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Research Update:

South Africa-Based Telkom SA SOC Ltd. Ratings Affirmed At 'BB+' On Solid Performance And Liquidity; Outlook Stable

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Overview

- On May 18, 2018, we affirmed our 'BB' sovereign rating on South Africa. Although its stand-alone credit profile is stronger, we currently limit our rating on South Africa-based Telkom to one notch above the sovereign rating.
- We are therefore affirming our foreign and local currency long-term issuer credit ratings on Telkom at 'BB+'.
- Telkom operates in an environment where economic growth is tentative and consumer spending still cautious, while solid business and financial risk profiles and adequate liquidity help maintain its stand-alone credit quality.
- The stable outlook on Telkom reflects that on South Africa, together with our expectation that Telkom will continue to exhibit resilience to a sovereign default scenario.

Rating Action

On Aug. 7, 2018, S&P Global Ratings affirmed its long-term issuer credit rating on South African telecommunications provider Telkom SA SOC Ltd. at 'BB+'. The outlook remains stable.

Rationale

The affirmation reflects Telkom's stand-alone creditworthiness, combined with our assessment that the government's significant ownership stake in Telkom caps the ratings at one notch above the long-term foreign currency rating on South Africa (BB/Stable/B).

We recently affirmed our rating on South Africa (see "Research Update: South Africa Foreign And Local Currency Ratings Affirmed At 'BB' And 'BB+'; Outlook Stable," published May 25, 2018, on RatingsDirect). We consider Telkom to be a government-related entity (GRE), because the South African government owns approximately 40% of it and it is classified as a state-owned enterprise under South Africa's Public Finance Management Act (PFMA). That said, Telkom has been exempted from several PFMA provisions. The exemption is linked to its listed status and the government's stake in Telkom remaining noncontrolling. This supports our view that the company is a self-governing GRE that has minimal operational, social mandate, and strategic interaction with the government. As a consequence of this, and the lack of historical interference in Telekom's operations, we see Telkom as having a limited link to the government. Furthermore, in our view, Telkom is of limited importance to the government--it is a for-profit enterprise and its operations can be easily assumed by other providers. We therefore assess Telkom's likelihood of receiving government support as low.

Based on our view of the low likelihood of government support, we do not cap the rating on Telkom at the foreign currency rating on South Africa. However, we do take cognisance of the conditionality of Telkom's PFMA exemption status, and its predominantly domestic operational orientation. Therefore, we cap our rating on Telkom at one notch above that on the sovereign after conducting a stress test on Telkom to assess the company's resilience under a hypothetical sovereign default scenario. The stress test includes a stress on earnings (20% haircut) and a 50% devaluation of the South African rand (ZAR).

Telkom's stand-alone credit profile (SACP) of 'bbb-' is supported by performance which is broadly in line with our base case, sustained adequate liquidity levels, and a strong commitment to maintaining a ceiling on net debt to EBITDA of 1.0x (FY2018: adjusted debt to EBITDA of 0.94x). Adjusted free operating cash flow (FOCF) was positive (ZAR860 million) in FY2018 (FY2017: negative ZAR250 million), while adjusted discretionary cash flow (DCF) remained negative, albeit without materially affecting leverage. Our assessment of Telkom's SACP is unchanged, and is based on our view of Telkom's business and financial risk profiles.

Our view of Telkom's business risk profile reflects its:

- Dominant position in the structurally declining fixed-line business; largely offset by increased fiber data penetration, together with a weak, but growing, position in the highly competitive mobile market.
- Broad information and communication technology product spectrum, with limited geographical scope as operations focus on the South African market.
- Lower margins relative to the domestic peer group, largely attributable to the fixed-line business orientation, and a rigid cost structure.
- Difficult operating environment, encompassing regulatory uncertainty, an evolving political landscape, and tentative economic growth and consumer spending.

Our view of the company's financial risk profile reflects its:

- Low leverage and positive funds from operations (FFO) for the current rating level.
- Robust liquidity position and solid fundraising capability to support modestly diminishing capital intensity.
- Clear guidance from management on commitment to maintain conservative leverage.
- Persistence of adjusted negative DCF beyond FY2019 and FY2020, partly reflecting working capital utilization remaining stable at FY2018 levels.

Telkom has issued debt, partly as part of its strategic decision to improve the term-matching of its balance sheet (by raising long-term debt to finance long-term capital expenditure). It has made notable progress in this area in 2018, raising about ZAR1.5 billion in long-term bonds between January and June 2018, some of which are earmarked to refinance expiring maturities.

Although we previously anticipated that adjusted DCF would turn positive in FY2019, we now anticipate an extended period in which adjusted DCF will remain negative. There are a number of factors behind our forecast, nonetheless, it chiefly stems from specific management choices, including the decision to refinance existing debt with longer maturities, while allocating operating cash flows to dividend payments, rather than debt reduction (given Telkom's current leverage below 1.0x). In addition, we considered Telkom's shareholder-friendly dividend payout policy and an expectation that debt-funded capital intensity will be slower to decline than previously forecasted.

The current dividend policy (60% of annual headline earnings--equating to around 75% of S&P Global Ratings-adjusted earnings) results in average cash payouts of around ZAR2 billion a year over the forecast period (FY2019-FY2020).

While S&P Global Ratings-adjusted DCF remained negative in FY2018, it was partly compensated for by the realization of around ZAR1.0 billion in marketable securities (not included in our adjusted DCF measure due to its nonoperational nature) which supported share repurchases. We understand that the remaining securities (around ZAR1.5 billion) are available for short-term realization, if required, and we include them in calculating Telkom's liquidity and adjusted debt. We also note the positive FOCF generation in FY2018; we expect FOCF will largely cover dividend payouts after FY2020. Our adjusted FOCF and DCF forecasts are based on the conservative assumption of negative ZAR400 million working capital utilization a year (in line with FY2018 levels) for the forecast period.

Although persistent negative DCF is already factored into our assessment, our view of Telkom's financial risk profile is also subject to maintaining adjusted debt to EBITDA of around 1.0x, and adjusted FFO/debt above 70%, in line with our base case.

Liquidity

We assess Telkom's liquidity as adequate. We anticipate that Telkom's strong cash flows and available facilities will exceed its commitments and obligations by more than 1.2x over the 12 months from July 1, 2018.

For the 12 months started July 1, 2018 we calculate the following principal liquidity sources:

- Unrestricted cash of around ZAR3.5 billion, including ZAR1.5 billion in cash-equivalent marketable securities, which Telkom intends to liquidate as required.
- Undrawn available committed revolving credit facilities (RCF) totaling ZAR4.5 billion. We discount ZAR1.0 billion issued under a commercial paper (CP) program from the total ZAR5.5 billion RCF, assuming the RCF is backstopping the CP.
- Our expectation of cash FFO of around ZAR8.8 billion.

For the same period, we calculate the following principal liquidity uses:

- Debt maturities of about ZAR1.7 billion.
- Negative (nonseasonal) working capital outflows of about ZAR400 million.
- Nondiscretionary capital expenditure of about ZAR7 billion.
- A cash dividend of about ZAR2 billion (assuming a dividend payout ratio of 60% of annual headline earnings, combined with 40% of interim headline earnings).
- No planned acquisition or mergers

We expect Telkom will maintain sufficient headroom under its financial covenants and headroom well over 15% on its interest coverage ratio (covenanted to remain above 3.5x), and net debt to EBITDA ratio (covenanted to remain below 3.0x).

Outlook

Our stable outlook on Telkom reflects the stable outlook on South Africa, and incorporates our expectation of top-line growth for Telkom of 2%-4%, supported by a modest pick up in the economic outlook for the country and, consequently, Telkom's operating environment.

Our 'BB+' rating on Telkom reflects our expectation that the company will maintain our growth and margin expectations such that adjusted debt to EBITDA will remain about 1.0x, FFO to debt over 70%, and DCF to debt will slowly become sustainably positive by FY2021. The rating also recognizes our expectation that the company's liquidity will remain at an adequate level, with sources of liquidity fully covering uses over a 12-month horizon starting July 1, 2018 even in a stress scenario associated with a hypothetical sovereign default.

We could revise down Telkom's SACP if we were to expect prolonged negative DCF to result in adjusted debt to EBITDA rising above 1.5x. This could occur if cash flows weaken considerably due to sustained aggressive capital expenditure or dividend policy. This could also result from poor operating performance, such as weak traction in the broadband business or a failure to maintain at least breakeven earnings in the mobile segment. However, all else being equal, a one-notch reduction in the SACP would not necessarily cause us to lower our rating on Telkom.

Downside Scenario

We could lower the rating on Telkom if we lowered our rating on South Africa to 'BB-', reflecting persistence of the weakening economic and fiscal trajectory of the country, and related increased pressures of operating in the South African market. We could also consider lowering the rating if a decline in liquidity left Telkom unable to pass our sovereign stress case, and we capped its rating at the level of our foreign currency rating on South Africa.

Upside Scenario

We could raise the rating if we took a similar action on South Africa, or if we believed the company's ability to withstand sovereign stress had improved, either as a result of significantly higher liquidity levels or moderated risk of negative intervention by the South African government.

We would also require the operating performance to be in line with our base case, and a supportive financial policy, with sustainable positive DCF and adjusted debt to EBITDA below 1.5x. However, we could accept leverage as high as 2x, if combined with stronger adjusted DCF of at least 15% of debt.

Ratings Score Snapshot

Corporate Issuer Credit Rating: BB+/Stable/--

Business Risk: Fair

- Country Risk: Moderately high
- Industry Risk: Intermediate
- Competitive Position: Fair

Financial Risk: Modest

- Cash Flow/Leverage: Modest

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

Stand-alone credit profile: bbb-

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

Related Criteria And Research

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 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 - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Research Update: South Africa Foreign And Local Currency Ratings Affirmed At 'BB' And 'BB+'; Outlook Stable, May 25, 2018
- Summary: Telkom SA SOC Ltd., April 18, 2018

Ratings List

	Rating	
	To	From
Telkom SA SOC Ltd.		
Corporate Credit Rating		
Foreign and Local Currency	BB+/Stable/--	BB+/Stable/--

Regulatory Disclosures

- Primary Credit Analyst: Omega Collocott, Director
- Rating Committee Chairperson: G.Andrew Stillman
- Date initial rating assigned: Nov. 20, 1995
- Date of previous review: Dec. 4, 2017

Disclaimers

This rating has been determined by a rating committee based solely on the committee's independent evaluation of the credit risks and merits of the issuer or issue being rated in accordance with S&P Global Ratings published criteria and no part of this rating was influenced by any other business activities of S&P Global Ratings.

This credit rating is solicited. The rated entity did participate in the credit rating process. S&P Global Ratings did have access to the accounts, financial records and other relevant internal, non-public documents of the rated entity or a related third party. S&P Global Ratings has used information from sources believed to be reliable but does not guarantee the accuracy, adequacy, or completeness of any information used.

Glossary

- Anchor: The starting point for assigning an issuer a long-term rating, based on its business risk profile assessment and its financial risk profile assessment.
- Business risk profile: This measure comprises the risk and return potential for a company in the market in which it participates (its industry risk), the country risks within those markets, the competitive climate, the company's competitive advantages and disadvantages (its competitive position).
- Comparable rating analysis: This involves taking a holistic review of a company's stand-alone credit risk profile (SACP), because each of the subfactors that ultimately generate the SACP can be at the upper or lower end, or at the mid-point, of such a range. It may also touch upon the overall comparative assessment of an issuer in relation to its peers across industry and jurisdiction and may capture some factors not (fully) covered, such as a short operating track record, entities in transition, unusual structures, or contingent risk exposures.

- Competitive advantage: The strategic positioning and attractiveness to customers of the company's products or services, and the fragility or sustainability of its business model.
- Competitive position: Our assessment of a company's: competitive advantage; operating efficiency; scale, scope, and diversity; and profitability.
- Country risk: This measures a country's influence on the overall credit risks for a rated company with regards to a country's economic, institutional and governance effectiveness, financial system, and payment culture/rule of law risks.
- Creditworthiness: Ability and willingness of a company to meet its debt and debt-like obligations; measured by assessing the level current and future resources relative to the size and timing of its commitments.
- Diversification/portfolio effect: Applicable to conglomerates. An assessment of the extent to which an entity's multiple core business lines are correlated and whether each contributes a material source of earnings and cash flow.
- Earnings: Proxy for profit or surplus yielded by an entity after production and overhead costs have been accounted for in a given period.
- EBITDA margin: This is EBITDA as a fraction of revenues.
- EBITDA: This is earnings before interest, tax, depreciation, and amortization.
- Financial headroom: Measure of deviation tolerated in financial metrics without moving outside or above a predesignated band or limit typically found in loan covenants (as in a debt-to-EBITDA multiple that places a constraint on leverage) or set for the respective rating level. Significant headroom would allow for larger deviations.
- Financial risk profile: This measure comprises our assessment of a company's cash flow/leverage analysis. It also takes into account the relationship of the cash flows the organization can achieve given its business risk profile. The measure is before assessing other financial drivers such as capital structure, financial policy, or liquidity.
- Free operating cash flow: Cash flow from operations minus capital expenditure.
- Funds from operations: EBITDA minus interest expense minus current tax.
- Government-related entity: An entity that could, under stress, benefit from extraordinary government support in order to meet its financial obligations; or conversely an entity controlled by a government that could be subject to negative extraordinary government intervention if the government is under stress.
- Industry risk: This addresses the major factors that affect the risks that companies face in their respective industries.
- Leverage: The level of a company's debt in relation to its earnings before interest, tax, depreciation, and amortization.
- Liquidity: This is the assessment of a company's monetary flows, assessed over a 12 to 24 month period. It also assesses the risk and potential consequences of a company's breach of covenant test, typically tied to declines in EBITDA.
- Management and governance: This addresses how management's strategic competence, organizational effectiveness, risk management, and governance practices shape the issuer's competitiveness in the marketplace, the strength of its financial risk management, and the robustness of its governance.
- Operating efficiency: The quality and flexibility of the company's asset base and its cost management and structure.
- Outlook: This is the assessment of the potential direction of a long-term issuer rating over the short to intermediate term (typically six months to two years).
- Rating above the sovereign assessment: Our assessment of whether an entity can be

rated above the sovereign rating on a jurisdiction it has a material exposure to.

- Scale, scope, and diversity: The concentration or diversification of business activities.
- Stand-alone credit profile (SACP): S&P Global Ratings' opinion of an issue's or issuer's creditworthiness, in the absence of extraordinary intervention or support from its parent, affiliate, or related government or from a third-party entity such as an insurer.
- Transfer and convertibility assessment: S&P Global Ratings' view of the likelihood of a sovereign restricting nonsovereign access to foreign exchange needed to satisfy the nonsovereign's debt service obligations.