Fitch Ratings

Fitch Places Sri Lanka Telecom's 'A(lka)' Rating on Watch Positive

Fitch Ratings - Colombo - 27 Mar 2023: Fitch Ratings has placed Sri Lanka Telecom PLC's (SLT) National Long-Term Rating of 'A(lka)' on Rating Watch Positive (RWP).

The RWP reflects the potential rating upside due to weakening linkages with SLT's parent, the government of Sri Lanka (Long-Term Local-Currency Issuer Default Rating: CC), due to the government's plan to sell its 49.5% stake in the company. Fitch will resolve the RWP when the proposed disposal becomes practically unconditional, which may take more than six months.

SLT's ratings are currently constrained by its parent's weak credit profile under Fitch's Parent and Subsidiary Linkage (PSL) Rating Criteria. SLT's Standalone Credit Profile (SCP) is stronger than that of the state, reflecting the company's market leadership in fixed-line services, second-largest share in mobile, ownership of an extensive optical fibre network and a strong financial profile. The extent of SLT's rating upside, following the proposed disposal, will depend on the credit profile of its new parent, the linkage strength with SLT according to our PSL criteria, and the proposed funding structure.

KEY RATING DRIVERS

Disposal Plan: SLT announced on 20 March 2023 that the Sri Lankan cabinet has granted in-principle approval to sell the 49.5% stake in SLT held by the state. The disposal is part of a plan to restructure state-owned entities (SOEs) to improve the state's financial position. SLT said steps have yet to be taken to identify potential buyers and it will take at least eight to 12 months to finalise the transaction. We believe the government will push through the disposal as SOE restructuring is an integral part of the IMF's financial support to Sri Lanka.

Sovereign Ownership Pressures Rating: We assess the legal ring-fencing and access and control between SLT and the state as 'Open' under the PSL criteria, given the absence of regulatory or self-imposed ring-fencing of SLT's cash flow and the government's significant influence over the subsidiary's operating and financial profile. SLT's second-biggest shareholder, Malaysia-based Usaha Tegas Sdn Bhd with a 44.9% stake, has no special provisions in its shareholder agreement to dilute the government's influence over SLT.

Higher Rating: However, the PSL criteria allows for a stronger subsidiary to be notched above the weaker parent's consolidated profile in extreme situations, such as when a parent is in financial distress but the subsidiary continues to operate independently and its banking access appears unaffected. We do not believe SLT is at risk of default in the next 12 months, as it has sufficient liquidity and its debt does not carry cross-default clauses that can be triggered by the parent's distress.

SLT's 'A(lka)' rating therefore reflects its relativities with national peers, but is still below its SCP due to the drag from state ownership. We apply our PSL criteria because our Government-Related Entities (GRE) Rating Criteria states that in cases where the SCP of the GRE is higher than the government's IDR, the relevant considerations of the PSL criteria will be applied to determine whether the IDR of the GRE is constrained or capped at the government's rating level.

Weak Demand in 2023: We expect SLT's revenue growth to slow to a low single-digit percentage in 2023 amid weakening consumer spending. Consumers are increasingly prioritising essential needs, such as food and medicine, as real income has fallen significantly following the currency depreciation and unprecedently high inflation. SLT's subscriber numbers and minutes of usage have already fallen in 2022. Competition has also intensified, especially in the mobile segment, leading to lower realisation of recently introduced tariff hikes.

Weak demand should be offset to an extent by increased migration to SLT's fibre-to-the-home (FTTH) network, from its own copper network, and subscriber additions. FTTH carries higher revenue per user than the copper network. SLT had 475,000 FTTH connections, a 35% increase yoy, by end-2022.

Weakening Profitability: We expect SLT's EBITDA margin to narrow to around 34% in 2023 (2022: 35.6%) amid lower demand and ongoing cost escalations. All telecom operators increased tariffs by 20%-25% in late 2022 to tackle falling margins. However, the realisation into revenue remains weak, especially in the mobile segment, due to deep price cuts by one of the smaller operators and falling demand. SLT's fixed-line business is able to maintain stable EBITDA margins due to the recent tariff hike and the FTTH segment's higher revenue per user.

Leverage to Stabilise: We expect SLT's EBITDA net leverage to remain around 1.3x in 2023 (2021: 0.9x, 2022: 1.3x) amid falling profitability. However, its leverage is strong for the rating. We expect capex of around LKR25.0 billion annually over 2023-2024 on network upgrades and expanding its fibre infrastructure.

Interest-Rate Hikes, Currency Depreciation Manageable: We expect SLT to maintain its EBITDA interest coverage closer to 4.0x over 2023-2024 (2022: 4.4x) despite interest rates rising almost threefold. Most of SLT's debt is on variable interest rates, which will raise costs. SLT's foreign-currency revenue, which accounts for 10%-12% of group revenue, is more than sufficient to meet the group's foreign-currency operating expenses and interest costs. SLT had around USD10 million in foreign-currency debt at end-December 2022, compared with USD40 million in foreign-currency cash deposits.

Sector Outlook Deteriorating: Fitch expects the average 2023 net debt/EBITDA ratio for SLT and mobile leader Dialog Axiata PLC (AAA(lka)/Stable) to remain around 1.3x (2022: 1.3x) amid weak margins and high capex. We expect sector revenue growth to slow to 8% in 2023 (2022: 15%), while the average 2023 EBITDA margin for SLT and Dialog should narrow to 31% (2022: 32%) amid low usage and high costs.

DERIVATION SUMMARY

SLT's SCP benefits from market leadership in fixed-line services and the second-largest position in mobile, along with ownership of an extensive optical fibre network. SLT has lower exposure to the crowded mobile market and has more diverse service platforms than Dialog. However, Dialog has a larger revenue base, lower forecast EBITDA net leverage and a better free cash flow (FCF) profile than SLT. Dialog is rated at 'AAA(lka)', while SLT's rating is under pressure because of the state's weak credit profile.

SLT has a larger operating scale than leading alcoholic-beverage manufacturer Melstacorp PLC (AAA(lka)/Stable), which distributes spirits in Sri Lanka through its subsidiary, Distilleries Company of Sri Lanka PLC (AAA(lka)/Stable). Melstacorp is exposed to more regulatory risk in its spirits business because of increases in the excise tax, but this is counterbalanced by its entrenched market position and high entry barriers. Consequently, the company can pass on cost inflation and maintain its operating EBITDA margin, supporting substantially stronger FCF generation than SLT.

KEY ASSUMPTIONS

Fitch's Key Assumptions within Our Rating Case for the Issuer:

- Revenue growth to slow to 4% in 2023 amid falling subscriber numbers and lower usage due to weakening consumer spending;

- Operating EBITDA margin to narrow by 150bp to 34% in 2023 due to higher costs and lower volume;

- SLT to continue capex on expanding its fibre and 4G network with LKR25 billion spent annually in 2023 and 2024;

- Effective tax rate of 28% from 2023;

- Dividend payout of 33% of net income over 2024-2025

RATING SENSITIVITIES

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

- Fitch will resolve the RWP when the proposed disposal becomes practically unconditional, which may take more than six months, and once Fitch has sufficient information on the new majority shareholder's credit profile and linkages with SLT and the proposed funding structure.

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

- Fitch would remove the RWP and affirm the National Long-Term Rating at 'A(lka)' with a Stable Outlook if the proposed disposal does not proceed and the linkages with the state remain intact.

LIQUIDITY AND DEBT STRUCTURE

Manageable Liquidity: SLT's unrestricted cash balance of LKR14 billion at end-December 2022 was sufficient to redeem its contractual maturities of around LKR11 billion. SLT's short-term working-capital debt amounted to another LKR10.0 billion and we expect the company to roll over the facilities given its solid access to local banks.

Liquidity is further enhanced by about LKR15 billion in undrawn bank credit facilities, although these are uncommitted. SLT typically does not pay commitment fees on its undrawn lines, although we believe most banks will allow the company to draw down the funds because of its healthy credit profile.

ISSUER PROFILE

SLT, an integrated telecom company operating in Sri Lanka, is a market leader in fixed-voice and broadband and the second-largest in the mobile market.

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.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

SLT's ratings are influenced by the sovereign's credit profile, in line with Fitch's PSL criteria.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Sri Lanka Telecom PLC	Natl LT	A(lka)	Rating Watch On	A(lka)
senior unsecured	Natl LT	A(lka)	Rating Watch On	A(lka)

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VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

- Government-Related Entities Rating Criteria (pub. 30 Sep 2020)
- National Scale Rating Criteria (pub. 22 Dec 2020)

- Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)
- 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

Sri Lanka Telecom PLC -

DISCLAIMER & DISCLOSURES

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

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