MOODY'S INVESTORS SERVICE

CREDIT OPINION
7 April 2020

Update

Rate this Research

RATINGS

Telkom SA SOC Limited

Domicile	South Africa
Long Term Rating	Ba1
Type	LT Corporate Family Ratings
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Telkom SA SOC Limited

Update following the downgrade to Ba1, negative outlook

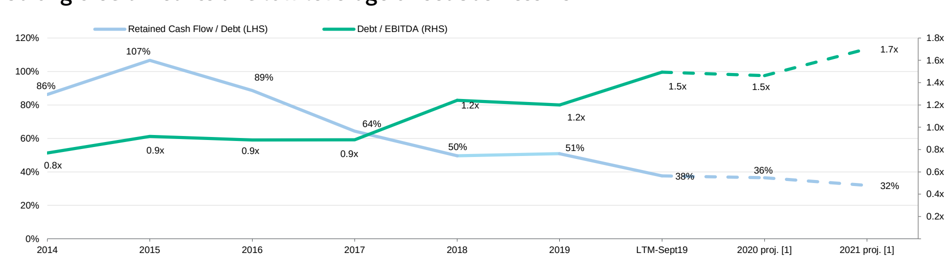
Summary

On 4 April 2019, Moody's downgraded Telkom SA SOC Limited's (Telkom) ratings to Ba1 and left the outlook on negative following the downgrade of the rating of the government of South Africa to Ba1 with a negative outlook on 27 March 2019. This action reflects Telkom's operational concentration in South Africa, exposing the company to the heightened risks associated with the operating environment in South Africa. As a result we view Telkom's ratings as being highly correlated with South Africa's long term bond rating and outlook.

Telkom's Ba1/Aa1.za long-term issuer ratings reflect our view of the fundamental credit quality of Telkom, represented by its Baseline Credit Assessment (BCA) of ba1, combined with our assumptions of high dependence on and moderate support from the South African government. We classify Telkom as a government related entity because it is 40.5% owned by the Government of South Africa.

Telkom's BCA of ba1 recognises the company's leading market position in South Africa's fixed-line business, with a growing presence in broadband and mobile offerings. It also reflects the transformation process of its business model and the execution challenges faced in the implementation of strategies to offset the structural decline in voice revenues. Telkom's low leverage, with Moody's adjusted debt to EBITDA of 1.5x as of last twelve months (LTM) ending 30 September 2019, and overall strong credit metrics for the rating category offset to some degree the company's operating and competitive challenges, as well as the larger capital investments required to deliver on its key strategies for the upcoming years.

Exhibit 1
Strong credit metrics and low leverage offset business risk



[1] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

Credit strengths

» Leading market position in South Africa's fixed-line business, with the largest fibre network in South Africa based on fibre kilometres

» Evolving business model, growing mobile business and right sizing of the cost base, which mitigate declining voice revenue

» Strong credit metrics and liquidity

Credit challenges

» Highly competitive telecommunications industry within broadband and mobile in South Africa

» Structural decline in fixed-line voice revenue

» Execution risk around Telkom's convergence strategies

Rating outlook

The negative outlook reflects Telkom's 100% operational concentration in South Africa, exposing the company to the heightened risks associated with the operating environment in South Africa. The outlook could be changed to stable if the Government of South Africa's rating is changed to stable.

Factors that could lead to an upgrade

Given the negative outlook, an upgrade is unlikely in the near-term. Subject to the South African government bond rating, we would consider an upgrade if:

» Telkom is successful in its turnaround strategy to diversify the business away from the structural decline in voice revenue

» Telkom right sizes its cost base and demonstrates that its mobile business remains profitable

» Leverage, as measured by debt/EBITDA, is below 2.0x

Factors that could lead to a downgrade

The ratings are likely to be downgraded in case of a downgrade of the Government of South Africa's rating. Negative pressure on Telkom's rating could also result from:

» Higher-than-expected competitive threats or execution challenges in its mobile offering or bundled services

» EBITDA margin falling and remaining below 20%

» Leverage, as measured by debt/EBITDA, increasing towards 3.0x

» Retained cash flow/total debt falling below 25% on a sustained basis as a result of higher debt levels or dividend distribution

» A deteriorating liquidity risk profile

All metrics are according to our standard definitions and analytic adjustments.

Key indicators

Exhibit 2

Telkom SA SOC Limited [1]

	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	LTM Sept-19	2020-proj. [2]	2021-proj. [2]
Revenue (ZAR Billion)	32.8	37.3	41.0	39.7	41.8	42.7	43.0	40.9
Debt / EBITDA	0.9x	0.9x	0.9x	1.3x	1.2x	1.5x	1.5x	1.7x
RCF / Debt	106.7%	88.6%	64.3%	49.3%	50.9%	37.6%	36.5%	31.9%
(EBITDA - CAPEX) / Interest Expense	4.6x	5.3x	2.9x	2.6x	3.0x	1.9x	2.8x	1.9x

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] This Represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

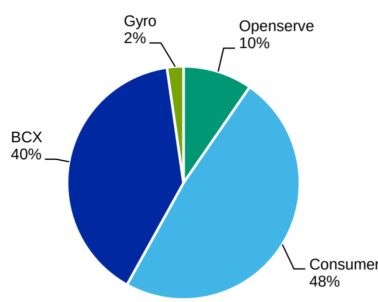
Profile

Telkom SA SOC Limited (Telkom) is the dominant South African fixed-line operator and the fourth incumbent mobile operator, controlling around 2.0 million telephone access lines, most of which are connected to digital exchanges, and has 11.8 million active mobile subscribers, representing around 9.5% of the South African mobile market. As of 30 September 2019, the company had the largest fibre network across South Africa (around 80% of the South African fibre network), supporting more than a million broadband subscribers. Telkom operates across five segments: consumer (mobile, fixed-line and broadband), Business Connection Group (BCX)(ICT business services), Openserve (wholesale data), Trudon (digital online services), and Gyro (property portfolio).

Telkom is listed on the Johannesburg Stock Exchange and is 40.5% owned by the South African government, 10.5% by the Public Investment Corporation, a South African state-owned investment management company, and the remaining 49.0% is free float, as of 30 September 2019.

Exhibit 3

Telkom's revenue split by business segment
LTM Ended 30 September 2019



Sources: Telkom, Moody's Investors Service

Detailed credit considerations

Leading fixed-line operator, but competition is intensifying

Our rating captures Telkom's dominant position as a provider of fixed-line operations, which is balanced by its growing mobile operations, and the intense competition the company faces in all three main areas of its operations: fixed-line voice, mobile and data/ internet services. Telkom has an integrated telecoms business model, encompassing both fixed-line and mobile operations, and such a model is more robust and de-risks revenue compared with a single platform. This is mainly because Telkom can target a wider array of customers and segments, and is able to provide bundled packages, which single platform operators cannot. As a strong fixed-line and broadband incumbent, and as the fourth largest company in the South African wireless market, Telkom has a business model of pursuing a convergence strategy that offers a competitive advantage relative to its competitors.

We note the competition in South Africa is high because mobile operators pursue similar convergent strategies and fibre operators expand their networks and compete directly with Telkom. Telkom has implemented various measures to defend its market position, which include (1) improving the customer experience, (2) winning back traffic through fixed-to-mobile convergence and more competitive bundled packages and pricing tariffs, (3) leveraging next-generation network (NGN) technology to provide high-quality broadband and aggressive rollout of fibre past the home (2.9 million premises passed, of which 458,905 are fibre to the home and 2,421,145 are fibre to the cabinet), and (4) encouraging customers to move to annuity-based bundles and calling plans. These measures have largely been successful and have improved the quality of cash flow and reduced its dependence on fixed-line voice revenue.

Evolving business model mitigates fixed-line voice revenue decline

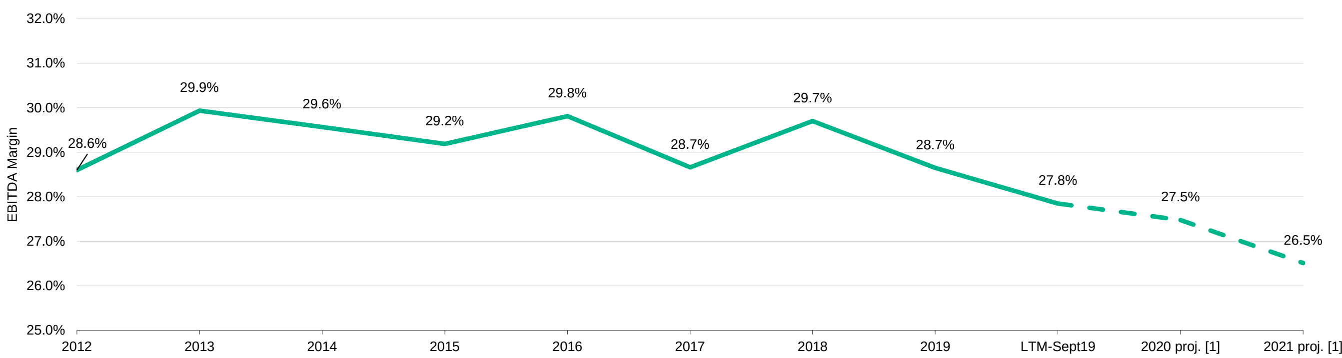
Telkom's fixed-line subscriber and usage continues its structural decline as customers migrate to mobile and broadband services, which has required Telkom to take corrective measures to change its business model to ensure it remains competitive and profitable. Telkom's transformational strategies focus on (1) improving profitability through cost optimisation (internal cost savings and exit of loss making operations), (2) growing its mobile operations and expanding its convergence strategy, and (3) rolling out fibre optic cable and growing its current position in broadband.

Part of Telkom's realignment strategy aims to establish itself as the leading South African converged (fixed/mobile voice and data) communication provider through the provisioning of a range of hosting services, managed solutions, mobile voice and wireless broadband services. Further, the acquisition of BCX in September 2015 helped Telkom increase its ICT services to include cloud-based and data centre service, and bolster its lagging business/enterprise solutions offerings. The BCX acquisition has also diversified Telkom's revenue base towards alternative services and become less reliant on voice revenue (voice revenue contributed 20% to group revenue for six months to 30 September 2019 versus 41% in fiscal 2016).

The adjusted EBITDA margin has been diluted as a result of the change in revenue mix with the acquisition of BCX, which has lower margins than Telkom's core businesses. We expect the EBITDA margin to fall over the next 12 months given the expected weak economic environment in South Africa.

Exhibit 4

EBITDA margin is likely to remain under pressure due to weak economic environment



[1] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

The implementation of the turnaround strategy to stabilise the business, which began in 2013, has been completed. Telkom is now focused on growing the businesses to become the leading telecommunications provider of converged services which carried and element of execution risk given the challenging macroeconomic environment in South Africa. To facilitate and drive its strategy further, Telkom has implemented a more flexible and agile operating model and restructured its operations into five distinct and independent operating divisions, namely Openserve, BCX, Telkom consumer, Trudon and Gyro. This ensures that management in the various divisions is more targeted in its cost deployment and strategies, leading to greater accountability.

We expect Telkom to continue to focus on organic growth, with both smaller bolt-on acquisitions and appropriately prized larger opportunities, as management focuses on enhancing its existing operations. Depending on the size, acquisitions will be financed with a combination of operating cash flow, debt and equity and ensuring that Telkom maintains a conservative capital structure and healthy balance sheet. Acquisitions will only be pursued if it gives the company access to an operation that has sizeable market positions in its respective sector.

The telecoms industry faces ongoing uncertainties with regard to the regulatory environment in South Africa. There are a number of critical regulatory decisions that may affect Telkom that are difficult to assess at this stage, namely (1) upcoming spectrum allocations, whereby access to spectrum below 1000 megahertz would offer a greater coverage with less infrastructure requirements for Telkom; and (2) implementation of government plans for a wholesale open access network (WOAN).

Financial credit metrics remain strong despite operating performance pressures

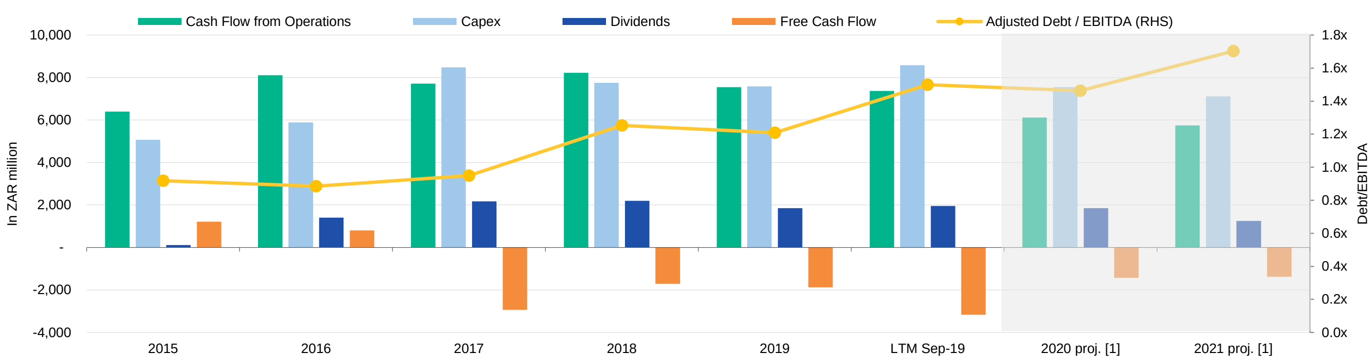
Despite declining fixed-line voice revenue, Telkom's operating results have been relatively stable. Due to the economic environment and coronavirus pandemic Moody's expects GDP to decline 2.5% for 2020. We expected revenue for financial 2021 to decline with operating margin remaining under pressure. However, the strong balance sheet in the form of low debt levels and leverage metrics gives Telkom the financial flexibility under the current rating. Furthermore, we expect Telkom to maintain its conservative financial policies and preserving its strong financial credit profile. Management has maintained stable metrics, with reported net debt to EBITDA of 1.4x (post IFRS 16) as of September 2019, which is temporary above the board target of around 1.0x-1.2x mainly due to higher capex to fund the rollout of mobile infrastructure.

In the current macro environment Telkom has the flexibility to be more prudent in its capital spending over the next 12 months, spending at the lower end of its market guidance between 16% and 20% of revenue. Deployment will focus on the modernisation of its copper network to fibre and the expansion of its mobile infrastructure making it less reliant on roaming agreements in high usage areas.

We expect operational cash flow to remain sufficient to meet Telkom's capital spending. Assuming Telkom maintains its dividend policy of paying out 60% of headline earning per share, we expect Telkom to remain free cash flow negative. Management have however indicated it will manage its dividend policy in the context of its future capital and liquidity needs.

Exhibit 5

Expected moderate increase in leverage due to negative free cash flow



[1] Cash flow from operations shown excluding dividend payments
[2] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

South African government support and dependence assumptions result in no rating uplift

Moody's default dependence assessment reflects the degree of correlation of a government-related issuer, such as Telkom, and its supporting government to being jointly susceptible to adverse circumstances that simultaneously move them closer to default. The “high” default dependence assumption reflects our view that both the South African government and Telkom's performance are highly correlated to the general business cycle in South Africa. In addition, it factors the moderate link between the government and Telkom, given the firm's partial privatisation during the past decade. Despite its 40.5% stake in Telkom, the South African government has no board representation, which limits its influence over the strategic direction of the company.

The “moderate” support assessment reflects the strategic role of the company in expanding telecommunications links to citizens in rural areas and in poorly serviced townships adjacent to large urban centres. The assessment also takes into account the government's moderate interventionist tendencies. Any reduction in government ownership could weaken our support assumption, but will not impact the overall rating position, given Telkom's standalone credit profile as reflected by the ba1 BCA, which is currently in line with that of the Government of South Africa.

Liquidity analysis

We take into consideration Telkom's liquidity profile to be good as it benefits from cash balances of ZAR1.2 billion, combined with liquid marketable securities of ZAR1.7 billion as of September 2019 and expected positive operating cash flow of around ZAR7 billion for the next 12 months. This is sufficient to meet its committed obligations over the next 18 months, which includes debt maturities, restructuring costs, planned capital spending and ongoing dividend payments to shareholders. Telkom also has flexibility to cut capex, manage cost and revise its dividend payments to strengthen liquidity.

In addition, Telkom has access to ZAR5.5 billion of undrawn committed borrowing facilities with varying maturities. ZAR 4 billion of the committed facilities is in the form of 360-day evergreen facilities, which increases the group's reliance on shorter-term funding. The facilities are subject to two financial covenants, interest cover and net leverage, which the company has been able to meet comfortably.

Rating methodology and scorecard factors

Our Rating Methodology for the Telecommunications Service Providers Industry, published in January 2017, sets out how we analyse the credit risk of telecommunications companies and arrive at their ratings. We expect the grid implied ratings to remain at Baa3 despite some weakening of credit metrics.

Exhibit 6

Rating Factors

Telkom SA SOC Limited

Telecommunications Service Providers Industry Scorecard [1][2]	Current LTM 9/30/2019		Moody's 12-18 Month Forward View As of Mar-20 [3]	
Factor 1 : Scale (12.5%)	**Measure**	**Score**	**Measure**	**Score**
a) Revenue (USD Billion)	$3.0	B	$2.3 - $2.4	B
Factor 2 : Business Profile (27.5%)				
a) Business Model, Competitive Environment and Technical Positioning	B	B	B	B
b) Regulatory Environment	Baa	Baa	Baa	Baa
c) Market Share	Baa	Baa	Baa	Baa
Factor 3 : Profitability and Efficiency (10%)				
a) Revenue Trend and Margin Sustainability	Baa	Baa	Baa	Baa
Factor 4 : Leverage and Coverage (35%)				
a) Debt / EBITDA	1.5x	A	1.5x - 1.7x	A
b) RCF / Debt	37.6%	A	31.9%-36.5%	Baa
c) (EBITDA - CAPEX) / Interest Expense	1.9x	B	1.9x - 2.8x	Ba
Factor 5 : Financial Policy (15%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Rating:				
a) Scorecard-Indicated Outcome		Baa3		Baa3
b) Actual Rating Assigned				Ba1
Government-Related Issuer	**Factor**			
a) Baseline Credit Assessment	ba1			
b) Government Local Currency Rating	Ba1			
c) Default Dependence	High			
d) Support	Moderate			
e) Actual Rating Assigned	Ba1			

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of LTM 09/30/2019.
[3] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

Appendix

Exhibit 7
Peer comparison
Telkom SA SOC Limited

(in US millions)	Telkom SA SOC Limited Baa3 Negative			MTN Group Limited Ba1 Negative			Telefonica Brasil S.A. Ba1 Stable		
	FYE Mar-18	FYE Mar-19	LTM Sep-19	FYE Dec-17	FYE Dec-18	FYE Dec-19	FYE Dec-17	FYE Dec-18	FYE Dec-19
Revenues	$3,061	$3,049	$2,983	$9,996	$10,223	$10,498	$13,534	$11,972	$11,243
EBITDA	$909	$874	$831	$4,135	$4,492	$4,385	$5,721	$5,927	$4,774
Total Debt	$1,241	$1,008	$1,173	$12,427	$12,678	$10,055	$6,446	$4,111	$3,244
Cash & Cash Equivalents	$216	$99	$80	$1,293	$1,101	$1,555	$1,221	$872	$844
EBITDA Margin	29.7%	28.7%	27.8%	41.4%	43.9%	41.8%	42.3%	49.5%	42.5%
(EBITDA-CAPEX) / Interest Expense	2.6x	2.9x	1.9x	1.7x	1.7x	2.3x	4.2x	6.6x	9.6x
Debt / EBITDA	1.2x	1.2x	1.5x	2.8x	3.1x	2.2x	1.2x	0.7x	0.7x
FCF / Debt	-11.7%	-12.9%	-20.0%	-4.4%	-4.3%	-3.5%	2.8%	-4.5%	20.7%
RCF / Debt	49.3%	50.9%	37.6%	26.0%	18.9%	25.8%	63.2%	104.5%	90.5%

[1] All figures are calculated using Moody's estimates and standard adjustments. FYE = Financial year-end. LTM = Last 12 months.
[2] Telefonica Brasil S.A.'s Ba1 rating is constrained by the Government of Brazil's rating (Ba2 stable).
Source: Moody's Investors Service

Exhibit 8
Moody's-adjusted debt breakdown
Telkom SA SOC Limited

(in ZAR Millions)	FYE Mar-15	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19	LTM Ending Sep-19
As Reported Debt	**4,857**	**5,275**	**6,378**	**9,427**	**10,241**	**17,031**
Pensions	812	1,274	1,151	1,966	752	752
Operating Leases	3,105	3,300	3,135	3,312	3,546	0
Moody's-Adjusted Debt	**8,774**	**9,849**	**10,664**	**14,705**	**14,539**	**17,783**

[1] All figures are calculated using Moody's standard adjustments. FYE = Financial year-end.
Source: Moody's Investors Service

Exhibit 9
Moody's-adjusted EBITDA breakdown
Telkom SA SOC Limited

(in ZAR Millions)	FYE Mar-15	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19	LTM Ending Sep-19
As Reported EBITDA	**9,223**	**8,952**	**10,824**	**10,580**	**10,706**	**11,005**
Pensions	-810	-626	82	84	85	85
Operating Leases	1,035	1,100	1,045	1,104	1,182	591
Unusual	113	1,701	-208	-59	-2	229
Non-Standard Adjustments	0	0	0	70	-2	-7
Moody's-Adjusted EBITDA	**9,561**	**11,127**	**11,743**	**11,779**	**11,969**	**11,903**

[1] All figures are calculated using Moody's standard adjustments. Financial year-end.
Source: Moody's Investors Service

Ratings

Exhibit 10

Category	Moody's Rating
TELKOM SA SOC LIMITED	
Outlook	Negative
Corporate Family Rating	Ba1
NSR LT Issuer Rating	Aa1.za

Source: Moody's Investors Service

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