FitchRatings

# Fitch Affirms Sri Lanka Telecom's IDR at 'B'; Withdraws Ratings

Fitch Ratings-Singapore-30 January 2019: Fitch Ratings has affirmed Sri Lanka Telecom PLC's (SLT) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'B'. The Outlook is Stable. The agency has simultaneously withdrawn the ratings for commercial reasons.

The ratings were withdrawn with the following reason
For Commercial Purposes

Key Rating Drivers
Ratings Constrained by Sovereign: Prior to the withdrawal, SLT's IDRs were constrained by Sri Lanka's IDRs of 'B' 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.

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 insufficient to fund large capex plans to expand the fibre infrastructure and 4G mobile networks. We expect SLT's 2019 capex to remain high, at around 28%-30% of revenue (2018 estimated: 30%), as it aims to complete its 4G population coverage to around 95% by end-2019. However, managment expects its capex/revenue to decline to around 18%-20% in 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 the 70,000 homes currently enabled. SLT would typically need to lay fibre for at least 2 million homes for 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-Driven 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: 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.

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 'BB' standalone credit profile, assessed by Fitch prior to the rating withdrawal, 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.

SLT has lower exposure to the crowded mobile market and more diverse service platforms than Dialog. However, Dialog has a larger revenue base, better operating EBITDAR margins, lower forecast FFO adjusted net leverage and a better FCF profile than SLT.

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 4G network.
- Operating EBITDAR margin to remain stable at around 29%-30%.
- Effective tax rate of 28%.
- Dividend payout of LKR1.6 billion-1.8 billion per year.

RATING SENSITIVITIES
No longer relevant as the ratings have been withdrawn.

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.

Sri Lanka Telecom PLC; Long Term Issuer Default Rating; Affirmed; B; RO:Sta
; Long Term Issuer Default Rating; Withdrawn; WD
; Local Currency Long Term Issuer Default Rating; Affirmed; B; RO:Sta
; Local Currency Long Term Issuer Default Rating; Withdrawn; WD

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Applicable Criteria
Government-Related Entities Rating Criteria (pub. 25 Oct 2018)
Sector Navigators (pub. 23 Mar 2018)
Corporate Rating Criteria (pub. 23 Mar 2018)

Additional Disclosures
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