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Research

Turkish Appliance Manufacturer Vestel Outlook Revised To Stable; 'B-' Rating Affirmed

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- Turkish appliance manufacturer Vestel's reliance on short-term financing is far higher than we anticipated, partly due to sizeable intragroup lending to its parent company, Zorlu Holding.
- This is partly offset by the company's solid operating performance and our expectation that it will gradually further improve.
- We are therefore revising our outlook on Vestel to stable and affirming the 'B-' long-term rating.
- The stable outlook reflects our view that the company is moving to sharply reduce its short-term debt in the second half of 2015, through refinancing and working capital management, as well as a decrease in lending to Zorlu Holding.

FRANKFURT (Standard & Poor's) Sept. 17, 2015--Standard & Poor's Ratings Services today revised its outlook on Turkey-based brown and white goods manufacturer Vestel Elektronik Sanayi Ve Ticaret A.S. (Vestel) to stable from positive. At the same time, we affirmed our 'B-' long-term corporate credit rating on the company.

The outlook revision primarily reflects Vestel's far higher reliance on short-term financing than we anticipated, partly owing to sizeable intragroup lending to its parent company, Zorlu Holding. In our view, the company's gradually improving operating results, partly helped by the recent marked depreciation of the Turkish lira against hard currencies, are offset by its aggressive liquidity management that relies heavily on continued access to short-term financing. In the first half of 2015, Vestel's short-term debt increased by Turkish lira (TRY) 1.6 billion to TRY2.1 billion ($0.7 billion) compared with year-end 2014. As a result, 81% of Vestel's gross financial debt

was short-term as of June 30, 2015, compared with 28% at year-end 2014.

Nevertheless, the company posts overall solid operating performance and is one of the largest exporters in Turkey. We consequently expect that Vestel will continue to have solid access to local banks and short-term loans to finance its working capital requirements. Therefore, we continue to view its liquidity as "less than adequate" rather than "weak."

Our assessment of Vestel's business risk profile reflects its volatile operating margins and cash flow generation, largely because of fierce competition and uneven demand in the consumer electronics sector. That said, Vestel's market share in liquid crystal display (LCD) TV sales in Europe has increased over the past several years, and the company has become the largest B-brand producer of LCD TVs in Europe. Yet, the company still largely depends on its key suppliers, which we see as another main weakness in Vestel's business risk profile.

Our assessment of Vestel's financial risk profile primarily incorporates its high Standard & Poor's adjusted gross debt to EBITDA and strong reliance on various forms of short-term financing. In addition, we expect the company's credit ratios and cash flow generation will remain highly volatile because it is exposed to demand swings and its margins and revenues are vulnerable to currency fluctuations. This is partly offset by our expectations of modest positive free operating cash flow (FOCF) and solid cash interest coverage ratios of between 3x and 4x in 2015-2016.

The Standard & Poor's adjusted gross debt figure is higher than Vestel's reported gross financial debt primarily because of our standard adjustments.

In our base case, we assume:

- Annual revenue growth of 3%-6% in 2015-2016, compared with 25% growth in 2014, when revenues received a boost from increasing sales before the FIFA World Cup in Brazil. In 2015-2016, we expect solid underlying demand for Vestel's main products and additional revenue growth from new products, such as smart phones.
- A gross profit margin of about 21%-22% in 2015-2016, compared with 20% in 2014, due to a better product mix, with a shift toward mid-to-high end products, lower raw material prices, favorable currency effects because of the weakening Turkish lira against hard currencies, as well as various measures to improve its brand image and recognition, such as store upgrades or improved sales and after-sales services.
- Moderately increasing capital expenditures of TRY400 million-TRY500 million in 2015-2016, compared with TRY395 million in 2014.
- No dividend distributions, as in previous years.
- Modestly positive working capital inflows for the full years 2015 and 2016.
- Rollover of short-term credit facilities.

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

- Modestly improving Standard & Poor's-adjusted EBITDA margin toward 7%-8% in 2016, compared with 5.5% in 2014.
- A Standard & Poor's-adjusted debt-to-EBITDA ratio of about 6x-7x at year-end 2015 and 4x-5x in 2016, compared with 6x at year-end 2014.
- Slightly positive Standard & Poor's-adjusted free operating cash flow in 2015 and 2016.

The stable outlook on Vestel reflects our view that the company is moving to sharply reduce its short-term debt in the second half of 2015, such that its liquidity sources will likely largely cover its liquidity uses over the 12 months started June 30, 2015. We think Vestel will report markedly lower short-term debt at year-end, primarily following working capital improvements, active refinancing of short-term domestic bank loans, and reduced lending to Zorlu Holding. In addition, we expect Vestel will generate at least roughly break-even free operating cash flow in 2015-2016.

We could lower the rating if Vestel is unable to materially reduce its currently very high short-term debt in the next six months. Furthermore, declining revenues and margin prospects due to weaker demand or tighter availability of consumer financing in Turkey, adverse currency swings, or heightened competition could prompt a lower rating. In particular, Standard & Poor's adjusted EBITDA margins sustainably below 4% and significantly negative FOCF for more than 12 months, coupled with a continued "less than adequate" liquidity, could trigger a downgrade.

A positive rating action on Vestel would hinge on an EBITDA margin consistently above 6%-7%, an adjusted debt leverage ratio of below 5x at year-end, and sustainably positive FOCF of more than TRY100 million per year. We do not see "adequate" liquidity as an absolute requirement for a one-notch upgrade, but the likely full coverage of liquidity uses, such as capital expenditures and short-term debt, throughout the fiscal year would be a key consideration for raising the rating.

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