FitchRatings

Fitch Affirms Sri Lanka Telecom at 'AA+(lka)'; Outlook Negative

Fitch Ratings - Singapore - 24 January 2020:

Fitch Ratings has affirmed Sir Lanka Telecom PLC's (SLT) National Long-Term Rating at 'AA+(lka)'. The Outlook is Negative. We have also affirmed the National Ratings on SLT's outstanding senior unsecured debentures at 'AA+(lka)'.

The Negative Outlook on SLT's rating reflects the Outlook on the Sri Lanka's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs).

KEY RATING DRIVERS

Strong State Linkages: SLT's ratings are constrained by the sovereign's as per Fitch's Parent and Subsidiary Rating Linkage criteria, as the state holds a majority stake in SLT directly and indirectly, and exercises significant influence on its operating and financial profiles. We assess the relationship between the sovereign and SLT as one of a weaker parent and stronger subsidiary with strong operational and strategic linkages.

SLT's second-biggest shareholder, Malaysia's Usaha Tegas Sdn Bhd, with a 44.9% stake, has no special provisions in its shareholder agreement to dilute the government's significant influence over SLT.

Negative FCF on High Capex: We expect SLT to have negative free cash flow (FCF) during 2019-2020 (2018: negative FCF of LKR3.4 billion), as cash flow from operations could be insufficient to fund capex needed to expand the fibre infrastructure and 4G mobile networks. We expect SLT's 2020 capex to remain high, at around 28%-30% of group revenue (estimated 2019: 30%-33%), as it aims to raise its 4G population coverage to around 100% (2019: 90%) by end-2020.

We expect SLT to continue to invest in expanding fibre coverage as it aims to connect about one million homes during 2020-2022, from the 200,000 homes currently enabled. SLT would typically need to lay fibre for at least two million homes to achieve one million connections. We expect SLT's fibre investments to have low returns due to the country's low broadband tariffs. Dividends are likely to remain around LKR2 billion a year in the next two to three years.

Lower Taxes to Boost Growth: We expect revenue to grow by mid-single-digit percentage in 2020, driven by data and fixed-broadband growth. We expect 4G smartphone penetration to improve from the current 50% with the proliferation of cheaper Chinese phones. SLT's 9M19 revenue growth slowed to around 6% due to higher taxes and flat blended mobile average revenue per user. However, we expect the government's recent announcement to reduce tax on telecommunication tariffs by 25%, reduce VAT to 8% from 15% and remove the 2% nation-building tax to support growth in 2020.

Further Industry Consolidation Probable: We expect Airtel Lanka, a subsidiary of Bharti Airtel Limited (BBB-/Rating Watch Negative) to seek M&A due to mobile competition and high capex requirements. The recently concluded merger between Hutch and Etisalat may relieve some of the competitive pressures that have undermined telecom companies' revenue and EBITDA growth in recent years.

Stable Sector Outlook: Fitch's outlook for the Sri Lankan telco sector is stable as we expect the 2020 mean funds from operations (FFO) adjusted net leverage for SLT and mobile leader Dialog Axiata PLC (AAA(lka)/Stable), to remain stable at 1.7x-1.9x (2019F: 1.7x-1.8x). We forecast average cash flow from operations for SLT and Dialog to improve to around LKR32 billion in 2020 (2019F: LKR28 billion), and for revenue and EBIDTA to rise by 5%-6% and 8%-10%, respectively.

The average operating EBITDAR margin should stay stable at around 34% (2019F: 34%) as improving economies of scale in the data and home-broadband segments offset the negative effects of a changing revenue mix.

DERIVATION SUMMARY

SLT's unconstrained standalone credit profile is stronger than that of the government of Sri Lanka, reflecting the company's market leadership 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 prospects for mid-single-digit revenue growth, moderate estimated 2019 FFO adjusted net leverage of 2.3x-2.4x, and stable operating EBITDAR margins.

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

SLT has a larger operating scale than leading alcoholic-beverage manufacturer Melstacorp PLC (AAA(lka)/Stable), which distributes spirits in Sri Lanka through its subsidiary, Distilleries Company of Sri Lanka (DIST: AAA(lka)/Stable). However, a significant portion of the country's alcoholic beverage consumption occurs outside the formal sector in which DIST operates. Melstacorp is also exposed to more regulatory risk in its spirits business due to increases in the excise tax, but this is counterbalanced by its entrenched market position and high entry barriers, as well as the importance of excise taxes to government revenue. Consequently, the company is able to pass on cost inflation and maintain operating EBITDAR margins, supporting substantially stronger free cash flow (FCF) generation than at SLT.

KEY ASSUMPTIONS

Fitch's Key Assumptions within Our Rating Case for the Issuer

- Revenue to grow by a mid-single-digit percentage annually, driven by fixed-broadband and mobile data services, in 2019-2020.

- SLT Group's Capex/revenue to remain high at around 30%-33% as it expands it fibre and 4G networks.

- Operating EBITDAR margin to remain stable at 29%-30%.

- Effective tax rate of 28% in 2019 and 24% during 2020-23.

- Dividend pay-out of LKR2 billion.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to a Revision of the Outlook to Stable:

A revision of the Outlook on the Sri Lankan sovereign's Long-Term IDRs to Stable from Negative

Developments That May, Individually or Collectively, Lead to Negative Rating Action

A downgrade in the Sri Lankan sovereign's Long-Term IDR would result in a downgrade on SLT's National Long-Term Rating.

For the sovereign rating of Sri Lanka, the following sensitivities were outlined by Fitch in the agency's Ratings Action Commentary of 18 December 2019:

The main factors that individually, or collectively, could trigger a downgrade are:

- Failure to place the gross general government debt/GDP ratio on a downward path due to wider budget deficits or the crystallisation on the sovereign balance sheet of contingent liabilities that are linked to state-owned entities or government-guaranteed debt.

- Increase in external sovereign funding stresses that threaten the government's ability to meet upcoming debt maturities, particularly in the event of a loss of confidence by international investors.

- A further deterioration in policy coherence and credibility, leading to lower GDP growth and/or macroeconomic instability.

The main factors that, individually or collectively, could lead to a revision of the Outlook to Stable:

- Stronger public finances, underpinned by a credible medium-term fiscal strategy that places gross general government debt/GDP on a downward path, accompanied by higher government revenue.

- Improvement in external finances, supported by lower net external debt or a reduction in refinancing risk; for example, from a lengthening of debt maturities or increased foreign-exchange reserves.

- Improved macroeconomic policy coherence and credibility, evidenced by more predictable policy-making and a track record of meeting previously announced economic and financial targets.

LIQUIDITY AND DEBT STRUCTURE
Reliant on Refinancing: At end-September 2019, SLT's cash balance of LKR9 billion was insufficient to cover its short-term debt of LKR19 billion. However, we expect SLT to roll over its maturing short-term debt given its solid access to local banks. It has demonstrated a solid track record of accessing capital from local banks and capital markets. The foreign-exchange risk stemming from US dollar denominated debt is mitigated through US dollar receipts that form about 9% (or USD40 million) of its revenue, which are provided mainly by international gateway operations, and through partial hedging of its US dollar debt.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS
SLT's ratings are capped by the sovereign rating of Sri Lanka, as discussed in the Key Ratings Drivers section.

RATING ACTIONS				
ENTITY/DEBT	RATING			PRIOR
HIDE RATING ACTIONS				
Sri Lanka Telecom PLC	Natl LT	AA+(lka)	Affirmed	AA+(lka)
senior unsecured	Natl LT	AA+(lka)	Affirmed	AA+(lka)
VIEW ADDITIONAL RATING DETAILS				

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA
Sector Navigators (pub. 23 Mar 2018)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)
Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019)
Government-Related Entities Rating Criteria (pub. 13 Nov 2019)
ADDITIONAL DISCLOSURES
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