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Research Update:

Turk Telekom Upgraded To 'BBB-/A-3'; Outlook Negative

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Overview

- Turk Telekom has completed issuance of a US\$1 billion bond, which has significantly improved its liquidity position.
- We are revising our assessment of Turk Telekom's liquidity to adequate from less than adequate.
- We are raising our ratings on Turk Telekom to 'BBB-/A-3' from 'BB+/B' and removing them from CreditWatch positive.
- The negative outlook mirrors that on the sovereign.

Rating Action

On July 24, 2014, Standard & Poor's Ratings Services raised its corporate credit ratings on Turkish telecoms operator Turk Telekom to 'BBB-/A-3' from 'BB/B'. The outlook is negative.

We also raised the ratings on Turk Telekom's senior unsecured debt to 'BBB-' from 'BB+'.

The ratings were removed from CreditWatch with positive implications, where they were placed on June 4, 2014.

Rationale

The upgrade reflects the improvement in Turk Telekom's liquidity position following issuance of a debut US\$1 billion bond. We therefore have revised our assessment of Turk Telekom's liquidity to "adequate" from "less than adequate." We believe that the reduction in short-term debt, together with the company's commitment to improving liquidity further, supports an investment-grade rating ('BBB-' or higher). In addition, we believe that it could allow the company to sustain a sovereign default. This allows us to rate the company higher than we rate the sovereign.

Our assessment of Turk Telekom's business risk profile as "satisfactory" 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 mature domestic, three-player mobile telephony market, where competitor Turkcell 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 its profitability low. That said, given the company's investments in mobile business in recent years, we expect its market position and profitability to improve in 2014-2015.

Our assessment of Turk Telekom's financial risk profile as "intermediate" 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 of distributing nearly 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 U.S. dollar- and euro-denominated debt. Consequently, discretionary cash flow (DCF, or cash generation after capital expenditures and dividends) was negative in 2012-2013, 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 3%-4% consolidated revenue growth in Turkish lira terms, as we expect the strong performance of the fixed-line business will continue, and the decline in revenues from the traditional voice segment will be fully offset by growth in broadband internet.
- Consolidated EBITDA margin of about 37%.
- A declining capital expenditures-to-sales ratio to 15%-16% from the historical level of 18%-20%.
- Payment of almost 100% of dividends, as per its financial policy.

Based on these assumptions, we arrive at the following credit measures:

- A Standard & Poor's-adjusted debt-to-EBITDA ratio of about 1.4x-1.5x over the next two years.
- Standard & Poor's-adjusted free operating cash flow to debt of about 25% over the same period.
- Positive DCF based on our expectation of lower dividends.

The long-term rating on Turk Telekom is higher than the long-term foreign currency rating on Turkey. We believe that with recent liquidity improvements, the company could sustain a sovereign default. That said, the company's capital structure is still dominated by use of hard currency debt, while the generated cash flow is lira denominated. This mismatch could create a situation where hard currency liquidity sources might not be sufficient to address a near-term maturity at the point of a hypothetical sovereign default. The company has a track record of maintaining relatively low cash balances, especially hard currency-denominated ones (according to our estimations), and has not widely used committed credit facilities to mitigate currency mismatches. For this reason, in our view, the long-term rating on Turk Telekom currently cannot exceed the long-term foreign currency rating on the sovereign

by more than one notch.

Liquidity

We consider Turk Telekom's liquidity to be "adequate" under our criteria. We calculate that the ratio of liquidity sources to uses exceeds 1.2x after the bond issuance and will remain at this level.

The company's liquidity management has been historically quite aggressive, given that it has run on low cash, has not used committed credit facilities, and has maintained significant amounts of short-term debt. We understand that the company has committed to improving these elements, so that it is able to maintain adequate liquidity at all times.

Outlook

The negative outlook on Turk Telekom mirrors that on Turkey.

Downside scenario

If we lowered our sovereign rating on Turkey, it would likely result in a similar rating action on Turk Telekom, assuming the constraining factors related to capital structure remain in place.

We could also lower the rating on Turk Telekom if the company's liquidity cushion weakens, so that it would no longer pass the sovereign default stress test. An increase in Standard & Poor's adjusted debt-to-EBITDA ratio to above 2x could also provoke ratings downside.

Upside scenario

We could revise the outlook to stable in case of a similar rating action on the sovereign. We could also consider revising the outlook to stable if the company's liquidity cushion were to strengthen and a mismatch between the currencies of revenues and debt improve, paving the way for a less stringent link to the sovereign rating.

In the longer term, the upside could be unlocked if Turk Telekom were to obtain a stronger position and higher profitability in mobile telephony, provided that its leverage stayed at moderate levels and a mismatch between the currencies of debt and revenues narrowed.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Negative/A-3

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: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Related Criteria And Research

- Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- 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
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded; CreditWatch/Outlook Action

	To	From
Turk Telekom		
Corporate Credit Rating	BBB-/Negative/A-3	BB+/Watch Pos/B
Senior Unsecured	BBB-	BB+/Watch Pos
Recovery Rating	NR	3

Additional Contact:

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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 Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers:

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