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

Fitch Ratings-London-18 September 2017: Fitch Ratings has affirmed Turk Telekomunikasyon A.S.'s (TT) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB-'. The Outlook on the IDRs is Negative. Its senior unsecured foreign-currency rating has also been affirmed at 'BBB-'.

TT is the leading integrated telecoms player in Turkey and operates the country's largest fixed network and the smallest of three mobile networks. The company's national fixed-line coverage, good spectrum position and growing base of converged customers make it a strong competitor for Turkcell Iletisim Hizmetleri A.S (BBB-/Negative) and Vodafone Group plc (BBB+/Stable). High leverage and exposure to foreign-currency risk remain a constraining factor for the rating but we see clear capacity for deleveraging as revenue and EBITDA grow against the backdrop of a strong Turkish economy.

KEY RATING DRIVERS

Impact of FX Mismatch: TT has a significant currency mismatch as almost all of its debt is denominated in dollars and euros while most of its FCF is generated in local currency. Depreciation of the lira in 2016 saw 2016 FFO-adjusted Net Leverage grow to 2.8x, exceeding our downgrade threshold of 2.2x. 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.

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-Line Position: TT is Turkey's largest telecoms company and the fixed-line incumbent operator, with around an 86% subscriber market share in fixed-voice and a 62% subscriber market share in retail fixed-broadband services. Broadband subscribers and ARPU continue to grow, helped by growing demand for high-speed broadband. It has a solid fixed-line franchise with less intense competition than other European incumbents. The Turkish fixed broadband market remains fairly under-penetrated at around 48% of households, lagging significantly behind the European average of around 71%, and offers firm growth potential.

FCF Generation Improving: We expect TT's FCF generation in 2017 to be much improved, with FCF margin in the low single-digit range. TT paid the last of four spectrum instalments in April 2017, and will pay no dividends in 2017 for the 2016 financial year following losses made in 2016. Cash generation should improve in 2017 and 2018 and we expect FFO adjusted net leverage to drop to 2.0x by the end of 2018, assuming modest Turkish lira depreciation from current levels. Controlling capex with any potential Turkish lira depreciation is going to be a key challenge for management, if TT is to protect its FCF generation and deleveraging capacity.

Financial Difficulties at Otas: We currently rate TT on a standalone basis with no support from any of its shareholders. We see no impact on TT's credit profile from the problems at 55% owner Ojer Telekomunikasyon AS (Otas) given a strong ring-fence around TT with dividend payments being the only source of cash being moved upstream to Otas, and there are no cross-default provisions on TT's debt from Otas. A sale of Otas's 55% stake to a third party in itself should not have an impact on TT's ratings as long as this ring-fence remains in place.

Sovereign Linkage Remains Weak: We assess the links between TT and the Turkish state to be weak, hence TT's rating is not constrained by the sovereign rating. The Turkish state owns 31.68% of TT. We do not anticipate our treatment of the sovereign linkage changing should the Turkish government increase its equity interest to a small majority stake in TT as a result of Otas' financial difficulties. This assumes the ring-fence around TT remains intact and the company's strategic priorities and financial policies remain the same.

The strong dividend ring-fencing, asset disposal restrictions and change of control clause are all consistent with a weak sovereign linkage. Given that TT mainly operates domestically, it is unlikely that TT would be rated higher than the Turkish Country Ceiling (BBB-/Stable), hence any further negative sovereign rating action could impact TT's rating.

Long-Term Concession Uncertainty: 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.

DERIVATION SUMMARY

Turk Telekom (TT) has a similar operating profile to other European incumbent peers. Its strength stems mainly from its leading fixed-line operations in Turkey with its increasing fibre deployment a key advantage. It is also a fully integrated telecoms operator with a growing mobile market share and increasing pay-TV penetration. Leverage thresholds for its current rating are tighter than for European peers due to higher risk from the FX mismatch between mainly hard currency debt and Turkish lira-denominated cash-flow generation. Even though the Turkish government owns a minority stake in TT, no parent/subsidiary linkage is applicable.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- 9.7% revenue growth in 2017 driven by gains in both fixed and mobile segments followed by high single digit growth thereafter;
- EBITDA to grow at a compound annual growth rate of 9.1% per year to TRY 7.8 billion by 2020;
- capex (excluding spectrum) as a percentage of revenue at 17%-18% for all years to 2020;
- spectrum costs of TRY900 million paid in April 2017 and no further spectrum fees expected in 2018-20;
- no dividends paid in 2017 for the 2016 financial year, 90% of net profits expected to be paid in dividends from 2018-20.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Evidence that TT can continue to minimise revenue declines, preserve deleveraging capability and maintain liquidity against the backdrop of higher Turkish inflation and further depreciation of the Turkish lira, together with FFO-adjusted net leverage trending sustainably below 2.2x (end-2016: 2.8x), could result in the Outlook being changed to Stable.
- Fitch views positive rating action as unlikely in the medium term. 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 could result in an upgrade, but not higher than the Turkish Country Ceiling.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
- FFO-adjusted net leverage trending above 2.2x 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 and Country Ceiling could put pressure on TT's rating

LIQUIDITY

Sufficient Liquidity: Turk Telekom has a good relationship with its banks, and had undrawn available facilities of USD32 million and EUR55 million at end-2Q17. A strong balance sheet, with the equivalent of TRY2.1 billion of cash at end-2Q17 also provides additional liquidity with limited short-term debt maturities. Future falls in the lira might weigh on liquidity over the next 12-18 month. This is mitigated by improving free cash flow as spectrum payment instalments have now been completed.

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Applicable Criteria

Corporate Rating Criteria (pub. 07 Aug 2017)

https://www.fitchratings.com/site/re/901296

Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)

https://www.fitchratings.com/site/re/886557