



RATING ACTION COMMENTARY

Fitch Downgrades Telefonica del Peru's Ratings to 'BB'; Rating Watch Negative

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Fitch Ratings - Chicago - 30 Jan 2023: Fitch Ratings has downgraded all of Telefonica del Peru's S.A.A.'s (TdP) ratings, to 'BB' from 'BB+'. The rating action applies to the Long Term (LT) Foreign Currency (FC) Issuer Default Rating (IDR), the LT Local Currency (LC) IDR, and the PEN1.7 billion notes due 2027. In conjunction with these moves, Fitch has placed all of these ratings on Rating Watch Negative (RWN).

The downgrade of TdP's ratings reflects the near-term materialization of the company's tax liability, which will result in a material deterioration in the company's leverage profile, although the timing and extent of additional debt financing needed to pay the tax payments remains uncertain. In addition, the company has continued to operate in an intense competitive environment amid lingering cost inflation pressures and an uncertain economic backdrop in Peru. While TdP benefits from its scale as the largest operator in Peru, as well as its diversified product portfolio, the company's negative FCF has weighed on its financial profile.

KEY RATING DRIVERS

Materialization of Tax Liability: As of Sept. 30, 2022, the total provision for income tax liability on the company's balance sheet was PEN2.8 billion, related to a long-running tax dispute with Peruvian authorities. Peru's supreme court recently ruled in favor of Peru's

tax agency, SUNAT, in relation to a big proportion of the outstanding income tax provisions in which TdP will be ordered to make payments in the near term.

At present, the exact amount, timing, and structure of the payments is not yet known, but Fitch expects, according to what the recent shareholders meeting approved, the company will seek additional financing and potential capital contributions to service these payments, which will affect the company's financial profile. Peruvian companies facing tax liabilities have the option to extend a portion of the final settlement payment up to six years by following standard procedures with the SUNAT.

Weak Profitability, Negative FCF Trends: Fitch expects FCF to gradually improve over the rating horizon, but will remain negative and continue to weigh on the company's financial profile. Despite experiencing a partial recovery in mobile revenues and margins off of pandemic lows, EBITDA margins have continued to be relatively weak versus peers in the region.

Fitch expects an acceleration of fiber rollout and low single digit ARPU growth to offset declining demand for fixed voice, generating revenue growth in the low single digits for the fixed business over the rating horizon. A more stable mobile competitive environment, growing demand for broadband, and cost containment efforts should result in modest EBITDA margin expansion over the rating horizon, albeit below historic levels and below that of investment-grade peers.

Leverage Expected to Worsen: Some modest improvements in YTD EBITDA in 2022 resulted in net debt/EBITDA improving to 2.3x as of September 2022, from 3.1x in 2021, driven in part by cost savings initiatives. Fitch forecasts capital intensity of roughly 11% while margins will likely only improve marginally as competition spurs network investments, limiting FCF improvement. While the extent and timing of new financing to cover near-term material tax payments is not yet known, Fitch expects leverage to materially weaken.

Strong Market Shares and Diversification: TdP's business profile, particularly in terms of market share and diversification, remains solid. TdP is well-diversified between fixed and mobile service offerings despite market share losses in recent years due to intense competition, most notably on the mobile side as Entel and Bitel (Viettel Group) continue to attract customers. Fitch estimates TdP has a mobile subscriber share of approximately 30% and a fixed-line subscriber share of over 60%. The company plans to focus on expanding and improving its fixed services over the medium term, mainly through the acceleration of

fiber deployment. Fitch expects marginal improvement in ARPUs on price increases as consumer spending improves and the product portfolio shifts to higher-value services.

Linkages with Telefonica S.A.: Fitch rates TdP on a standalone basis, and does not factor in any expectation of support from ultimate parent Telefonica S.A. (TEF; BBB/Stable). TEF has indicated its intention to divest its Hispano-American operations, including TdP, Telefonica Moviles Chile SA (BBB+/Stable), and Colombia Telecomunicaciones SA ESP (BBB-/Stable), and nonrated entities in Mexico, Argentina and elsewhere. Fitch rates TDP on a standalone basis, given the stronger financial profile of parent Telefonica SA relative to TdP, while legal, strategic, and operational incentives for support from the parent are deemed low.

DERIVATION SUMMARY

In comparison with other regional peers in the 'BBB' rating category, TdP's business position is toward the lower end of the category because of its still-leading, but weakening market positions in the highly competitive Peruvian telecom industry. The company's financial profile deteriorated since 2016 due to intense competition. This caused a decline in operating margins and cash flow generation, which are more in line with 'BB' category issuers.

TdP's business position is roughly in line with sister company Telefonica Moviles Chile (TCH, BBB+/Negative) in terms of service diversification and market position, although TMCH is stronger financially, supported by lower leverage and consistently positive FCF. TdP's business profile is comparable with Colombian peers UNE EPM Telecomunicaciones S.A. (Tigo UNE, BBB-/Stable) and Colombia Telecomunicaciones S.A. E.S.P. (ColTel, BBB-/Stable) with respect to market shares in fixed and mobile, although Tigo UNE and ColTel have higher margins and lower leverage metrics that are more in line with investment-grade issuers.

TdP is rated one notch below competitor Entel (BBB/Stable), as Entel has been able to capitalize on its improved scale in Peru and sustained its strong operational performance in Chile. Although TdP's large fixed-line presence supports its business position in Peru, Entel has a superior financial profile due to the continued strength in its Chilean operations and improving profitability metrics in Peru.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within the Rating Case for the Issuer Include

--Mobile revenues grow to PEN3.9 billion from PEN3.5 billion over the rating horizon;

--Low-single-digit growth in mobile subscribers and growth in ARPUs;

--Fixed revenues remaining relatively flat, near PEN3.6 billion over the rating horizon;

--Continued double-digit declines in fixed-line voice subscribers, partially offset by broadband and pay-TV subscribers, growing in the low single digits, with fixed ARPUs growing in the low-single-digit percentage range;

--EBITDA margins gradually improving to around 14.5%, with an improved pricing environment offset by mix-shift and cost inflation;

--Capital intensity in the low-double-digits percentage range;

--Material tax payments pressure FCF.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Stabilization of the ratings is dependent on attaining greater clarity on manageability of tax liability payments and the company achieving stability in market position and margin expansion materially above forecasts.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Continued deterioration of margins and competitive position regardless of credit metrics;

--Total debt/EBITDA sustained above 4.0x or net debt/EBITDA above 3.5x;

--Unfavorable financing structure of payments.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in

a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

LIQUIDITY AND DEBT STRUCTURE

Uncertain Liquidity: As of Sept. 30, 2022, the company had PEN360 million in short-term debt, and readily available cash of PEN476 million. TdP benefits from its manageable amortization schedule, with PEN2.1 billion of its PEN2.7 billion long-term debt, maturing beyond 2025, including its PEN1.7 billion note due in 2027. However, projected negative FCF, including the impact of material tax payments, implies that the company will need to issue significant additional debt in the near-term. Positively, the company's debt is completely payable in Peruvian soles, limiting foreign exchange risk for the company.

ISSUER PROFILE

Telefonica del Peru S.A.A. is the largest integrated telecom operator in Peru in terms of revenue share. The company provides mobile and fixed-line telephony, broadband and Pay-TV through its Movistar brand, as well as IT solution services for corporate clients.

SUMMARY OF FINANCIAL ADJUSTMENTS

Standard lease adjustments

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
Telefonica del Peru, S.A.A.	LT IDR BB Rating Watch Negative Downgrade	BB+ Rating Outlook Negative
	LC LT IDR BB Rating Watch Negative Downgrade	BB+ Rating Outlook Negative
senior unsecured	LT BB Rating Watch Negative Downgrade	BB+

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[Parent and Subsidiary Linkage Rating Criteria \(pub. 01 Dec 2021\)](#)

[Sector Navigators: Addendum to the Corporate Rating Criteria \(pub. 28 Oct 2022\)](#)

[Corporate Rating Criteria \(pub. 28 Oct 2022\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 ([1](#))

ADDITIONAL DISCLOSURES

[Dodd-Frank Rating Information Disclosure Form](#)

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ENDORSEMENT STATUS

Telefonica del Peru, S.A.A.

EU Endorsed, UK Endorsed

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