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## Research Update:

# Turkish Airline Turk Hava Yollari Assigned 'BB+' Rating; Outlook Negative

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## Table Of Contents

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## Overview

- The business risk profile of Turkish airline Turk Hava Yollari (THY) reflects its market position at Istanbul Ataturk airport, Istanbul's beneficial geographic position as a transfer hub, and the company's strong track record of growth over the past three years. The business risk is partly constrained by the volatility of the airline industry, THY's exposure to currency movements, and potential emerging competitive challenges.
- Our view of THY's financial risk profile takes into account planned capital expenditures that could weaken its financial ratios in 2015 and 2016 from historical levels.
- The rating on THY also reflects our view that the Turkish government has a moderately high likelihood of offering extraordinary support to THY because of the strong link between THY and the government and the airline's important role in the Turkish economy.
- We therefore consider THY's stand-alone credit profile to be 'bb' and are assigning a long-term corporate credit rating of 'BB+'.
- The negative outlook mainly reflects that on the sovereign and the risk that we could lower our rating on THY if we downgrade Turkey.

## Rating Action

On March 6, 2015, Standard & Poor's Ratings Services assigned its 'BB+' long-term corporate credit rating to Turkish airline Turk Hava Yollari A.O. (THY). The outlook is negative.

## Rationale

The ratings on THY reflect its stand-alone credit profile (SACP) of 'bb' and the likelihood of extraordinary support from the Turkish government.

In accordance with our criteria for rating government-related entities, we factor into our 'BB+' long-term corporate credit rating on THY one notch of uplift from its 'bb' SACP to reflect our opinion that there is a moderately high likelihood that the Turkish government would provide timely and sufficient extraordinary support to THY in the event of financial distress. The negative outlook on THY indicates that if we lowered our local currency sovereign credit rating on Turkey to 'BBB-', we would no longer apply this notch of support to our ratings on THY.

We consider the Turkish government has a moderately high likelihood of



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providing extraordinary support to THY in case of need. We base our view on:

- THY's important role for the Turkish government; and
- "Strong" link to the Turkish government.

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, it would disrupt its activities because the company relies heavily on foreign funding for its aircrafts, 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.

The business risk profile reflects THY's market position at Ataturk airport, where the company is by far the leading operator. It also benefits from Istanbul's geographic position. It acts as a transfer hub, allowing THY to connect to a large proportion of Europe, Middle East, Central Asia, and Africa on narrow-body aircraft. This allows THY to generate profits on routes that other airlines would find difficult. The company has used its position to materially and profitably grow the business over the past three years. In 2014, its Standard & Poor's-adjusted EBITDA reached $1.7 billion and its EBITDA margin was higher than that of most of its European peers at 14.9%.

The business risk assessment is partly constrained by the volatile nature of the airline industry, which is susceptible to external shocks such as wars, terror attacks, epidemics, and oil price shocks. We expect THY's exposure to the more competitive and lower-yielding transfer passenger market to increase as its network grows. If the Turkish lira appreciates significantly, it could threaten THY's current cost-competitiveness, although we anticipate that any such appreciation would cause GDP growth in Turkey to accelerate, increasing demand for air travel. Overall we view the business risk profile of THY as "fair" under our criteria.

In our base-case scenario, we forecast that THY will maintain weighted-average adjusted funds from operations (FFO) to debt above 20%, although we expect overall leverage and sales to continue to increase as THY will take delivery of a significant number of new aircraft over the coming three years.

Our base case assumes:

- Average GDP growth in Turkey of about 3% in 2015-2016 and about 1%-2% in the eurozone in the same period (see "Ratings On Republic of Turkey Affirmed; Outlook Remains Negative," published Nov. 21, 2014);
- THY will continue to increase capacity by about 15% in 2015;
- Passenger numbers will grow roughly in line with capacity growth in 2015, leading to stable capacity utilization (measured using load factors);
- Average ticket prices will drop by 4%-6%, mainly because of increasing transfer volumes and the partial transfer to consumers of the reduction in fuel costs.
- Brent oil price will be about $55 in 2015, increasing to $65 in 2016. Overlaid with THY's hedging policy, this is likely to cause the fuel bill to fall, despite the significant capacity increase (see "Standard & Poor's Revises Its Crude Oil And Natural Gas Price Assumptions" published

Jan. 9, 2015).
- Employee costs per available seat kilometer to be relatively stable during 2015.

Based on these assumptions, we arrive at the following credit measures for 2015-2016:
- Return on capital averaging 5%-7%;
- Weighted-average FFO to debt of 20%-24%; and
- Weighted-average EBITDA interest coverage of 5x-7x.

### Liquidity

We assess THY's liquidity as "adequate" under our criteria, reflecting our view that sources of funding will cover uses of funding by more than 1.2x over the next 12 months.

We anticipate the company will have the following principal liquidity sources over the next 12 months:
- $722 million in cash and short-term financial assets;
- About $1 billion available under committed bank facilities;
- About $1.5 billion of FFO; and
- Neutral to slightly positive working capital.

We anticipate the company will have the following principal liquidity uses over the next 12 months:
- $632 million of debt amortization; and
- About $2 billion of capital expenditure (capex).

## Outlook

The negative outlook signifies that we would lower the rating on THY if we lowered the local currency sovereign credit rating on Turkey to 'BBB-' because, under our criteria, we would rate THY at the level of its SACP if the local currency rating on the related sovereign was 'BBB-' or lower. We could also lower the rating if THY could not maintain its weighted-average FFO to debt above 20%, for example because the lira or euro had weakened, or THY saw weaker-than-anticipated domestic demand and weaker average ticket prices for international business, causing THY's 2015 revenues to grow by less than 7% and its EBITDA margin to fall below 13%. We could also lower the rating if oil prices increased to above $90 per barrel, but the ticket price environment remained weak, or if THY's liquidity position weakened, for example, because THY was unable to secure funding for its significant upcoming capex.

We could revise the outlook to stable if we revised the outlook on Turkey to stable. We could also revise the outlook to stable if we were to revise THY's SACP to 'bb+'. While unlikely, this could occur if THY were able to achieve and maintain adjusted FFO to debt above 30%. In our view, this would require stronger growth in passenger numbers and average ticket price growth than we assume in our current base case.

## Ratings Score Snapshot

Corporate Credit Rating: BB+/Negative/--

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

Financial risk: Significant
- Cash flow/Leverage: Significant

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: Neutral (no impact)

Stand-alone credit profile: bb
- Sovereign rating: Turkey (LC: BBB/Negative)
- Likelihood of government support: Moderately High

## Related Criteria And Research

### Related Criteria
- 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
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

## Ratings List

New Rating; CreditWatch/Outlook Action

Turk Hava Yollari A.O.

| | |
|---|---|
| Corporate Credit Rating | BB+/Negative/-- |

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