

Research Update:

# Lorca Telecom (MasMovil) Downgraded To 'B' On Expected Leverage Increase; Outlook Stable

September 28, 2021

S&PGR Cuts Lorca Telecom (MasMovil) Rating To 'B'; Otlk Stable

## Rating Action Overview

- Lorca Telecom, the holding company of MasMovil group, is placing €3.05 billion of underwritten debt related to the acquisition and existing debt refinancing of Euskaltel S.A., including a €500 million subordinated facility via financing subsidiary Kaixo Bondco Telecom SAU.
- Lorca Telecom is also selling at least 700,000 of Euskaltel's hybrid fiber coaxial (HFC) building units to a new network company (Netco). In exchange, Lorca Telecom expects a sizeable minority stake in the Netco and net cash consideration, with which it plans to repay an outstanding €500 million asset bridge loan.
- We believe MasMovil's business profile strengthened materially in recent years, based on its improved Spanish residential market share in both mobile (24%) and fixed broadband (18%), with adjusted margins expected to remain above 40%.
- However, given the acquisition, we anticipate Lorca Telecom's adjusted debt to EBITDA (leverage) will remain above 5.5x, and that its reported free operating cash flow (FOCF) to debt will be minimal through 2022.
- We therefore downgraded Lorca Telecom to 'B' from 'B+', and assigned a 'B' rating to its €800 million senior secured term loan B (TLB) and €1.75 billion senior secured notes.
- We also assigned a 'CCC+' rating to Kaixo Bondco Telecom's €500 million senior unsecured notes.
- The outlook on both entities is stable, reflecting our expectation that MasMovil's leverage will remain above 5.5x through 2022, while generating positive but minimal FOCF.

## Rating Action Rationale

### **Lorca Telecom's leverage will remain elevated through 2022, along with minimal FOCF generation.**

Pro forma for the acquisition of Euskaltel, we expect Lorca Telecom's adjusted leverage will remain elevated at about 6.4x in 2021 pre-synergies, before declining to 5.6x-5.8x in

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2022 and about 5.0x in 2023. We forecast that Lorca Telecom will generate negative reported FOCF after leases in 2021, before turning moderately positive in 2022 and exceeding €200 million in 2023. Adjusted FOCF to debt will be about 1.5%-2.0% in 2022, improving to 4.0%-5.0% in 2023. We believe that the sale of HFC assets to the Netco and its deconsolidation from Lorca Telecom will not impact MasMovil's business, since the company will still have a 25-year exclusivity contract with the Netco, and given that proceeds from the sale will be utilized to repay its bridge facility.

**Our view of MasMovil's business profile has improved as it has strengthened its market position over the past few years.**

We believe that Lorca's market position and share has materially improved in both fixed broadband and mobile since 2018 when it was ranked No. 4 in the Spanish market. With a 24% mobile market share, the company now ranks No. 2 along with Orange, and closely behind Telefonica's 25% market share. MasMovil remains the No. 4 fixed broadband player, but has significantly bridged the gap (from 8% market share in 2018 to 18% in 2021), following Vodafone with a 19% market share. MasMovil has also strengthened its network position, reaching nearly the entire Spanish market with advanced FTTH and 5G network offerings.

**We expect management will remain prudent, with a conservative financial policy, and focus on deleveraging.**

We believe that Lorca Telecom's management will remain focused on deleveraging by both EBITDA expansion and debt repayment. We assume that any cash balance above €100 million will be utilized to repay the outstanding commercial paper (CP). This results in full CP repayment by the end of 2023 in our forecast. Furthermore, we have also not factored in any mergers and acquisitions, or distributions to shareholders into our forecast. We also assume that the current outstanding shareholder loan and loans from Key Wolf and Onchena totaling €224.3 million will be equitized. Any deviations on the financial policy might have an impact on our current assessment.

## Outlook

The stable outlook reflects our expectation that MasMovil's leverage will remain above 5.5x through 2022. We expect deleveraging from an elevated starting point above 6x after the Euskaltel acquisition prior to synergies, and that adjusted debt to EBITDA will decline to about 5.0x in 2023. We also expect adjusted FOCF to debt will turn positive in 2022. This is supported by our forecast for continued organic revenue growth and adjusted EBITDA margin improvement to sustainably above 40%. At the same time, execution risk against the business plan and integration create uncertainties around the achievement and timing of the forecast, particularly given the potential for add-on spending in the highly competitive Spanish as well as Portuguese markets.

## Upside scenario

We could consider raising our rating if MasMovil is able to execute its business plan to continue increasing its fixed broadband and mobile market share at a high pace, and successfully integrate Euskaltel and its network upgrade, such that its adjusted EBITDA margin remains sustainably above 40%. An upgrade could occur if these developments lead to positive adjusted free cash flow generation over €300 million (above €200 million reported after leases), combined with EBITDA growth resulting in adjusted leverage declining sustainably below 5.5x, along with a track record of financial policy commitment to maintain these levels.

## **Downside scenario**

We could lower the ratings if reported FOCF after leases remains negative, and adjusted debt to EBITDA rises above 7x for a prolonged period. This could stem from lower-than-expected revenue or EBITDA growth, higher capital expenditure (capex), additional acquisitions, or financial policy decisions that increase leverage.

## **Company Description**

Lorca Telecom is one of the four-largest telecommunications operators in Spain, providing fixed and mobile voice and internet services to business and retail customers. It is the holding company owned in majority by a consortium of private equity firms (Cinven, KKR and Providence Equity Partners) created for the takeover of MasMovil. Lorca Telecom has acquired Euskaltel, a regional provider of high-speed broadband, pay TV, mobile, and fixed telephony services to residential and business customers.

Pro forma for the acquisition of Euskaltel, the group generated revenue of €2.7 billion and served about 10.0 million subscribers (2.3 million mobile postpaid only, 3.6 million mobile prepaid, 1.5 million mobile enterprise, and 2.6 million fixed broadband customers) as of Dec. 31, 2020. This has risen to 11.4 million mobile and 3 million fixed broadband subscribers as of June 30, 2021.

Lorca Telecom's hybrid infrastructure model has allowed it to grow rapidly and economically. While more asset-light than many of its peers across Europe, Lorca Telecom's model has given it flexibility to obtain long-term and predictable infrastructure access on an economically efficient capex and operating expenditure basis, though it still invests heavily to provide subscriber access at the socket level. Its fixed network is mainly a mix of co-investment for indefeasible right of use (IRU) access to fiber infrastructure in high-utilization areas and bitstream access in other areas. Its mobile network consists of substantial mid- and high-band frequency holdings, and a mix of owned and co-invested antenna, active network sharing agreements, and two national roaming agreements (NRAs). The company has entered into contracts with all the leading peers (Telefonica, Orange, and Vodafone) for mobile and fiber-to-the-home (FTTH) coverage, thereby reducing its risk of dependence on just one operator and third parties for its core network. Its mobile access contracts have an average tenure of 10 years or more (except for its shorter-term NRA with Telefonica), and its FTTH contracts have an average tenure of more than 20 years.

Other than reported lease liabilities, we make additional company specific adjustments to debt. Given Lorca Telecom's asset-light operations and long-term contracts with multiple providers, we capitalize minimum commitments under its contracts with Netco, Cellnex, Telefonica and Orange. Furthermore, Lorca Telecom's contract with Telefonica provides an option to convert its bitstream agreement to an IRU in 2031, which we treat as debt. Likewise, we treat a similar agreement with Orange (until 2022) as debt. Overall, we add about €1.5 billion in 2021 and €1.4 billion in 2022 to debt, including all of our standard adjustments. The company also has a minority interest (49.9%) in Ucles, and we expect it will have a sizeable minority stake in Netco as well, once its HFC asset sale is completed. Deconsolidated reporting has a mildly positive impact on credit measures. We have chosen not to partially consolidate either, since we believe the impact is not currently material.

## Our Base-Case Scenario

### Assumptions

- Spanish real GDP growth of 6.3% and 6.4% in 2021 and 2022, respectively.
- Pro forma for the Euskaltel acquisition, revenue growth of 10%-11% in 2021 (more than 50% on a reported basis) and 8%-9% in 2022, fueled by residential service revenue growth of about 6% per year, and stronger growth in convergent and enterprise revenue. In addition, we expect energy and new businesses will generate about €85 million-€90 million revenue in 2021 and €130 million-€140 million in 2022.
- The adjusted EBITDA margin will improve and remain at about 40%-41% in both 2021 and 2022, mainly driven by the consolidation of higher-margin business from Euskaltel, and contractual cost savings from the acquisition, partially tempered by integration costs.
- Reported FOCF after leases will remain negative in 2021, before turning moderately positive in 2022, and rising above €200 million in 2023.
- Capex will remain at about 18% of revenue in 2021 and 17% 2022, underpinned by success-based customer level capex. On a steady-state customer basis, we assume capex intensity in the low-teens. In addition, we also treat the €32 million per year cost to convert the Telefonica bitstream contract to an IRU as capex.
- No dividends or acquisitions in our forecast.
- We assume that the company will utilize cash balances above €100 million for the repayment of CP borrowings. This would repay the entire CP program by the end of 2023 in our forecast.

Based on these assumptions, we expect:

- Adjusted leverage of about 6.4x in 2021 (pre-synergies), before declining to 5.6x-5.8x in 2022 and about 5.0x in 2023.
- Adjusted FOCF to debt will be about 1.5%-2.0% in 2022, improving to 4%-5% in 2023.

### Liquidity

We assess liquidity as adequate for the 12 months starting Jan. 1, 2022, based on our estimate that liquidity sources will cover uses by about 1.2x, after the proposed Euskaltel financing closes. As part of the transaction, Lorca Telecom's revolving credit facility (RCF) will be upsized to €750 million from €500 million, providing the company with additional liquidity. Our assessment does not assume proceeds from the majority sale of the Netco until an agreement is signed, at which point our liquidity ratio would likely rise to over 1.5x. Our assessment is also restricted by the company's financial ownership and history of growth via acquisitions.

We estimate principal sources of liquidity will include:

- About €100 million of cash and cash equivalents and current financial assets;
- About €750 million of undrawn and committed facilities maturing beyond Dec. 31, 2022;
- Cash funds from operations (FFO) after lease principal payments of €645 million-€655 million; and

## Research Update: Lorca Telecom (MasMovil) Downgraded To 'B' On Expected Leverage Increase; Outlook Stable

- Proceeds of about €90 million from the sale of stake in Onivia and Agile TV in 2022.

We estimate principal liquidity uses will include:

- Payments for capex of about €540 million, proforma for the sale of the NetCo. This includes costs of €32 million per year to convert the Telefonica bitstream contract to an IRU;
- About €660 million of short-term debt maturities, including the bridge loan and outstanding commercial paper (until NetCo sale proceeds are raised and used to repay the bridge facility);
- Working capital outflows of about €100 million; and
- No dividends or acquisitions.

## Covenants

The RCF includes a springing net senior leverage covenant at 8x, applicable when 40% or more is drawn. We expect the RCF will not be drawn more than 40% over the next 12-24 months. Hence, we expect that the springing covenant will not be triggered.

## Issue Ratings - Recovery Analysis

### Key analytical factors

- We assigned a 'B' issue-level rating and '3' recovery rating to Lorca Telecom's proposed €800 million senior secured TLB and €1.75 billion senior secured notes, and a 'CCC+' issue-level rating and '6' recovery rating to the €500 million senior unsecured notes.
- The '3' recovery rating on both on the proposed and current debt reflects our expectation of meaningful recovery (50%-70%; rounded estimate: 55%). Our '6' recovery rating on the senior unsecured notes reflects our expectation of negligible recovery (0%-10%; rounded estimate: 0%) in the event of default.
- Lorca Telecom's TLB (including new term loan), senior secured bonds, and €750 million RCF all rank pari passu.
- While recovery prospects are supported by our valuation of MasMovil as a going concern and the secured nature of the group's debt, they are constrained by the large amount of equal-ranking and pari passu debt.
- In our hypothetical default scenario, we envision a combination of increased competition between telecom providers, weighing on average revenue per user, combined with slower-than-expected subscriber growth, resulting in lower profitability and higher cash burn.
- We value MasMovil as a going concern, because it is a midsize European telecom operator that is increasing market share in both fixed broadband and mobile, benefiting from well-defined brand positioning and a proven hybrid network strategy.
- We do not include the equity bridge loan at Ucles in our recovery analysis, because we assume it will be refinanced without new debt issuance from the group, and will not have any implications on, or dilution of the current equity ownership structure.
- We do not attribute any residual value to the NetCo investment given it is mainly dependent on Lorca Telecom for its operations, and it is still expanding from a very small base generating

minimal EBITDA

### **Simulated default assumptions**

- Year of default: 2024
- Jurisdiction: Spain
- Minimum capex: 6%
- Cyclicity adjustment factor: 0% (standard sector assumption for telecom and cable)
- Operational adjustment: 30% (indicating about 30% decline from reference EBITDA, in line with other 'B'-rated peers)
- Emergence EBITDA after recovery adjustments: about €725 million
- Implied enterprise value multiple: 5.5x

### **Simplified waterfall**

- Gross enterprise value at default: About €4.0 billion
- Net enterprise value available to Lorca Telecom at default: About €3.8 billion
- Senior secured debt claims: About €6.4 billion
- --Recovery expectation: 50%-70% (rounded estimate: 55%)
- Senior unsecured debt claims: About €740 million
- --Recovery expectation: 0%-10% (rounded estimate: 0%)

All debt amounts include six months of prepetition interest. The revolving credit facility is assumed 85% drawn on the path to default.

### **Ratings Score Snapshot**

Issuer Credit Rating: B/Stable/--

Business risk: Satisfactory

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

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)

## Research Update: Lorca Telecom (MasMovil) Downgraded To 'B' On Expected Leverage Increase; Outlook Stable

- Capital structure: Neutral (no impact)
- Financial policy: Financial sponsor-6 (no further impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: B

### Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

### Ratings List

#### Downgraded; Outlook Action

	To	From
<b>Lorca Telecom Bidco S.A.U.</b>		
Issuer Credit Rating	B/Stable/--	B+/Negative/--

#### New Rating

##### Kaixo Bondco Telecom SAU

Senior Unsecured	CCC+
Recovery Rating	6(0%)

##### Lorca Telecom Bondco S.A.U.

Senior Secured	B
Recovery Rating	3(55%)

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### Downgraded

	To	From
<b>Lorca Telecom Bidco S.A.U.</b>		
Senior Secured		
Local Currency	B	B+
Recovery Rating	3(55%)	3(50%)
<b>Lorca Telecom Bondco S.A.U.</b>		
Senior Secured		
Local Currency	B	B+
Recovery Rating	3(55%)	3(50%)

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](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://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.

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