FITCH AFFIRMS TURK TELEKOM AT 'BBB-'; OUTLOOK STABLE

Fitch Ratings-London-27 June 2016: Fitch Ratings has affirmed Turk Telekomunikasyon A.S.'s (TT) Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BBB-'. The Outlook is Stable. Its senior unsecured debt in foreign currency rating has also been affirmed at 'BBB-'.

TT is the leading operator of the fixed telecoms network in Turkey. The competitive position of the company's mobile operations, which has the smallest market share of the three networks in Turkey, has improved following the acquisition of important lower frequency spectrum. Spectrum payments in 2016 and 2017 mean that TT's free cashflow (FCF) generation will be limited. We expect TT's leverage in 2016 and 2017 to be high relative to our rating threshold, leaving TT with limited headroom. Foreign exchange risk is TT's main credit weakness.

KEY RATING DRIVERS
Improved Competitive Position
TT has improved the competitiveness of its mobile service capability, with the acquisition of 800MHz and 900MHz spectrum in the recent auction, which gives the company similar spectrum holdings in the sub-1GHz band to its competitors and removes a historical spectrum disadvantage. These low frequencies are important for providing good network coverage given the increasing focus on mobile data. TT has also invested in its pay-TV offering, investing in content (such as European football rights) and its delivery platform. TT has launched a satellite service to complement its IPTV network and to provide nationwide coverage. TT now has a strong converged services position in fixed, mobile and pay-TV, which allows it to differentiate its offering from its main competitors.

Strong Fixed-Line Position
TT's pay-TV and fixed-mobile convergent service offering is built on the company's leading fixed-line position. TT ended 1Q16 with a 67% retail subscriber market share in fixed broadband services. TT's broadband subscribers and average revenue per user (ARPU) continue to grow, helped by growing demand for high-speed broadband. TT's fibre network (both fibre to the premise and fibre to the cabinet) passed 12.4 million homes at end-1Q16 and the company had 1.6 million fibre customers. While fixed voice revenue is declining, though at a decelerated rate compared to the previous periods, the number of fixed access lines has stabilised at 13 million.

FCF Generation Curtailed
Spectrum payments totalling around TRY3.2bn (paid in four instalments semi-annually in 2015-2017) means that FCF after dividends will be reduced, leading to an increase in leverage in 2016, with limited deleveraging prospect in 2017. Once the spectrum payments are completed, cash generation should improve significantly and we expect funds from operations (FFO)-adjusted net leverage to drop to 2.0x by end-2018, from our expectation of 2.3x at the end of 2016 (assuming no material TRY devaluation for the rest of the year) .

1Q16 results showed strong revenue growth of 11% but a 5% drop in EBITDA, due to increased commercial activity to support growth in fixed broadband, mobile and pay-TV, rebranding costs and personnel costs related to retirement incentives. Together with the launch of LTE services in 2Q16, these costs are likely to weigh on EBITDA margin in 1H16. We expect a significant improvement in profitability in 2H16. Management is confident that the company will meet its full-year revenue and EBITDA guidance.

Impact of FX Mismatch
TT has a significant currency mismatch as almost all of its debt is denominated in USD and EUR while most of its FCF is generated in local currency. This exposes TT to significant risks arising from potential adverse movements in foreign exchange rates. This FX risk is the main reason why the leverage thresholds for negative rating action are tighter than other western European telecoms companies at a similar rating level.

In order to reduce its total FX exposure on its balance sheet, the company has been increasing the hedged portion of its debt (14% of its debt at end-1Q16 was in TRY). TT has also been shifting its cash position from TRY to hard currencies. At end-1Q16, TT held USD1.25bn -equivalent of hard-currency unrestricted cash, 77% of its total cash position (compared to 72% at end-4Q15 and 19% at end-1Q15). Another way FX risk is mitigated is through lower dividends and taxes. Any FX losses will reduce net income, which will lead to a fall in cash taxes and dividends paid in the following year - the company can only pay a dividend of up to a maximum of 100% of distributable net income,

Sovereign Linkage
The Turkish government owns 31.7% of TT. However, TT is rated on a standalone basis with no support from any of its shareholders. Given that TT mainly operates domestically, it is unlikely that TT would be rated higher than the Turkish sovereign rating (BBB-/Stable), hence any negative sovereign rating action (downgrade or revision of the Outlook to Negative) could impact TT's rating.

Long-term Uncertainty from Concession Expiry
The rating factors in some long-term uncertainty relating to the expiry of TT's fixed-line concession agreement with the Turkish government in 2026. The concession agreement only covers TT's fixed network assets which will return to the government if the concession expires - the company's customer base and brand will remain with TT. Fitch does not rule out the risk that in the lead-up to the concession termination date, the views of TT's management, TT's main shareholder and the Turkish government on TT's operational and financial priorities may diverge. In the event of uncertainty around a concession renewal, Fitch believes that TT's management will pursue a conservative financial policy to ensure that all debt will be repaid before the expiry of the concession agreement.

KEY ASSUMPTIONS
Fitch's key assumptions within the rating case for TT include:
- Revenue growth of over 7% in 2016 (company guidance is for 7-9%), followed by 5%-6% increases in 2017 and 2018, with mobile and broadband growth offsetting domestic PSTN declines.
- EBITDA margin of around 36% in 2016 and 2017, increasing slightly in 2018.
- Capex (excluding spectrum payments) to increase to 20% of revenue in 2016 before reducing to 17% in 2018.
- After the first payment in 2015, TT is to make three more spectrum payments of TRY2.4bn split over 2016-2017 - one was made in 2Q16, one will be paid in 2H16 and the final payment in 2017.
- Lower dividend payment of TRY841m made in 2Q16, following FX losses in 2015. Dividend payments in 2017 and 2018 to increase in line with net income in prior year, assuming no TRY devaluation.

RATING SENSITIVITIES
Negative: Future developments that could lead to negative rating action include:
-FFO-adjusted net leverage trending above 2.2x (end-2015: 2.0x) on a sustained basis.
-Material deterioration in TT's pre-dividend FCF margin, or in the regulatory or operating environment.

-Negative rating action on the Turkish sovereign (a downgrade or revision of the Outlook to Negative) could put pressure on TT's rating.

Positive: Fitch views positive rating action as unlikely in the medium term. However, future developments that could lead to positive rating action include:
-Improved visibility on how the expiry of fixed-line concession agreement would be resolved, an improved liquidity profile and a reduced currency mismatch in its debt structure.

LIQUIDITY
TT has a sound liquidity profile. The company has significant available committed facilities, with an undrawn USD facility of USD387m and an undrawn EUR facility of EUR455m at end-2015. A strong year-end cash balance of TRY2.8bn also provides additional liquidity against limited short-term debt maturities. While spectrum payments, along with high capital expenditure, will weigh on cash flow in the coming 24-36 months we expect these to be largely covered by the company's operating cash flow. Further devaluation of the Turkish lira could, however, put liquidity under pressure.

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Applicable Criteria
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362

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