S&P Global
Ratings

RatingsDirect®

Research Update:

Turk Telekom Rating Lowered To 'BB-' After Sovereign Downgrade; Outlook Stable

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

Research Update:

Turk Telekom Rating Lowered To 'BB-' After Sovereign Downgrade; Outlook Stable

Overview

- On Aug. 17, 2018, we downgraded Turkey to 'B+' from 'BB-', and assigned a stable outlook.
- We also revised to 'BB-' from 'BB+' 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.
- We continue to assess that our rating on Turk Telekom can exceed the sovereign rating by two notches, but we also cap it at the level of the T&C assessment on Turkey, since Turk Telekom is a nonexport company with over 90% of its revenues coming from the domestic market.
- We are consequently lowering our long-term rating on Turk Telekom to 'BB-' from 'BB+'.
- Furthermore, following the substantial weakening of the Turkish lira, we now expect much weaker credit ratios in 2018 and 2019, and are hence revising our stand-alone credit profile for Turk Telekom to 'bb+' from 'bbb-'.
- The stable outlook on Turk Telekom reflects our stable outlook on Turkey, and our expectation of continued solid operational performance

Rating Action

On Aug. 28, 2018, S&P Global Ratings lowered its long-term issuer credit rating on Turk Telekom to 'BB-' from 'BB+'. The outlook is stable. At the same time, we affirmed the 'B' short-term issuer credit rating.

We also lowered the issue rating on Turk Telekom's senior unsecured debt to 'BB-' from 'BB+'. The recovery rating remains at '3', indicating our expectation of meaningful (50%-70%) recovery (rounded estimate: 65%) for noteholders in the case of a default.

Rationale

The rating action on Turk Telekom follows our downgrade (and T&C revision) of Turkey on Aug. 17, 2018 (see "Turkey Long-Term Foreign Currency Rating Lowered To 'B+' On Implications Of Extreme Lira Volatility; Outlook Stable" on RatingsDirect). We cap our rating on Turk Telekom rating at the level of the T&C assessment on Turkey, which is now 'BB-', since Turk Telekom is a nonexport company with over 90% of its revenues coming from the domestic market.

In addition, we have revised down our assessment of the company's stand-alone credit profile (SACP) to 'bb+' from 'bbb-', primarily due to the significant recent depreciation of the lira (year to date as of Aug. 22, the lira has dropped 38% against the U.S. dollar), which results in our downward revision of credit ratios in 2018 and 2019. Since about 50% of Turk Telekom's capital expenditures (capex) are denominated in hard currencies, we expect to see a material increase in capex. Assuming an exchange rate of Turkish lira (TRY) 6.9 per U.S. dollar at year-end 2018, we estimate an increase in annual capex in 2018 of about TRY1.0 billion, versus our previous base case, to about TRY4.5 billion-TRY4.6 billion. As a result, we expect our free operating cash flow (FOCF)-to-debt ratio will weaken to about 6% in 2018 and 12% in 2019, from about 15%-20% in our previous, May 2018, forecast. In addition, we expect S&P Global Ratings' adjusted debt-to-EBITDA ratio will increase to about 2.9x at year-end 2018, compared with 1.9x in our previous forecast, before gradually declining in following years, assuming an unchanged exchange rate of TRY6.9 per US$1.

Our views on the SACP also reflect the company's:
- Strong position in its domestic fixed-line business (63% subscriber market share in retail broadband and 82% subscriber market share in wholesale broadband as of second-quarter 2018);
- Improving position, albeit at a slow pace, in mobile market (26% subscriber market share as of second-quarter 2018);
- Extensive network infrastructure (87% LTE [long-term evolution] population coverage); and
- Strong profitability, with our expectation of adjusted EBITDA margin at 37%-38% in 2018 and 2019.

Somewhat offsetting these factors is Turk Telekom's exposure to high country risks in Turkey and exposure to foreign exchange risk (approximately 43% of debt was hedged against U.S. dollar and euro as of second-quarter 2018).

Our rating on Turk Telekom can be 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 continue to 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 targets keeping about 80% of its cash in hard currencies as of June 30, 2018, and aims to keep sufficient cash reserves to serve its debt obligations in the next 12 months. Therefore, in the hypothetical case of further depreciation of the lira, we think the appreciation of the cash balance would offset the increase in unhedged short-term debt maturities and capex.

In our base case, we assume:

- Annual real GDP growth in Turkey of 4.0% in 2018 and 3.2% in 2019, compared with 7.0% in 2017.
- Consumer price index growth of 15.9% in 2018 and 14.5% in 2019, compared with 11.1% in 2017.
- Depreciation of the lira against the U.S. dollar of about 40% by year-end 2018 compared with year-end 2017.
- Revenue growth of above 10% for 2018-2019, mainly driven by solid average revenue per user growth in the fixed broadband and mobile segments, supported by convergence in both fixed and mobile.
- Stable adjusted EBITDA margin at about 37%-38% in 2018-2019 (from 36.9% in 2017) supported by top-line growth and continued cost efficiencies, but balanced by our view that the company may need some time to fully pass on rising inflationary pressures to customers.
- Increased capex in 2018 to reflect the adverse impact of currency on capex, as around 50% capex is in hard currency. We expect the ratio of capex (excluding spectrum fees) to sales to be at or above 20% in 2018-2020, from 18% in 2017.
- No dividends in 2019.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted debt to EBITDA at 2.9x in 2018 and declining to about 2.4x in 2019 (from 2.2x in 2017).
- Adjusted funds from operations (FFO) to debt at about 28%-30% in 2018 and 33%-35% in 2019 (from 37% in 2017).
- Adjusted FOCF to debt at 6% in 2018 and 12% in 2019 (from 11% in 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. However, we also foresee some tightening in the company's liquidity position and covenant headroom compared with our previous base case from May 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 June 30, 2018, compared with about 1.4x previously.

We estimate that principal liquidity sources for the 12 months from June 30, 2018, include:

- Reported cash balances of about TRY4.0 billion (approximately $1.0 billion);
- FFO of about TRY6.8 billion; and
- Undrawn committed facilities of about TRY490 million (denominated in U.S. dollar and euro).

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

- Debt maturities of about TRY5.8 billion; and
- Minimum required capex of about TRY2.5 billion (excluding impact adjustments for International Financial Reporting Standards [IFRS] 15 and IFRS 9).

Outlook

The stable outlook on Turk Telekom reflects 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 our adjusted debt-to-EBITDA ratio will be below 3x in 2019 and FOCF to debt above 5%.

Downside scenario

A negative rating action on the sovereign would 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.

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

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 Long-Term Foreign Currency Rating Lowered To 'B+' On Implications Of Extreme Lira Volatility; Outlook Stable, Aug 17, 2018

Ratings List

Downgraded; Ratings Affirmed

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

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

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.capitaliq.com. All ratings affected by this rating action can be found on 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.