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Summary:

Turk Telekom

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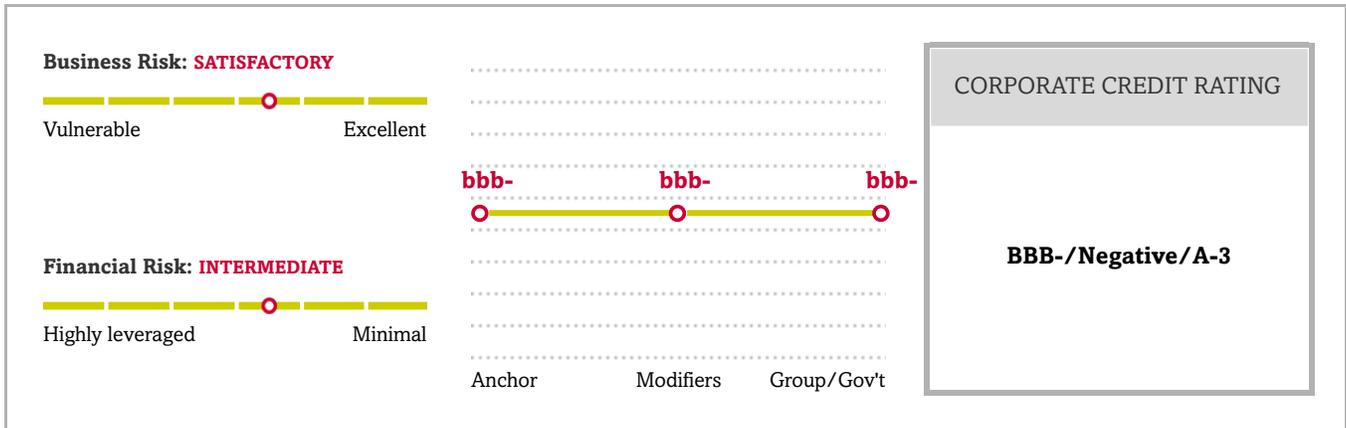
Ratings Score Snapshot

Related Criteria

Related Research

Summary:

Turk Telekom



Rationale

Business Risk: Satisfactory	Financial Risk: Intermediate
<ul style="list-style-type: none"> • Dominant position in Turkey's fixed-line segments, with an 86% market share in voice, and 62% in retail broadband. • Extensive network infrastructure, with 98% fixed-line household coverage and 81% long-term evolution (LTE) population coverage. • Strong profitability, with an adjusted EBITDA margin of 37%-38%. • Exposure to country risks in Turkey. • Challenger position, albeit expanding, in the competitive Turkish mobile telephony market, with a 25% market share. 	<ul style="list-style-type: none"> • Moderate financial leverage, with adjusted debt to EBITDA temporarily above 2x, supported by a conservative financial policy. • Improving, albeit weak free operating cash flows in 2017, mainly due to high capital expenditures, including spectrum fees. • Exposure to foreign exchange risk, primarily because only about 20% of its U.S. dollar- and euro-denominated gross financial debt is hedged (as of third-quarter 2017).

Outlook: Negative

S&P Global Ratings' negative outlook on Turk Telekom reflects the negative outlook on Turkey (foreign currency BB/Negative/B, local currency BB+/Negative/B), 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 transfer and convertibility (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.

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 for a prolonged period, with adjusted funds from operations (FFO) to debt below 40%. We think this could be caused by weaker-than-expected operating developments, for instance material adverse foreign exchange movements or fierce price competition, coupled with market share losses.

Upside scenario

We could revise our outlook to stable if we raised the sovereign rating on Turkey or revised our outlook on the sovereign to stable.

Our Base-Case Scenario

Assumptions	Key Metrics			
<ul style="list-style-type: none"> Revenue growth of about 10%-11% for 2017 and 2018, mainly driven by solid average revenue per user (ARPU) growth in fixed broadband and mobile segments, supported by convergence in both fixed and mobile. No major impact from the changes in the Special Communications Tax law, which will be implemented from Jan. 1, 2018. Rebound in adjusted EBITDA margin by about 3 percentage points compared with 2016, which was negatively impacted by Turkish lira (TRY) 430 million (about \$122 million) in foreign-exchange losses. This is supported by strong revenue growth and continued cost efficiencies. Gradual decline of the ratio of capital expenditures (capex) excluding spectrum fees to sales from 19% in 2016, to 17%-18% in 2017 and 2018, as the majority of the network upgrade and expansion has been completed. No dividends for 2017. Dividends distribution to resume from 2018, at about 90% of the previous year's net income. Depreciation of the lira against the U.S. dollar of 6% in 2017 and 11% in 2018, following a depreciation of 20% in 2016. 		2016a	2017e	2018e
	Revenue (bil. TRY)	16.1	17-18	19-20
	EBITDA margin* (x)	33.6	36-37	35-38
	Debt to EBITDA (x)*	2.8	2.0-2.5	1.5-2.5
	FFO to debt (%)*	29.5	38-39	40-45
	FOCF to debt (%)*	1.7	7-8	10-15
<p>*S&P Global Ratings adjusted ratios. A--Actual. E--Estimate. FFO--Funds from operations. FOCF--Free operating cash flow. TRY—Turkish lira.</p>				

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 primarily 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, 2017, Turk Telekom reported 9.5 million fixed voice lines, 9.4 million broadband internet subscribers, and 19.2 million mobile subscribers.

Following privatization in 2005 and an IPO in 2008, 55% of the company is owned by holding company, Oger Telecom, which is a joint venture between two Saudi companies--Saudi Oger and Saudi Telecom Co. (A-/Stable/A-2). The Turkish government (including 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, 2017, including an increasing presence in fiber, given fixed-line household coverage of 98%. As a result, we expect Turk Telekom to benefit from broadband household penetration growth in Turkey, which currently stands at 50%, and from increasing demand for higher broadband speed 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 14% of revenues in third-quarter 2017, 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 consumer price index [CPI] growth between 7.9% and 10.8% in 2017 and 2018), 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 45% market share, and Turk Telekom is still the smallest operator with a subscriber market share of 25% as of Sept. 30, 2017, 5 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 significantly weaker than those of its competitor, Turkcell. That said, given Turk Telekom's spectrum purchase in 2015 and its high investments in the mobile business in recent years--notably providing 81% of the population with LTE coverage as of Sept. 30, 2017--we think its market position and profitability could further improve in coming years.

Financial Risk: Intermediate

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 2017 and 2018, after a temporary peak at about 2.8x in 2016 caused primarily by the lira depreciation and spectrum obligations. 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 2019). We also expect S&P Global Ratings' adjusted FFO to debt to recover well above 40% from 2018, and increase gradually thereafter.

These strengths are partly offset by Turk Telekom's temporarily weak FOCF in 2017 as it continues significant investments in mobile and fiber fixed networks, including large spectrum instalments (the final installment of TRY902 million out of the total TRY3 billion was paid in April 2017). Moreover, we take into account the company's limited discretionary cash flow generation, due to its dividend policy, which aims to maximize the distribution of Turk Telekom's available profit (based on the Capital Markets Board of Turkey's regulations). While there is no dividend for 2017 due to net losses incurred from the currency devaluation, we expect dividend payouts to resume at 90% of the previous year's net income from 2018. We understand that Turk Telekom's majority owner, Oger Telecom, has faced issues in servicing its debt. That said, we consider that Turk Telekom's articles of association constrain Oger Telecom's 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 have no indication whether there could be a change of ownership structure at Turk Telekom but, if that was the case, we would look at potential implications.

Turk Telekom has exposure to foreign-exchange risk, primarily because it had about \$3.3 billion-equivalent of unhedged gross financial debt as of Sept. 30, 2017, denominated in U.S. dollars and euros (\$2.9 billion after deducting hard currency cash). However, it generates almost all of its revenues and EBITDA in lira.

Liquidity: 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 more than 1.2x in the 12 months from Sept. 30, 2017.

In our view, the company has sound relationships with its banks. We think liquidity management has improved because there are no significant debt maturities in foreign currencies before 2019.

Principal Liquidity Sources	Principal Liquidity Uses
<p>As of Sept. 30, 2017, principal liquidity sources for the next 12 months include:</p> <ul style="list-style-type: none"> • Cash balances of about TRY2.7 billion (including cash of TRY0.4 billion deposited at banks related to collection protocols and automated teller machine collection). • Undrawn credit lines (excluding credit lines with Turkish banks) of about TRY0.3 billion. • FFO of about TRY5 billion. 	<p>For the same period, principal liquidity uses include:</p> <ul style="list-style-type: none"> • Short-term debt maturities of about TRY2 billion. • Modest working capital requirements. • Capex (excluding spectrum costs) of about TRY3.3 billion.

Covenant Analysis

Turk Telekom must 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 have sufficient headroom of more than 20% in 2017-2019.

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 Turk Telekom's rating can exceed the sovereign rating by two notches. This is because we understand that management keeps 61% of its cash in hard currencies as of Sept. 30, 2017, and aims at keeping 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.

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)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : bbb-

- **Related government rating:** BB

Related Criteria

- Reflecting Subordination Risk In Corporate Issue Ratings, September 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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: 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 Foreign And Local Currency Ratings Affirmed; Outlook Remains Negative, May 5, 2017
- Turk Telekom Outlook Revised To Negative After Similar Action On Sovereign; 'BBB-/A-3' Ratings Affirmed, Feb. 1, 2017

Business And Financial Risk Matrix						
Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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