FitchRatings

Fitch Affirms Arcelik's at 'BB+'; Outlook Negative

Fitch Ratings - Barcelona - 18 July 2019:

Fitch Ratings has affirmed Turkish consumer goods manufacturer Arcelik A.S.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) at 'BB+'. The Outlook is Negative.

The affirmation follows the downgrade of Turkey's sovereign Long-Term IDR to 'BB-' from 'BB 'on 12 July 2019 and the Country Ceiling to 'BB-' from 'BB+'. The ratings of Arcelik are above the 'BB-'Turkish Country Ceiling, reflecting Fitch's expectations that Arcelik has sufficient structural enhancements that would mitigate transfer and convertibility risks.

Nevertheless, the Negative Outlook reflects Fitch's expectation of 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 (FCF) forecasts. However, we expect Arcelik will maintain funds from operations (FFO) adjusted (for receivables) net leverage below 2.5x in the medium term, which is more in line with the 'BBB' rating median.

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

FCF Generation Remains Weak: 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 maintain some headroom under our current leverage sensitivity. Although leverage is currently in line with the ratings, uncertainty on the domestic Turkish economy has increased materially, and sharp FX and interest rate movements could lead to swift and sharp 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 negative impact on Arcelik's profitability. With 32% 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. Its 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 a high revenue base in 2018.On the international front, we expect the expanding business footprint, increased overseas market shares 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 depreciation, strong R&D and a solid product line. We expect international markets to be the main growth driver in the medium term, 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 a 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 share declined to 32% in 1Q19 from 41% in 1H17, and 50% in 2008. Nevertheless, Arcelik's emerging market presence is high compared with that of peers such as, 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%). These financial metrics are commensurate with the 'BBB' rating median in our capital goods navigator, and are in line with that of higher-rated peers like Whirlpool Corp. (BBB/Stable) and Panasonic Corporation (BBB/Negative). 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

-Double-digit revenue growth in European markets and mid-to-low singe-digit revenue declines in Turkey for 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 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

Developments That May, Individually or Collectively, Lead to Positive Rating Action

-We do not expect the ratings to be upgraded while they are constrained by Turkey's Country Ceiling.

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 its high working capital needs. Available cash on balance sheet was TRY2,955 million at end-2Q18, which was not sufficient to cover short-term debt of TRY4,413 million and our expected negative FCF of TRY1,196 million.

Fitch believes that liquidity risk is mitigated by Arcelik's comfortable (uncommitted) lines in Turkish banks, which were available even during the global financial crisis of 2008-2009, and continues to be in place despite current stress. While the liquidity score below 1x is not adequate for the current rating, the risk is also partly mitigated by customer receivables financing that are deemed self-liquidating.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Arcelik	LT IDR BB+ Affirmed		BB+
	LC LT IDR		BB+

	BB+ Affirmed		
senior unsecured	LT BB+ Affirmed		BB+

Additional information is available on www.fitchratings.com

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Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Non-Financial Corporates Exceeding the Country Ceiling Criteria (pub. 17 Jan 2019)
Corporate Rating Criteria (pub. 19 Feb 2019)

Additional Disclosures

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