Frontier Communications Inc. 11.0% 15-September-2025 senior unsecured bond

Disclaimer

This product has not been reviewed by research nor should this document be considered as credit research. This Factsheet is only a summary document designed to help investors quickly identify the key elements of the company or financial product referred to in this document and should be read in conjunction with the other offering documentation available.

Issuer

Frontier Communications Inc. (Frontier) is the fourth largest Incumbent Local Exchange Carrier (ILEC) in the US by revenue, after AT&T, Verizon and CenturyLink. The firm was originally established in 1935 as Citizens Utilities Company, and after various acquisitions became a diversified operator of public utilities, providing services for telecommunications, natural gas, electricity and water in the US. In 1999, the firm started to pursue the strategy of divesting the other utility operations to become a pure play telecoms provider. In 2000 the company was renamed Citizens Communications Company, providing wireline communications services to rural areas as well as small and medium sized cities and towns across the US, mainly as an ILEC. After acquiring Frontier Corp from Global Crossing Ltd in 2001, the company rebranded the ILEC operations to "Frontier". In 2008, the company was renamed Frontier Communications Corporation.

Acquisitions of wireline and network assets from other US telecommunications companies have been a key feature of Frontier's growth strategy. In 2010, Frontier acquired Verizon's local exchanges and related business assets in 14 states for USD5.2bn. In 2014, the company bought AT&T's fibre network and triple-play telecommunications services (known as U-verse) in Connecticut for USD2bn. Most recently in 2015, Frontier agreed to acquire Verizon's wireline operations in California, Florida and Texas for USD10.5bn. The deal closed on 1 April 2016, and included the bundled telecommunications services (known as FiOS) provided over a fibre network in those states. Frontier has the right to use the FiOS brand and media guide for the next five years. These acquisitions have enabled Frontier to grow to a business of significant scale, operating in 29 states with over 5.5 million customers, including over 4.4 million broadband subscribers. The 2015/16 acquisition of assets from Verizon has been the most significant, adding over 2.2 million customers and has the potential to double Frontier's revenues. The newly acquired Verizon and AT&T assets have lower capital intensity due to being younger network assets, but these assets also have lower revenue growth potential due to the already high penetration in the relevant markets.

Frontier provides a breakdown of revenue data by five business lines: voice (32% of total consolidated revenues in 3Q16), data and internet (41%), video (16%), switched access and subsidy (8%), and other (3%). Of note, video revenues increased dramatically after the latest Verizon acquisition due to the addition of FiOS video services, with over 1.5 million video subscribers at the end of 3Q16 as compared to around 550,000 as at year end FY15. Revenue split by customer type 50.5% residential, 41.5% business, and 8% regulatory (switched access and subsidy). As at 30 September 2016, around 30% of Frontier's footprint is served by newer fibre networks, with the remaining 70% served by traditional DSL networks. The scale and reach of Frontier's network coupled with targeted incremental investments (aimed at driving fibre deeper into the existing network) allow the potential for Frontier to evolve with the industry and maintain competitiveness versus incumbent cable companies.

For the last twelve month (LTM) period ending 30 September 2016, Frontier generated total consolidated revenues of USD7.9bn, and consolidated adjusted EBITDA of $3.2bn, with an adjusted margin of 40%. The acquisition of the Verizon assets closed only at the start of 2Q16, and on a pro forma combined basis, pro forma LTM consolidated revenues and adjusted EBITDA would have been USD10.7bn and USD3.9bn respectively. Management originally identified USD1bn of synergies associated with the acquisition of the Verizon assets, which were estimated to have been realised as at 30 June 2016. Partly in response to weaker-than-expected performance in the last two quarters, management have identified a further USD400m of annual run-rate cost synergies, USD250m of which are expected to be achieved by mid-2017, and a further USD150m by mid-2019. Adjusting 4Q15 and 1Q16 for management-expected run-rate synergies of USD1.4bn, pro forma LTM adjusted EBITDA would have been USD4.6bn. As at 30 September 2016, total debt and net debt stood at USD18.2bn and USD17.9bn respectively. This represents net leverage (net debt to LTM adjusted EBITDA) of 5.7x, pro forma net leverage (net debt to pro forma combined LTM adjusted EBITDA) of 4.6x, and pro forma net leverage including synergies (net debt to pro forma combined LTM adjusted EBITDA including 4Q15 and 1Q16 adjusted for the full USD1.4bn of management estimated annual run-rate synergies) of 3.9x. The latter figure is the leverage figure reported by the company, and management targets a net leverage ratio of 3.5x or less for the medium term.

Please refer to the Investment Memorandum for full details on the company and transaction.

Guarantor/Credit Wrapper	N/A
ISIN	US35906AAZ12

Trading Information	
Minimum amount	USD10,000 (FIIG restriction)
Denominations	USD1,000
Retail / Wholesale	Wholesale clients only (FIIG restriction)

Coupon	
Coupon Type	Fixed rate note
Rate	11.0%
Amortisation	N/A
Coupon Payment Frequency	Semi-annually

Important Dates	
Issue Date	2-June-2016
Call Dates	15-June-2025 @ USD100.00 Make whole at 50 basis points over the relevant treasury yield until 15-June-2025
Maturity Date	15-September-2025

Structure	
Type / Rank	Senior Unsecured
Domicile	US
Currency	USD
Amount Issued/Outstanding	USD3,600m/USD3,600m
Issuer Credit Rating	B1/BB-/BB (Moody's S&P/Fitch) Neg outlook Moody's and Fitch; Watch Neg S&P
Issue Credit Rating	B1/BB-/BB (Moody's/S&P/Fitch) Neg outlook Moody's and Fitch; Watch Neg S&P
Australian W/H tax exempt	No

Strengths

- **Best-in-class adjusted EBITDA margins:** Despite margin erosion over the last three years, Frontier has maintained higher adjusted EBITDA margins versus other US IELCs that are rated single B,. Adjusted EBITDA margin for the LTM period ended 30 September 2016 was 40.0%, versus 38.3% for CenturyLink, and 34.3% for Windstream. A key factor driving high margins has been the company's continued focus on cost, as changing industry trends have led to structural revenue declines for certain business lines. Another contributing factor is the targeting of acquisitions in higher margin products and services, such as the significant addition of video subscribers following the acquisition of the Verizon's FiOS in California, Texas and Florida
- **Acquisition of Verizon assets doubles scale:** The acquisition of the Verizon wireline assets (fibre networks) in California, Texas and Florida more than doubles Frontiers revenues and improves the quality of the overall network by adding substantial new fibre assets to existing copper networks. As a result, high quality broadband and TV systems (e.g. FiOS video) have been added to Frontier's suite of service offerings, with generally more stable revenues than Frontier's previous existing internet and video revenues
- **Focus on cost structure:** 3Q16 was another demonstration of the company's dynamic approach to its cost structure, where operating expenses were reigned in over the period as it became apparent that revenue trends were weakening. This allowed the company to achieve its USD1bn adjusted EBITDA target for the quarter, despite a 3.2% sequential decline in revenues
- **Significant synergies realised post acquisition of Verizon assets:** Management estimated that by the end of 2Q16, the originally estimated USD1bn of annual run-rate cost synergies associated with the acquisition of the Verizon assets had been achieved. A further USD400m of annual run-rate cost synergies have since been identified, of which an annual run-rate of USD250m is expected to be achieved by mid-2017, and an additional USD150m by mid-2019
- **Efficiencies in changing organisational structure:** Frontier is moving towards a national telecommunications services provider, from its previous structure as a more regionally focused business. The change in organisational structure announced in conjunction with 3Q16 earnings results suggest meaningful

redundancies can be removed from the existing cost structure, such as a headcount reduction of around 1,000 staff members, as a result of centralising non-customer facing functions

- **Execution is key:** Management comments on the 3Q16 earnings call indicated that the weak subscriber and revenue trends were a result of Frontier's execution. Arguably, this is an easier problem to fix than if it were an industry-wide issue that the company is less able to control (such as intensifying competitive pressures or a slowing of service penetration). As per management comments on the 3Q16 earnings call, Frontier expects to achieve revenue stability relating to FiOS in California, Texas and Florida in 1Q17
- **Legacy Frontier businesses relatively stable:** Absent of the operational issues in 3Q16, the legacy Frontier businesses have been relatively stable for both residential and business customers. On the residential side, there have been steady gains in broadband subscribers, whilst SME revenue stability had been maintained for the eleventh sequential quarter as at the end of Q3. Management indicate that absent of legacy subscriber losses in Q3 relating to the onshoring of the call centre, 3Q16 would have been one of the strongest recent quarters for the legacy Frontier businesses
- **Lower capital intensity of acquired network assets:** The fibre assets acquired from AT&T in 2014 and most recently from Verizon in 2015/16 require lower capital investment due to their relatively young maturity. This benefit is mitigated somewhat by lower revenue growth prospects associated with these newer assets
- **CAF Phase II Funding:** Frontier's focus on the provision of telecommunications services to rural areas and small towns and cities has allowed it to benefit from various subsidies received from state and federal authorities due to the higher cost of providing wireline services in remote and rural areas, including grants and subsidies under the Connect America Fund. Regulatory revenues relating to the Phase II of CAF help to offset the anticipated decrease in Business Data Services (BDS) rates imposed by the regulator. CAF Phase II provides USD332m in annual support to Frontier through 2020 to make available 10 Mbps downstream/1 Mbps upstream broadband service to approximately 774,000 households across 29 states
- **Majority of integration costs incurred:** Management indicate that from 1Q17, integration costs will be minimal, which would help to boost operating cash flow. The focus of the business moving forward is to recover growth in gross subscriber additions, stabilise subscriber churn, and a continued responsive approach to the cost structure
- **Long term value in network assets:** Despite warranted concern over the ability of copper networks to remain competitive versus higher speed fibre networks, the sheer scale and reach of any IELC's assets (such as Frontier) mean that these networks remain the backbone architecture on which to make incremental investments. IELCs networks have been evolving since wireline telecommunications operated as regional monopolies in the US, and by investing to drive fibre deeper into the networks in order to shorten the "last mile" segment, significant speed improvements can be achieved across traditional DSL networks and allow companies like Frontier to remain competitive versus other operators over time as data demand continues to climb. Whilst the unsecured bonds do not have any direct recourse to fixed assets, industry trends that underpin the long term value of the network assets could ultimately underpin recovery prospects for the bonds in the event of a default. S&P estimates recovery rates to be at the lower end of the 50%-70% range in the event of payment default. A recovery rate of 50% on senior unsecured bonds would imply that after giving effect to USD2.3bn of secured debt, PP&E recovers approximately 63% of book value, as reported at 30 September 2016
- **Adequate liquidity:** As at 30 September 2016, the company had USD331m cash on the balance sheet and access to an undrawn revolving credit facility of USD750m. The RCF matures on 31 May 2018 and cannot be used to fund dividend payments. Total debt maturities are around USD500m in 2017 and USD730m in 2018, and management expects to be able to meet these debt principal operations from liquidity sources and free operating cash flow. However, it must be noted that Frontier's access to the RCF is subject to restrictive covenants which prohibit net leverage to exceed 4.5x. As at 30 September 2016, the company reported net leverage for the LTM period to be 3.9x, which includes full annual run-rate cost synergies of USD1.4bn. Absent of synergies, pro forma net leverage for the LTM period ending 30 September 2016 was 4.6x. The exact definition of the leverage ratio test calculation pertaining to the RCF covenants are part of a private credit agreement and this information is not made generally available to unsecured bond holders or other investors
- **Existence of certain restrictive covenants:** The indenture governing the Frontier 11.0% senior unsecured bonds maturing in 2025 contain certain restrictive covenants, including limitations on subsidiary indebtedness, limitations on liens, restrictions on sales of assets and application of proceeds thereof, and limitations on restricted payments. In particular, the covenants include a maximum debt incurrence leverage ratio test of 4.5x (net debt to adjusted EBITDA), maximum permitted liens or subsidiary debt of 1.25x, and cumulative restricted payments no greater than cumulative adjusted EBITDA less 1.4x cumulative interest expense. The 11.0% unsecured bonds also benefit from a cross default provision

Risks

- **Risks relating to integration and synergies:** Due to execution issues such as the onshoring of the customer call centre in 3Q16, Frontier has experienced significant customer losses, including 2% of broadband subscribers and 6% of video subscribers on a consolidated basis. The majority of customer losses relate to the newly acquired Verizon assets. Frontier now faces the challenge of stabilising and reversing the subscriber trends. In addition, although management estimates that USD1bn of annual run-rate acquisition-related cost synergies were achieved by the end of 2Q16, an additional USD400m of annual run-rate synergies have been identified, USD250m of which are expected to be achievec by mid-2017, with the remaining USD150m expected to be achieved by mid-2019. There are risks that Frontier fails to achieve all of some of these additional synergy expectations, or that the synergy benefits are eroded by a continued deterioration in net subscriber trends. Continued subscriber losses relating to the newly acquired assets may lead to impairments to goodwill, and whilst such impairments would be non-cash in nature, the overall implication would be a lower equity valuation being placed on the company and hence a smaller equity cushion for debt investors
- **Recent weak operating trends:** Due to various operational factors, including a deliberate pause on marketing activity in 2Q16 and the onshoring of the call centre in 3Q16, Frontier has been losing subscribers, which in turn has contributed to two consecutive quarters of revenue declines. There is a risk that customer losses continue, with the continued losses of voice access lines being particularly harmful to margins. On the back of weak 3Q16 results, Moody's downgraded Frontier senior unsecured credit rating to B1 from Ba3 and changed the outlook to negative from stable. Moody's expects Frontier to be able to eventually stabilise subscriber and revenue trends and continue to demonstrate sound control over costs but the rating agency anticipates that the recovery process will take longer than previously anticipated. As a result, Moody's has significantly revised down its EBITDA forecasts for FY16, FY17 and FY18 to under USD4bn (from USD4.1bn), USD3.9bn (from USD4.3bn) and USD3.8bn (from USD4.3bn) respectively. Management has indicated that the recent weakness is attributable to Frontier's execution and are optimistic about a reversal of recent trends
- **Weakened cash flow trends:** As a result of the above mentioned deterioration of operating trends seen in the last two quarters, cash flow trends have also weakened. Based on management guidance given for 4Q16, FIIG estimates a net cash outflow for FY16 as a result of the weaker operating cash flow generation, combined with the high cash needs accompanying the current dividend policy. Should Frontier fail to reverse revenue and subscriber trends, gains from acquisition synergies are at risk of being further eroded from weakening underlying operating cash flow trends
- **High financial leverage:** Whilst management reports LTM pro forma net leverage to be 3.9x, absent of the application of run-rate synergies, LTM pro forma net leverage stands at 4.6x. High financial leverage could lead to a loss of access to the USD750m undrawn RCF, and limits Frontier's access to additional debt funding under the restrictive debt incurrence covenants on certain other senior unsecured bonds. A high debt burden also reduces the attractiveness of Frontier as an acquisition target
- **Liquidity risk:** Whilst the current liquidity position remains adequate, including USD331m in cash and cash equivalents and access to an undrawn USD750m RCF as at 30 September 2016, the Credit Agreement governing the RCF and other senior bank facilities contains a maximum leverage ratio covenant. Under this covenant, the ratio of total debt minus cash and cash equivalents in excess of USD50m to consolidated adjusted EBITDA (as defined in the agreements) must not exceed 4.5x. The exact definitions around the calculation of consolidated adjusted EBITDA under the ratio definition are part of a private credit agreement and this information is not made generally available to unsecured bond holders and other investors. As at 30 September 2016, the company reported net leverage for the LTM period to be 3.9x (which includes pro forma adjustments and run-rate synergy adjustments), and there were no breaches of covenants reported. Continued high and increasing leverage could mean falling headroom under this leverage covenant and increased risk of the company no longer having access to the RCF as well as various other senior bank facilities
- **Risk of underinvestment:** Whilst the newly acquired assets have lower capital intensity that Frontier's legacy assets, the company needs to maintain a high base level of capex in order to ensure that the company is able to evolve with the growing demand for data and remain competitive versus the large cable companies. In the last few years, capex has ranged from 13% to 17% of total revenues. Moody's estimates that a minimum capex of 12% of total revenues going forward would be needed for Frontier's network assets to be adequately invested. The downside to underinvestment is usually difficult to detect during the immediate subsequent investment periods but can lead to significant revenue and earnings erosion in the medium to longer term
- **No immediate plans for a single architecture:** In Moody's 9 November 2016 update report following its downgrade of Frontier credit ratings, the rating agency pointed to the potential of significant operational savings that could come from unifying the operations of Frontier's current platforms under a single network architecture, including U-verse (acquired from AT&T in 2014) and FiOS (acquired from Verizon in 2015/16). However, Frontier plans to continue operating the platforms separately, most likely as a result of the significant investment expense that would be required to undergo such a network unification project, which is not currently feasible given Frontier's cash flow metrics
- **Regulatory risk:** Whilst Frontier benefits from certain grants and subsidies relating to the higher cost of wireline service provision to more remote areas, such as funding under CAF and CAF II, there are regulatory pressures on business data services (BDS) that seek to impose price caps on such services. BDS services, also

known as special access lines, are used by many businesses to transmit large amounts of data quickly. Such services are relied on by a wide variety of businesses and institutions such as banks, retailers, schools and hospitals. In April 2016, the Federal Communications Commission (FCC) proposed a plan to reduce pricing for BDS by 11% over the next three years, but the ruling faced appeal by ILECs such as Frontier and AT&T. Following the election victory of Donald Trump in November 2016, these previously announced FCC proposals have been put on hold, but regulatory pricing risks could still negatively affect Frontier's business in the future. For example, Frontier management have estimated that should such regulatory price caps be introduced in July 2017, the negative impact on Frontier earnings would have been approximately USD10m in FY17, and USD20m in each of FY18 and FY19

- **Industry and competition risks:** The telecommunications industry is facing revenue declines in traditional services (such as voice and traditional broadband), which needs to be offset by revenues on new and additional services which generally drive the demand for data and network speeds (video and other media streaming, cloud hosting, and various business IP services). Telecommunications providers compete on price and service offerings, including various bundling options and the quality and speed of network connections. On the latter point, IELCs also face competition from traditional cable companies who offer faster network speeds than IELC's traditional copper networks. As a result, companies such as Frontier must maintain a high minimum level of investment in their network to maintain competitive positioning, whilst facing pricing and revenue pressures on its traditional services. A failure to attract new customers on new and higher-priced services or an inability to find further cost savings would increase the risks relating to weakening operating trends (highlighted above). A plateauing of service penetration rates or an industry price war could further contribute to such risks
- **Further risk of ratings downgrades:** Following the release of 3Q16 earnings, Frontier corporate and issuer ratings were placed on negative watch by S&P, and were downgraded and placed on negative outlook by Moody's. The results disappointed versus the rating agencies' expectations. Frontier's current corporate and senior unsecured issue credit ratings are BB- (negative watch) by S&P, and B1 (negative outlook) by Moody's. S&P's expects to resolve its negative watch placement over the next few months, and the rating action is dependent on Frontier's ability to demonstrate a sustainable reversal of the negative trends on its newly acquired markets from Verizon. Moody's primary reasons for the downgrade to B1 from Ba3 were the weaker-than-expected operating trends, covenant pressures posing an increased risk to liquidity, and continued shareholder friendly capital allocation. The negative outlook reflects Moody's concern that negative subscriber trends may be hard for Frontier to reverse. Moody's previous Ba3 rating was predicated on expectations of improving fundamentals, including debt reduction from the improving cash flow as a result of planned merger synergies, but these expectations have now changed following the release of 3Q16 results and the rating agency anticipates further weakness on revenue, EBITDA and cash flow. Moody's also expects a continuation of shareholder friendly financial policies (see below)
- **Shareholder friendly financial policy:** Whilst management have stated that reducing financial leverage is a priority, thus far the company maintains a generous dividend policy. Total cash dividends currently stand at over USD700m per annum, USD500m of which is the dividend on common stock. The large dividend leaves limited retained free cash flow for debt reduction, but may also serve as a double-edged sword to enforce further discipline on costs and motivate the drive towards a recovery in subscriber and revenue trends. Nevertheless, one of the reasons given by Moody's for the negative outlook accompanying the newly downgraded rating to B1 is the potential for shareholder friendly financial policies to continue
- **Significant exceptions to certain restrictive covenants:** The indenture governing the Frontier 11% senior unsecured bonds maturing in 2025 contain certain restrictive covenants, including a maximum debt incurrence leverage ratio test of 4.5x (net debt to adjusted EBITDA), maximum permitted liens or subsidiary debt of 1.25x, and cumulative restricted payments no greater than cumulative adjusted EBITDA less 1.4x cumulative interest expense. However, there are several exceptions to the covenants, including significant exceptional allowances for additional debt incurrence (subject to certain conditions). Additional debt incurrence would increase the risk relating to significant financial leverage highlighted above
- **Relatively weak Change of Control provision:** There exists a Change of Control investor put provision relating to the bonds which allows investors to sell their holdings of the bonds back to the company at a price of USD101.00 plus accrued interest in the event that a) there has been a change of control of the company *and* b) this is accompanied by a ratings downgrade. This provision is relatively weak versus a standard Change of Control provision in which the company would be required to make an offer to repurchase the bonds as long as condition (a) is satisfied
- **Lack of call premium associated with the June 2025 call date:** Frontier 11.0% senior unsecured bonds maturing in 2025 are callable three months prior to the maturity date at a capital price of USD100.00 plus any accrued and unpaid interest. This call provision is designed to allow the company some timing flexibility around the refinancing of this bond, but does not provide investors in return with any call premium above par
- **Duration risk:** The bonds mature in September 2025 and have a relatively long duration. Investors are exposed to a degree of interest rate risk on the bond. For example, a 1% increase in yields would result in about USD5.4 fall in the capital price of the bond, all other things being equal

Call Risk	Frontier has the option to call the bonds early at the call date listed above. A decision to call the bonds ahead of maturity depends on a number of factors, including the relative

	cost of entering new debt financing, the company's liquidity position and the availability and attractiveness of new funding opportunities at the call date. Investors should examine the yield to worst, which may be the yield to call or the yield to maturity, when evaluating the investment opportunity
Interest deferral/Cancellation	N/A
Non-viability trigger	N/A

Summary

Frontier USD 11.0% senior unsecured bonds maturing 15 September 2025 provide investors with a US dollar high yielding telecommunications opportunity with increased scale following recent acquisitions. The bond is relatively long dated with a maturity in 2025 and as such carries relatively long duration. The capital prices of long duration bonds can be highly sensitive to changes in underlying changes in interest rates, as highlighted in the risks above.