Fitch Downgrades Sri Lanka Telecom to 'B' on Sovereign Downgrade

Fitch Ratings - Singapore,Colombo - 05 December 2018: Fitch Ratings has downgraded Sri Lanka Telecom PLC's (SLT) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'B' from 'B+'. The Outlook is Stable. The agency has affirmed SLT's National Long-Term Rating at 'AAA(lka)' with a Stable Outlook. We have also affirmed the national rating at 'AAA(lka)' on the LKR7 billion debt programme.

The rating action follows Fitch's downgrade of Sri Lanka's Long-Term Foreign- and Local-Currency IDRs to 'B' from 'B+' (see "Fitch Downgrades Sri Lanka to 'B'; Outlook Stable," dated 4 December 2018 on www.fitchratings.com).

SLT's IDRs are constrained by Sri Lanka's IDRs as per Fitch's Government-Related Entities Rating Criteria, as the state holds a majority stake in SLT directly and indirectly, and exercises significant influence on its operating and financial profile. SLT's second-biggest shareholder, Malaysia's Usaha Tegas Sdn Bhd at 44.9%, has no special provisions in its shareholder agreement to dilute the government's significant influence over SLT.

SLT's standalone credit profile, assessed by Fitch at 'BB', is stronger than that of its owner, reflecting the company's market-leading position in fixed-line services and second-largest position in mobile, along with its ownership of an extensive optical-fibre network. The standalone profile is also underpinned by its mid-single-digit percentage growth prospects, moderate estimated 2018 FFO adjusted net leverage of 1.7x and stable operating EBITDAR margin.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
HIDE RATING ACTIONS				
Sri Lanka Telecom PLC	LT IDR	B	Downgrade	B+
	LC LT IDR	B	Downgrade	B+
	Natl LT	AAA(lka)	Affirmed	AAA(lka)
senior unsecured	Natl LT	AAA(lka)	Affirmed	AAA(lka)
VIEW ADDITIONAL RATING DETAILS				

KEY RATING DRIVERS

Strong State Linkages: Fitch sees SLT's status, ownership and control by the Sri Lankan sovereign as 'Strong'. The state's ownership gives it significant influence over operating and financial policies. We view the support record and expectations for the likelihood of state support for SLT as 'Strong', given its strategic importance in expanding the country's fibre infrastructure. Historically, SLT has not required tangible financial support due to its healthy financial profile.

State's Incentive to Support: Fitch sees the socio-political implications of a default by SLT as 'Moderate' due to the presence of three other privately owned telcos. However, it could affect the fixed-line market because SLT acts as a policy company to invest in fibre networks across the island to support the government's vision of fibre-based internet for all households. Fitch also sees the financial implications of a default as 'Strong', as a financial default by SLT may have an impact on the availability and cost of financing options for other government-related entities.

High Capex, Negative FCF: We expect SLT to have negative free cash flow (FCF) during 2019-2020 (estimated 2018 negative FCF of LK2 billion-3 billion) as cash flow from operations may be insufficent to fund large capex plans to expand the fibre infrastructure and 4G mobile networks. SLT's 2019 capex is likely to remain high, at around 28%-30% of revenue, as it aims to complete its 4G population coverage to around 95% by end-2019.

We expect SLT to continue to invest in expanding fibre coverage as it aims to connect about 1 million homes by 2020-2021, from an existing 70,000 homes currently enable. Typically, SLT would need to lay fibre for at least 2 million homes to half of the households to be connected. We expect SLT's fibre investments to have low returns due to the country's low broadband tariffs. Dividends are likely to remain around LKR1.6 billion-1.8 billion in the next two to three years.

Data Drives Growth: We expect revenue to grow by a mid-single-digit percentage during 2019-2020 (barring any tax shocks), driven by data and fixed-broadband growth. We expect 4G smartphone penetration to improve from the current 25% with the proliferation of cheaper Chinese phones. Revenue rose strongly by 6.5% in the first nine months of 2018, driven by fixed-broadband and mobile usage after a temporary usage slump in 2017 due to higher taxes on voice and data. We expect the government's recent announcement on the removal of floor rates for voice call charges to have only a limited impact on growth.

Industry Consolidation, M&A Risk: We believe the recently announced merger between Hutchison Telecommunications Lanka (Private) Ltd and Etisalat Lanka (Private) Ltd is likely to relieve some competitive pressures that have undermined telecom companies' revenue and EBITDA growth in recent years. The merger is pending regulatory approval. Industry consolidation is likely to provide some relief from pricing pressure, especially in the data segment where telcos have not been able to fully capture the strong growth in data traffic.

SLT's National Long-Term Rating could come under pressure if it were to carry out a debt-funded acquisition of the smallest telco - Bharti Airtel Limited's (BBB-/Stable) Sri Lankan subsidiary, Airtel Lanka. However, any rating action will be based on the acquisition price, funding structure, and the financial and operating profile of the combined entity.

Stable Sector Outlook: Fitch's outlook for the Sri Lankan telco sector is stable as we expect the mean net leverage for SLT and mobile market leader, Dialog Axiata PLC (AAA(lka)/Stable), to remain stable at around 1.4x in 2019. We expect the sector's cash generation to improve, driven by higher mobile and broadband data usage, which will be insufficient, however, to fund the large capex requirement, leading to negative FCF. We also expect average operating EBITDAR margins to remain stable at around 34% (2018 estimate: 34%), driven by improving economies of scale in the data and home broadband segment, offsetting the negative impact of the changing revenue mix.

DERIVATION SUMMARY

SLT's standalone rating reflects its moderate financial profile and strong market position in the fixed-line industry segment, and second-largest position in the mobile market. SLT has lower exposure to the crowded mobile market and more diverse service platforms than Dialog. However, Dialog has a larger revenue base and better operating EBITDAR margin than SLT, while SLT's forecast FFO adjusted net leverage and FCF profile are worse than that of Dialog.

SLT has a larger operating scale and a wider EBITDAR margin than Hemas Holdings PLC (AA-(lka)/Stable), which is a diversified conglomerate with exposure to pharmaceuticals, fast-moving consumer goods, leisure and transport. Hemas is the largest private retail pharmaceutical distributor in the country and the second-largest home care and personal care manufacturer. Hemas's FFO adjusted net leverage is likely to be better than SLT's over the medium term.

KEY ASSUMPTIONS
Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Revenue to grow by the mid-single-digit percentage, driven by fixed-broadband and mobile data services in 2018-2019.
- Capex/revenue to remain high at around 28%-30% as SLT expands its fibre and 3G/4G networks.
- Operating EBITDAR margin to remain stable at around 29%-30%.
- Effective tax rate of 28%.
- Dividend payout of LKR1.6 billion-1.8 billion.

RATING SENSITIVITIES
Developments That May, Individually or Collectively, Lead to Positive Rating Action
- An upgrade in Sri Lanka's IDRs would result in corresponding action on SLT's IDRs;
- A weakening of links between SLT and the sovereign could result in SLT's Local-Currency IDR being
upgraded above Sri Lanka's Local-Currency IDR. However, SLT's Foreign-Currency IDR will remain constrained by
Sri Lanka's Country Ceiling of 'B'
There is no scope for an upgrade as SLT is at the highest rating on the Sri Lankan national ratings scale.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- A downgrade of Sri Lanka's IDRs would result in corresponding action on SLT's IDRs;
- A debt-funded acquisition of a smaller operator could threaten SLT's National Long-Term Rating, depending on
the acquisition price and the financial profile of the combined entity.

For the sovereign rating of Sri Lanka, the following sensitivities were outlined by Fitch in its Rating Action
Commentary of 4 December 2018:

The main factors that, individually or collectively, might lead to positive rating action are:
- Improvement in external finances supported by higher non-debt inflows, or a reduction in external sovereign
refinancing risks from an improved liability profile
- Improved policy coherence and credibility
- Stronger public finances, underpinned by a credible medium-term fiscal strategy

The main factors that could lead to negative rating action, individually or collectively, are:
- Further increases in external funding stresses that threaten the ability to repay external debt
- Continued political uncertainty that contributes to a loss of investor confidence, possibly affecting the
macroeconomic outlook
- A deterioration in policy coherence and credibility that leads to an increase in general government debt and deficit
levels.

LIQUIDITY AND DEBT STRUCTURE
Strong Access to Local Banks: At end-September 2018, SLT's liquidity - cash of LKR12 billion and committed undrawn bank lines of LKR13.5 billion - was sufficient to fund its short-term debt of LKR13.5 billion. We expect SLT to refinance its short-term debt in light of its access to local banks. It has demonstrated a solid track record of accessing capital from local banks and capital markets. Total debt was about LKR53 billion, out of which about 25% was denominated in US dollars.

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Corporate Rating Criteria (pub. 23 Mar 2018)
Sector Navigators (pub. 23 Mar 2018)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Government-Related Entities Rating Criteria (pub. 25 Oct 2018)

ADDITIONAL DISCLOSURES
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

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