

### Research Update:

## Outlook On Turkey-Based Vestel Revised To Stable On Improved Performance And Covenant Headroom; 'B-' Rating Affirmed

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## Research Update:

# Outlook On Turkey-Based Vestel Revised To Stable On Improved Performance And Covenant Headroom; 'B-' Rating Affirmed

## Overview

- Turkish electronics manufacturer Vestel Elektronik Sanayi Ve Ticaret A.S. has higher covenant headroom than in the past, in our view particularly because of demonstrated shareholder support, strengthening sales in recent months, and effective cost management.
- We are revising the outlook on the 'B-' rating on Vestel to stable.
- The rating remains constrained by Vestel's reliance on short-term funding and its weak cash generation in 2009. An improvement in Vestel's cash generation and a reduction in gross short-term debt could be positive for the rating.

## Rating Action

On Feb. 22, 2010, Standard & Poor's Ratings Services revised to stable from negative its outlook on Turkish brown and white goods manufacturer Vestel Elektronik Sanayi Ve Ticaret A.S. (Vestel). At the same time, we affirmed the 'B-' long-term corporate credit rating on Vestel. We also affirmed the 'B-' issue rating on Vestel subsidiary Vestel Electronics Finance Ltd.'s \$225 million notes due May 2012. The '4' recovery rating on these notes remains unchanged.

## Rationale

The outlook revision reflects our belief that Vestel's covenant headroom at Dec. 31, 2009, remained adequate, after a sizable increase as of June 30, 2009, versus the tight year-end 2008 level. In our opinion, these improvements in turn reflect the demonstrated support from Vestel's main shareholder, Mr. Ahmet Zorlu, through a Turkish lira (TRY) 160 million equity increase in 2009, and Vestel's recently improved profitability.

Still, the rating remains constrained by what we see as Vestel's high reliance on various forms of short-term funding; high leverage; volatile operating performance, partly reflecting uneven macroeconomic conditions in Turkey and foreign exchange rate swings; and weak and recently negative cash generation. These weaknesses are only partially mitigated, in our view, by the company's cost-efficient manufacturing and rising market share in the EU TV market after weathering the challenging transition to flat-screen TVs. At Sept. 30, 2009, Vestel reported gross consolidated debt of \$589 million.

We believe, based on discussions with Vestel's management, that the company preserved covenant headroom at year-end 2009 about in line with June 30, 2009, recorded levels. The latter date marked the end of six consecutive calculation dates where the company had headroom of less than 15% on at least one of its financial covenants.

In first-nine-months 2009, Vestel reported an 8% year-on-year increase, in Turkish lira terms, in its consolidated revenues. Reported revenues benefited from the weaker Turkish lira, however. In dollar terms, revenues declined by 16% during the nine-month period, but rose by 21% in third-quarter 2009, on the back of Vestel's solid export growth. Vestel reported exports up 51% year-on-year in dollar terms in third-quarter 2009. Despite weak demand for brown and white goods in 2009, Vestel's early and aggressive cost cutting has enabled it in our view to lift reported EBITDA margins to 13% in first-nine months 2009 from 8% a year before.

In first-nine months 2009, we calculate that Vestel's unadjusted free operating cash flow (FOCF) was negative TRY321 million, including a very large TRY526 million outflow for changes in operating assets and liabilities, primarily reflecting Vestel's materially deteriorated working capital. This was partly offset, however by a TRY160 million equity injection by Collar Holding, Vestel's largest shareholder, which is 100% owned by Mr. Zorlu. We believe, based on discussions with Vestel, that Mr. Zorlu's main holding company Zorlu Holding, still has sizable cash and low debt at parent company level.

### **Liquidity**

We continue to assess Vestel's liquidity as "weak" in spite of significant improvement in its covenant headroom, the recent equity increase, and our expectation for positive cash generation in fourth-quarter 2009. Our assessment primarily reflects Vestel's continued reliance on various forms of short-term funding, including short-term borrowings, receivables factoring, and letters of credit. It also reflects our expectation that Vestel's covenant headroom will remain exposed to currency fluctuations, particularly around calculation dates.

Consolidated short-term borrowings were TRY480 million at Sept. 30, 2009, against consolidated cash and equivalents and assets held for trading of TRY322 million. We understand that these figures include short-term debt of about TRY168 million and cash and equivalents of TRY109 million at 72.6%-owned, listed Vestel White Goods (VWG), suggesting to us that the parent company's short-term debt could significantly exceed cash and investments.

Although Vestel has cut gross tangible and intangible capital expenditures (including capitalized development costs) to about 3% of revenues (from about 4% a year before), we expect near-term free cash flow generation to remain volatile and constrained by the company's profitability, which we consider weak. In addition, Vestel's working capital frequently experiences large swings, as illustrated by a TRY259 million decline in trade payables and a

TRY275 million increase in inventories in first-nine months 2009, which contributed to an overall TRY526 million cash outflow from "changes in operating assets and liabilities" as reported by the company, and largely explained the negative TRY321 million FOCF figure. Vestel's FOCF is generally skewed toward the fourth quarter, however.

Vestel Electronics did not pay a parent company dividend with regard to 2008 and we do not anticipate that it will pay one for 2009. The company relies to a large extent on VWG's annual dividends, which declined significantly, however, to TRY6 million in cash in 2009 (including only about TRY4 million paid to Vestel), from TRY52 million (of which about TRY37 million to Vestel) in 2008. We anticipate, however, that VWG will likely be able and willing to increase dividends for 2009. We note that VG's net profit as reported under Turkey's capital market board rules stood at TRY93 million in first-nine months 2009, up from TRY46 million in first-nine months 2008.

At June 30, 2009, Vestel complied with financial covenants included in the indenture of Vestel Electronics Finance Ltd.'s \$225 million bond due May 2012--the company's main long-term debt instrument. Covenants are calculated at end-June and end-December. We calculate that the margins under the 4x debt-to-EBITDA ratio and above the 2.25x fixed charge coverage ratio improved significantly from the December 2008 level, to about 28% and 26%, respectively, from about 4% for both ratios at year-end 2008. As the improvement came from significantly higher calculated EBITDA--which more than offset higher covenant debt and interest, despite the rights issue--we are uncertain about Vestel's ability to maintain and increase the current headroom, and expect future compliance and headroom levels to remain largely dependent on potential swings in currencies and in Vestel's margins. The debt-to-EBITDA covenant is calculated on gross adjusted debt, including discounted and undiscounted letters of credit, and as a result has steadily increased in lira terms (and slightly decreased in dollars) over the past 18 months. The extent to which Vestel's covenant headroom could benefit from Turkey's current lower interest rate environment is unclear to us, the bulk of the company's cash-funded debt being denominated in dollars and euros, while the currency mix of other instruments affecting covenant debt and interest is not disclosed. We see risks of currency mismatch as partly offset, from a liquidity perspective, by Vestel's maintenance of a large proportion of dollar-denominated (49%) and euro-denominated (38%) cash and investments. Although interest coverage is calculated on gross interest costs, it benefits somewhat from the inclusion of gross interest income in EBITDA.

### **Recovery analysis**

The \$225 million guaranteed notes are rated 'B-', with a recovery rating of '4', indicating our expectation of average (30%-50%) recovery in the event of a payment default.

We have valued Vestel on a liquidation basis, given our assessment of the company's business risk profile as "weak," the strong competition the company faces from several strong players, and its leading brands globally. However,

as we see some potential for restructuring in Turkey (valuable distribution network and brand), we have also assessed recovery prospects in a going-concern scenario. After deducting priority liabilities, we estimate recovery prospects for the unsecured issues in the 30%-50% range.

Recovery prospects for Vestel's unsecured notes reflect, in our view, the estimated value available and accessible to creditors, the likelihood of insolvency proceedings being adversely influenced by Vestel's Turkish domicile, and the complex capital structure, with a significant proportion of short-term debt rolled over periodically. The recovery ratings also reflect the unsecured nature of the debt.

For more details on our recovery analysis on Vestel, please see "Vestel Elektronik Sanayi Ve Ticaret A.S.'s Recovery Rating Profile," published on Dec. 22, 2008, on RatingsDirect.

## Outlook

The stable outlook reflects our expectation that Vestel will likely unwind some of its working capital built up over 2009 to meaningfully improve free cash flow in 2010, and will allocate free cash flow primarily to debt reduction. The stable outlook also factors in the maintenance of covenant headroom of at least 15%-20% for the next calculation dates.

The ratings could experience downward pressure in particular if we see that covenant headroom weakens or cash flow generation does not improve in line with our expectations.

Ratings upside could in our view come from Vestel's steady reduction of its gross debt, particularly short-term debt, and the maintenance of adequate financial covenant headroom, among others.

## Related Research

- Principles Of Corporate And Government Ratings, June 26, 2007
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009
- Key Credit Factors: Business And Financial Risks In The Global High Technology Industry, Sept. 18, 2008

## Ratings List

Ratings Affirmed; Outlook Action

To

From

*Research Update: Outlook On Turkey-Based Vestel Revised To Stable On Improved Performance And Covenant Headroom; 'B-' Rating Affirmed*

Vestel Elektronik Sanayi Ve Ticaret A.S.		
Corporate Credit Rating	B-/Stable/--	B-/Negative/--
Vestel Electronics Finance Ltd.		
Senior Unsecured*	B-	B-
Recovery Rating	4	4

\*Guaranteed by Vestel Elektronik Sanayi Ve Ticaret A.S.

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Complete ratings information is available to RatingsDirect on the Global Credit Portal subscribers at [www.globalcreditportal.com](http://www.globalcreditportal.com) and RatingsDirect subscribers at [www.ratingsdirect.com](http://www.ratingsdirect.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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) 495-783-4011.

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