



RATING ACTION COMMENTARY

Fitch Downgrades Telefonica del Peru's LC and FC IDRs to 'BB-'; Outlook Negative

Mon 27 Feb, 2023 - 4:09 PM ET

Fitch Ratings - Chicago - 27 Feb 2023: Fitch Ratings has removed from Rating Watch Negative and downgraded Telefonica del Peru S.A.A.'s (TdP) ratings, including its Long-Term (LT) Foreign Currency (FC) and Local Currency (LC) Issuer Default Ratings (IDR), and senior unsecured PEN1.7 billion notes to 'BB-' from 'BB'. The Rating Outlook is Negative.

The downgrade and Negative Outlook reflect the near-term materialization of TdP's tax liability, which will result in a material deterioration of its leverage profile, although the exact timing and extent of additional debt financing needed to pay the tax payments remains uncertain. In addition, the company continues to operate in an intense competitive environment amid 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 Dec. 31, 2022, the total provision for income tax liability on TdP's balance sheet was PEN3.3 billion, with a large portion relating to a long-running tax dispute with Peruvian authorities. In January 2023, Peru's supreme court ruled in favor of its tax agency, SUNAT, in relation to the outstanding income tax provisions

stemming from the dispute, in which TdP will be ordered to make payments in the near term.

The exact amount, timing, and structure of the payments are not yet known. Fitch expects, according to what the recent shareholders meeting approved, that the company will seek additional financing and potential additional capital contributions to service these payments (in addition to the partial capitalization of shareholder loans which have already been disbursed), and this 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.

Leverage Expected to Worsen: Improvements in EBITDA in 2022 resulted in net debt/EBITDA improving to 2.2x as of year-end 2022, from 3.1x in 2021, driven in part by cost savings initiatives. 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, as the company is likely to finance a significant portion of the near-term payments with debt financing. Positively, TdP has already received disbursements of a shareholder loan of PEN365 million, which has been partially capitalized. Additional disbursements and capitalizations are possible, but this remains uncertain.

Relatively Weak Profitability, Negative FCF: Fitch expects FCF to gradually improve over the rating horizon but to remain negative and continue to weigh on the company's financial profile. While mobile revenues have mostly recovered off of pandemic lows, fixed revenues have remained weak. EBITDA margins improved impressively in 2022 on cost savings initiatives but remain relatively weak compared to 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. Fitch forecasts capital intensity of just under 10% while margins will likely only improve marginally as competition spurs network investments, limiting FCF improvement.

Strong Market Shares and Diversification: TdP's business profile, particularly in terms of market share and diversification, remains solid. It 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 significant support from ultimate parent Telefonica S.A. (TEF; BBB/Stable). 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 low.

DERIVATION SUMMARY

In comparison with 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 has deteriorated since 2016 due to intense competition. This has caused a general decline in operating margins and cash flow generation, which are now 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 three notches 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 PEN3.5 billion over the rating horizon;
- Continued double-digit declines in fixed-line voice subscribers, partially offset by broadband subscribers growing in the low single digits, with fixed ARPUs growing in the low-single-digit percentage range;
- EBITDA margins gradually improving to around 15.7%, with an improved pricing environment partially offset by some continued cost inflation;
- Capital expenditures near 10% of revenues;
- 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 the company achieving stability in market position and margin expansion above forecasts and attaining greater clarity on manageability of tax liability payments;
- Sustained neutral or positive FCF generation.

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 4.5x or net debt/EBITDA above 4.0x;
- Unfavorable financing structure of tax 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 Dec. 31, 2022, the company had PEN303 million in short-term debt, and readily available cash of PEN433 million. TdP benefits from its manageable amortization schedule, with the majority of its 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 secure additional debt financing in the near-term. Positively, the company's existing 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 are applied.

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 Outlook Negative	BB Rating
	Downgrade		Watch Negative
	LC LT IDR	BB- Rating Outlook Negative	BB Rating
	Downgrade		Watch Negative
senior unsecured	LT	BB- Downgrade	BB Rating Watch Negative

[VIEW ADDITIONAL RATING DETAILS](#)

FITCH RATINGS ANALYSTS

Andrew Bushey, CFA

Director

Primary Rating Analyst

+1 312 205 3385

andrew.bushey@fitchratings.com

Fitch Ratings, Inc.

One North Wacker Drive Chicago, IL 60606

Francisco Mercadal

Associate Director

Secondary Rating Analyst

+56 2 3321 2912

francisco.mercadal@fitchratings.com

Martha Rocha

Managing Director

Committee Chairperson

+1 212 908 0591

martha.rocha@fitchratings.com

MEDIA CONTACTS**Elizabeth Fogerty**

New York

+1 212 908 0526

elizabeth.fogerty@thefitchgroup.com

Jaqueline Carvalho

Rio de Janeiro

+55 21 4503 2623

jaqueline.carvalho@thefitchgroup.com

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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](#)

[Solicitation Status](#)

[Endorsement Policy](#)

ENDORSEMENT STATUS

Telefonica del Peru, S.A.A.

EU Endorsed, UK Endorsed

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