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Research Update:

Outlook On Turk Telekom Revised To Stable After Similar Action On Sovereign; 'BBB-/A-3' Ratings Affirmed

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

Secondary Contact:
Sandra Wessman, Stockholm (46) 8-440-5910; sandra.wessman@spglobal.com

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Overview

- On Nov. 4, 2016, we revised our outlook on Turkey to stable from negative and affirmed our 'BB' long-term foreign currency rating.
- We continue to assess that our rating on Turk Telekom can exceed the sovereign rating by two notches.
- Therefore, we have revised the outlook on Turk Telekom to stable from negative and affirmed our 'BBB-' long-term corporate credit rating on the company.
- The stable outlook reflects our anticipation that, over the next two years, Turk Telekom's revenues and EBITDA will continue to increase, with its adjusted debt to EBITDA remaining at or below 2x and funds from operations to debt at about 40%.

Rating Action

On Nov. 10, 2016, S&P Global Ratings revised its outlook on Turkey-based telecommunications operator Turk Telekom to stable from negative. At the same time, we affirmed our 'BBB-/A-3' long- and short-term corporate credit ratings on the company.

Rationale

The outlook revision follows our outlook revision on the Republic of Turkey (see "Republic of Turkey Outlook Revised To Stable On Gradual Implementation Of Economic Reforms; FC And LC Ratings Affirmed," published Nov. 4, 2016, On RatingsDirect).

We revised our outlook on Turk Telekom to stable given that the long-term rating is no longer constrained by the outlook on its sovereign. We continue to limit our rating on Turk Telekom to two notches above the sovereign foreign currency rating.

The stable outlook also reflects our view that Turk Telekom has continued to report solid revenue growth over recent quarters, and we expect credit metrics will remain solid over the forecast period.

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. We expect Turk Telekom will 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. At the moment, the company's very profitable fixed-line business enables it to enjoy somewhat stronger EBITDA margins than many of its European peers. However, 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. This is in line with our understanding that the company would like to maintain reported net debt to EBITDA of about 1.5x in the medium term, although we think it could take some time before Turk Telekom returns this level. S&P Global Ratings' adjusted funds from operations (FFO) to debt was healthy at 50% at year-end 2015, and we expect it will likely to dip to about 40%-45% in 2016-2017 and gradually improve thereafter.

These strengths are partly offset by our expectation that Turk Telekom's free operating cash flow (FOCF) will be slightly weaker 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 will remain high because we understand that Turk Telekom's majority owner, Ojer Telekomünikasyon A.#. (OTA#), needs to service its debt. That said, we consider that Turk Telekom's articles of association constrain OTA#' 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. As a result, we do not expect that the recent reported issues relating to the missed interest payment by OTA# will have any impact on Turk Telekom as it does not have any guarantee in favor of OTA# and there are no cross-default clauses.

Turk Telekom has exposure to foreign exchange risk, primarily because it had about $3.6 billion-equivalent of unhedged gross financial debt as of Sept.30, 2016, denominated in U.S. dollars and euros ($3.1 billion after deducting hard currency cash). However, it generates almost all of its revenues and EBITDA in Turkish lira.

Our rating on Turk Telekom is higher than the sovereign foreign currency credit 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 the rating on Turk Telekom 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.

Liquidity

We assess Turk Telekom's liquidity as adequate. We calculate that the ratio of liquidity sources to uses for the 12 months started Sept. 30, 2016 at about 1.2x.

Principal liquidity sources include:
- Reported cash balances of about Turkish lira (TRY)3.2 billion ($1.1 billion);
- FFO of about TRY4.9 billion; and
- Undrawn committed facilities of about TRY375 million.

Principal liquidity uses include:
- Debt maturities of about TRY2.4 billion;
- Capital expenditures of about TRY 4 billion, including spectrum payments, however we also take into account that a meaningful amount is discretionary;
- Minor working capital outflow; and
- Annual dividends of about TRY800 million.

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.

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.

Outlook

The stable outlook reflects our anticipation that Turk Telekom's revenues and EBITDA will continue to increase, with S&P Global Ratings' adjusted debt to EBITDA at or below 2x and FFO to debt of 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 test or if 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.

In addition, a negative rating action on Turk Telekom could arise from a negative rating action on the sovereign or if we lowered Turkey's transfer and convertibility (T&C) assessment on deterioration in Turkish corporations' access to domestic and external liquidity. This is because the rating on Turk Telekom, as a non-export company, cannot exceed our T&C assessment under our criteria.

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.

An upgrade would be contingent on a revision of our transfer and convertibility (T&C) assessment on Turkey to 'BBB', from 'BBB-' currently.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/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)
- 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

- 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
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- 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

Outlook Action; Ratings Affirmed

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

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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

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