FitchRatings

Fitch Revises Arcelik's Outlook to Negative; Affirms 'BB+'

Fitch Ratings - Dubai - 18 October 2018: Fitch Ratings has revised Turkish consumer goods manufacturer Arcelik A.S.'s Outlook to Negative from Stable while affirming the Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) at 'BB+' and National Long-Term Rating at 'AA+ (tur)'.

The Outlook change reflects Arcelik's continuing weak free cash flow (FCF) generation, which we forecast to be negative in 2018 and 2019 . Fitch expects a more prolonged stress on cash generation compared with Arcelik management's expectations, driven by higher financing costs, plus increased inventory and receivable collection days in the domestic market. Significant volatility in the Turkish economy is compounding uncertainty over free cash flow forecasts. However, we expect Arcelik will maintain funds from operations (FFO) adjusted (for receivables) net leverage below 2.5x in the medium term, in line with the 'BBB' rating median.

RATING ACTIONS

ENTITY	RATING		PRIOR
Arcelik	Natl LT AA+(tur) Affirmed		AA+(tur)
	LT IDR BB+ Affirmed		BB+
	LC LT IDR BB+ Affirmed		BB+
senior unsecured	LT BB+ Affirmed		BB+

KEY RATING DRIVERS

FCF Generation Remains Weak: FCF generation continues to be under stress, driven by increased working capital needs, higher capex , and sharp increases in interest rates in Turkey. Fitch believes that current FCF generation is not commensurate with the current ratings, and prolonged stress on cash generation could further increase leverage. However Fitch expects FCF generation to turn positive in 2020, as the expansion programme completes and inventory levels in factories normalise.

Leverage Still Commensurate with Ratings: Despite significant volatility in working capital needs, sharp movements in currency and interest rates, Fitch forecasts FFO adjusted (for receivables) net leverage to average 2x until 2020, remaining below our negative rating sensitivity, which is comfortably in line with the 'BBB' rating median of 2.5x.

Fitch forecasts profitability to remain at current stressed levels until 2020, along with a negative FCF margin averaging 3% for the next 24 months. However, we expect Arcelik to maintainsome headroom under our current leverage sensitivity. Although leverage is currently in line with the ratings, Fitch highlights a significant increase in uncertainty in the domestic Turkish economy , and sharp FX and interest rate movements could lead to swift and material increases in leverage and, consequently, a downgrade.

Immaterial Currency Impact on Profitability: Compared with Turkish peers, sharp FX movements in 2018 have had a lower impact on Arcelik's profitability. With 36% of revenue coming from the domestic market, Arcelik remains a significant Turkish exporter, with healthy hedging policies in place for hard currency movements. However, along with current business expansion, Arcelik is still highly exposed to emerging markets, such as Pakistan and Egypt where hedging policies are very limited, which is stressing profitability. The current business expansion will increase this exposure.

Fitch believes that sharp movements in other emerging market currencies could marginally lower profitability in the next 12-18 months. However, Fitch still expects the EBIT margin to remain around 7%, which is in line with current ratings and slightly below our 'BBB' rating median of 8%.

Revenue Growth Remains Strong: We expect Arcelik to maintain double-digit revenue growth throughout our four-year forecast horizon, supported by an expanding international presence. We expect a slowdown in domestic volumes as a result of challenging macroeconomic conditions in Turkey and high revenue base in 2017.On the international front, we expect the expanding business footprint, increased market share and the recent Turkish lira devaluation to drive revenue growth

Growing Market Shares: Arcelik has generated strong international revenue growth in the past few years, by attracting more price-conscious consumers in western Europe and by capitalising on its strong marketing and distribution network,which has allowed it to become one of the top three white goods manufacturers in Europe. We believe Arcelik will be able to further increase its market shares , through its low-cost manufacturing abilities, the Turkish lira deprecation, strong R&D and a solid product line. We expect international markets to be the main growth driver beyond 2017, as Arcelik has targeted markets where appliance penetration rates are lower than the rest of the world.

Emerging Market Exposure: We believe recent investment/expansion plans in the ASEAN region is a positive step towards reducing Arcelik's exposure to the Turkish economy, which has constrained the ratings. Arcelik has become more geographically diverse white goods manufacturer in the past 10 years, by gaining solid market shares in Europe and expanding into new emerging markets. Domestic revenue declined.to 36% in 1H18 from 41% in 1H17, and 50% in 2008 Nevertheless, Arcelik's emerging market presence is high compared with peers' like Whirlpool and Electrolux, and remains a credit risk.

Financial Services Adjustments: Arcelik's reported leverage is affected by higher-than-average working capital needs, as a significant portion of durable goods are sold on credit in Turkey. While this is partly financed by Arcelik, the dealer credit risk is covered by banks' letters of credit and mortgages. Fitch assumes approximately 120 days of domestic receivables come from this business practice in Turkey and adjusts debt accordingly to reflect a more accurate peer comparison. Based on its financial services criteria, Fitch applies a 3x debt/equity ratio for these receivables.

DERIVATION SUMMARY

Arcelik has strong market shares in Turkey and Europe, which drive stable EBITDA (around 10%) and FFO margins (around 8%), which are commensurate with the 'BBB' rating median in our capital goods navigator, and are in line with higher-rated peers like Whirlpool Corp. (BBB/Stable) and Panasonic Corporation (BBB/Stable). However, these strengths are offset by weak FCF generation, driven by intense capex in new markets, and structurally high working capital needs. Despite the current investment phase, Arcelik's leverage metric adjusted for financial services remains below our negative rating sensitivity and conforms to an 'A' rating median in our capital goods navigator.

The technological content and R&D capabilities of Arcelik are broadly in line with that of Whirlpool, Electrolux and the broad white goods industry. However, Arcelik's revenue from emerging markets is much higher than higher-rated white goods manufacturers'.Although Arcelik is broadening its geographical diversification -away from Turkey - it remains vulnerable to macro-economic, political and FX risks in emerging markets.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- Double-digit revenue growth in the European markets and mid-to-low singe-digit revenue declines in Turkey for 2018 and 2019
- Stress on profitability to continue for the next 12-18 months
- Sizeable capex outlay in the medium term in line with expansion plans
- Effective interest rates for 2018-2019 higher than four-year historical averages
- Dividend pay-out to remain at historical averages despite stressed cash flow generation
- Financial services adjustment assumes 120 days of domestic receivables

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
- FCF generation turning positive in the next 12-18 months., which may lead to the Outlook being revised to Stable

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
- Receivable-adjusted FFO net leverage ratio above 2.5x
- FFO margin below 8%
- Consistently negative FCF

LIQUIDITY AND DEBT STRUCTURE

Low Liquidity Score: Historically Arcelik's liquidity score has been below 1x, driven by the use of short-term debt to finance the group's high working capital needs. Available cash on balance sheet at end-2Q18 was TRY2,955 million , which falls short of covering Arcelik's short-term debt of TRY4,413 million and our negative FCF expectations of TRY1,196 million.

Fitch believes this risk is mitigated by Arcelik's comfortable uncommitted lines in Turkish banks, which were available even in 2008 - 2009, and continues to be in place despite current stress in the Turkish market. Although the liquidity score of below 1x is inadequate for the current rating, this risk is partly mitigated by customer receivables financing, which we deem as self-liquidating.

SUMMARY OF FINANCIAL STATEMENT ADJUSTMENTS

- Fitch assumes approximately 120 days of domestic receivables come from quasi financing operations in Turkey and adjusts debt accordingly to reflect a more accurate peer comparison (TRY2 billion for end-2017).

- Fitch treats 2% of cash/revenue as restricted cash required for operational needs. (TRY417 million for end-2017).

- Fitch treats TRY834 million factoring receivables as debt, and adjusts its debt ratios accordingly.

DATE OF RELEVANT COMMITTEE

17 October 2018

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Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018) (/site/re/10023785)
Sector Navigators (pub. 23 Mar 2018) (/site/re/10023790)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018) (/site/re/10024585)

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