Research Update:

Colombian Telecommunication Company Coltel Downgraded To 'BB' From 'BB+' On Slower Deleveraging, Outlook Negative

March 24, 2021

Rating Action Overview

- Colombian telecommunication service provider Colombia Telecomunicaciones S.A. E.S.P (Coltel) to generate lower-than-expected EBITDA, and we expect higher competition ahead with a new player entering the industry. As a result, we forecast the company will take longer to reduce debt to EBITDA below 3.0x.
- On March 24, 2021, S&P Global Ratings lowered its issuer credit rating on Coltel to 'BB' from 'BB+' and did the same on the issue-level rating on its $500 million senior unsecured notes due 2030.
- The negative outlook on Coltel reflects our expectations of lower likelihood of support from its parent, Telefonica S.A., given its divestment plans for the Latin American subsidiaries.

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Rating Action Rationale

We think that the company's deleverage will take longer than we expected in our previous forecast. We base the downgrade of Coltel on our assumption that leverage metrics (debt to EBITDA) for the next two years will remain above 3.0x (versus the 2.9x expected for 2021 and 2.5x for 2022). Our expectations included our view that the pandemic wouldn't hit the telecommunications industry hard because during the lockdowns, we predicted higher demand for telecom services by consumers and corporate businesses. However, Colombia has continued to have high competition among the main telecom service providers, causing a continuous price war in which Coltel was forced to keep decreasing average revenue per user (ARPU) in 2020 in order to maintain low churn rates. In addition, the company reported a decline in mobile equipment sales amid the economic crisis suffered by most economies worldwide.

The refinancing of its hybrid bond in 2020 also affected Coltel's leverage metrics (please see: "Colombia Telecomunicaciones S.A. E.S.P Outlook Revised To Negative Amid Expected Higher Leverage; 'BB+' Ratings Affirmed, March 30, 2020). During the first quarter of 2020, Coltel redeemed its hybrid bond, on which we applied a 50.0% haircut to the value given its intermediate equity content. The company issued a $500 million senior unsecured bond maturing in 2030 and signed a $320 million syndicated loan due 2025 to replace the hybrid bond, causing an increase in leverage metrics (which we had already expected in our previous review and was our main reason for revising the outlook to negative).

High competition and continuous price declines has hampered the company's top line growth. For the past couple of years, Coltel has been lowering its prices to remain competitive with the rest of its peers in the telecom market. Coltel reduced its postpaid mobile service ARPU by about 10.2% and its business-to-business (B2B) about 3.9% at year-end 2020. Even though the company managed to increase its customer base in both segments, this growth failed to offset the decline in prepaid service revenues and mobile equipment sales, leading revenue from mobile services to decline 1.4%.

The pandemic had the opposite effect on Coltel's fixed services. As of Dec. 31, 2020, the company reported 7.1% higher fixed service revenues driven by increases in serviced households and enterprises. This was mainly due to the company's accelerated rollout of fiber optic throughout the cities of Bogotá, Cali, and Medellin, and the necessity for telecom services during lockdowns.

We expect the company to keep steadily growing revenue in its mobile and fixed business units; however, EBITDA generation will still be lower than previously expected. We believe that the company will continue its competitive pricing strategy to maintain its market position, seeking to increase its customer base through mobile telephony services, B2B and B2C services, and through resuming growth in mobile equipment sales, which the pandemic hurt most. We see potential risks from the entry of a new competitor in Colombia, Wom S.A. (Wom, B+/Stable/--), which we expect to occur this year and which could pressure Coltel's customer retention even more.

Telefonica's intentions to divest from its Latin American subsidiaries (excluding those in Brazil) could indicate lower commitment of extraordinary support for Coltel. As of the date of this report, we do not have additional information regarding Telefonica's (BBB-/Stable/A-3) potential divestment in Coltel after announcing its plans to spin off its subsidiaries in Latin America (excluding Brazil) in 2019. We consider that this potential divestment in Latin America will serve to reduce Telefonica's leverage (please see: "Spanish Telecom Operator Telefonica Downgraded To 'BBB-/A-3' On Weaker Leverage Prospects; Outlook Stable," Nov. 20, 2020). Given that Coltel's future as part of the Telefonica group is still uncertain, if its long-term relevance to its parent diminishes, we could reassess our view of the company as a moderately strategic subsidiary and remove the one-notch uplift on the rating.

Outlook

The negative outlook reflects our view that Coltel could lose its status as a moderately strategic subsidiary for Telefonica if during the next 12-18 months the holding company divests from the company or we perceive less commitment to provide extraordinary support during adverse conditions.

Downside scenario

We could lower the ratings on Coltel in the next 12-18 months if:

- Telefonica divests from Coltel so the company loses its one-notch uplift benefit as a moderately strategic subsidiary for the group.

- Coltel's credit metrics erode due to adverse economic and business conditions, leading to lower EBITDA than we expected due to more aggressive competition in the Colombian telecom market. In such a scenario, debt to EBITDA would rise above 4.0x.
- The company's liquidity position weakens.

Upside scenario

We could revise the outlook to stable in the next 12-18 months if there is high certainty that Coltel will remain a part of Telefonica's long-term business and financial strategy and we have increased certainty that it could receive potential support under a stress scenario.

Company Description

Coltel is an integrated telecom provider that operates under the trademark Movistar. It has been part of the Telefonica group since 2006. In 2012, Coltel merged with Telefonica Moviles Colombia S.A. As of this report's date, Telefonica owns 67.5% of Coltel and the Colombian government owns the rest. Coltel provides fixed telephony, mobile telephony, internet, broadband, data transmission services, satellite television, and corporate services (such as data centers and IT services).

Our Base-Case Scenario

- Colombia's real GDP to grow 5.1% in 2021 and 4.6% in 2022. We consider that these macroeconomic conditions will support the telecom industry in the next two years because GDP is the main driver for customers to increase spending for household services.
- Year-end foreign exchange rates of COP3,675 per $1 in 2021 and COP3,650 per $1 in 2022. During 2020, the company entered a 10-year interest rate hedge on its 4.95% dollar-denominated interest rate on the $500 million senior unsecured bond due 2030. It also maintains a five-year hedge on the principal payment of the same notes and a non-deliverable forward on $465 million of bank debt. Thus, we don't think Coltel has any foreign exchange (FX) volatility risk on its debt.
- Total revenues to rise 5.6% in 2021 and 4.0% in 2022, mostly due to our expectation that the negative effects of the pandemic will ease and the company will achieve stronger mobile equipment sales, a larger postpaid customer base through unlimited packages, and continuous growth in its business-to-consumer (B2C) and B2B services. These estimates are directly linked to our expectation of higher volumes because we expect average ARPU to decline amid high competition.
- Coltel undertook extensive expense reductions to preserve cash during the pandemic. For the next two years, we expect operating efficiencies to continue, but Coltel's lower ARPU could still hurt its profitability. We think this will be partially offset by its digitalization strategy, including process efficiencies, online customer centers, and a mobile app that could result in additional cost reductions.
- Adjusted EBITDA between COP1.6 trillion and COP1.7 trillion per year.
- We expect annual capital spending of between COP650 billion and COP750 billion for the next two years mainly to increase fiber optic coverage in Colombia, 4G deployment, B2B installed capacity, and maintenance.

- Adjusted debt of COP5.30 trillion by 2021 and COP5.28 trillion by 2022. In our base-case scenario, we do not expect additional debt for Coltel. On the contrary, we expect the company to prepay its U.S. dollar-denominated bank loan for $250 million (or its equivalent of about COP900 billion) during 2021 using cash.

These assumptions result in the following credit metrics for the next two years:

Adjusted EBITDA margin (%)	28.5% in 2021 and 29.1% in 2022
Adjusted debt to EBITDA (x)	3.3 in 2021 and 3.1 in 2022
FFO to debt (%)	Between 20.0 and 30.0
FOCF to debt (%)	Less than 5.0

FFO--Funds from operations. FOCF--Free operating cash flow.

Liquidity

We assess Coltel's liquidity as adequate, based on our calculation that estimated cash sources will cover estimated uses by more than 1.2x for the next 12 months. We also expect that sources would exceed uses and covenant cushion would remain adequate if EBITDA were to decline by 15% from our base-case forecast. In addition, we view the company as having well-established banking relationships as shown by its hybrid bond refinancing and available credit lines.

Principal liquidity sources:

- Cash and equivalents of COP711 billion as of Dec. 31, 2020.
- Expected cash FFO of COP783 billion for the next 12 months.
- Expected working capital inflows of about COP423 billion for the next 12 months.

Principal liquidity uses

- Short-term debt maturities of COP207 billion as of Dec. 31, 2020.
- Expected capex of about COP645 billion for the next 12 months.
- Intra-year working capital requirements of about COP500 billion for the next 12 months.

Covenants

As of Dec. 31, 2020, Coltel maintains a financial covenant on its local credits and on its syndicated loan of net debt to EBITDA no greater than 4.0x. This covenant will only be activated in the event of a change of control of the company. We expect the company to be in compliance with its financial covenant in the next 12 months, even if activated.

Issue Ratings - Subordination Risk Analysis

Capital structure

Coltel's capital structure consists of $500 million (equivalent to about COP1.7 trillion) senior unsecured notes, bank debt, and financial leases. As of Dec. 31, 2020, liabilities totaled COP6.56 trillion.

Analytical conclusions

The long-term issue rating on Coltel's senior unsecured debt is 'BB', in line with the issuer credit rating, because no significant elements of subordination risk are present in the capital structure as it only has debt at its level.

Ratings Score Snapshot

Issuer Credit Rating: BB/Negative/--

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb-

- Entity status within group: Moderately strategic (+1 notch from SACP)
- Likelihood of government support: Low (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015

- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Telecommunications And Cable Industry, June 23, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded

	To	From
Colombia Telecomunicaciones S.A. E.S.P		
Issuer Credit Rating	BB/Negative/--	BB+/Negative/--
Colombia Telecomunicaciones S.A. E.S.P		
Senior Unsecured	BB	BB+

Not Rated Action

	To	From
Colombia Telecomunicaciones S.A. E.S.P		
Senior Unsecured	NR	BB+