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Research Update:

Finnish Telecom Operator DNA PLC Assigned 'BBB' Rating; Outlook Stable

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Overview

- DNA is the leader in Finland's cable TV market and a close No. 3 in fixed and mobile broadband markets, thanks to well-invested networks, but has a small absolute scale, operates in a single country, and competes with larger players.
- The company has a very strong balance sheet, with adjusted debt to EBITDA at 1.6x year-end 2017, supported by a conservative financial policy and solid free operating cash flow (FOCF).
- We are assigning our 'BBB' long-term issuer credit rating to DNA.
- The stable outlook reflects our expectation that DNA will deliver organic revenue growth of about 3% and an EBITDA margin of at least 35%, while maintaining S&P Global Ratings' adjusted leverage comfortably below 2.25x and FOCF to debt well above 25%.

Rating Action

On March 2, 2018, S&P Global Ratings assigned its 'BBB' long-term issuer credit rating to Finnish telecommunications operator DNA PLC. The outlook is stable.

Rationale

The rating reflects DNA's leading market position in the Finnish cable TV market and its well-established and increasing presence in mobile and fixed broadband, paired with our expectations that DNA will maintain low leverage and strong free cash flow generation. DNA's revenue growth in recent years has primarily come from winning subscriber market share, and, over the last year, also from rising average revenues per user (ARPU) in the Finnish mobile market. In coming years, we expect that DNA will continue to show single-digit organic revenue growth. We expect this will be driven by upselling of higher mobile data speeds that is supported by its 4G mobile network, which covers 99.7% of the Finnish population, and by continued strong demand for mobile data in Finland, balanced by competition from larger competitors Elisa and Telia.

DNA's S&P Global Ratings' adjusted profitability has improved in recent years to 37.1% in 2017 from about 33% in 2015, as a result of scale, increasing revenues from high-margin segments, and successful integration of previous acquisitions. We expect that there is headroom to improve margins further, albeit marginally, stemming from further scale effects, increasing revenues from mobile services, and upselling of higher broadband speeds, which have higher margins than the declining revenue streams from digital terrestrial television. Furthermore, the company's well-invested mobile and fixed networks create a foundation for the company to maintain capital expenditures (capex) of about 15% of revenues. As a result, we expect that DNA will deliver solid free operating cash flow (FOCF), reaching about 28% of debt in 2018, and maintain leverage sustainably below its stated financial policy target of below 2.0x (S&P Global Ratings' adjusted 2.2x-2.3x).

Our assessment of DNA's business risk is supported by the company's well-invested 4G network and its increasing market share in the Finnish mobile market, which reached 27% in 2017. In our view, the three-player Finnish mobile telecoms market exhibits rather stable competitive dynamics, with future growth opportunities from well-invested networks and high spectrum availability. Finland has a relatively small population of 5.6 million, a relatively dense population compared with most European countries, allowing for high data consumption and speed (the highest in Europe with 14.7 gigabytes [GB] per month). However, we also are mindful that the mobile ARPU is among the lowest in Europe, with an average price of €10 for 10 GB per month (this reflects the pricing model that offers mainly unlimited data consumption with a speed differentiator). In the fixed broadband market, DNA ranks No. 3 with a 26% market share, just behind Elisa (35%) and Telia (29%), and well ahead of the companies that are part of the Finnet association (jointly 8%). Furthermore, DNA has gradually increased its market share (from about 10% in 2009) and, in our view, is well positioned to gain further shares, given its high-quality fixed network that is able to deliver speeds of 1 GB per second to the footprint covering 850,000 households (33% of households in Finland), of which 620,000 are already connected to DNA. This allows DNA to benefit from gradually upselling higher speed subscriptions. Currently, fixed broadband penetration and average speeds in Finland are below the European average, but we think rising data consumption will stimulate additional demand for high-speed fixed broadband in coming years. In addition, we consider the competitive environment in this segment as fairly stable, with only moderate incentives for operators to poach customers outside their own fixed broadband footprint. DNA has a leading position in the Finnish cable TV market, with a market share of about 40%, but it has recently experienced subscriber losses in its terrestrial network, which declined by 10% in 2017, though in part due to a switch-off of the platform in selected regions.

Our assessment of DNA's business risk is constrained by the company's very limited scale, competition from larger players and geographic diversification, with annual revenues of €886 million in 2017 and a subscriber base that is confined to Finland. In addition, DNA competes with two much larger players, Telia and Elisa, which have stronger market positions in both mobile and fixed broadband, as well as a larger presence in the corporate segment. DNA is so far mainly focused on smaller businesses and public services, and the markets for larger corporations are still dominated by Elisa and Telia, helped by their more comprehensive product portfolio across telecom, digital, and adjacent services. Moreover, we think that medium- to long-term growth opportunities may be constrained by a high degree of market saturation for mobile subscriptions. As of June 30, 2016, Finland's mobile broadband penetration stood at 147% (subscriptions/population), the highest in the EU and well ahead of second-ranking Denmark with 123%, according to data from the European Commission.

Our view of DNA's financial risk profile is supported by its low leverage and strong FOCF generation. Based on our forecast that DNA will distribute most of its solid FOCF to shareholders, we expect that leverage will remain at about 1.6x-1.7x over 2018-2019, as adjusted by S&P Global Ratings. Our adjustments to debt primarily include the addition of operating lease liabilities of about €190 million (which is the discounted value of operating lease payments relating to certain assets, primarily telecom networks, which we think are essential to run operations over a number of years) and about €13 million of spectrum lease liabilities. In addition, we apply our adjustments for captive finance operations and deconsolidate DNA's equipment installment program from DNA's adjusted credit metrics (see "The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers," published Dec. 14, 2015, on RatingsDirect). We do not publish these adjustments, but note that in aggregate they reduce our adjusted debt to EBITDA calculation by 0.2x.

Our rating on DNA also incorporates our view that the company's overall credit quality is somewhat weaker than that of peers we rate 'BBB+', based on the company's limited scale, lack of geographic diversification, and small presence in the corporate segment. Furthermore, we take into account the company's stated leverage target of below 2.0x (S&P Global Ratings' adjusted 2.25x), which implies that credit ratios could be weaker than in our base case as a result of debt-funded acquisitions or extraordinary return to shareholders.

In our base case, we assume:

- Positive macroeconomic trend in Finland with projected real GDP growth of about 1.5%-2.0% in 2018-2019 and consumer price index growth for the same years of about 1%.
- Group revenue growth of about 3% in 2018-2019, stemming from the upselling of higher mobile data speeds, increasing fixed broadband subscribers, and selective price increases in the consumer segment, balanced by declining revenues on subscriber losses in the terrestrial network, secular decline in fixed line telephony, and price pressure in the corporate segment.
- Mobile service revenue growth of about 5%-8% in 2018-2019, as we expect that there is still headroom for ARPU increases, following a 9% increase in 2017. However, we expect that subscriber intakes will remain rather flat, given strong competition and an over-penetrated market with a 147% subscription rate.
- S&P Global Ratings' adjusted EBITDA margin of about 37%-38% in 2018-2019, a gradual improvement from 33% in 2015, stemming from increasing revenues from high-margin service revenues and increasing scale.
- Capex as a percentage of sales of about 15%, excluding spectrum in 2018-2019.
- Moderate spectrum payments of about €4 million per year in 2018-2019.

- Dividend payments of about €145 million in 2018 and 70%-90% of free cash flow to equity in 2019.

Based on these assumptions, we arrive at the following credit measures:
- Adjusted debt to EBITDA of 1.6x-1.7x in 2018-2019, after 1.6x in 2017.
- Adjusted funds from operations (FFO) to debt of about 50%-55% in 2018 and 2019, following 55% in 2017.
- Adjusted FOCF to debt of about 25%-27% in 2018 and 2019, following 28% in 2017.
- Adjusted discretionary cash flow of about 5% in 2018-2019, after 16% in 2017.

Liquidity

We assess DNA's liquidity as adequate, based on our view that sources will cover uses by more than 1.2x over the coming 12 months. We also take into account our view of the company's satisfactory standing in credit markets, longstanding relationships with banks and generally prudent risk management.

We estimate that principal liquidity sources as of Jan 1, 2018, include:
- Cash and cash equivalents of about €46 million;
- Committed revolving credit facility of €150 million; and
- Cash FFO of around €250 million.

We estimate that principal liquidity uses as of the same date include:
- €100 million bond maturing in November 2018;
- Annual capex of about €145 million; and
- Annual dividend payments of 70%-90% of free cash flow to equity as per the company's financial policy.

Outlook

The stable outlook reflects our expectation that DNA will deliver organic revenue growth of about 3% and an EBITDA margin of at least 35%, while maintaining S&P Global Ratings' adjusted leverage comfortably below 2.25x and FOCF to debt well above 25%.

Downside scenario

We could take a negative rating action if DNA experienced declining revenues or if margins started to deteriorate, likely stemming from intensified competition in the Finnish market. We could also take a negative rating action if leverage increased for a prolonged period above 2.25x or FOCF approached 20%, for example from a more aggressive financial policy or acquisitions.

Upside scenario

We see rating upside as remote given DNA's limited scale and diversification, and its financial policy.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/--

Business risk: Satisfactory
- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Negative (-1 notch)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

New Rating

DNA PLC	
Issuer Credit Rating	BBB/Stable/--

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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 the 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.