FitchRatings

20 MAR 2024

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

Fitch Ratings - Singapore/Colombo - 20 Mar 2024: Fitch Ratings has affirmed Sri Lanka-based telecom company Dialog Axiata PLC's National Long-Term Rating at 'AAA(lka)' with a Stable Outlook.

This reflects our view that Dialog can maintain a credit profile commensurate with a 'AAA(lka)' rating in the next 12-18 months, despite slower revenue growth, escalated costs and likely slight higher leverage.

Dialog's rating is based on its Standalone Credit Profile (SCP) of 'aaa(lka)'. This reflects a strong market position across mobile, home broadband (HBB) and pay-TV segments, effective cost management amid a challenging economic environment and a solid financial profile, compared with national peers.

Key Rating Drivers

Airtel Lanka Merger: We expect no material impact on leverage from Dialog's merger with Airtel Lanka PLC. Dialog plans to settle the transaction by issuing new shares to Bharti Airtel Ltd (Bharti, BBB-/Stable) and inherit a small portion of Airtel Lanka's outstanding borrowing. EBITDA is likely to be affected by consolidation of Airtel Lanka's operation, which we expect to have an EBITDA loss in first 12-18 months after the merger. The slight deterioration in Dialog's financial profile is mitigated by a slightly improved business profile and high ratings headroom.

Market Leadership: Dialog is the market leader across mobile and home broadband segments.

The acquisition of Airtel Lanka subscribers is likely to increase Dialog's mobile subscriber market share to over 60% from above 50% in 2023. The merger will also improve Dialog's competitiveness in both mobile and home broadband through acquiring Airtel Lanka's 4G network and a portion of Airtel Lanka's 75MHz spectrum across the 850MHz to 2.6GHz bands. Dialog relies on fixed-wireless access to deliver its broadband service to households.

Lower Organic Revenue Growth: We expect Dialog's organic revenue growth to remain at a low to mid single digits (2023: 5%) in 2024, as household purchasing power will be affected by a higher value-added-tax rate on a wider range of goods. Real income has fallen significantly following the currency depreciation and unprecedently high inflation in the past two years. Dialog has already seen a decline in its mobile and Pay TV subscribers and much slower broadband subscriber growth in 2022 and 2023.

Profitability Bottomed: We expect EBITDA margin to remain above 30% in 2024-2025 (2023: 32%) despite consolidation of loss-making Airtel Lanka, before improving in 2025 and beyond. The company expects to reduce the EBITDA loss at the Airtel Lanka business and gradually reach break-even within 12 months of the merger. We expect this to be achieved by cost savings generated from integrated network, sales and marketing channels and other administrative costs.

Lower Foreign-Currency Debt: The company paid down foreign-currency (FC) debt to USD157 million by end-2023 or 45% of total outstanding debt, from USD227 million a year earlier. There is no imminent repayment pressure on FC debt as it is mostly a term loan from International Finance Corporation that matures in 2029 and a shareholder loan from Axiata Group Berhad. Dialog had USD56 million in FC deposits to meet its FC interest costs of around USD11 million a year.

Moderating Capex: We expect capex intensity to remain largely flat at the 2023 level of around 23%-24%, before household spending power recovers further. The acquisition of Airtel Lanka's network and spectrum should also reduce the capex requirement in the near term. The absolute capex amount has risen significantly in comparison with the level before 2022, due to the currency devaluation as most of the equipment is imported.

Support from Strong Parent: Our assessment of 'Medium' legal and strategic support incentives from its stronger parent, Axiata Group Berhad, would result in a potential two-notch uplift to its rating if its SCP were to weaken, under our Parent and Subsidiary Linkage Rating Criteria. Axiata guaranteed around 40% of Dialog's debt as of end-2023. The subsidiary makes a moderate 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 Improving: Fitch expects the aggregate EBITDA net leverage for Dialog and Sri Lanka Telecom PLC (SLT, A(lka)/Rating Watch Positive) to peak in 2024, before improving from 2025 onwards, supported by margin recovery and cautious capex. The aggregate EBITDA margin should start improving after largely stabilising in 2023 at 30%, due to cost reductions, moderating inflation and a recovery in the exchange rate against the US dollar. Competition in the mobile sector is likely to moderate, as the merger of Dialog and Airtel Lanka reduces price competition.

Derivation Summary

Dialog has a stronger business profile than SLT, underpinned by its stronger market position in both mobile and home broadband and a larger EBITDA scale. SLT has a larger fibre network infrastructure and legacy fixed telephone network. In contrast, Dialog's larger radio spectrum holding supports its home broadband service based on fixed wireless technology. Both have similar financial profiles with similar forecast EBITDA net leverage. SLT's rating is drag down by Sri Lanka's sovereign rating (Long-Term Local-Currency Issuer Default Rating C).

Dialog has a slightly better business risk profile than leading alcoholic-beverage manufacturer Melstacorp PLC (AAA(lka)/Stable). This is reflected in Dialog's larger operating scale and lower regulatory risk. Melstacorp's subsidiary, Distilleries Company of Sri Lanka PLC (DIST, AAA(lka)/Stable), controls 70% of Sri Lanka's spirits production, and has maintained market leadership with its entrenched brand and access to a countrywide distribution network. Still, we expect Dialog to maintain a weaker financial risk profile due to higher forecast EBITDA net leverage and weaker free cash flow generation.

Compared with Hemas Holdings PLC (AAA(lka)/Stable), Dialog has a 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 on part of its pharmaceutical business and a more limited ability to pass on cost escalation to customers in the consumer sector in a short time. Hemas' stronger financial profile compensates for these differences, resulting in both companies being rated the same.

Key Assumptions

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

- Revenue to rise by 4%-8% over 2024-2026 (2023: 6%);

- EBITDA margin of 31%-33% over 2024-2026 (2023: 32%);

- Capex/revenue of around 24% over 2024-2026 (2023: 24%);

- Effective tax rate of 2.0% of revenue (2023: 2%);

- Dividend of around 55% of previous year's net income to be paid over 2024-2026 (2023: nil);

- Effective interest rate to climb to 9%-10% over 2024-2025 (2023: 8%);

- Subsidiary Dialog Finance PLC's (AA(lka)/Stable) debt obligations above what is required to maintain an Fitch assessed appropriate debt/tangible equity ratio of 0x will be assumed by Dialog as a hypothetical equity infusion under Fitch criteria. We assume this hypothetical equity injection to be LKR13 billion over 2024-2026 (2023: nil) to fund Dialog Finance's loan book growth.

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 our 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

Manageable Liquidity: Dialog had an unrestricted cash balance of LKR40 billion at end-December 2023, which can cover the majority of the short-term debt of LKR55 billion, including LKR33 billion outstanding bank overdraft. Dialog's liquidity has deteriorated like many other Sri Lanka corporates in the current environment. Even so, we believe local banks will honour Dialog's extended credit lines and roll over facilities given it is one of Sri Lanka's largest corporates with a solid credit profile.

At end-2023, FC debt had decreased to 45% of total borrowings, including a USD137 million term loan from International Finance Corporation that matures in 2029. The remaining US dollar borrowings are a shareholder loan from Axiata Group.

Issuer Profile

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

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Rating Actions

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

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Rating Criteria (pub.03 Nov 2023) (including rating assumption sensitivity)

National Scale Rating Criteria (pub.22 Dec 2020)

Parent and Subsidiary Linkage Rating Criteria (pub.16 Jun 2023)

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 Status

DISCLAIMER & DISCLOSURES

historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and

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