-Mobile Netherlands looks to improve its financial performance. We are not confident about the long-term viability of Tele2's business model in its current form and are concerned that this may lead to less rational behaviour as the operator seeks to cover fixed costs and potentially an exit in its pursuit of a solution. These factors will continue to pose medium-term operational risks for KPN.

Stable EBITDA, Improving FCF: Our base-case forecasts for KPN indicate that the company will be able to improve its free cash flow (FCF) along with an expansion in pre-dividend FCF margin to around 12% within the next two to three years from 9% in 2016. The expansion reflects broadly stable EBITDA and improvements in cash interest costs and lower capex. Our base-case EBITDA forecasts reflect the company's ongoing cost improvement programme and potential operational risks that may preclude further growth. These include increases in content costs, pricing pressure, execution risks in cost reduction and delayed revenue inflection within the business market segment.

Maintaining Financial Flexibility: KPN's funds from operations (FFO) adjusted net leverage of 3.0x is comfortably within the 'BBB' rating level and provides about 0.5x of headroom. The headroom is partly driven by approximately EUR70 million of annual dividends received from its holding in Telefonica Deutschland and minimal tax payments due to sizeable tax assets. KPN's investment in Telefonica Deutschland (TEFD) is financial in nature and we expect KPN will continue to slowly reduce its stake. To date the company has used sale proceeds from asset disposals for both shareholder returns and to maintain its operational and financial flexibility. We believe KPN will continue to take this approach in the future.

DERIVATION SUMMARY

KPN's rating reflects its leading position in the Dutch telecoms market. The company has strong in-market scale and share that spans both fixed and mobile segments enabling it to pursue an effective product bundling strategy. KPN's leverage metrics at the 'BBB' level compare favourably to other western European telecoms incumbents, but these are offset by greater operational risks relating to its domestic mobile market and business segment. KPN has to date effectively managed these risks through operational execution and maintaining financial flexibility.

KPN's rating is anchored in the middle of its western European telecoms peer group. Telecoms operators with a similar domestic focus such as TDC A/S (BBB-/Stable), Telecom Italia S.p.A and BT Group Plc (BBB+/Stable) have a lower rating due to higher leverage and lower financial flexibility or a higher rating due to better competitive dynamics in the domestic market with similarly strong leverage metrics. Higher-rated peers such as Orange S.A. (BBB+/Stable), Deutsche Telekom AG (BBB+/Stable) and Telefonica SA (BBB/Stable) have similar strong domestic profiles but also benefit from greater geographic diversification and scale.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- revenue decline of -3% in 2017 improving to -1% by 2019;
- broadly stable EBITDA around EUR2.4 billion , driven by a 2.5 percentage point improvement in EBITDA margin between 2016 and 2019;
- a stable capex-to-sales ratio of 17.5% (excluding spectrum);
- a dividend payout ratio between 60% - 70% of pre-dividend FCF (excluding any dividend proceeds from TEFD);
- all TEFD dividends received are passed through to shareholders.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
-Revenue and EBITDA growth across all divisions combined with strengthened operating profile and competitive capability
-Expectations of FFO adjusted net leverage sustainably below 3.0x
-Reduced competitive risks in the mobile segment which we currently see as unlikely in the short to mediumterm
Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
-A deterioration in KPN's domestic 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 be in line with company's operating risk profile

LIQUIDITY

Comfortable Liquidity: KPN has a strong liquidity position as a result of existing cash resources, free cash-flow generation and committed available credit facilities. At end-1H17 KPN had cash and cash equivalents amounting to EUR916 million and a revolving credit facility of EUR1.25 billion that is available until July 2022. Apart from the first call date of its euro-denominated hybrids in 2018, KPN has no bond maturities over the next 12 months.

FULL LIST OF RATING ACTIONS

Royal KPN N.V
-- Long-Term IDR: affirmed at 'BBB', Outlook Stable;
-- Senior unsecured debt: affirmed at 'BBB';
-- Subordinated capital securities: affirmed at 'BB+';

Contact:

Principal Analyst
Alexander Cherepovitsyn, CFA
Analyst
+44 20 3530 1755

Supervisory Analyst
Tajesh Tailor
Senior Director
+44 20 3530 1726
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Committee Chairperson
Nikolai Lukashevich, CFA
Senior Director
+7 495 956 9968

Summary of Financial Statement Adjustments
Fitch has taken a 30% discount on EUR140 million of other financial assets as reported by KPN in its definition of net debt in 2016. The adjustment is in line with Fitch policy on fixed-income funds and has a minor impact on KPN's credit metrics.
Fitch has treated coupon payments related to KPN's EUR1.1 billion hybrids as regular bond coupons and thus included within FFO and cash flow from operations. KPN's financial reporting treats the coupon payments as equity distributions.

Media Relations: Adrian Simpson, London, Tel: +44 203 530 1010, Email: adrian.simpson@fitchratings.com.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017)
https://www.fitchratings.com/site/re/901296
Non-Financial Corporates Hybrids Treatment and Notching Criteria (pub. 27 Apr 2017)
https://www.fitchratings.com/site/re/896881
Non-Financial Corporates Notching and Recovery Ratings Criteria (pub. 16 Jun 2017)
https://www.fitchratings.com/site/re/899659