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CREDIT OPINION
16 January 2017

Update

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RATINGS

**PLDT Inc.**

| | |
|---|---|
| Domicile | Philippines |
| Long Term Rating | Baa2 |
| Type | LT Issuer Rating - Dom Curr |
| 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.*

Analyst Contacts

Annalisa Di Chiara 852-3758-1537
*VP-Senior Credit Officer*
annalisa.dichiara@moodys.com

Carole Herve 852-3758-1505
*Associate Analyst*
carole.herve@moodys.com

Laura Acres 65-6398-8335
*MD-Corporate Finance*
laura.acres@moodys.com

# PLDT Inc.

## Leverage on the Rise Reflecting Acquisitions, High Capex and Muted Performance in Wireless Segment

### Summary Rating Rationale

PLDT Inc.'s Baa2 rating reflects its dominant revenue market share in the Philippines' duopolistic telecommunications market, as well as its strong operating margins when compared to global telecommunications peers in the Baa rating category.

Data and broadband will drive earnings going forward. However, intense domestic competition in the cellular space and a continued shift of users away from texting and international inbound calling to over-the-top (OTT) options will constrain earnings.

Higher debt levels associated with elevated capex, ongoing investments to support "digital pivot" initiatives and its acquisition of the **San Miguel Corporation** (SMC, unrated)'s telecommunication business, combined with muted performance in wireless business, will drive an increase in PLDT's adjusted leverage at upper end of the tolerance level for the Baa2 rating through 2017. However, the company's liquidity position remains healthy, supported by its ability to reduce dividends and proceeds from sale of assets.

### Rating Outlook

The stable outlook reflects our expectation that PLDT will retain solid margins relative to the Baa rating category given its dominant market position and maintain a solid liquidity profile,. We also expect that management will remain prudent in its use of cash, particularly during periods of high and accelerated capex.

### Factors that Could Lead to an Upgrade

PLDT's could be upgraded if the company: (1) maintains adjusted consolidated EBITDA margins that exceed 45%; (2) lowers adjusted consolidated debt/EBITDA to below 1.5x on a sustained basis; (3) increases retained cash flow/debt to above 30%; and (4) ensures that shareholder returns and asset investment policies do not substantially weaken its financial profile.

### Factors that Could Lead to a Downgrade

PLDT's ratings will come under downward pressure if : (1) adjusted EBITDA margin falls below 40%; (2) adjusted debt/EBITDA exceeds the range of 2.0x-2.5x on a sustained basis; or (3) retained cash flow/debt declines to below 20%, as a result of a continued weak operating performance or event risk. Any additional investments in non-core businesses would also be negative for the ratings.

## Key Indicators

Exhibit 1

| | 9/30/2016(L) | 12/31/2015 | 12/31/2014 | 12/31/2013 | 12/31/2012 |
|---|---|---|---|---|---|
| Scale (USD Billion) | $3.6 | $3.8 | $3.8 | $4.0 | $3.9 |
| EBITDA Margin | 45.7% | 49.4% | 52.8% | 52.2% | 56.2% |
| Debt / EBITDA | 2.5x | 2.2x | 1.8x | 1.5x | 1.5x |
| FCF / Debt | -5.6% | -2.3% | -4.1% | 3.2% | 3.7% |
| RCF / Debt | 24.4% | 18.4% | 21.8% | 25.7% | 28.9% |
| (FFO + Interest Expense) / Interest Expense | 9.2x | 9.9x | 12.2x | 12.4x | 11.2x |
| (EBITDA - Capex) / Interest Expense | 3.0x | 4.7x | 7.4x | 8.5x | 6.9x |

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

## Credit Strengths

» Dominant revenue market share in the Philippines' duopolistic telecommunications market

» Healthy liquidity profile

## Credit Challenges

» Intense competition and decline in high-margin SMS and toll revenues

» Weak free cash flow, reflecting weaker profitability and heavy capex (although lower dividend payouts)

» Adjusted leverage expected to remain elevated at 2.6x-2.7x through 2017

» Event risks associated with investments in core and non-core businesses

## Corporate Profile

PLDT is the leading integrated provider of wireless and fixed-line services in the Philippines. It is headquartered in Manila and listed on the Philippine Stock Exchange, with American Depository Receipts traded on the New York Stock Exchange.

## Detailed Rating Considerations

### Dominant revenue market share in the Philippines' duopolistic telecommunications market, although intensification in competition adversely impacts operating performance

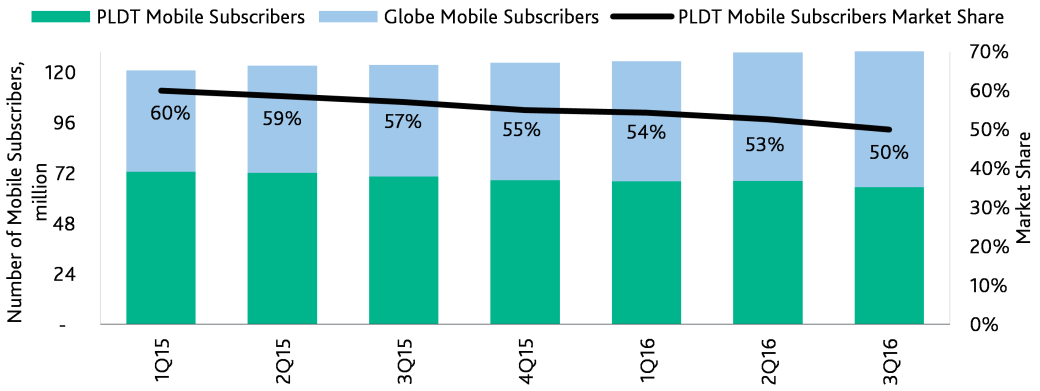
PLDT's dominant revenue market share in a duopolistic telecommunications market supports its Baa2 rating.

The sector is effectively a duopoly with PLDT and **Globe Telecom Inc.** (unrated) as the top market players. Of note, the National Telecommunications Commission -- the Philippines' telecoms regulator -- is planning to sell unused and unassigned spectrum in 2017 in an auction open only to new mobile players. The entry of a potential third player to the Philippine market would likely over time intensify price competition and reduce the incumbents' market share, however it would also take a period of some years for a new entrant to build a network and establish a customer base.

PLDT has been losing subscriber market share to Globe over the past few years. As shown in Exhibit 2, PLDT's mobile subscriber market share decreased from 60% in 1Q 2015 to 50% in 3Q 2016.

Exhibit 2

**PLDT has been Losing Subscriber Market Share to Globe in Recent Years**




*Source: Companies filings*

Despite this erosion in subscriber market share, PLDT still maintains its leadership in terms of revenue market share. PLDT's consolidated revenues for the twelve months ended 30 September 2016 were PHP169 billion (approximately $3.6 billion), while Globe's total revenues were PHP126 billion (about $2.7 billion) for the same period, implying a 57%/43% revenue split, respectively, broadly similar to the end of 2015, and compared to the 62%/38% split recorded at end-2014.

In response to intensifying competition and the loss of some market share to Globe in recent years, PLDT has become more aggressive, including matching competitor's pricing, particularly in the prepaid cellular space, which has - and will continue to - adversely impact margins.

PLDT reported a 15% contraction in EBITDA year-over-year in the nine months to September 2016 to PHP45.7 billion, primarily driven by a 31% contraction in EBITDA in the wireless segment reflecting a rise in subsidies (modems and handsets) associated with accelerating broadband and smartphone penetration. These initiatives were driven by the company's efforts to grow postpaid cellular revenues, as well as increase smartphone ownership among its prepaid subscriber base, in order to further stimulate data usage and stabilize market share losses

Still, PLDT`s consolidated adjusted EBITDA margin of 45.7% for the twelve months to September 2016 was higher than Globe at 42.8%, and strong relative to similarly rated global telecommunications peers with EBITDA margins in the 30%-40% range.

We expect the continuing decline in PLDT's toll revenues -- international long distance (ILD) and national long distance (NLD)- that accounted for 11% of service revenues in the nine months to September 2016 -- to weigh heavily on revenue growth for a few more years.

As a result, we expect adjusted consolidated EBITDA margin to erode slightly over the next 12 months, as domestic competition remains intense, pricing pressures persist, and high-margin toll and SMS revenues continue to decline.

In addition, the company will continue to drive its "digital pivot", with network and service investments to support anticipated increases in data usage and to improve customers' data experience. As a result, we expect reported cash flow from operations (CFO) to be approximately PHP50-55 billion in 2016 and lower than the PHP70 billion recorded in 2015.

### Weak free cash flow, reflecting weaker profitability and heavy capex (although lower dividend payouts)

PLDT has reported negative free cash flows (after dividends) since 2014. We expect this trend to continue over the next twelve months, as capex requirements remain elevated and muted performance in wireless segment continues.

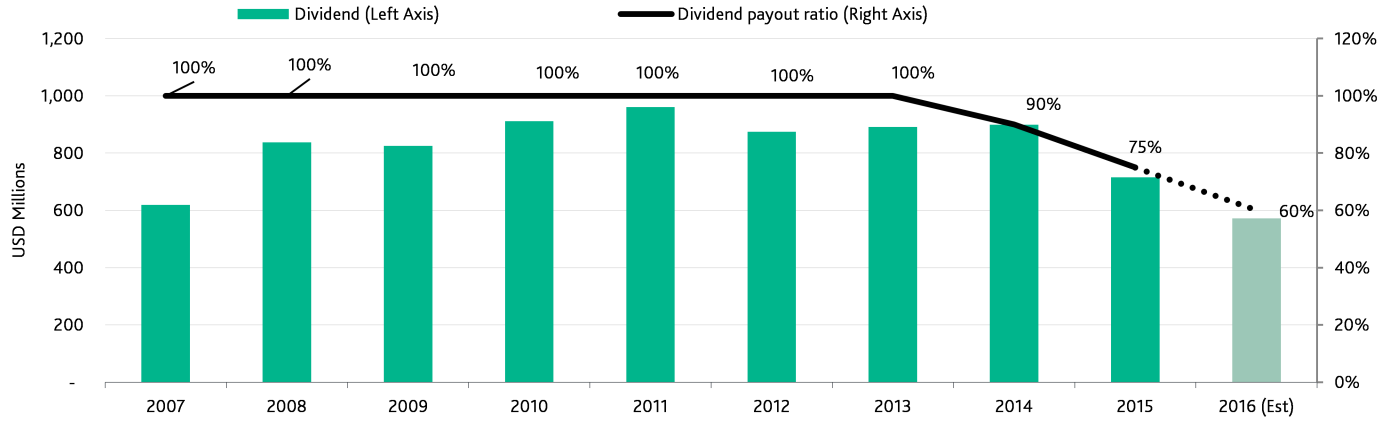
PLDT expects capex of around PHP48 billion in 2016, or slightly around 26%-28% of revenues, to support high growth in data usage and network demand, and roll-out of network using the newly acquired frequencies from SMC. We expect capex to decline in 2017 from 2016 levels, but will remain elevated in the PHP40-45 billion range. We expect capex will be funded from a combination of internally generated cash flows and debt.

PLDT's dividends are based on core EPS, with the company having the flexibility to conduct a "look back" at year-end to distribute excess cash as special dividends.

To conserve cash to support higher capex requirements, PLDT only paid the 75% regular dividend in 2015 - which was lower than the 90% payout of 2014 - and the 100% payout of the seven preceding years (see Exhibit 3). In addition, the company further reduced its regular dividend payout to 60% in 2016.

Exhibit 3

**PLDT Progressively Reduced Dividends to Conserve Cash**




*Sources: Company filings, Moody's Financial Metrics*

## Event risk associated with investments in core and non-core businesses

PLDT's rating continues to consider the company's investment appetite, as major investments will require debt financing or asset sales. Although we understand management's intention to keep investments modestly sized, we continue to evaluate the business and financial risks associated with any potential investments on a case by case basis.

In May 2016, PLDT and Globe announced they would jointly acquire SMC's telecommunication business for PHP69.1 billion, including the assumption of PHP17.0 billion in liabilities as well as jointly acquire the shares of **New Century Telecoms, Inc** (unrated) and **eTelco, Inc** (unrated) for a total of PHP897 million, including the assumption of PHP130 million in liabilities. As a result, for its 50% equity portion, PLDT will pay PHP35 billion (composed of a PHP26 billion cash payment and PHP9 billion of assumed liabilities). PLDT already made its first payment of PHP13.2 billion in May. A second payment of PHP6.6 billion (comprising 25% of the purchase price) was paid on 1 December 2016 and the remainder is due on 30 May 2017.

While we expect a portion of these payments will be debt financed and increase PLDT's leverage, these transactions provide the company with new spectrum frequencies, notably in the 700- megahertz, 900-megahertz and 1800-megahertz bands, which will help improve its network quality and rollout in regional and rural areas, as well as neutralize the threat of a third player (SMC/Telstra).

In August 2014, PLDT debt financed its EUR333 million (PHP19.6 billion) purchase of a 10% stake in **Rocket Internet AG** (unrated), a German Internet company, to jointly develop mobile and online payment technologies and services for the Philippines and other emerging markets. Although this investment allows PLDT to expand its revenue in the mobile payment business, helping to offset declines in revenue from voice and short message services, we view it as non-core. It also increased PLDT's leverage and exposed the company to the highly competitive Internet business. PLDT's stake was subsequently reduced to 6.1% after Rocket completed its IPO in October and a subsequent private placement in February 2015. The total market value of PLDT's stake in Rocket declined significantly in recent years, from EUR501 million as of March 2015, to EUR193 million as of December 2016.

We expect PLDT to continue to invest in internet and multimedia sectors, as it aims to strengthen its ability to deliver multimedia content through its broadband and mobile networks and grow its e-commerce business, given its strategy to transform itself into a multi-media organization. However, management has indicated that any new acquisitions in this space (around three to four per year) will be in the range of US$10 million to US$20 million each. No acquisitions in this space were made in 2016.

We note that PLDT has also received dividends from some of its investments which has helped to supplement cash flows or support investment activities.

For example, in May 2016, PLDT announced the sale of a 25% stake in **Beacon Electric Asset Holding Inc.** (unrated) to **Metro Pacific Investments Corporation** (MPIC, unrated) for PHP26.2 billion. PLDT received PHP17.0 billion at closing, while the remaining PHP9.2 billion will be paid in annual installments until June 2020. Proceeds from this sale have been and will be used to help fund the SMC acquisition.

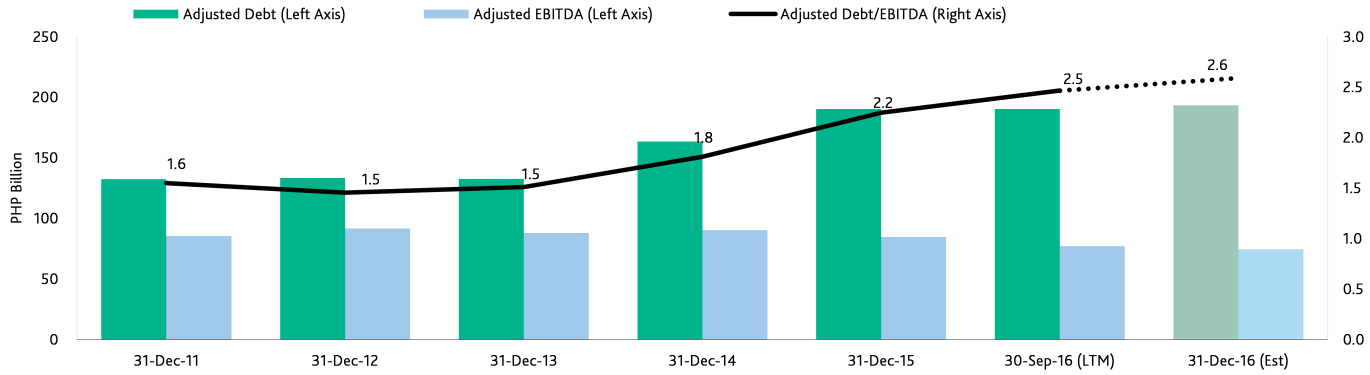
### Adjusted leverage expected to remain elevated at 2.6x-2.7x through 2017

As shown in Exhibit 4, PLDT's adjusted leverage rose to 2.5x for the twelve months ended 30 September 2016 from 1.8x at end-2014, reflecting high capex outlays and weaker profitability.

As significant debt reduction is unlikely without the sale of major assets, we expect adjusted leverage to trend towards 2.6x-2.7x in 2016 and remain at the upper end of tolerance level for the Baa2 rating in 2017, reflecting elevated capex, further investments to support the company's "digital pivot" initiatives, our expectation of partial debt funding of remaining SMC payments, and subdued operating performance.

Exhibit 4

**PLDT's Leverage Is Increasing On the Back of High Capex, Acquisitions and Soft Operating Performance**




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

## Liquidity Analysis

PLDT's liquidity profile remains healthy. The company reported cash and cash equivalents of PHP26 billion at 30 September 2016. We expect cash flows from operations of about PHP55-60 billion over the next twelve months, which when combined with its cash and cash equivalents, should be sufficient to cover current debt maturities of PHP33 billion and estimated capex of around PHP40-45 billion over through September 2017.

In conjunction with its acquisition of SMC's telecommunications business, PLDT paid PHP6.6 billion on 1 December 2016 and will pay PHP6.6 billion on 30 May 2017, which will weaken PLDT's liquidity position if paid out of the company's cash balance.

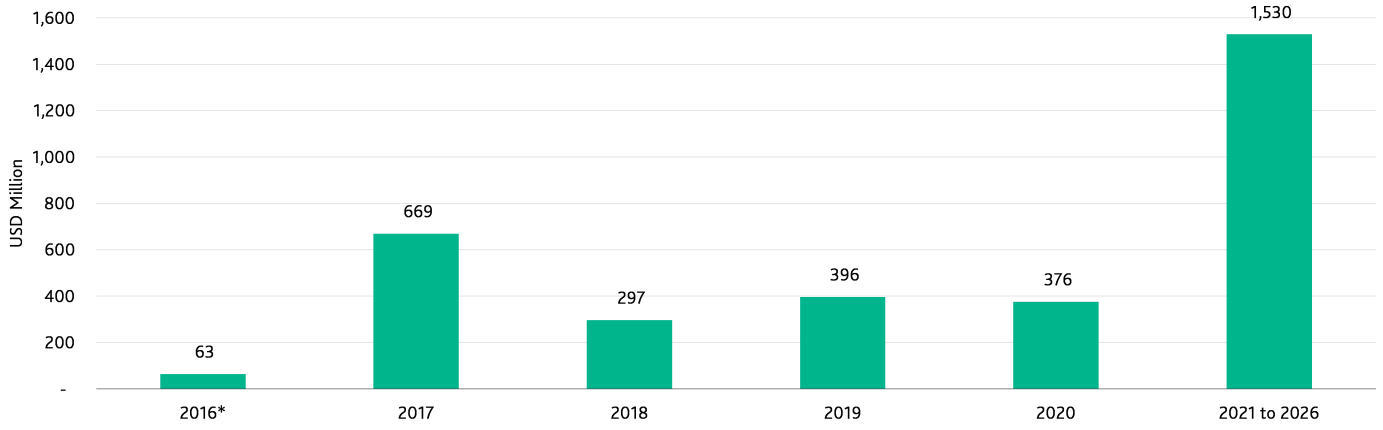
Still, we expect the company to prudently manage its dividend payouts over the next 12 months, as well as retain access to the local bank and bond markets to enhance liquidity, fund these acquisition related payments and ensure scheduled debt maturities are refinanced in a timely manner. In addition, PLDT has investment assets (including a 8.74% stake in Meralco and a 20% ownership in **SPi Global** (unrated) – a business process outsourcing company) which it could monetize if needed.

As shown in Exhibit 6, aside from around $63 million (PHP3 billion) of debt maturities through year-end 2016, PLDT has an additional $669 million (PHP32 billion) of debt maturing through year-end 2017 (together representing 22% of total reported debt), and which includes the company's USD228 million Senior Unsecured Notes due 6 March 2017.

Thereafter, the company's debt maturity profile is relatively long dated with the majority of debt maturing after 2021.

Exhibit 5

**PLDT's Debt Maturity Profile as of September 2016**




*October 2016 through December 2016
*Sources: Company filings, Moody's Financial Metrics*

## Rating Methodology and Scorecard Factors

Methodology Output: In accordance with the Global Telecommunications Industry (December 2010) methodology, PLDT's grid-indicated rating is Baa1 for the twelve months to September 2016. The differential from the assigned Baa2 issuer rating largely reflects the company's investment appetite.

Exhibit 6

| Global Telecommunications Industry Grid | Current LTM 9/30/2016 | Moody's 12 Month Forward View |
|---|---|---|
| **Factor 1: Scale And Business Model, Competitive Environment And Technical Positioning (27% )** | Score | Score |
| a) Scale (USD Billion) | Ba | Ba |
| b) Business Model, Competitive Environment and Technical Positioning | A | A |
| **Factor 2: Operation Environment (16%)** | | |
| a) Regulatory and Political | Baa | Baa |
| b) Market Share | Aa | Aa |
| **Factor 3: Financial Policy (5%)** | | |
| a) Financial Policy | A | A |
| **Factor 4:Operating Performance (5%)** | | |
| a) EBITDA Margin | Aa | A |
| **Factor 5: Financial Strength (47%)** | | |
| a) Debt / EBITDA | Baa | Baa |
| b) FCF / Debt | Caa | Caa |
| c) RCF / Debt | Ba | Ba |
| d) (FFO + Interest Expense) / Interest Expense | Aa | A |
| e) (EBITDA - Capex) / Interest Expense | Ba | Ba |
| **Rating:** | | |
| a) Indicated Rating from Grid | Baa1 | Baa2 |
| b) Actual Rating Assigned | Baa2 | |

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

Major Shareholders: PLDT's major shareholders are **First Pacific Company Limited** (FirstPac, unrated) and **NTT Communications**/NTT DoCoMo (the NTT Group, Aa3 stable), with effective common shareholdings at September 2016 of

approximately 26% and 20% respectively. In addition, following the Digitel acquisition, about 8% of PLDT is held by JG Summit Holdings (unrated).

We understand that the NTT Group has an existing shareholders agreement with FirstPac that specifies that the NTT Group should not increase its stake in PLDT beyond 21%.

Moreover, the NTT Group and FirstPac have a right of first refusal over the other's PLDT shares. Furthermore, under its cooperation agreement with PLDT, the NTT Group must give prior approval to any major acquisitions, investments or transactions involving PLDT and its subsidiaries.

In our view, this arrangement partially tempers the risk of PLDT being used as a conduit for FirstPac investments. While no rating uplift is factored into PLDT's rating because of the NTT Group's ownership stake, we view positively the presence of a financially strong investor with the potential to aid technology transfers.

Foreign currency risk: Exposures to US dollar/peso exchange rate movements are partially mitigated by hedging arrangements. Approximately 37% of gross debt was US dollar-denominated as of September 2016. We expect this exposure will decrease to around 30% following the repayment of its USD228 million notes due March 2017. The unhedged portion equates to 11% of total debt, or $0.4 billion, after taking into account PLDT's US dollar cash holdings and currency hedges. In addition, approximately 16% of PLDT's consolidated service revenues were denominated in and/or linked with the US dollar in the nine months to September 2016.

## Ratings

Exhibit 7

| Category | Moody's Rating |
|---|---|
| **PLDT INC.** | |
| Outlook | Stable |
| Issuer Rating -Dom Curr | Baa2 |
| Senior Unsecured | Baa2 |

*Source: Moody's Investors Service*

REPORT NUMBER 1056125

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