

Research

Research Update:

South African Telecoms Service Provider Telkom 'BBB-' Rating Affirmed; Outlook Stable

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South African Telecoms Service Provider Telkom 'BBB-' Rating Affirmed; Outlook Stable

Overview

- South Africa-based telecommunications service provider Telkom has significantly cut its debt by about South African rand 2.4 billion, prompting us to revise our assessment of Telkom's financial risk profile to minimal from modest.
- Telkom continues to face pressure on revenues and margins from a combination of fixed-to-mobile switching and fierce competition, and we consider that the company's business risk profile limits our rating.
- We are therefore affirming our 'BBB-' long-term rating on Telkom.
- The stable outlook reflects our expectation of Telkom's improving operational performance and free operating cash flow, its maintenance of a solid capital structure and conservative financial policy, and its strengthened credit metrics, with Standard & Poor's-adjusted debt to EBITDA below 1.0x.

Rating Action

On Nov. 24, 2014, Standard & Poor's Ratings Services affirmed its 'BBB-' long-term corporate credit rating on South Africa-based telecommunications service provider Telkom SA SOC Ltd. The outlook is stable.

Rationale

The affirmation incorporates Telkom's improved financial risk profile, which we now assess as "minimal" versus "modest" previously. We base our revision on the company's deleveraging, which has strengthened its balance sheet and afforded it more financial flexibility at the current rating as it continues to pursue its turnaround strategy. However, this financial improvement does not offset our view of the company's "fair" business risk profile, which limits our rating. Telkom continues to suffer, in our opinion, from a structural decline in its fixed voice business, while facing tough competition in its mobile and data businesses.

We regard Telkom as a government-related entity (GRE). Under our GRE criteria, we consider there's a "low" likelihood that the South African government would provide timely and sufficient extraordinary support to the company if it encountered financial distress, based on Telkom's:

- "Limited" link with the government. The state owns 39.8% of Telkom, and although it has a track record of providing support to some GREs, we think it may not provide timely support to Telkom. We also consider that

the government's strategic priorities have on occasion compromised the company's. We do not expect that the link will strengthen in the next couple of years, particularly given the government's stated intent to sell down its ownership in private entities.

- "Limited" importance to the government. Telkom plays a key role in providing essential telecoms infrastructure and service throughout South Africa. However, we believe the government is more interested in the stability of Telkom's operations than in its credit standing. We think that responsibility for Telkom's business could readily continue without government ownership.

Our assessment of Telkom's business risk profile primarily reflects the company's very weak challenger position in South Africa's mobile telephony market, where Vodacom Group Ltd. and MTN Group Ltd. currently dominate. Although the company has ambitious plans to markedly strengthen its position in the market and it has recently begun to more rapidly grow its customer and revenue base, its market share remains in the low single digits. We think Telkom may face a hard time building a profitable mobile operation of scale in a mature market with strong and entrenched competition and fairly low profitability.

Telkom's dominant position in fixed-line telephony only partially offsets these risks, because of a gradual structural decline of revenues in the segment. Mobile penetration in South Africa, at over 100%, is more than 10x that of fixed-line penetration. Although we see good potential for Telkom to grow in fixed-line broadband, mobile broadband's pace of growth in South Africa is increasingly outpacing that of digital subscriber line (DSL) subscriptions, driven by 3G handsets and dongle products. At the same time, we assume that Telkom's profitability will rely more on cost cutting than improved pricing stemming from competition.

Our assessment of Telkom's financial risk profile primarily reflects its strong balance sheet and conservative financial policy. We believe Telkom's proposed network sharing agreement with MTN will enable cost-effective expansion of its mobile operations while retaining significant flexibility and liquidity to finance any further increase in capital expenditures. We therefore project that our ratio of adjusted debt to EBITDA will not exceed 1x in 2015, without extraordinary outlays related to acquisitions or litigations.

Although its revenues from traditional fixed-line business are declining, Telkom generates the bulk of consolidated cash flows via its fixed-line business, which helps the company absorb cash burn in the mobile division. Although we think cash flow will be negative in 2015 as a result of the company's potential acquisition of BCX, we expect at least South African rand (ZAR) 1 billion (€75 million) in discretionary cash flow for our fiscal 2015-2017 forecast period.

Telkom's capital structure leans toward short- and medium-term debt maturities. This remains commensurate with the current rating, as long as debt to EBITDA remains fairly low. Moreover, we anticipate that the company will

proactively address its refinancing needs.

Telkom continues to face litigation risk, which could lead to substantial cash payouts that could weaken credit metrics. Given the uncertainty of outcomes and timing, the ratings do not factor in the repercussions if these legal proceedings end unfavorably for Telkom. We will continue to closely monitor the future legal or economic implications of these lawsuits. Nevertheless, we believe it is essential for the group to maintain solid financial flexibility, notably good liquidity, to preserve its credit strength.

In our base case for Telkom, we assume:

- About ZAR33 billion of revenues in fiscal 2015, reflecting flat to low-single-digit revenue growth primarily on growing mobile and data revenues, helping to offset fixed-line voice declines. This excludes the potential acquisition of BCX. Thereafter, we expect a similar organic growth rate at between 1% and 2%.
- We expect Telkom's adjusted EBITDA margin to increase from 26% to 29% over the next three years. We expect that the mobile termination rate (MTR) schedule will continue to support margins by lowering Telkom's MTR costs by more than the associated negative revenue impact. We also think the company will benefit from its continued cost cutting related to retrenchment and its network sharing agreement with MTN.

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

- We expect adjusted debt to EBITDA (leverage) will fall slightly from 0.6x to 0.3x over the next three years, with incremental improvement thereafter.
- We expect adjusted funds from operations to debt will remain well above 100%.
- We expect significantly higher adjusted free operating cash flow to debt in 2015, at more than 40% on improved cash flow from operations and lower capital spending.
- Although cash flow will likely be negative if the BCX acquisition closes, we expect discretionary cash flow will remain comfortably above ZAR1 billion even after the resumption of dividend payments in 2015.

Liquidity

We assess Telkom's liquidity profile as "adequate," as defined in our criteria, supported by our expectation that the ratio of liquidity sources to uses will exceed 1.2x in 2015 and 2016. In addition, we assess Telkom's standing in capital markets as high and its financial risk management as very prudent. In addition, it has sound relationships with its banks.

For the fiscal year starting March 31, 2014, we estimate Telkom's liquidity sources at more than ZAR13.7 billion for fiscal 2015. These include primarily:

- Cash and liquid investments of about ZAR1.8 billion.
- Undrawn committed credit facilities totalling ZAR4 billion.
- Sizable and recurrent funds from operations of more than ZAR7.9 billion.

As of March 31, 2014, we estimate Telkom's liquidity needs at more than ZAR10.0 billion for fiscal 2015. These include primarily:

- Debt maturities of about ZAR1.2 billion.
- Sizable capital expenditures, including spectrum payments of ZAR5.7 billion.
- Annual shareholder dividends between ZAR0.5 billion and ZAR1.0 billion.
- Cash outflows related to the potential acquisition of BCX amounting to ZAR2.7 billion.

Outlook

The stable outlook on Telkom reflects our expectation that the company will generate stable underlying operating revenues over the next couple of years. We anticipate persistent mid-single-digit revenue declines from the company's core fixed-line voice business, offset by growth in its mobile and fixed-line data businesses, a continued focus on cost savings, and the maintenance of a solid capital structure and conservative financial policy over the next two years. We estimate Telkom's Standard & Poor's adjusted EBITDA margin in the 26%-29% range, with adjusted leverage well below 1.0x and funds from operations to debt well above 100%.

Upside Scenario

We could raise the rating if our view of Telkom's business risk profile improves, for example, if it successfully builds a sustainable competitive position in mobile and fixed data segments to offset its more mature fixed-line voice business, while maintaining robust free operating cash flow and adjusted leverage below 2x. We could also raise the rating if Telkom demonstrates an improvement in its adjusted EBITDA margin toward 30%-35%. To upgrade Telkom to higher than our foreign currency sovereign rating on South Africa (foreign currency BBB-/Stable/A-3, local currency BBB+/Stable/A-2), we would also need to assess that the company could withstand a hypothetical sovereign stress test under our criteria.

Downside Scenario

A downgrade is unlikely at this stage. However, we could lower the rating if revenues underperform our expectation, leading to adjusted leverage above 2x. This could occur if the fixed-line voice business shrinks more rapidly than we expect without offsetting growth in mobile or broadband because of price competition, negative regulatory changes, or poor execution. Although a remote scenario over the next two years, we could also lower the rating if we do not believe Telkom will generate positive free operating cash flow beyond 2015, due to outsized merger and acquisition activity or capital expenditures.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/--

Business risk: Fair

- Country risk: Moderately High
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Minimal

- Cash flow/Leverage: Minimal

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: Fair (no impact)
- Comparable ratings analysis: Neutral (no impact)

SACP: bbb-

- Sovereign rating: BBB-
- Likelihood of government support: Low (no impact)

Related Criteria And Research

- Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Ratings List

Ratings Affirmed

Telkom SA SOC Ltd.

Corporate Credit Rating

BBB-/Stable/--

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