Chorus Limited
Level 10, 1 Willis Street
P O Box 632
Wellington
New Zealand

Email: company.secretary@chorus.co.nz

STOCK EXCHANGE ANNOUNCEMENT

31 January 2022

S&P increases Chorus' credit rating threshold

S&P has released the attached update on Chorus.

The update states that the downgrade threshold for Chorus has been increased to a debt to EBITDA ratio of 5.0x at the current rating level, compared with a ratio of 4.25x previously.

The long-term rating remains unchanged at BBB stable.

Authorised by:
David Collins
Chief Financial Officer

ENDS

For further information:

Steve Pettigrew
Head of External Communications
Mobile: +64 (27) 258 6257
Email: steve.pettigrew@chorus.co.nz

Brett Jackson
Investor Relations Manager
Phone: +64 4 896 4039
Mobile: +64 (27) 488 7808
Email: brett.jackson@chorus.co.nz

Research Update:

Chorus Ltd. 'BBB' Ratings Affirmed With Stable Outlook; Outlook Thresholds Revised With Enhanced Earnings Predictability

January 31, 2022

Rating Action Overview

- We expect Chorus Ltd.'s earnings to be more predictable and stable following the introduction of New Zealand's utility-like "building block" regulatory framework, which determines the annual maximum allowable revenue that the company can earn over each regulatory period on its fiber network.
- We believe the enhanced earnings quality improves Chorus' underlying creditworthiness and allows it to tolerate a higher leverage at the 'BBB' rating level. We therefore revised our downgrade threshold for the company to a debt-to-EBITDA ratio of 5x, from 4.25x.
- On Jan. 31, 2022, S&P Global Ratings affirmed its 'BBB' long-term issuer credit rating on the New Zealand-based fixed line wholesale-only telecom company. We also affirmed the 'BBB' long-term issue credit ratings on the company's senior unsecured notes.
- The stable outlook reflects our expectations that Chorus will maintain its solid network position and earnings, as well as its commitment to maintain financial policies, including a leverage profile, commensurate with a 'BBB' rating.

PRIMARY CREDIT ANALYST

Yijing Ng
Singapore
(65) 6216-1170
yijing.ng
@spglobal.com

SECONDARY CONTACT

Richard P Creed
Melbourne
+ 61 3 9631 2045
richard.creed
@spglobal.com

Rating Action Rationale

Chorus' earnings are more transparent and resilient, with New Zealand's new regulatory framework coming into effect in January 2022. The regulatory regime, applicable to Chorus' fiber network, determines the annual maximum allowable revenue that Chorus can earn over each regulatory period. The first regulatory period runs from 2022 to 2024 and the New Zealand Commerce Commission (NZCC) has applied a revenue cap of NZ$2.2 billion for Chorus in the period. A wash-up mechanism will adjust for any under or over recovery of revenue arising from differences between projected and actual demand levels. This adds a layer of earnings certainty.

The shift toward becoming a utility-like business, characterized by high predictability of earnings and low volatility, underpins our view that Chorus can accommodate higher leverage. Fiber revenues subject to the regulatory regime accounted for a high 60% of Chorus' total revenues in fiscal 2021 (ended June 30, 2021), and this proportion is expected to rise on the back of increasing fiber uptake, spurred by demand for faster and more reliable connections. We estimate that by fiscal 2024, fiber will account for almost three-quarters of Chorus' revenue.

At the same time, we view the residual execution and cost escalation risks associated with the ultra-fast broadband (UFB) rollout as minimal. The implementation of the new regulatory framework follows Chorus' transition to operating from the building phase of its fiber network. As of December 2021, the UFB rollout was 97% complete, with 32,000 premises remaining to pass by December 2022. As the rollout completes, we expect Chorus' free operating cash flow (FOCF) to turn positive from fiscal 2023, improving the company's financial flexibility. We project Chorus' capital expenditure (capex) to drop to NZ$560 million-NZ$580 million in fiscal 2022 from the NZ$800 million spent in fiscal 2019 during the peak network buildout, and for this to reduce further to below NZ$400 million by fiscal 2024.

How the regulatory framework stays or changes through subsequent resets will drive the leverage tolerance parameters for the rating. Despite application of the regulatory framework, Chorus retains some longer-term exposure to competition from alternative technologies such as wireless network substitution. Vertically integrated mobile network operators have an incentive to bypass fixed-line wholesalers in order to capture the full value chain and earn a higher margin. As a result, fiber uptake could be lower than the company expects. The wash-up mechanism partially mitigates such risks to earnings. Beyond a single regulatory period, however, these risks are also somewhat a function of how the regulator responds to material changes in market dynamics through the regulatory reset periods. Notably, the regulator may choose to move to a price-cap model within the second regulatory period. We will look for clarity of the regulator's stance as Chorus move through the first regulatory period.

We view Chorus as committed to maintaining a leverage level commensurate with our 'BBB' ratings. Chorus has a record of maintaining a disciplined approach to shareholder returns and financial policy decisions. Chorus is transitioning its distribution policy from being a proportion of profit to one based on free operating cash flow. This reflects the transition to a regulated entity in which capex is skewed to stay in business levels. We expect this change will help the company manage its leverage according to its operating performance and capex cycle. We project Chorus' debt-to-EBITDA ratio to be 4.0x-4.2x through fiscal 2024. That said, we believe the company may have a higher leverage appetite in response to the greater revenue certainty stemming from the introduction of the regulatory regime. Nonetheless, we expect the company to continue to manage its leverage below our downgrade threshold.

Outlook

The stable outlook reflects our expectation that Chorus' strong network position and enhanced earnings predictability due to regulation--coupled with increasing FOCF generation and disciplined approach to capital management--will offset risks associated with wireless substitution, line loss to other local fiber companies, and migration from its legacy copper network.

We will monitor the extent to which Chorus is forced to respond to wireless substitution risk under the new regulatory framework. We may further adjust the company's debt capacity at the 'BBB' rating level, either upward or downward, to reflect our view of the stability of the new regulatory regime, particularly how the regulator manages medium-to-long term returns, regardless of market dynamics.

Downside scenario

Downward rating pressure could occur if the ratio of debt to EBITDA is sustained at 5x or more or a material decline in the group's covenant headroom or liquidity were to occur.

Changes to the new regulatory regime that materially reduce the amount, predictability, and sustainability of the group's earnings generation or stability could put downward pressure on the rating or debt capacity at the 'BBB' rating level.

Upside scenario

We consider upward rating momentum to be unlikely over the next few years, given the company's capital management objectives. It would require Chorus to adopt and adhere to a more conservative financial policy such that its debt-to-EBITDA ratio remains substantially below 4x.

The establishment of a regulatory track record demonstrating earnings that are sustainable, highly predictable and resilient to wireless substitution risks could provide incremental debt capacity at the 'BBB' rating level.

Company Description

Chorus is a provider of telecommunications infrastructure throughout New Zealand. The company owns most of the telephone lines and exchange equipment in New Zealand and responsible for building about 75% of the new fiber optic UFB network. The government-backed UFB will cover 87% of the population by the end of 2022.

Chorus owns and operates the majority of New Zealand's fixed-line telecom access network, including the legacy copper network. The group provides wholesale access to copper and fiber networks to retail service providers. In 2011, Chorus was structurally separated from Telecom New Zealand, later rebranded as Spark New Zealand prior to the UFB rollout.

Our Base-Case Scenario

Assumptions

- New Zealand's GDP to recover after contracting 1.1% in 2020, with a growth of 5.3% in 2021, 3.0% in 2022 and 2.8% in 2023. The advent of the regulatory regime reduces the impact of GDP growth as a revenue driver, but inflation could drive up the business' operating expenses.
- Chorus' revenue to be virtually flat in fiscals 2022 and 2023, before rising about 1%-3% in fiscal 2024. The revenue composition will change, however, with fiber-based revenues (fiber broadband and fiber premium) growing to account for almost three-quarters of revenue by fiscal 2024, up from about 60% in fiscal 2021. In contrast, copper-based revenues will decline and contribute to less than 15% of total revenues, down from about 30% in fiscal 2021. This shift is due to copper-to-fiber migration as consumers seek faster connections.

- Adjusted EBITDA margin to improve from 68.6% in fiscal 2021 and be 69%-71% over fiscal 2022 to fiscal 2024 reflecting Chorus' cost-reduction efforts.
- Capex of NZ$560 million-NZ$580 million in fiscal 2022. This amount will decline as UFB network rollout completes by end of 2022, and is projected to be NZ$440 million-NZ$470 million in fiscal 2023 and NZ$370 million-NZ$400 million in fiscal 2024.
- Dividend of 26 cents per share in fiscal 2022 and gradually increase thereafter.

Key Metrics

Chorus Ltd.--Key Metrics*

Mil. NZ$	2020a	2021a	2022e	2023f	2024f
Revenue growth (%)	-1.1	-1.3	0-1	0-1	1-3
EBITDA margin (%)	67.6	68.6	69-71	69-71	69-71
Capital expenditure	679	647	560-580	440-470	370-400
Debt to EBITDA (x)	4.1	4.2	4.0-4.2	4.0-4.2	4.0-4.2
FFO to debt (%)	18.5	20.2	18-20	18-20	18-20
FOCF to debt (%)	-7.8	-3.4	(3)-(1)	2-4	4-6

*All figures adjusted by S&P Global Ratings. Year ending June 30. a--Actual. e--Estimate. f--Forecast.

Liquidity

We consider Chorus' liquidity to be adequate, reflecting our expectation that the group's sources of liquidity will cover its uses by about 1.2x over the 12-month period ending June 30, 2022. We also expect the company's net sources to remain positive even if EBITDA were to decline by 15%.

Also supporting the group's liquidity are its sound relationships with banks as well as its generally high standing in credit markets. Chorus has accessed funding in the domestic New Zealand and euro medium-term note markets.

Principal liquidity sources include:

- Cash and cash equivalents of NZ$53 million as of June 30, 2021.
- Undrawn committed bank facilities of about NZ$210 million, expiring beyond 12 months, as of June 30, 2021.
- Cash funds from operations of NZ$500 million-NZ$510 million over the 12 months to June 30, 2022.
- Funds received from Crown Infrastructure Partners (CIP) and other government funding of NZ$140 million-NZ$150 million over the same period.

Principal liquidity uses include:

- Debt of about NZ$140 million maturing within a year as of June 30, 2021.
- Capex of NZ$570 million-NZ$580 million over the 12 months to June 30, 2022.
- Dividend of 26 cents per share over the same period.

Covenants

We expect Chorus to maintain sufficient headroom against its covenants, which include net senior debt to EBITDA of less than 4.75x and net interest to EBITDA of more than 2.75x.

We project Chorus' net debt to EBITDA to be below 4.25x through 2023, and its net interest to EBITDA to be comfortably more than 4x over the same period.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of June 30, 2021, Chorus' capital structure consisted of a NZ$140 million revolving credit facility, €800 million medium-term notes, NZ$900 million New Zealand domestic bonds, and debt securities from CIP, which we treat as debt.

Analytical conclusions

We rate Chorus' debt at 'BBB', in line with the issuer credit rating, given that no significant elements of subordination risk are present in the capital structure.

We treat the equity securities as 100% equity. These securities are provided by the New Zealand government to support a project of national importance. The securities are deeply subordinated and dividends are optional, mandatorily deferrable, and will not be paid initially.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/--

Business risk: Excellent

- Country risk: Low Risk
- Industry risk: Intermediate Risk
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

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

- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

Ratings Affirmed	
Chorus Ltd.	
Issuer Credit Rating	BBB/Stable/--
Chorus Ltd.	
Senior Unsecured	BBB

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.