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Research Update:

Turkish Electronics Co. Vestel Downgraded To 'B-' On Covenants, Weak Demand; Outlook Negative

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Rationale

On Dec. 22, 2008, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on Turkey-based consumer electronics and white goods manufacturer Vestel Elektronik Sanayi Ve Ticaret A.S. to 'B-' from 'B'. The outlook is negative.

At the same time, we lowered the issue rating on the $225 million guaranteed notes issued by Vestel Electronics Finance Ltd. to 'B-' from 'B', in line with the corporate credit rating. The notes carry a recovery rating of 4, indicating our expectation of average (30%-50%) recovery in the event of a payment default.

At Sept. 30, 2008, Vestel had gross unadjusted debt of about $543 million.

The downgrade reflects Vestel's continued low headroom under its financial covenants in a very difficult operating environment, including in the key business of TV exports to the EU. The rapid demand shift to flat (liquid crystal display, or LCD, and plasma) TVs away from cathode ray tube (CRT) based models continues to challenge Vestel's volume growth. Vestel's competitive and flexible manufacturing base and the Turkish lira's (TRY) recent weakening against the euro should continue to support the company's competitiveness, however. Support from diversified group Zorlu (not rated), Vestel's owner, could become increasingly important, including through a planned TRY160 million restricted cash rights issue, for which Vestel is awaiting regulatory approval. The rights issue would be a positive development for Vestel's credit quality.

Vestel remains exposed to currency volatility. Its short foreign exchange balance sheet position somewhat offsets the competitive benefits of the recent TRY depreciation against the euro and dollar. We remain concerned that increasing currency volatility could create significant temporary imbalances for Vestel, including at financial covenant calculation dates. The group's competitive position and profit margin could benefit from the rapidly weakening TRY against the euro, as in the past, but we are concerned that the economic recession in Vestel's export markets and a weaker domestic environment could more than offset these factors.

Vestel's TV shipments fell by 22%, year on year, in the nine months ended Sept. 30, 2008, as a 23% increase in flat TVs (for which Vestel has an about 11% market share in Europe) failed to offset a 44% drop, from a larger base, in CRT TVs (Vestel's CRT market share is about 50% in the EU). Overall, revenues were up by 2% year on year in dollar terms in the first nine months of 2008, including 8% domestic growth, but were down about 16% in third-quarter 2008, including a 24% decline for exports. Vestel derived 72% of its $3.6 billion revenue base from exports in the 12 months ended Sept. 30, 2008.

The ratings on Vestel continue to reflect the group's cost-efficient manufacturing, but remain primarily constrained by the volatile Turkish macroeconomic environment and resulting currency swings; weakening European economies and demand for durable goods; the company's significant, and largely short-term, debt burden; low covenant headroom; the highly competitive nature of the company's end-markets; and the very limited visibility of near-term demand.

Liquidity

Vestel's liquidity remains tight, as a result of its low covenant headroom and continued reliance on various sources of short-term funding, including short-term borrowings, receivables factoring, and letters of credit. Consolidated short-term borrowings were $243 million at Sept. 30, 2008, against cash and equivalents of $327 million. These figures include short-term debt of $20 million and cash and equivalents of $18 million at Vestel White Goods. Free cash flow generation is generally skewed toward the fourth quarter. Free operating cash flow after gross tangible and intangible capital expenditures was a solid TRY410 million in the 12 months ended June 30, 2008, but could decline somewhat in the next few quarters as margins are pressured.

Although gross tangible and intangible capital expenditures (including capitalized development costs) have come down significantly, currently representing about 4% of revenues, we expect near-term free cash flow generation to remain constrained by the company's weak profitability.

Vestel Electronics does not pay a parent company dividend. The company is reliant to a large extent on annual dividends from its 72.6%-owned listed subsidiary Vestel White Goods, which paid dividends to its minority shareholders of TRY14 million in second-quarter 2008.

At June 30, 2008, the company complied with financial covenants included in the indenture of Vestel Electronics Finance Ltd.'s $225 million bond due May 2012. Covenants are calculated at end-September and end-December. The margins under the 4x debt-to-EBITDA ratio and above the 2.25x fixed charge coverage ratio were very small, however, at 14% and 9%, respectively. Although interest coverage is calculated on gross interest costs, it benefits somewhat from the inclusion of gross interest income in EBITDA. The debt-to-EBITDA covenant is calculated on gross adjusted debt, including discounted and undiscounted letters of credit, and as a result has not meaningfully benefited from Vestel's net debt balance sheet debt reduction over the past two years. Given the covenant EBITDA base of about TRY350 million used for covenant calculation, applying the rights issue to gross debt reduction would help the debt-to-EBITDA covenant by about 0.45x, which would be a significant improvement for Vestel's liquidity.

Recovery rating

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 the company on a liquidation basis, given the vulnerable business profile and a competitive environment characterized by strong competition with several strong players and 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 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 today on RatingsDirect.

Outlook

The negative outlook reflects our concerns about the group's trading prospects, weak margins, and tight liquidity. We could lower the ratings if the company's liquidity position does not rapidly improve.

We would deem any discounted exchange offer for the $225 million bonds--currently trading at low levels--as distressed given the company's weak liquidity and deteriorating trading environment. The execution of distressed exchange offers are tantamount to default under our criteria. It should be noted that we have no indication that Vestel's management intends to explore such a route, but also that many low-rated companies have recently executed or considered discounted exchange offers.

We could revise the outlook to stable if Vestel uses proceeds from the planned TRY160 million cash rights issue from Zorlu Holding for gross debt reduction--notably reducing its reliance on short-term funding--and improves covenant headroom.

Ratings List

Downgraded

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

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

Additional Contact:
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