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Research Update:

Turkish Airline Turk Hava Yollari Downgraded To 'BB-' On Weaker-Than-Expected Operating Performance; Outlook Negative

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Overview

- Turk Hava Yollari A.O.'s (THY's) performance was weaker than we expected in the first quarter of 2016, with EBITDA falling by almost 50% year on year.
- In our view, the terror attacks at Istanbul airport last month and the resulting potential adverse effect on traffic have significantly dented the recovery prospects of Turkish airlines.
- We anticipate that this will contribute to further deterioration in THY's credit measures in 2016 and are therefore lowering our corporate credit rating on THY to 'BB-' from 'BB'.
- The negative outlook reflects uncertainty around the geopolitical environment in Turkey and the heavy investment that the airline is undertaking for fleet expansion during this uncertainty.

Rating Action

On July 14, 2016, S&P Global Ratings lowered its long-term corporate credit rating on Turkish airline Turk Hava Yollari A.O. (THY) to 'BB-' from 'BB'. The outlook is negative.

At the same time, we lowered the issue ratings on THY's aircraft-backed enhanced-equipment trust certificates to 'BBB'.

Rationale

The downgrade reflects THY's significantly weaker-than-we-anticipated performance since early 2016 and our expectation that the company will not fully recover to deliver financial metrics in line with the prior rating. THY has been operating under a challenging environment facing low levels of traffic to and from Turkey, mainly due to security concerns and weak tourism activity. Also, demand still lags its strong planned capacity increase for the full year, resulting in continuing load factor decline (the number of passenger kilometers compared with maximum capacity) and revenue pressure. The load factor fell to 77% in the first quarter of 2016 compared with 78% for the full year 2015, while yield fell by around 13% during the same period.

Although the lower fuel prices have provided some respite, THY's overall profitability has weakened materially. That said, we continue to expect fuel cost savings and tight non-fuel cost control to partially offset those risks. While we expect mild recovery in the second half of 2016 and in 2017, Turkey's geopolitical environment and unfavorable currency movements should, in our view, limit the recovery prospects in the near term. We now forecast funds from operations (FFO) to debt to be around 10%-14%, which is materially lower than our guideline of at least 20% for the previous 'BB' rating. This has led us to revise down our financial risk profile assessment and, as a result, our stand alone credit profile to 'b+' from 'bb'. Our two-notch downward revision of THY's stand-alone credit profile results in metrics at the very low end of the aggressive financial risk category.

Our 'BB-' rating on THY factors in one notch of support based on our assessment of a moderately high likelihood that the Turkish government would provide timely and sufficient extraordinary financial support to the airline in the event of financial distress. We base this view on our assessment of THY's:

- Important role in Turkey's economy as the main gateway to the country's capital city; and
- Strong link with the government of Turkey.

Although THY is a profit-seeking enterprise, it provides Turkey with an essential service and foreign currency. In our view, if THY were to default this would disrupt its activities. This is because THY relies heavily on foreign funding for its aircraft, which could be repossessed in the event of a default. The government is an important shareholder for THY and it has a policy of supporting THY in certain circumstances.

THY's business risk profile continues to reflect the company's market position at Ataturk airport, where it is by far the leading operator with a market share of close to 75%. THY benefits from the geographical position of Istanbul, which acts as a transfer hub allowing THY to connect a large proportion of Europe, the Middle East, Central Asia, and Africa using narrow-body aircraft. In our view, the weak Turkish lira should continue to support THY's cost competitiveness.

In our base case for THY, we assume:

- Average GDP growth in Turkey of about 3.5% in 2016-2017 and about 1.7%-1.3% in the eurozone in the same period. An increase in capacity of about 14%-15% in 2016.
- Growth in passenger numbers lower than capacity growth in 2016, leading to fall in capacity utilization for about 73%-75% (measured using load factors).
- A Brent oil price of about $40 per barrel in 2016, increasing to $45 in 2017. Alongside THY's hedging policy, these prices are likely to cause THY's fuel bill to fall in 2016, despite a significant capacity increase.
- A modest increase in employee costs leading to lower employee costs per available seat kilometers.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted EBITDA of approximately $1.4 billion-$1.7 billion in 2016 in

2017;
- An adjusted EBITDA margin of 13.5%-17.0% in 2016 and 2017; and
- Adjusted FFO to debt of around 10%-14% in the next two years.

Liquidity

We assess THY's liquidity as adequate, reflecting our view that sources of funding will cover uses by slightly more than 1.2x over the next 12 months. We take into account that the company will retain an uninterrupted access to bank funding to cover new aircraft delivery and working capital needs. We would re-assess the liquidity profile if it appeared not to be the case.

Principal liquidity sources for the next 12 months are:
- $1.2 billion in cash and short-term financial assets; and
- About $1.0 billion of cash FFO.

Principal liquidity uses for the next 12 months are:
- $1.3 billion of debt amortization;
- About $0.3 billion of cash capital expenditure (capex); and
- About $700 million of working capital needs to be fully funded by credit facilities that are renewed on an annual basis.

Outlook

The negative outlook on THY reflects our view that the company will need to take significant steps to restore FFO-to-debt ratios of around 15% in 2017. Currently, THY is heavily investing in its fleet and the environment in the airline industry remains highly competitive due to significant capacity increases in recent years. We expect particularly weak credit metrics for 2016 as THY is facing geopolitical challenges and the resulting adverse effect on traffic. We assume that a rating change would be driven by our assessment of THY's financial risk profile rather than by our view of its business risk profile or its status as a government-related entity in Turkey.

Downside scenario

We could lower the rating if THY did not maintain a weighted-average FFO to debt ratio of at least 12% in the next two years. This could occur, for example, because the lira or euro weakened or if average ticket prices declined further, as well as if demand and load factors did not improve from current levels in the next 12 months. We could also lower the rating if THY's liquidity position deteriorated, for example, because THY was unable to secure funding for its significant upcoming capex.

Upside scenario

We could revise the outlook to stable if THY stabilized its FFO-to-debt ratios at around 15%, maintaining its competitive position despite the competitive environment in the airline industry. Also, given the inherent volatility and capital intensity in the underlying sector, we consider the company's consistently adequate liquidity profile to be a critical and stabilizing rating factor.

Ratings Score Snapshot

Corporate Credit Rating: BB-/Negative/--

Business risk: Fair
- Country risk: Intermediate
- Industry risk: High
- Competitive position: Strong

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: b+
- Sovereign rating: Local Currency Rating: BBB-/Stable/A-3 Foreign Currency Rating: BB+/Stable/B
- Likelihood of government support: Moderately High (+1 notch)

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Transportation Cyclical Industry, Feb. 12, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Criteria For Rating Aircraft-Backed Debt And Enhanced Equipment Trust

Certificates, Sept. 12, 2002

Ratings List

Downgraded

	To	From
Turk Hava Yollari A.O.		
Corporate Credit Rating	BB-/Negative/--	BB/Stable/--
Equipment Trust Certificates	BBB	BBB+

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