S&P Global
Ratings

RatingsDirect®

Research Update:

Home Appliances Maker Arcelik Outlook Revised To Negative On Worsening Domestic Credit Conditions; 'BB+' Affirmed

Primary Credit Analyst:
Nicolas Baudouin, Paris (33) 1-4420-6672; nicolas.baudouin@spglobal.com

Secondary Contacts:
Nikolay Popov, London + 020 7176 3392; nikolay.popov@spglobal.com
Maxime Puget, London (44) 20-7176-7239; maxime.puget@spglobal.com

Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Issue Ratings--Recovery Analysis

Related Criteria

Related Research

Ratings List

Research Update:

Home Appliances Maker Arcelik Outlook Revised To Negative On Worsening Domestic Credit Conditions; 'BB+' Affirmed

Overview

- Turkey is currently facing challenging economic conditions alongside weakening of the lira, and prospects for Turkish corporate entities relative to key macroeconomic indicators such as consumer spending, cost of funding, and inflation remain unclear.
- These factors and a spike in interest expenses are eating into Arcelik's cash flow generation and debt-service coverage ratios.
- However, we consider that Arcelik can withstand a sovereign stress scenario, allowing us to rate it four notches above Turkey.
- We are revising our outlook on Arcelik to negative from stable and affirming our 'BB+' ratings.
- The negative outlook indicates that we could lower the ratings on Arcelik over the next 12-18 months if the group is unable to restore positive free cash flow generation and an adjusted EBITDA interest coverage ratio of at least 3.0x.

Rating Action

On Sept. 20, 2018, S&P Global Ratings revised its outlook on Turkey-based home appliances manufacturer Arcelik A.S. to negative from stable. At the same time, we affirmed our 'BB+' long-term issuer credit rating on Arcelik.

We also affirmed our 'BB+' issue ratings on Arcelik's $500 million senior unsecured notes due 2023 and €350 million senior unsecured notes due 2021. The recovery rating is '3', indicating meaningful recovery prospects (50%-70%; rounded estimate 50%) in the event of a payment default.

Rationale

The outlook revision stems from our view that the macroeconomic environment in Turkey has deteriorated substantially in recent months and has the potential to weaken Arcelik's credit profile (see "Turkey Long-Term Foreign Currency Rating Lowered To 'B+' On Implications Of Extreme Lira Volatility; Outlook Stable," published Aug. 17, 2018, on RatingsDirect). In particular, we consider that the following factors, by order of importance, are weighing on the group's credit profile:

- The marked deterioration of interest coverage ratios as domestic interest rates surged while the interest on hard-currency bonds suffered from the steep decline of the Turkish lira.
- The weakening of cash flow generation, which we now believe will turn more negative than expected in 2018, amid higher capital expenditure (capex) and working capital needs, adding to the mounting interest burden.
- Higher leverage, due to the conversion effect on the hard currency bonds, although EBITDA is boosted by international revenues as the lira depreciates.

The lira lost about 46% and 44% of its value against the U.S. dollar and euro, respectively, year on year as of Sept. 12, 2018. Given Arcelik's large share of debt in these currencies (about 54% of total gross debt as of half-year 2018), this has pushed up the group's financial expenses considerably due to the negative translation impact, since almost all of the debt is at fixed interest rates. On the domestic side, Turkish authorities' recent decision to raise interest rates to contain the fall of the lira, and the increased cost of funding from Turkish banks, are also weighing heavily on the group's cash flow generation. In addition, Arcelik's domestic borrowing costs have increased somewhat, with average interest rates rising to about 17% so far this year, from 13% on average in 2017. We expect domestic interest rates to hit the group even harder next year as Arcelik progressively rolls over its short-term facilities.

As a result of these factors, we now project our adjusted EBITDA interest coverage ratio will fall markedly below 3.0x in 2018 and likely stay below that level in 2019, compared with 3.3x in 2017, which is contrary to our previous base case of 4.0x-4.5x for 2018-2019. This is despite our forecasts of a positive impact from the weaker lira on EBITDA margins, supported by the group's sizeable exports (about 50% of production) from its Turkish operations and improved cost control.

We expect elevated borrowing costs and sizeable working capital needs related to the group's expansion efforts in international markets to hamper free cash flow generation. In particular, contrary to our previous base case, we now expect free operating cash flow (FOCF) to remain deep in negative territory in 2018 and 2019. After a strong 2016, the group's FOCF turned negative in 2017 (about -TRY950 million) due to large working capital requirements caused by an increase in domestic inventory to meet higher demand. We expect FOCF generation to be constrained in 2018 by the spill-over effect of investment capex in Romania and the Voltbek joint venture in India. Even though we note that there is no plan to increase investment capex in 2019, due to sufficient capacity to serve current market needs, the group's structural net working capital outflow position will remain a drag on free cash flow generation, despite ongoing cost control and improving profitability.

When we lowered our ratings on Turkey on Aug. 17, 2018, we also revised our transfer and convertibility assessment on Turkey down to 'BB-' from 'BB+' to reflect our view of the likelihood that Turkey would restrict access to foreign exchange liquidity for Turkish companies. Nevertheless, we continue to rate Arcelik at 'BB+', which is three notches higher than the foreign currency credit rating on Turkey. This is because Arcelik passes our hypothetical sovereign default stress test, which, among other factors, assumes a 50% devaluation of the lira against hard currencies and a 15%-20% decline in Arcelik's organic EBITDA. Because of this, we currently assess that our rating on Arcelik can exceed the sovereign rating by up to four notches.

We believe the company can withstand a hypothetical sovereign default because of the large share of earnings in hard currency. Therefore, in the hypothetical case of further depreciation of the lira, we think the appreciation of deposits abroad would offset the increase in Arcelik's short-term foreign currency debt-service burden and capex related to the ongoing expansion efforts outside Turkey.

Failure to pass this test would lead us to equalize our rating on Arcelik with the foreign currency sovereign ratings on Turkey (unsolicited; B+/Stable/B), which would imply a three-notch downgrade.

We continue to assess Arcelik's business risk profile as satisfactory, reflecting its leading market position in the Turkish home appliances market and increasing international presence in Europe and Asia. It also reflects its above-average profitability supported by production located entirely in low-cost jurisdictions. Arcelik has enjoyed a robust track record of volume growth through local brands and its global brand, Beko, with good international recognition over the past several years. These strengths are counterbalanced by what we view as a still-fragmented and competitive market environment in the group's key markets, the cyclical nature of demand (partly discretionary), and volatility in profitability metrics, since approximately 65%-70% of Arcelik's operating costs are raw materials, mostly plastics and metals.

We also continue to de-link our ratings on Arcelik from those on Arcelik's majority shareholder Koc Holding A.S. (BB-/Stable/B). This is because there is a track record of good corporate governance, independent and consistent strategy, policy-setting, and execution at Arcelik, as well as lower dividends in periods of lower cash-flow generation. Any evidence to the contrary would cause us to reevaluate this assessment.

In our base case, we assume:

- Turkey's real GDP growth will slow down to 3.9% in 2018 and -0.5% in 2019, compared with 7.4% in 2017.
- Arcelik's revenue base will likely increase considerably in 2018 and 2019, owing to the lira's weakness versus hard currencies, and the group's sizeable foreign-currency earnings base (about 64% of sales as of first-half 2018).
- The adjusted EBITDA margin will strengthen in 2018 and 2019, compared

with 2017 when it was 9.6%, supported by the positive impact of a weaker Turkish lira and production being predominantly located in low-cost countries.

- S&P Global Ratings-projected working capital outflows of TRY1.6 billion-TRY1.4 billion in 2018 and 2019 reflecting forecast sales growth.
- Small bolt-on acquisitions of TRY500 million in 2018 and TRY300 million per annum thereafter.
- Annual capex requirements of 5.0%-5.5% of total sales in 2018, including investment capex related to expansion in Romania and India, followed by a decrease to about 4% of total sales in 2019, owing to reduced investment capex.
- A decrease in annual dividend distribution to shareholders to 20%-22% of net distributable income from about 50% (historical average), in line with the track record of support from majority shareholder Koc Holding in previous periods of macroeconomic turbulence.

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

- S&P Global Ratings-adjusted net debt to EBITDA of 3.3x-3.6x in 2018 and 2.8x-3.1x in 2019, compared with 2.7x in 2017.
- Adjusted cash funds from operations to debt of 15%-20% in 2018 and 2019, compared with 23% in 2017.
- Adjusted EBITDA interest coverage of 2.5x-3.0x in 2018 and 2.0x-2.5x in 2019, compared with 3.3x in 2017.

Liquidity

We assess Arcelik's liquidity position as less than adequate because, in our liquidity calculation, we exclude about TRY11.6 billion of uncommitted undrawn credit lines. However, we understand that having uncommitted credit facilities is standard market practice in Turkey and we note that Arcelik has consistently been able to draw on these credit lines to meet its short-term funding needs.

We estimate that Arcelik's principal liquidity sources for the 12 months from June 30, 2018, include:

- Reported unrestricted cash balances of about TRY2.96 billion; and
- Cash funds from operations that we forecast at about TRY2.0 billion.

For the same period, we estimate that principal liquidity uses include:

- Debt maturities of about TRY4.3 billion;
- Our forecast of capex of TRY1.5 billion-TRY1.6 billion;
- Our forecast of negative working capital requirements of TRY1.6 billion-TRY1.7 billion; and
- Dividend distribution of TRY250 million-TRY350 million.

Outlook

The negative outlook reflects the substantial increase of the group's interest burden, as domestic interest rates have surged while the lira's steep depreciation has strongly inflated the interest payable on Arcelik's euro and dollar bonds.

Additionally, the persistence of substantial working capital needs makes free cash flows structurally negative, which further increases debt and interest expenses.

Downside scenario

We could lower our rating on Arcelik over the next 12 months if we see that the group is unable to restore positive FOCF generation and achieve an adjusted EBITDA interest coverage ratio of at least 3.0x. We could also lower the ratings should debt to EBITDA increase to more than 4x, but we foresee this as a more remote scenario because we anticipate an increase in EBITDA. The company's large share of earnings in hard currencies mitigates the unfavorable currency movements that affect its debt and the cost of raw materials.

Upside scenario

We could revise the outlook to stable if we saw a marked improvement of refinancing conditions in Turkey and robust EBITDA growth at Arcelik, spurred by an increase in volumes in Western European markets, which provide hard-currency inflows.

The group's ability to restore positive free cash flows in the medium term is a key factor in our consideration of a positive rating action, as is EBITDA interest coverage close to 3.0x.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Negative/--

Business risk: Satisfactory
- Country risk: Moderately High
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (-1 notch)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb+

Issue Ratings--Recovery Analysis

Key Analytical Factors

- The $500 million senior unsecured notes and €350 million senior unsecured notes have an issue rating of 'BB+' and a recovery rating of '3' to reflect our expectations of meaningful recovery (50%-70%; rounded estimate 50%) in a default scenario. The recovery ratings are constrained by the notes' unsecured nature and a significant amount of outstanding debt.
- The lower rounded estimate of recovery compared with that in our previous base case (60%) stems from the higher amount of debt in the group's capital structure. This is due to the negative translation effects of the weaker Turkish lira versus hard currencies (U.S. dollar and euro), which more than offset the positive impact of higher interest expense on our EBITDA at emergence figure, and the limited amount of priority liabilities.
- In our hypothetical default scenario, we assume an increase in price competition in the mid-price segments, combined with sharp cuts in consumer spending stemming from uncertainty in the Turkish economy. Additionally, liquidity pressures from volatile working capital movements and a strong deterioration of the Turkish lira could accelerate a payment default.
- Our going-concern valuation reflects the group's well-known brands in local and international markets.

Simulated Default Assumptions

Year of default: 2023
Jurisdiction: Turkey

Simplified Waterfall

- EBITDA at emergence: TRY1366.6 million (capex represents 2.5% of projected sales revenues)

- Cyclicality adjustment is 5%, in line with the specific industry subsegment, and there is no operational adjustment.
- Multiple: 5.0x in line with the standard multiple for the specific industry subsegment.
- Net enterprise value at default (after admin. expenses 5%): TRY6,491.5 million.
- Unsecured debt claims: TRY10,720.7 million.
- Recovery expectation: 50%-70% (rounded estimate; 50%).
- --Recovery rating: '3'

Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Consumer Durables Industry, Dec. 12, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Turkey Long-Term Foreign Currency Rating Lowered To 'B+' On Implications Of Extreme Lira Volatility; Outlook Stable, Aug. 17, 2018

Ratings List

```
Ratings Affirmed; Outlook Action
                                        To                  From
Arcelik A.S.
 Issuer Credit Rating                   BB+/Negative/--     BB+/Stable/--

Ratings Affirmed

Arcelik A.S.
 Senior Unsecured                       BB+
   Recovery Rating                      3(50%)
```

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com