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Turk Telekom

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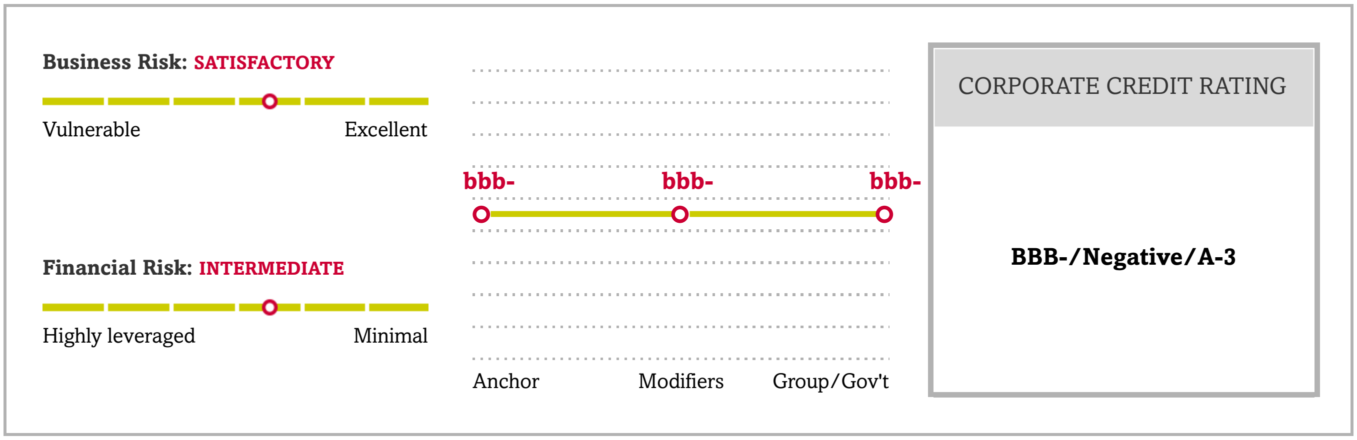
Table Of Contents

Turk Telekom



Rationale

Business Risk: Satisfactory	Financial Risk: Intermediate
• Solid leadership position in Turkey's fixed-line telephony and broadband Internet market. • Solid profitability and cash flow generation. • Challenger position in the saturated Turkish mobile telephony market. • Exposure to country risk in Turkey.	• Modest financial leverage. • Conservative financial policy, with a leverage target of unadjusted net debt to EBITDA of below 1.5x. • Limited discretionary cash flow due to high dividend distributions. • Exposure to foreign exchange risk, primarily because a significant amount of its U.S. dollar- and euro-denominated financial debt is unhedged.

Outlook: Negative

The negative outlook on Turk Telekom mirrors that on Turkey.

Downside scenario

If we lowered our sovereign rating on Turkey, we would likely take a similar rating action on Turk Telekom, assuming the constraining factors related to its capital structure still applied. We could also lower the rating on Turk Telekom if its liquidity cushion weakened, so that it would no longer pass the sovereign default stress test. A sustainable increase in Standard & Poor's-adjusted debt-to-EBITDA ratio to above 2x, coupled with an funds from operations (FFO)-to-debt ratio below 40%, could also cause us to lower the rating.

Upside scenario

We could revise the outlook to stable if we took a similar rating action on the sovereign. We could also consider revising the outlook to stable if the company's liquidity profile were to strengthen and the currency mismatch between Turk Telekom's revenues and debt reduced, weakening the link to the sovereign rating.

In the longer term, we could raise the rating if Turk Telekom were to sustain its strong fixed-line broadband market position and obtain a stronger mobile market position and EBITDA margins in mobile telephony of 20%-25%, provided that its leverage stayed at or below 2x and the currency mismatch between its debt and revenues narrowed.

Standard & Poor's Base-Case Scenario

Assumptions

- About 6%-7% revenue growth in 2015 and about 4%-6% in 2016, primarily supported by continued growth in mobile revenues of 15%-20% in 2015 and 8%-15% in 2016.
- Stable reported EBITDA margins of about 37% in 2015 and 2016.
- Almost-flat capital expenditure-to-sales ratio of about 15%-16% in 2015 and 2016 (was 16% in 2014).
- Meaningful spectrum costs, although the related cash outflows could be spread over four equal installments in 2015-2017.
- Dividend distributions remain significant (Turkish lira [TRY] 1.84 billion in 2014).
- Annual depreciation of the Turkish lira against the U.S. dollar of about 10% per year.

Key Metrics

	2014A	2015E	2016E
Debt to EBITDA (x)*	1.5	1.7-1.9	1.7-2.0
FFO to debt (%)*	55.0	46-49	41-45
DCF to debt (%)*§	16.1	(6)-(4)	(10)-(5)

*Standard & Poor's-adjusted ratios. §Discretionary cash flow (DCF) defined as cash flow from operations after cash interest, capital expenditures, spectrum costs, and dividends. FFO--Funds from operations. A--Actual. E--Estimate.

Company Description

Turk Telekom is a former telecom incumbent operator and provides integrated telecommunication and technology services to residential and commercial customers, primarily in Turkey. It primarily offers fixed-line telephony, broadband Internet, TV, corporate data, and mobile telephony services, as well as infrastructure and wholesale voice services. As of June 30, 2015, Turk Telekom reported 10.8 million fixed voice lines, 7.7 million broadband Internet subscribers, and 16.7 million mobile subscribers.

Following privatization in 2005 and an IPO in 2008, 55.8% of the company is owned by holding company, Oger Telecom, which is a joint venture between two Saudi companies--Saudi Oger and Saudi Telecom. The Turkish government holds a 31.7% stake in Turk Telekom.

Business Risk: Satisfactory

Turk Telekom's "satisfactory" business risk profile is supported by the company's strong leadership position in domestic fixed-line business and extensive network infrastructure. It almost fully controls the fixed-line voice segment (about 91% market share) and is the dominant player in the fixed-line broadband market, where it had a retail market share of about 71% as of March 31, 2015. In addition, Turk Telekom has built the largest fiber to the home or building (FTTH/B) network in Turkey, passing about 3.1 million homes. As of June 30, 2015, it commanded a solid market share of 47% for fiber broadband customers, although this share has declined somewhat recently. The company's fiber-to-the-cabinet network currently passes about 8.2 million homes.

As a result, we expect Turk Telekom to benefit as broadband internet penetration increases in Turkey and from increasing demand for higher broadband speed 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. For the present, the company's very profitable fixed-line business enables it to enjoy somewhat stronger EBITDA margins than many of its European peers.

These strengths are partly offset by the company's exposure to meaningful country risks in Turkey, and the smaller scale of its mobile subsidiary, Avea, in the mature domestic mobile telephony market. There are three players in this market; Turkcell dominates and Avea is still the smallest operator. Avea had a subscriber market share of about 23% as of June 30, 2015. Although Avea is gradually increasing its market share in mobile telephony, its scale and profitability (18% EBITDA margin in the first half of 2015) are significantly weaker than those of its competitor Turkcell. That said, given Avea's high investments in the mobile business in recent years, we expect its market position and profitability to improve further in 2015-2017.

We currently see a negative economic risk trend in Turkey, reflecting our view that there is a one-in-three chance that the real economy will stagnate. Over the next two years, we currently think it unlikely that the level of economic risk will ease, given the country's low GDP per capita, moderating growth prospects, heightened domestic political risks, and high current account deficits. We see risks to economic growth from lower consumer confidence associated with a weaker lira against hard currencies and a potential decline in the inflow of foreign funds.

S&P Base-Case Operating Scenario

- Stable average annual real GDP growth of about 3% in 2015-2016, compared with about 2.9% in 2014, and a moderate decline in inflation to about 7% in 2015 and about 6% in 2016 from about 9% in 2014.
- About 6%-7% revenue growth in 2015 and about 4%-6% in 2016, primarily supported by continued growth in mobile revenues of 15%-20% in 2015 and 8%-15% in 2016, based on continued postpaid subscriber growth.
- We expect revenue growth of about 1%-3% in the fixed-line business, where a continued decline in voice revenues will be more than offset by solid growth in broadband Internet and TV services, as well as corporate data business.
- Stable reported EBITDA margins of about 37% in 2015 and 2016; margin dilution from higher revenue growth in the less-profitable mobile operations will be offset by higher operating efficiencies, with personnel expense growth below inflation.

Peer comparison

Table 1

Turk Telekom -- Peer Comparison

	Turk Telekom	Turkcell Iletisim Hizmetleri A.S.	Rostelecom OJSC	Telkom SA SOC Ltd.	Kazakhtelecom JSC
	--Fiscal year ended Dec. 31, 2014--			--Fiscal year ended March 31, 2015--	--Fiscal year ended Dec. 31, 2014--
(Mil. $)					
Revenues	5,819.9	5,512.9	5,148.9	2,672.4	1,142.1
EBITDA	2,276.1	1,822.5	1,740.7	752.2	384.9
Funds from operations (FFO)	1,851.9	1,867.4	1,357.8	711.8	320.2
Net income from cont. oper.	859.0	864.9	222.1	229.8	41.0
Cash flow from operations	1,861.2	1,269.5	1,481.1	557.3	169.2
Capital expenditures	928.2	1,022.6	971.1	406.3	284.9
Free operating cash flow	933.0	246.9	510.0	151.0	(115.7)
Discretionary cash flow	542.8	243.2	379.1	141.0	(115.7)
Cash and short-term investments	0.0	2,500.9	81.3	74.6	165.1
Debt	3,361.1	445.9	3,128.0	414.2	484.3
Equity	2,697.1	7,206.3	4,223.8	2,191.5	1,482.6
Adjusted ratios					
EBITDA margin (%)	39.1	33.1	33.8	28.1	33.6
Return on capital (%)	23.0	20.3	7.5	11.0	8.5
EBITDA interest coverage (x)	12.0	27.3	6.0	10.8	9.0
FFO cash int. cov. (X)	16.9	39.0	5.6	16.2	12.7
Debt/EBITDA (x)	1.5	0.2	1.8	0.6	1.3
FFO/debt (%)	55.0	418.8	43.4	171.4	66.0
Cash flow from operations/debt (%)	55.3	284.7	47.3	134.1	34.8

Table 1

Turk Telekom -- Peer Comparison (cont.)					
Free operating cash flow/debt (%)	27.7	55.4	16.3	36.0	(24.0)
Discretionary cash flow/debt (%)	16.1	54.5	12.1	33.6	(24.0)

Financial Risk: Intermediate

Turk Telekom's "intermediate" financial risk profile is supported by our assumption that its Standard & Poor's-adjusted debt-to-EBITDA ratio will remain below 2x in 2015 and 2016, which is commensurate with the company's financial policy of maintaining unadjusted net debt to EBITDA below 1.5x. Furthermore, we forecast a solid adjusted FOCF-to-debt ratio of about 20% in 2015 and 2016, excluding the potentially significant spectrum costs in the upcoming 4G spectrum auction at the end of August 2015. The government expects to raise at least €2.3 billion, based on the reserve prices it has set.

These strengths are partly offset by Turk Telekom's limited discretionary cash flow generation, due to its dividend policy, which aims to distribute 100% of distributable profit (calculated based on Capital Markets Board regulations). We understand that Turk Telekom's majority owner, Oger Telecom, has a meaningful level of debt and therefore needs dividends from Turk Telekom to service its debt. That said, we consider that Turk Telekom's articles of association constrain Oger Telecom's 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 a sound financial standing of the group, consider the company's investment needs and trading prospects, and take into account covenants agreed with lenders.

Turk Telekom has exposure to foreign exchange risk, primarily because it had about $3.1 billion-equivalent of unhedged financial debt as of June 30, 2015 (denominated in U.S. dollars and euros) and generates almost all of its revenues and EBITDA in Turkish lira. Furthermore, in the 12 months to July 31, 2015, the Turkish lira depreciated by about 30% to the U.S. dollar.

S&P Base-Case Cash Flow And Capital Structure Scenario

- An almost-flat capital expenditure-to-sales ratio of about 15%-16% in 2015 and 2016 (16% in 2014).
- Meaningful spectrum costs, although the related cash outflows could be spread over four equal installments in 2015-2017.
- Continued significant dividend distributions (TRY1.84 billion in 2014).
- Annual depreciation of the Turkish lira against the U.S. dollar of about 10% per year.
- We view all of the group's unrestricted cash balances as surplus cash.

Financial summary

Table 2

Turk Telekom -- Financial Summary

	--Fiscal year ended Dec. 31--				
(Mil. TRY)	**2014**	**2013**	**2012**	**2011**	**2010**
Revenues	13,601.6	13,190.0	12,706.1	11,940.6	10,852.5
EBITDA	5,313.6	5,247.0	5,337.7	5,292.8	4,950.9
Funds from operations (FFO)	4,323.3	4,564.1	4,383.3	4,377.4	4,041.4
Net income from continuing operations	2,007.4	1,303.0	2,637.1	2,068.7	2,450.9
Cash flow from operations	4,345.2	3,954.8	3,522.0	4,043.6	3,873.6
Capital expenditures	2,169.3	2,293.2	2,347.6	2,327.0	1,805.0
Free operating cash flow	2,175.9	1,661.7	1,174.4	1,716.6	2,068.6
Discretionary cash flow	1,263.8	(751.6)	(722.1)	(527.4)	478.9
Debt	7,855.2	8,963.7	6,940.8	6,941.3	5,456.5
Equity	6,303.3	5,327.6	6,455.1	5,763.2	6,161.8
Adjusted ratios					
EBITDA margin (%)	39.1	39.8	42.0	44.3	45.6
Return on capital (%)	23.0	23.8	27.9	30.9	30.7
EBITDA interest coverage (x)	12.0	15.5	13.0	14.4	13.9
FFO cash int. cov. (x)	16.9	18.1	15.5	20.9	23.0
Debt/EBITDA (x)	1.5	1.7	1.3	1.3	1.1
FFO/debt (%)	55.0	50.9	63.2	63.1	74.1
Cash flow from operations/debt (%)	55.3	44.1	50.7	58.3	71.0
Free operating cash flow/debt (%)	27.7	18.5	16.9	24.7	37.9
Discretionary cash flow/debt (%)	16.1	(8.4)	(10.4)	(7.6)	8.8

Liquidity: Adequate

We assess Turk Telekom's liquidity as "adequate" according to our criteria, as we anticipate in our base case that its sources of liquidity will cover its uses by more than 1.2x in the 12 months from June 30, 2015.

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, mainly because it does not use long-term committee credit facilities and maintains most of its cash balances in Turkish lira (more than 70% as of June 30, 2015). Although it has taken steps to extend its average debt maturity--this is currently about 3.9 years, up from 2.6 years in 2013--it still faces meaningful debt maturities in foreign currencies in 2015-2017.

Principal Liquidity Sources	Principal Liquidity Uses
As of June 30, 2015, principal liquidity sources for the next 12 months include: • Unrestricted cash balances of about TRY1.7 billion. • Undrawn credit lines of about TRY0.6 billion. • FFO of about TRY4.6 billion.	For the same period, principal liquidity uses include: • Short-term debt maturities of about TRY1.2 billion. • Moderate working capital requirements. • Capital expenditure (excluding spectrum costs) of about TRY2.3 billion. • Significant dividend payments (TRY1.84 billion in 2014).

Debt maturities*

- Within one year: TRY1.2 billion-equivalent
- Within two to five years: TRY6.5 billion-equivalent
- Thereafter: TRY2.7 billion-equivalent

*As of June 30, 2015

Covenant Analysis

Compliance Expectations	Requirements
In our base case, we estimate that Turk Telekom will maintain adequate headroom of more than 30% under its covenants in 2015 and 2016.	Under its covenants, Turk Telekom is required to maintain its debt to EBITDA leverage below 2.5x and EBITDA interest coverage above 4x.

Rating Above The Sovereign

Our rating on Turk Telekom exceeds the sovereign foreign currency rating on Turkey by one notch because it 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 EBITDA. In addition, the company took additional steps in 2015 to reduce its foreign currency debt exposure.

At this point, we think that the rating on Turk Telekom can exceed the sovereign rating by only one notch. This is because depreciation of the Turkish lira against the U.S. dollar has recently accelerated and because Turk Telekom's capital structure still features a meaningful currency mismatch between debt and revenues. In addition, a significant share of its debt matures in 2015-2017, of which a large part is denominated in foreign currencies.

Nevertheless, further improvements in the liquidity profile, for example, in the form of a further extension of its debt maturity profile, a reduced short-term debt exposure in foreign currencies, or higher long-term committed credit facilities, could support a higher rating differential to the foreign currency rating on Turkey over time.

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

Reconciliation

Table 3

Reconciliation Of Turk Telekom Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. TRY)

	--Fiscal year ended Dec. 31, 2014--					
	Debt	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**
Turk Telekom reported amounts	8,877.8	5,125.6	3,123.8	357.2	5,125.6	4,436.0
Standard & Poor's adjustments						
Interest expense (reported)	--	--	--	--	(357.2)	--
Interest income (reported)	--	--	--	--	130.4	--
Current tax expense (reported)	--	--	--	--	(696.2)	--
Operating leases	434.9	131.6	27.7	27.7	103.9	103.9
Postretirement benefit obligations/deferred compensation	447.7	56.5	56.5	56.5	16.9	(67.5)
Surplus cash	(2,270.8)	--	--	--	--	--
Non-operating income (expense)	--	--	130.4	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	(150.9)
Debt - Derivatives	(74.0)	--	--	--	--	--

Table 3

Reconciliation Of Turk Telekom Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. TRY) (cont.)						
Debt - Put options on minority stakes	439.7	--	--	--	--	--
OCF - Derivatives	--	--	--	--	--	23.7
Total adjustments	(1,022.6)	188.1	214.6	84.2	(802.3)	(90.9)
	Debt	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**
Standard & Poor's adjusted amounts	7,855.2	5,313.6	3,338.4	441.4	4,323.3	4,345.2

Related Criteria And Research

Related Criteria

- Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Methodology: Industry Risk - November 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Key Credit Factors For The Telecommunications And Cable Industry - June 22, 2014
- Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Corporate Methodology - November 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Use Of CreditWatch And Outlooks - September 14, 2009
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013
- 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- Corporate Criteria--Parent/Subsidiary Links - October 28, 2004

Related Research

- Banking Industry Country Risk Assessment: Turkey; July 14, 2015
- Local Currency Ratings On Turkey Lowered To 'BBB-/A-3'; Outlook Remains Negative; May 8, 2015

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	**Intermediate**	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	**bbb/bbb-**	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of August 10, 2015)	
Turk Telekom	
Corporate Credit Rating	BBB-/Negative/A-3

Ratings Detail (As Of August 10, 2015) (cont.)	
Senior Unsecured	BBB-
Corporate Credit Ratings History	
24-Jul-2014	BBB-/Negative/A-3
04-Jun-2014	BB+/Watch Pos/B

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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