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Research Update:

Russia-Based ER-Telecom Outlook Revised To Negative On Expected Weaker Metrics; Ratings Affirmed At 'B+' And 'ruA'

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Research Update:

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Overview

- The committed VTB Bank facility of Russia's second-largest broadband telecom player, ER-Telecom, will remain available to draw until the end of 2016, which will mitigate the near-term liquidity pressure resulting from the negative free operating cash flow stemming from the company's high expansionary spending.
- ER-Telecom continues its active growth strategy through debt-financed mergers and acquisitions, and we now expect that its adjusted leverage will be 3.0x-3.5x in 2016-2017, compared with below the 3.0x we expected previously.
- We are therefore revising our outlook on ER-Telecom to negative from stable and affirming the 'B+' and 'ruA' ratings.
- The negative outlook reflects our view that ER-Telecom's adjusted leverage will exceed 3.0x and will remain below or close to 3.5x.

Rating Action

On Aug. 29, 2016, S&P Global Ratings revised its outlook on ER-Telecom to negative from stable and affirmed the 'B+' long-term corporate credit rating. At the same time, we also affirmed the 'ruA' Russia national scale rating on ER-Telecom.

Rationale

The outlook revision reflects our view that ER-Telecom will continue to invest in growth, including through mergers and acquisitions (M&A), which will result in negative free operating cash flows (FOCF). We now expect that ER-Telecom's adjusted leverage will exceed 3.0x (compared with 2.1x in 2015) and remain close to or below 3.5x in 2016-2017.

That said, we believe that ER-Telecom has very limited headroom to further increase its leverage through debt-financed acquisitions or paying out significant dividends because of the covenant on ER-Telecom's Russian ruble (RUB) 27 billion (about US$417 million) facility from VTB Bank. The facility remains the key source of ER-Telecom's financing for further growth. That said, we also factor in that in July 2016 ER-Telecom successfully placed a RUB3 billion three-year domestic bond.

We also take into account that availability on the remaining balance under the RUB27 billion facility from VTB Bank has been very recently extended until year-end 2016. This mitigates the short-term liquidity pressure resulting from ER-Telecom's high expansionary spending.

Our rating on ER-Telecom factors in its position as Russia's second-largest broadband operator after the incumbent Rostelecom, offering internet, Pay-TV, and fixed telephony services under the DOM.RU brand. This is balanced by exposure to the competitive and saturated Russian broadband market.

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. According to the management, the company has a 26% share of the local internet access market and 32% share of the local cable TV market by revenues.

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 566 Russian towns. 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 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 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 around 30% in the first half of 2016 from 34.6% in 2015 and 40.6% in 2014. We expect that it will be below 30% in full-year 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%. We expect that margins will continue to be pressured until 2017, given the company's acquisitive growth trend, which we consider would dilute margins.

We expect margins to gradually rebound in 2018-2019 on the back of synergies management expects to materialize after integration of the acquisitions, including overhead savings and lower network costs, as Enforta will be using ER-Telecom's fiber infrastructure where technically feasible.

Our base case assumes:

- Strong revenue growth of around 21% for 2016 and around 7% 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 2016-2017 to slightly below 30%, with a subsequent recovery to about 30%-31% in 2018-2019 supported by the Enforta integration;
- Quite aggressive capital expenditure (capex) plans for 2016 (30% of revenues in 2016-2017, up from 18% in 2015), aimed at supporting growth and increasing penetration in the cities where the company already has a presence; and
- A dividend cash outflow of RUB1.9 billion in 2016, most of which has been already repaid in the first half 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-3.5x in 2016-2017;
- Negative FOCF of around RUB2.8 billion in 2016 and RUB3.2 billion in 2017.

Liquidity

We assess ER-Telecom's liquidity as less than adequate. Our assessment reflects our view that ER-Telecom's ratio of sources to uses will be above 1.2x in the next 12 months. That said, our assessment is constrained by the company's lack of available long-term financing after 2016, when availability under the existing facility from VTB Bank will expire.

Principal liquidity sources over the next 12 months include:

- Cash and equivalents of RUB1.3 billion;
- Some availability under its RUB27 billion facility until year-end 2016; and
- Our anticipation of FFO at close to RUB5.1 billion.

We estimate principal liquidity uses for the same period as:

- Debt maturity and amortization of RUB2.7 billion;
- Annual capex of about RUB4 billion, which we consider maintenance and which is circa 50% of the total capex; and
- Cash dividend payment of about RUB500 million.

We understand that the company maintains healthy headroom under its recently amended covenants.

Outlook

Our negative outlook on ER-Telecom reflects our view that its leverage will exceed 3.0x in 2016-2017.

Downside scenario

We would downgrade ER-Telecom if its adjusted leverage exceeds 3.5x, driven in particular by M&A activity or dividend payout. We will also consider a downgrade if ER-Telecom's liquidity deteriorates.

Upside scenario

We may revise the outlook to stable and affirm the rating if ER-Telecom sustains its adjusted leverage ratio below 3.0x, combined with a solid liquidity position.

Ratings Score Snapshot

Corporate Credit Rating: B+/Negative/--

Business risk: Weak

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

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: b+

Modifiers

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

Related Criteria And Research

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term

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

Ratings List

Outlook Action; Ratings Affirmed

	To	From
ER-Telecom		
Corporate Credit Rating	B+/Negative/--	B+/Stable/--
Russia National Scale	ruA	ruA

Additional Contact:
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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.