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Research Update:

Italian Incumbent Telecom Italia SpA Outlook Revised To Stable On Expected Debt Containment; 'BB+/B' Ratings Affirmed

Primary Credit Analyst:
Xavier Buffon, Paris (33) 1-4420-6675; xavier.buffon@standardandpoors.com
Secondary Contact:
Patrice Cochelin, Paris (33) 1-4420-7325; patrice.cochelin@standardandpoors.com
Recovery Analyst:
Gemma Johnson, London (44) 20-7176-3451; gemma.johnson@standardandpoors.com

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Overview

- Italy's leading telecommunications operator, Telecom Italia SpA, continues to face a tough competitive and economic environment in Italy, but mobile pricing pressures have subsided since end-September.
- Telecom Italia's rollout of 4G/LTE technology in Italy and the weaker competitive position and network quality of two smaller competitors should provide some differentiating advantages to Telecom Italia.
- We foresee modest, continuously positive discretionary cash flow generation, and adjusted debt to EBITDA remaining well below 3.7x.
- We are therefore revising our outlook on Telecom Italia to stable from negative and affirming our 'BB+/B' ratings.
- The stable outlook balances the impact of increasing mobile- and fixed-network differentiation through 4G/LTE and fiber deployments, still-high operating margins, positive discretionary cash flows, and healthy liquidity, against tough economic and competitive pressures and heavy investment outlays.

Rating Action

On Nov. 28, 2014, Standard & Poor's Ratings Services revised its outlook on Italy's incumbent telecommunications operator Telecom Italia SpA to stable from negative and affirmed its 'BB+' long-term and 'B' short-term corporate credit ratings.
At the same time, we affirmed our 'BB+' and 'B+' issue ratings on Telecom Italia's debt instruments. The '3' and '6' recovery ratings on these instruments remain unchanged.

Rationale

The outlook revision reflects our view in our base case that Telecom Italia will maintain healthy liquidity and keep its leverage in check, thanks to the company's still-positive generation of discretionary cash flows, although leverage will slightly increase in 2015, due to heavy spending on spectrum in Brazil. In our view, the company's cost measures and efficiency savings will help mitigate the impact of falling revenues and heavy investments in 4G/LTE and fiber. Moreover, its €1.3 billion mandatory convertible bonds, which will convert into equity in November 2016, will have a beneficial impact. We now ascribe full equity content to the bulk of the notes (€1.15 billion, excluding the current make-whole amount), given the bond's remaining maturity of less than two years and since the company has obtained the required shareholder approval.

We think that recent softening of the decline in mobile revenues will continue in the coming quarters, thanks to both diminishing price aggressiveness in the market and to some beneficial impact of rapidly increasing data usage, which should in turn increasingly favor higher quality networks. More generally, Telecom Italia's strong push in fiber and 4G/LTE deployment should contribute to its maintaining leading competitive positions in the future, and help to mitigate very high pressures experienced in more traditional voice products.

However, given an underpenetrated fixed-broadband market and a tougher economic context in Italy, the infrastructure upgrades will, in our view, help Telecom Italia to a lesser extent than such upgrades would help many of its European peers.

The disposal of the subsidiary in Argentina, although more challenging to execute than expected and still only partially complete, the convertible bond issue, and last year's dividend cut have been important steps illustrating management's intent to keep leverage in check, in our view. The company has also recently accelerated the deployment of 4G/LTE networks in its domestic market, and enhanced its bundles and service offers, including Internet TV services, thereby reversing a previous lack of long-term strategic vision and investments, in our view.

At the same time, however, we think it will take time before Telecom Italia's fixed-line performance benefits from such initiatives, because the Italian market suffers structural underpenetration of fixed-line broadband, a highly concentrated TV landscape, and unfavorable real estate and economic fundamentals. We think this will likely continue to translate into hefty fixed-line losses and fixed-to-mobile substitution. In addition, we do not have sufficient visibility on management's future dividend policy and whether its efforts toward debt reduction will be sustained, given the recent spectrum investment in Brazil and the high level of capital expenditures. Thus, despite some improvements in the governance structure and a clearer strategy, our assessment of the company's management and governance remains "fair" at this stage, pending evidence that the company can leverage its strategic investments to durably and materially improve its credit profile.

We forecast sluggish GDP growth in 2014 and 2015 for Italy, constrained disposable household income, a depressed housing market, and small and midsize corporates seeking to cut costs, which will likely translate into a still-weak backdrop for the telecoms sector.

We think Telecom Italia's 67%-owned Brazilian subsidiary broadens the company's diversity and provides benefits from operating in a very large and still-growing market. But this subsidiary will only partly offset pressures in Italy. Its revenues are materially impacted by regulatory headwinds, and its contribution is also subject to currency swings.

Against this backdrop, we foresee Telecom Italia's revenues dropping by about 4%-6% in 2015-2016, assuming no further impact from currency exchange, after a sharper decline of about 10% in 2014 stemming from the very negative effect of the depreciation of the Brazilian real against the euro.

In our base-case assumptions, we foresee the company's EBITDA falling by 5%-6%
in 2015, after a significantly larger drop in 2014 after heavy negative currency effects and handset subsidies reclassification. We foresee an overall EBITDA margin of more than 40% across 2014-2016, with cost-saving initiatives likely to materially cushion the revenue drop.

We foresee positive but diminishing discretionary cash flows, held back by the heavy investment outlays required to roll out 4G/LTE mobile networks and extend fiber penetration in the fixed-line network in Italy. We also factor in continuously heavy outlays in Brazil to extend and upgrade the network. We therefore anticipate fixed-line investments of about 20% of revenues and annual free cash flow of about €900 million-€1.2 billion over 2015-2016, leaving about €500 million-€800 million in annual discretionary cash flow after dividends.

We think that the company's Standard & Poor's-adjusted debt-to-EBITDA ratio will slightly increase in 2015 after the heavy spending on spectrum in Brazil, but will remain within 3.5x. Moreover, although the full consolidation of the 67%-owned Brazilian subsidiary continues to benefit the ratio (an about 0.2x impact, in our estimate), given a much lower level of leverage in Brazil than in Italy, the releveraging in Brazil following the spectrum outlays could slightly reduce the distortion.

The ratings reflect our assessment of the company's business risk profile as "satisfactory" and financial risk profile as "significant." Our view of Telecom Italia's business risk balances its solid fixed-line and mobile positions, high EBITDA margins in Italy, and the benefits of geographic diversity in the attractive Brazilian market, against fierce mobile competition and underpenetration of fixed-line broadband in Italy, ongoing cannibalization issues between and within the fixed-line and mobile segments,
the challenging economic and regulatory environments in Italy, and our "fair" assessment of Telecom Italia's management and governance.

Liquidity

We view Telecom Italia's liquidity as "strong" according to our criteria, primarily thanks to its large cash balances and undrawn credit lines, good access to capital markets, and our expectation of continued positive discretionary cash flow.

We believe that Telecom Italia's sources of liquidity comfortably cover its liquidity uses by more than 2x over the 12 months started Sept. 30, 2014, and by about 1.9x in the 12 months thereafter.

As of Sept. 30, 2014, we understand that Telecom Italia's liquidity sources mainly include:

- Reported surplus cash of €5.3 billion, including about €1.7 billion cash held in Brazil, which we include in our calculations, given that it could be used to repay local debt;
- Reported committed undrawn long-term credit facilities of €7 billion, of which €4 billion matures in May 2017 and €3 billion in March 2018; and · Our anticipation of about €6 billion in funds from operations (FFO).

Liquidity uses as of Sept. 30, 2014, chiefly include:

- Our anticipation of about €4.7 billion of capital expenditures, including about €700 million of spectrum outlays in Brazil;
- About €2.2 billion of reported debt maturing in the next 12 months; and · Our anticipation of about €300 million in annual dividends.

Reported maturities will rise to €4.6 billion in the 12 months beginning Sept. 30, 2015. On an annual basis, maturities will range in the €3.3 billion-€3.8 billion range over 2015-2018, against about €1.0 billion-€1.5 billion of annual free cash flow generation. At this stage, without factoring in new financing sources, we believe the company's liquidity will be sufficient through 2017, given its positive discretionary cash flows, available cash, and undrawn facilities.

We are not aware of rating triggers in Telecom Italia's outstanding debt or undrawn facilities. Undrawn syndicated facilities do not contain financial covenants. However, the cost of these lines is linked to our rating on Telecom Italia. We understand that Telecom Italia currently has €2.75 billion of European Investment Bank (EIB) loans and that the EIB has requested guarantees for €1.95 billion of these loans.

Financial covenants exist in the 67%-owned Brazilian subsidiary's local debt instruments, but we understand comfortable headroom will continue to exist.

Also, we are not aware of cross acceleration clauses in Telecom Italia's debt that would accelerate its debt in case of a default in Brazil.

Outlook

The stable outlook reflects our view that the annual decline in domestic mobile revenues will sustainably soften in full year 2015 and Telecom Italia will maintain its current domestic EBITDA margin through sufficient cost cutting, and that Telecom Italia's network upgrades will yield competitive advantages and provide monetization opportunities in 4G/LTE and very-high-bit-rate digital subscriber line services. It also reflects our expectation of continuous absolute debt reduction through positive discretionary cash flows, fully adjusted ratios of debt to EBITDA at around 3.5x, FFO to debt at about 20%, and unaltered "strong" liquidity.

Downside scenario

Renewed rating pressure could occur if the EBITDA drop fails to soften and exceeds our base-case forecast in 2015. This could be triggered by any fresh mobile price war in Italy, deteriorating trends in the fixed-line segment, or insufficient cost cutting. In addition, rating pressure could stem from fully adjusted ratios of debt to EBITDA approaching 3.7x and FFO to debt dropping near 15%, or if positive discretionary cash flow generation is jeopardized by overly aggressive investment and dividend spend.

Upside scenario

Rating upside seems remote at this stage, and could stem from sustained stabilization of operating performance and debt leverage dropping to below 3x.

Ratings Score Snapshot

Corporate Credit Rating: BB+/Stable/B

Business risk: Satisfactory

- Country risk: Moderately high risk
- Industry risk: Intermediate risk
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no additional impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Recovery Analysis

Key analytical factors

- The issue rating on the senior unsecured notes is 'BB+'. The '3' recovery rating on these notes indicates our expectation of meaningful (50%-70%) recovery prospects in the event of default, albeit in the lower end of the range.
- The issue rating on the deeply subordinate debt is 'B+', reflecting their subordination to the company's unsecured debt and other prior ranking liabilities. The '6' recovery rating on this debt reflects our expectation of negligible (0%-10%) recovery prospects in the event of default.
- Our hypothetical default scenario assumes that a decrease in domestic fixed-line business and increased competition will negatively impact Telecom Italia's earnings and profitability.
- The recovery ratings reflect our view that Telecom Italia would be sold as a going concern in the event of default, thanks to the company's strong market position as Italy's incumbent telecoms operator.
- We also see value remaining in the company's 67% ownership of its Brazilian operations, which we include in our stressed enterprise value.

We do not assign any value to the company's Argentinian investment.

Simulated default and valuation assumptions

- Year of default: 2019
- Stressed EBITDA: €4.587 billion
- Implied enterprise valuation multiple: 5.0x
- Jurisdiction: Italy

Simplified waterfall

- Gross enterprise value at default: €22.935 billion
- Administrative costs: €1.605 billion
- Net enterprise value: €21.330 billion
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- Priority debt claims: €3.632 billion(1)
- Senior unsecured debt claims: €34.348 billion(1)(2)
- Recovery expectation: 50%-70% (lower half of range)
- Deeply subordinate debt claims: €779 million(1)
- Recovery expectation: 0%-10%

(1)All debt amounts include six months of prepetition interest. (2)Assumes revolving credit facility is fully drawn.

Related Criteria And Research

- Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Telecom Italia SpA		
Corporate Credit Rating	BB+/Stable/B	BB+/Negative/B

Ratings Affirmed

Telecom Italia SpA	
Senior Unsecured	BB+
Recovery Rating	3
Junior Subordinated	B+
Recovery Rating	6

Telecom Italia Capital S.A.	
Senior Unsecured*	BB+
Recovery Rating	3
Telecom Italia Finance S.A.	
Senior Unsecured*	BB+
Recovery Rating	3
Junior Subordinated*	B+
Recovery Rating	6

*Guaranteed by Telecom Italia SpA.

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@standardandpoors.com