FitchRatings

Fitch Affirms Sri Lanka's Dialog Axiata at 'AAA(lka)'; Outlook Stable

Fitch Ratings - Colombo/Singapore - 22 Feb 2023: Fitch Ratings has affirmed the National Long-Term Rating of Sri Lanka-based telecom company Dialog Axiata PLC at 'AAA(lka)'. The Outlook is Stable.

The affirmation and Stable Outlook reflect Fitch's view that Dialog will be able to maintain a credit profile commensurate with a 'AAA(lka)' rating in the next 12-18 months, despite lower demand for telecom services, escalating costs and a significant increase in the company's debt amid the Sri Lankan rupee's devaluation.

Dialog's rating is driven by its Standalone Credit Profile (SCP) of 'aaa(lka)', which reflects its market leadership across mobile, pay-TV and home-broadband (HBB) segments, better execution and network capability and a solid financial profile, offset to an extent by the high exposure of its revenue to the weak Sri Lankan market.

KEY RATING DRIVERS

Weak Demand in 2023: We expect Dialog's revenue growth to slow to around 10% in 2023, from 25% in 2022, amid weakening consumer spending. Consumers are increasingly prioritising essential needs, such as food and medicine, as real income has plunged following the currency depreciation and unprecedently high inflation. Dialog faced pressure on subscriber numbers and usage minutes in 2022. Telecom operators raised voice and data tariffs by 20% and pay-TV by 25% in 2022 to pass through the escalating costs, reducing the services' affordability.

We believe the recent increases in telecom taxes would also discourage demand as consumers now have to pay 38% tax on voice and 20% on data. Sri Lanka currently has one of the highest telecom tax structures in Asia. To mitigate its domestic market exposure, Dialog is increasingly focusing on its international businesses and enterprise clients, who are somewhat immune to the local environment. The contribution from the international business climbed to 23% in 2022, from 16%-17% earlier.

Market Leadership: Dialog is the domestic market leader across mobile, pay-TV and HBB segments. The competition within the mobile segment has intensified in recent months amid the falling demand, with some of the smaller operators aggressively cutting prices. However, we do not believe such a strategy is sustainable as the smaller telcos do not have the network capability, service quality or the financial strength to compete with operators such as Dialog.

Low Profitability: We expect Dialog's EBITDA margin to improve to around 30%-32% over 2023-2024 from 28% in 2022, benefitting from the recent tariff hikes

and cost rationalisation measures. Dialog's EBITDA margin contracted by 12 percentage points in 2022 amid the high inflation and currency depreciation. Around 52% of Dialog's direct costs are in foreign currency (FC) compared with only 30% of its revenue, exposing the company to currency volatility.

Dialog expects to streamline its costs by consolidating its facilities, optimising its network and rationalising overheads, but we do not believe this will be sufficient to improve margins to the 39%-40% levels before 2022. The low realisation of the recent tariff hikes amid the drop in usage and increased contribution from the low-margin international business would also mean margins would remain in the low-to-mid 30s range in the next few years.

High Foreign-Currency Debt: Around 91% of Dialog's outstanding debt was in FC at end-2022. The depreciation of the rupee by almost 80% in 2022 materially increased Dialog's FC debt exposure, while it had to raise more FC debt to fund capex amid the FC shortage in Sri Lanka. We do not believe Dialog's current FC revenue is sufficient to meet its FC debt obligations, but the company does not have any FC debt repayments due in the next 24 months. Dialog has USD41 million in FC deposits to meet its FC interest costs of around USD12 million per year.

Balance-Sheet Restructuring: Dialog is planning to manage its currency exposure by reducing the FC debt to less than 50% of its outstanding debt by end-2023. It is considering asset monetisation and alternative funding arrangements with existing lenders to achieve a more balanced funding mix. The higher debt stock also raised Dialog's EBITDA net leverage to 1.3x in 2022, from 0.4x in 2021. We expect leverage to remain around 1.0x until there is a sustainable recovery in margins.

Positive FCF from 2024: We expect Dialog to generate negative free cash flow (FCF) in 2023 amid low profitability and high capex. Dialog's capex has risen due to the currency devaluation as most of the equipment is imported. Therefore, we expect capex intensity to rise to around 27% of revenue in the next few years from around 23% earlier. Capex will be spent mostly on mobile and fixed-data capacity expansion to cater to the growing demand. Dialog's FCF should turn positive from 2024, once EBITDA margins gradually recover.

Support from Strong Parent: Our assessment of 'Medium' legal and strategic support incentive from its stronger parent, Axiata Group Berhad, would result in a potential two-notch uplift to its rating if its SCP were to weaken, according to our Parent and Subsidiary Linkage Rating Criteria. Axiata guaranteed around 45% of Dialog's debt as of end-2022. The subsidiary makes a reasonably material financial contribution to the parent, with moderate long-term growth potential. The operational support incentive is 'Weak' due to minimal operating synergies with the parent.

Sector Outlook Deteriorating: Fitch expects the average 2023 net debt/EBITDA ratio for Dialog and fixed-line leader Sri Lanka Telecom PLC (SLT, A(lka)/Stable) to weaken to 1.4x in 2023 (2022E: 1.2x) amid weak margins and high capex. We expect sector revenue growth to slow to 8% in 2023 (2022E: 15%), while the

average 2023 EBITDA margin for SLT and Dialog will remain flat at 32% (2021: 38% and 2022E: 32%) amid low usage and high costs.

DERIVATION SUMMARY

Dialog's business risk profile is stronger than that of similarly rated national peers, given its market leadership in Sri Lanka's mobile industry and integrated service offerings. Dialog's financial profile is better than that of SLT, with a larger revenue base, lower forecast EBITDA net leverage and a better FCF profile. However, SLT is the monopoly fixed-line operator in the country and has lower exposure to the crowded mobile market, although its rating is under pressure because of the state's weak credit profile.

Dialog has a better business risk profile than leading alcoholic-beverage manufacturer Melstacorp PLC (AAA(lka)/Stable), reflected in the former's larger operating scale and higher margins. Melstacorp's subsidiary, Distilleries Company of Sri Lanka PLC (DIST: AAA(lka)/Stable), controls 70% of Sri Lanka's spirits production, and has maintained its market leadership due to its entrenched brand and access to a countrywide distribution network. However, DIST is exposed to high regulatory risk through regular tax increases. We expect both companies to maintain a similar financial risk profile with 2023 net debt to EBITDA of around 1.4x.

Hemas Holdings PLC (AAA(lka)/Stable) is the largest private pharmaceutical distributor in the country. It is also in the fast-moving consumer goods (FMCG) business. Dialog has a significantly stronger business profile with its market-leading position, larger operating scale, and the ability to generate a wider operating EBITDA margin and pass on higher taxes to consumers. Hemas' operations are constrained by regulatory pressure from price controls in its pharmaceutical business and cost escalation in the FMCG sector, where cost pass-through to the end-customer may take time. We forecast Hemas to maintain a better financial risk profile in the next few years with net leverage below 1.0x.

KEY ASSUMPTIONS

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

- Revenue to rise by 9%-10% over 2023-2024

- EBITDA margin of 30%-32% over 2023-2024

- Capex/revenue of around 27% over 2023-2024 to be spent mainly on 4G expansion

- Effective tax rate of 2.0% of revenue

- Dividend of around 50% of previous year's net income as per the company's policy to be paid over 2024-2026

- Effective interest rate to climb to 10%-11% over 2023-2024 with a shift towards high-cost domestic debt

- Subsidiary Dialog Finance PLC's (AA(lka)/Stable) debt obligations over and above what is required to maintain an appropriate debt-to-tangible equity ratio of 1.0x will be assumed by Dialog as a hypothetical equity infusion as per Fitch criteria. We assume this to be LKR1.1 billion in 2023, LKR2.2 billion in 2024 and LKR4.5 billion in 2025.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- There is no scope for an upgrade, as Dialog is rated at the highest end of the Sri Lankan National Rating scale.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- We do not envisage any negative rating action in the medium term given the standalone strength of the business profile, low financial leverage and implied support from the stronger parent.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity: Dialog had an unrestricted cash balance of LKR37.0 billion and undrawn but committed bank facilities of around LKR15 billion at end-December 2022, which can comfortably cover short-term local-currency debt maturities of about LKR4.2 billion. We believe local banks will honour the credit lines extended and roll over the facilities as and when required given Dialog's position as one of Sri Lanka's largest corporates and its solid credit profile. Around 91% of Dialog's debt consisted of FC debt at end-December 2022, but most of the debt will be due after 2024.

ISSUER PROFILE

Dialog is a Sri Lanka-based telecom company with domestic market leadership across mobile, pay-TV and HBB segments.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Dialog Axiata PLC	Natl LT	AAA(lka)	Affirmed	AAA(lka)

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VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

- National Scale Rating Criteria (pub. 22 Dec 2020)
- Parent and Subsidiary Linkage Rating Criteria (pub. 01 Dec 2021)
- Corporate Rating Criteria (pub. 29 Oct 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

- Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

- Solicitation Status
- Endorsement Policy
- Potential Conflicts Resulting from Revenue Concentrations

ENDORSEMENT STATUS

Dialog Axiata PLC -

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