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Research Update:

Turkish Appliance Manufacturer Vestel Downgraded To 'CCC+' On Liquidity Concerns; Outlook Stable

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Overview

- Vestel has not extended its debt maturity profile and remains heavily reliant on short-term debt financing, which represents 83% of its total reported debt.
- We now expect Vestel's debt (after our adjustments) will be about 50% higher than in our previous forecast since the lira has weakened and 42.5% of debt is denominated in hard currency, and Vestel acquired a 50% stake in META for TRY1.1 billion in June 2018.
- Nevertheless, we anticipate 15%-20% revenue growth and forecast the S&P Global Ratings-adjusted EBITDA margin at 7%-8% in 2018, mainly because the weaker lira supports export demand (69% of revenues).
- We are lowering our long-term rating on Vestel to 'CCC+' from 'B-'.
- The stable outlook reflects our expectation that over the next 12 months Vestel can keep rolling over its debt and meet its financial obligations, supported by continued solid operating performance, with an adjusted EBITDA margin higher than 6% in 2018-2019.

Rating Action

On Sept. 18, 2018, S&P Global Ratings lowered its long-term issuer credit rating on Turkey–based TV, electronics, and household appliances manufacturer Vestel Elektronik Sanayi Ve Ticaret A.S. (Vestel) to 'CCC+' from 'B-'. The outlook is stable.

Rationale

The downgrade stems from Vestel's deteriorated liquidity position and higher debt, combined with Turkey's overall weaker macroeconomic environment.

Vestel's liquidity has weakened further in 2018 compared with 2017, as demonstrated by an increase in short-term debt maturities. We calculate that the company's liquidity sources represented about 0.42x its liquidity uses in the 12 months to June 30, 2018, down from 0.54x the previous year. We understand that reliance on short-term financing is a common feature in Turkey, since short-term debt is less costly than longer-term financing.

However, Vestel remains exposed to banks' willingness to continuously roll over its debt.

Furthermore, the company's S&P Global Ratings-adjusted debt increased to Turkish lira (TRY) 8.4 billion (about $1.9 billion) in June 2018, from TRY6.7 billion in December 2017. This was partly due to the weaker lira, since 42.5% of the debt is denominated in hard currency, resulting in a reported debt increase of about TRY1.2 billion; and Vestel's acquisition of 50% of nickel and cobalt producer META for TRY1.1 billion (about $250 million) on June 29, 2018, from its parent Zorlu. This acquisition could increase Vestel's diversification in the automotive business by securing the raw materials for the production of electric vehicle batteries. However, we think execution risks are high, given Vestel's limited track record in the automotive space.

More importantly, we view Vestel's continued intracompany lending to Zorlu as a further source of concern regarding liquidity and debt. We don't expect Vestel's intracompany lending will increase significantly beyond the TRY1.6 billion reported in second-quarter 2018 (TRY1.2 billion at year-end 2017), given that the level of debt is capped in the loan documentation. However, the META transaction resulted in Vestel increasing its external debt to finance Zorlu.

We also think the overall macroeconomic environment in Turkey could result in weaker consumer purchasing power, translating into slower domestic demand. In addition, we believe the country's accumulated imbalances, domestic policy, and geopolitical risks could push up the cost of funding, weaken the lending environment, and increase refinancing risk for corporate entities. As a result, refinancing or rolling over debt could become challenging for Vestel as interest rates remain high. We estimate Vestel's average cost of debt at about 20% over the next 12 months. However, we acknowledge that Vestel enjoys solid relationships with a wide network of lenders, predominantly Turkish banks, but also international banks. Vestel also has a long track record of consistently rolling over its short-term facilities.

Vestel manufactures brown (household appliances and TVs) and white goods (such as electrical appliances, refrigerators, washing machines, and dryers). 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, more recently from Asian competitors, and uneven demand in the consumer electronics sector, in addition to volatile 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, has increased its market share in Europe, becoming the largest original design manufacturer of LCD TVs on the continent. Vestel also increased its market share in the domestic white goods market to 20% as of June 30, 2018, from about 15% in 2015. Nevertheless, the company still depends heavily on its key suppliers in the consumer electronics specifically, which we see as a key weakness. Although we think Vestel's margins can be volatile, we believe they are relatively protected against currency movements, given that both revenues and the cost of goods sold are predominantly denominated in euros and U.S.

dollars. We also note that the company is pursuing hedging efforts to mitigate the exposure.

Our assessment of Vestel's financial risk profile primarily incorporates its high S&P Global Ratings-adjusted debt to EBITDA and volatile free operating cash flow. We project that Vestel's adjusted leverage will remain high, at 9x-10x, in 2018-2019 as the increase in EBITDA is offset by higher debt stemming from the Turkish lira's depreciation, working capital needs, and some impact from the META acquisition. We expect the company's credit ratios and cash flow generation will remain highly volatile because of its exposure to demand swings and its margins' vulnerability to raw material and cell prices. However, we anticipate relatively stronger cash interest coverage ratios of between 2.5x and 2.8x.

In our base case, we assume:

- GDP growth of about 4% in Turkey over 2018 before turning negative in 2019, and about 1.5%-2.0% GDP growth in the eurozone.
- An exchange rate of TRY6.90 to $1 by year-end 2018 and remaining stable after that, compared with TRY3.78 at year-end 2017.
- Revenue growth of 15%-20% in 2018 and 2019. We expect the white goods segment (40%-45% of consolidated revenue) to expand by 20%-30% in 2018 and 2019, mainly benefiting from the weaker lira lifting international demand, and higher domestic demand for air conditioning (A/C) units. We expect the TV segment (55%-60% of consolidated revenue) to expand by 10%-15% in 2018 and 2019. While we continue to expect a contraction in domestic volumes, due to reduced consumer confidence and increasing competition, we expect an improving sales mix (higher contribution of larger screens and UHD TVs) and price adjustments in line with inflation to support domestic operations. We also expect the weaker lira to benefit international demand in this segment.
- We expect our adjusted EBITDA margins to strengthen to 7%-8% in 2018 from 5.5% in 2017 and a gradual contraction in 2019 to 6%-7%, mainly due to higher competition and rising panel prices. More specifically, we expect reported gross margins of around 21%-22% in 2018 compared with 20% in 2017 on the weaker Turkish Lira, easing plastic and metal prices, and an improved sales mix (higher-margin A/C units).
- A positive change in working capital in 2018 of TRY150 million–TRY200 million in 2018, mainly benefiting from the positive impact of the World Cup in first-half 2018, which led to lower inventory. We expect negative working capital changes of TRY100 million–TRY 150 million in the future, in line with historical levels.
- We expect reported capital expenditure (capex) to remain stable at 4%-5% of sales, with reported annual capex of TRY700 million–TRY850 million in 2018-2019.

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

- S&P Global Ratings-adjusted debt to EBITDA of 9x-10x in 2018-2019 compared with 10.2x in 2017.

- Positive free operating cash flow of TRY100 million–TRY300 million in 2018, and almost breakeven from 2019 onward, as the combination of negative working capital and declining margins from 2019 weighs in.
- EBITDA cash interest coverage of 2.5x-3.0x for 2018-2019 compared with 2.5x in 2017.

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.

We also take 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 total about 0.42x its liquidity uses in the 12 months from June 30, 2018. We believe the principal liquidity sources for that period include:

- Consolidated cash and equivalents of TRY1.66 billion.
- Funds from operations of TRY850 million-TRY900 million.

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

- Debt maturities of about TRY5.1 billion, of which TRY1.6 billion is related to the short-term portion of long-term financial liabilities. More specifically, we expect an even, quarterly spread between upcoming debt maturities of $180-$200 million over the next three quarters.
- Annual capex of TRY700 million–TRY800 million.

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

Outlook

The stable outlook reflects our expectation that Vestel should meet its financial obligations in the next 12 months, supported by continued solid operational performance, with an adjusted EBITDA margin higher than 6% in 2018-2019. We also expect that Vestel will manage to roll over its short-term debt, given that the maturities are evenly spread out over the next 12 months.

Downside scenario

We could take a negative rating action if Vestel was unable to refinance its upcoming short-term maturities on time. This could result from unanticipated liquidity concerns in the Turkish banking system, higher-than-expected funding costs, weaker-than-expected operational performance due to lower demand in the TV segment, or increased competition in international markets.

Upside scenario

We could upgrade Vestel if its liquidity position improved and the company was able to extend its debt maturity profile, such that liquidity sources sustainably approached liquidity uses, while operating performance remains solid.

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

Related Research

- Credit FAQ: What's Next For Turkish Issuers, Aug. 21, 2018
- Turkey Long-Term Foreign Currency Rating Lowered To 'B+' On Implications Of Extreme Lira Volatility; Outlook Stable, Aug. 17, 2018

Ratings List

Downgraded

	To	From
Vestel Elektronik Sanayi Ve Ticaret A.S.		
Issuer Credit Rating	CCC+/Stable/--	B-/Negative/--

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.