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Research Update:

Turk Telekom Assigned 'BB+/B' Ratings And Placed On CreditWatch Positive

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Overview

Turkey's largest fixed-line telecoms operator, Turk Telekom, generates strong profitability and cash flow.
The rating on Turk Telekom is primarily supported by its strong positions in Turkey's fixed-line telephony market and its moderate leverage.
We are assigning our 'BB+/B' ratings to Turk Telekom and our 'BB+' rating to its proposed senior unsecured bond and placing the ratings on CreditWatch positive.
The CreditWatch reflects the possibility that we could raise the ratings to 'BBB-/A-3' if we thought that after the proposed bond issue, Turk Telekom's currency and liquidity risk management could underpin the ratings above the our long-term foreign currency sovereign rating on Turkey.

Rating Action

On June 4, 2014, Standard & Poor's Ratings Services assigned its 'BB+/B' long- and short-term corporate credit ratings to Turkey's largest fixed-line telecommunications operator Turk Telekom. We have also assigned our 'BB+' issue rating to the proposed senior unsecured bond to be issued by Turk Telekom. The recovery rating on this proposed bond is '3', indicating our expectation of meaningful (50%-70%) recovery in the event of a payment default.

At the same time, we have placed our corporate credit and issue ratings on Turk Telekom on CreditWatch with positive implications.

Rationale

The rating on Turk Telekom is primarily supported by its solid positions in the Turkish fixed-line telephony market, robust cash generation, and conservative leverage (debt to EBITDA). The rating is mainly constrained by the company's currently "less than adequate" liquidity and a currency mismatch between its revenues and debt.

Turk Telekom's "satisfactory" business risk profile is supported by the company's strong leadership position in domestic fixed-line business. In addition, the company generates strong profitability and cash flow. The business risk profile is constrained by the company's exposure to country risk in Turkey and the weak competitive position of its mobile subsidiary, Avea, in the saturated domestic, three-player mobile telephony market, where competitor Turkcell Iletisim Hizmetleri A.S. dominates. Turk Telekom has achieved a dominant market share in broadband internet, which allows the company to grow and to compensate for declining traditional voice revenues. Turk Telekom is also developing Avea, which is the No. 3 operator in domestic mobile telephony. Although Turk Telekom is gradually increasing its market share in mobile telephony, its market position is relatively weak and profitability low. That said, given the company's investments in mobile business in recent years, we expect market position and profitability to improve in 2014-2015.

Our assessment of Turk Telekom's "intermediate" financial risk profile reflects our assumption that its Standard & Poor's-adjusted debt-to-EBITDA ratio will remain below 2x, which is commensurate with the management's policy of unadjusted net debt to EBITDA of below 1.5x. Constraining the company's financial risk profile is its limited financial flexibility, resulting from the policy to distribute close to 100% of net income as dividends, including to its highly leveraged majority shareholder OTAS, and its unhedged exposure to foreign exchange risk resulting from its primarily dollar- and euro-denominated debt. Consequently, discretionary cash flow (DCF, or cash generation after capital expenditures and dividends) was negative in 2012 and 2013, and is likely to be only modestly positive in 2014-2015, covering about 5%-15% of debt, as adjusted by Standard & Poor's.

In our base case, we assume:
- About 4%-6% consolidated revenue growth in Turkish lira terms, slightly below Turkey's inflation, based on our expectation that fixed-line's strong performance will continue, and declining revenues in the traditional voice segment will be broadly offset by growth in broadband internet.
- Consolidated EBITDA margin of about 37%.
- A capital expenditures-to-sales ratio declining to 15%-16% from the historical level of 18%-20.
- Dividends at close to 100% of net income, as per the company's financial policy, with a lower dividend to be paid for 2013.

Based on these assumptions, we arrive at the following credit measures for Turk Telekom:
- A Standard & Poor's-adjusted debt-to-EBITDA ratio of about 1.6x over the next two years.
- Standard & Poor's-adjusted free operating cash flow (FOCF) to debt of about 25% over the same period.
- Positive DCF based on our expectation of lower dividends.

We currently rate Turk Telekom at the same level as the foreign currency long-term rating on Turkey (unsolicited: foreign currency BB+/Negative/BB; local currency BBB/Negative/A-2). We believe the rating on Turk Telekom cannot exceed our foreign currency long-term rating on the sovereign based on the company's current capital structure, which includes meaningful short-term debt and significant unhedged exposure to foreign exchange risk, and overall management of liquidity and foreign exchange risk. However, we think a rating higher than that on Turkey is possible if Turk Telekom issues meaningful long-term debt and applies the proceeds toward repayment of its short-term maturities, and maintains this approach in the future.

Liquidity

The short-term rating is 'B'. We consider Turk Telekom's liquidity to be "less than adequate," before the issue of the proposed bond. We calculate that the ratio of liquidity sources to uses was close to 1x on Dec. 31, 2013, and that it will remain at this level over the next 24 months. The company's debt maturity profile is not demanding, but negative DCF and the absence of committed credit facilities contribute to our "less than adequate" liquidity assessment.

That said, in our assessment, we factor in a substantial amount of uncommitted facilities and Turk Telekom's generally strong access to financial markets, resulting from its position as one of Turkey's largest corporate issuers, its moderate debt leverage, and predictable cash flow generation. We expect that Turk Telekom will continue financing itself primarily with debt in U.S. dollars and euros, because even medium-term financing in Turkish lira is more expensive.

Recovery analysis

Our 'BB+' issue rating and '3' recovery rating on Turk Telekom's proposed senior unsecured notes reflects the limited amount of debt sitting at its subsidiaries ranking ahead of the notes.

We cap our recovery rating at '3' because the proposed notes will be unsecured.

The proposed notes' indenture includes standard provisions such as a negative pledge limiting the amount of secured debt and a change-of-control clause. Noteholders will be able to exercise their put option if the rating on the proposed notes is lowered following a change of control.

CreditWatch

We aim to resolve the CreditWatch by the end of July 2014, after Turk Telekom issues its proposed senior unsecured bond and we have discussions with the company's management regarding use of the proceeds to repay short-term debt, and improve its debt maturity profile and liquidity management in general.

We could upgrade Turk Telekom after its proposed senior unsecured bond issue and application of the proceeds to repay its short-term debt and improve its debt maturity profile. Such repayment could in turn lead us to revise our assessment of its liquidity to "adequate" from "less than adequate." Our preliminary calculations indicate that the company could achieve sufficient numerical coverage of liquidity sources by uses to match the minimum 1.2x sources-to-uses coverage ratio consistent with a higher rating, depending on the amount of the bond issue. However, we also estimate that consistent maintenance of such coverage would require liquidity and currency management policies that proactively address these risks.

To rate the company higher than the foreign currency rating on Turkey, we would also need to consider Turk Telekom's liquidity as sufficient to pass a stress test under our sovereign default scenario, which includes a 50% devaluation of the Turkish lira against the dollar and the euro. We believe Turk Telekom could pass this test with its proposed bond issue. However, given the currency mismatch between the company's earnings and its debt, we would likely rate Turk Telekom only one notch higher than Turkey and not higher than our 'bbb' transfer and convertibility assessment on Turkey.

We could affirm the ratings if we thought that Turk Telekom could not pass a stress test in our scenario of a hypothetical sovereign default. This could come from an insufficient reduction of its short-term debt maturities.

Ratings Score Snapshot

Corporate Credit Rating: BB+/WatchPos/--

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: Less than adequate (-1 notch)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Related Criteria And Research

Related Criteria
- Key Credit Factors For The Telecommunications And Cable Industry, Dec. 12, 2013
- Ratings Above The Sovereign—Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013

- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009

Ratings List

New Rating; CreditWatch Action

Turk Telekom	
Corporate Credit Rating	BB+/Watch Pos/B
Senior Unsecured	BB+/Watch Pos
Recovery Rating	3

Additional Contact:
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