S&P Global
Ratings

RatingsDirect®

Research Update:

Home Appliances Group Arcelik A.S. 'BB+' Ratings Affirmed; Outlook Remains Negative On Challenges In Key Markets

November 11, 2019

PRIMARY CREDIT ANALYST

Remi Bringuier

Paris

+ 33 14 420 6796

remi.bringuier
@spglobal.com

SECONDARY CONTACT

Maxime Puget

Paris

(33) 1-4075-2577

maxime.puget
@spglobal.com

Rating Action Overview

- Arcelik A.S.'s third-quarter growth from international markets and Turkey white goods market both weakened.
- Separately, Turkey's central bank lowered its policy rate by 250 basis points (bps) in late October, causing the one-week repo rate to decrease to 14% from 24% in July 2019.
- Despite weaker growth prospects in main markets, we believe Arcelik's EBITDA interest coverage ratio should rebound to about 3x in 2020 and free cash flow to gradually stabilize thanks to lower borrowing costs on the large local-currency-denominated debt.
- We are affirming our 'BB+' ratings on Arcelik and on the company's senior unsecured debt, based on our view that the company can withstand a sovereign stress scenario, allowing us to rate it four notches above Turkey.
- The negative outlook reflects our view that weak consumer demand in Turkey and foreign currency exchange volatility might pressure credit metrics over the next 12 months.

Rating Action Rationale

Arcelik's debt service metrics should benefit from lower borrowing cost, enabling EBITDA interest coverage to gradually go back to 3x in 2020. Turkey has undergone three straight interest rate reductions since July 2019, when the one-week repo rate was 24%--it reached this level because of double-digit inflation and to ease a tumble in the Turkish lira (TRY) following financial turmoil within the country in 2018. The central bank is now significantly pulling interest rates down again. On Oct. 23, it cut its benchmark interest rate by 250 bps, bringing it down to 14%. This should meaningfully reduce Arcelik's interest expenses over the next 12 months. Indeed, 40% of the company's debt is denominated in Turkey lira (as of Sept. 30, 2019) and serves mostly to fund the large working capital needs in the country. We therefore believe the mechanical decrease in local borrowings costs will be the main factor in supporting EBITDA interest coverage of about 3x in 2020. We also think this will support the currently negative free cash flow base, which is important because the company will have a €350 million senior bond to refinance by September 2021.

Operational headwinds are not only linked to weak consumer demand in Turkey. Arcelik generates about 35% of its revenues in Turkey and will most likely continue to be negatively affected by the weak market conditions in white goods and consumer electronics. Foreign exchange (FX) volatility of the lira versus the euro and U.S. dollar remains a high risk over 2020 due to macroeconomic uncertainty. We expect a market slowdown in most of Western Europe with flat growth; and mid-to-high single digit for Eastern Europe. Emerging markets should also positively affect the group's profitability despite bringing some FX volatility that could impair the group's margins. The larger exposure to Eastern Europe and Asia enables the group to enjoy volume growth over the medium term despite some volatility. The large presence in Western Europe (30% of revenues) enables Arcelik to generate earnings in hard currencies to service the bonds and a stable geographical diversification.

Arcelik's main competitive advantage is its low operating cost base and increasingly its brands. The operating cost base benefits from having group production facilities located in countries that have low labor costs (Turkey, Romania, South Africa, Bangladesh, and Pakistan) and are close to consumer end markets. Arcelik has some pricing power thanks to its well-known local (Arcelik, Singer, Arctic, Defy, and Dawlance) and global (Beko) brands covering various segments within the consumer durable space. We are more cautious on the group's competitive advantage in consumer electronics. Also, raw materials costs (plastics and steel) seem to be declining, which should support more stable operating margins in the next 12 months.

Arcelik can withstand a sovereign stress scenario, allowing us to rate it four notches above Turkey. The company enjoys a large share of earnings in hard currency thanks to its large presence in Western Europe. The group also maintains at all times very large cash balances (TRY5.5 billion at September 2019) mostly held in U.S. dollars and euros. This enables the group to pass both the sovereign and transfer and convertibility stress tests, hence why we can rate it four notches above Turkey. In our hypothetical sovereign default stress test, we assume, among other factors, a 50% devaluation of the lira against hard currencies and a 15%-20% decline in Arcelik's organic EBITDA. We believe the company can withstand a hypothetical sovereign default because, in the event of further depreciation of the lira, the appreciation of deposits abroad would offset the increase in Arcelik's short-term foreign currency debt-service. 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.

Outlook

The negative outlook reflects downside risks to our base-case projections given weak consumer demand in Turkey and currency exchange volatility. Our base case assumes 20%-25% revenue growth (mostly due to high price inflation in Turkey) and about 10% EBITDA margin thanks to pricing power and flexible operations costs. We therefore forecast EBITDA interest coverage of about 2.5x in 2019 and about 3.0x in 2020.

Downside scenario

We could lower our rating on Arcelik over the next 12 months if the group could not lower its interest burden on its Turkish lira-denominated debt due to inability to refinance the bulk of its short-term debt at a rate below 20% on average, leading to EBITDA interest coverage of close to 2x. We would also view negatively weak operating performance in Western Europe, which helps generate hard currency earnings.

Upside scenario

We could revise the outlook to stable if Arcelik is able to sustainably lower its interest expenses while posting solid operating performance in Western Europe and stabilize cash flows in Turkey. We would therefore need to see sustained interest coverage close to about 3x and positive free cash flow. This would materialize if Arcelik refinances its short-term debt at a cost close to 16%, and if the group's EBITDA margin increases by almost 150 bps in in the next 12 months.

Company Description

Arcelik is a Turkey-based manufacturer of home appliances, including white goods (refrigerators, washing machines, ovens, and dishwashers) and electronics products like TVs. It has expanded beyond its domestic market and is a major player in Europe with its Beko brand, the leading brand in the free-standing appliance market in Europe. The company is also developing its Grundig brand, which has good recognition and enables the group to address the premium segment. Beyond Europe, it has established an industry footprint in the low-cost countries South Africa, Pakistan, and more recently Bangladesh, after the integration of Singer, thereby opening up a market of 165 million inhabitants with potential growth prospects.

Our Base-Case Scenario

In our base-case scenario, we assume the following:

- Turkey's real GDP to decline by 0.5% in 2019, before bouncing back to 2.9% growth in 2020 and 3.3% in 2021.
- Strong revenue growth of 24% with revenues close to TRY33.5 billion in 2019 compared with TRY26.9 billion in 2018, mainly due to the positive impact of foreign sales when converted into Turkish lira. However, the group's sizable foreign-currency earnings base (about 64% of sales as of September 2019) and good organic growth in Eastern Europe are driving some of the group's growth, while price increases in Turkey will offset declining domestic volume.
- Reported EBITDA of about TRY3.4 billion, a significant increase from the TRY2.8 billion reported in 2018, on the back of substantial top-line growth stemming from high level of TRY inflation.
- EBITDA margins slightly decreasing to about 10.1% in fiscal 2019 due to pound and euro depreciation against the U.S. dollar, and recovering to 11.5% in the medium term on the back of favorable raw material prices and positive FX impact.
- Negative FOCF in 2019 that we assume will turn positive again in 2020.
- Preventively bolt-on acquisitions of TRY500 million-TRY600 million per year.
- Dividends of TRY430 million-TRY520 million for each of the coming two years.

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 Arcelik has consistently been able to draw on these credit lines to meet its short-term funding needs. In addition, we considered very positively the interest cut from the Turkish central bank and we strongly believe the group will refinance its short-term debt maturing in the next six months below the current average rate of about 22%. The company has a robust track record of accessing financial markets as illustrated by its diversified portfolio of debt instruments (comprising the €350 million senior unsecured notes and the $500 million senior unsecured notes).

We estimate that Arcelik's principal liquidity sources for the 12 months from Sept. 30, 2019, include:

- Reported unrestricted cash balances of about TRY5.5 billion; and
- Cash funds from operations that we forecast at about TRY3.0 billion.

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

- Debt maturities of about TRY4 billion for the next 12 months;
- Maximum annual working capital outflows of TRY 1.9 billion;
- Capital expenditure of about TRY1.5 billion; and
- No dividends in 2019 and a dividend payment of about TRY430 million in 2020.

Issue Ratings--Subordination Risk Analysis

Capital structure

The 'BB+' issue ratings on the existing senior unsecured debt constituting the €350 million senior unsecured notes and the $500 million senior unsecured notes due respectively in September 2021 and April 2023 are in line with the issuer credit rating on Arcelik.

The issue ratings reflects the limited amount of priority-ranking liabilities in the capital structure, with a ratio of priority debt over total debt materially lower than our 20% threshold triggering any eventual notching on the issue-level ratings.

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+

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed	
Arcelik A.S.	
Issuer Credit Rating	BB+/Negative/--

Ratings Affirmed

Arcelik A.S.	
Senior Unsecured	BB+