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Research Update:

Turk Telekom Ratings Lowered To 'BB+/B' After Sovereign Downgrade; Outlook Stable

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Overview

- On May 1, 2018, we lowered our unsolicited long-term foreign currency rating on Turkey to 'BB-' from 'BB', and assigned a stable outlook, and we lowered to 'BB+' from 'BBB-' our transfer and convertibility (T&C) assessment, which reflects our view of the likelihood that Turkey would restrict access to foreign exchange liquidity for Turkish companies.
- While we continue to assess that our rating on Turk Telekom can exceed the sovereign rating by two notches, the rating is capped at the level of the T&C assessment on Turkey, since Turk Telekom is a nonexport company with over 90% of its revenue coming from the domestic market.
- We are consequently lowering our ratings on Turk Telekom to 'BB+/B' from 'BBB-/A-3', although our assessment of the company's stand-alone creditworthiness remains unchanged.
- The stable outlook mirrors that on the sovereign.

Rating Action

On May 8, 2018, S&P Global Ratings lowered its long- and short-term issuer credit ratings on Turkish telecommunications operator Turk Telekom to 'BB+/B' from 'BBB-/A-3'. The outlook is stable.

We also lowered our issue rating on Turk Telekom's senior unsecured debt to 'BB+' from 'BBB-'. We assigned a '3' recovery rating to the debt, reflecting our expectation of meaningful recovery (50%-70%; rounded estimate: 65%) in the event of default.

Rationale

The rating actions follow our downgrade of Turkey (see "Turkey Ratings Lowered On Deteriorating External Performance and Higher Inflation; Outlook Stable," published May 1, 2018, on RatingsDirect).

Because we limit our rating on Turk Telekom to two notches above the sovereign foreign currency rating, the rating action on the sovereign resulted in a lower rating on the company. In addition, we cap the rating on Turk Telekom at the 'BB+' transfer and convertibility (T&C) assessment on Turkey because Turk Telekom is a nonexport company. Our T&C assessment reflects our view of the likelihood of Turkey restricting access to foreign exchange liquidity for

Turkish companies.

We continue to assess Turk Telekom's stand-alone credit profile (SACP) at 'bbb-', which is three notches higher than the foreign currency credit rating on Turkey. Our rating on Turk Telekom is higher than the sovereign foreign currency rating because Turk Telekom passes our hypothetical sovereign default stress test, which, among other factors, assumes a 50% devaluation of the lira against hard currencies and a 15%-20% decline in organic EBITDA. Because of this, we currently assess that our rating on Turk Telekom can exceed the sovereign rating by two notches. We believe the company would pass the hypothetical sovereign default, because we understand that management keeps 67% of its cash in hard currencies as of March 31, 2018, and aims to keep sufficient cash reserves to serve its next 12-months' debt obligations. Therefore, in the hypothetical case of depreciation of the lira, we think the appreciation of the cash balance would offset the increase in unhedged short-term debt maturities and capex.

The SACP primarily reflects our view of Turk Telekom's strong position in its domestic fixed line business (63% subscriber market share in retail broadband; 82% subscriber market share in wholesale broadband as of fourth-quarter 2017); improving position, albeit at a slow pace, in mobile market (26% subscriber market share as of fourth-quarter 2017); extensive network infrastructure (87% LTE [long-term evolution] population coverage); and strong profitability (our expectation of S&P Global Ratings' adjusted EBITDA margin of 37%-38% in 2018 and 2019). Moreover, we expect that the company's debt to EBITDA will improve to 1.6x-1.8x in 2018 and 2019 from 2.2x in 2017, on an S&P Global Ratings' adjusted basis, and consider that the company is improving its free cash flow generation, with reduced capital expenditure (capex) requirements and dividends (no payments for 2017). We expect free operating cash flow (FOCF) to debt to be between 15%-20% in 2018 and 2019, compared with 11.7% in 2017.

Somewhat offsetting this is Turk Telekom's exposure to high country risks in Turkey, exposure to foreign exchange risk (approximately 40% of debt was hedged against U.S. dollar and euro as of first-quarter 2018). For more details on our base-case assumptions for Turk Telekom, please see the full analysis "Turk Telekom," published Dec. 22, 2017.

Liquidity

The short-term rating on Turk Telekom is 'B', reflecting the long-term issuer credit rating and our assessment of Turk Telekom's liquidity as adequate. We assess Turk Telekom's liquidity as adequate because we anticipate in our base case that its sources of liquidity will cover its uses by about 1.4x in the 12 months from March 31, 2018. In our view, the company has sound relationships with its banks.

We estimate that principal liquidity sources for the 12 months from March 31, 2018, include:

- Reported cash balances of about Turkish lira (TRY) 4.0 billion (\$1.0 billion);

- Funds from operations of about TRY6.8 billion; and
- Undrawn committed facilities of about TRY410 million (denominated in U.S. dollar and euro).

For the same period, we estimate that principal liquidity uses include:

- Debt maturities of about TRY2.7 billion;
- Capex of about TRY3.5 billion (excluding impact adjustments for International Financial Reporting Standards [IFRS] 15 and IFRS 9);
- Moderately negative working capital of around TRY300 million; and
- Annual dividends of about TL1.0 billion-TL1.2 billion.

Outlook

The stable outlook on Turk Telekom mirrors our stable outlook on Turkey, and our expectation of continued solid operational performance. Our current assessment of Turk Telekom's SACP reflects our expectation that for 2018 and 2019 the company will maintain revenue growth of above 10% and a leverage (debt-to-EBITDA) ratio below 2.25x.

Downside scenario

In addition to a negative rating action on the sovereign, we could also downgrade Turk Telekom if we lowered our T&C assessment on Turkey, due to deterioration in Turkish corporations' access to domestic and external liquidity, or if we believed the business risk of operating in Turkey had materially increased.

Upside scenario

We could upgrade Turk Telekom if we raise the sovereign rating on Turkey and the T&C assessment.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Stable/B

Business risk: Satisfactory

- Country risk: 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)

Stand-alone credit profile: bbb-

- Related government rating: BB-

Issue Ratings--Recovery Analysis

Key analytical factors

- We lowered Turk Telekom's senior unsecured debt to 'BB+' from 'BBB-', in line with the rating action on the issuer credit rating. The recovery rating is '3'.
- We cap our recovery rating at '3' to account for the the unsecured nature of the debt, and and our view of Turkey as a relatively unfavorable jurisdiction for creditors.
- Our hypothetical default scenario assumes a payment default due to increased competitive pressure on fixed-line revenues, accompanied by increasing subscriber acquisition and retention costs, as well as continued high network investments.
- We value Turk Telekom as a going concern, given its strong position in the Turkish market.

Simulated default assumptions

- Year of default: 2023
- Minimum capex (percentage of last three years' average sales): 6%
- Cyclicity adjustment factor: +0% (standard sector assumption)
- Operational adjustment: +35% (minimum capex excluding spectrum payments around 9%-10%)
- Emergence EBITDA after recovery adjustments: about TRY2.6 billion
- Implied enterprise value multiple: 6x
- Jurisdiction: Turkey

Simplified waterfall

- Gross enterprise value at default: about TRY15.3 billion

- Administrative costs: 5%
- Net value available to debtors: TRY14.6 billion
- Unsecured debt claims[1]: about TRY14.6 billion
- Recovery expectation[2]: 65%
- Recovery rating: 3

[1]All debt amounts include six months of prepetition interest. RCF assumed 85% drawn on the path to default. [2]Rounded down to the nearest 5%.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Turkey Ratings Lowered On Deteriorating External Performance and Higher Inflation; Outlook Stable, May 1, 2018
- Turk Telekom, Dec. 22, 2017

Ratings List

Downgraded; New Recovery Rating

	To	From
Turk Telekom		
Issuer Credit Rating	BB+/Stable/B	BBB-/Negative/A-3
Senior Unsecured	BB+	BBB-
Recovery Rating	3 (65%)	NR

NR--Not rated.

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