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Ratings

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Research Update:

Home Appliances Group Arcelik Downgraded To 'BB' On Expected Less Demand Due To COVID-19; Outlook Negative

March 30, 2020

Rating Action Overview

- We see Arcelik's EBITDA declining markedly in 2020 due to lower sales volume and logistical challenges stemming from the impact of COVID-19 across its main markets.
- We believe Arcelik's EBITDA interest coverage ratio will fall below 2x in 2020, and its free cash flow could be negative because of a low EBITDA base and uncertainty on working capital movements.
- We are consequently lowering to 'BB' from 'BB+' our ratings on Arcelik and on its senior unsecured.
- The negative outlook reflects that consumer demand may only rebound very gradually in 2021 and prolong the strain on the group's credit metrics.

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Rating Action Rationale

A marked drop in consumer demand for Arcelik's goods in 2020 will materially hurt the group's credit metrics. In line with S&P Global Ratings' forecasts of a global recession emerging due to the economic impact of COVID-19, consumers are likely to defer spending on home appliances and electronics apart from the necessary replacements. The resulting reduced volumes in all Arcelik's geographies, alongside retailers' difficulties delivering goods to end customers due to disruption in retail distribution, leads us to anticipate a decrease of at least 5% in sales this year. Under this scenario, the group's funds from operations (FFO) to debt could near 10% and there's potential negative free cash flow of about Turkish lira (TRY) 150 million. We note that the effect is offset by high price inflation in Turkey and positive foreign exchange translation effect (TRY/euro and TRY/the pound sterling) on sales made in hard currencies (about 40% of total sales). We anticipate lower profitability because of higher logistic costs and lower capacity utilization in production plants. Lower prices for key raw materials plastic, and steel, iron ore linked to weaker global demand could partially abate cost inflation.

Arcelik's debt service metrics are likely to slide below 2x despite lower borrowing costs in Turkey and the group's supportive financial policy. The expected drop in EBITDA should translate into weaker-than-anticipated credit metrics, notably EBITDA interest coverage. The ratio will likely fall to around 1.5x-1.7x in 2020 from about 2.1x in 2019. We now think the lower borrowing rates in TRY-denominated debt will no longer be able to offset the expected weak operating performance. Positively, we note that the group's debt leverage, as adjusted by S&P Global Ratings, remains at about 3.5x and in line with the current ratings for 2020. This is notably thanks to the supportive dividend policy (no dividends to be paid in 2020), reflecting the longstanding shareholder support from Koc Holding. We believe the current refinancing risks are moderate for the 2021 bonds, since Arcelik retains ample cash in hard currencies to repay the bond if it was unable to raise sufficient hard currency new debt.

Arcelik's main competitive advantage remains its low operating cost base. We think the company should be able to somewhat absorb the decline in demand given the nature of the industry allows it to manage high operating leverage. The operating cost base benefits 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. We also believe main raw materials costs (plastics and steel) are declining, which should help the operating cost base in a few months. That said, there could be disruption in the supply-chain, notably from China.

Arcelik still has access to ample liquidity, allowing us to rate it two notches above the foreign currency rating of Turkey. The company enjoys a large share of earnings in hard currency thanks to its large presence in Western Europe. Arcelik also maintains at all times very large cash balances (TRY7 billion at end-December 2019) mostly held in U.S. dollars and euros. 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 two-notch downgrade.

Outlook

The negative outlook reflects the risks to our base-case financial projections despite a supportive financial policy. We see debilitated consumer demand in main markets in 2020 and uncertainty on the timing of a rebound in 2021. Our base case for 2020 assumes a 20% decline in EBITDA due to weaker sales volume and higher operational costs stemming from the COVID-19 disruption.

Downside scenario

We could lower our ratings on Arcelik over the next 12-18 months if we see a sharper-than-expected decline in sales and EBITDA due to sustained, diluted demand and high disruption of production and distribution in 2020 with very delayed demand recovery in 2021. Ratings downside would therefore stem from the EBITDA interest coverage remaining below 2x, funds from operations (FFO) to debt close to 12%, and potentially significant negative free cash flow.

Upside scenario

We could revise the outlook to stable if, for example, Arcelik demonstrates resilient operating performance amid adverse market conditions over the next 12-18 months. Lower financing costs in Turkey would support ratings upside. We would also need to see interest coverage comfortably above 2x and FFO to debt close to 20%.

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 freestanding 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:

- Global recession affecting Arcelik's main markets.
- A decline in sales of around 5% in 2020 with a large drop in volume largely mitigated by lira inflation and positive currency translation effect. We assume only a gradual rebound in sales in 2021.
- EBITDA margin decreasing at about 8.0%-8.5% in 2020 due to higher production costs due to low capacity utilization, higher logistical costs, but partially offset by lower raw material prices.
- Negative free operating cash flow (FOCF) in 2020, then turning neutral to negative in 2021. We assume conservatively negative working capital movements in 2021 given low visibility on inventory destocking versus increase in receivables delinquencies. Capital expenditure (capex) to be markedly cut to a minimum of about 4% of sales in 2020-2021.
- No dividends in 2020 and likely none in 2021.

This translates into the followings credit metrics:

- EBITDA interest coverage of 1.5x-1.7x in 2020 and 1.8x-2.0x in 2021.
- FFO to debt of around 10% in 2020 and at 10%-15% in 2021.
- S&P Global Ratings-adjusted debt to EBITDA of around 3.5x in 2020 and between 3.0-3.5x in 2021.

Liquidity

We assess Arcelik's liquidity as less than adequate because, in our calculation, we exclude about TRY13.2 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.

The cut from the Turkish central bank of its main policy rate to 9.25% should support Arcelik's large borrowing costs in local currency. We believe the group will refinance its TRY-denominated debt to lower its current average rate to below 15% from about 19% in the next 12 months.

We estimate that Arcelik's principal liquidity sources for the 12 months from Jan. 1, 2020, include:

- Reported unrestricted cash balances of about TRY 7 billion; and
- Cash funds from operations that we forecast at about TRY 1.4 billion.

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

- Debt maturities of about TRY6.2 billion;
- Working capital outflow of TRY 400 million;
- Capex of about TRY 250 million; and
- No dividends 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: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb

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: Positive (+1 notch)

Stand-alone credit profile: bb

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

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 | 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, 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: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded

	To	From
Arcelik A.S.		
Issuer Credit Rating	BB/Negative/--	BB+/Negative/--
Senior Unsecured	BB	BB+