25 April 2018

# Turkcell

## We prefer the TCELLT 5.8% 2028s to the 2025s

### Credit ratings

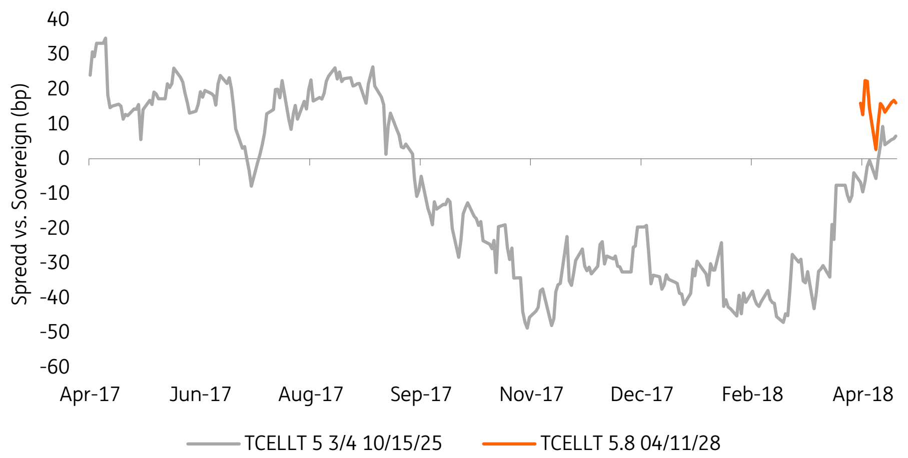
| | |
|---|---|
| **Moody's** | |
| Senior unsecured | Ba1/Stable |
| **S&P** | |
| Senior unsecured | BBB-/Neg |
| **Fitch** | |
| Senior unsecured | BBB-/Stable |

Source: Rating agencies, Bloomberg

Bloomberg: TCELLT
Turkey
Telecoms

**Turkcell (TCELLT) has become interesting again. Following a long period where its 2025 bond traded inside the sovereign, it has now repriced and trades at a small discount (see chart). The 2028 bond, issued in January, trades at a greater discount of 18bp outside the sovereign. While we continue to believe that the banking sector has greater value, we think that the TCELLT 5.8% 2028 bond represents a good opportunity to invest in a company that is operationally and financially strong (as we lay out in this report) and whose bonds are rated above those of the sovereign in investment-grade territory. TCELLT's latest earnings report outlined its strong profitability, modest leverage, decent currency hedging and an enthusiastic customer base. Combined with the recent softening of spreads, we think that the opportunity to invest in an investment grade bond, which currently trades at z+312, is hard to resist.**

**TCELLT 5.75% 2025 and 5.8% 2028 bonds – spread vs. sovereign**




Source: Bloomberg, ING

## Catalyst – 1Q18 earnings (credit positive)

TCELLT's 1Q18 results were very strong. Robust revenues of TRY 4.8bn (+18% YoY) and EBITDA of TRY 2.0bn (+44% YoY), boosted by increased data usage and increasing customer penetration, showed that TCELLT remains little affected by Turkey's geopolitical issues. The balance sheet was also solid. Net Debt / EBITDA of 0.8x is strong, despite a modest increase YoY (rising to 1.4x if we include Turkcell Consumer Finance, while the company's short FX position is now just $204mn. 69% of cash is held in FX to mitigate currency risk, while liability hedging reduces the FX component here from 79% to 35%. While some profitability metrics were inflated by new IFRS standards, this is nevertheless an impressive set of results which provided reassurance on currency exposures and balance-sheet strength.

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# TCELLT: Strong, and more to come

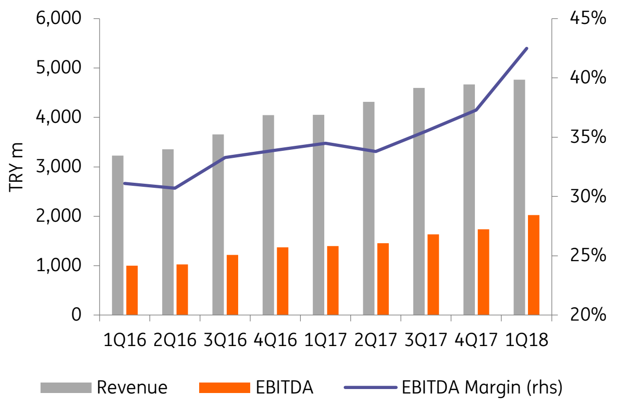
## Results highlights

- TCELLT's 1Q18 results were very strong. Robust revenues of TRY4.8bn (+18% YoY) and EBITDA of TRY2.0bn (+44% YoY) were driven by the strong ARPU performance of the Turkish operation (86% of Group revenues) following a solid performance by the data and digital services segments as smartphone penetration increased, the number of data users rose and data consumption grew. However, a change in IFRS accounting played its part; an 8ppt increase in EBITDA margins to 42.8% would have been a more usual – though still strong – 35.7% under the old rules.
- Nonetheless, this should not deflect from the company's very impressive performance. 59% of mobile customers are now in triple-play packages, up from 42.4% last year, while mobile blended ARPU rose 10.2% YoY to TRY33.6.
- The balance sheet was also solid. Net Debt/EBITDA of 0.8x is strong, despite a modest increase YoY (rising to 1.4x if we include Turkcell Consumer Finance, which is excluded under the new rules), while the company's short FX position is now just $204m, well within its $500m comfort zone.
- Use of hedging has also improved. 69% of cash is held in FX to mitigate currency risk, while liability hedging reduces the FX component here from 79% to 35%. In fact, despite the TRY volatility in the past year, the extra FX loss YoY amounts to just TRY49m, compared to an EBITDA gain of TRY622m.

## Earnings in detail

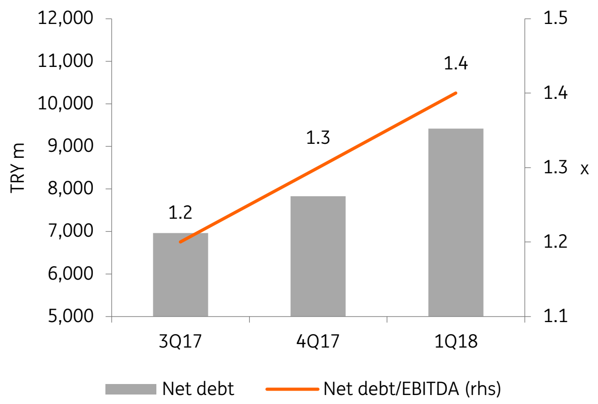
- Revenues increased by a very impressive 17.5% YoY to TRY4.8bn as past (and ongoing) investments in infrastructure and content bore fruit, particularly in 4.5G. As ever, Turkcell Turkey contributed the lion's share, with revenues rising TRY554m, with other subsidiaries adding TRY155m between them. EBITDA performance was even more impressive, rising 44.4% YoY to TRY2.0bn. The EBITDA margin rose a tremendous 8ppt YoY to 42.5%, mainly on higher revenues. New subscribers were added across all growth areas of the company in 1Q18: Mobile (+1.3m YoY to 34.6m) and Fibre (+63,000 to 1.2m) and TV (+133,000 to 2.4m). Note that the EBITDA figures were inflated by new accounting standards (see below).

**Fig 1 TECLLT - Revenue and EBITDA development**




Source: Company data, ING

**Fig 2 TCELLT - Debt and Leverage development**

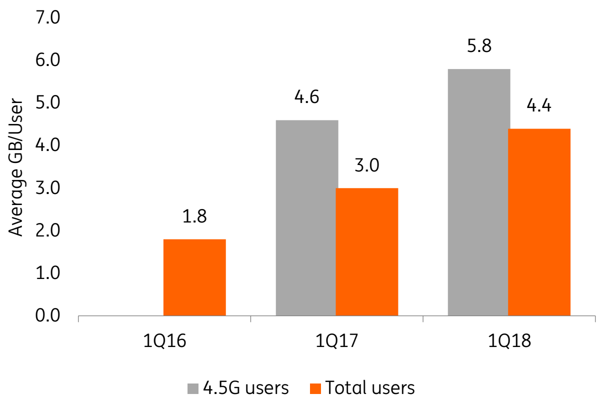



Source: Company data, ING

- As well as growing volumes, ARPU increased across all segments, as TCELLT saw further success in upselling products to customers. To illustrate the point, Fixed Residential ARPU increased 4.1% YoY to TRY55.3 as the number of fibre customers and data consumption rose, while Mobile Blended ARPU grew 10.2% to TRY33.6, as smartphone penetration rose – 70% of smartphones are now 4.5G compatible, with quarterly additions of c.1m – and average monthly data usage increased 47% YoY to 4.4GB per subscriber (rising to 5.8GB for the growing class of 4.5G users). Finally, TCELLT's mobile churn rate in 1Q18 was down to 4.2%, down from 5.0% in the prior-year period.

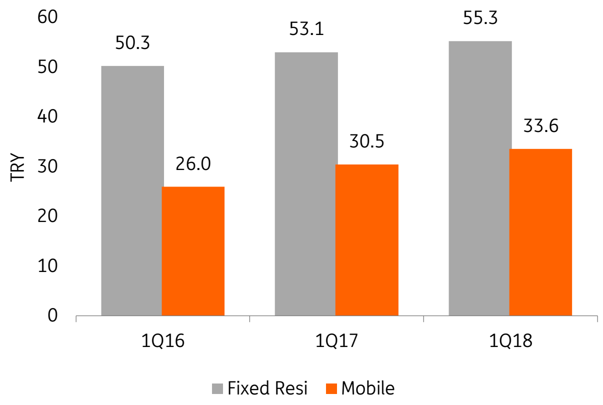
- Looking at the company's operations, 86% of revenues were generated by Turkcell Turkey (revenues +15.6% YoY to TRY4.1bn), 6% by Turkcell International (+12.6% to TRY 279mn) and 8% by Other Businesses (+51.0% to TRY 365mn). TCELLT began rolling out its 4.5G capabilities two years ago. Today, 89% of TCELLT's mobile customers are 4.5G subscribers, of whom 52% use a 4.5G-capable smartphone. These customers also use more data than their non-4.5G peers (see above), increasing ARPU for the company. The Organic Capex/Sales ratio declined from 13.2% to 11.5% over the period.

**Fig 3 TCELLT's customers are using more data...**




Source: Company data, ING

**Fig 4 ...pushing up ARPU**

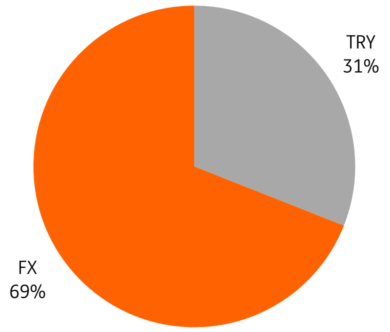



Source: Company data, ING

- Turning to the balance sheet, the increase in EBITDA failed to offset a rise in net debt from TRY 3.6bn to TRY 5.0bn QoQ, causing leverage to increase from 0.6x to 0.8x YoY. This number excludes Turkcell Consumer Finance, including which leverage rose from 1.3x to 1.4x over the period. This is still very healthy, and the company demonstrated good market access by launching a $500m 10 year bond in April at ms+324bp.

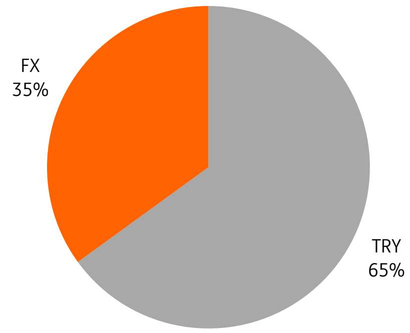
- The company has total gross debt outstanding of TRY15.1bn (including TRY 1.1bn from IFRS 16; see below), of which 38% will mature in the next twelve months. Net debt excluding IFRS 16 was TRY9.4bn. TCELLT has worked hard to reduce its FX risk. 69% of its cash pile is denominated in FX, while this holds true for only 35% of its debt (after hedging). The company maintains that its net FX short position is just $204m, down from $1.2bn in 2Q16.

**Fig 5 TCELLT holds most of its cash in FX…**




Source: Company data, ING

**Fig 6 …but hedges most of its debt into TRY**




Before hedging, 79% of debt is denominated in FX.
Source: Company data, ING

- As stated above, TCELLT has introduced new reporting standards: IFRS 9 (which governs the classification of financial assets and allows provisioning against expected losses), IFRS 15 (which governs the accounting of revenue from contracts with customers, essentially capitalising contract costs, which are then amortised as revenue flows in) and IFRS 16 (governing leases, on which right-of-use assets are recognised on the balance sheet and amortised over time, balanced by an equivalent increase in the Borrowings line). IFRS 9 did not have a significant impact on TCELLT's financial position. IFRS 15 inflated EBITDA by adding to Depreciation and Amortisation as customer contracts run down (IFRS 15 thus increased the cost of revenue by TRY84m in 1Q18). IFRS 16 increased Borrowings, as mentioned above, as well as adding TRY56m to finance costs as leases came due. In sum, these changes added TRY323m to revenues and inflated the EBITDA margin to 42.5%, from 35.7% if they are excluded.
- Looking forward, TCELLT continues to guide to revenue growth of 14-16% this year, along with higher EBITDA margins of 37-40% and operational capex/sales of around 18-19%. Following the strong performance in 1Q18, the new accounting rules that boost EBITDA, ongoing evidence of strong increases in data consumption and digitalisation and the slowdown in Capex as the investment cycle turns, we find these targets entirely credible.

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