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Contacts

Carlos Winzer 34-91-768-8238
Senior Vice President
carlos.winzer@moodys.com

Luigi Bucci 44-2077-72-1961
Associate Analyst
luigi.bucci@moodys.com

Ivan Palacios 34-91-768-8229
Associate Managing Director
ivan.palacios@moodys.com

Česká Telekomunikační Infrastruktura a.s. (CETIN)

First-Time Issuer Report

Summary

» **On 11 July 2016, we assigned a first-time Baa2 long-term issuer rating to Česká telekomunikační infrastruktura a.s. (CETIN)**, the leading telecommunications infrastructure provider in the Czech Republic. The outlook on the rating is stable.

» **CETIN represents the first case of structural separation for the European telecom sector and the first case of voluntary separation worldwide**. The decision to undertake the spin-off of CETIN from O2 Czech Republic was based on four main arguments: (1) streamlining the business; (2) a more rational approach towards regulation; (3) possibility to open the network to other users; and (4) the different financial risk profile of the two entities.

» **Resilient business model underpinned by solid commercial agreements with O2 Czech Republic (O2, unrated) and T-Mobile Czech Republic (T-Mobile, unrated).** There are no comparable alternative nationwide infrastructure based competitors in the Czech Republic, which contributes to the resilience of the business model.

» **A key consideration is customer concentration.** O2 is the key customer for CETIN driving approximately 80% of the company's EBITDA and more than 95% of committed revenues over the period 2016-2022.

» **CETIN's capex planning is driven by infrastructure development and specific customer projects.** One of management's objectives is to gradually upgrade its fixed network using a hybrid technology approach, combining fibre and enhanced copper technologies. The plan will entail a total capex of CZK21 billion in 2016-22 and will be predominantly driven by infrastructure development. However, CETIN is not obliged to deliver this investment and it can manage (delay or cancel) a number of discretionary projects if needed.

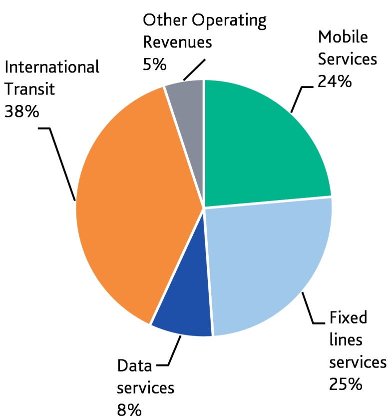
» **We expect CETIN to continue to pursue a deleveraging strategy in line with its conservative financial objectives**. This includes a deleveraging path from Moody's adjusted gross debt to EBITDA of 3.7x as of December 2015, to around 2.9x as of December 2018 and trending towards 2.5x thereafter.

Corporate Profile

Česká telekomunikační infrastruktura a.s. (CETIN), headquartered in Prague (Czech Republic), is the only national Czech telecommunications infrastructure provider. The company was incorporated in June 2015 after its spin-off from O2 Czech Republic (unrated).

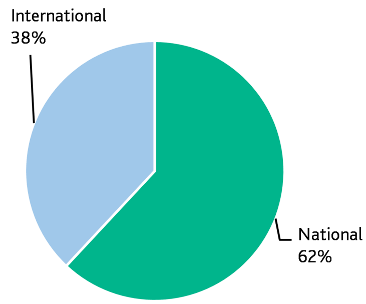
CETIN currently operates and manages fixed and mobile infrastructure in the domestic market and transit infrastructure abroad, with an international presence in Germany, Austria, Slovakia and England. In 2015, CETIN generated revenues of CZK19.13 billion and EBITDA of CZK7.94 billion. As of December 2015, domestic fixed and mobile services segments represented 96% of CETIN's EBITDA. CETIN's main customer is O2 Czech Republic, accounting for almost 80% of CETIN's EBITDA.

Exhibit 1
Revenue Breakdown by Segment
As of December 2015



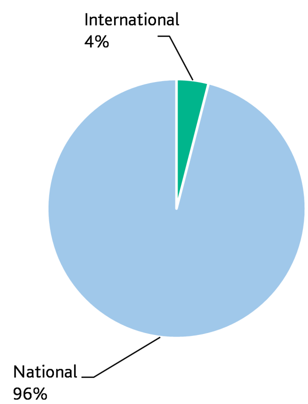
Source: Company Data

Exhibit 2
Revenue Breakdown by Geography
As of December 2015



Source: Company Data

Exhibit 3
EBITDA Breakdown by Geography
As of December 2015



Source: Company Data

The key shareholder of the company is the PPF Group (unrated), a Czech investment group, one of the largest in Central and Eastern Europe with diverse business investments encompassing banking and financial services, telecommunications, biotechnology, insurance, retail, real estate and agriculture in Europe, Russia, Asia and the US.

Management Strategy

The company's key objective is to enhance the quality of its network through continued investments in its infrastructure. A very predictable revenue stream from strong commercial partners through long-term commitments supports the current capex programme.

The company intends to strengthen its leading position in the Czech Republic market in both mobile and fixed, benefitting from its quality network, growth in the capacity & density of 4G and the roll out of fibre.

Although less material in terms of EBITDA contribution, the company aims to stabilise its revenues from the Data Services segment and to grow strongly in the low margin international transit revenue business. Key to EBITDA expansion will be the focus on stable operating expenses to be achieved through operating efficiencies.

Summary Rating Rationale

The Baa2 issuer rating reflects the company's differentiated business model as a telecom infrastructure operator, and its strong market position as the only national fixed telecom infrastructure provider with a resilient business model underpinned by solid commercial agreements with O2 Czech Republic (driving 80% EBITDA in the next 7 years) and T-Mobile Czech Republic. There are no comparable alternative nationwide infrastructure based competitors in the Czech Republic, which contributes to the resilience of the business model.

The rating also takes into consideration: (1) CETIN's de-leveraging objective supported by management's conservative financial strategy in which the dividend pay-out is subject to operating cash flow strength, capex funding and debt repayment as priority objectives; (2) CETIN's modest size but strong market position as a national infrastructure provider with very strong EBITDA margins in its domestic business; (3) the growth prospects of the telecom market given the strength of the economy in the Czech Republic supported by resilient GDP growth when compared with other European markets; (4) the expected supportive regulatory environment; (5) the stable business risk as CETIN benefits from operating leverage that contributes to high EBITDA margins in the domestic business (more than 64% EBITDA margin excluding the international transit business) and stable capex overall; (6) its strong cash flow generation before dividends; and (7) its adequate liquidity profile over the next 12-24 months.

Detailed Rating Considerations

First Example of Structural Separation in the European Telecom Sector

CETIN represents the first case of structural separation in the European sector and the first case of voluntary separation (absent regulatory mandate) worldwide. The decision to undertake the spin-off of CETIN from O2 Czech Republic was based on four main arguments: (1) streamlining the business; (2) a more rational approach towards regulation; (3) possibility to open the network; and (4) the different financial risk profile of the two entities.

The two businesses were substantially different, dealing with the services and infrastructure segments, and required a different type of approach and strategy, being customer service/content/spectrum oriented on one side, and capital intensive on the other. From a regulatory point of view, the separation of the two entities was beneficial for both sides. On the one hand, O2 was subject to lower regulatory scrutiny, and on the other, CETIN would voluntarily provide remedies to the regulator in order to avoid any possible negative implications. Moreover, the operation has enabled CETIN to open its network and expand its customer base.

Leading Market Position in the Czech Telecom Market

CETIN currently covers more than 50% of the Czech Republic telecommunication infrastructure market. There is no comparable nationwide infrastructure based provider, as the closest competitors, UPC Holding B.V. (UPC, Ba3 stable) and Vodafone Group Plc (Vodafone, Baa1 stable), are smaller, have lower coverage or have a weaker market position. CETIN is also the only operator with a copper network in the country, with approximately 85% of households covered. In spite of the roll-out of fibre, this network will remain crucial for the last metres of access. In the mobile segment, CETIN's current 3G and 4G coverage amount to 80% and 90% of the Czech population respectively.

Such a strong position is underpinned by (1) the fact that it provides mobile voice and data services to O2 and T-Mobile through the shared network; (2) the partnership with O2 in all downstream retail markets; (3) T-Mobile's fixed broadband services representing mostly a resale of CETIN's xDSL and voice; and (4) the delivery of backbone transport network to numerous alternative network operators and retail service providers, including T-Mobile and Vodafone. The two key customers of CETIN (O2 and T-Mobile) are the market leaders in mobile with about 38% market share each.

CETIN also provides wholesale international voice services to more than 160 customers worldwide and terminates more than half a billion minutes per month, with a steady growth in volume and number of partners. This segment is a low margin business with high revenues and high cost of sales entailing minimum opex and capex.

High Customer Concentration with O2 Czech Republic

O2 is the key customer for CETIN, driving approximately 80% of the company's EBITDA and more than 95% of the committed revenues over the period 2016-22. O2 Czech Republic appears to be a sound business partner with stable revenues, low leverage (with a target reported net leverage of up to 1.5x) and strong cash flow metrics.

Although we note a strong customer concentration, we have also factored into the rating the multi-year commitment between O2 and CETIN, which provides greater predictability of the revenue stream until 2022, as well as the sustainable long-term demand for the network independently from O2.

Network Sharing Agreement with T-Mobile Czech Republic

In 2013, CETIN and T-Mobile signed an agreement for network sharing inclusive of active Radio Access Network (RAN) sharing for 2G/3G/4G.

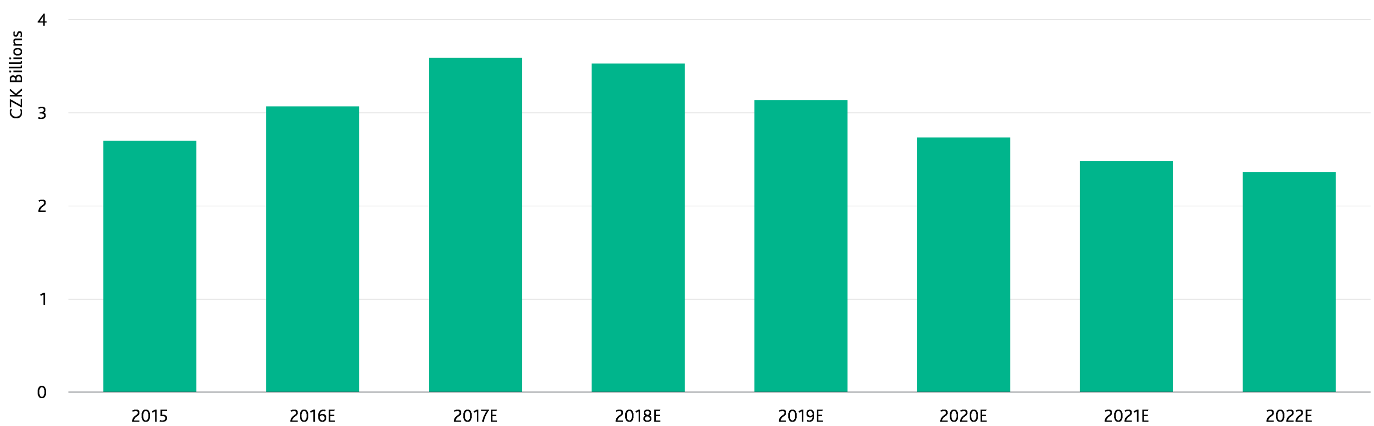
The key elements of the agreement are that: (1) T-Mobile is the master operator for the western part of the Czech Republic, while CETIN covers the eastern side: the cities of Prague and Brno are excluded from the agreement; (2) the master operator owns and operates the active technology on all sites within its region; (3) ownership of the passive infrastructure is not changing: some sites in CETIN's region are owned by CETIN, some by T-Mobile, but all have active equipment owned and operated only by CETIN; (4) minimum cash flow between T-Mobile and CETIN as expenses are assumed to be broadly similar; and (5) CETIN provides nationwide mobile network for O2.

Sustained CAPEX over the Upcoming Years to Enhance Quality of the Network

CETIN's capex planning is driven by infrastructure development and specific customer projects. One of management's objectives is to gradually upgrade its fixed network using a hybrid technology approach, combining fibre and enhanced copper technologies, which support an efficient investment. In this regard, CETIN continues to implement a major capex plan that will set a strong basis for long-term business growth. The plan will entail a total capex of CZK21 billion in 2016-22 and will be predominantly driven by infrastructure development. We have assumed that around 50% of the capex in the plan is highly discretionary and will only be executed if a minimum rate of return is achieved.

Exhibit 4

CETIN Capex Evolution 2015-2022



Source: Moody's Financial Metrics, Moody's estimates

The key project in the plan involves the fixed network upgrade to FTTC. The project, which is expected to provide 41% of CETIN's fixed broadband connections with a speed of 100 Mbps by 2020, is critical for the company's long-term positioning in the broadband market. The delivery of premium speeds will enable CETIN to (1) change its competitive positioning against wi-fi and cable operators, leveraging both their limited speed and coverage; (2) add approximately 200,000 units to its customer base (900,000 at present) and; (3) increase its market share. Key to this will be the modernisation of the current copper network through the installation of 9,300 remote digital subscriber line access multiplexer (DSLAMs).

CETIN has committed to develop its mobile infrastructure as part of its long-term agreement with O2. One of the key implementations will entail 4G and will enable O2 to achieve the licence requirements (95% coverage by 2018) by year-end 2016. This project will be important for CETIN even from a 5G perspective, as it will help the company to set the foundation for future implementation of the new technology.

Regulatory Environment in the Czech Republic Is Stable

CETIN is regulated by the Czech Telecommunications Office. The structural separation model is relatively new and there are few examples globally. Chorus (Baa2 stable) in New Zealand is the best comparison from a business model perspective.

The regulatory environment in the Czech Republic is broadly in line with other EU countries (mainly because the same set of laws are applied). Notably, the Czech regulator is broadly consistent in the decisions, analysis and approach.

Focusing on New Generation Access (NGA) and wholesale broadband, the regulator does not provide direct guidance on pricing. According to the regulator, a change in this direction is unlikely considering CETIN's full compliance with the regulatory requirements and the level of existing infrastructure competition.

High Visibility on Future Performance Underpins Steady Deleveraging

We expect that CETIN will continue to pursue a deleveraging strategy to comply with conservative financial objectives. This includes a deleveraging path from its current Moody's-adjusted gross debt to EBITDA ratio of 3.7x (equivalent to reported net debt to EBITDA of 3.5x) as of December 2015, to around 2.9x as of December 2018 and trending towards 2.5x thereafter.

We have factored into the rating a high confidence in management's ability to deliver financial objectives on the basis of reliable and predictable revenues, based on the nature of existing contracts with O2 and T-Mobile. The company's operating costs are predictable, which implies high certainty on future EBITDA margins.

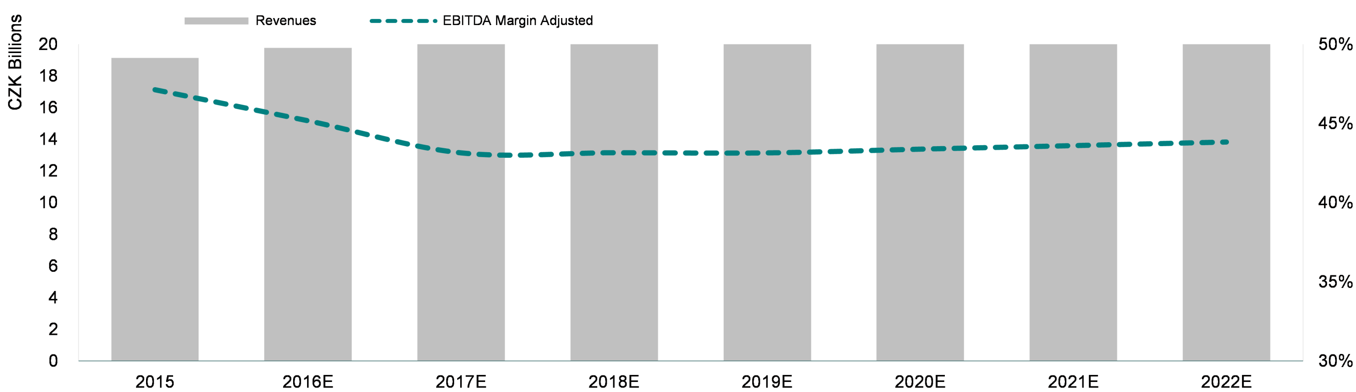
We have taken into consideration the high margin component of domestic revenue, which becomes highly diluted as a result of the substantial transit traffic with a single digit margin. Given that 96% of the EBITDA is generated by the domestic fixed and mobile business, we have given a high weight to the high margin of the domestic business in our analysis.

Slow Revenue Growth and High Domestic Margins Underpin Resilient Cash Flow

Under our assumptions, CETIN's consolidated revenues will increase by 3% in 2016 and approximately by 2% in 2017, mainly as a result of higher volumes in the transit traffic and the mobile business.

Exhibit 5

Revenue and Adjusted EBITDA Margin Evolution 2015-2022



Source: Moody's Financial Metrics, Moody's Estimates

2016 is the true reference year for CETIN in fixed after the spin-off from O2. This is due to two key points: (1) a new reference offer was introduced in mid-2015 with the same pricing for all the different market players: in light of the higher prices applied to O2 in H1 2015, 2016 is going to represent the first year with a full impact from the new price point; and (2) O2 introduced flat tariffs for fixed voice in 2016, driving an initial drop in accesses and revenues.

In 2016 and in future years (1) investments in the fixed network will accelerate net adds – mainly through IPTV and xDLS; while (2) higher volumes in data services are likely to counterbalance the continued pricing decline. As a general rule, continued losses in voice customers will be more than compensated by an increase in both broadband and IPTV, driven by the network enhancement. Moreover, unlike in mobile, traffic is key to revenue growth and equal conditions for all operators will be key to drive the growth of accesses.

We expect revenue growth in the mobile segment to remain broadly stable over 2016-22, owing to the flat fees from O2. Further upside pressure in terms of revenues may come from new projects with O2, which would add extra capacity and coverage to the mobile network.

CETIN, with its strong focus on revenue, profitability and capex optimisation, is a highly cash generative business. We expect that the company's cash flow generation will continue to improve owing to a moderate improving trend in revenues, a relatively fixed and efficient cost base and stable capex. CETIN will benefit from the degree of operating leverage embedded in this business, which will drive the high domestic margin. As the company gains traffic and increases scale, incremental growth in domestic revenues will drop to the EBITDA line, having a positive impact on margins.

CETIN's Rating Assumes That PPF Will Not Need Extraordinary Cash Upstreams From CETIN to Support Other Businesses

CETIN's key shareholder, with a 100% stake in the company, is the PPF Group, a Czech investment group, one of the largest in Central and Eastern Europe with diverse business activities encompassing banking and financial services, telecommunications, biotechnology, insurance, retail, real estate, and agriculture in Europe, Russia, Asia and the US. PPF Group is active in the telecom sector through its stakes in CETIN and O2 Czech Republic.

We currently factor into the rating a distribution of 100% of previous year net income by 2018. Nevertheless, PPF is willing to lower its dividend expectations to offset any possible operational weakness and preserve an investment-grade rating.

We have assumed that PPF, as the 100% owner of CETIN, will not impose extraordinary cash upstreaming measures, other than the ordinary dividend policy described above. We have treated PPF as a shareholder with an adequate corporate governance in place and with no extraordinary cash needs to fund other businesses within its conglomerate of different activities.

The Czech Republic Has a Favourable Macroeconomic Environment

Understanding the credit quality of the sovereign, the Czech Republic, is important, given the high correlation between the macroeconomic environment and the telecoms sector. The Czech Republic's A1 sovereign rating with a stable outlook is underpinned by high economic strength, very high institutional strength, very high fiscal strength, and a low susceptibility to event risk.

The fiscal framework overhaul, currently under parliamentary debate, will further strengthen institutional quality once implemented. The Czech Republic's very high fiscal strength is underpinned by an affordable debt burden and favourable debt affordability metrics. Government finances draw strength from the ability to easily tap local-currency financing through its large, though underdeveloped, domestic capital market. The financial sector remains healthy and vulnerability indicators point to a low risk of shocks that could adversely affect the sovereign's balance sheet. Nevertheless, owing to its high degree of openness, the economy remains exposed to external demand fluctuations.

Liquidity Analysis

CETIN's liquidity risk profile is adequate, supported by the company's strong operating cash flow generation. This takes into consideration that although there are no debt maturities until July 2018, management will be gradually repaying debt based on free cash flow generation after capex and dividend payments. Although CETIN does not have bank back up facilities in place for the time being, management could plan to have them in the future.

According to its liquidity policy, CETIN needs to hold a minimum technical cash reserve of CZK300 million. Additional funds may be used for capex, debt reduction and dividend distributions, unless net leverage is above 3.5x.

Peer Comparison

Due to its unique business model, CETIN's closest peer is Chorus Limited (Baa2 stable), a New Zealand-based telecommunications utility group. Chorus owns copper and fibre optic fixed-line telecommunications networks in New Zealand, together with exchanges, roadside cabinets, and associated infrastructure. It is a wholesaler of access to these networks.

CETIN is relatively more diversified than Chorus both geographically and operationally. CETIN operates both on the mobile and fixed segments with an international exposure through its transit division, while Chorus is a fixed-only infrastructure operator operating in a single country. The regulatory environment in New Zealand has been less predictable, while we expect it to be stable in Czech Republic.

Shareholder influence appears to be different for the two companies and presents a clear higher risk for CETIN, given that PPF Group may require increasing support for its wide range of activities.

Key difference in financial ratios between CETIN and Chorus are margins as CETIN's figures are diluted by the transit division which shows high revenues but very low margins.

Exhibit 6

Peer Comparison: CETIN and Chorus

Global Communications Infrastructure Industry Grid [1][2]	CETIN - Current FY 12/31/2015		Chorus - Current LTM 12/31/2015	
Factor 1: Scale, Business Model, and Competitive Environment and Business Conditions (30%)	**Measure**	**Score**	**Measure**	**Score**
a) Scale & Financial Flexibility Based on Revenue (in $Bn)	$0.8	B	$0.7	B
b) Business Model	A	A	A	A
c) Competitive Environment and Business Conditions	A	A	A	A
Factor 2: Financial Policy (10%)				
a) Financial Policy	Baa	Baa	A	A
Factor 3: Operating Performance (25%)				
a) FFO Margin %	41.1%	Ba	41.8%	Ba
b) EBIT Margin %	14.8%	Ba	24.9%	Baa
Factor 4: Financial Strength (35%)				
c) (FFO+Interest Expense) / Interest Expense	20.7x	Aaa	4.0x	Ba
d) (EBITDA-CapEx) / Interest Expense	14.2x	Aaa	0.4x	Ca
e) (RCF-CapEx) / Debt	13.7%	A	-5.9%	Ca
f) Debt / EBITDA	3.7x	Baa	3.3x	Baa
Triggers Rating Up	Debt/EBITDA ratio drops below 2.5x on a sustained basis.		Debt/EBITDA dropping below 3.5x or FFO/Interest staying above 4.5x on a sustained basis.	
Triggers Rating Down	Debt/EBITDA remains above 3.5x by 2017.		Debt/EBITDA exceeds 4.6x and/or FFO/Interest drops below 3.7x on a sustained basis.	

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 12/31/2015
[3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Financial Metrics

Rating Outlook

The stable outlook factors in that CETIN's credit metrics will continue to be well positioned for the rating category based on our expectation that the company will de-lever and therefore the adjusted debt/EBITDA ratio will improve over the next two years, while the group will continue to generate positive free cash flow. This includes a deleveraging path from Moody's adjusted gross debt to EBITDA of 3.7x (equivalent to reported net debt to EBITDA of 3.5x) as of December 2015, to around 2.9x as of December 2018 and trending towards 2.5x thereafter.

The stable outlook also assumes that CETIN will meet or exceed its deleveraging targets and management will distribute up to 100% of its annual Net Income through dividends over the projected period, only if the deleveraging plan is achieved. There will be no cash dividend distribution in 2016 and approximately one third of planned 2016 net income in 2017. We note that PPF, CETIN's shareholder, has committed to adjust the company's dividend to mitigate any future deviation in operating performance and hence protect financial ratios within the current rating.

Factors that Could Lead to an Upgrade

Upward pressure on the rating could develop if the company delivers on its business plan, such that its adjusted debt/EBITDA ratio drops below 2.5x on a sustained basis. This decrease in leverage would likely be reliant on the company maintaining a conservative approach to any further acquisitions, such that its deleveraging profile is not compromised.

Factors that Could Lead to a Downgrade

Downward pressure could be exerted on the rating if CETIN's operating performance weakens as a result of pricing pressures or market share losses reducing cash flow generation, or if the company increases debt as a result of acquisitions or shareholder distributions such that its adjusted debt/EBITDA remains above 3.5x by 2017. A weakening in the company's liquidity profile could also exert downward pressure on the rating.

Financial Profile and Key Credit Metrics

Exhibit 7

Key Indicators

	12/31/2015
Scale & Financial Flexibility Based on Revenue (in $Bn)	$0.8
FFO Margin %	41.1%
EBIT Margin %	14.8%
(FFO+Interest Expense) / Interest Expense	20.7x
(EBITDA-CapEx) / Interest Expense	14.2x
(RCF-CapEx) / Debt	13.7%
Debt / EBITDA	3.7x

All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics™
Source: Moody's Financial Metrics

Rating Factors

Exhibit 8

Global Communications Infrastructure Industry Grid [1][2]	Current FY 12/31/2015		Moody's 12-18 Month Forward View As of 7/13/2016 [3]	
Factor 1: Scale, Business Model, and Competitive Environment and Business Conditions (30%)	**Measure**	**Score**	**Measure**	**Score**
a) Scale & Financial Flexibility Based on Revenue (in $Bn)	$0.8	B	$0.7	B
b) Business Model	A	A	A	A
c) Competitive Environment and Business Conditions	A	A	A	A
Factor 2: Financial Policy (10%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 3: Operating Performance (25%)				
a) FFO Margin %	41.1%	Ba	36.5% - 36.9%	B
b) EBIT Margin %	14.8%	Ba	20.5% - 21.5%	Baa
Factor 4: Financial Strength (35%)				
c) (FFO+Interest Expense) / Interest Expense	20.7x	Aaa	13x - 14x	Aa
d) (EBITDA-CapEx) / Interest Expense	14.2x	Aaa	7.5x - 8.5x	Aa
e) (RCF-CapEx) / Debt	13.7%	A	7.5% - 13.5%	A
f) Debt / EBITDA	3.7x	Baa	3.2x - 3.3x	Baa
Rating:				
a) Indicated Rating from Grid		A3		Baa1
b) Actual Rating Assigned				Baa2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 12/31/2015
[3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Financial Metrics

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