S&P Global
Ratings

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Summary:

Turk Telekom

Primary Credit Analyst:
Rawan Oueidat, CFA, Dubai + 971(0)43727196; rawan.oueidat@spglobal.com

Secondary Contact:
Thierry Guermann, Stockholm (46) 8-440-5905; thierry.guermann@spglobal.com

Table Of Contents

Summary:

Turk Telekom

Issuer Credit Rating	BB-/Stable/B

Credit Highlights

Overview

Key Strengths	Key Risks
Leading position in Turkey's fixed-line segments, with an 81% market share in wholesale broadband, and 62% in retail broadband.	Weakening of the Turkish lira (TRY; 30% between year-end 2017 and Nov. 28, 2018) and inflationary pressure (14%-16% in 2018/2019) could pressure FOCF generation, since around 50% of capex is hard-currency denominated.
Extensive network infrastructure, with fixed-line household coverage above 90% and 89% long-term evolution (LTE) population coverage.	Modest market position in the mobile telephony market, No. 3 with a 26% subscriber market share, far behind the market leader Turkcell (44%).
Relatively stable profitability and solid free operating cash flow (FOCF) generation, despite the current volatile economic conditions.	A negative rating action on the sovereign or our transfer and convertibility (T&C) assessment.
Significant gross debt currency exposure, albeit recently reduced to 43% as of Q3 2018 from 65% in Q4 2017 through hedging instruments and an increasing cash portion in hard currencies.	

While a weaker lira could hurt the company's financial performance, we already factor in a weaker exchange rate than currently into our assumptions.

Turk Telekom has exposure to foreign-exchange risk, because, although almost all of its revenues and EBITDA are in lira, around 40% of its total debt is unhedged foreign-currency debt (U.S. dollars and euros). A weaker lira would translate into higher debt and capital expenditures (capex), because around 50% of capex is denominated in hard currencies, in addition to some foreign currency-based revenues (5%-10%). The same is true for operating expenditure (opex), although to a lesser extent, given only 10% of the opex is in hard currencies. The recent lira devaluation has weakened the company's credit metrics. Nevertheless, our base-case exchange rate of 6.9 lira per dollar at Dec. 31, 2018, leaves some headroom for further weakening from current levels (5.26 as of Nov. 28, 2018).

Thanks to resilient operating performance and modest capex needs (excluding currency impact), we expect credit metrics will rebound in 2019.

We base this on our estimate of a stable lira to dollar exchange rate of 6.9 through 2021, coupled with our expectation that Turk Telekom will be able to pass on most inflationary pressure to customers and maintain relatively stable margins, given its dominant position in fixed-line, increasing share in mobile, and cost-efficiency initiatives. We continue to expect Turk Telekom will have stronger FOCF flow generation than its Turkish peers, mainly due to its leading position in the higher margin fixed segment position. As a result, we expect FOCF to debt will surpass 5% and debt to EBITDA will fall well below 2.5x from 2019, on an S&P Global Ratings' adjusted basis.

Outlook: Stable

The stable outlook on Turk Telekom reflects our stable outlook on Turkey (unsolicited foreign currency B+/Stable/B; local currency BB-/Stable/B), and our expectation of continued solid operational performance. Our current assessment of Turk Telekom's stand-alone credit profile (SACP) reflects our expectation that our adjusted debt-to-EBITDA ratio will be below 3x in 2019 (most likely 2.0x-2.5x) and FOCF to debt above 5%.

Downside scenario

A negative rating action on the sovereign could trigger the same action on Turk Telekom. We could also downgrade Turk Telekom if we revised down 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 took the same action on the sovereign and revised up the T&C assessment.

Our Base-Case Scenario

Assumptions

- Annual real GDP growth in Turkey of 3.9% in 2018 and a contraction of 0.5% in 2019 (7.4% in 2017).
- Consumer price index (CPI) growth of 15.9% in 2018 and 14.5% in 2019 (11.1% in 2017).
- Depreciation of the lira against the U.S. dollar of about 40% by year-end 2018 from year-end 2017 to TRY/USD 6.9 from 2018. We expect the lira to remain at 6.9 through 2021.
- Revenue growth above 10% for 2018-2019, as a result of the company's ability to pass on most inflationary pricing to customers, continued growth in broadband thanks to penetration-focused campaigns, and TV subscribers thanks to its multiplay offering, and its gradually increasing market share in the mobile segment.
- A stable adjusted EBITDA margin of about 37% in 2018-2019 (36.9% in 2017) supported by top-line growth and continued cost efficiencies. We factor some impact, albeit not material (less than 2%-3% increase in opex) from currency depreciation, given that less than 10% of opex and revenues is denominated in hard currencies.
- Increased capex in 2018 due to the adverse impact of currency on capex. We expect the ratio of capex (excluding spectrum fees) to sales to be at or above 20% in 2018-2020, compared with 18% in 2017.
- No dividends in 2019, to incorporate the net loss in 2018 caused by the weaker lira. Similarly, we do not expect the company to distribute dividends in 2020, given our foreign currency assumptions.

Key Metrics

	2017A	2018E	2019E	2020E
Revenue growth (%)	12.6	>10	>10	5-10
EBITDA margin* (%)	36.9	37-38	37-38	37-38
Debt to EBITDA* (x)	2.2	2.5-3.0	2.0-2.5	<2.25
FFO to debt* (%)	37.3	30-35	35-40	40-45
FOCF to debt* (%)	11.7	5-10	10-15	15-20

*S&P Global Ratings' adjusted ratio. FFO--Funds from operation. FOCF—Free operating cash flow. 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 predominantly offers fixed-line telephony, broadband Internet, TV, corporate data, and mobile telephony services, as well as infrastructure and wholesale voice and data services. As of Sept. 30, 2018, Turk Telekom reported 9.8 million fixed voice lines, 10.6 million broadband internet subscribers, and 20.8 million mobile subscribers.

Following privatization in 2005 and an IPO in 2008, 55% of the company is owned by Ojer Telekomunikasyon A.#. (OTAS), which is owned by Oger Telecom. Oger Telecom is in turn largely owned by three Saudi companies--Saudi Oger Limited, Oger Telecom Saudi Arabia, and Saudi Telecom Co. (A-/Stable/A-2). The Turkish government (including the Turkish Wealth Fund) holds a 31.7% stake in Turk Telekom.

Business Risk : Satisfactory

Our assessment of Turk Telekom's business risk profile is supported by the company's strong leadership position in domestic fixed-line business, its extensive network infrastructure, good growth prospects, and solid profitability. Turk Telekom almost fully controls the fixed-line voice segment, and is the dominant player in the fixed-line broadband market, where it had captured a 62% retail market share as of Sept. 30, 2018, including an increasing presence in fiber, given fixed-line household coverage of more than 90%.

As a result, we expect Turk Telekom to benefit from broadband household penetration growth in Turkey, which currently stands at 53%, and from increasing demand for higher broadband speeds and quota packages and corporate data, and to a lesser extent from increasing revenues from TV services along with growth in mobile data. This should more than offset the predicted decline in revenues from traditional fixed-line voice, which comprised 12% of revenues in third-quarter 2018, compared with about 30% in first-quarter 2014.

These strengths are partly offset by the company's exposure to meaningful country risks, such as higher uncertainty of consumer spending or foreign exchange volatility, which would lead to inflationary pressures (expected CPI growth of 15.9% in 2018 and 14.5% in 2019, compared with 11.1% in 2017), and the smaller scale of its mobile operations in the mature domestic mobile telephony market. There are three players in this market: Turkcell dominates with a 44% market share, and Turk Telekom is still the No. 3 operator with a subscriber market share of 26% as of Sept.30, 2018, four percentage points behind the No. 2 player, Vodafone. Although Turk Telekom is gradually increasing its market share in the mobile market, its scale and profitability in the segment are still lower than those of Turkcell. That said, given Turk Telekom's solid spectrum position (32% share) and its high investments in the mobile business in recent years--notably providing 89% of the population with LTE coverage as of Sept. 30, 2018--we think its market position and profitability could further improve in coming years.

Peer comparison

Our peer assessment includes telecom operators across the Middle East, Africa and Russia, including Turkcell, Ooredoo, Megafon, MTS, Veon, and MTN.

Compared with Turkcell, Turk Telekom has stronger FOCF generation, benefiting from stronger profitability, and slightly lower capex requirements. However, it has a smaller share in the mobile segment (No. 3 position) and a weaker hedging profile until third-quarter 2018 (average 50% of foreign-currency denominated debt hedged compared with 60% for Turkcell year to date).

Compared with Russian operators, Turk Telekom is more leveraged, but has stronger FOCF generation.

Financial Risk: Significant

Our assessment of Turk Telekom's financial risk profile is supported by our assumption that its S&P Global Ratings' adjusted debt-to-EBITDA ratio will decline in 2019 and 2020, after a temporary peak at about 2.8x in 2018 caused primarily by the sharp lira devaluation. This is in line with our understanding that the company would like to maintain reported net debt to EBITDA at about 1.5x in the medium term, although we think it could take a few years before Turk Telekom returns to this level (at least 2020), depending on the development of the lira. We also expect S&P Global Ratings' adjusted fund from operations (FFO) to debt to recover well above 35% from 2019, and increase gradually thereafter.

These strengths are partly offset by Turk Telekom's temporarily weak discretionary cash flow (DCF) in 2018 (DCF to debt of less than 10%), and modest FOCF to debt ratio ranging from 8% in 2018 to about 15% in 2019, mainly due to weaker lira assumptions. We understand that Turk Telekom's majority owner, OTAS, has faced issues in servicing its debt. That said, we consider that Turk Telekom's articles of association constrain OTAS' influence on Turk Telekom's dividend policy. The articles stipulate that when Turk Telekom's board of directors decides on the dividend distribution proposal, it needs to maintain the group's sound financial standing, consider Turk Telekom's investment needs and trading prospects, and take into account covenants agreed with lenders. We understand that the Ministry of Treasury and Finance approved the transfer 55% shares in Turk Telekom that are owned by OTAS (55%), which is 99% owned by Oger Telecom, to a special purpose vehicle owned by the creditor banks of OTAS. Although we expect a subsequent change in ownership of Turk Telekom at some point, we have no details about timing or potential implications of a longer term shareholder, which we would assess once it takes place.

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. However, we also foresee some tightening in the company's liquidity position and covenant headroom compared with our previous base case from August 2018. We now anticipate in our base case that the company's sources of liquidity will cover its uses by about 1.2x in the 12 months from Sept. 30, 2018.

Principal Liquidity Sources	Principal Liquidity Uses
• Reported cash balances of about TRY6.2 billion; • FFO of about TRY6.6 billion; and • Undrawn committed facilities of about TRY610 million (denominated in U.S. dollar and euro).	• Debt maturities of about TRY7.7 billion; and • Minimum required capex of about TRY3.5 billion (excluding impact adjustments for International Financial Reporting Standards [IFRS] 15 and IFRS 9).

Debt maturitiesas of Sept. 30, 2018

- Debt maturing within one year: 31% of total gross debt (about TRY7.7 billion)
- Debt maturing between one to two years: 19% of total gross debt (about TRY4.8 billion)
- Debt maturing between two and five years: 30% of total gross debt (about TRY 7.4 billion)
- Debt maturing beyond five years: 20% of total gross debt (about TRY4.8 billion)

Covenant Analysis

Requirements

Turk Telekom must comply with two financial covenants: a net leverage ratio below 2.5x and an interest coverage ratio above 4x.

Compliance Expectations

Based on our exchange rate assumptions that are 30% weaker than current rates of 5.4 lire per dollar), we think that Turk Telekom's headroom under its leverage covenant will be extremely tight for the remainder of 2018 before rebounding to 10% in 2019 and growing to 30% in 2020. However, we also acknowledge the long-standing relationship Turk Telekom has with the local banks. As a result, in case of temporary tightening in covenant headroom, we expect the company would proactively negotiate a temporary solution with banks.

Rating Above The Sovereign

Our rating on Turk Telekom is higher than the sovereign foreign currency rating on Turkey 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.

We currently assess that our rating on Turk Telekom can exceed the sovereign rating by two notches. This is because we understand that management keeps almost one-half of its cash in hard currencies, and aims at keeping sufficient cash reserves to serve its next 12-month 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 capital expenditures.

We cap the rating on Turk Telekom at the level of our 'BB-' T&C assessment on Turkey, since Turk Telekom is a non-export company with over 90% of its revenues coming from the domestic market.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Stable/B

Business risk: Satisfactory

- Country risk: High

- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

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: bb+

- Sovereign foreign currency rating: B+
- Transfer & Convertibility Assessment: BB- (caps the ratings)
- Rating above the sovereign: (-2 notches from SACP)

Issue Ratings--Recovery Analysis

Key analytical factors

- Turk Telekom's senior unsecured debt is rated 'BB-', in line with the issuer credit rating. The recovery rating is '3'.
- We cap our recovery rating at '3' to account for the unsecured nature of the debt, 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: 2022
- Jurisdiction: Turkey

Simplified waterfall

- Minimum capex (percentage of last three years' average sales): 6%
- Cyclicality 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
- Gross enterprise value at default: about TRY15.9 billion
- Administrative costs: 5%
- Net value available to debtors: TRY15.1 billion
- Unsecured debt claims[1]: about TRY15.1 billion
- Recovery expectation[2]: 65%
- --Recovery rating: 3

[1]All debt amounts include six months of prepetition interest. Revolving credit facility 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

- Turk Telekom Rating Lowered To 'BB-' After Sovereign Downgrade; Outlook Stable, Aug. 28, 2018
- Turkey Long-Term Foreign Currency Rating Lowered To 'B+' On Implications Of Extreme Lira Volatility; Outlook Stable, Aug. 17, 2018
- Industry Top Trends 2019 Telecommunications, Nov. 15, 2018

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com