

Research

Research Update:

Turk Telekom Outlook Revised To Negative After Similar Action On Sovereign; 'BBB-/A-3' Ratings Affirmed

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Overview

- On Jan. 27, 2017, we revised our outlook on Turkey to negative from stable and affirmed our 'BB' long-term foreign currency rating.
- The Turkish lira's depreciation against the dollar and the euro in recent months has somewhat weakened our estimated credit metrics for Turk Telekom, but we still expect its adjusted debt to EBITDA will remain below 2.25x.
- We continue to assess that our rating on Turk Telekom can exceed the sovereign rating by two notches and we are therefore affirming our 'BBB-/A-3' ratings on Turk Telekom.
- However, we are revising our outlook on Turk Telekom to negative from stable because a downgrade of Turkey could result in a downgrade of Turk Telekom.

Rating Action

On Feb. 1, 2017, S&P Global Ratings revised its outlook on Turkey-based telecommunications operator Turk Telekom to negative from stable. At the same time, we affirmed our 'BBB-/A-3' long- and short-term corporate credit ratings on the company.

Rationale

The outlook revision stems from a similar action on our foreign currency rating on Turkey (see "Republic of Turkey Outlook Revised To Negative; Ratings Affirmed," published Jan. 27, 2017, On RatingsDirect). Because we limit our rating on Turk Telekom to two notches above the sovereign foreign currency rating, a downgrade of Turkey would lead us to lower our rating on the company. In addition, we cap the rating on Turk Telekom at the 'BBB-' 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.

The rating on Turk Telekom is supported by the company's strong leadership position in domestic fixed-line business, its extensive network infrastructure, still good growth prospects (although we see heightened downside risks on revenues and margins if the weaker economic environment affects consumer spending), solid profitability, and leverage below 2.25x. Our

base-case assumptions for Turk Telekom have not changed materially since our latest publication ("Outlook On Turk Telekom Revised To Stable After Similar Action On Sovereign; 'BBB-/A-3' Ratings Affirmed," published Nov. 10, 2016) because we already assumed meaningful depreciation of the lira. However, after the recent sharp depreciation of the lira (about 25% against the dollar and the euro since Sept. 30, 2016), we now expect leverage will exceed 2.0x in 2017. This is because Turk Telekom had about \$3.6 billion-equivalent of unhedged gross financial debt as of Sept. 30, 2016, denominated in U.S. dollars and euros (\$3.1 billion after deducting hard currency cash). However, in the absence of further significant depreciation, we expect leverage will remain below 2.25x over our forecast period.

Our rating on Turk Telekom is higher than the sovereign foreign currency credit rating on Turkey because Turk Telekom 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 organic EBITDA. We continue to assess that the rating on Turk Telekom can exceed the sovereign rating by two notches. This is because we understand that management keeps half of its cash in hard currencies, and aims to keep 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 short-term debt maturities and capital expenditure.

Liquidity

We assess Turk Telekom's liquidity as adequate. We calculate the ratio of liquidity sources to uses for the 12 months started Sept. 30, 2016, at about 1.2x.

Principal liquidity sources include:

- Reported cash balances of about Turkish lira (TRY) 3.2 billion (\$1.1 billion);
- Funds from operations (FFO) of about TRY4.9 billion; and
- Undrawn committed facilities of about TRY375 million.

Principal liquidity uses include:

- Debt maturities of about TRY2.4 billion;
- Capital expenditures of about TRY4 billion, including spectrum payments, although we note that a meaningful amount is discretionary;
- Minor working capital outflow; and
- Dividend payments.

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 because it faces meaningful debt maturities in foreign currencies in 2017.

Turk Telekom has to comply with two financial covenants: a net leverage ratio below 2.5x and an interest coverage ratio above 4x. In our base case, we

estimate that Turk Telekom will maintain headroom of about 15% under these covenants in 2017.

Outlook

The negative outlook on Turk Telekom reflects the negative outlook on Turkey, meaning that a negative rating action on the sovereign could lead to a downgrade of Turk Telekom.

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 because of deterioration in Turkish corporations' access to domestic and external liquidity, or if we believed the business risk of operating in Turkey had materially increased.

Furthermore, we could also lower the rating on Turk Telekom if the S&P Global Ratings-adjusted debt-to-EBITDA ratio increased beyond 2.25x, with adjusted FFO to debt below 40%, for a prolonged period. We think this could be caused by further adverse foreign exchange movements or weaker-than-expected operating developments, for instance from fierce price competition coupled with market share losses.

Upside scenario

We could revise our outlook to stable if we took the same action on the sovereign. We could also change the outlook to stable if we believed Turk Telekom had substantially improved its ability to survive a sovereign stress scenario--for example through greater liquidity or currency risk mitigation--thereby giving it additional scope to be rated above the sovereign.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Negative/A-3

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 rating analysis: Neutral (no impact)

Related Criteria

- 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
- 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: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Republic of Turkey Outlook Revised To Negative; Ratings Affirmed, Jan. 27, 2017
- Outlook On Turk Telekom Revised To Stable After Similar Action On Sovereign; 'BBB-/A-3' Ratings Affirmed, Nov. 10, 2016

Ratings List

Ratings Affirmed; Outlook Action

| | To | From |
|-------------------------|-------------------|-----------------|
| Turk Telekom | | |
| Corporate Credit Rating | BBB-/Negative/A-3 | BBB-/Stable/A-3 |
| Senior Unsecured | BBB- | BBB- |

Additional Contact:

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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