S&P Global Ratings

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Research Update:

Russia-Based Er-Telecom Assigned 'B+' Rating; Outlook Stable

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Research Update:

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Overview

- Russian second-largest broadband telecom player Er-Telecom has recently acquired Enforta, a Russian broadband player active in the business-to-business market.
- We forecast negative free operating cash flow in 2016, driven by expansionary capital spending, and we view Er-Telecom's liquidity as less than adequate.
- We are assigning our 'B+' long-term rating to Er-Telecom.
- The outlook is stable, reflecting our expectation of solid growth of operating performance supported by integration of Enforta, and our anticipation that Er-Telecom will be able to secure additional long-term financing within the next three months; we expect adjusted debt to EBITDA to remain below or close to 3x.

Rating Action

On June 21, 2016, S&P Global Ratings assigned its 'B+' long-term foreign currency corporate credit rating to Er-Telecom. The outlook is stable.

We have also assigned our 'ruA' Russia national scale rating to the company.

Rationale

The rating reflects the strong position of Er-Telecom in the Russian broadband market and its robust growth, both organic and through mergers and acquisitions (M&A), balanced by exposure to the competitive and saturated Russian broadband market. We also factor in our expectation of adjusted debt to EBITDA of below or close to 3.0x in 2016, increasing from 2.1x in 2015, coupled with significant negative free operating cash flow (FOCF) driven by investment in the network. We assess Er-Telecom's liquidity as less than adequate, since liquidity sources cover uses by around 1.0x, and availability under its long-term Russian ruble (RUB)27 billion ($415 million) facility from VTB Bank expires early July 2016.

Er-Telecom is Russia's second-largest broadband operator after the incumbent Rostelecom, offering internet, pay-TV, and fixed telephony services under the DOM.RU brand. Er-Telecom is ultimately controlled by Russian businessman Andrey Kuzyaev via Cyprus-registered Er-Telecom Holding Ltd. Other shareholders of Er-Telecom Holding are institutional investors (including Barings Vostok, Sumitomo, UFG, EBRD, and others) and the management.

In previous years, Er-Telecom demonstrated very robust growth, both organic and via acquisitions, with a strong 15.8% revenue increase in 2014, slowing to 0.5% in 2015, bringing revenues to RUB22.2 billion. Our assessment of Er-Telecom's business risk profile is supported by availability of its own backbone fiber network and by its presence in 56 Russian cities with a total population exceeding 30 million people and 12 million households. As of early 2016, according to management, it had a 11% share of the internet access market and 12% of the cable TV market. We also take into account the company's recent entrance into the Moscow business-to-business (B2B) market and strengthening of its footprint in other Russian cities after the equity-swap based acquisition of OOO Prestige-Internet (operating under the Enforta brand), which was completed in late May 2016. Enforta is a Russian cable operator with 88 offices in 63 Russian regions and with a platform covering 400 Russian cities. Enforta's Russian market share is estimated at 3%, and it has a strong value proposition in B2B and business-to-government segments.

These factors are balanced by our assessment of Er-Telecom's business risk, factoring in the high country risks of operating in Russia where 100% of Er-Telecom's assets are concentrated. We note that Russia is experiencing a general economic slowdown, with real GDP growth projected at negative 1.3% in 2016, returning to 1% growth in 2017. We also factor in the saturated and very competitive broadband market where the incumbent Rostelecom has a dominant position with a 38% market share in business-to-customers and 34% in B2B.

In our view, fierce competition will continue to put pressure on Er-Telecom's margins. Er-Telecom's adjusted EBITDA margin fell to 34.6% in 2015, from 40.6% in 2014, and we expect that it will be below 30% in 2016, as a result of price pressure and the acquisition of Enforta, whose margins have historically been lower than Er-Telecom's, at around 24%. That said, we expect that margins will gradually rebound in 2017-2018 on the back of synergies expected by management after integration of Enforta, including overhead savings and lower network cost as Enforta will be using the fiber infrastructure of Er-Telecom where technically feasible.

Our assessment of Er-Telecom's financial risk reflects the company's moderate but increasing leverage (adjusted debt to EBITDA of 2.1x at end-2015 compared with 1.7x at end-2014) and our expectation of significant negative FOCF generation in 2016. We expect that adjusted leverage will increase to around 3.0x by end-2016, with adjusted debt increasing to around RUB22 billion at year-end 2016 primarily to finance network investments and dividends, from RUB15.8 billion at year-end 2015. We understand that the company is drawing down further on its RUB27 billion facility at VTB Bank, which we expect should remain available to Er-Telecom under our base case. Currently, the outstanding amount under this facility is around RUB17 billion; otherwise the group's key liabilities include around RUB2.5 billion equivalent of a shareholder liability related to the Enforta acquisition.

We factor into the rating the risk of a more aggressive expansion strategy than we currently forecast in our base case, either organically or through acquisitions. That said, we take into account the company's limitation on dividend payouts at 75% of consolidated net income, which mitigates this risk. We also note that we do not have full clarity over the financial standing of the company's major shareholder.

In our base case, we assume:
- Strong revenue growth of around 25% for 2016 and around 10% growth in 2017, driven by M&A, including the recent Enforta acquisition, and by organic growth supported by investment in the network. This reflects management's aggressive business plan as it attempts to increase market reach and grow the subscriber base very rapidly;
- A decline of the adjusted EBITDA margin in 2016 to slightly below 30%, from 35% in 2015, with a subsequent recovery to about 33% in 2017 supported by the Enforta integration;
- Quite aggressive capital expenditure (capex) plans for 2016 (29% of revenues in 2016 and 27% in 2017, up from 18% in 2015), aimed to support growth and increase penetration in the cities where the company already has a presence; and
- A dividend cash outflow of RUB1.8 billion in 2016 (including RUB950 million for 2015, paid in the first quarter of 2016).

Based on these assumptions, we arrive at the following credit measures:
- An S&P Global Ratings-adjusted debt-to-EBITDA ratio not exceeding 3.0x in 2016-2017;
- Funds from operations (FFO) to debt of 25%-30% in 2016 and above 30% in 2017; and
- Negative FOCF of around RUB2 billion in 2016 and RUB900 million in 2017.

Liquidity

We assess Er-Telecom's liquidity as less than adequate, with a ratio of liquidity sources to potential uses of slightly below 1.0x for the 12 months started March 31, 2016.

For the same period, principal liquidity sources include:
- Cash and equivalents of RUB0.6 billion; and
- Our anticipation of FFO close to RUB6.5 billion pro forma the Enforta integration.

We estimate principal liquidity uses as:
- Debt maturity and amortization of RUB2.0 billion;
- Annual capex of about RUB4.0 billion, which is about 50% of the company's capex budget for the next 12 months. We understand that the capex is largely expansionary and the company has a good degree of discretion in its investment decisions; and
- A cash dividend payment of about RUB900 million.

Our calculation of liquidity does not include the RUB9.7 billion available under the RUB27 billion secured facility from VTB Bank, which expires early July 2016. We understand that the company is currently negotiating the extension of this facility.

We also understand that the company is contemplating the issuance of domestic bonds. This should allow Er-Telecom to mitigate the refinancing risk related to increase of maturities in the next 12 to 24 months when it will need to repay over RUB3 billion.

We understand that the company maintains healthy headroom under its covenants, including net debt to reported EBITDA of 3.0x starting from 2016 and EBITDA to interest above 2.0x.

Outlook

The stable outlook reflects our expectation that the company will continue to show solid revenue and EBITDA growth. We also expect that Er-Telecom will be able to successfully integrate Enforta, allowing improvement of operating margins in line with our base case. Our stable outlook also factors in our expectation that Er-Telecom will be able to secure additional long-term financing within the next three months to fund the network extension. We also expect that S&P Global Ratings-adjusted debt to EBITDA will remain below or close to 3x despite the company's aggressive expansion strategy.

Upside scenario

We could raise the rating if Er-Telecom's operating performance continued to improve, including further market share gains supporting revenue growth. Furthermore, for an upgrade we would need to see a sustainable long-term capital structure and solid liquidity profile. We would expect this to be combined with our adjusted debt to EBITDA remaining consistently below 2x and the company generating consistently positive FOCF.

Downside scenario

We could lower the rating if the company failed to improve its liquidity and secure a more long-term capital structure in the next three months. We would also downgrade if credit metrics were to weaken significantly, including as a result of significant M&A or a recapitalization

Ratings Score Snapshot

Corporate Credit Rating: B+/Stable/--

Business risk: Weak
- Country risk: High
- Industry risk: Intermediate
- Competitive position: Weak

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Financial policy: Negative (-1 notch)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria And Research

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 01, 2016
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013

Ratings List

New Rating

Er-Telecom	
Corporate Credit Rating	B+/Stable/--
Russia National Scale	ruA/--/--

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.