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April 12, 2012

Swisscom AG

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Swisscom AG

Major Rating Factors

Corporate Credit Rating
A/Stable/--

Strengths:

- Strong positions in domestic fixed-line and mobile telecommunications.
- High domestic operating margins and robust free operating cash flow.
- Strong liquidity and proactive treasury management.
- Likely demonstrations of financial discipline by using discretionary cash flow to reduce debt.
- Our expectation of the "moderate" likelihood of extraordinary support, if needed, from the Swiss government.

Weaknesses:

- Mature, albeit wealthy, domestic service area with low growth prospects.
- Heavy capital expenditures to sustain, expand, and upgrade the high-quality network.
- Ongoing price pressures in fixed-line and mobile voice services and potential regulatory changes.
- Weakening performances and execution risks at Italian subsidiary Fastweb.

Rationale

The ratings on Swisscom AG are supported by Standard & Poor's Ratings Services' assessment of the group's strong business risk profile, underpinned by its very solid domestic position as the leading integrated provider of telecommunications services in Switzerland. Swisscom posts high margins and consistently generates robust free operating cash flow (FOCF). These strengths are mitigated by the weakening performances and positioning of the Italian subsidiary Fastweb and the ensuing exposure to currency translation risks, and the limited growth prospects of the Swiss telecoms market as a result of increasing market saturation. Our assessment of the group's financial risk profile as intermediate is also a rating constraint. Our view balances Swisscom's conservative financial policy with some lack of flexibility on the shareholder distribution policy and an increasing divergence between reported and Standard & Poor's adjusted ratios.

We factor into the long-term rating on Swisscom one notch of uplift from our 'a-' assessment of its stand-alone credit profile (SACP), to reflect our view that there is a "moderate" likelihood that the Swiss government (Swiss Confederation, (unsolicited AAA/Stable/A-1+) would provide timely and sufficient extraordinary support to Swisscom should it encounter periods of financial distress.

S&P base-case operating scenario

In our base-case assessment, we anticipate that Swisscom will post low-single-digit revenue and EBITDA declines in 2012 and 2013. We believe Swisscom will likely encounter continued price erosion in the Swiss market, and further revenue slippage at Fastweb, stemming from a combination of the depressed Italian economy and competitive pricing. Increased commoditization of voice products and the proliferation of flat-rate bundled services will likely accentuate price pressures in our view, while increased take-up of TV products on the fixed-line side and soaring mobile data traffic should partly cushion this trend.

Our base case does not factor in the potential effects of euro fluctuations against the Swiss franc, which are difficult to predict. But we note that overall revenues and EBITDA could be negatively affected if the euro depreciated further against the Swiss franc.

We have factored in some slight margin erosion over 2012-2013, but we think that Swisscom will continue to leverage its strong domestic position and scale, consequently maintaining industry leading domestic EBITDA margin close to the middle of the 40%-50% range. Including the less profitable Fastweb business, overall EBITDA margin should be around 40% in 2012-2013.

S&P base-case cash flow and capital-structure scenario

We believe that Swisscom will generate robust free cash flows in the future, at around 15% of revenues on average. That said, we think fixed outlays will be heavy at close to 20% of revenues, reflecting the group's strategic focus on maintaining the superiority of its network over its competitors', in order to cater to quality sensitive customers and tackle increasing mobile data traffic. In addition, a nonrecurrent Swiss franc (CHF)360 million cost for the acquisition of spectrum in 2012 will temporarily drag down free cash flow this year.

We think the group's Standard & Poor's adjusted debt-to-EBITDA ratio will in 2012-2013 stand at or close to the 2.5x maximum guideline we consider adequate for the rating. This is versus the year-end 2011 figure of 2.4x, hit by a large pension deficit charge under International Financial Reporting Standards (IFRS) on the back of lower discounting rates. Our recently revised assessment of Swisscom's financial risk profile as intermediate reflects the headroom, now lower than what we previously forecast, within the rating parameters.

Overall, we anticipate that Swisscom will generate only modest discretionary cash flows in 2012, while experiencing a rebound from 2013 owing to one-off spending to acquire spectrum. This should enable Swisscom to reduce absolute debt from 2013 onward to a greater extent than what we anticipate in 2012, and reconstitute large headroom within its rating category.

Liquidity

We consider Swisscom's liquidity to be strong under our criteria. We believe that the group can more than cover its needs for the coming years, even in the event of a sharp, unexpected decline in EBITDA.

In addition, we think management has a strong track record of proactive refinancing, that it will likely maintain, ahead of increasing annual debt maturities to around CHF1.5 billion in 2014-2016.

We anticipate that Swisscom's liquidity sources (including cash, funds from operations (FFO), and credit facility availability) over the next 12 and 24 months should exceed its uses by about 1.5x.

Our 2012-2013 liquidity assessment is based on our anticipation of the following sources and uses:

- FFO of about CHF3.8 billion-CHF3.9 billion,
- A CHF2 billion undrawn committed back-up facility due in 2015,
- Debt maturities of CHF804 million and CHF719 million in 2012-2013,
- Capital expenditure of CHF2.1 billion-CHF2.2 billion in 2012-2013, and
- Annual dividends of CHF1.1 billion.

Outlook

The stable outlook reflects our view that Swisscom will continue to successfully defend its core domestic market positions, maintain solid operating margins, and generate robust FOCF. We also anticipate that the group will maintain adjusted debt to EBITDA not higher than 2.5x and an adjusted ratio of FFO to debt in the 35%-40% range. In addition, we believe that the Swiss government will retain its majority ownership of Swisscom over the next few years.

We could consider lowering the ratings if Swisscom's credit metrics deteriorated more than we currently expect this year and with no convincing prospects for improvement thereafter. This could happen if operating measures or domestic competitive positions were to weaken materially, or, which seems less likely, if management were to adopt a more aggressive financial policy.

Rating upside seems remote at this stage. It would depend on Swisscom's net debt-to-EBITDA ratio improving to about 2x on a Standard & Poor's-adjusted basis, which would likely require a very conservative financial policy to compensate for the large pension-related adjustments to our debt figures.

Business Description

Swisscom is Switzerland's leading telecoms provider. It offers a wide range of products and services for mobile, landline, and Internet protocol (IP)-based voice and data communication and TV services.

Swisscom owns 100% of Fastweb, the third largest fixed-line operator in Italy. The Italian subsidiary offers fixed-line broadband, voice, and TV services for residential and corporate customers. In addition, it acts as a mobile virtual network operator (MVNO).

The Swiss government's stake in Swisscom was 56.9% as of Dec. 31, 2011.

Government Support And GRE Methodology Impact

The 'A' rating on Swisscom is based on the company's SACP, which we assess at 'a-', and includes one notch of uplift to reflect our view that there is a "moderate" likelihood that the Swiss government would provide timely and sufficient extraordinary support to Swisscom if it encountered periods of financial distress.

We consider Swisscom to be a government-related entity (GRE) under our criteria. In accordance with our criteria for rating GREs, our view of a "moderate" likelihood of extraordinary government support is based on our assessment of Swisscom's:

- "Strong" link with the Swiss government, primarily because the latter defines Swisscom's strategic goals and is unlikely, in our view, to reduce its majority ownership stake in the next few years; and
- "Limited" role, as the Swiss government is primarily interested in the stability of Swisscom's operations and not so much by its credit standing.

For further details of our criteria on GREs, see "Rating Government-Related Entities: Methodology And Assumptions," Dec. 9, 2010, on RatingsDirect on the Global Credit Portal.

Business Risk Profile: Strong Market Position And Profitability, But Limited Growth Prospects In Switzerland

The major supports for Swisscom's strong business risk profile are:

- An established and strong domestic position in its business and residential customer segments. As of year-end 2011, Swisscom had relatively high and sustainable market shares for subscriptions in fixed-line telephony (about 89%), fixed-line broadband (55%), and mobile telephony (62%), according to company estimates. Furthermore, Swisscom has been able to rapidly grow its market share in digital pay-TV services in the past few years, up to about 25% at year-end 2011, through its IPTV offer.
- Significant investments in a fiber-to-the-home (FTTH) network (in conjunction with local Swiss utility companies) in order to sustain the group's competitive position against cable operators in the medium to long term. We understand that Swisscom aims to connect more than 1 million households (about one-third of the Swiss population) to its fiber network by year-end 2015.
- Above-average margins, compared with those of other European telecoms incumbents, stemming from Swisscom's solid market position and scale, strategic focus on network quality that caters to quality sensitive customers, and a relatively moderate regulatory environment.
- Superior, integrated network compared with those of competitors, and ongoing focus to maintain this competitive edge, which we think should allow Swisscom to benefit from soaring mobile data usage and take-up of bundled services including attractive IPTV services.
- Moderate regulatory pressure. Currently, Swisscom faces less regulatory pressure than many other European telecoms incumbents, in our view. This is because regulation in Switzerland continues to be retroactive, and complaints and rulings that pass through legal process significantly delay the implementation of regulatory measures. This creates high price uncertainty and is an advantage for Swisscom, in our opinion. Furthermore, the introduction of an up-front regulation--in cases where the regulator deems telecoms operators to have a dominant market position--would require a change of the current law on telecommunications ("Fernmeldegesetz"), and the legislative process could take more than two years.
- Fastweb's fully IP-based and triple-play-ready network, which covers about 11 million homes. A potential key competitive advantage for Fastweb is that it has already rolled out an extensive FTTH network to about 2 million homes, through which it can offer significantly higher bandwidth speeds without further significant infrastructure investments. In addition, there is no competition from cable operators in Italy.

These supports are partially offset by:

- Limited growth prospects in the wealthy, but relatively small and highly penetrated telecoms market in Switzerland, which has about 7.7 million inhabitants and 3.4 million households.
- Secular decline in fixed-line telephony market both in terms of access lines and traffic, as in other European countries. In addition, mobile voice services are increasingly commoditized and suffering ongoing pricing pressures.
- Weaker performances and growth execution risks at Fastweb, as a result of a less favorable regulatory environment, tough macroeconomic conditions, and fierce price competition in Italy, with offerings from its main competitor, incumbent operator Telecom Italia SpA (BBB/Negative/A-3), as well as from integrated operator Wind Telecomunicazioni SpA (BB-/Stable/--), and the Italian subsidiary of Vodafone AG (A-/Stable/--). In addition, planned increases in the monthly local loop unbundling (LLU) fee of 4% in 2012 after 5% in 2011

(from €8.70 per month previously) somewhat weakens Fastweb's competitive position against Telecom Italia.

- Some exposure to currency risks given the translation of Fastweb's contribution to Swiss francs from euros.

Financial Risk Profile: Robust Cash Flow Generation, Partly Offset By Policy Of Relatively High Shareholder Distribution

The main strengths of Swisscom's modest financial risk profile are:

- Our anticipation that Swisscom should generate robust FOCF in the future, supported by overall high operating margins, and moderate interest and tax costs.
- Our assumption that Swisscom will likely exercise financial discipline. We believe the group will use discretionary cash flow to reduce debt and remain conservative in the event of unforeseen extraordinary circumstances.
- Track record of financial debt leverage reduction, translating into an actual reported net debt-to-EBITDA ratio comfortably within the group's 2x financial policy guideline.
- Strong liquidity and proactive treasury management.

These strengths are moderated by:

- A financial policy that its principal shareholder, Switzerland, governs. We consider that the policy aims for relatively high shareholder distributions and somewhat limits the group's ability to quickly reduce debt, if fully applied. The policy also stipulates that dividend payments should remain at least stable.
- Significant pension obligations and a sharp IFRS deficit increase in 2011, on the back of revised actuarial assumptions, leading to widening divergence between reported and Standard & Poor's adjusted ratios.
- Heavy capital outlays driven by the industry's high capital intensity and Swisscom's particular focus on maintaining a competitive edge on network quality, as well as requirements for capacity expansion and upgrades.
- The change-of-control clauses that the group's bank loans, bonds, and private placements contain. The bank loans would be due for immediate repayment if Switzerland's stake in Swisscom were to fall below 35%, or if another shareholder were to take control of the company. Bondholders would be entitled to sell the bonds if a another shareholder gained a majority share in Swisscom and at the same time the long-term corporate credit rating on the group fell below 'BBB-'.

Financial Statistics/Adjustments

Swisscom discloses consolidated financial statements under IFRS.

In assessing financial leverage, we make adjustments to Swisscom's reported figures (see table 1). Most importantly, we adjust financial debt for operating leases, unfunded pension liabilities, asset-retirement obligations, and defeased cross-border tax lease obligations, which have been converted into bank loans since 2009.

Swisscom does not rely on any cash position to finance its ongoing operations, owing to its strong FOCF generation and ample undrawn credit facilities. Therefore, we consider nonrestricted cash and current financial assets as surplus cash and deduct it from gross debt in our calculations.

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009

Table 1

Reconciliation Of Swisscom AG Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. CHF)

	--Fiscal year ended Dec. 31, 2011--				
Swisscom AG reported amounts					
	Debt	**EBITDA**	**Interest expense**	**Cash flow from operations**	**Capital expenditures**
Reported	8,831.0	4,584.0	299.0	3,951.0	2,095.0
Standard & Poor's adjustments					
Operating leases	534.4	23.3	23.3	184.2	90.1
Postretirement benefit obligations	1,488.0	(48.0)	--	53.2	--
Surplus cash and near cash investments	(387.0)	--	--	--	--
Share-based compensation expense	--	9.0	--	--	--
Asset retirement obligations	435.9	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	(221.0)	--
Reclassification of working-capital cash flow changes	--	--	--	314.0	--
Minority interests	--	--	--	--	--
Assets related to cross-border tax lease obligations	(135.0)	--	--	--	--
Total adjustments	1,936.3	(15.7)	23.3	330.4	90.1
Standard & Poor's adjusted amounts					
	Debt	**EBITDA**	**Interest expense**	**Funds from operations**	**Capital expenditures**
Adjusted	10,767.3	4,568.3	322.3	4,281.4	2,185.1

CHF--Swiss franc.

Table 2

Swisscom AG Peer Comparison

Industry Sector: Diversified Telecom				
	Swisscom AG	**France Telecom S.A.**	**Belgacom S.A.**	**TeliaSonera AB**
Rating as of April 12, 2012	A/Stable/--	A-/Stable/A-2	A/Stable/A-1	A-/Stable/A-2
	--Average of past three fiscal years--			
(Mil. €)				
Revenues	9,043.7	45,208.3	6,361.3	11,415.0
EBITDA	3,556.5	16,088.6	2,001.0	3,967.8
Net income from continuing operations	1,103.9	3,507.7	975.3	2,086.2
Funds from operations (FFO)	3,243.0	13,534.6	1,785.7	3,365.0

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Table 2

Swisscom AG Peer Comparison (cont.)				
Capital expenditures	1,629.7	7,116.6	788.8	1,884.2
Free operating cash flow	1,594.4	6,582.7	894.1	1,328.9
Discretionary cash flow	781.7	2,444.1	180.5	(69.0)
Cash and short-term investments	43.9	306.7	200.0	69.9
Debt	8,347.1	39,313.6	2,625.5	8,135.7
Equity	3,769.0	29,978.3	3,004.3	13,914.6
Adjusted ratios				
EBITDA margin (%)	39.3	35.6	31.5	34.7
EBITDA interest coverage (x)	13.4	6.6	12.9	12.1
EBIT interest coverage (x)	6.6	3.6	8.1	10.3
Return on capital (%)	13.6	12.4	22.1	14.4
FFO/debt (%)	38.9	34.4	68.0	41.6
Free operating cash flow/debt (%)	19.7	16.7	34.1	17.2
Debt/EBITDA (x)	2.3	2.4	1.3	2.0
Total debt/debt plus equity (%)	68.6	56.7	46.6	36.8

Table 3

Swisscom AG Financial Summary					
Industry Sector: Diversified Telecom					
	--Fiscal year ended Dec. 31--				
	2011	**2010**	**2009**	**2008**	**2007**
Rating history	A/Stable/--	A/Stable/--	A/Stable/--	A-/Stable/--	A-/Stable/--
(Mil. CHF)					
Revenues	11,467.0	11,988.0	12,001.0	12,198.0	11,089.0
EBITDA	4,568.3	4,626.8	4,755.4	4,778.5	4,503.1
Net income from continuing operations	683.0	1,813.0	1,926.0	1,756.0	2,068.0
Funds from operations (FFO)	4,281.4	4,125.2	4,333.9	4,068.5	3,980.9
Capital expenditures	2,185.1	2,080.5	1,987.0	2,111.2	2,304.7
Free operating cash flow	1,782.4	2,134.7	2,539.9	1,870.2	1,357.2
Discretionary cash flow	687.4	1,090.7	1,500.9	822.2	375.2
Cash and short-term investments	0.0	93.0	85.0	146.0	142.0
Debt	10,767.3	10,853.6	11,102.7	12,253.5	12,489.7
Equity	4,373.0	4,494.1	6,093.0	5,146.0	5,799.0
Adjusted ratios					
EBITDA margin (%)	39.8	38.6	39.6	39.2	40.6
EBITDA interest coverage (x)	14.2	13.6	12.6	9.9	10.3
EBIT interest coverage (x)	3.7	8.1	7.7	5.8	6.0
Return on capital (%)	7.6	16.5	16.3	15.4	17.7
FFO/debt (%)	39.8	38.0	39.0	33.2	31.9
Free operating cash flow/debt (%)	16.6	19.7	22.9	15.3	10.9
Debt/EBITDA (x)	2.4	2.3	2.3	2.6	2.8
Debt/debt and equity (%)	71.1	70.7	64.6	70.4	68.3

Table 3

Swisscom AG Financial Summary (cont.)
CHF--Swiss franc.

Ratings Detail (As Of April 12, 2012)	
Swisscom AG	
Corporate Credit Rating	A/Stable/--
Senior Unsecured (7 Issues)	A
Corporate Credit Ratings History	
30-Jun-2009	A/Stable/--
12-Mar-2007	A-/Stable/--
Business Risk Profile	Strong
Financial Risk Profile	Intermediate
Debt Maturities	
On Dec. 31, 2011 2012: CHF0.8 billion 2012-2013: CHF0.8 billion 2014-2016: CHF1.5 billion 2017-2012: CHF1.4 billion Thereafter: CHF4.3 billion	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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