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Ratings

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Research Update:

Outlook On Turk Telekom Revised To Negative After Sovereign Rating Action; 'BBB-' Affirmed

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Overview

- On July 20, 2016, S&P Global Ratings lowered its long-term foreign currency sovereign credit rating on the Republic of Turkey to 'BB' from 'BB+' and revised the outlook to negative from stable.
- We are affirming our 'BBB-' long-term corporate credit rating on Turk Telekom, as we believe that Turk Telekom will continue to demonstrate robust operating performance and solid credit metrics, as well as a solid liquidity.
- However, we are revising our outlook on Turk Telekom to negative from stable because we consider that the rating on Turk Telekom is now constrained by the outlook on the sovereign.

Rating Action

On July 22, 2016, S&P Global Ratings revised the outlook to negative from stable on Turkish telecommunications operator Turk Telekom. At the same time, we affirmed our 'BBB-' long-term corporate credit rating on the company.

Rationale

The outlook revision follows our downgrade and outlook revision on Turkey (see "Republic of Turkey Foreign Currency Ratings Lowered To 'BB/B'; Outlook Negative," published July 20, 2016).

The negative outlook on Turk Telekom mirrors that on the foreign currency rating on Turkey. Because we limit our rating on Turk Telekom to two notches above the sovereign foreign currency rating, a further downgrade of Turkey would lead us to lower our rating on the company. In addition, we cap the rating on Turk Telekom at the 'BBB-' transfer and convertibility (T&C) assessment for Turkey because Turk Telekom does not have any meaningful hard currency earnings. The T&C assessment is now at the same level as our rating on Turk Telekom.

Nevertheless, at this stage, we continue to view the long-term rating on Turk Telekom and stand-alone credit profile (SACP) as strong, at 'bbb-'.

Turk Telekom's business risk profile continues to reflect the company's strong leadership position in domestic fixed-line business, its extensive network infrastructure, good growth prospects, and solid profitability. We expect Turk Telekom will benefit as broadband internet penetration increases in Turkey and due to increasing demand for higher broadband speed and quota packages and corporate data, as well as increasing revenues from TV services. This should more than offset the predicted decline in revenues from traditional fixed-line voice. For the moment, the company's very profitable fixed-line business enables it to enjoy somewhat stronger EBITDA margins than many of its 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.

Our assessment of Turk Telekom's financial risk profile is supported by our assumption that its S&P Global Ratings adjusted debt-to-EBITDA ratio, after a temporary peak at about 2x in 2016-2017, will decline gradually towards the company's mid-term target of 1.5x. S&P Global Ratings adjusted funds from operations (FFO) to debt was healthy at 50% at year-end 2015, which is likely to dip to around 40%-45% in 2016-2017 and gradually improve thereafter. 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, including large spectrum instalments.

Moreover, we take into account the company's limited discretionary cash flow generation, due to its dividend policy, which aims to maximize the distribution of Turk Telekom's available profits. Turk Telekom has exposure to foreign exchange risk, primarily because it had about $4 billion-equivalent of unhedged gross financial debt as of March 31, 2016, denominated in U.S. dollars and euros($2.7 billion after deducting hard currency cash), but generates almost all of its revenues and EBITDA in Turkish lira.

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 Turkish lira (TRY)4.3 billion ($1.5 billion)
- Undrawn credit lines of about TRY0.4 billion ($140 million).
- FFO of about TRY4.7 billion ($1.7 billion).

For the same period, principal liquidity uses include:

- Short-term debt maturities of about TRY2.8 billion ($1 billion).
- Modest working capital requirements.
- Capital expenditure (excluding spectrum costs) of about TRY3.2 billion ($1.1 billion).
- Spectrum-cost-related cash outflows of TRY1.55 billion ($550 million).
- A dividend payment of TRY841 million ($296 million).

Rating Above The Sovereign

Our rating on Turk Telekom is higher than the sovereign foreign currency rating on Turkey because Turk Telekom passes 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.

We currently assess that Turk Telekom's rating can exceed the sovereign rating by two notches, compared with one notch previously. This is because we understand that management keeps most of its cash in hard currencies, and aims at keeping sufficient cash reserves to serve its next 12-month debt obligations. Therefore, in the hypothetical case of depreciation of the lira, we think the appreciation of the cash balance would offset the increase in short-term debt maturities and capital expenditure.

Outlook

The negative outlook reflects the negative outlook on the Republic of Turkey, meaning that a negative rating action on the sovereign could potentially lead to a downgrade of Turk Telekom.

Upside scenario

We could revise our outlook to stable if there was a positive rating action or a revision to stable on the sovereign. We could also stabilize our outlook if we believed Turk Telekom had substantially improved its ability to survive a sovereign stress case scenario--for example through greater liquidity or currency risk mitigation--thereby giving it additional scope to be rated above the sovereign.

Downside scenario

In addition to a negative rating action on the sovereign, we could also downgrade Turk Telekom if we lowered Turkey's T&C assessment due to deterioration in Turkish corporations' access to domestic and external liquidity, or if we believed the business risk of operating in Turkey had materially increased. Furthermore, we could also lower the rating on Turk Telekom if the S&P Global Ratings adjusted debt-to-EBITDA ratio increased beyond 2.25x for a prolonged period, with adjusted 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.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Negative/--

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 ratings analysis: Neutral (no impact)

Related Criteria And Research

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Telecommunications And Cable Industry - June 22, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013

Ratings List

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Ratings Affirmed; CreditWatch/Outlook Action
                                        To                  From
Turk Telekom
 Corporate Credit Rating                BBB-/Negative/A-3  BBB-/Stable/A-3
 Senior Unsecured                       BBB-                BBB-
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