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

Fitch Ratings-London-30 June 2015: 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. A full list of rating actions is at the end of this commentary.

TT has a leading voice and broadband position in the Turkish telecoms market, with resulting high fixed-line EBITDA margin. The company's mobile operations, the smallest of three networks in Turkey, is growing quickly and is the main driver of TT's group EBITDA growth. Foreign exchange risk is TT's main credit weakness.

KEY RATING DRIVERS

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 free cash flow (FCF) is generated in local currency. This exposes TT to significant risks arising from potential adverse movements in foreign exchange rates. However, as the company can only pay a dividend of up to a maximum of 100% of distributable net income, any FX losses will reduce net income, which will lead to a fall in cash taxes and dividends paid in the following year.

Fitch estimates that the Turkish lira (TRY) devaluation against both the USD and the EUR so far in 2015 has increased net debt by around TRY1.3bn. Unadjusted net debt to EBITDA of 1.3x at end-2014 is expected to increase to around 1.5x at end-2015, assuming a TRY/USD exchange rate of 2.68. TT has low leverage compared with other European telecoms companies, but this FX risk is the main reason why the leverage thresholds for negative rating action are at a lower level than other western European telecoms companies at a similar rating level.

Strong Fixed Position

TT is Turkey's largest telecoms company and the fixed-line incumbent operator, with around a 91% subscriber market share in fixed voice and an 86% subscriber market share in fixed broadband services in 1Q15. It has a solid fixed-line franchise with less intense competition relative to other European incumbents as local loop unbundling is infrequently used and the cable network in Turkey is underdeveloped.

Turkcell is TT's main competitor in the fixed line market and has been rolling out its fibre-to-the-home (FTTH) network. Both TT and Turkcell have a similar number of FTTH subscribers (0.7m-0.8m at 1Q15), but TT also has 0.5m fibre-to-the-cabinet (FTTC) subscribers. Overall, TT's FTTH and FTTC network footprint of 11m homes passed is greater than Turkcell's FTTH footprint of 2m homes passed. We believe this greater coverage should allow TT to maintain its leading position in fixed broadband. The Turkish fixed broadband market significantly lags behind the European average and offers firm growth potential.

Growing Mobile to Boost EBITDA

TT owns 90% of Avea, Turkey's third-largest mobile operator with around a 23% subscriber market share. Revenue growth as Turkish mobile penetration increases and as TT gains market share should lead to improved scale efficiencies and increased profitability in the mobile business. Fixed EBITDA has come under pressure over the past two years, but this has been mainly offset by mobile EBITDA growth. Fitch expects TT's EBITDA less capex (before spectrum costs) to grow over the next few years as the mobile business becomes more cash-generative, underpinning our expectations of pre-dividend FCF margin (excluding spectrum costs) of around 13%-14% over the medium term.

We believe payments for mobile spectrum scheduled to be auctioned in August are likely to result in an increase in leverage by 2016. This should not result in an increase in competitive intensity in the Turkish mobile market as we believe the entrance of a fourth mobile operator is unlikely. Given the announced auction rules, Avea should benefit from a more equal distribution of 800MHz and 900MHz spectrum amongst all three mobile operators. The resulting increase in its holding of attractive low-frequency spectrum should allow Avea to improve its network coverage and capacity.

Bundled Services
TT is currently in the process of buying the 10% of Avea it does not own. This transaction should be completed by 3Q15 and should make it easier for TT to offer fixed and mobile bundled packages. TT also has plans to expand its TV offering. The company intends to launch a satellite TV service later this year to complement the IPTV services currently offered over its fixed network. This should allow TT to offer a bundle of fixed, mobile and pay-TV services, helping it to maintain and grow market share in the residential market. Fitch believes that the investments needed to expand the company's TV offering should be fairly limited relative to TT's existing opex and capex profile.

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.

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. 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. Fitch believes that TT's management will pursue a conservative financial policy to ensure that all debt could be repaid before the expiry of the concession agreement.

KEY ASSUMPTIONS
Fitch's key assumptions within the rating case for TT include the following:
- Revenue growth of 5% in FY15 followed by 3%-4% increases annually thereafter, with mobile and broadband growth offsetting domestic PSTN declines.
- Gradual EBITDA margin declines due to change in business mix, reaching around 35% in 2018.
- Capex (excluding spectrum payments) to remain at 16% of revenues in 2015-16 before reducing thereafter.
- Spectrum payments of TRY2.4bn split over 2015-2017 in semi-annual instalments.
- Significant FX losses in 2015 reducing dividend payments in 2016. No FX devaluation assumed thereafter with dividend payments increasing in line with net income

RATING SENSITIVITIES
Negative: Future developments that could lead to negative rating action include:
-Funds flow from operations (FFO) net leverage trending above 2.25x (FYE14: 1.7x) or unadjusted net debt to EBITDA breaching 1.5x (FYE14: 1.3x) on a prolonged basis.
-Material deterioration in TT's pre-dividend FCF margin, or in the company's regulatory or competitive environment.
-Negative rating action on the Turkish sovereign (a downgrade or revision of the Outlook to Negative) could put pressure on TT's rating.

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. It had TRY3bn of cash at the end of 1Q15 ahead of a TRY1.8bn dividend payment in 2Q15 and TRY2.2bn of debt due in the last three quarters of 2015 and in 2016. The company has a diversified borrowing portfolio and ready access to financing provided by local and international banks and export credit agencies, as well as international bond markets. TT can also count on a strong pre-dividend cash flow generation profile. However, liquidity could be tested with the upcoming spectrum payments. If these payments (spread out over 18 months after the auction has ended) are higher than expected, cash and liquidity sources could prove insufficient to service its short-term debt repayment obligations. In such a scenario, TT might be more reliant on regular refinancing of its short-term debt. This refinancing risk could be exacerbated by a further depreciation of the TRL against the EUR and/or USD.

FULL LIST OF RATING ACTIONS
Long-term foreign currency IDR: affirmed at 'BBB-'; Outlook Stable
Long-term local currency IDR: affirmed at 'BBB-'; Outlook Stable
Senior unsecured debt in foreign currency: affirmed at 'BBB-'

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 28 May 2014)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=749393