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**Research Update:**

# U.K.-Based ITV Lowered To 'B+' On Mounting Pension Deficit, Weaker-Than-Expected First-Half Results; Outlook Negative

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## Research Update:

# U.K.-Based ITV Lowered To 'B+' On Mounting Pension Deficit, Weaker-Than-Expected First-Half Results; Outlook Negative

## Overview

- U.K. private TV broadcaster ITV has posted a sizable increase in its pension deficit and weaker-than-expected first-half 2009 results.
- We are lowering our long-term ratings on ITV to 'B+' from 'BB-'.
- The negative outlook reflects our opinion that, under our scenario of weak economic recovery, ITV's substantial profitability and credit measure improvements expected in 2010 may be delayed.

## Rating Action

On Sept. 16, 2009, Standard & Poor's Ratings Services lowered its long-term corporate credit and senior unsecured debt ratings on U.K. private TV broadcaster ITV PLC to 'B+' from 'BB-'. The outlook is negative.

At the same time, we affirmed our 'B' short-term corporate credit rating on ITV. The '4' recovery rating on all of ITV's outstanding bonds is unchanged. The '4' recovery rating indicates our expectation of average (30%-50%) recovery for unsecured creditors in the event of a payment default.

## Rationale

The downgrade reflects our view that ITV's credit measures will likely be materially weaker than expected in 2009, and stand to remain weak in 2010. We base our opinion on ITV's lower-than-expected first-half 2009 performance and its ballooning pension deficit. Although we had previously anticipated the group's Standard & Poor's adjusted gross debt to EBITDA ratio to return below 7x in 2009 and to about 5x in 2010--mostly on the back of ITV's planned material reductions in programming costs and other expenses--we now believe these ratios are likely to be significantly higher in both years.

In our opinion, there are substantial uncertainties on the extent of any lasting improvement in the U.K. economy and advertising market over the next few quarters. ITV reported a pre-restructuring EBITDA margin of 7.7% in the first half of 2009, or a near 600 basis-point fall year on year, on the back of a 15% drop in advertising revenues. Although the U.K. advertising market appears to have since stabilized, we believe that it may take longer than expected for ITV to restore its operating margin to healthier levels, despite ITV's lower cost base.

In addition, ITV reported a pension deficit triple the £178 million recorded at the end of December 2008. The main contributors to the increase were lower asset values, higher inflation assumptions, and a lower discount

rate. The jump in the pension deficit contributed significantly to the material rise in ITV's adjusted leverage at the end of June 2009. In the year ended June 30, 2009, ITV's adjusted gross debt to EBITDA ratio stood at about 9x, versus 6.8x and 4.2x at Dec. 31 and June 30, 2008, respectively. While ITV has said that its pension liabilities may be reduced by £75 million to £100 million in the short term if it successfully implements changes to its defined benefit schemes, we believe that the group's pension deficit is likely to be substantially higher than the 2008 figure for some time.

On the positive side, ITV managed to stabilize its audience share and increase advertising market share in the first half of 2009. In addition, although the U.K. Competition Commission (CC) decided today to maintain the Contract Rights Renewal (CRR) mechanism (to which only ITV1 is subject to for broadcasters), we think that ITV may benefit from a potential relaxation of the CRR by year-end 2009, in time for the 2010 round of advertising deals. Also, a potential lift of the current ban on product placement could be favorable to ITV.

## **Liquidity**

In our view, ITV's liquidity is currently adequate for the ratings. ITV reported about £476 million of cash as of June 30, 2009, which covered about £11 million of short-term debt. ITV repaid a £250 million bond at maturity in March 2009. We understand, however, that about £100 million of the group's cash is not available for debt repayment, and that, in addition, peak working capital requirements may exceed £100 million during any given year.

ITV raised new funding in the first six months of 2009. In February 2009, the group drew down a £200 million loan facility maturing in March 2019, which is secured against about £149 million worth of U.K. gilts that have the same maturity as the loan. ITV also drew down a £125 million covenant free loan in March 2009, with a maturity of May 2013, and completed in May 2009 a £100 million bond issue, which was a tap of the existing £325 million October 2015 bond and resulted in net proceeds of £58 million.

Furthermore, in June 2009, under the terms of an exchange offer, ITV repaid €81 million (£69 million) of the €500 million October 2011 Eurobond and exchanged at par €188 million of the October 2011 bonds for the issuance at par of new bonds with a maturity of June 2014 and carrying a coupon of 10%.

Owing to ITV's funding initiatives taken in the first half of 2009, we estimate that the group's cash balances are likely to be about £500 million at year-end 2009. Importantly, liquidity has improved following the exchange offer, since ITV's closest debt maturity is about £140 million in October 2011, versus about £330 million prior to the exchange offer. The next maturity after the October 2011 bond is about £235 million in early 2013. In the light of the improved debt schedule, ITV cancelled its undrawn £450 million revolving facility maturing in June 2011. Also on the upside, we continue to expect ITV to remain free cash flow positive in 2009, despite the material contraction in first-half 2009 operating margin. ITV has managed to increase cash conversion during the period, reported unadjusted free cash flow of about £68 million in the first half of 2009, higher than the same period in 2008, owing to capital expenditure restraint, and a focus on working capital management. We consequently expect ITV's discretionary cash flow to return to

positive territory following the suspension of the final dividend to be paid in 2009. ITV's dividend paid in 2009 stood at £25 million, compared with about £122 million in 2008.

### **Recovery analysis**

ITV's senior unsecured notes are rated 'B+', in line with the corporate credit rating. The recovery rating on these notes is '4', indicating our expectation of average (30%-50%) recovery for unsecured creditors in the event of a payment default.

In our hypothetical scenario, we assume default in 2013, triggered by a significant decline in ITV's revenues and profitability and its inability to repay or refinance debt maturing in 2013 (£200 million bilateral financing and £110 million notes).

Standard & Poor's has valued ITV on a going-concern basis, given the strength of its brand, licenses, programming rights, market share, and knowhow, which might still retain some value at default. We estimate ITV's enterprise value at the hypothetical point of default at about £900 million. This represents a meaningful decline from today's value, given the likely structural and significant changes in the business prior to default.

After deducting priority liabilities, we estimate that coverage for the senior unsecured notes will be in the 30%-50% range.

Recovery prospects for unsecured debt instruments reflect the estimated value available and accessible to creditors and are constrained by the bonds' lack of security and documentary provisions, and the likelihood that the capital structure at default might be materially different, as additional debt could be raised along the path to default with parity or priority to the rated unsecured debt instruments.

For more details, please see "ITV PLC's Recovery Rating Profile," published March 10, 2009, on RatingsDirect.

### **Outlook**

The negative outlook reflects the possibility that, in the case of a prolonged weakness in the U.K. advertising market that could spill into the better part of 2010, ITV may experience further delays in materially improving profitability and credit measures in 2010. The outlook also integrates our uncertainties about the future levels of ITV's pension deficit. Under our scenario for weak economic recovery, we believe this deficit is likely to remain high over the next few quarters. We also factor in our anticipation that ITV's liquidity will remain adequate and that the group will continue to successfully defend its audience and advertising market shares over the medium term.

We could lower the ratings if ITV were unable to meaningfully reduce adjusted debt to EBITDA to about 6x, from the expected very high year-end 2009 levels, and if the group were unable to maintain positive free cash flow generation.

We could revise the outlook to stable if ITV were able to materially improve operating margins and credit measures in line with the current rating

expectations, as detailed above, while preserving its competitive position in the U.K. advertising market.

We do not see any upward rating movement at this point, given the expected operational challenges facing ITV in our economic scenario over the next few quarters. Any positive momentum, would, however, likely stem from substantially better-than-expected advertising and economic conditions in the U.K.

## Related Research

- "Business Risk/Financial Risk Matrix Expanded," published May 27, 2009

## Ratings List

### Downgraded; Outlook Action

	To	From
ITV PLC Carlton Communications Ltd. Long-Term Corporate Credit Rating	B+/Negative	BB-/Stable

ITV PLC Senior Unsecured Recovery Rating	B+ 4	BB- 4
*Guaranteed by Carlton Communications Ltd.		

### Ratings Affirmed

	To	From
ITV PLC Carlton Communications Ltd. Short-Term Corporate Credit Rating	B	B

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