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RESEARCH

## Research Update:

# Turkish Electronics Co Vestel Outlook To Positive On Cash Flow Prospects; 'B+' Rating Affirmed

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## Rationale

On Jan. 30, 2007, Standard & Poor's Ratings Services revised to positive from negative its outlook on Turkey-based Vestel Elektronik Sanayi Ve Ticaret A.S. (Vestel), a cost-efficient consumer electronics manufacturer, reflecting our expectations of improving cash flow generation and positive shareholding developments at Vestel. At the same time, the 'B+' long-term corporate credit rating was affirmed.

At Sept. 30, 2006, Vestel had consolidated financial debt of $692 million.

Vestel's cash flow generation, which is currently modest, is expected to improve in 2007, as revenues and EBITDA from the white-goods division (about 20% and 30%, respectively, of group totals in first-half 2006) continue to rise, on the back of recently increased production capacity. Capital expenditures should remain at about $100 million per year.

During fourth-quarter 2006 Vestel's shareholder Zorlu Holding, a holding company controlled by Vestel's chairman Ahmet Zorlu, sold a majority stake in Denizbank for $2.4 billion and announced its intention to use part of the proceeds to purchase the 51.6% of Vestel's equity owned by Collar Holding (100% owned by Mr. Zorlu). Having a controlling shareholder in a comfortable net cash position is positive for Vestel's credit quality.

In 2005, 72% of Vestel's revenues and 64% of its gross profit came from exports, largely to the EU. In Europe, robust consumer demand for Vestel's product range is supported by the substitution of cathode ray tube (CRT) TV sets by liquid crystal display (LCD) TV screens, falling prices per square inch, and the rising adoption of high-definition displays. Vestel shipped about 11% of flatscreen TVs sold in Europe in the first nine months of 2006. In addition, in April 2006 Vestel increased to 72.6% from 35% its stake in Vestel Beyaz Esya Sanayi ve Ticaret A.S (Vestel White Goods), the third-largest player in refrigerators and washing machines in Turkey, and a fast-growing contender in European white goods.

The rating on Vestel remains primarily constrained by the volatile Turkish macroeconomic environment and resulting currency swings; the company's significant debt burden; and the highly competitive nature of the company's end-markets.

Vestel continues to benefit from its favorable cost position, flexible manufacturing capabilities, considerable economies of scale, limited marketing and distribution expenses, service quality, and end-market proximity. Turkey's participation in the European Customs Union gives Vestel a significant competitive advantage, although competitors with equally low costs could present a threat in the future.

About 53% of Vestel's debt at June 30, 2006, was dollar-denominated. In addition, an increasing proportion of input costs are also dollar-denominated, while manufacturing costs are essentially lira-denominated. A large part of Vestel's most predictable cash flows is euro-denominated, however, which creates significant risks. An increasing proportion of LCD TV sales are dollar-denominated.

The company's EBITDA margins, on the other hand, have benefited from the Turkish lira's recent weakness, jumping to 10.7% in the first nine months of 2006, from 5.7% in the first nine months of 2005.

### Liquidity

Vestel's liquidity is adequate for the rating, but not ample. At Sept. 30, 2006, the company had cash and equivalents of new Turkish lira (TRY) 478 million. We believe that the company's liquidity investment policies, which have historically included more than one-half of TRY-denominated assets, expose Vestel to currency mismatches compared with its significant short-term borrowings of TRY578 million at Sept. 30, 2006. Apart from its $225 million bond and its €75 million notes and financial leases, the company's funding is largely sourced on a short-term basis.

With significantly lower capital spending in the coming months, we expect Vestel's free cash flow generation to be positive, however, and to therefore become a source of liquidity.

At June 30, 2006, the company complied with financial covenants included in the indenture of Vestel Electronics Finance Ltd.'s $225 million 'B+' rated bond. The margin under the 4x debt-to-EBITDA ratio was moderate at 13%, however, reflecting the significant depreciation of the Turkish lira against the dollar in second-quarter 2006. We estimate that currency impacts alone caused a more than TRY200 million net debt increase in first-half 2006, about one-half of which was reversed by year end, as the lira regained some ground in second-half 2006.

## Outlook

The positive outlook reflects the potential for an upgrade if the company's operating performance and, notably, cash flow generation, continues to improve, enabling some debt reduction. An upgrade would also hinge on our satisfaction with Vestel's majority shareholder's long-term financial and strategic goals, a lower reliance on short-term funding, and better currency matching of currencies and cash flows. On the other hand, the outlook could return to stable in the case of operating underperformance or liquidity pressure.

## Ratings List

| | To | From |
|---|---|---|
| Corporate credit rating | | |
| | B+/Positive/-- | B+/Negative/-- |

NB: This list does not include all ratings affected.

**Additional Contact:** Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

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