FitchRatings

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

Fitch Ratings-London-01 February 2017: Fitch Ratings has affirmed Turk Telekomunikasyon AS's (TT) Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BBB-'. The Outlooks for both IDRs are Negative. Its senior unsecured 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. Spectrum payments depressed free cash flow (FCF) generation in 2016. FCF should be stronger in 2017 as the last spectrum instalment is paid, and with significantly lower dividends following lower net profits in 2016 due to foreign exchange losses.

FX risk is TT's main credit weakness, which can be exacerbated by Turkey's weak macroeconomic environment.

KEY RATING DRIVERS

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 Country Ceiling (BBB-/ Stable), which was revised from 'BBB' on 27 January 2017. Hence further negative sovereign rating action could impact TT's ratings.

Weak Macroeconomic Environment: The Negative Outlook reflects the challenging operating environment TT faces. Fitch forecasts inflation could temporarily hit double-digits in 1H17 and put pressure on TT's profitability if it is not passed on to customers. Continued weakness in the Turkish lira is likely to increase leverage and put pressure on FCF as a portion of TT's capex is denominated in hard currencies. We expect TT's fixed-line and post-paid mobile services to remain resilient in a slowing economy with continued demand for data connectivity.

FX Risk Exposure: TT has a significant currency mismatch as almost all of its debt is denominated in USD and EUR while most of its FCF is generated in local currency. This exposes TT to significant risks arising from potential adverse movements in foreign exchange rates. However, the company's dividend policy is to pay out 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.

Strong Competitive Position: TT's pay-TV and fixed-mobile convergent service offering is built on the company's leading fixed line position. TT ended 3Q16 with a 65% and 83% subscriber market share in retail and wholesale fixed broadband services respectively. Broadband subscribers and average revenue per user (ARPU) continue to grow, helped by increasing demand for high-speed connectivity.

While fixed voice revenue is declining, the number of fixed access lines has stabilised at 12.9 million. TT has improved its mobile service capability, helped by spectrum bought in the 2015 auction. TT's mobile operations have a higher smartphone penetration and post-paid mix than the rest of the Turkish mobile market. TT has also invested in its pay-TV offering, investing in content (such as European football rights) and using satellite delivery to complement its fixed network.

FCF Generation Improving: We expect TT's FCF generation in 2017 to significantly improve, with FCF margin in the mid-single digit range. TT has the last of four spectrum instalments to pay in April 2017, and dividends are likely to be significantly lower this year than in 2016.

Cash generation should improve in 2017 and 2018 and we expect funds from operations (FFO)-adjusted net leverage to drop to 1.9x by end-2018, assuming modest Turkish lira depreciation from current levels. Controlling capex with potential Turkish lira depreciation will be a key challenge for management, if TT is to protect its FCF generation and deleveraging capacity.

Shareholder Developments: We do not expect financial challenges at Ojer Telekomunikasyon AS (Ojer), which controls 55% of TT, to have any immediate impact on TT. Our rating assumes that the potential shareholder changes at Ojer will not trigger a change-of-control put option for TT's USD bonds due 2019 and 2024.

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.

DERIVATION SUMMARY

TT has a similar operating profile to other European incumbent peers. Its strength stems mainly from the leading fixed-line operations of TT in Turkey with its increasing fibre deployment a key advantage. It is becoming a fully integrated telecoms operator with a growing mobile market share and pay-TV penetration.

Leverage thresholds for its current ratings 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. Given that TT mainly operates domestically, it is unlikely that TT will be rated higher than the Turkish Country Ceiling (BBB-)

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for TT include:

- Revenue growth of over 7% in 2016 (company guidance is for 7%-9%), followed by 5%-6% increases in 2017 and 2018, with mobile and broadband growth offsetting fixed voice declines;
- EBITDA margin of 35%-36% in 2016 and 2017, and increasing slightly in 2018;
- Capex (excluding spectrum payments) to have increased to 20% of revenue in 2016 before reducing to 17% in 2018;
- Significantly lower dividend payments in 2017, with 2018 dividends to increase in line with net income in prior year, assuming no further depreciation of Turkish lira.

RATING SENSITIVITIES

TT

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

-Evidence that TT can maintain revenue growth and profitability, preserve deleveraging capability and maintain liquidity against the backdrop of higher Turkish inflation and further depreciation in the Turkish lira could result in the Outlook being changed to Stable.

-Fitch views an upgrade 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 no 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 (end-2015: 2.0x) 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.

Turkey Sovereign Rating
The main factors that could, individually, or collectively, lead to negative rating action are:
- Heightened stresses stemming from external financing vulnerabilities;
- Weaker public finances reflected by deterioration in the government debt/GDP ratio;
- Deterioration in the political or security situation.

The main factors that could, individually, or collectively, lead to positive rating action are:
- Implementation of reforms that address structural deficiencies and reduce external vulnerabilities;
- A political and security environment that supports a pronounced improvement in key macroeconomic data.

LIQUIDITY
Sufficient Liquidity: TT has a good relationship with its banks, and had undrawn available facilities of USD93 million and EUR28 million at end-3Q16. A strong balance sheet, with TRY3.2 billion of cash at end-3Q16 (49% in hard currency) also provides additional liquidity against limited short-term debt maturities. A final spectrum payment in 1H17, along with high capex is likely to weigh on cash flow over the next 12-18 months; however, we expect these to be covered by the company's operating cash flows. Further significant TRY depreciation could, however, put some pressures on liquidity.

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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
Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016)
https://www.fitchratings.com/site/re/885629