

RatingsDirect®

Turk Telekom

Primary Credit Analyst:

Thierry Guermann, Stockholm (46) 8-440-5905; thierry.guermann@spglobal.com

Secondary Contact:

Mark Habib, Paris (33) 1-4420-6736; mark.habib@spglobal.com

Table Of Contents

Rationale

Outlook

Our Base-Case Scenario

Company Description

Business Risk

Financial Risk

Liquidity

Covenant Analysis

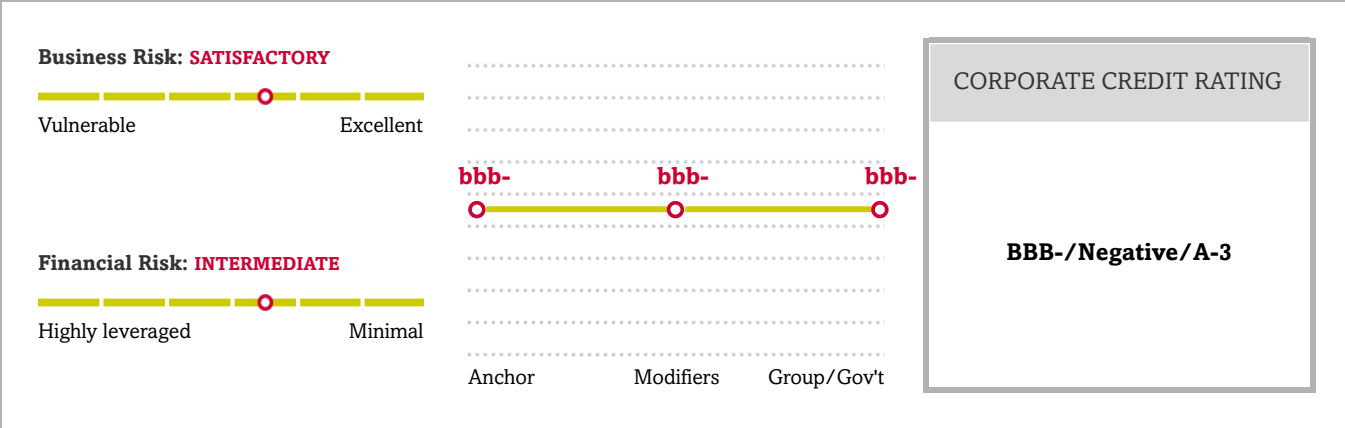
Rating Above The Sovereign

Ratings Score Snapshot

Reconciliation

Related Criteria And Research

Turk Telekom



Rationale

Business Risk: Satisfactory	Financial Risk: Intermediate
<ul style="list-style-type: none"> • Strong leadership position in Turkey's fixed-line telephony market. • Extensive network infrastructure. • Strong profitability and cash flow generation. • Exposure to country risk in Turkey. • Challenger, albeit growing, position in the competitive Turkish mobile telephony market. 	<ul style="list-style-type: none"> • Moderate financial leverage supported by a conservative financial policy. • Negative discretionary cash flows in 2016-2017 because of high capital expenditure including spectrum fees and a high dividend payout ratio. • Exposure to foreign exchange risk, primarily because a significant amount of its U.S. dollar- and euro-denominated financial debt is unhedged.

Outlook: Negative

S&P Global Ratings' negative outlook on Turk Telekom reflects the negative outlook on the Republic of Turkey, meaning that a negative rating action on the sovereign could lead to a downgrade of Turk Telekom.

Upside scenario

We could revise our outlook to stable if there was a positive rating action or an outlook revision to stable on the sovereign. We could also revise the outlook on Turk Telekom to stable if we believed the company 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 our transfer and convertibility (T&C) assessment on Turkey 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 funds from operations (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.

Our Base-Case Scenario**Assumptions**

- Revenue growth of 8%-9% in 2016 and 7%-8% in 2017, primarily supported by continued growth in mobile revenues and fixed broadband.
- A temporary decline in the EBITDA margin in 2016 and 2017 caused by brand unification costs, commercial expense related to the expansion of long-term evolution (LTE) coverage, and an early retirement program, before rebounding in following years due to continued revenue growth.
- A high capital expenditure (capex)-to-sales ratio of 29%-31% in 2016 and 19%-21% in 2017, including significant spectrum fees.
- Significant dividend distributions, although the absolute amount will be lower in 2016-2017 than in previous years because of an expected lower net result.
- Annual depreciation of the Turkish lira against the U.S. dollar of about 5%.

Key Metrics

	2015A	2016E	2017E
EBITDA margin*	38.6	35-37	35-37
Debt to EBITDA (x)*	1.8	1.9-2.1	1.9-2.1
FFO to debt (%)*	50.5	40-43	40-43

*S&P Global Ratings adjusted ratios. A--Actual. E--Estimate. FFO--Funds from operations.

Company Description

Turk Telekom is a former telecom incumbent operator and provides integrated telecommunication and technology services to residential and commercial customers, primarily in Turkey. It primarily offers fixed-line telephony, broadband Internet, TV, corporate data, and mobile telephony services, as well as infrastructure and wholesale voice and data services. As of June 30, 2016, Turk Telekom reported 10 million fixed voice lines, 8.3 million broadband Internet subscribers, and 18 million mobile subscribers.

Following privatization in 2005 and an IPO in 2008, 55.8% of the company is owned by holding company, Oger Telecom, which is a joint venture between two Saudi companies--Saudi Oger and Saudi Telecom. The Turkish government holds a 31.7% stake in Turk Telekom.

Business Risk: Satisfactory

Our assessment of Turk Telekom's business risk profile is supported by the company's strong leadership position in domestic fixed-line business, its extensive network infrastructure, good 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 June 30, 2016, including a growing presence in fiber, given household coverage of nearly 60%. As a result, we expect Turk Telekom to benefit as broadband internet penetration increases in Turkey and from 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. There are three players in this market: Turkcell dominates, and Turk Telekom is still the smallest operator with a subscriber market share of 24.7% as of June 30, 2016, 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 spectrum purchase in 2015 and its high investments in the mobile business in recent years, notably providing 86% of the population with 3G (third generation) coverage and 68% with LTE coverage on June 30, 2016, we think its market position and profitability could improve in the coming years.

Our Base-Case Operating Scenario

- Stable average annual real GDP growth of Turkey of about 3.5% in 2016-2017, compared with about 2.9% in 2014, and a moderate decline in inflation to about 7% in 2016-2017.
- About 8%-9% revenue growth in 2016 and about 7%-8% in 2017. We expect revenue decline of about 8%-10% in the fixed voice business but this will be more than offset by growth in fixed broadband, mobile, and TV services, as well as corporate data business. We think Turk Telekom could benefit from cross-selling opportunities, offering several products to its customers.
- After temporarily weaker profitability in the first half of 2016, caused by brand unification, commercial expense related to LTE, and an early retirement program, we expect some recovery in the second half and an adjusted

EBITDA margin of about 36% in 2016. Once the mobile subscriber base reaches a larger scale, profitability could increase in the following years.

Peer comparison

Table 1

Turk Telekom -- Peer Comparison				
Industry Sector: Telecom				
	Turk Telekom	Turkcell Iletisim Hizmetleri A.S.	Rostelecom OJSC	Telkom SA SOC Ltd.
Rating as of Aug. 19, 2016	BBB-/Negative/A-3	BBB-/Negative/--	BB+/Negative/--	BBB-/Stable/--
(Mil. TRY)	--Fiscal year ended Dec. 31, 2015--			--Fiscal year ended March 31, 2016--
Revenues	14,523	12,769	11,876	7,394
EBITDA	5,602	4,123	3,893	2,267
Funds from operations (FFO)	4,967	3,952	2,986	2,039
Net income from continued operations	907	2,068	557	430
Cash flow from operations	4,474	2,715	3,215	1,656
Capital expenditures	3,320	4,522	2,423	1,118
Free operating cash flow	1,154	(1,807)	791	538
Discretionary cash flow	(687)	(5,833)	473	270
Cash and short-term investments	2,514	2,919	515	488
Debt	9,827	2,944	8,220	1,297
Equity	4,993	14,419	9,971	4,927
Adjusted ratios				
EBITDA margin (%)	38.6	32.3	32.8	30.7
Return on capital (%)	23.1	19.5	6.1	17.8
EBITDA interest coverage (x)	11.5	12.8	5.2	14.1
FFO cash interest coverage (x)	16.0	18.7	4.9	13.2
Debt/EBITDA (x)	1.8	0.7	2.1	0.6
FFO/debt (%)	50.5	134.2	36.3	157.2
Cash flow from operations/debt (%)	45.5	92.2	39.1	127.6
Free operating cash flow/debt (%)	11.7	(61.4)	9.6	41.5
Discretionary cash flow/debt (%)	(7.0)	(198.1)	5.7	20.8

Financial Risk: Intermediate

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. This is in line with our understanding that the company would like to maintain reported net debt to EBITDA at about 1.5x in the mid-term, although we think it could take some time before Turk Telekom returns this level. S&P Global Ratings

adjusted 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 profit (based on Capital Markets Board regulations). We expect the dividend payout 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 \$3.8 billion-equivalent of unhedged gross financial debt as of June 30, 2016, denominated in U.S. dollars and euros (\$2.84 billion after deducting hard currency cash). However, it generates almost all of its revenues and EBITDA in Turkish lira.

Our Base-Case Cash Flow And Capital Structure Scenario

- Capital expenditure-to-sales ratio (excluding spectrum fees) of about 18%-20% in 2016 and 2017.
- Meaningful spectrum costs of Turkish lira (TRY) 1.55 billion and TRY0.77 million in 2016 and 2017, respectively.
- Continued significant dividend pay-out ratio.
- Annual depreciation of the Turkish lira against the U.S. dollar of about 5% per year.

Financial summary

Table 2

Turk Telekom -- Financial Summary					
Industry Sector: Telecom					
(Mil. TRY)	--Fiscal year ended Dec. 31--				
	2015	2014	2013	2012	2011
Revenues	14,522.9	13,601.6	13,190.0	12,706.1	11,940.6
EBITDA	5,601.7	5,313.6	5,247.0	5,337.7	5,292.8
Funds from operations (FFO)	4,966.7	4,323.3	4,564.1	4,383.3	4,377.4
Net income from continuing operations	907.4	2,007.4	1,303.0	2,637.1	2,068.7
Cash flow from operations	4,473.8	4,345.2	3,954.8	3,522.0	4,043.6
Capital expenditures	3,319.6	2,169.3	2,293.2	2,347.6	2,327.0
Free operating cash flow	1,154.2	2,175.9	1,661.7	1,174.4	1,716.6
Discretionary cash flow	(686.7)	1,263.8	(751.6)	(722.1)	(527.4)
Cash and short-term investments	2,514.4	2,270.8	697.4	571.4	510.6
Debt	9,826.8	7,855.2	8,963.7	6,940.8	6,941.3
Equity	4,993.4	6,303.3	5,327.6	6,455.1	5,763.2
Adjusted ratios					
EBITDA margin (%)	38.6	39.1	39.8	42.0	44.3
Return on capital (%)	23.1	23.0	23.8	27.9	30.9

Table 2

Turk Telekom -- Financial Summary (cont.)

(Mil. TRY)	--Fiscal year ended Dec. 31--				
	2015	2014	2013	2012	2011
EBITDA interest coverage (x)	11.5	12.0	15.5	13.0	14.4
FFO cash int. cov. (x)	16.0	16.9	18.1	15.5	20.9
Debt/EBITDA (x)	1.8	1.5	1.7	1.3	1.3
FFO/debt (%)	50.5	55.0	50.9	63.2	63.1
Cash flow from operations/debt (%)	45.5	55.3	44.1	50.7	58.3
Free operating cash flow/debt (%)	11.7	27.7	18.5	16.9	24.7
Discretionary cash flow/debt (%)	(7.0)	16.1	(8.4)	(10.4)	(7.6)

TRY--Turkish lira.

Liquidity: Adequate

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 June 30, 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 3.4 years from 3.9 years the year before.

Principal liquidity sources

As of June 30, 2016, principal liquidity sources for the next 12 months include:

- Unrestricted cash balances of about TRY2.8 billion.
- Undrawn credit lines of about TRY0.7 billion.
- FFO of about TRY4.7 billion.

Principal liquidity uses

For the same period, principal liquidity uses include:

- Short-term debt maturities of about TRY3.1 billion.
- Modest working capital requirements.
- Capital expenditure (excluding spectrum costs) of about TRY3.2 billion.
- Spectrum-cost-related cash outflows of TRY1.55 billion.

Debt maturities

On June 30, 2016:

- 12 months started June 30, 2016: TRY2.1 billion-equivalent.
- 12 months started June 30, 2017: TRY1.1 billion-equivalent.
- Thereafter: TRY9.5 billion-equivalent.

Covenant Analysis

Turk Telekom has to comply with two financial covenants: a net leverage ratio below 2.5x and an interest coverage ratio above 4x. In our base case, we estimate that Turk Telekom will maintain adequate headroom of more than 20% under these covenants in 2016 and 2017.

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. 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.

Ratings Score Snapshot

Corporate Credit Rating

BBB-/Negative/A-3

Business risk: Satisfactory

- **Country risk:** 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)
- **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 government rating: BB+

Reconciliation

Table 3

Reconciliation Of Turk Telekom Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. TRY)						
--Fiscal year ended Dec. 31, 2015--						
Turk Telekom reported amounts						
	Debt	EBITDA*	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	11,802.7	5,436.8	3,165.0	404.3	5,436.8	4,583.1
S&P Global Ratings' adjustments						
Interest expense (reported)	--	--	--	--	(404.3)	--
Interest income (reported)	--	--	--	--	157.4	--
Current tax expense (reported)	--	--	--	--	(310.8)	--
Operating leases	416.9	114.0	29.8	29.8	84.1	84.1
Postretirement benefit obligations/deferred compensation	510.4	51.0	51.0	51.0	3.4	(13.8)
Surplus cash	(2,514.4)	--	--	--	--	--
Non-operating income (expense)	--	--	157.4	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	(183.7)
Debt - Derivatives	(388.8)	--	--	--	--	--
OCF - Derivatives	--	--	--	--	--	4.0
Total adjustments	(1,975.9)	164.9	238.2	80.8	(470.1)	(109.4)
S&P Global Ratings' adjusted amounts						
	Debt	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	9,826.8	5,601.7	3,403.2	485.1	4,966.7	4,473.8

*Calculated as operating profit before financial expenses + reported depreciation and amortization. OCF--Operating cash flow. TRY--Turkish lira.

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 Foreign Currency Ratings Lowered To 'BB/B'; Outlook Negative, July 20, 2016
- Country Risk Assessments Update Following The Recent Downgrade Of Turkey: July 2016, July 22, 2016
- Outlook On Turk Telekom Revised To Negative After Sovereign Rating Action; 'BBB-' Affirmed, July 22, 2016

Business And Financial Risk Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of August 19, 2016)

Turk Telekom

Corporate Credit Rating

BBB-/Negative/A-3

Senior Unsecured

BBB-

Corporate Credit Ratings History

22-Jul-2016

BBB-/Negative/A-3

11-May-2016

BBB-/Stable/A-3

24-Jul-2014

BBB-/Negative/A-3

04-Jun-2014

BB+/Watch Pos/B

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

Additional Contact:

Industrial Ratings Europe; Corporate_Admin_London@standardandpoors.com

Copyright © 2016 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.