Arçelik A.Ş. Second Quarter 2022 Financial Results Conference Call

Tuesday, July 26th, 2022, 19:00 (TR Time)

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Conference Call Conducted by Chorus Call Hellas

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OPERATOR: Ladies and Gentlemen, thank you for standing by. I am Konstantinos your Chorus Call operator. Welcome and thank you for joining the Arçelik conference call and Live Webcast to present and discuss the Second Quarter 2022 Financial Results.

At this time, I would like to turn the conference over to Mr. Özkan Çimen, Chief Financial Officer & Mr. Öktem Söylemez, Investor Relations Lead.

Mr. Çimen, you may now proceed.

ÇIMEN Ö: Thank you. Good morning and good afternoon ladies and gentlemen. Welcome to our Second Quarter 2022 Results Webcast. I'm here with Öktem Söylemez, our Investor Relations Lead. Before starting discussing our operational and financial results, I would like to take this opportunity to thank all of our employees for their dedication and hard work through these challenging times.

I will start with second quarter '22 highlights. Our consolidated net sales in the second quarter grew significantly by 122% on a yearly basis to 32.3 billion Turkish lira. On an organic basis, the growth was still very solid. On a quarterly basis, the revenue growth was 15%. In Turkey, strong sell-out in the first quarter got even accelerated during the second quarter. However, sell-in got weaker and in Europe, consumer demand declined as expected.

Our EBITDA margin was 7.5% in the second quarter of the year, reflecting 312 basis points quarterly and 232 basis points annual contraction, mainly due to higher OPEX sales ratio, declining gross profit margin as a result of higher raw material costs. Our OPEX to sales ratio in the second quarter was 24.8%, reflecting 178 basis points year-on-year and 208 basis points quarter-on-quarter increase.

Net working capital sales ratio increased to 28.3% as of June compared to 27.7% as of March. Our leverage increased to 3.15 times as of June from 2.81 times as of March, mainly due to increased working capital requirement and shares bought back and also negative impact of currency translation. Excluding 0.32 times impacts of shares bought back as of June and adding also 0.13 positive impact of annualized EBITDA and cash contribution of our last year's acquisitions, the leverage will be 2.70 times.

We move to the next slide. After a significant revenue growth in the previous quarter, we are pleased to report that this growth trend was maintained in the second quarter as well. On a consolidated basis, our revenue increased by 122% on a yearly basis to 32.3 billion Turkish liras in the second quarter, with robust revenue growth fuelled by price increases across regions, Turkish lira depreciation and inorganic growth. If we exclude the contribution of last year's acquisitions, we delivered 90% annual revenue growth. And on a quarterly basis, again, price increases and Turkish lira depreciation were the main drivers of 15% revenue growth.

Consolidated gross profit margin was 29.6% in the second quarter, representing a decrease of 122 basis points quarter-on-quarter and a decrease of 61 basis points year-on-year, mainly due to higher raw material costs, lower capacity utilization and depreciation of euro against US dollar.

On the right hand side, you can see consolidated EBITDA margin figures. In the first quarter, EBITDA margin was...in the second quarter, EBITDA margin was 7.5%, down by 312 basis points compared to previous quarter, and by 232 basis points compared to the same period of last year. Higher OPEX sales ratio on both quarterly and yearly basis were mainly as a result of high logistic costs and sales and installation expenses. Those were the main reasons of margin contraction, together with raw material inflation.

If you move to the next slide, domestic market. Turkish MDA market was down by 7% on a yearly basis, as expected. In the same period, our units were down by 15% on a yearly basis. And despite declining sell-in market, sell-out accelerated its growth momentum in April and May, due mainly as a result of consumers' expectation of further rise in product prices and also high season effect. Due to the high inflation in Turkey that is negatively impacting the affordability and also changing consumer spending priorities, such as increasing vacation spending in this pandemic environment; increased spending to social gatherings and moreover, global recession concerns, we expect a contraction in Turkish MDA6 wholesale and retail market in 2022 on a yearly basis.

If you look at the A/C market, the A/C market was up by 37% in unit terms on a yearly basis, while Arçelik A/C sales increased by 57%, mainly with the impact of pull-forward of demand, high season effect and our successful campaigns. TV sell-outs were down by 6% while Arçelik sold 2% higher compared to a year ago in 5 month period.

Revenues from domestic markets were strongly higher on both quarterly and yearly basis, registering 103% yearly and 16% quarterly growth. Domestic revenues reached 9.7 billion Turkish lira in the second quarter. This revenue growth was mainly driven by strong price increases on both yearly and quarterly basis, and also higher air conditioning sales despite declining MDA6 units. With the geographical expansion that we have completed last year, the share of domestic revenues decreased to 30% in the second quarter from 33% a year ago.

We move to the next slide, to the European markets. In the second quarter, the share of Europe region in total revenue was 37%, down by around 8% versus a year ago as a result of higher growth in APAC region. In Western Europe, consumer demand was further declined in April and May by mid to high single-digits, with the contraction in majority of the countries. Despite lower units sold in the markets, the market as a whole grew in value terms mainly as a result of price increases and leaning towards to more premium segments. However, at a lower pace compared to a quarter ago. Having 24% share in total revenue, Arçelik sales were up by 6% in euro terms on a yearly basis. Thanks to price increases and inorganic revenue contribution.

Beko maintained its leadership position in the UK. If you look at the Eastern Europe, consumer demand in April and May declined by around 20% on a yearly basis due to the pull-forward demand in the first quarter as expected. Markets in Eastern Europe also grew in value terms, however, slowed down compared to first quarter of this year. Having 13% share in total revenue, Arçelik sales were up by around 20% on a yearly basis in euro terms. And Arçelik's brands continued to lead the key markets, Beko maintained its leadership position in Poland, while Arctic and Beko maintained their first and second position in Romania, respectively.

The challenge that we are facing around the supply chain, historic high inflation levels, increasing interest rates and geopolitical tensions have remained persistent in this quarter and impacted consumer demand negatively. Together with the high base effect, in the remainder of the year, we do not expect to see improvement in consumer demand in those regions.

If you look to the next slide, Africa and Middle East and APAC, we will share our comments on those regions. Having a total of 9% share in our total revenue, Africa and Middle East region posted around 49% annual growth in Q2 in euro terms, with balanced contribution from both regions.

Defy's units sold in domestic market was mid single-digit percent higher on a yearly basis, while on a quarterly basis, it was contracted by mid to low single-digit, mainly due to the flood disaster in South Africa. If you look at Defy's export units, those were contracted on both yearly and quarterly basis, mainly due to the high base effect of the first quarter. In terms of revenue, Defy delivered 16% revenue growth in euro terms in the second quarter of the year on a yearly basis, which is backed by higher units sold and price increases. And as usual, Defy maintained its strong market leader position in the first 5 months of the year.

In Egypt, strong unit sales and price increases led 68% year-on-year revenue growth in euro terms in the second quarter of this year. Unit sales have dropped on a quarterly basis due to high base of first quarter as it contained successful campaigns, thus on a quarterly basis, revenue from Egypt was down by 25% in euro terms.

APAC sales, which has a share of 22%, grew by 147% in euro terms in the second quarter versus a year ago, and this is mainly due to Arçelik's-Hitachi revenue contribution. If we exclude the revenue from Arçelik-Hitachi, the revenue growth was still significant with 15%.

In Pakistan, high season effect and also our well received new product range of refrigerator resulted in higher unit sales on a yearly basis. Together with continuous price increases, we delivered 54% yearly and 45% quarterly revenue growth in PKR terms. The revenue growth was also substantial in euro terms, registering 38% annual and 39% quarterly growth despite weaker rupee against euro.

And unit sales in refrigerator and washing machine, TV, were driven by special promotional campaigns which impacted

Bangladesh revenue. We see an increase of 9% in taka terms on a yearly basis in the second quarter. And in euro terms, the revenue growth was around 17% on a yearly basis, backed by depreciated taka against euro.

We continue with the raw material prices. In this quarter, we have seen quite a volatile raw material market for raw...for metal raw materials after an increase in the market prices, mainly due to Russia and Ukraine conflict in the previous quarter. Due to increasing global recession concerns, particularly starting from May, and decline in consumer demand, market prices slumped. We expect this retreatment in market prices to continue in the remainder of the year as macroeconomic outlook doesn't seem promising.

For plastic raw materials, energy prices are the main cost drivers in plastic raw material production. Ongoing rise of energy prices, which have further accelerated after the Russia and Ukraine war, oil gas prices jumped. So, we do not expect the prices to go down as quickly as they ramp up. All-in-all, we do not expect much lower plastic raw material market prices in the remainder of the year as energy prices are likely to remain at high levels. We want to underline that, through strict and effective cost management in a timely manner Arçelik's costs have been below compared to market levels.

We move to the Slide 10, sales bridge slide. In Q2, Turkish sales grew by 103.3% organically on a yearly basis, with the impact of price increase and unit growth in air conditioners. International sales grew by 131.6%.And out of this growth

7.2% was organic, 76.5% was FX impact, as a result of Turkish lira depreciation and 47.9% is coming from the acquisitions. On the right-hand side, you can see our regional sales breakdown. Arçelik enjoys having enhanced operation...operating geographies. With the last year's acquisition of Arçelik-Hitachi, the share of APAC increased by 10% on a yearly basis in the second quarter, while Turkey and Europe's shares was declining.

We continue with the summary of our P&L. Those figures are given on a consolidated basis and they include the impact of our last year's acquisitions. In the second quarter of this year, Arçelik's consolidated net sales grew considerably by 122% on a yearly basis. As I mentioned in the previous slides, behind this growth, price increase, in organic revenue contribution and significant Turkish lira depreciation were the main factors, despite declining units due to inflationary pressures across the world, geopolitical tensions and high base.

Excluding the acquisition impact, the growth is still strong 90%. And on a quarterly basis, our net sales increased by 15%. Cost inflation got further placed in the second quarter of this year. Together with lower capacity utilization and the depreciation of euro against dollar, our gross margin declined to 29.6%, registering 61 basis points yearly and 122 basis points quarterly contraction.

In this quarter, our consolidated EBITDA margin was 7.5%, contracted by 232 basis points on a yearly basis and 312 basis points on a quarterly basis. OPEX to sales ratio in the second quarter of this year was 24.8%, mainly due to higher logistic costs, marketing and installation expenses. Together, with higher OPEX sales ratio, declining GP margin was another reason for EBITDA margin contraction.

Net income before minority share was 340 million Turkish lira in Q2 and net profit margin was 1.1% in the second quarter of this year, down by 267 basis points on a yearly basis and 329 basis points on a quarterly basis, which is reflecting the higher interest costs.

We continue with the net debt and the leverage slide. Our net debt increased by around 6.5 billion Turkish lira, mainly due to working capital funding needs, share buyback and negative currency translation impact. In the second quarter, we continued to acquire shares back, as of June the ratio of total shares acquired issued capital was 9.97%. In the second quarter of the year, around 0.7 billion Turkish lira was paid for the share buybacks. The remainder part of the increase in net debt mainly stems from working capital funding of our operations and Turkish lira depreciation. As a result of net debt increase, our leverage was increased by 0.33 times to 3.15 times as of second quarter compared to the previous quarter.

If we analyze the EBITDA and cash contribution of our acquisitions, the leverage will be around 3.02 times. On the right-hand side, you can see our loan and bond portfolio. As of June, we have 42.2 billion Turkish lira equivalent debt, and 29% of our total portfolio is in Turkish lira terms. Our Turkish lira effective interest was 21.5%, up by 223 basis points compared to previous quarter end.

We still enjoy having Turkish lira loans at relatively lower interest rates in our total portfolio. In the remainder of the year, we expect Turkish lira effective interest rate to increase since we have 3.6 billion Turkish lira loans to be rolled within this year, which are renewed with higher interest rates than our current effective interest rates. As of June, we have 15 billion equivalent cash in our balance sheet, which is well diversified between geographies. 66% of our total cash is in hard currency terms while Turkish lira share was 7% as of June.

To continue with the next slide. On the left upper corner, you can see the bridge of EBITDA margin. As mentioned, it is impacted by higher OPEX sales ratio on a yearly basis. Main operating expenses were logistics, marketing, sales and installations. On the left...on the lower left corner, you can see our CAPEX sales ratio, which is 3.3%, flattish compared to second quarter of last year. On the upper right-hand corner, net working capital sales ratio is 28.3%, which was 27.7% as of March. And the increase is mainly with the temporary impact of the increase in payables. Finally, on the lower right corner, you can see that we've delivered negative free cash flow of 4.3 billion, which is mainly due to working capital and FX impact.

And final slide is guidance slide. To reflect our Q2 results and the expectation and conditions in the market to our guidance, we have made adjustments on our revenue guidance and EBITDA margin guidance. Based on our most recent forecast, we increased our Turkey sales growth expectation from around 60% to around 70% in Turkish lira terms. We revised our international sales growth expectation as higher than 20% from previous around 25% in euro terms, given the uncertainties on demand outlook. Thus, our consolidated sales growth expectation is changed from more than 80% to more than 90% in Turkish lira terms. These changes reflect price increases that we have already done so far due to rising costs.

When all the headwinds, such as increasing energy prices, increasing inflation and declining demand incorporated in our assumptions, we revised our EBITDA margin guidance to around 10% from around 10.5% for the full year. And our OPEX and net working sales...net working capital to sales guidance remains unchanged with 25% working capital sales ratio and around €220 million CAPEX.

So, this was the end of our presentation. Now, we can have the Q&A session.

Q&A

OPERATOR: The first question is from the line of Kilickiran Hanzade with JP Morgan. Please go ahead.

KILICKIRAN H: Hello, thank you for the presentation Özkan Bey. I have 2 questions. The first one is about the outlook, particularly in the Eastern Europe, I mean, your peers have said that Eastern Europe was quite weak in the second quarter, down to around mid single-digit, I mean, actually high and mid-teens. Do you still continue to see slower demand in Eastern Europe and is there any sort of risk in the overall international volume guidance...I mean revenue guidance in the rest of the year? And also, I want to hear your opinion about the Western European trends in terms of consumption?

And the second is regarding your margin guidance. You have already cut to 10%, but when I do some calculation, it looks like that you still see very high EBITDA margin in the second half, which is around 11%, to achieve the 10% margin. So, what are the drivers in the second half that could keep the margin higher than the first half?

ÇIMEN Ö: Okay. Thank you for your question.

KILICKIRAN H: Thank you very much.

ÇIMEN Ö: Generally, in the coming months, with the inflationary pressures, consumer demand is expected to slow down. And also, the changing consumer spending priorities, such as increasing vacation spending in the eased pandemic environment, increased spending's to social gatherings. And moreover, the global recession concerns which is combined with increasing interest rates. And on top of everything, the strong base across regions will be impacting the demand negatively. So, if we look at how the markets will be impacted with all these uncertainties, I can say that, in European markets which is a saturated market is also cycling quite high by a bit, above normal 2020 and 2021 sales. Inflation is a problem for the countries in the region as well. And we saw market contraction in the first 5 months, and we do not expect improvements in the remainder of the year. So that contraction is also expected in the Eastern Europe as well.

However, we will benefit from inorganic and unit contribution through our acquisition last year to compensate some of the unit contraction. And also, we have been able to increase our prices in all those countries that we have seen a contraction in the markets. And that helped us to offset some of the costs on our production and logistic costs. We continue to improve our mix along with price changes as long as possible, depending on the market conditions. And as I have mentioned, we have seen some easiness in the costs of metals...raw materials. And with the continuation of our sales price increases and also some improvement in our production cost and also OPEX to be under control, we expect an improvement in our margin. As you rightly pointed out, the remainder of the year should be around 11% to hit our 10% margin, which we have seen an improvement in our margin in the June results. And we are confident that we will be...if we can increase the prices and with the cost control, we will be able to hit our guidance margin of 10%.

KILICKIRAN H: Thank you Özkan Bey. And so, basically, you feel comfortable that the demand is okay to reflect further price increases...on the demand front.

ÇIMEN Ö: Yes. At a certain degree, we are passing some of the costs to the market. But as I said, this will...this might contract the market further which we are not sure, but we are following closely. But on the other hand, we are trying to improve our mix to have a higher sales priced products with a better margin. So, this is also helping to compensate any contraction in the market, as well as the margin loss.

KILICKIRAN H: Alright. Thank you very much. Can I ask a final question? The industry has faced some sort of supply shortage, particularly in the electronics, in the second quarter. Was it also the same on your side, I mean, did you also experience some supply shortage that's led to lower capacity utilization rate?

ÇIMEN Ö: No, actually. We have been able to secure all the components in the agreements that we have done with our suppliers in a timely manner. So, we don't have any shortage problem and this is not impacting our production. And the main impact on the low capacity utilization ratio is coming from the demand side, which we couldn't adapt fast, because it was a sharp decrease especially in April.

KILICKIRAN H: Alright. Thank you very much.

OPERATOR: The next question is from the line of Zaczkiewicz Daniel with Barclays Investment Bank. Please go ahead.

ZACZKIEWICZ D: Hello. Thank you for the call. Could I just please ask how you've been impacted by the government's recent restrictions on lira borrowing for companies holding FX balances? Have you seen any impact? And could I also just ask about what options you're exploring for refinancing your 2023 Eurobonds given the current market environment? Thanks.

ÇIMEN Ö: Thank you. Let me start with the Eurobond redemption for the next year. Actually, before the Ukraine and Russia crisis, we have made all our preparations to go to the market, but that conflict has impacted all the markets, as we all know. And we are ready for a possible renewal. However, we are...there is no open window for an issue from Turkey. So right now, what we are doing is we are waiting for the right time. And we are taking all the necessary steps to be ready for the redemption. We will wait for the best option. And even if we cannot find a good window for the new issues, we have enough cash to pay upcoming redemption and to cover a certain time of period. So therefore, we are watching the markets closely for a better window.

And your question related to the regulation. At the first stage, it was unclear how it will be implemented, but we had a further guidance and explanation from the regulatory body. And it is still not very clear and there seems a lack of guidance in terms of...which requires some clarifications. So Arçelik has FX in its balance sheet, which is mainly for the balancing of the provisions, as well as, for our short term bank loans. However, we are not fully confident that how the ratio will be calculated, so we are expecting further clearance from the market. But right now, what we are doing is we have bond issuance in Turkish lira for our Turkish lira borrowing needs. And due to the regulations, we are also...we also need to sell 40% of our export collection, which if needed, is used for Turkish lira funding needs. So right now, we do not see a major problem. However, we expect some clearance from the regulatory body, how this is going to be implemented, considering that there will be the auditing party and the documents to be provided to the banks.

ZACZKIEWICZ D: Okay. Thanks very much.

OPERATOR: The next question is from the line of Demirtas Cemal with Ata Invest. Please go ahead.

DEMIRTAS C: Thank you for the presentation. My question is about the margins. Hanzade asked the question to some extent. But I want to further elaborate the marketing expenses side and the administrative. Did you have any specific additional or one-off expense, marketing or front-loaded marketing expense in the second quarter? That's my question.

And the second question is about the July. You mentioned that there you see some improvement in June. And I wonder how the profitability trends are just going in July so far, because in order to reach 10% margin, you need to see some recovery. And in addition to that, I would like to understand how much this euro/dollar parity change, this had some effect on your statement...income statement, because as we know in the past, when euro is better, it's better for Arçelik. But so far, it's around to parity. So, did we see some impact in second quarter or are we going to see some euro/dollar parity impact in the following quarters? Thank you.

ÇIMEN Ö: Thank you, Cemal Bey. And if you look at our expenses, you are ask if there is any one-off which is impacting our ratio.

What I can say, the marketing expenses is actually a seasonal impact which has a higher ratio compared to Q1. However, as you...as we have mentioned, our A/C sales has increased significantly, which has higher installation costs. So, this is one of the changes compared to Q1. And for the fixed costs, we do not have a major change compared to Q1. And you have asked our margin improvement. So, we are trying to control our OPEXs and also improve sales prices, along with the margin of high value products, improve the mix.

However, euro and dollar parity is a risk that we need to monitor and take action, because a lower euro/dollar parity, let me say appreciating US dollar against euro, is impacting our margins, because our euro revenue has a higher share compared to US dollar revenue. Therefore, in the coming month if the euro/dollar parity is within those levels, you need to find production improvements, as well as price mix improvements to offset that impact in the coming month. In Q2, we see a limited impact, which has reflected to the lowest euro/dollar parity impact to the P&L. However, in the coming month, this will be something that we need to mitigate.

DEMIRTAS C: And about July, any indication about the profitable trend?

ÇIMEN Ö: Sorry, I forgot that question. It is early to comment on the gross profit or profit side. But what I can say is, we expect June trend to continue in the coming month with an increasing trend especially in Q4.

DEMIRTAS C: And as a follow-up, related to some strategic issues, especially in Europe, I think there is heavy competition, as far as, I understand that. And when we look at Whirlpool, they earlier stated that they will come up with a strategy regarding the EMEA business because they are already having very low margin, although they have much better margins in the other segments. And we see some US corporations at this stage, where you just bought some assets from Whirlpool. Could we expect a further improvement in the relations or synergies with some co-operations with Whirlpool in the European market? Is there any parcel of that which we could see some further improvement in the relations or creating some synergies? And in addition to that, I would like to understand, what is the competition putting the euro/dollar aside. That's one input...one positive thing about Turkey. How's you know, Arçelik's competitors in these markets, you mentioned something that maybe you might do some additions, just some couple of comments? Thank you.

ÇIMEN Ö: Thank you. As you pointed out, we had a business relationship with Whirlpool, which has started after our acquisition of Manisa factory. So, we are a supplier to Whirlpool for the EMEA market. And in addition to that, we have made recent acquisition, and we know that they are thinking of European operations differently. So, they would like to reposition themselves. Right now, we are watching Whirlpool's position. So we don't have any concrete plan. Our own relationship is based on Manisa factory and the recent acquisition we are about to close. Other than that, we don't have any plans that we can declare with Whirlpool.

DEMIRTAS C: And the last question about...sorry.

ÇIMEN Ö: So please go ahead, sorry, Cemal Bey.

DEMIRTAS C: And about the buyback, we see some you know, it's having some impacts on your financial debt. And we should...in case of any deterioration in financial, do you see a chance of just cancelling the buyback? Or you will go as much as you promised in the future?

ÇIMEN Ö: Actually, this is...the amount is the target. You will recall that we have announced the previous one its 3 billion Turkish lira, which took around 1 year...almost 1 year, let's say. We are looking to acquire the shares if there is value in much lower compared to the previous values. And of course, it is subject to the general assembly. So, we will continue, as long as, the market conditions allow us to acquire the shares. And of course, we need to consider the liquidity position of our company. So, we are looking the best time that is in line with our balance sheet ratios to acquire such shares.

DEMIRTAS C: And I think I cut your line about the competition in Europe in the region. How solid's your position compared to previous...post-pandemic? Did you see any...you just give some more margin. But overall, do you see any strong...strengthening or just some losing in some markets?

ÇIMEN Ö: Actually, it is tough to increase the prices, but at the same time, to keep your market share. So, what we have been successful is we have been able to increase our margin and also slightly improve our market share in almost all the markets, and we have been able to slightly increase our price index both in Eastern and Western Europe. And it is a tough market. We see price competition from all the companies. And the Chinese and all the European players and the other players actually, we have a competition on low value prices. But they are all, at the same time, trying to increase their mix with higher priced products.

DEMIRTAS C: Thank you Özkan Bey.

ÇIMEN Ö: Thank you.

OPERATOR: Next question is a follow-up question from the line of Kilickiran Hanzade with JP Morgan. Please go ahead.

KILICKIRAN H: Özkan Bey, my question is related to your interest charges. We start to observe increasing interest cost versus Q1. And given the limitation on Turkish lira loans, actually, I mean, lack of clarity, let me say. And I think you are planning Turkish lira bond issue. So this could be a higher cost of financing, the Turkish lira, I mean loans, right, I mean, how should we think about your total interest charge for the full year?

ÇIMEN Ö: Right now, our average rate is around 21.5% as of June, effective interest rate in Turkish lira. And the new loans is around 35%, actually we are not having bank loans right now. We are using our options of Turkish lira bonds issuance which has a similar rate of 35% annual. So, what I can say, that as we're going to renew around 3.6 billion by the end of this year, this will increase our costs around 3 or 3.5...350 basis points compared to 21.5 basis percentage

KILICKIRAN H: That's an increase for the full year or it's just the average for the second half?

ÇIMEN Ö: It is the effective rate for the full year.

KILICKIRAN H: Thank you very much.

OPERATOR: Ladies and gentlemen, there are no further questions at this time. I will now turn the conference over to Mr. Çimen, for any closing comments. Thank you.

ÇIMEN Ö: I would like to thank you, all the participants for our Q2 Earnings Call. Good afternoon, and have a good day, everyone.