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Credit Opinion: Elisa Corporation

Global Credit Research - 27 Sep 2013

Helsinki, Finland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa2
Senior Unsecured -Dom Curr	Baa2

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Key Indicators

[1]**Elisa Corporation**

	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	[2]6/30/2013(L)
EBITDA Margin	**33.7%**	**35.3%**	**34.0%**	**36.6%**	**35.8%**	**35.4%**
Total Debt / EBITDA	**2.0x**	**1.8x**	**2.2x**	**2.0x**	**2.1x**	**2.5x**
RCF / Debt	**28.1%**	**27.7%**	**21.0%**	**22.0%**	**20.9%**	**17.5%**
FCF / Debt	**16.5%**	**11.9%**	**-3.0%**	**0.1%**	**-4.2%**	**-2.8%**
(FFO+Interest Exp) / Interest Expense	**8.4x**	**10.8x**	**9.9x**	**9.8x**	**10.6x**	**10.9x**
(EBITDA-Capex) / Interest Expense	**5.9x**	**7.8x**	**5.6x**	**6.6x**	**7.2x**	**7.0x**

[1] All ratios are calculated using Moody's standard accounting adjustments based on audited company results. [2] Based on the last twelve months ending in June 2013 and Moody's estimated adjustments. Source: Moody's Investors Service

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

Opinion

Rating Drivers

- Integrated operator with leading market positions in Finland

- Small size and low international diversification

- Recent weak operating performance may be bottoming out with improved performance in Q2 2013

- Predictable financial policies drive stable and conservative credit metrics

Corporate Profile

Elisa is an integrated provider of telecommunications services to around 2.9 million mobile consumer and 1.1

million mobile corporate customers in Finland (as of end-June 2013), adding up to a total mobile market share of around 40%. Principal sources of revenue include voice and data services, connections to the internet and customised ICT solutions, based on its own fixed and mobile networks. It also operates its own wireless network in Estonia, where it had around 465,300 consumer and around 106,200 corporate subscribers as of end-June 2013, representing a mobile communications market share of around 29%.

The Finnish state, through its investment arm Solidium, owns a 10% stake in Elisa. In addition, the State Pension Fund owns a 1.1% stake in the company.

SUMMARY RATING RATIONALE

The Baa2 rating reflects (1) Elisa's integrated business profile and strong positions in Finland's fixed and mobile markets; (2) its solid financial profile; and (3) its conservative financial policy that we consider to be balanced between shareholder remuneration and creditor protection, with a stated target of net debt/EBITDA in the range of 1.5x-2.0x.

The rating also factors in (1) Elisa's lack of scale and diversification in an international context; (2) the intense competition that the company faces in its domestic market; (3) its modest domestic growth prospects, which could exert pressure on the company to continue returning cash to shareholders or increase event risk in the form of acquisitions, and (4) its track record of aggressive management of debt maturities.

DETAILED RATING CONSIDERATIONS

SMALL SCALE AND LOW GEOGRAPHICAL DIVERSIFICATION, SOMEWHAT OFFSET BY STRONG MARKET POSITIONS

With annual revenues of EUR1.53 billion and EBITDA of EUR489 million for the twelve months ending in June 2013, Elisa is one of the smallest rated incumbent telecom operators in Europe. Its operations are focused in Finland, where it enjoys strong market shares; around 40% in mobile and 30% in fixed as of December 2012. Elisa also operates a wireless network in Estonia, which contributes around 7% of the group's revenues and 6% of its EBITDA as of the last twelve months ended June 2013. Given the overall size of the Finnish market, Elisa's small scale (despite its strong domestic position) and limited geographical diversification (only Estonia) constrain the rating.

FINLAND ENJOYS A MORE STABLE ENVIRONMENT THAN OTHER EUROPEAN MARKETS, BUT IS NOT IMMUNE TO THE MACROECONOMIC CRISIS AND MOBILE PENETRATION IS ALREADY HIGH

Finland (Aaa stable) has a relatively stable macroeconomic environment compared with other countries in the euro area. It has high GDP per capita, above-average GDP growth, low public sector debt and below-average unemployment (7.7%). Nevertheless, the economy is sluggish, with -0.8% real GDP growth in 2012, 0.1% forecasted decline in 2013 and 1.6% growth in 2014.

In the mobile market, Finland has delivered continued subscriber growth for the past few years. However, going forward, we expect the growth potential of mobile services in Finland to be more limited because the market is very mature, with a total penetration rate at 177% in 2012. We believe there is some scope for growth from tablets as well as from the move to Long Term Evolution (LTE), albeit lower than in less penetrated markets.

The Finnish market has the largest proportion of postpaid subscribers in Europe (89%), which we regard as a positive feature, providing for a high degree of revenue visibility.

INTEGRATED BUSINESS MODEL AND MODERATE TECHNOLOGY RISK

Elisa is an integrated operator in Finland. Overall, we consider an integrated telecom business model such as Elisa's to be more robust than either a standalone fixed-line operation or mobile business. As markets converge, a position in both fixed and mobile should enable an operator to benefit from developing growth trends in either or both segments, as well as hedge its exposure to slowing sub-segments, such as fixed voice. The integrated player has a better platform from which to adopt a range of new products and benefits from the diversity of its business risk.

We view Elisa's technology risk as moderate. In this regard, Elisa's 3G and 4G network coverage are important factors to consider. Elisa has focused on increasing the capacity of its network as a response to the increasing data requirements of smartphones, which made up more than 80% of all handsets sold in Q2 2013. Due to the acceleration in smartphone sales, smartphone penetration within Elisa's customer base has increased to 37.5% in

June 2013 from 7% in January 2011 and below 1% in January 2010. As of December 2012, Elisa covered more than 95% of the Finnish population with 3G, and it can provide 4G speeds in over 200 municipalities and LTE in 42 cities. Elisa was the first operator in Finland to open a 4G network for corporate users and has also been investing in invoice and customer management systems to improve service quality.

In 2012, Elisa maintained its capital expenditure (capex)/revenue ratio at around 12%. The company expects to report a capex/revenue ratio of 13% in 2013 excluding licence fees.

COMPETITIVE ENVIRONMENT REMAINS CHALLENGING, ALTHOUGH THERE ARE SIGNS OF STABILISATION

Competition in Finland remains intense, as is characteristic of the domestic markets of many of the incumbents in northern Europe. Mobile network providers, mobile virtual network operators (MVNOs) and re-sellers ensure that the competitive intensity remains high and average prices relatively low by European market standards. Nevertheless, we note that in Finland, the independent service providers or MVNOs have a 2% share of the market.

We observed increasing promotional activity in the Finnish market in Q4 2012 and Q1 2013. TeliaSonera (A3 stable) is seeking to regain some of the market share that it has lost since 2005. It has changed its management team and has been more aggressive during Q4 2012 and Q1 2013 (by introducing subsidies on handsets in October 2012). We note that Elisa and DNA (not rated) have substantially reduced the already low levels of handset subsidies. While the level of subsidies in Finland is low compared with in other European markets, the adoption of a more aggressive handset subsidisation policy by one player can confer an advantage over the others. Elisa has also responded with aggressive price plans, although we note that in Q2 2013, it raised prices again on its most attractive offerings. There are initial signs that promotional activity has slowed down. In fact, the company's performance in Q2 2013 improved compared with the first quarter.

We note that there is no volume-based pricing in the Finnish market. Tariffs include unlimited data packages, while price differentiation is based on speed. We believe that it will be difficult to monetise growth in data traffic if packages have unlimited data plans.

OPPORTUNISTIC BOLT-ON ACQUISITIONS TO STRENGTHEN FIXED-LINE POSITION

Elisa has strengthened its fixed market position through several small, opportunistic bolt-on acquisitions of fixed operators in Finland since 2001. In December 2012, the company announced that it had acquired PPO's telecom and ICT businesses and PPO's shares in fixed-line operators Telekarelia (67%) and Kymen Puhelin (46%), adding around 70,000 broadband subscribers to Elisa's existing base of 500,000. Elisa expects this transaction to increase the company's pro-forma EBITDA by more than EUR22 million, without taking into account synergies that are expected to materialise in 2014. PPO was consolidated from May 2013 onwards and the merger with Telekarelia and Kymen Puhelin is expected to close by 31 December 2013.

Including the impact of the PPO acquisition, Elisa's guidance for 2013 is for stable reported revenue and EBITDA (excluding non-recurring items).

PREDICTABLE FINANCIAL POLICIES DRIVE STABLE CREDIT METRICS

Elisa has a track record of maintaining a stable and predictable financial policy that targets a net debt/EBITDA ratio (as reported by the company) of between 1.5x and 2.0x. The company's financial policies also put a strong focus on shareholder remuneration, given that surplus cash is distributed to shareholders through dividends and buybacks.

We consider this policy to be balanced between shareholders and creditors. We also note that Elisa has a track record of being conservative in its approach to acquisitions. The company's other key medium-term targets are maintaining an equity ratio above 35% and a maximum capex/sales ratio of 12%.

As a result of the PPO acquisition for EUR103 million and the payment of the EUR203 million dividend in H1 2013, Elisa has exceeded its internal leverage guidance ratio of net debt/EBITDA between of 1.5x-2.0x. This ratio stood at 2.1x in Q2 2013, while the equity ratio was 36%. We expect these ratios to return to levels within guidance in the coming quarters.

In light of its generous dividend policy, we expect Elisa to exhibit an adjusted retained cash flow (RCF)/debt ratio at the lower end of the guidance range for its Baa2 rating (between 20%-30%) through the forecasts.

Liquidity Profile

On 17 September 2013, Elisa placed a EUR300 million 2.75% bond due January 2021. With this bond issuance, Elisa will refinance the EUR162 million bond due March 2014 and repay other short term debt, including part of the existing commercial paper maturities of EUR203 million as of June 2013.

While the company has a track record of aggressive management of debt maturities, we also note that Elisa has demonstrated its ability to access the capital markets at good rates. In addition, we derive comfort from the company's track record of support from domestic and international banks, as well as from its flexibility in terms of capex and dividend payments in a stressed situation.

As of June 2013, the company had cash and cash equivalents of EUR48 million, and EUR129 million in availability under EUR300 million of committed revolving credit facilities maturing in November 2014 (EUR130 million) and June 2018 (EUR170 million). These sources, together with the recent EUR300 million bond issued in September 2013 and expected annual funds from operations (FFO) of around EUR400 million, will more than cover Elisa's next twelve months remaining cash needs of EUR203 million commercial paper maturities, the EUR162 million bond maturing in March 2014, approximately EUR200 million in capex and around EUR200 million in dividends. Elisa will need to refinance the EUR130 million revolving credit facility maturing in November 2014.

Rating Outlook

The stable rating outlook assumes that Elisa will retain strong market positions, and maintain its profitability in stabilising, albeit still very competitive, market conditions. The outlook also assumes that Elisa will perform according to its business plan while maintaining sustainable credit metrics for the current rating category. In addition, it factors in our expectation that the company will maintain an adequate liquidity profile at all times.

What Could Change the Rating - Up

Positive pressure could be exerted on the rating as a result of (1) a sustainable improvement in profitability; (2) clearer evidence that domestic market pressures have eased; and (3) a track record of financial discipline, as evidenced by net debt/EBITDA (as reported by the company) sustainably below 1.5x and RCF/adjusted debt above 30%. Upward rating pressure would also require a track record of solid liquidity management, with the refinancing of debt maturities at least 12 months ahead of repayment.

What Could Change the Rating - Down

Negative rating pressure could result from any potential unexpected deterioration in market conditions, or larger-than-expected investments and further returns to shareholders (such that net debt/EBITDA (as reported by the company) is sustained above 2.0x and RCF/adjusted debt trends towards 20% without any prospect of recovery). Elisa's small scale also exposes the rating to event risk in the form of the possibility of a leveraged bid for the company, although this risk is somewhat mitigated by the company's 10% government ownership.

Other Considerations

RATING METHODOLOGY GRID

The telecoms methodology grid outcome for Elisa, based on its adjusted results for the last 12 months ended June 2013, is Baa2, in line with the final rating assigned. This outcome is influenced by moderately strong qualitative factors, reflecting Elisa's status as an integrated incumbent in a highly competitive domestic market. These factors are combined with quantitative factors that reflect solid coverage ratios, but also weak cash flow/debt ratios due to the company's high dividend payout policy. We highlight that we have recently lowered Elisa's score for the "Regulatory and Political" sub-factor to Baa from A to reflect the negative impact that the tough regulatory environment in Europe is having on operators across the region.

Elisa's assigned rating of Baa2 reflects its prospective nature and also takes account of the group's lack of scale, as well as our view that modest domestic growth prospects could potentially (1) increase pressure on the company to continue to return cash to shareholders, or otherwise (2) increase event risk in the form of the possibility of a leveraged bid for the company. However, we note that Elisa's 10% government ownership somewhat mitigates this risk.

Rating Factors

Elisa Corporation

Global Telecommunications Industry [1]	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Scale, business model & competitive environment							
a) Scale						$2.0	
b) Business model, comp. environment & technological positioning				x			
Factor 2: Operating environment							
a) Regulatory and political				x			
b) Market share			x				
Factor 3: Financial policy							
a) Management's financial policy				x			
Factor 4: Operating performance							
a) EBITDA Margin				35.4%			
Factor 5: Financial Strength							
a) Debt / EBITDA				2.5x			
b) FCF / Debt							-2.8%
c) RCF / Debt						17.5%	
d) (FFO + Interest Expense) / Interest Expense		10.9x					
e) (EBITDA - Capex) / Interest Expense		7.0x					
Rating:							
a) Indicated rating from grid				Baa2			
b) Actual rating assigned				Baa2			

[1] All ratios are calculated using Moody's estimated standard accounting adjustments based on financials for the last twelve months ending in June 2013. Source: Moody's Investors Service

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