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Ratings

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Research Update:

Turk Telekom 'BB-/B' Rating Affirmed On Improving Credit Ratios; Outlook Remains Stable

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Table Of Contents

Table Of Contents (cont.)

Research Update:

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Rating Action Overview

- We now expect a stronger Turkish lira against the U.S. dollar at 5.50 in 2019, compared with 6.90 in our previous base case.
- Given that 72% of Turk Telekom's debt is denominated in U.S. dollars, the stronger lira, alongside cost-reduction initiatives, results in improved ratios for 2019-2020, notably S&P Global Ratings-adjusted debt to EBITDA of around 2.0x and free operating cash flow to debt above 10%, compared with 2.0x-2.5x and 10%-15%, respectively, in our previous forecast.
- Although Turk Telekom's stronger credit metrics have prompted us to reassess the stand-alone credit profile to 'bbb-' from 'bb+', the ratings on Turk Telekom are capped by our transfer and convertibility (T&C) assessment on Turkey.
- We are therefore affirming our 'BB-/B' ratings on Turk Telekom and are assigning our 'BB-' issue rating to the company's proposed U.S. dollar-denominated benchmark-size senior unsecured notes.
- The stable outlook reflects our stable outlook on Turkey and our expectation that Turk Telekom will maintain solid operational performance.

Rating Action Rationale

The affirmation reflects the improved Turkish lira (TRY) against the U.S. dollar, coupled with Turk Telekom's focus on cost efficiency. These efforts translate to better free cash flow generation and debt to EBITDA. We also incorporate into our analysis our ratings on Turkey (unsolicited, foreign currency B+/Stable/B, local currency BB-/Stable/B).

The lira has stabilized since August 2018, ending the year at TRY5.3 for $1, stronger than our previous forecast of TRY6.90:$1. This led us to revise our foreign exchange assumptions by about 15%-25% for 2019-2020, and we anticipate it will positively affect projections of Turk Telekom's debt and capital expenditures (capex), since the majority of the company's debt and about 50% of its capex are denominated in U.S. dollars and euros.

Although inflationary pressure persists (S&P Global Ratings' assumption for consumer price index (CPI) growth to peak at about 20% in 2019, before tapering off to less than 10% in 2021), we expect Turk Telekom will likely maintain relatively stable margins of around 37% (as adjusted by S&P Global Ratings) throughout our forecast period. This is mainly since we expect the company's focus on cost efficiency, especially on the commercial costs, to offset the inflationary pressures. We continue to expect Turk Telekom will have stronger free operating cash flow (FOCF) generation than its peer Turkcell, mainly thanks to the former's leading position in the higher-margin fixed segment position.

As a result, we now expect adjusted FOCF to debt will exceed 10% and adjusted debt to EBITDA will fall to about 2x from 2019. This compares with FOCF to debt between 10% and 15% and debt to EBITDA between 2.0x-2.5x for 2019 in our previous forecast (debt to EBIDTA stood of 2.4x in 2018).

Our views of Turk Telekom's business risk profile and our ratings above the sovereign assessment are unchanged. In addition, the recent ownership change has no impact on our view at this time, since we consider that Turk Telekom's articles of association constrain the special purpose vehicle's influence on Turk Telekom's dividend policy. We still expect a subsequent change in ownership of Turk Telekom at some point but have no details about timing or potential implications of a longer-term shareholder, which we would assess once it takes place. For more details, see our full analysis "Turk Telekom," published Dec. 12, 2018, on RatingsDirect.

Outlook

The stable outlook reflects our stable outlook on Turkey and our expectation that Turk Telekom will maintain solid operational performance. Our current assessment of Turk Telekom's stand-alone credit profile incorporates our expectation that, in 2019, the company's adjusted debt-to-EBITDA ratio will remain below 2.25x and FOCF to debt will exceed 10%.

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 Turkey and revised up the T&C assessment.

Company Description

Turk Telekom is a former incumbent telecom 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 Dec. 31, 2018, Turk Telekom reported 9.9 million fixed-voice lines, 10.9 million broadband internet subscribers, and 21.5 million mobile subscribers.

In December 2018, Turk Telekom announced the completion of the transfer of the shares from Ojer Telekomünikasyon A.S's ("OTAS"), which owned 55% of the shares, to Levent Yapilandirma Yonetimi A.S. (LYY). LYY is a special purpose vehicle owned by the group of lenders of OTAS, including Akbank (35.6%; not rated), Turkiye Garanti Bankasi (22.1%; B+/Stable/--), and Turkiye Is Bankasi (11.6%; B+/Negative/B). The Turkish government (including the Turkish Wealth Fund) holds a 31.7% stake in Turk Telekom.

Our Base-Case Scenario

- Consumer price index (CPI) growth of 19.6% in 2019 and 11.9% in 2020, versus 16.9% in 2018.
- The lira to remain at 5.50 in 2019, followed by a depreciation to 5.85 and 6.00 in 2020 and 2021, respectively.
- Revenue growth above 10% for 2019-2020 thanks to of the company's ability to pass on most inflationary pricing to customers, continued expansion in broadband on the back of penetration-focused campaigns, and increased TV subscribers thanks to its multi-play offering, and its gradually rising market share in the mobile segment.
- A stable adjusted EBITDA margin of about 37% in 2019-2020 (38.9% in 2018), supported by top-line growth and continued cost efficiencies. We expect the cost optimization efforts, especially on commercial side to offset the impact of inflationary pressure expected in H2 2019.
- Capex (excluding spectrum fees) to sales to be 19%-20% in 2019-2020, against 20% in 2018.
- No dividends in 2019, to incorporate the net loss in 2018 caused by the weaker lira. However, we expect the company to distribute dividends from 2020, in line with historical trends, assuming no further weakening of the lira.

Based on our assumptions, we expect the following progression of S&P Global Ratings-adjusted credit metrics:

- Debt to EBITDA at around 2.0x in 2019 and 2020, from 2.4x in 2018.
- Funds from operations (FFO) to debt at around 40%-45% in 2019 and 2020, improving to about 50%-55% in 2021; from 37% in 2018.
- FOCF to debt at around 10%-15% in 2019, improving to around 15%-20% in 2020; from 15.8% in 2018.

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 1.2x in the 12 months from Dec. 31, 2018. In our view, the company has sound relationships with its banks.

Principal liquidity sources:

- Reported cash balances of about Turkish lira (TRY) 4.5 billion;
- FFO of about TRY7.4 billion;
- Undrawn committed facilities of about TRY 360 million (EUR denominated); and
- Debt issuance of TRY2.6 billion (denominated in U.S. dollars).

Principal liquidity uses:

- Debt maturities of about TRY6.8 billion; and
- Capex of about TRY4.8billion.

Covenants

Turk Telekom must comply with two financial covenants: a net leverage ratio below 2.5x and an interest coverage ratio above 4x for the majority of its bank loan facilities. Based on our base case, we note that Turk Telekom will have significant (above 30%) headroom under its covenants.

Issue Ratings - Recovery Analysis

Key analytical factors

- Turk Telekom's senior unsecured debt, existing and the proposed, 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.
- In our hypothetical default scenario, we assume 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
- Jurisdiction: Turkey

Simplified waterfall

- Minimum capex (percentage of past-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 TRY2.9 billion
- Implied enterprise value (EV) multiple: 6x
- Gross EV at default: about TRY17.8 billion
- Administrative costs: 5%
- Net value available to debtors: TRY16.9 billion
- Unsecured debt claims[1]: about TRY23 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%.

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-

- Sovereign foreign currency rating: B+
- Transfer & Convertibility Assessment: BB- (caps the ratings)
- Rating above the sovereign: (-3 notches from SACP)

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, Dec. 12, 2018

Ratings List

Ratings Affirmed

Turk Telekom	
Issuer Credit Rating	BB-/Stable/B
Senior Unsecured	BB-
Recovery Rating	3(65%)

New Rating

Turk Telekom	
Senior Unsecured	BB-
Recovery Rating	3(65%)

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