Fitch Affirms Turk Telekom at 'BB+'; Outlook Negative

Fitch Ratings - London - 10 January 2019: Fitch Ratings has affirmed Turk Telekomunikasyon A.S.'s (TT) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BB+'. The Outlook on the IDRs is Negative.

TT is the leading integrated telecoms player in Turkey and operates the country's largest fixed network and the smallest of three but growing mobile networks. The company's national fixed-line coverage, good spectrum position and growing base of converged customers make it a strong competitor for Turkcell Iletisim Hizmetleri A.S (BB+/Negative) and Vodafone Group plc (BBB+/Stable). High leverage and exposure to foreign-currency risk remain a constraining factor for the rating but we see clear capacity for deleveraging as revenue and EBITDA grow against the backdrop of an expanding Turkish economy.

RATING ACTIONS

ENTITY/DEBT	RATING				PRIOR
Turk Telekomunikasyon A.S.	LT IDR	BB+	Affirmed		BB+
	LC LT IDR	BB+	Affirmed		BB+
senior unsecured	LT	BB+	Affirmed		BB+

KEY RATING DRIVERS

Turkey Downgrade Restricts Rating: On 13 July 2018 Fitch downgraded Turkey's Long-Term Foreign Currency IDR to 'BB'/Outlook Negative (see 'Fitch Downgrades Turkey to 'BB'; Outlook Negative' at www.fitchratings.com). The Turkish state and Turkish Wealth Fund own a combined 31.68% share of TT yet in our view the links between TT and the Turkish state are viewed as weak. This means TT's rating is not constrained by the Turkish sovereign rating but due to its exposure to the Turkish market the Foreign Currency IDR is capped by the Turkish Country Ceiling, which was also downgraded to 'BB+' on 13 July

2018.

The Local Currency IDR is not constrained by the sovereign Country Ceiling; the Local Currency IDR and Negative Outlook reflect our assessment of the liquidity and refinancing risks faced by the company in light of a volatile FX environment and TT's high exposure to foreign banks. Our Negative Outlook on the Foreign Currency IDR reflects that on Turkey's sovereign rating and our expectation that further negative action on the Country Ceiling would be reflected in TT's Foreign Currency IDR.

FX Mismatch: TT has a significant currency mismatch as almost all of its debt is denominated in US dollars and euros while most of its free cash flow (FCF) is generated in local currency. The company hedges part of its debt with an effective hedge ratio estimated at 57% at end-3Q18, an improvement to previous years, which, however, increases interest expense as hedges themselves are costly. The lira depreciated over 50% against the dollar and euro in the first nine months of 2018, which drove funds from operations (FFO)-adjusted net leverage for LTM 3Q18 to 2.4x, just 0.3x below our downgrade threshold of 2.7x. However, as the company can only pay a dividend of up to a maximum of 100% of distributable net income, any FX losses will reduce net income, which will lead to a fall in cash taxes and dividends paid in the following year.

FCF Generation Improving: We expect TT's FCF generation in 2018 to have exceeded recent years', with FCF margin in the low double-digit range. TT made profits in 2017 but will pay no dividends in 2018 to strengthen its balance sheet. Cash generation should improve in 2018 and we expect FFO adjusted net leverage to have dropped to 2.0x by end-2018, following a strengthening of the lira against the dollar and euro in the final quarter of the year. Controlling capex alongside any potential Turkish lira depreciation is going to be a key challenge for management, if TT is to protect its FCF generation and deleveraging capacity.

Shareholder Change Rating-Neutral: On 22 December 2018 the company announced that the 55% shareholding held by Ojer Telekomunikasyon AS (Otas) had been transferred to Levent Yapilandırma Yonetimi A.S. (LYY). We currently rate TT on a standalone basis with no support from any of its shareholders. We see no impact on TT's credit profile from the transfer of the stake given a strong dividend ring-fence around TT, which is unchanged following the ownership change.

Long-Term Concession Uncertainty: The ratings factor in some long-term uncertainty relating to the expiry of TT's fixed-line concession agreement with the Turkish government in 2026. Fitch does not rule out the risk that in the lead-up to the concession termination date, the views of TT's management, TT's main shareholder and the Turkish government on TT's operational and financial priorities may diverge. Fitch believes that TT's management will pursue a conservative financial policy to ensure that all debt could be repaid before the expiry of the concession agreement.

DERIVATION SUMMARY

TT has a similar operating profile to other European incumbent peers. The strength of TT stems mainly from its leading fixed-line operations in Turkey with its increasing fibre deployment a key advantage. It is also a fully integrated telecoms operator with a growing mobile market share and increasing pay-TV penetration. Leverage thresholds for its current ratings are tighter than for European peers due to higher risk from the FX mismatch between mainly hard currency debt and Turkish lira-denominated cash-flow generation. Even though the Turkish government owns a minority stake in TT, no parent/subsidiary linkage is applicable.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Revenue growth of 12.3% in 2018 followed by high-single digit growth thereafter;
- EBITDA margin of 39.1% in 2018, contracting to 37.4% in 2019 following inflation-linked cost rises and FX-based increases in non-lira operating costs;
- Capex at 22% of revenue in 2018, rising to 23% in 2019 as US dollar-capex becomes more expensive following the lira's depreciation in 2018;
- TRY4 billion of debt added in 2018 following the depreciation in the lira. Further lira depreciation is assumed in 2019-2020 and is expected to add an additional TRY2 billion of debt over these two years;
- No dividends paid in 2018 or 2019 for the 2017 and 2018 financial years. Ninety per cent of net profits expected to be paid in dividends from 2020-21.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
-TT's Foreign Currency IDR is currently constrained by Turkey's Country Ceiling of 'BB+'; therefore, a positive rating action is limited by the sovereign.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
-FFO-adjusted net leverage trending above 2.7x on a sustained basis.
-Material deterioration in TT's pre-dividend FCF margin, or in the regulatory or operating environment.
-Negative rating action on the Turkish sovereign and Country Ceiling, which could put pressure on TT's rating.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: TT faced material short-term maturities as at September-2018, the company has debt maturing in the next 12 months of TRY 7.7 billion. In our view, this should be covered by continued strong cash flow generation and good access to international credit facilities. However, refinancing risks remain and a reliance on short-term borrowings may exacerbate pressure on TT's liquidity profile in an uncertain FX environment.

TT reported free cash flow (FCF) of around TRY1.5 billion in 2017 and on LTM basis in 3Q18 this has risen to around TRY4 billion. We expect the company to remain FCF-positive in each of the next four years. At September-2018 the company had TRY6.2 billion of cash on the balance and access to unutilised credit lines of EUR81 million and USD8 million.

Additional information is available on www.fitchratings.com

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Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018) (/site/re/10023785)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018) (/site/re/10024585)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018) (/site/re/10036366)

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