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Research Update:

Turkish Appliance Manufacturer Vestel 'B-' Rating Affirmed On Plans To Improve Liquidity; Outlook Negative

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Overview

- Vestel's operating performance remained solid in first-half 2017, with 15% year-on-year revenue growth, supported by strong volume growth in household appliances and positive currency effects.
- Although Vestel's healthy performance and favorable demographics support long-term domestic demand, the group's debt remains high and its liquidity position vulnerable due to heavy reliance on short-term debt financing.
- We note, however, that Vestel is looking to extend its debt maturity profile and has a proven track record of rolling credit lines.
- We are therefore affirming our 'B-' long-term corporate credit rating on Vestel.
- The negative outlook reflects the likelihood of a downgrade if the company fails to extend its maturity profile or if its operating performance weakens.

Rating Action

On Sept. 20, 2017, S&P Global Ratings affirmed its 'B-' long-term corporate credit rating on Turkey-based brown and white goods manufacturer Vestel Elektronik Sanayi Ve Ticaret A.S. (Vestel). The outlook is negative.

Rationale

The affirmation reflects our view that Vestel's operating performance remains sound and our expectation that Vestel's liquidity will improve in the coming months, as we understand that the company is in talks with banks to extend its debt maturity profile. However, we note that Vestel's liquidity could remain weak if the company continues relying on short-term debt financing or if its operating performance weakens. This would translate into heightened refinancing risk given Vestel's reliance on banks' willingness to continuously roll its credit facilities over.

On June 30, 2017, Vestel's liquidity position had weakened compared with the level on Dec. 31, 2016, because of some debt maturities coming due by the second quarter of 2018, which, coupled with short-term maturities, produces a significant liquidity deficit over the coming 12 months. However, we understand that Vestel intends to extend its maturity schedule for a portion

of its debt. This would somewhat smooth the debt maturity profile and reduce the liquidity risk, and we acknowledge that Vestel enjoys solid relationships with a wide network of predominantly Turkish and some international banks. Vestel also has a long track record of consistently rolling over its short-term facilities. Moreover, we understand that reliance on short-term financing is also a common feature of the Turkish funding system, since it yields lower funding rates than longer-term financing. In addition, we think Turkey's domestic banks will remain well regulated and amply capitalized.

Our assessment of Vestel's business risk profile continues to reflect the company's volatile operating margins and cash flow generation, largely because of fierce competition and uneven demand in the consumer electronics sector, in addition to volatility of raw material prices. However, Vestel has had a leading domestic market position in liquid crystal display (LCD) TV sales since 2014, and over the past several years the company has increased its market share in Europe, becoming the largest original design manufacturer of LCD TVs on the continent. Vestel has also increased its market share in the domestic white goods market to 18% at June 30, 2017, from about 15% in 2015. Nevertheless, the company still depends heavily on its key suppliers, which we see as another main weakness in Vestel's business risk profile. Although we think that margins could be volatile, we assess that they are relatively protected against currency moves, given that both revenues and operating costs are predominantly denominated in euros and U.S. dollars. We also note that the company is pursuing some hedging efforts to mitigate the exposure.

Our assessment of Vestel's financial risk profile primarily incorporates its high S&P Global Ratings-adjusted gross debt to EBITDA and strong reliance on various forms of short-term financing. We project that Vestel's adjusted leverage will remain at a high 8x-9x in 2017, as the increase in EBITDA is offset by an increase in debt stemming from the Turkish lira's depreciation and intracompany lending to the main owner Zorlu Holding (77.5% of capital). We expect the company's credit ratios and cash flow generation will remain highly volatile because of the company's exposure to demand swings, and its margins are vulnerable to raw material and cell prices. This is partly offset by our expectations of modest positive free operating cash flow (FOCF) in the coming two years, alongside solid cash interest coverage ratios of between 2.0x and 2.5x.

In our base case, we assume:

- GDP growth of about 2%-3% in Turkey over 2017-2018 and about 1.5%-2.0% in the eurozone.
- The Turkish lira (TRY) to U.S. dollar exchange rate to reach 3.90 by end-2017 and 4.15 by end-2018, compared with 3.52 at end-2016.
- Revenue growth of about 5%-6% in 2017 and 2018. For 2017, we expect a 2% year-on-year decline in TV revenues (56% of consolidated revenue) to erode some of the 17% growth expected in white goods segments (44% of consolidated revenue) due to the tax breaks during the year. We expect the Turkish government to lift the suspension on its special consumption tax, which significantly drove growth in the segment in the first half of 2017, by end-September, and therefore normalize white goods growth. In

2018, we expect white goods revenue growth to normalize to 1%-3%, and the TV segment to benefit from the world cup and new marketing brands.

- Gross profit margin to remain at about 21%-22% in 2017-2018 (22.2% in 2016), supported by stabilization in raw material prices in the white goods segment and a decline in cell prices in the TV segment, after a peak in first-quarter 2017.
- Adjusted EBITDA margin of 6.4% in 2017 compared with 6.1% in 2016, stemming from lower operating expenses thanks to sales driving increasing scale.
- Reported annual capital expenditures (capex) of about TRY400 million (about \$115 million) in 2017-2018.

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

- S&P Global Ratings-adjusted debt to EBITDA of about 8x-9x in 2017-2018.
- Positive FOCF of higher than TRY100 million in 2017 and at least break even in 2018.

Liquidity

We continue to assess Vestel's liquidity as weak. This reflects Vestel's long track record of relying on various forms of short-term funding, including bilateral loans and receivables factoring. We view this as an indication of aggressive liquidity management, since the company fully exposes itself to the volatility of the local capital markets.

Our current liquidity assessment also takes into account qualitative factors such as Vestel's solid, 20-year relationships with its key lending banks, which we assume will continue to roll over the facilities, provided they are covered by operating cash flow and the company continues to deliver satisfactory underlying operating performance.

We calculate that the company's liquidity sources will not fully cover its liquidity uses in the 12 months from June 30, 2017.

We believe that principal liquidity sources for the 12 months from June 30, 2017, include:

- Consolidated cash and equivalents of TRY1.45 billion.
- Funds from operations of about TRY450 million-TRY500 million.

We believe that principal liquidity uses for the same period include:

- Debt maturities of about TRY3.2 billion, of which TRY2.4 billion is related to the short-term portion of long-term financial liabilities.
- Annual capex of about TRY400 million.

We anticipate headroom of at least 15% under the current liabilities ratio of the financial covenants under its loan agreement with the European Bank for Reconstruction and Development.

Outlook

The negative outlook on Vestel reflects the potential for a downgrade in the next 12 months if the company doesn't succeed in improving its maturity profile, or if its operating performance deteriorates.

Downside scenario

We could lower the rating if:

- Vestel does not improve its liquidity position (with sources of cash to uses of cash remaining at current level); or
- Operational performance deteriorates due to weaker demand or tighter availability of consumer financing in Turkey, adverse currency swings that could impact both domestic and international demand, or heightened competition. More specifically, we would lower the rating if the adjusted EBITDA margin was sustainably below 5%, translating into significantly negative FOCF.

Upside scenario

We could revise the outlook to stable if the company improves its liquidity position by extending the debt maturity profile in such a way that liquidity sources sustainably approach its liquidity uses, while its operating performance remains solid.

Ratings Score Snapshot

Corporate Credit Rating: B-/Negative/--

Business risk: Weak

- Country risk: High
- Industry risk: Moderately high
- Competitive position: Weak

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Negative (-1 notch)
- Liquidity: Weak (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable ratings analysis: Neutral (no impact)

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Technology Hardware And Semiconductors Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Vestel Elektronik Sanayi Ve Ticaret A.S.

Corporate Credit Rating

B-/Negative/--

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