MOODY'S INVESTORS SERVICE

CREDIT OPINION

21 April 2017

Update

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**RATINGS**

**Elisa Corporation**

| | |
|---|---|
| Domicile | Finland |
| Long Term Rating | Baa2 |
| Type | LT Issuer Rating |
| Outlook | Stable |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*

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# Elisa Corporation

## Update to Discussion of Key Credit Factors

### Summary Rating Rationale

Elisa Corporation's (Elisa) Baa2 rating reflects (1) the company's integrated business profile and leading positions in Finland's fixed and mobile markets; (2) the stable operating environment in Finland (Aa1 stable), which supports a rational pricing environment; (3) the company's solid financial profile; and (4) its track record of operating with predictable financial policies, including a target leverage (the net reported debt-to-EBITDA ratio) in the range of 1.5x-2.0x (equivalent to Moody's adjusted gross debt-to-EBITDA of 1.8x-2.3x).

The rating also factors in (1) Elisa's small scale and revenue concentration in Finland, except for its increasing exposure to Estonia; and (2) our expectation that the company's credit metrics will only marginally improve over the next 24 months, owing to its high dividend pay-out policy.

### Credit Strengths

» Strong market position in Finland and increasing international diversification

» Integrated business model and moderate technology risk

» Stable market structure despite heightened pricing competition in the mobile segment

» Relatively high EBITDA margins and low capex intensity, which support cash flow generation

» Predictable financial policies, which support stable and conservative credit metrics

### Credit Challenges

» Small scale despite Elisa's solid market position in Finland

» Competitive domestic market, which limits growth opportunities

» Expectations that economic growth in Finland will remain low

### Rating Outlook

The stable rating outlook assumes that Elisa will perform according to its business plan while maintaining sustainable credit metrics for the current rating category. In addition, the stable outlook factors in our expectation that the company will maintain an adequate liquidity profile at all times.

## Factors that Could Lead to an Upgrade

Positive pressure could be exerted on the rating if the company's credit metrics improve such that its Moody's-adjusted gross debt-to-EBITDA ratio is well below 2.0x and retained cash flow (RCF)-to-adjusted debt ratio is above 30%.

## Factors that Could Lead to a Downgrade

Negative rating pressure could result from (1) any unexpected deterioration in market conditions; or (2) larger-than-expected investments and further returns to shareholders, resulting in the company's Moody's-adjusted gross debt-to-EBITDA ratio rising above 2.5x and RCF-to-adjusted debt ratio trending towards 20% without any prospect of recovery.

## Key Indicators

Exhibit 1

**Elisa Corporation**

| | 12/31/2016 | 12/31/2015 | 12/31/2014 | 12/31/2013 | 12/31/2012 |
|---|---|---|---|---|---|
| Revenue (USD Billion) | $1.8 | $1.7 | $2.0 | $2.1 | $2.0 |
| Debt / EBITDA | 2.2x | 2.0x | 2.2x | 2.4x | 1.9x |
| RCF / Debt | 22.3% | 25.1% | 21.9% | 18.8% | 24.2% |
| (EBITDA - CAPEX) / Interest Expense | 12.4x | 10.8x | 9.9x | 8.5x | 9.4x |

(1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
*Source: Moody's Financial Metrics*TM

## Detailed Rating Considerations

### Small size and limited geographical diversification, partially offset by strong market position in Finland

With annual revenue of €1.64 billion and EBITDA of €563 million in 2016, Elisa is a relatively small incumbent telecom operator in Europe. The company's operations are concentrated in Finland, which accounted for 92.1% of its revenue for 2016. In Finland, the company enjoys leading market shares in terms of subscriptions: around 40% in mobile and 35% in fixed broadband as of the end of December 2016, according to the company and Ficora.

In Estonia, which accounted for 6.1% of Elisa's revenue and 5.6% of EBITDA in 2016, the company operated as a wireless network operator. However, the acquisitions of Starman (announced in December 2016) and Santa Monica (announced in March 2017) significantly improved Elisa's competitive positioning in Estonia, creating an integrated operator offering fixed broadband (about 20% market share), mobile (about 32%) and pay TV (about 35%) services. In the near term, we expect Elisa's management to remain focused on building its competitive position in its core markets, Finland and Estonia.

### Integrated business model and moderate technology risk

Elisa is an integrated operator in Finland. Overall, we view integrated operators more favourably than standalone fixed-line operators or mobile-only companies. As markets converge, integrated operators are better positioned to benefit from growth trends in either fixed-line or mobile business, while hedging their exposure to slowing sub-segments such as fixed voice. Equally, converged operators tend to merge corporate functions, such as sales, marketing and network operations, thereby enhancing operating efficiency.

We view Elisa's technology risk as moderate, given its leading position in 4G networks, in terms of both coverage and speed. The company has made heavy investments in its 4G LTE network, reaching over 99% coverage in Finland and 98% coverage in Estonia as of the end of December 2016. Elisa's 4G network is the fastest in Finland, according to the European Communications Engineering Oy (ECE). Elisa has also started testing 5G technology and expects to have a mass-market product by 2020.

Owing to its large spectrum ownership (Elisa won part of the new spectrum auction for 700 Mhz frequencies in November 2016) and the low population density in Finland, the company has more spectrum per capita than other European operators. As a result, Elisa is one of the few European companies that differentiate their offers by speed rather than the size of data buckets.

### Operating environment in Finland is relatively stable, although economic growth is expected to remain low

Finland has a very high per capita income, a relatively diversified economy and a high level of government debt affordability. However, over 2012-15, economic growth was extremely weak after key sectors of the economy experienced a structural decline (real GDP growth averaged -0.6% annually). The sluggish macroeconomic environment had a bigger impact on Elisa's Corporate division (accounted for 37.1% of revenue in 2016) than on the Consumer division (62.9%), as corporates reduced headcount and demanded lower prices for telecom services.

In 2016, the economy recovered with GDP up 1.4% annually on the back of growth in domestic demand. As a result, the operating performance of Elisa's Corporate division improved, with revenue up 3.4% annually in 2016 (vs. 0.9% the previous year). While management expects the positive momentum to continue into 2017, we expect real GDP growth to remain weak over the next couple of years (Moody's forecasts GDP growth of 0.9% and 1.1% in 2017 and 2018, respectively).

In the mobile market, Finland has delivered continued subscriber growth for the past few years. However, we expect growth potential in mobile data services in the country to be more limited because the market is very mature. Finland has the highest mobile broadband penetration rate (139% as of June 2016) in Europe, followed by Sweden (125%) and Denmark (124%).

### Stable market structure supports a rational pricing environment

Elisa is one of the more stable operators in the European telecom peer group in terms of operating performance and cash flow generation. This stability derives from a favourable operating environment, where despite slow macroeconomic trends and intense competition, the three established national operators, Elisa, Telia Company (Baa1 stable) and DNA, own fixed broadband and mobile assets, and try to take their fair share of modest market growth with no major shifts in market position. Average prices are relatively low by European market standards, leaving little room for discounted offers by mobile virtual network operators, which only have a 1% share of the market.

The mobile market remains dominated by Elisa, which had a 40% market share in terms of subscribers as of the end of December 2016, followed by Telia Company with 33% and DNA with 27%. In fixed broadband, Elisa leads with a 35% market share, followed by Telia Company with 30%, DNA with 25% and Finnet with 8% as of the end of December 2016. While market shares have remained broadly stable, mobile competition increased to some extent in 2016, driven by greater promotional activity by some companies, including DNA. As a result, Elisa's mobile churn increased 1.2 percentage points annually to 17.3% as of the end of December 2016.

### Strong operating performance in 2016

Elisa's operating performance has been solid, with revenue and EBITDA up 4.2% (up 2.0% organically) and 5.3%, respectively, in 2016. Revenue growth has been driven by higher mobile service revenue (up 6.0%, amongst the fastest growth rates in Europe), good performance in Estonia (up 4.1%) and the impact of the acquisition of Anvia's information communications technology business (consolidated from July 2016 onwards). EBITDA was driven by top-line growth and ongoing productivity improvements.

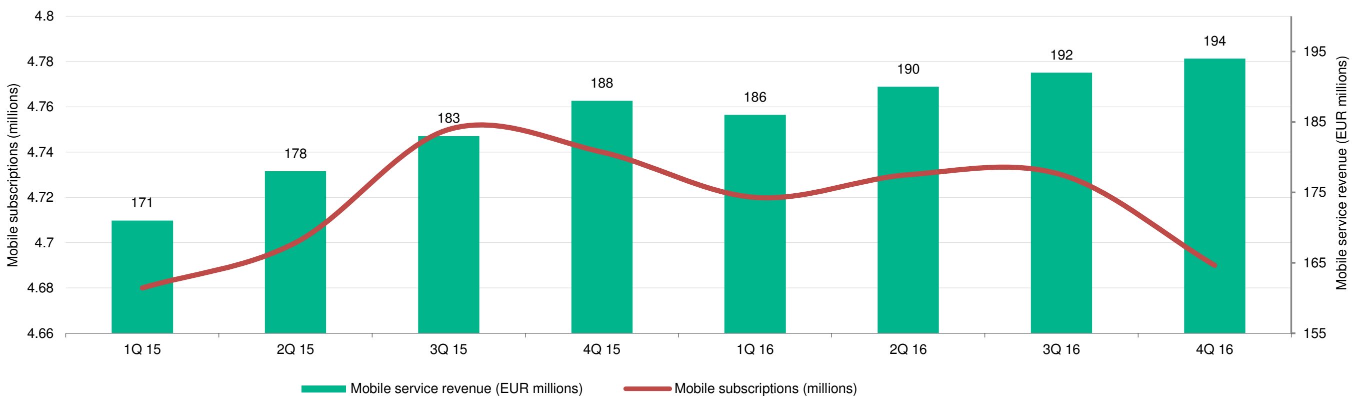
In the mobile segment (accounted for 62.4% of sales in 2016), Elisa has been successful in upselling higher speeds to customers at higher prices (mobile average revenue per user increased €0.6 in 2016). This shift to higher speeds has been accelerated by the rapid uptake of smartphones in Finland (74% of Elisa's customers used a 3G- and 4G-capable smartphone in the fourth quarter of 2016, as compared with 68% in the fourth quarter of 2015), greater demand for online TV and videos, and the company's unlimited mobile data pricing model, amongst others. However, price increases, coupled with greater competitive pressure, have had an adverse impact on Elisa's consumer mobile subscription base, which declined 1.0% in 2016 from 2015.

We expect the good operating performance to continue in the near term, with organic revenue growth of around 1% per year and the reported EBITDA margin trending towards 36%. Earnings growth should be supported by (1) growth in the company's mobile service revenue, given the significant potential to upsell to 4G (Elisa's 4G penetration of its subscriber base is only about 50%); (2) growth in digital services revenue (currently margin dilutive as the business is in the investment phase); (3) productivity improvements amid Elisa's track record in improving its reported EBITDA margin (up 210 basis points over 2012-16); (4) synergies of approximately €6 million per annum from the acquisition of Anvia's information communications technology business; and (5) the consolidation of Starman, expected to increase margins in Estonia by approximately 500 basis points.

Exhibit 2

**Mobile Service Revenue Growth Has Been Solid, Driven by Successful Upselling to Higher Speeds, Partially Offset by a Decline in Subscriptions**

**Evolution of mobile service revenue and mobile subscriptions**




*Source: Company data*

## Predictable financial policies drive stable and conservative credit metrics

Elisa has a track record of maintaining a stable financial policy. The company's medium-term financial targets include (1) a reported net debt-to-EBITDA ratio in the 1.5x-2.0x range; (2) a net debt-to-EBITDA equity ratio above 35%; and (3) a maximum capex-to-sales ratio of 12% (although expected to temporarily increase in 2017 to 13% of sales due to the Anvia integration). We note Elisa's capex intensity is lower than the European average, which management attributes to the company's strict capex policy, its lean strategy focused on market demands and its effectiveness at actively managing its network.

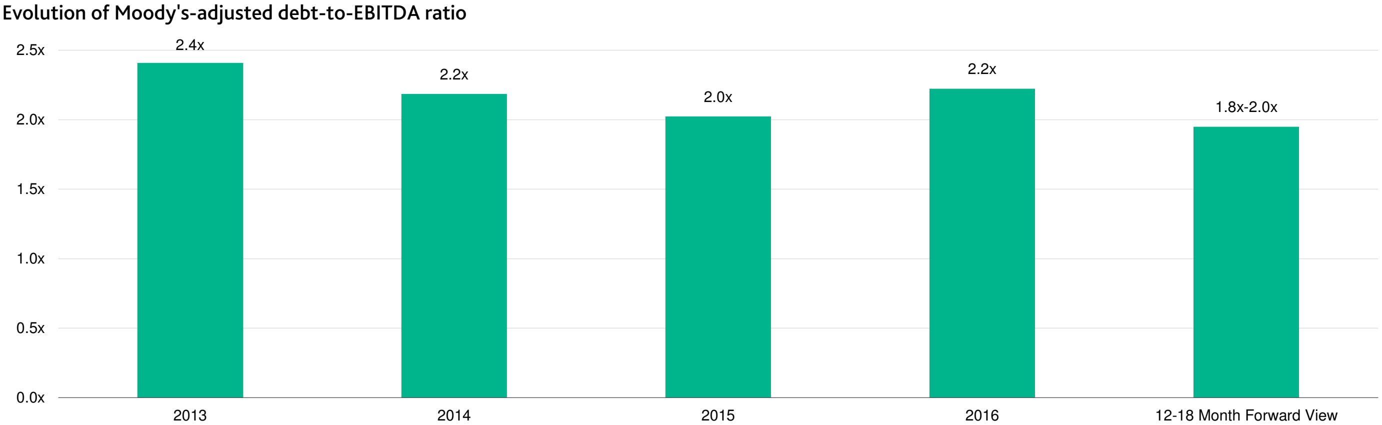
Elisa's stable financial policy provides good cash flow visibility and supports a generous dividend policy aimed at distributing between 80% and 100% of net profit, provided net debt/EBITDA remains within the 1.5x-2.0x target range. Given that the vast majority of excess cash flow is distributed to shareholders, this policy leaves little headroom to accommodate extraordinary capex plans (beyond Elisa's 12% capex/sales target) or sizeable debt-financed M&A.

Elisa's reported net debt-to-EBITDA ratio stood at 2.0x as of the end of December 2016, at the high end of its leverage target range. The company's reported RCF-to-debt ratio was 22.3% as of the end of December 2016, at the lower end of the range for the rating category (between 20% and 30%). In light of its generous dividend policy, we expect Elisa to continue to exhibit credit metrics most closely associated with a Baa2 rating.

Exhibit 3

**We Expect Debt/EBITDA to Improve Marginally In the Next 12-18 Months**

**Evolution of Moody's-adjusted debt-to-EBITDA ratio**




(1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.

*Sources: Moody's Financial Metrics™, Moody's Investors Service estimates*

## Liquidity Analysis

Elisa's liquidity profile is adequate, supported by cash and cash equivalents of €45 million as of the end of December 2016 and €220 million available under its €300 million committed revolving credit facilities maturing in 2018 (€170 million) and 2021 (€130 million). These sources, together with expected annual funds from operations of around €520 million, will more than cover Elisa's cash needs over the next 12-18 months, including €199 million in commercial paper maturities, €64 million in bank loans, around €225 million in capex and around €250 million in dividends. The next large debt maturity is a €300 million bond due in 2019, but in March 2017, Elisa refinanced €120 million of the €300 million with new bonds maturing in 2024. We expect Elisa to refinance its €170 million revolving credit facility due in 2018 in the next 12 months.

## Profile

Elisa is an integrated provider of telecommunication services in Finland, with around 4.7 million mobile and 0.6 million fixed broadband subscriptions as of the end of December 2016. Elisa holds leading positions in Finland in both mobile and fixed-line segments, with a 40% subscriber market share in mobile and 35% in fixed broadband as of the end of December 2016. The company also operates in Estonia, offering fixed broadband (about 20% market share), mobile (about 32%), TV (about 35%) and corporate network services. The Finnish state, through its investment arm Solidium, owns a 10.0 % stake in Elisa. In addition, the State Pension Fund owns a 0.75% stake in the company.

## Rating Methodology and Scorecard Factors

The telecoms methodology grid outcome for Elisa, based on our forecasts for the next 12-18 months, is in line with the actual rating assigned of Baa2. The outcome reflects the company's status as an integrated incumbent in a highly competitive domestic market as well as its small scale compared with that of its industry peers. The outcome also incorporates the company's strong interest expense coverage ratio and modest leverage for its rating category, partially offset by a relatively weak RCF/debt due to the company's high dividend payout policy.

Exhibit 4
**Methodology Grid**

| Telecommunications Service Providers Industry Grid [1][2] | Current FY 12/31/2016 | | Moody's 12-18 Month Forward View As of 4/6/2017 [3] | |
|---|---|---|---|---|
| **Factor 1 : Scale (12.5%)** | **Measure** | **Score** | **Measure** | **Score** |
| a) Revenue (USD Billion) | $1.8 | Caa | $1.8 | Caa |
| **Factor 2 : Business Profile (27.5%)** | | | | |
| a) Business Model, Competitive Environment and Technical Positioning | Baa | Baa | Baa | Baa |
| b) Regulatory Environment | Ba | Ba | Ba | Ba |
| c) Market Share | Baa | Baa | Baa | Baa |
| **Factor 3 : Profitability and Efficiency (10%)** | | | | |
| a) Revenue Trend and Margin Sustainability | Baa | Baa | Baa | Baa |
| **Factor 4 : Leverage and Coverage (35%)** | | | | |
| a) Debt / EBITDA | 2.2x | Baa | 1.8x - 2x | A |
| b) RCF / Debt | 22.3% | Ba | 25% - 26% | Baa |
| c) (EBITDA - CAPEX) / Interest Expense | 12.4x | Aaa | 12x - 13x | Aaa |
| **Factor 5 : Financial Policy (15%)** | | | | |
| a) Financial Policy | Baa | Baa | Baa | Baa |
| **Rating:** | | | | |
| a) Indicated Outcome from Scorecard | | Baa3 | | Baa2 |
| b) Actual Rating Assigned | | | | Baa2 |

(1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
(2) As of 12/31/2016.
(3) This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions or divestitures.
*Source: Moody's Financial Metrics*TM

## Ratings

Exhibit 5

| Category | Moody's Rating |
|---|---|
| **ELISA CORPORATION** | |
| Outlook | Stable |
| Issuer Rating | Baa2 |
| Senior Unsecured -Dom Curr | Baa2 |

*Source: Moody's Investors Service*

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