MOODY'S
INVESTORS SERVICE

CREDIT OPINION
12 November 2019

Update

Rate this Research

RATINGS

Telkom SA SOC Limited

Domicile	South Africa
Long Term Rating	Baa3
Type	LT Issuer Rating - Fgn Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Telkom SA SOC Limited

Update of Key Credit Factors Following Sovereign Rating Action

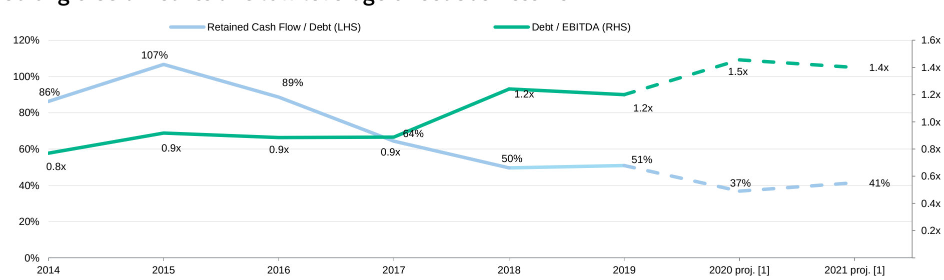
Summary

On 7 November 2019, Moody's changed Telkom SA SOC Limited's (Telkom) ratings outlook to negative following the affirmation of the Baa3 rating of the government of South Africa and a change in outlook to negative from stable on 1 November 2019. This action reflects Telkom's operational concentration in South Africa, exposing the company to the heightened risks associated with the operating environment in South Africa. As a result we view Telkom's ratings as being highly correlated with South Africa's long term bond rating and outlook.

Telkom's Baa3/Aa1.za long-term issuer ratings reflect our view of the fundamental credit quality of Telkom, represented by its Baseline Credit Assessment (BCA) of baa3, combined with our assumptions of high dependence on and moderate support from the South African government. We classify Telkom as a government related entity because it is 40.5% owned by the Government of South Africa.

Telkom's BCA of baa3 recognises the company's leading market position in South Africa's fixed-line business, with a growing presence in broadband and mobile offerings. It also reflects the transformation process of its business model and the execution challenges faced in the implementation of strategies to offset the structural decline in voice revenues. Telkom's low leverage and overall strong credit metrics for the rating category offset to some degree the company's operating and competitive challenges, as well as the larger capital investments required to deliver on its key strategies for the upcoming years.

Exhibit 1
Strong credit metrics and low leverage offset business risk



[1] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

Credit strengths

- » Leading market position in South Africa's fixed-line business, with the largest fibre network in South Africa based on fibre kilometres
- » Evolving business model, growing mobile business and right sizing of the cost base, which mitigate declining voice revenue
- » Strong credit metrics and liquidity

Credit challenges

- » Highly competitive telecommunications industry within broadband and mobile in South Africa
- » Structural decline in fixed-line voice revenue
- » Execution risk around Telkom's convergence strategies

Rating outlook

The negative outlook reflects Telkom's 100% operational concentration in South Africa, exposing the company to the heightened risks associated with the operating environment in South Africa. The outlook could be changed to stable if the Government of South Africa's rating is changed to stable.

Factors that could lead to an upgrade

Given the negative outlook, an upgrade is unlikely in the near-term. Subject to the South African government bond rating, we would consider an upgrade if:

- » Telkom is successful in its turnaround strategy to diversify the business away from the structural decline in voice revenue;
- » Telkom right sizes its cost base and demonstrates that its mobile business remains profitable such that the company's consolidated EBITDA margin is on an improving trajectory above 30% on an adjusted basis.

Factors that could lead to a downgrade

The ratings are likely to be downgraded in case of a downgrade of the Government of South Africa's rating. Negative pressure on Telkom's rating could also result from:

- » Higher-than-expected competitive threats or execution challenges in its mobile offering or bundled services;
- » EBITDA margin falling and remaining below 20% (fiscal 2019: 28.8%);
- » Leverage, as measured by debt/EBITDA, increasing towards 2.5x (fiscal 2019: 1.2x); and
- » Retained cash flow/total debt falling below 25% (fiscal 2019: 50.9%) on a sustained basis as a result of higher debt levels or dividend distribution.

All metrics are according to our standard definitions and analytic adjustments.

Key indicators

Telkom SA SOC Limited [1]

	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	2020-proj. [2]	2021-proj. [2]
Revenue (ZAR Billion)	31.3	32.8	37.3	41.0	39.7	41.8	43.2	44.7
Debt / EBITDA	0.8x	0.9x	0.9x	0.9x	1.3x	1.2x	1.5x	1.4x
RCF / Debt	86.2%	106.7%	88.6%	64.3%	49.3%	50.9%	36.8%	41.4%
(EBITDA - CAPEX) / Interest Expense	2.4x	4.6x	5.3x	2.9x	2.6x	3.0x	2.8x	2.6x

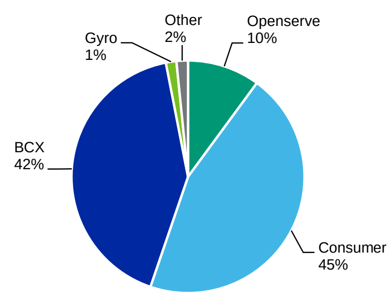
[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

Profile

Telkom SA SOC Limited (Telkom) is the dominant South African fixed-line operator and the fourth incumbent mobile operator, controlling around 2.3 million telephone access lines, most of which are connected to digital exchanges, and has 6.4 million active mobile subscribers, representing around 5.5% of the South African mobile market. As of 31 March 2019, the company had the largest fibre network across South Africa (around 80% of the South African fibre network), supporting more than a million broadband subscribers. Telkom operates across five segments: consumer (mobile, fixed-line and broadband), Business Connection Group (BCX)(ICT business services), Openserve (wholesale data), Trudon (digital online services), and Gyro (property portfolio).

Telkom is listed on the Johannesburg Stock Exchange and is 40.5% owned by the South African government, 11.9% by the Public Investment Corporation, a South African state-owned investment management company, and the remaining 47.6% is free float, as of 31 March 2019.

Exhibit 3
Telkom's revenue split by business segment
31 March 2019



Sources: Telkom, Moody's Investors Service

Detailed credit considerations

Leading fixed-line operator, but competition is intensifying

Our rating captures Telkom's dominant position as a provider of fixed-line operations, which is balanced by its small, but growing, mobile operations, and the intense competition the company faces in all three main areas of its operations: fixed-line voice, mobile and data/internet services. Telkom has an integrated telecoms business model, encompassing both fixed-line and mobile operations, and such a model is more robust and de-risks revenue compared with a single platform. This is mainly because Telkom can target a wider array of customers and segments, and is able to provide bundled packages, which single platform operators cannot. As a strong fixed-line and broadband incumbent, and as the fourth largest company in the South African wireless market, Telkom has a business model of pursuing a convergence strategy that offers a competitive advantage relative to its competitors.

We note the competition in South Africa is high because mobile operators pursue similar convergent strategies and fibre operators expand their networks and compete directly with Telkom. Telkom has implemented various measures to defend its market position, which include (1) improving the customer experience, (2) winning back traffic through fixed-to-mobile convergence and more competitive bundled packages and pricing tariffs, (3) leveraging next-generation network (NGN) technology to provide high-quality broadband and aggressive rollout of fibre past the home (2.8 million premises passed, of which 430,659 are fibre to the home and 2,390,235 are fibre to the cabinet), (4) encouraging customers to move to annuity-based bundles and calling plans, and (5) diversifying its revenue streams (BCX acquisition). These measures have largely been successful and have improved the quality of cash flow and reduced its dependence on fixed-line voice revenue.

Evolving business model mitigates fixed-line voice revenue decline

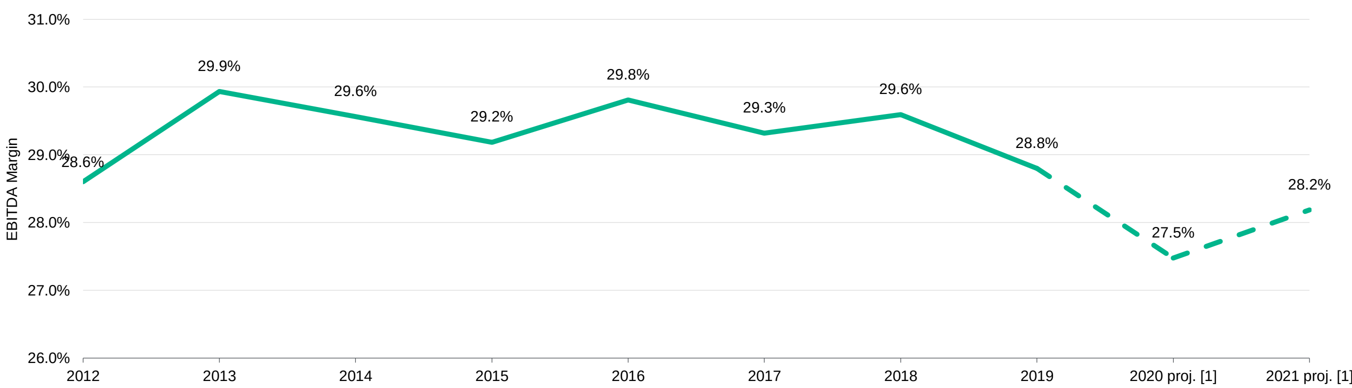
Telkom's fixed-line subscriber and usage continues its structural decline as customers migrate to mobile and broadband services, which has required Telkom to take corrective measures to change its business model to ensure it remains competitive and profitable. Telkom's transformational strategies focus on (1) improving profitability through cost optimisation (internal cost savings and exit of loss making operations), (2) growing its mobile operations and expanding its convergence strategy, and (3) rolling out fibre optic cable and growing its current position in broadband.

Part of Telkom's realignment strategy aims to establish itself as the leading South African converged (fixed/mobile voice and data) communication provider through the provisioning of a range of hosting services, managed solutions, mobile voice and wireless broadband services. Further, the acquisition of BCX in September 2015 has helped Telkom increase its ICT services to include cloud-based and data centre service, and bolster its lagging business/enterprise solutions offerings. The BCX acquisition has also diversified Telkom's revenue base towards alternative services and become less reliant on voice revenue (voice revenue contributed 33% to group revenue for fiscal 2019 versus 41% in fiscal 2016).

The adjusted EBITDA margin has been diluted as a result of the change in revenue mix with the acquisition of BCX, which has lower margins than Telkom's core businesses. We expect overall EBITDA margin to remain stable with the higher margin telecom revenues offsetting the lower margin IT revenues.

Exhibit 4

EBITDA margin is likely to remain under pressure due to changing revenue mix



[1] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

The implementation of the turnaround strategy to stabilise the business, which began in 2013, has been completed. Telkom is now focused on growing the businesses to be come the leading telecommunications provider of converged services which carried and element of execution risk given the challenging marco economic environment in South Africa. To facilitate and drive its strategy further, Telkom has implemented a more flexible and agile operating model and restructured its operations into five distinct and independent operating divisions, namely Openserve, BCX, Telkom consumer, Trudon and Gyro. This ensures the management in the various divisions are more targeted in their cost deployment and strategies, leading to greater accountability.

We expect Telkom to continue to focus on organic growth, with both smaller bolt-on acquisitions and appropriately prized larger opportunities, as management focuses on enhancing its existing operations. Depending on the size, acquisitions will be financed with a combination of operating cash flow, debt and equity and ensuring that Telkom maintains a conservative capital structure and healthy balance sheet. Acquisitions will only be pursued if it gives the company access to an operation that has sizeable market positions in its respective sector, similar to its BCX acquisition.

The telecoms industry faces ongoing uncertainties with regard to the regulatory environment in South Africa. There are a number of critical regulatory decisions that may affect Telkom that are difficult to assess at this stage, namely (1) future spectrum allocations, whereby access to spectrum below 1000 megahertz would offer a greater coverage with less infrastructure requirements for Telkom; and (2) the company's involvement in fulfilling the government's National Broadband Plan of providing wider internet access to the South African population, which may hurt Telkom's profitability.

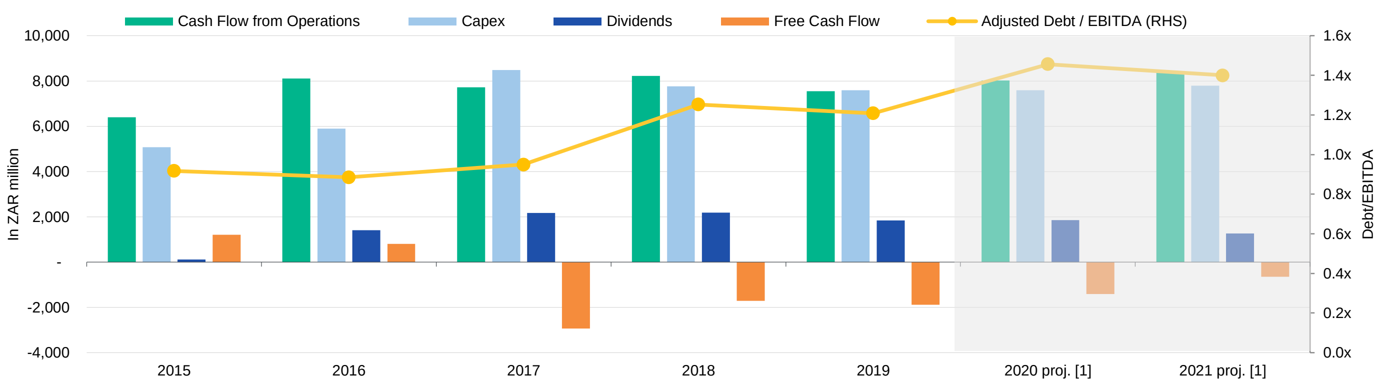
Financial credit metrics remain strong despite operating performance pressures

Despite declining fixed-line voice revenue, Telkom's operating results have been relatively stable. In the current weak economic environment, we expect low single-digit organic revenue growth in percentage terms over the next 12 to 18 months, with operating margin remaining under pressure. Telkom's growth strategy may entail higher economic, financial or political risks, and the execution risk of Telkom's transformation plan remains high and might take some time to fully materialise. However, the strong balance sheet in the form of low debt levels and leverage metrics gives Telkom the financial flexibility under the current rating to pursue its turnaround strategy. Furthermore, we expect Telkom to remain committed to an investment-grade rating by maintaining its conservative financial policies and preserving its strong financial credit profile. Management has maintained stable metrics, with reported net debt to EBITDA of 0.8x fiscal 2019, which is within the board target of below 1.0x. Reported net debt to EBITDA will increase to 1.2x as Telkom implement IFRS 16. Going forward reported leverage metrics will be more in line with Moody's adjusted leverage calculations.

Telkom is likely to maintain capital spending between ZAR7.5 billion and ZAR8 billion, or between 16% and 20% of revenue, with the deployment focused on the modernisation of its copper network to fibre and the expansion of its mobile infrastructure (making it less reliant on roaming agreements in high usage areas). Telkom's capital spending compares favourably with that of local competitors, MTN South Africa and Vodacom South Africa.

We expect operational cash flow to remain sufficient to meet Telkom's higher capital spending. However, the resumption of dividend payments (policy of 60% of headline earning per share) is likely to lead to marginal negative free cash flow, but without a material impact on debt levels or leverage metrics.

Exhibit 5
Expected moderate increase in leverage due to negative free cash flow generation



[1] Cash flow from operations shown excluding dividend payments
[2] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

South African government support and dependence assumptions result in no rating uplift

The default dependence assessment reflects the degree of correlation of a government-related issuer, such as Telkom, and its supporting government to being jointly susceptible to adverse circumstances that simultaneously move them closer to default. The high default dependence reflects our view that both the South African government and Telkom's performance are highly correlated to the general business cycle in South Africa. In addition, it factors the moderate link between the government and Telkom, given the firm's partial privatisation during the past decade and the presence of new entrants into both the fixed and cellular telecommunications market. Despite its 40.5% stake in Telkom, the South African government has no board representation, which limits its influence over the strategic direction of the company.

The moderate support assessment reflects the strategic role of the company in expanding telecommunications links to citizens in rural areas and in poorly serviced townships adjacent to large urban centres. The assessment also takes into account the government's moderate interventionist tendencies. Any reduction in government ownership could weaken our support assumption, but will not impact the overall rating position, given Telkom's strong standalone credit profile as reflected by the baa3 BCA, which is currently in line with that of the Government of South Africa.

Liquidity analysis

We take into consideration Telkom's liquidity profile to be adequate as it benefits from cash balances of ZAR1.6 billion, combined with liquid marketable securities of ZAR1.6 billion as of fiscal 2019 and expected positive operating cash flow of around ZAR8.2 billion per year. This is sufficient to meet its committed obligations over the next 18 months, which includes debt maturities of ZAR4.0 billion (includes the ZAR1.0 billion bond maturing in February 2020 and ZAR 800 million of commercial paper), planned capital spending and a dividend payment to shareholders.

Telkom has access to ZAR5.5 billion undrawn committed borrowing facilities with varying maturities. The facilities are subject to two financial covenants, interest cover and net leverage, which the company has been able to meet comfortably.

Rating methodology and scorecard factors

Our Rating Methodology for the Telecommunications Service Providers Industry, published in January 2017, sets out how we analyse the credit risk of telecommunications companies and arrive at their ratings. We expect the grid implied ratings to remain at Baa3 despite some minor weakening of credit metrics.

Exhibit 6
Rating Factors
Telkom SA SOC Limited

Rating Factors				
Telkom SA SOC Limited				
Telecommunications Service Providers Industry Grid [1][2]	**Current FY 3/31/2019**		**Moody's 12-18 Month Forward View As of 11/4/2019 [3]**	
Factor 1 : Scale (12.5%)	**Measure**	**Score**	**Measure**	**Score**
a) Revenue (USD Billion)	$3.1	B	$2.9 - $3.1	B
Factor 2 : Business Profile (27.5%)				
a) Business Model, Competitive Environment and Technical Positioning	B	B	B	B
b) Regulatory Environment	Baa	Baa	Baa	Baa
c) Market Share	Baa	Baa	Baa	Baa
Factor 3 : Profitability and Efficiency (10%)				
a) Revenue Trend and Margin Sustainability	Baa	Baa	Baa	Baa
Factor 4 : Leverage and Coverage (35%)				
a) Debt / EBITDA	1.2x	A	1.3x - 1.5x	A
b) RCF / Debt	50.9%	Aa	37% - 45%	A
c) (EBITDA - CAPEX) / Interest Expense	3.0x	Ba	2.6x - 3x	Ba
Factor 5 : Financial Policy (15%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Rating:				
a) Indicated Outcome from Scorecard		Baa3		Baa3
b) Actual Rating Assigned				Baa3
Government-Related Issuer	**Factor**			
a) Baseline Credit Assessment	baa3			
b) Government Local Currency Rating	Baa3			
c) Default Dependence	High			
d) Support	Moderate			
e) Final Rating Outcome	Baa3			

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 03/31/2019.
[3] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

Appendix

Exhibit 7
Peer comparison
Telkom SA SOC Limited

	Telkom SA SOC Limited			MTN Group Limited			Telefonica Brasil S.A.		
	Baa3 Negative			Ba1 Negative			Ba1 Stable		
(in US millions)	FYE Mar-17	FYE Mar-18	FYE Mar-19	FYE Dec-17	FYE Dec-18	LTM Jun-19	FYE Dec-17	FYE Dec-18	LTM Jun-19
Revenues	$2,921	$3,061	$3,049	$9,996	$10,223	$10,183	$13,534	$11,972	$11,328
EBITDA	$857	$906	$878	$4,135	$4,492	$4,305	$5,721	$5,927	$5,096
Total Debt	$795	$1,241	$1,008	$12,427	$12,678	$9,650	$6,446	$4,111	$3,725
Cash & Cash Equivalents	$120	$216	$99	$1,293	$1,101	$958	$1,221	$872	$1,528
EBITDA Margin	29.3%	29.6%	28.8%	41.4%	43.9%	42.3%	42.3%	49.5%	45.0%
(EBITDA-CAPEX) / Interest Expense	2.9x	2.6x	3.0x	1.7x	1.7x	1.9x	4.2x	6.6x	7.4x
Debt / EBITDA	0.9x	1.3x	1.2x	2.8x	3.1x	2.2x	1.2x	0.7x	0.7x
FCF / Debt	-27.5%	-11.7%	-12.9%	-4.4%	-4.3%	-5.9%	2.8%	-4.5%	13.1%
RCF / Debt	64.3%	49.3%	50.9%	26.0%	18.9%	27.0%	63.2%	104.5%	105.6%

[1] All figures are calculated using Moody's estimates and standard adjustments. FYE = Financial year-end. LTM = Last 12 months.
[2] Telefonica Brasil S.A.'s Ba1 rating is constrained by the Government of Brazil's rating (Ba2 stable).
Source: Moody's Investors Service

Exhibit 8
Moody's-adjusted debt breakdown
Telkom SA SOC Limited

(in ZAR Millions)	FYE Mar-14	FYE Mar-15	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19
As Reported Debt	**4,097**	**4,857**	**5,275**	**6,378**	**9,427**	**10,241**
Pensions	0	812	1,274	1,151	1,966	752
Operating Leases	3,021	3,105	3,300	3,135	3,312	3,546
Moody's-Adjusted Debt	**7,118**	**8,774**	**9,849**	**10,664**	**14,705**	**14,539**

[1] All figures are calculated using Moody's standard adjustments. FYE = Financial year-end.
Source: Moody's Investors Service

Exhibit 9
Moody's-adjusted EBITDA breakdown
Telkom SA SOC Limited

(in ZAR Millions)	FYE Mar-14	FYE Mar-15	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19
As Reported EBITDA	**10,474**	**9,223**	**8,952**	**10,824**	**10,580**	**10,706**
Pensions	-5	-810	-626	82	84	85
Operating Leases	1,007	1,035	1,100	1,045	1,104	1,182
Unusual	-2,223	113	1,701	62	-101	60
Non-Standard Adjustments	-3	0	0	0	70	-2
Moody's-Adjusted EBITDA	**9,250**	**9,561**	**11,127**	**12,013**	**11,737**	**12,031**

[1] All figures are calculated using Moody's standard adjustments. Financial year-end.
Source: Moody's Investors Service

Ratings

Exhibit 10

Category	Moody's Rating
TELKOM SA SOC LIMITED	
Outlook	Negative
Issuer Rating	Baa3
NSR LT Issuer Rating	Aa1.za

Source: Moody's Investors Service

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