

Vestel Elektronik Sanayi Ve Ticaret A.S.

Istanbul, Turkey

Ratings & Contacts

Category	Moody's Rating	Analyst	Phone
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Guaranteed Notes due 2012	Ba3	David Staples, London	

Key Indicators

Vestel Elektronik Sanayi Ve Ticaret A.S.

	FY2005	FY2004	FY2003
EBIT Margin (1)	3.7%	6.2%	7.3%
Adjusted RCF / Net Adjusted Debt	139.6%	390.7%	547.9%
Adjusted FFO Interest Coverage	301.6%	335.0%	307.3%
Adjusted RCF / Capex + Investments (net of disposals) (2)	70.3%	119.1%	104.4%
Adjusted Total Debt / Adjusted EBITDAR (3)	2.52x	1.75x	1.88x
(Adj. EBITDA - Capex) / Net Cash Interest Expense (4)	0.08x	(2.32x)	(3.89x)

[1] Adjusted for Operating Exceptional Items; [2] Excludes Net Financial Investments; [3] Adjusted for Pensions; [4] Cash Interest Paid net of Interest Income from P&L

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Corporate Profile

Vestel Elektronik Sanayi Ve Ticaret A.S. ('Vestel', or 'the company') is a leading manufacturer and distributor of consumer electronics, digital products and white goods within Turkey and the EU, and is the third largest original electronic equipment (OEM) manufacturer in the world. The company was acquired by its current majority owners, Collar Holding, in 1994, which retains a 51.6% stake, with the remainder floated on the Istanbul Stock Exchange. Collar Holding is itself wholly owned by Ahmet Nazif Zorlu, who also owns interests in other businesses (textiles, financial services, energy) via Zorlu Holding. The Zorlu family represents two of seven of Vestel's Board members, with two other executive and one non-executive member, and two being independent.

The company's production capacity and sales have grown very rapidly in recent years, with total units sold rising from c.6.5 million in 2000 to about 23 million in 2005. At the same time, however, the company has diversified away from TVs, a fairly saturated market in the EU, resulting in a significant change in the composition of its sales. In 2000, TVs represented about 80% of total units sold; by 2005 this fell to less than half, including flat TVs, which were introduced in 2004. The main growth areas have been digital products, refrigerators and washing machines. The company also intends to increase or launch production of cookers, dish washers and dryers by 2007.

Vestel's European market for TVs falls into 'A' brand and 'B' brand companies. 'A' brands tend to be higher end and better known, with customers including Hitachi, Toshiba, JVC, Panasonic, Sharp, Mitsubishi, Akai, Sanyo and TEAC. 'B' brand customers consist mainly of large retailers, eg. Dixons, Kesa, Carrefour, Metro, Makro, Quelle, Alba and Bush, whose products are generally sold under their brand name. Under so-called 'model exclusivity' agreements Vestel designs a product exclusively for a single customer. Vestel estimates that 'B' brands make up 70% of the European market in terms of units but 50% in terms of value, while higher priced 'A' brands make up the rest. In light of the mature market for TVs in the EU, Vestel is targeting the replacement market, especially for flat panel TVs, and in the higher priced 'A' brand market. Vestel's own exports are about 75% to the 'B' brand market and 25% to 'A' brand markets. Its exports accounted for 57.5% of Turkish TV exports in 2005, well ahead of its nearest competitors.

As part of its strategy to diversify its production range, Vestel has gradually increased its stake in Vestel Beyaz Esya Sanayi Ve Ticaret A.S. ('Vestel White Goods', or 'VWG'), which has been fully consolidated in Vestel's accounts since 2004. VWG is a manufacturer of refrigerators, washing machines, and air conditioners. It was established in 1997 by the Zorlu family, which retained a majority ownership until this year. In April 2006 VWG completed an IPO whereby Vestel Electronics raised its stake in VWG from 35% to 68.53%, with the remaining share being publicly traded. The net cost to Vestel amounted to c.YTL 98 million (USD 72 million), while VWG intends to use the proceeds in part to pay down debt.

The company is also seeking to diversify geographically, notably in Russia, Ukraine, the Middle East, and North Africa. To this end, in 2003 the company opened its first TV manufacturing plant in Alexandrov, near Moscow, with a further plant for the construction of washing machines and refrigerators commencing production in 2005. Vestel has invested over USD 60 million in Russia to date, and targets production in that country at around one million units by 2006, thus accounting for the bulk of the increase in its overall targeted production capacity in the near term.

Credit Challenges

- Severe pricing pressure: Increased volumes have been offset by declining prices for Vestel's core products. Television and digital products prices (in YTL) in both the domestic and export markets fell significantly in the 2002-2004 period as a result of stronger competition, including from Asia. The downward trend in television prices continued in 2005. Moody's notes that this was at least partly attributable to the relative strength of the YTL versus the EUR.
- Decline in operating margins: While some of the margin impact of the weak pricing environment has been absorbed by Vestel's components manufacturers, EBITDA margins at Vestel have also fallen significantly in recent years, to 6.4% in 2005, from 16.6% in 2002. Moody's notes, however, that the impact on retained cash flows has to some degree been offset by lower finance charges due to the appreciation in 2005 of the YTL versus the EUR, in which a large share of the company's debt is denominated.
- Expansion into new markets remains uncertain: The returns from geographic expansion, notably in Russia, remain uncertain and are likely to be longer term, while the investments have resulted in free cash flow turning negative in 2005. While the company expects capex to decline in 2006, free cash flows may remain constrained on account of the cost to increase Vestel's stake in VWG and difficult market conditions.
- EU enlargement: The recent enlargement of the EU to new countries in Central Europe could create additional pricing pressures in the industry.
- Fairly concentrated customer base. The client base is fairly concentrated, with the top five clients accounting for about 41% of TV and digital sales and 31% of white goods sales in 2004.

Credit Strengths

- Growing market share in EU market: Vestel remains a leader in the European colour TV markets, with growing market shares. Vestel estimates its share of the market to be 23% in 2004, versus 16% in 2002. This is comprised of 24% for 'B' brands (in units) and 19% for 'A' brands. Vestel's market share of the domestic TV market also remains strong, estimated at 45% in 2005.
- Proximity and tariff-free access to EU markets: Since Turkey's entry into a Customs Union with the EU in January 1996 its exports have benefited from free access to that market (although certain of the company's components sourced from outside the EU are subject to EU customs taxes).
- Adaptability to changing consumer demands. The company has shifted its product range considerably in recent years in recognition of changing consumer demands. New product launches in TVs include flat screen and wide screen TVs, and digital products (DVDs, PVR's, set top boxes). The company has also entered the market for refrigerators, air conditioners and washing machines. Going forward, TVs are expected to account for less than half of production capacity, versus 80% in 2000.
- Zero dividend policy. The company has maintained a zero dividend policy in recent years. However, to satisfy CMB (Capital Market Board) requirements, Vestel will distribute 20% of net profits in the form of a bonus share premium in the medium term.

Rating Rationale

In May 2006 Moody's assigned a corporate family rating of Ba3 to the Group with a negative outlook, while similarly changing the outlook of the USD 225 million guaranteed notes due 2012 to negative. The change in outlook reflected the impact of a combination of factors currently affecting the company's credit metrics. These include: i) the continued weakening in operating margins, which have shown a sustained decline in recent years and was the main driver behind the change in outlook, in addition to; ii) the increased capital spending in the past two years, aimed mainly at increasing production capacities in Russia, where long-term returns on the investment remain uncertain; and iii) the recently increased stake in Vestel White Goods, an entity that has been consolidated since 2004, which the company estimates led to a net cash outflow of USD 72 million. While Moody's recognises that some of the decline in margins in 2005 was attributable to the relative strength of the Turkish Lira versus the Euro, the decline also reflects continued downward price pressure within Vestel's main markets, and increased commoditisation of its products.

Structural Considerations

The guaranteed notes due 2012 are rated at the same level as the corporate family rating, as Moody's expects that going forward only a limited portion of total debt will be outside the guarantor group, notably at Vestel White Goods, and therefore structurally senior to the bonds. The bonds are issued by Vestel Electronics Finance Ltd., and guaranteed by Vestel Elektronik Sanayi ve Ticaret A.S, but not by its subsidiaries.

Key Indenture Covenants

Key indenture of the USD 225mn guaranteed notes due 2012 include:

- Restricted payments not to exceed 25% of consolidated net worth (USD50mn carve-out for investments in unrestricted subsidiaries or joint ventures);
- Maximum total debt/EBITDA of 4x;
- Secured debt/EBITDA maximum 0.75x;
- Minimum fixed charge coverage of 2.25x;
- Maintenance of consolidated net worth of at least USD 300 million;
- Put option in case of change of control.

Liquidity Profile

Vestel's liquidity remains strong. At the end of 2005 Vestel reported YTL 581 million in cash and equivalents, and YTL 698 million in total borrowings, of which YTL 172 million in current liabilities. A cash balance in excess of short-term debt and net financial charges has been maintained since 2002. At end-2005, the company further had access to USD 600 million in undrawn credit lines. Moody's notes that virtually all the company's borrowings are in USD and Euros, and that while c.72% of revenues in 2005 were from exports, there remains some exposure to currency volatility.

The company generated free cash flows in the 2002-04 period, but this turned negative in 2005 partly due to weaker operating cash flows, and investments in new capacity and in the Russian plants. While the company expects these investments to decline in 2006 and 2007, free cash flows may be remain constrained in 2006 by the purchase cost of the increased stake in VWG.

Financial Profile

Vestel's revenues fell by 3.3% in 2005 following a very strong growth of 24% in 2004, which was boosted by one-off events such as the Olympics and Football Championships. However, the company's EBITDA margins have progressively weakened in recent years, from as high as 16.7% in 2002 to 8.6% in 2004 and 6.4% in 2005.

The decrease in operating margins can be partially explained by the Turkish Lira appreciation against the Euro in 2005, given that over 80% of the company's cost base is denominated in USD and EUR, particularly for components. However, Moody's believes that the severity of the decline in margins is clearly also the result of pricing pressure due to increased international competition, only some of which can be passed on to the components manufacturers.

Due to the inverse impact of YTL currency movements on operating profits and financial charges, which can distort reported operating profits, Moody's believes that cash flow metrics are a better indicator of the company's liquidity. In 2005, Adj. Retained Cash Flow/Total debt was at 26.3%, and 139.6% for net debt.

Rating Outlook

The negative outlook reflects primarily Moody's concerns about the ongoing decline in operating margins, more recently combined with increased investments to increase the stake in Vestel White Goods as well as to expand production capacity in Russia.

What Could Drive the Rating Up

The outlook could be stabilised if the company manages to maintain or improve on current margins and generate free cash flow, thereby preventing a further weakening in its credit metrics.

What Could Drive the Rating Down

The ratings could be lowered if the company's operating environment continues to negatively impact on margins, and if free cash flows remain negative leading to a weakening in credit metrics.

Company Description

Headquartered in Istanbul, Turkey, Vestel is a leading manufacturer of consumer electronic products, including televisions, digital products and white goods. The company is one of the largest original equipment manufacturers (OEMs) in the world. In fiscal year 2005 the company reported YTL 4.46 billion (USD 3.3 billion) and YTL 284 million (USD 210 million) in revenues and EBITDA, respectively.

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Note: For the most current liquidity ratings and analysis, see the Speculative Grade Liquidity Assessment on this issuer.

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