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## Research Update:

# Outlook On Turk Telekom Revised To Stable; 'BBB-/A-3' Ratings Affirmed

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## Research Update:

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## Overview

- On May 6, 2016, we revised our outlook on Turkey to stable from negative and affirmed the 'BB+' long-term foreign currency rating.
- Turk Telekom has reported solid operating results in recent quarters, thanks to solid subscriber growth in its mobile and fixed broadband segments.
- We expect S&P Global Ratings' adjusted debt to EBITDA figure to gradually decrease after peaking at about 2x in 2016 due to high spectrum costs and mobile network investments.
- We are revising our outlook on Turk Telekom to stable from negative and affirming our 'BBB-/A-3' ratings.
- The stable outlook reflects our anticipation that, over the next two years, Turk Telekom's revenues and EBITDA will continue to increase and its adjusted debt to EBITDA will remain at or below 2x, and funds from operations to debt at about 40%.

## Rating Action

On May 11, 2016, S&P Global Ratings revised its outlook on Turkish telecommunications operator Turk Telekom to stable from negative. The 'BBB-/A-3' long- and short-term corporate credit ratings were affirmed.

## Rationale

The outlook revision follows that on Turkey (see "Republic of Turkey Outlook Revised To Stable; 'BB+/B' Ratings Affirmed," published May 6, 2016, on RatingsDirect). It is also supported by Turk Telekom's solid operating results in recent quarters and strong revenue growth prospects, which offset our forecast that the S&P Global Ratings-adjusted debt to EBITDA will peak temporarily at 2.0x in 2016.

Our long-term rating on Turk Telekom is higher than the sovereign foreign currency rating on Turkey because the company has passed our hypothetical sovereign default stress test, which, among other factors, assumes a 50% devaluation of the Turkish lira against hard currencies and a 15%-20% decline in organic EBITDA. That said, the company's capital structure is still dominated by use of hard currency debt, while it generates cash flow in lira. For this reason, we currently cap the rating at one notch above the long-term foreign currency sovereign rating.

Revenue growth has accelerated at Turk Telekom in recent months, reaching 10.7% in the first quarter of 2016 after 7.6% the previous quarter. We expect this will continue, fueled by growth of the customer base in the mobile- and fixed-broadband segments, increasing demand for faster broadband and data consumption, and higher revenues from TV. We also anticipate relatively stable profitability in the coming years. In our view, this positive operating trend will offset higher leverage in 2016 caused by instalment payments relating to the 4G (fourth generation) spectrum that Turk Telekom secured in 2015 and significant LTE (long-term evolution) mobile network investments. Furthermore, Turk Telekom's dividends declined in 2016 by about 55% compared with the previous year, which helped narrow the gap between our understanding that the company would like to maintain reported net debt to EBITDA at about 1.5x and our current estimate of reported net debt to EBITDA of about 1.9x or lower at year-end 2016 (compared with 1.68x in March 2016).

Our assessment of Turk Telekom's business risk profile remains supported by the company's strong leadership position in domestic fixed-line business, its extensive network infrastructure, growth prospects, and solid profitability. Turk Telekom almost fully controls the fixed-line voice segment and is the dominant player in the fixed-line broadband market, where it had a retail market share of about 67% as of Dec. 31, 2015, including a growing presence in fiber, given 60% household coverage. Another strength is the company's very profitable fixed-line business, which results in somewhat stronger EBITDA margins than that of many European peers.

These strengths are partly offset by the company's exposure to meaningful country risks in Turkey, and the smaller scale of its mobile operations in the mature domestic mobile telephony market. There are three players in this market: Turkcell dominates, and Turk Telekom is still the smallest operator with a subscriber market share of 23.6% as of Dec. 31, 2015, six percentage points behind the No. 2 player Vodafone. Although Turk Telekom is gradually increasing its market share in the mobile market, its scale and profitability are significantly weaker than those of its competitor Turkcell. That said, given Turk Telekom's high investments in the mobile business in recent years, notably providing 86% of the population with 3G (third generation) coverage and 66% with LTE coverage on April 1, 2016, we think its market position and profitability could improve in the coming years.

Our assessment of Turk Telekom's financial risk profile is supported by our assumption that its adjusted debt-to-EBITDA ratio, after a temporary peak at about 2x in 2016, will decline gradually. This is in line with our understanding that the company would like to maintain reported net debt to EBITDA at about 1.5x, although we think it could take some time before Turk Telekom returns to this level.

These strengths are partly offset by Turk Telekom's likely temporary weaker free operating cash flow (FOCF) in 2016-2017 as it continues significant investments in mobile and fiber fixed networks. Moreover, we consider the company's limited discretionary cash flow generation, due to its dividend policy, which aims to distribute up to 92% of distributable profit (calculated based on Capital Markets Board regulations). We expect the dividend pay-out ratio to remain high because we understand that Turk Telekom's majority owner, Oger Telecom, needs to service its debt. That said, we consider that Turk Telekom's articles of association constrain Oger Telecom's influence on Turk Telekom's dividend policy. The articles stipulate that when Turk Telekom's board of directors decide on the dividend distribution proposal, it needs to maintain the group's sound financial standing, consider Turk Telekom's investment needs and trading prospects, and take into account covenants agreed with lenders.

Turk Telekom has exposure to foreign exchange risk, primarily because it had about $4 billion-equivalent of unhedged financial debt as of March 31, 2016 (denominated in U.S. dollars and euros), but generates almost all of its revenues and EBITDA in Turkish lira. Furthermore, in the 12 months to March 31, 2016, the Turkish lira depreciated by about 10% against the U.S. dollar.

In our base case, we assume:
- Annual GDP growth in Turkey of 3.4% in 2016 and 2017.
- About 7% revenue growth in 2016 and about 5% in 2017, primarily supported by continued growth in mobile revenues (10%-15% in 2016 and about 10% in 2017).
- Turk Telekom will benefit from higher broadband Internet penetration in Turkey, increasing demand for faster broadband and corporate data transfers, and higher revenues from TV services. This should more than offset the predicted decline in revenues from traditional fixed-line voice business.
- Despite weaker profitability in the first quarter of 2016, caused by brand unification and an early retirement program, we expect a relatively stable adjusted EBITDA margin of about 37%-39% in 2016 and 2017.
- Still relatively high capital expenditure to sales of 21% in 2016 (after 20% in 2015) before declining to about 15% in the following years.
- Spectrum-cost-related cash outflows of Turkish lira (TRY) 1.55 billion (about $0.5 billion) in 2016 and TRY0.77 billion in 2017.
- A dividend of TRY841 million in 2016 and about TRY1.8 billion-TRY1.9 billion in 2017.
- Annual depreciation of the Turkish lira against the U.S. dollar of about 5% per year.

Based on these assumptions, we arrive at the following credit measures for Turk Telekom:
- Adjusted debt to EBITDA of about 2x in 2016 and below 2x in 2017.
- Funds from operations (FFO) to debt at about 40%.
- FOCF to debt of 10% in 2016, before rebounding to 20% in 2017.

### Liquidity

We assess Turk Telekom's liquidity as adequate because we anticipate in our base case that its sources of liquidity will cover its uses by more than 1.2x in the 12 months from March 31, 2016.

In our view, the company has sound relationships with its banks. However, we view its liquidity management as less prudent than that of its international peers because it faces meaningful debt maturities in foreign currencies in 2016-2017. Furthermore, its average remaining debt term has declined to 3.5 years from 3.9 years the year before.

As of March 31, 2016, principal liquidity sources for the next 12 months include:

- Unrestricted cash balances of about TRY4.3 billion.
- Undrawn credit lines of about TRY0.4 billion.
- FFO of about TRY4.7 billion.

For the same period, principal liquidity uses include:

- Short-term debt maturities of about TRY2.7 billion.
- Modest working capital requirements.
- Capital expenditure (excluding spectrum costs) of about TRY3 billion.
- Spectrum-cost-related cash outflows of TRY1.55 billion.
- A dividend payment of TRY841 million.

In our base case, we estimate that in 2016 and 2017, Turk Telekom will maintain adequate headroom of more than 20% under its covenants, which require it to maintain debt to EBITDA below 2.5x and EBITDA interest coverage above 4x.

## Outlook

The stable outlook reflects our anticipation that Turk Telekom's revenues and EBITDA will continue to increase, with adjusted debt to EBITDA at or below 2x and FFO to debt at about 40% in the next two years.

### Downside scenario

We could lower the rating on Turk Telekom if:

- Its liquidity cushion weakened such that it no longer passes our sovereign default stress test.
- The adjusted debt-to-EBITDA ratio increased beyond 2.25x for a long period, with FFO to debt below 40%. We think this could be caused by weaker-than-expected operating developments, for instance material adverse foreign exchange movements or fierce price competition coupled with market share losses.
- Although currently unlikely, if we lowered our sovereign rating on Turkey by one notch, we would likely take a similar rating action on Turk Telekom, assuming the constraints related to its capital structure still applied.

### Upside scenario

We could take a positive rating action if Turk Telekom were to sustain its strong fixed-line broadband market position, obtain a stronger mobile market position, and achieve EBITDA margins in mobile telephony of 20%-25%. However, an upgrade would also require leverage staying at or below 2x and narrowing of the currency mismatch between debt and revenues. These factors could lead us to consider rating Turk Telekom two notches above the long-term sovereign currency rating on Turkey.

## Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/A-3

Business risk: Satisfactory
- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb-

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

## Related Criteria And Research

### Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

### Related Research

- Republic of Turkey Outlook Revised To Stable; 'BB+/B' Ratings Affirmed, May 6, 2016

## Ratings List

Ratings Affirmed; Outlook Action

| | To | From |
|---|---|---|
| Turk Telekom | | |
| Corporate Credit Rating | BBB-/Stable/A-3 | BBB-/Negative/A-3 |
| Senior Unsecured | BBB- | |

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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.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.