MOODY'S
INVESTORS SERVICE

Credit Opinion: Swisscom AG

Global Credit Research - 15 Mar 2016

Switzerland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	A2
Senior Unsecured	A2

Contacts

Analyst	Phone
Carlos Winzer/Madrid	34.91.768.8200
Ivan Palacios/Madrid	
Michael J. Mulvaney/London	44.20.7772.5454

Key Indicators

[1]**Swisscom AG**

	12/31/2015	12/31/2014	12/31/2013	12/31/2012	12/31/2011
Scale (USD Billion)	$12.1	$12.8	$12.3	$12.1	$13.0
EBITDA Margin	38.6%	39.9%	40.5%	39.9%	41.6%
Debt / EBITDA	2.7x	2.6x	2.4x	2.6x	2.4x
FCF / Debt	1.0%	-0.2%	3.2%	6.1%	5.0%
RCF / Debt	24.9%	23.9%	26.1%	23.9%	27.1%
(FFO + Interest Expense) / Interest Expense	14.3x	14.3x	12.0x	11.3x	11.6x
(EBITDA - Capex) / Interest Expense	5.7x	6.3x	5.3x	5.5x	6.1x

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

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Leading integrated telecommunications operator in Switzerland

- Significant share positioning in the Italian broadband market through Fastweb

- High quality network supports Swisscom's competitive positioning and offering differentiation

- Prudent financial strategy that includes a maximum leverage of reported net debt/EBITDA of 2.1x

- Adequate liquidity risk management

Company Profile

Swisscom AG (A2 stable) is a medium-sized telecommunications operator primarily active in Switzerland, where it generated approximately 82% of net revenues in 2015. The company's international diversification is limited to Italy through Fastweb, which accounts for 16% of the Group's revenue (total group revenues of CHF11.7 billion) and 15% of EBITDA (total group EBITDA CHF4.1 billion) as of December 2015. The company services 6.6 million mobile customers, 2.6 million fixed lines, almost 2.3 million broadband connections, and 1.3 million TV customers as of December 2015. The company is also active both in IT infrastructure outsourcing and in the management of communications infrastructures for business customers.

Rating Rationale

Swisscom's A2 rating reflects (1) the group's leading position in both wireline and wireless; (2) the company's very high quality network, supported by large investments; and (3) the quality of management and its determination to execute its strategy, as demonstrated by strong market shares in all segments, high customer satisfaction, data revenue growth rates and the scope of new products being launched to stimulate future usage.

Swisscom's rating benefits from a two-notch uplift resulting from its 51% Swiss government ownership. The rating also reflects Swisscom's low international diversification and medium size.The rating considers positively Swisscom's strong operating and financial profile and our expectation that the group will adhere to its public commitment to maintain maximum leverage of 2.1x - measured as reported net debt/EBITDA.

DETAILED RATING CONSIDERATIONS

LEADING INTEGRATED TELECOMMUNICATIONS OPERATOR IN SWITZERLAND

The Swiss mobile market is mature, with a penetration rate of around 145%, slightly above the European average. Despite this high level of penetration, the market continues to grow as a result of the popularity of smartphones and fast take up of 4G. The competitive environment in the telecoms market in Switzerland is relatively stable compared to other European countries: Swisscom is a long-standing operator with one of the highest market shares in Europe, followed by Sunrise (Ba2 stable) and Salt (B2 stable). The potential for new competitors to join the market is extremely unlikely owing to the high barriers of entry, underpinned by (1) the small market size and high penetration; (2) built-out networks, which are difficult to replicate; (3) the strict environmental regulation for the installation of new antennas; and (4) the fact that no spectrum licences will be awarded until 2028.

In addition to the top three players, there are a number of mobile virtual network operators (MVNOs)/Resellers, but their scale in the local mobile market remains marginal. The main MVNOs/Resellers are Lebara (on Sunrise's network), Coop (on Salt's network) and Migros (on Swisscom's network).

Notably, pricing pressure has not intensified as dramatically as expected by the market since Xavier Niel became involved in the market through his investment in Salt. This is mainly owing to Salt's unwillingness to tarnish the current customer base: an aggressive pricing strategy for new customers would negatively affect customers' brand loyalty as existing customers would either ask for price reductions or move to another operator. Since Q4 2015, pricing pressure has become stronger but mostly in the lower-end of the post-paid market.

In order to introduce upselling and decrease further price pressure, Swisscom increased by 5/10% its Infinity tariffs in March 2016. The approach was for a "more for more" offering where price increases were combined with more roaming allowance and higher speeds. Moreover, Swisscom introduced for the first time sim-only offers in the Infinity plan: this could represent a way to address competition in the low end of the market. In our view, this overall move indicates further signs of price stabilization that we expect to continue in upcoming years and to translate into a slightly positive revenue growth in 2016 and 2017. In this regard, the share of flat-rates offers have continued to increase in 2015 to 68% (63% in 2014) of total post-paid implying a clear uplift in ARPU (according to management ARPU for the Infinity program amounts to 83 CHF).

In the fixed line business, there is now greater competition to provide telephone, television and internet services with higher bandwidths. Cable network operators (with their own fixed-line infrastructure) are amongst the most dynamic operators in the fixed-line voice market, owing to fairly attractive triple-play (i.e.TV/broadband/voice) bundled offers. Nevertheless, it is worth noting that competition coming from Cable is subject to sector players capability to undertake future heavy investments in order to meet the increasing demand for data.

As the incumbent operator, Swisscom benefits from a strong market position in the fixed line business and in broadband, with a retail market share of approximately 54% in broadband lines as of December 2015. Swisscom's ability to offer content and convergent services, such as video on demand (VoD), is fundamental to its product differentiation and technology leadership. At present, Swisscom retains exclusive content only for Football and Hockey, as sports exclusives do not represent a key growth driver in the Swiss Market.

The small size of the Swiss market represents a weakness in terms of growth potential. Nevertheless, this is offset by (1) the relative stability and resilience of the Swiss economy compared with other European economies; (2) consumers' ability and willingness to pay for premium services; and (3) relatively high absolute pricing levels. We forecast Swiss GDP growth at approximately 1.5% and 1.8% in 2016 and 2017, respectively.

SIGNIFICANT SHARE POSITIONING IN THE ITALIAN BROADBAND MARKET THROUGH FASTWEB

Fastweb is the second-largest broadband provider in Italy, with a 16% market share. Wind Telecomunicazioni SpA (B2 positive) also has a 16% market share, under the brand InfoStrada, with Telecom Italia (Ba1 negative) the largest player in the market with a 49% share. Italy's fixed broadband market is the fourth largest in Europe, with an estimated annual revenue of EUR13 billion. However, slightly over 50% of Italian households currently have access to the broadband network and the penetration of broadband is therefore well below the European average. The competitive environment in Italy is different from that most European countries owing to the lack of cable network operators offering broadband solutions.

In January 2016, Fastweb announced its intention to abandon its existing MVNO agreement with 3 Italia (a division of CK Hutchison Holdings, A3 stable), and to become a full MVNO, using Telecom Italia's infrastructure. The new agreement will allow Fastweb to have a greater degree of independence, being able to leverage on a higher quality network, extended coverage and more attractive tariffs to its customers. Given the high competition of the Italian market, having flexibility to establish tariffs and being able to bundle different products represents a key success driver.

After CK Hutchison Holdings and VimpelCom (Ba3 stable) agreed in August 2015 to merge their Italian telecom divisions, 3 Italia and Wind Telecomunicazioni, Fastweb could strengthen its positioning in the Italian market. With the regulator likely to ask for divestitures to mitigate anti-competitive aspects of the merge, Fastweb could be one of the companies interested in the purchase of the disposed assets.

Finally, another driver of Fastweb subscriber growth could arrive via Telecom Italia's recent announcement that it will accelerate the roll-out of its infrastructure. This will be beneficial for Fastweb as it will enable it to penetrate new cities all over the Italian peninsula.

HIGH QUALITY NETWORK SUPPORTS SWISSCOM'S COMPETITIVE POSITIONING AND OFFERING DIFFERENTIATION

Switzerland has one of the most advanced telecommunications infrastructures in Europe. In such an environment, Swisscom is continually investing and expanding its broadband networks. This is because extending the product range and increasing the number of antenna sites, in order to offer the best network and service, represent two key ways in which to differentiate themselves from competitors. In order to develop its infrastructure to the highest level, Swisscom operates a fixed network with copper and fibre-optic lines, as well as the latest generation mobile communications network. While setting up its new high-speed network, Swisscom has continued to upgrade its asymmetric digital subscriber line (ADSL) infrastructure, thereby increasing the speed of DSL lines for broadband internet access.

One of Swisscom's key technology themes is the group's investment in its fibre-optic network. Since 2008, Swisscom has been extending access to residential customers and small and medium-sized enterprises. At the end of 2015, according to the company, 3.6 million homes and 0.7 million businesses were within the ultra-broadband (>50Mbps) footprint. Notably, Swisscom intends to reach 85% of homes and businesses with access to >100Mbps by 2020, thus enabling the rapid and cost-effective nationwide rollout of ultra-fast broadband. As of December 2015, Swisscom had 2.86 million of ultra-broadband connections, 2 million of whom were equipped with new fibre technologies.

Swisscom completed the modernisation of the mobile network in mid-2014, creating the basis for a rapid rollout of 4G/LTE technology across all mobile sites alongside second- and third-generation mobile technology. Thanks to the new frequency bands acquired by auction in 2012, Swisscom is able to deploy all mobile technologies over the long term and in a needs-appropriate manner. By the end of 2015, Swisscom had a 4G/LTE coverage of 98% of the Swiss population (99% by 2016).

Although the company will continue to roll-out its infrastructure, we forecast the company's capital expenditure (capex) to slow down in the next three years, with its capex/revenues ratio to be in the 18.5%-20% range over 2016-18.

PRUDENT FINANCIAL STRATEGY THAT INCLUDES A MAXIMUM LEVERAGE OF REPORTED NET DEBT/EBITDA OF 2.1X

We expect that Swisscom will remain prudent in taking advantage of its financial flexibility, thereby making limited debt-financed acquisitions. We forecast that it will continue to pay out similar dividends at CHF22 per share going forward. We also expect that Swisscom will continue to improve its financial profile, with low leverage (adjusted debt/EBITDA improving towards 2.5x), and strong cash flow ratios (adjusted retained cash flow (RCF)/debt improving over 25%). In addition, we anticipate that the group will maintain its high profitability, with its adjusted EBITDA margins to remain in the high 30s.

Swisscom is also expected to pursue a conservative financial risk and investment strategy. The group's leverage limit is a reported net debt/EBITDA ratio of 2.1x as per strategic goals set by the Swiss Government for the company. In this regard, we do not expect management to pursue further investments outside of its existing footprint in the short term, as it will focus on maintaining market share in Switzerland and consolidating Fastweb's market positioning in Italy.

Liquidity

Swisscom's liquidity profile for the next 12-18 months is adequate. We consider that internal sources will enable the group to cover its 2016 debt maturities of approximately CHF1.1 billion (including a CHF822 million bank debt maturing over Q1 2016) and its capital expenditures. As of fiscal year ending December 2015, Swisscom had approximately CHF321 million of cash, and CHF2.0 billion of undrawn long-term committed facilities. The company holds an operative liquidity reserve to ensure short-term funding needs, and a strategic liquidity reserve to maintain strategic flexibility on financial needs over the next 24 months.

Notably, as a consequence of negative interest rates applied by financial institutions, Swisscom's cash balance in our view is expected to be lower over the upcoming years. The company currently has CHF0.9bn and CHF1.6bn maturities in 2017-18, which we consider that management will be able to prefund in advance of the final maturity date. The company does not have any financial covenants or rating triggers attached to any of its bank contracts.

Rating Outlook

The stable outlook is based on the strength of Swisscom's operations, the implicit support from the government and our expectation that the group will maintain a prudent financial policy. We expect that changes in Swisscom's credit metrics will be the key drivers of any future changes in its baseline credit assessment (BCA) of baa1. We note that financial ratios factor the increase in the accounting pension deficit, which is determined by the lower discount rates and mortality assumptions under IFRS; but under Swiss law there is actually no deficit owing to the different discount rates applied.

What Could Change the Rating - Up

Upward pressure could develop on the BCA in the event of a stronger-than-expected improvement in Swisscom's underlying operating performance on a sustainable basis. Assuming the other government-related issuer (GRI) factors remained constant, upward pressure could be exerted on the rating if the company's RCF/adjusted debt ratio were to exceed 35% and adjusted debt/EBITDA were to fall below 2.0x.

What Could Change the Rating - Down

Negative pressure could be exerted on the BCA if, for example, the company's RCF/adjusted debt ratio dropped sustainably below 25% and its adjusted debt/EBITDA ratio increased towards 3x, with no expectation of improvement. Currently these ratios look tight because of the pension deficit adjustment but we give some degree of tolerance given that this is mainly being caused by the low discount rate being applied under IFRS, which differs from the one under Swiss law.

Swisscom's ratings could be affected by changes to the Swiss government's ratings (Aaa stable), or by changes in our assessment of default dependence and support described in the Other Considerations section. For example, if the government were to reduce its stake to below 20%, we would most likely no longer consider the company to be a GRI and would likely implement a two-notch downgrade.

Downward rating pressure could also develop if there were a reduction in state support, or if the government were to distance itself from the company even before the share disposal.

Other Considerations

METHODOLOGY GRID

The A3 grid outcome is one notch above the BCA of baa1. The methodology grid outcome is based on the company's audited financial statements as of December 2015 and Moody's standard adjustments.We expect that Swisscom's credit metrics will remain broadly stable in the next 12-18 months. Overall, we expect the company's revenue to slightly increase in 2016-17 and its adjusted EBITDA margin to be in the high 30s. We anticipate an adjusted RCF/debt ratio of 24%-27% and free cash flow/debt between 1%-4%, as high investments continue. We also anticipate funds from operations coverage in the 14x-17x range and the (EBITDA - capex)/gross interest expense ratio to be in the mid to high single digits. In terms of leverage, we expect adjusted gross debt/EBITDA to remain stable in 2016 at around 2.7x and to decrease towards the 2.5x-2.6x region in 2017.

GOVERNMENT-RELATED ISSUER INPUTS

Swisscom's majority shareholder with a stake of 51% is the Swiss Confederation, which by law must hold a majority of the capital and voting rights. As such, Swisscom qualifies as a government-related issuer under Moody's GRI methodology, last updated in October 2014.

In accordance with this methodology, Swisscom's A2 rating reflects the combination of the following inputs:

1) a baseline credit assessment (BCA) of baa1, reflecting Swisscom's underlying credit quality, underpinned by leading positions in the Swiss market for wireline and wireless services;

2) the Aaa local currency rating of Switzerland with a stable outlook;

3) low default dependence between Swisscom and the government, reflecting both the weak correlation between the strength of Swisscom's credit profile and Swiss economic trends (despite the group's importance to the national economy) and, more specifically, the low financial and operational links between Swisscom and the government; and

4) a moderate level of government support, which is based on the following observations that:

i) there is no explicit support from the government;

ii) the government's 51% ownership of Swisscom and its willingness to behave as a rational shareholder suggests that the government is unlikely to provide support alone, and instead would consider only providing shareholder support jointly with other shareholders in the form of a capital increase; and

iii) we consider the Swiss government's historical approach with regard to Swisscom to be highly interventionist: the state appoints a board member, which is positive in terms of support assumptions.

Rating Factors

Swisscom AG

Global Telecommunications Industry Grid [1][2]	**Current FY 12/31/2015**			[3]**Moody's 12-18 Month Forward ViewAs of 3/8/2016**	
Factor 1: Scale And Business Model, Competitive Environment And Technical Positioning (27%)	**Measure**	**Score**		**Measure**	**Score**
a) Scale (USD Billion)	$12.1	A		$12.3	A
b) Business Model, Competitive Environment and Technical Positioning	A	A		A	A
Factor 2: Operation Environment (16%)					

a) Regulatory and Political	A	A	A	A
b) Market Share	Aa	Aa	Aa	Aa
Factor 3: Financial Policy (5%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 4:Operating Performance (5%)				
a) EBITDA Margin	38.6%	Baa	38% - 39%	Baa
Factor 5: Financial Strength (47%)				
a) Debt / EBITDA	2.7x	Baa	2.5x - 2.7x	Baa
b) FCF / Debt	1.0%	Caa	1% - 4%	Caa
c) RCF / Debt	24.9%	Ba	24% - 27%	Baa
d) (FFO + Interest Expense) / Interest Expense	14.3x	Aaa	14x - 17x	Aaa
e) (EBITDA - Capex) / Interest Expense	5.7x	A	5.5x - 8x	Aa
Rating:				
a) Indicated Rating from Grid		A3		A3
b) Actual Rating Assigned				A2

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	baa1
b) Government Local Currency Rating	Aaa
c) Default Dependence	Low
d) Support	Moderate
e) Final Rating Outcome	A2

[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; Source: Moody's Financial Metrics [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.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

MOODY'S INVESTORS SERVICE