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Research Update:

Turkish Domestic Appliances Producer Arcelik A.S. Downgraded To 'BB' On Higher Cost Of Debt; Outlook Negative

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Rating Action Overview

- Arcelik A.S. is facing a higher cost of debt due to its reliance on local currency short-term funding and difficult market conditions, which resulted in its EBITDA interest coverage deteriorating to 2.9x in 2022 from 3.7x in 2021.
- We forecast Arcelik's ability to cover interest payments will weaken in the next 12-18 months due to the upcoming maturity of its $500 million bond that bears a low coupon, and to deteriorating consumer demand, resulting in forecast EBITDA interest coverage of about 2.8x in 2023 and 2024.
- We therefore lowered to 'BB' from 'BB+' our long-term issuer credit ratings on Arcelik and issue ratings on its senior unsecured debt.
- The negative outlook indicates our view that consumer demand could deteriorate more than we currently anticipate, the cost of Turkish short-term debt may materially increase, or the business combination with Whirlpool's European assets could lead to costly integration, resulting in weaker debt-service coverage ratios than we currently anticipate.

Rating Action Rationale

Arcelik's debt-service coverage came under pressure in 2022 due to higher cost of funding in Turkish lira (TRY), resulting in EBITDA interest coverage of 2.9x, and we forecast further deterioration in the next 12-18 months. The company has historically been supportive to its retail partners in Turkey and granted specific payment terms to support revenue growth, meaning that it relies on local currency short-term debt to fund working capital requirements. As a result, at year-end 2022, 70% of the debt in its capital structure had a remaining maturity of up to 12 months. The company issued short-term local currency bonds in 2022 with a coupon rate of 25%, which illustrates the currently high cost of short-term funding. We forecast interest payments will likely increase for Arcelik due to the upcoming maturity of the $500 million senior unsecured bond in April 2023 that has a coupon rate of 5%. Arcelik is contemplating several options to refinance this bond with another multi-year facility, however, we anticipate that any new debt instrument will bear higher interest because of currently difficult debt market conditions. We forecast Arcelik will successfully refinance its debt maturities in 2023 because the company has a positive track record of accessing bank and capital market financing, and its management team is experienced in operating in difficult market conditions. We also forecast financing conditions on the short-term TRY bond market could deteriorate further and push the average cost of short-term debt to about 30% or higher. Overall, we forecast the company will achieve EBITDA interest coverage of about 2.8x in 2023 and 2024.

Arcelik was overall resilient to the worsening consumer demand environment in its important markets in 2022 and we forecast challenges will remain in the next 12-18 months. The company achieved 96% revenue growth last year, thanks to higher prices, pull forward demand in Turkey in anticipation of further inflation, TRY depreciation against hard currencies, and the integration of Hitachi and assets from Whirlpool acquired in 2021. This was partly offset by lower consumer demand in Europe. The company posted an S&P Global Ratings-adjusted EBITDA margin of 8.9% in 2022, which was lower than the 10.1% in 2021, primarily because of lower absorption of fixed costs due to fewer units sold and the higher costs of raw materials, logistics, and energy, which were partly offset by price increases. The company also recorded negative TRY3.3 billion of free operating cash flow (FOCF) because of high working capital requirements amid cost inflation and continued investment capital expenditure (capex). This performance resulted in S&P Global Ratings-adjusted debt to EBITDA of 2.8x in 2022. For 2023, we forecast consumer demand could continue to worsen, especially in Western Europe, which accounts for 26% of 2022 revenue, because the ongoing deterioration in purchasing power and consumer confidence is likely to reduce or postpone replacement and refurbishment by households. The recent earthquakes in Turkey could also result in lower demand and a longer time to collect trade receivables from distributors in the affected regions. We consider Arcelik well positioned to meet potentially lower consumer demand thanks to its geographical diversification across mature and emerging markets, and continued application of its pricing strategy, which it can achieve thanks to a portfolio of well-regarded brands. Positively, we also note that the costs of certain key raw materials and energy and logistics could start easing this year. We forecast this will enable Arcelik to maintain robust S&P Global Ratings-adjusted leverage of 2.3x-2.8x in the next 12-18 months.

The announced partnership with Whirlpool in Europe presents cost synergy opportunities and could improve Arcelik's business diversification, but carries execution risks, in our view. The partnership will combine both companies' European manufacturing assets and appliance brands under a newly established business. At closing, we understand that Arcelik would own a 75% stake in the new company, meaning that it will fully consolidate its results. Arcelik and Whirlpool anticipate the transaction will close in second-half 2023. We estimate that it will increase Arcelik's scale because Whirlpool's divested business brings 14 factories across the U.K. and Continental Europe and it generated $3.5 billion in sales in 2022, which could drive cost synergies across procurement and footprint optimization. The transaction also increases Arcelik's presence in Europe and its product diversification, thanks to the integration of Whirlpool's portfolio of built-in appliances. However, we note that Whirlpool's assets are less profitable than Arcelik's, as illustrated by the negative 3% EBIT margin achieved in 2022, which we believe is partly due to its manufacturing assets being in countries where labor costs are higher. Therefore, we anticipate a dilutive effect from the business combination on Arcelik's profitability after completion. In addition, we believe the size of the transaction carries execution risks, since the targeted cost synergies could take longer and require greater costs and capex than anticipated. That said, we note management's experience and good track record of integrating and extracting cost synergies from acquisitions, as illustrated by the successful integration of Hitachi, which was acquired in 2021.

We rate Arcelik three notches above our 'B' foreign currency sovereign credit rating on Turkey, in line with our 'bb' assessment of the company's standalone creditworthiness. Arcelik has sizable operations in the stable and mature Western European market (about 26% of 2022 revenue), resulting in a material amount of cash in bank deposits denominated in euros and U.S. dollars (59% at year-end 2022). In addition, we view as positive the company's well-established and diversified manufacturing footprint and the advanced approach to sustainability embedded in its supply chain. These factors give Arcelik significant control over the financial performance and cash flow of its business and allow it to pass our sovereign stress test, meaning that we expect its ratio of liquidity sources to uses to be greater than 1.0x over a one-year stress scenario. Given the diversified international footprint of Arcelik's production capacity and operations, our rating on the company is not capped by our 'B' transfer and convertibility assessment on Turkey. Liquidity sources sufficiently cover short-term debt, working capital, and maintenance capex needs under our stressed economic scenario of a hypothetical sovereign default.

Outlook

The negative outlook reflects the risk of rising short-term domestic debt costs in the next 12 months, resulting in a stronger deterioration of Arcelik's debt-service coverage than we currently anticipate. Our current forecast is that Arcelik will continue to achieve solid operational performance and successfully integrate recent acquisitions, overall maintaining S&P Global Ratings-adjusted debt to EBITDA of 2.3x-2.8x and EBITDA interest coverage of about 2.8x.

Downside scenario

We could lower the rating on Arcelik if deteriorating macroeconomic conditions in Turkey result in a significant rise in the cost of short-term corporate debt, combined with greater-than-anticipated deterioration in consumer demand for household appliances in its main markets. Under this scenario, we anticipate EBITDA interest coverage will deteriorate to below 2.5x with no expectation of near-term recovery. Difficulties to refinance the group's upcoming domestic or foreign currency short- and long-term debt maturities would also likely lead to a rating downgrade.

We could also lower the rating in case of material setbacks in the business combination with Whirlpool Europe, resulting in materially greater costs and capex requirements than anticipated, and overall leading to weaker debt-service coverage ratios and FOCF than forecast.

Upside scenario

We could revise our outlook on Arcelik to stable if we see tangible signs of lowering costs for local currency short-term debt, combined with improving consumer demand in its main markets. Under this scenario, we anticipate Arcelik's EBITDA interest coverage will sustainably approach 3.0x and positive FOCF. A seamless integration of recent acquisitions, including the planned partnership with Whirlpool Europe, would also support a stable outlook.

Company Description

Arcelik is a Turkey-based producer of home appliances, including white goods (refrigerators, washing machines, ovens, and dishwashers, among others) and electronics products like televisions and tablets. It is the largest consumer goods companies in Turkey and is listed on the Istanbul Stock Exchange. The group is majority owned (57.2%) by Koc Group and 17.6% by Burla group. The remaining shares belong to Arcelik (10.2%) and are free float (15%). In 2022, the group had revenue of TRY133 billion and S&P Global Rating-adjusted EBITDA of TRY11.96 billion.

The company owns a portfolio of well-regarded brands in their relevant markets, including Arcelik--the leading home appliance brand in Turkey--and Beko--a leading European free-standing major appliance brand in Europe. It also owns the Grundig brand, which helps the company address the premium home appliances market.

Arcelik generated the majority of its 2022 sales in Turkey (30%) followed by Western Europe (26%), the Commonwealth of Independent States and Eastern Europe (15%). It also has an established footprint in South Africa, Pakistan, and Bangladesh.

Our Base-Case Scenario

Assumptions

- Revenue growth of about 50%-55% in 2023, of which 38%-41% is organic. We forecast the remainder will come from the full-year integration of assets acquired from Whirlpool in July 2022 and the integration of Whirlpool Middle East and North Africa (MENA)'s subsidiaries in 2023. We include the contribution from the business combination with Whirlpool Europe for the fourth quarter. Revenue growth will be supported by price increases in Turkey and Europe, although we forecast lower volumes in those regions. We forecast revenue growth in Asia-Pacific, the Middle East, and Africa from expanding volumes thanks to Arcelik's strong brand positioning in those regions, and price increases.
- In 2024, 28%-33% revenue growth thanks to the full-year integration of Whirlpool MENA's subsidiaries and full-year contribution from the business combination with Whirlpool Europe.
- An S&P Global Ratings-adjusted EBITDA margin of about 8.5% in 2023, which is lower than the 8.9% achieved in 2022, declining further to about 7.5% in 2024. The forecast decline is from the dilutive effect of the combination with Whirlpool Europe, which is less profitable. On a standalone basis, we forecast Arcelik's profitability will gradually improve thanks to better utilization of its manufacturing capacity, a more predictable raw material cost environment, a better product mix toward the sale of more-profitable built-in appliances, and its ability to increase prices when needed. We forecast profitability could increase beyond 2024 as the company realizes cost synergies from recent acquisitions.
- Working capital requirements of about TRY16 billion-TRY19 billion in 2023, reflecting the effects of cost inflation on inventories and trade-receivables, and the need to integrate inventories from recent acquisitions. We forecast working capital requirements will reduce to about TRY8 billion-TRY10 billion in 2024.
- Capex of about TRY8 billion-TRY9 billion in 2023 and 2024 to support the planned investments in factories in Egypt and Bangladesh to serve demand in MENA and Asia-Pacific.
- Up to TRY1 billion annually for potential acquisitions in Europe or emerging markets, including

€20 million for the acquisition of Whirlpool MENA.

- A dividend payout ratio of close to 50% of profit.

Key metrics

- EBITDA interest coverage of about 2.8x in 2023 and 2024.
- S&P Global Ratings-adjusted debt to EBITDA of 2.3x-2.8x in 2023 and 2024.
- Negative FOCF of about TRY5 billion-TRY7 billion in 2023 and neutral FOCF in 2024.

Liquidity

We assess Arcelik's liquidity as less than adequate because our calculation of liquidity sources to uses is below 1.2x over the next 12 months. This is because we exclude uncommitted undrawn credit lines from liquidity sources. That said, we understand having uncommitted credit facilities is standard market practice in Turkey and we note Arcelik has consistently been able to draw on these lines to meet its short-term funding needs.

We believe the group will successfully refinance its debt maturities in 2023, including the $500 million senior unsecured bond, because the company has a positive track record of accessing bank and capital market financing, and its management team is experienced in operating in difficult market conditions.

We estimate Arcelik's principal liquidity uses for the next 12 months from Dec. 31, 2022, include:

- Available cash balances of TRY24.5 billion.
- Forecast cash funds from operations of about TRY17 billion-TRY18 billion.

We estimate liquidity uses over the same period include:

- TRY34 billion of debt maturing in 2023.
- TRY10 billion of ongoing working capital requirements.
- TRY1.8 billion of capex that we estimate cannot be curtailed.
- €20 million for the acquisition of Whirlpool MENA's subsidiaries.

Issue Ratings - Subordination Risk Analysis

Capital structure

The 'BB' issue rating on the outstanding senior unsecured debt, comprising the $500 million senior unsecured notes due in 2023 and the €350 million senior unsecured green bond due in 2026, is in line with the issuer credit rating on Arcelik.

Analytical conclusions

The issue rating reflects the limited amount of priority-ranking liabilities in the capital structure, which represent materially less than 50% of total debt.

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)
Financial policy	Neutral (no impact)
Liquidity	Less than Adequate (-1 notch)
Management and governance	Fair (no impact)
Comparable rating analysis	Positive (+1 notch)
Stand-alone credit profile:	bb

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate

Entities, Nov. 13, 2012

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded

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