

RESEARCH

Research Update: Outlook On Turkish Electronics Manufacturer Vestel Revised To Negative; 'B+' Rating Affirmed

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Credit Rating: B+/Negative/--

Rationale

On Sept. 27, 2005, Standard & Poor's Ratings Services revised its outlook to negative from stable on Turkish integrated, low-cost consumer-electronics manufacturer Vestel Elektronik Sanayi Ve Ticaret A.S. (Vestel), reflecting the company's sudden deterioration in operating performance in the first half of 2005. At the same time, the 'B+' long-term corporate credit rating was affirmed.

The rating remains primarily constrained by Vestel's high exposure to foreign currency-denominated debt (nearly 100% of the total) and costs, and by expected significant business expansion investments. These weaknesses are partially mitigated by Vestel's good position in the EU TV market and its high proportion of hard currency-denominated revenues (although these decreased to 63% in the first half of 2005 from 78% a year earlier). In the first half of 2005, the company faced heightened competition in the European market and severe price declines, particularly in flat TVs and digital products.

Total debt at June 30, 2005, was New Turkish lira (TRY) 1.1 billion (about \$815 million), including TRY386 million of vendor financing.

Vestel's sales decreased by 4% in the first half of 2005 with a 23% drop in export sales partially compensated by 64% growth in the domestic market. In addition to volume and price declines in foreign markets, euro-denominated sales were also negatively affected by a 12% appreciation of the Turkish lira against the euro during the period (as opposed to a 6.5% depreciation in the first half of 2004).

The impact of competition and currency fluctuations on profitability was even more severe, exacerbated by a real increase in Turkish lira costs and a stable exchange rate against the dollar, which accounts for a growing proportion of foreign component purchases. EBITDA adjusted for gains and losses on foreign currency transactions was down 40%, resulting in an EBITDA margin of 11.6%, compared with 18.7% a year earlier. This profit erosion led to a significant deterioration of debt coverage measures, with gross debt to adjusted EBITDA estimated at about 5x in the 12 months ended June 30, 2005, up from about 3x in 2004.

Despite sustained capital expenditures at TRY147 million in the first half of 2005, free cash flow generation was slightly positive, essentially owing to a positive swing in working capital.

Vestel sells TVs and digital products under its own name in Turkey and abroad under the name of its distributors or Japanese clients. It also holds a 35% stake in Vestel White Goods (VWG), which it fully consolidates in its accounts.

Liquidity

At end-June 2005, the company was in compliance with the 4x gross debt-to-EBITDA covenants of the \$225 million bond due in 2012, issued by Vestel Electronics Finance Ltd., and of the €75 million notes due

in 2007, issued by Financial Enterprises Ltd., but headroom under these covenants could prove limited in the medium term. (These bonds are guaranteed by Vestel.) Therefore, despite reported consolidated cash balances of TRY590 million (including long-term deposits on a post-tax basis) at end-June 2005 offsetting TRY 584 million in short-term financial obligations, Vestel's liquidity may be challenged if operating performance deteriorates further.

Vestel's family ownership structure (51.6% control by Ahmet Zorlu) limits the company's ability to raise capital. Importantly, the rating does not assume any cash drain on Vestel's liquidity position from sister company Zorlu Holding's diversification strategy or from related-party transactions, apart from the likely increase of Vestel's stake in VWG from the current 35%.

Outlook

The negative outlook reflects the deterioration in the company's financial profile and possible liquidity challenges owing to the financial covenants of its public bond indenture. Although the recent poor operating performance was influenced, to some extent, by unfavorable currency fluctuations and is viewed only as a temporary setback, the rating could be lowered if a sufficient recovery in profitability fails to materialize in the second half of 2005. To revert back to a stable outlook and to sustain the rating, we also expect the company to maintain its solid business positions as a contract manufacturer for the European consumer electronics market, moderate its negative free cash flow generation following a heavy investment phase in 2003-2005, and back any further expansion by a controlled financial policy.

The rating will continue to be affected, either positively or negatively, by risks relating to Turkey's economic environment and currency evolution.

Ratings List

	To	From
Corporate credit rating	B+/Negative/--	B+/Stable/--

NB: This list does not include all ratings affected.

Additional Contact: [Industrial Ratings Europe;](mailto:IndustrialRatingsEurope@standardandpoors.com)
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