S&P Global
Ratings

RatingsDirect®

Research Update:

South Africa's Telkom SA SOC Ltd. Rating Affirmed At 'BB'; Outlook Stable

August 23, 2023

Rating Action Overview

- Telkom SA SOC Ltd.'s S&P Global Ratings-adjusted funds from operations (FFO) to debt declined in fiscal 2023 (ended March 31, 2023) to about 33% from 63% in fiscal 2022, reflective of lower EBITDA generation; free operating cash flows (FOCF) turned negative and adjusted debt increased.
- Although we expect gradual improvement in Telkom's FFO in the 2024-2026 fiscal years, we expect the company's financial performance to remain below our previous expectations.
- We therefore revised down our assessment of Telkom's stand-alone credit profile (SACP) to 'bb+' from 'bbb-', reflecting the company's weaker expected financial measures.
- We affirmed our 'BB' long-term issuer credit rating on Telkom.
- The stable outlook reflects Telkom's 'bb+' SACP and our expectation that the group's EBITDA will not weaken further, supporting S&P Global Ratings-adjusted FFO to debt of 30%-45% on average over the next two years.

PRIMARY CREDIT ANALYST

Munya Chawana
Johannesburg
2711-214-4814
munya.chawana
@spglobal.com

SECONDARY CONTACT

Omega M Collocott
Johannesburg
+ 27 11 214 4854
omega.collocott
@spglobal.com

Rating Action Rationale

We lowered our assessment of Telkom's SACP to reflect reduced FFO generation in fiscals 2024-2026. While revenue grew modestly by 0.9%, in line with our expectation, to South African rand (ZAR) 43.1 billion in fiscal 2023, the continuing tilt in revenue and EBITDA from legacy to new technology and persisting operational headwinds (loadshedding, high inflation, declining consumer affordability) resulted in Telkom's S&P Global Ratings-adjusted FFO declining to ZAR6 billion versus our expectation of FFO around ZAR8 billion. We expect Telkom's continuing technological shift from legacy to new technologies and operational headwinds to continue negatively affecting its FFO generation. As a result, we now expect Telkom to maintain S&P Global Ratings-adjusted FFO to debt of 30%-45% on average over the next two years, versus our previous expectation of FFO to debt above 60%, and thus we now assess its financial risk profile as intermediate, from modest previously. Our financial risk assessment also incorporates our expectation that Telkom's EBITDA and cash flows will remain under pressure. However, we expect ongoing cost-saving initiatives, particularly further optimization of mobile and information technology direct costs and continuing investment in network optimization and new technologies to support margins in the near term.

Telkom's ability to generate FOCF in the near term will remain under pressure, absent improvements to operating performance. Due to continuing operating model evolution, reduced EBITDA generation, investment in the mobile post-paid segment aimed at driving higher annuity revenue, and relatively high capital expenditure (capex) of ZAR6 billion-ZAR8 billion, Telkom's FOCF has been strained in the last two fiscal years with negative S&P Global Ratings-adjusted FOCF of ZAR461 million in fiscal 2022 and ZAR1.8 billion in fiscal 2023. We forecast negative S&P Global Ratings-adjusted FOCF of about ZAR877 million in fiscal 2024, improving to positive ZAR1.3 billion in fiscal 2025 and positive ZAR2.7 billion in fiscal 2026. While we expect capex to be around ZAR6.6 billion (including ZAR1 billion spectrum cost), we expect an improvement in working capital as the drag from the investment in handsets abates to support lower negative FOCF in line with improving EBITDA generation (lower operating costs due to cost-savings initiatives) and lower capex. We expect capex will average around ZAR5 billion annually as the company tilts its capex priority from being mainly mobile business oriented to fiber (in line with a focus on monetization of the investment in fiber).

In our view, Telkom's business will temporarily weaken somewhat, due to the runoff in the higher margin legacy business. In our business profile assessment, we consider that the company has a diverse product offering as the dominant provider of fixed-line services and fiber infrastructure in South Africa, as well as an increasing presence in mobile and next-generation data-based business. However, we believe these factors could be offset in the near term by a weakening operating efficiency and elevated earnings volatility, due to the runoff in the higher margin legacy business and a constrained South African operating environment characterized by power constraints, high inflation, and lower consumer affordability. Telkom's operating model has been evolving as the group focuses on transitioning from the legacy copper wire base to fiber optic cabling, LTE, and LTE Advanced solutions. In a competitive and operationally challenging environment, the structurally declining legacy technology-based revenue is putting downward pressure on EBITDA margins. Telkom's unique business mix comprises a remaining share of ZAR7 billion-ZAR9 billion (of about ZAR43 billion total revenue) legacy technology-based business revenue. While the traditional fixed-line business is in decline, it is a high-EBITDA-margin business and the investments in the new technology-based businesses do not yet fully offset the decline in the higher-margin legacy business and S&P Global Ratings-adjusted EBITDA margins declined to 18.8% in fiscal 2023 from 27.5% in fiscal 2022. We expect Telkom's cost-saving initiatives to rebase its operating cost base (including staff rationalization and cost to serve optimization), continuing investment in its network, and fiber network monetization to support a reduction in EBITDA margin volatility. In our base case, we expect Telkom's S&P Global Ratings-adjusted EBITDA margin to gradually improve to about 25% by fiscal 2026 from 18.8% in fiscal 2023. However, in the near term, inflation-linked costs and power-supply-related spending will continue to put downward pressure on margins.

Our rating on Telkom remains influenced by those on South Africa, even if we assess the likelihood of support or negative intervention as low. The government owns about 40.5% of Telkom, and therefore we consider the company a government-related entity (GRE). We view the likelihood of state intervention in Telkom's operations as low, based on the government's current policy, the company's for-profit focus and listed status, and the governance and management structures. Nevertheless, in our view, there is risk, if low, that key exemptions (operational and reporting requirement exemptions granted by the National Treasury) from provisions applicable to state-owned companies (SOCs) could change. To assess the possibility of Telkom having a higher rating than the sovereign, we apply a stress test to its liquidity under our simulated economic scenario that would accompany a sovereign default. The test consists of stressing Telkom's earnings (20% haircut) and assuming a 50% devaluation of the rand and a doubling of inflation and interest rates. Given that the company passes the stress test, we do not cap the rating on the company by the rating on South Africa. Due to Telkom's GRE status, however, we limit the rating uplift above the sovereign foreign currency rating to one notch.

Outlook

The stable outlook reflects Telkom's 'bb+' SACP and our view that the rating cannot exceed our long-term foreign currency rating on South Africa by more than one notch, given the company's predominantly domestic operations, as well as the government's significant minority ownership stake. We also expect that the group's EBITDA will not weaken materially, supporting S&P Global Ratings-adjusted FFO to debt of 30%-45% on average over the next two years.

Downside scenario

We could revise the outlook on Telkom to negative if we took a similar action on South Africa, which could occur due to a lasting weakening economic and fiscal trajectory of the country, and a surge in related operating constraints in South Africa.

The ratings on Telkom could also come under pressure if, in our view, we revise down our view of its SACP by two notches to 'bb-'. This, in our view, could result from further weakening of Telkom's EBITDA generation, leading to S&P Global Ratings-adjusted FFO to debt falling sustainably below 20%.

We could also consider lowering the rating if weakened liquidity left Telkom unable to pass our sovereign stress test, and we capped the rating at the level of our foreign currency rating on South Africa.

Upside scenario

We could take a positive action on Telkom if we took a similar action on South Africa and Telkom continues to pass our sovereign stress test, allowing it to be rated one notch above the level of our foreign currency rating on South Africa.

Company Description

Telkom owns and operates South Africa's largest national wholesale telecommunications infrastructure, comprising integrated copper and fiber lines linked to a high-speed backhaul network. Fixed broadband internet and mobile voice and data services are available to individuals and small and midsize enterprises, while a diversified information and communications technologies product offering--including access to telecommunications, data centers, and IT services--is aimed at the enterprise market. The company also undertakes property and tower management services (through Gyro). Telkom generated annual revenue of ZAR43.1 billion (about $2.4 billion) and reported EBITDA of ZAR9.6 billion ($0.5 billion) in fiscal 2023 and is listed on the Johannesburg Securities Exchange with a current market capitalization of ZAR14.3 billion (about

$800 million).

As of March 31, 2023, Telkom had 18.3 million active mobile subscribers, 11.6 million mobile broadband subscribers, more than 170,000 kilometers of fiber deployed, 492,812 fiber-to-home connections, and 9,003 fiber-to-base station connections.

Our Base-Case Scenario

Assumptions

- South African GDP growth of 0.6% in 2023, 1.7% in 2024, and 1.7% in 2025.
- Revenue growth of 1.5% in fiscal 2024, improving to 2.5%-4% annually in fiscals 2025 and 2026, driven by improving economic conditions and improved contributions from Openserve and BCX.
- EBITDA margin of 20.3% in fiscal 2024, improving to 22% in fiscal 2025 and 25% in fiscal 2026 as a result of ongoing cost optimization and reducing legacy business.
- Working capital outflows around ZAR1.8 billion in fiscal 2024 and about ZAR1.5 billion in fiscals 2025 and 2026.
- Capex of ZAR6.6 billion in fiscal 2024, reflecting capex intensity around 15% and about ZAR5 billion in fiscals 2025 and 2026, reflecting capex intensity of about 11%.
- We currently do not incorporate potential acquisitions or disposals during the forecast period.
- No dividends in fiscals 2024 and 2025

Key metrics

- Adjusted debt to EBITDA of 2.3x in fiscal 2024, improving to about 1.7x by fiscal 2026.
- Negative FOCF of about ZAR877 in fiscal 2024, then turning positive in fiscal 2025 to ZAR1.3 billion and ZAR2.7 billion in fiscal 2026.

Liquidity

We assess Telkom's liquidity as adequate. We anticipate that Telkom's cash flows and available facilities will exceed its commitments and obligations by nearly 1.8x over the 12 months started April 1, 2023.

For the 12 months started April 1, 2023, we estimate the following principal liquidity sources:

- Unrestricted cash and cash equivalents of about ZAR3.5 billion.
- Undrawn committed revolving credit facilities totaling ZAR2.8 billion.
- Our expectation of cash FFO of ZAR6.0 billion-ZAR6.5 billion.

For the same period, we estimate the following principal liquidity uses:

- Debt maturities of about ZAR2.4 billion.

- Negative (nonseasonal) working capital outflows of about ZAR1.8 million.
- Maintenance capex of about ZAR2.7 billion.
- No planned dividends, acquisition, or mergers.

Covenants

We expect Telkom will maintain sufficient headroom under its financial covenants, with headroom well in excess of 15% on its interest coverage (3.5x) and net debt to EBITDA (3.0x) ratios.

Environmental, Social, And Governance

Environmental, social, and governance (ESG) factors are an overall neutral consideration in our credit rating analysis of Telkom. We view the inherent social tensions and inequalities in South Africa as having the potential to translate into weaker business and investment conditions. Furthermore, increasing risk of infrastructure damage from human encroachment and criminality could affect the stability and quality of Telkom's network. We see potential exposure to governance risks stemming mainly from Telkom's SOC status, and regulatory risks. Although Telkom is a SOC, we believe its listed status and solid management have protected it from the governance weaknesses that many other South African SOCs are exposed to. The regulatory environment exposes Telkom to mobile and data price reduction policies, plus data protection and SIM registration requirements, which may pressure future revenues or margins.

Group Influence

The Telkom SA SOC group comprises the parent company and its subsidiaries. In line with our criteria, we consider an assumed group credit profile (GCP) at the same level as the issuer credit rating on the parent company Telkom. The assumed GCP is based on the scope of consolidation and Telkom can be referred to in terms of the assumed GCP, in accordance with our criteria.

Government Influence

Our foreign and local currency sovereign credit ratings on South Africa are 'BB-' and 'BB' with stable outlooks (see "South Africa Outlook Revised To Stable As Infrastructure Constraints Weigh On Growth; 'BB-/B' FC Ratings Affirmed," published March 9, 2023, on RatingsDirect). We consider Telkom to be a GRE, with a limited link and limited importance to the South African government. We therefore believe there is a low likelihood of government support for Telkom, given the government's minority (about 40.5%) shareholding, the company's listed status, and the commercial operating model.

Rating Above The Sovereign

Telkom's 'bb+' SACP is higher than the foreign currency rating on South Africa ('BB-'). Based on our view of the low likelihood of government support, we do not cap the rating on Telkom at the level of the foreign currency rating on South Africa. We assess that Telkom may be rated one notch above the foreign currency rating on South Africa, since it passes our hypothetical sovereign default scenario, which includes a 20% earnings stress and a 50% depreciation of the South

African rand. In our view, the one notch above the foreign currency rating on South Africa considers the conditionality of Telkom's Public Finance Management Act exemption status, and its predominantly domestic operational focus.

Ratings Score Snapshot

Issuer Credit Rating	**BB/Stable/--**
Business risk:	Fair
Country risk	Moderately High Risk
Industry risk	Intermediate Risk
Competitive position	Fair
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	bb+
Modifiers:	
Diversification/Portfolio effect	Neutral/Undiversified
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Fair
Comparable rating analysis	Neutral
Stand-alone credit profile (SACP):	bb+
Group credit profile	bb
Related government rating	BB-
Likelihood of government support	Low
Rating above the sovereign	+1 notch from SACP

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Various Rating Actions Taken On Three South Africa Corporate And Infrastructure Issuers On Outlook Revision To Sovereign, March 10, 2023

Ratings List

Ratings Affirmed	
Telkom SA SOC Ltd.	
Issuer Credit Rating	BB/Stable/--

Regulatory Disclosures

Primary Credit Analyst: Munya Chawana, Associate

Rating Committee Chairperson: G. Andrew Stillman

Date initial rating assigned: June 18, 2008

Date of previous review: March 10, 2023

Disclaimers

This rating has been determined by a rating committee based solely on the committee's independent evaluation of the credit risks and merits of the issuer or issue being rated in accordance with S&P Global Ratings published criteria and no part of this rating was influenced by any other business activities of S&P Global Ratings.

This credit rating is solicited. The rated entity did participate in the credit rating process. S&P Global Ratings did have access to the accounts, financial records and other relevant internal, non-public documents of the rated entity or a related third party. S&P Global Ratings has used information from sources believed to be reliable but does not guarantee the accuracy, adequacy, or completeness of any information used.

Materials Used In The Credit Rating Process: Sufficient information in general consists of both (i) financial statements that describe the Issuer's financial condition, results of operations and cash-flows, and (ii) a description of the activities and obligations of the entity including of its governance and legal structure.

This credit rating was disclosed to the rated entity or related third party before being issued.

S&P Global Ratings' regulatory disclosures (PCRs) are published as of a point-in-time, which is current as of the date a Credit Rating Action was last published. S&P Global Ratings updates the PCR for a given Credit Rating to include any changes to PCR disclosures only when a subsequent Credit Rating Action is published. Thus, disclosure information in this PCR may not reflect changes to data within PCR disclosures that can occur over time subsequent to the publication of a PCR but that are not otherwise associated with a Credit Rating Action. Note that there may be instances where the PCR reflects an updated Ratings Model version in business use as of the date of the last Credit Rating Action although use of the updated Ratings Model was deemed unnecessary to produce that Credit Rating Action. For example, this may occur in the case of eventdriven reviews where the event being assessed is considered to be not relevant to running the updated Ratings Model version. Note also that, in accordance with applicable regulatory requirements, S&P Global Ratings evaluates the impact of material changes to Ratings Models and, where appropriate, issues revised Credit Ratings where necessitated by the updated Ratings Model.

Glossary

- Anchor: The starting point for assigning an issuer a long-term rating, based on its business risk profile assessment and its financial risk profile assessment.
- Business risk profile: This measure comprises the risk and return potential for a company in the market in which it participates (its industry risk), the country risks within those markets, the competitive climate, the company's competitive advantages and disadvantages (its competitive position).
- Comparable rating analysis: This involves taking a holistic review of a company's stand-alone credit risk profile (SACP), because each of the subfactors that ultimately generate the SACP can be at the upper or lower end, or at the midpoint, of such a range. It may also touch upon the overall comparative assessment of an issuer in relation to its peers across industry and jurisdiction and may capture some factors not (fully) covered, such as a short operating track record, entities in transition, unusual structures, or contingent risk exposures.
- Competitive advantage: The strategic positioning and attractiveness to customers of the company's products or services, and the fragility or sustainability of its business model.
- Competitive position: Our assessment of a company's: competitive advantage; operating efficiency; scale, scope, and diversity; and profitability.
- Corporate Industry and Country Risk Assessment (CICRA): Derived by combining an issuer's country risk assessment and industry risk assessment.
- Country risk: This measures a country's influence on the overall credit risks for a rated company with regards to a country's economic, institutional and governance effectiveness, financial system, and payment culture/rule of law risks.
- CreditWatch: This highlights the potential direction of a short- or long-term rating over the short term, typically less than three months. Ratings may be placed on CreditWatch where, in our view, an event or a deviation from an expected trend has occurred or is expected and additional information is necessary to determine the rating impact.
- Creditworthiness: Ability and willingness of a company to meet its debt and debtlike obligations; measured by assessing the level current and future resources relative to the size and timing of its commitments.

- Diversification/portfolio effect: Applicable to conglomerates. An assessment of the extent to which an entity's multiple core business lines are correlated and whether each contributes a material source of earnings and cash flow.
- Earnings: Proxy for profit or surplus yielded by an entity after production and overhead costs have been accounted for in a given period.
- EBITDA margin: This is EBITDA as a fraction of revenues.
- EBITDA: This is earnings before interest, tax, depreciation, and amortization.
- Economies of scale: This is the cost advantage that arises with increased size or output of a product.
- Efficiency gains: Cost improvements.
- Financial headroom: Measure of deviation tolerated in financial metrics without moving outside or above a predesignated band or limit typically found in loan covenants (as in a debt-to-EBITDA multiple that places a constraint on leverage) or set for the respective rating level. Significant headroom would allow for larger deviations.
- Financial risk profile: This measure comprises our assessment of a company's cash flow/leverage analysis. It also takes into account the relationship of the cash flows the organization can achieve given its business risk profile. The measure is before assessing other financial drivers such as capital structure, financial policy, or liquidity.
- Free operating cash flow: Cash flow from operations minus capital expenditure.
- Funds from operations: EBITDA minus interest expense minus current tax.
- Government-related entity: An entity that could, under stress, benefit from extraordinary government support to meet its financial obligations; or conversely an entity controlled by a government that could be subject to negative extraordinary government intervention if the government is under stress.
- Group rating methodology: The assessment of the likelihood of extraordinary group support (or conversely, negative group intervention) that is factored into the rating on an entity that is a member of a group.
- Industry risk: This addresses the major factors that affect the risks that companies face in their respective industries.
- Issuer credit rating: This is a forward-looking opinion about the creditworthiness of an obligor with respect to a specific class of financial obligations or a specific financial program.
- Issuer credit rating: This is a forward-looking opinion of an obligor's overall creditworthiness.
- Leverage: The level of a company's debt in relation to its earnings before interest, tax, depreciation, and amortization.
- Liquidity: This is the assessment of a company's monetary flows, assessed over a 12 to 24 month period. It also assesses the risk and potential consequences of a company's breach of covenant test, typically tied to declines in EBITDA.
- Management and governance: This addresses how management's strategic competence, organizational effectiveness, risk management, and governance practices shape the issuer's competitiveness in the marketplace, the strength of its financial risk management, and the robustness of its governance.
- Operating efficiency: The quality and flexibility of the company's asset base and its cost

management and structure.

- Outlook: This is the assessment of the potential direction of a long-term issuer rating over the short to intermediate term (typically six months to two years).
- Profitability ratio: Commonly measured using return on capital and EBITDA margins, but can be measured using sector-specific ratios.
- Rating above the sovereign assessment: Our assessment of whether an entity can be rated above the sovereign rating on a jurisdiction it has a material exposure to.
- Scale, scope, and diversity: The concentration or diversification of business activities.
- Stand-alone credit profile (SACP): S&P Global Ratings' opinion of an issue's or issuer's creditworthiness, in the absence of extraordinary intervention or support from its parent, affiliate, or related government or from a third-party entity such as an insurer.
- Transfer and convertibility assessment: S&P Global Ratings' view of the likelihood of a sovereign restricting nonsovereign access to foreign exchange needed to satisfy the nonsovereign's debt service obligations.