Arçelik A.Ş. Second Quarter 2023 Financial Results Conference Call

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***Conductors*:**

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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 2023 Financial Results.

At this time, I would like to turn the conference over to Mr. Özkan Çimen, Chief Financial Officer, Mrs. Mine Şule Yazgan, Finance & Enterprise Risk Executive Director and Mr. Öktem Söylemez, Investor Relations Senior Lead.

Mr. Çimen you may now proceed.

ÇIMEN Ö: Good morning, and good afternoon, ladies and gentlemen. Welcome to our second quarter 2023 results webcast. As challenging operating environment remains persistent, I would like to seize this moment to extend management heartfelt gratitude to our valued people for their dedication and hard work that have been instrumental in driving our growth journey.

I will start with a highlight of second quarter. We recognized TRY47 billion revenue in the second quarter with an annual revenue growth of 45%. Organic annual growth was 38% and revenues were 18% higher compared to the previous quarter. The strong sales of growth in this quarter in both the wholesale and the retail markets in Turkey across product groups. As opposed to Turkish markets, consumer demand remained under pressure in international markets.

Our consolidated EBITDA margin was 10.8% in the second quarter of 2023, marking 327 basis point annual and 150 basis points quarterly expansion. Margin expansion was mainly supported by eased material costs, cost improvements, mix improvement and additionally improved OPEX/sales ratio that has contributed to our margin expansion. Our net working capital to sales ratio as of second quarter was 24.4%. Despite negative FX conversion impact, thanks to improved EBITDA, our leverage was 2.45x as of second quarter of 2023.

If we move to the next slide, in the second quarter of 2023, we generated consolidated revenue of TRY47 billion with a 45% year-on-year increase. Robust unit growth in Turkey, strategic pricing initiatives, further depreciated Turkish lira and inorganic revenue generated by our recent acquisition of IHP Appliances and Asogem are among the key factors behind the revenue growth.

Organically, consolidated revenue growth was 38%, compared to a year ago. Our consolidated gross profit margin for the second quarter was 31.9%, representing 233 basis points expansion, compared to the same period of last year. Margin improvement has been achieved on the back of strong unit growth in Turkey, further eased raw material costs, favorable euro-dollar parity. On a quarterly basis, gross profit margin was up by 82 basis points. In the second quarter, we achieved a consolidated EBITDA margin of 10.8%, marking an annual expansion of 327 basis points and a quarterly expansion of 150 basis points.

Lower transportation costs compared to previous year has also supported the improvement of OPEX/sales ratio in the second quarter. This has led to EBITDA margin expansion together with the improved gross profitability. On a quarterly basis, margin expansion has been posted on the back of normalized G&A expenses.

When we look at the domestic market in the coming slide, second quarter was marked by the substantial consumer demand in Turkey across product groups. MDA6 wholesale market grew by 30% in April-May period on a cumulative basis compared to a year ago. Arçelik units sold increased by 31% in the same period. Retail market was also strong in the same period, with a growth at mid-20s percentage.

Pull forward demand due to the anticipation of further price increases and effective campaigns together with the degrowth experienced in the same period of last year were main drivers of the growth. Arçelik Group maintained its strong leadership position by far as of May 2023. Sales in air conditioner markets were significantly up by 82% in April-May period on a cumulative annual business, while we outperformed the market with 128% growth in the same period. And the growth was mainly driven by pull forward demand.

TV market grew by 25% in January-May period on a cumulative basis, which is driven by higher sales of low price index products, and our units were increased by 11% in the same period. The revenues generated in Turkey in the second quarter was TRY18.4 billion, which is registering 89% yearly and 22% quarterly growth. Annual growth was mainly driven by strong unit growth and price increases. The share of domestic market in total business was 39% in second quarter.

If you move to the next slide, the European market. Having 36% share in total consolidated revenue in the second quarter, revenue generated from Europe was up by 5% in euro terms compared to a year ago, thanks mainly to price increases and inorganic revenue contribution.

On an organic basis, the revenues from Europe declined by 9%, which reflects the overall demand contraction. Following the first quarter, demand in Western Europe remained weak, around 10% annual unit contraction experienced in the region in the first quarter. Consumer demand contracted further by around 10% year-on-year in April-May period on a cumulative basis.

Meanwhile, in Russia, where the market was cycling a low base, consumer demand increased by approximately 50% in the same period. Demand remained negative in other major countries in Eastern Europe. When we look at the price increases in the industry, we are not able to mitigate the unit contraction. Both Western, Eastern Europe market contracted in value terms by close to mid-single-digit percent and high single-digit percent, respectively.

Having 22% share in total revenue in second quarter, our revenues in Western Europe were down by a low-single digit in euro terms, reflecting the overall demand contraction despite price increases. And having 14% share in total revenue, Arcelik's revenues were up by 20% on a yearly basis in euro terms, thanks to price increases and also inorganic revenue contribution.

When we move to the next slide, Africa and Middle East and APAC, the revenues from Africa and Middle East region represents around 6% of our consolidated sales in Q2. This has declined by around 25% annually in euro terms due to the weak demand and challenging macroeconomic environment. Contraction in consumer demand in South Africa has been decelerated compared to previous quarters, yet the market has observed declining demand at mid-teens percentage in the second quarter of 2023.

Similar to the market, Defy's unit sales contracted in the second quarter, compared to the previous year with a lower pace. Price increases mitigated the unit contraction and Defy's net sales increased by around 1% in local currency terms and ZAR continued to fall against euro in the second quarter as well. And revenues in euro terms were contracted at around high-teens percentage. As of June, Defy maintained a strong leadership position in the market.

In Egypt, White Goods market in the first four months of 2023 contracted at mid-single-digit percentage, compared to the same period of last year. Beko Egypt's units sold were contracted, yet strong pricing resulted in around 29% higher revenue in euro terms despite the depreciated Egyptian pound.

During January-April 2023 period, Beko increased its market share in Egypt in both units and value terms compared to the same period of last year.

Revenues from APAC region having 17% share in total revenue were down by around 11% in euro terms on a yearly basis in the second quarter. This contraction reflects the declining demand environment.

In Pakistan, compared to a year ago, revenues contracted by around 23% in PKR terms in the second quarter as a result of lower units sold due to challenged economic conditions. And in euro terms, net sales contracted by 48%as a result of further depreciated Pakistani rupee.

In Bangladesh, units growth in major products and price increases supported annual growth of 34% in local currency in the second quarter. And in euro terms, net sales increased by around 9% in the same period.

When we look at the raw material price index change, metal raw material market prices have been slump during the second quarter, mainly as a result of declining demand and sliding energy and input costs. Global declining demand, eased energy and logistics costs have also resulted in lower plastic raw material market prices during this quarter.

And we move to the next slide, sales bridge. In second quarter, Turkish sales grew significantly by 89%, thanks to units growth and price increases. And international sales increased by 26.5%, and international sales were down by slightly by 3% in the second quarter of this year compared to a year ago if you look at organically growth. The contribution of FX conversion impact in the annual international growth was 22.7%, while inorganic revenue contribution was 6.7%.

On the right-hand side, you can see our regional sales breakdown. Because of the growth in Turkey and declining markets internationally, Turkey's share in total revenue was 39% in the second quarter, while the share of Western Europe declined to 22% from 24%, compared to a year ago, and the share of Eastern Europe was 14% in this quarter.

I will leave the floor to Mine to continue with the financials.

YAZGAN M: Thank you very much. Good morning, and good afternoon all. Here is the summary of our second quarter financials with yearly and quarterly comparison given on a consolidated basis. Arçelik's consolidated net sales registered an annual growth of 45% in the Second Quarter. This growth was mainly driven by robust Turkey performance. Organically, revenue growth was 38%. On a quarterly basis, Arçelik's consolidated net sales increased by 18%.

Arçelik posted consolidated gross margin of 31.9% in the Second Quarter of 2023, increased by 233 basis points on a yearly and 82 basis points on a quarterly, thanks to lower material costs together with strategic pricing. Consolidated EBITDA margin showed strong annual growth, expanding by 327 basis points and quarterly growth increasing by 150 basis points and reaching 10.8% in the second quarter of this year. This growth was driven not only by an improved gross profit margin, but also by prudent management of operating expenses.

OPEX-to-sales ratio improved by 119 basis points annually, contributing significantly to the overall margin expansion. Arçelik posted net income of TRY683 million in the second quarter of this year. Net profit margin declined by 47 basis points annually and 145 basis points quarterly and realized at 1.5%. The contraction mainly reflects higher financing costs and tax expenses.

If we move on to the next slide, our net debt increased by TRY4.9 billion, compared to the first quarter, mainly due to increased working capital funding and Turkish lira depreciation. As of second quarter of this year, we have TRY28.7 billion equivalent cash in our balance sheet with well diversification between currencies. 14% of our cash is USD denominated, 35% euro-denominated and Turkish lira's share was 21%. As a result, through improved EBITDA, our leverage was down to 2.45x at the end of second quarter despite negative FX conversion impact.

On the right-hand side, you can see our loan and bond portfolio. As of second quarter '23, we have TRY61.2 billion equivalent debt. 12% of total portfolio is in Turkish lira terms, while euro has 69% share. Our Turkish lira effective interest rate was 16.1% as of second quarter, mainly as a result of matured loans, which relatively have higher interest rates.

If we move to the next slide. On the upper left corner, you can see the bridge of EBITDA margin. Better gross margin and lower OPEX to sales ratio has resulted in margin expansion. On the lower left corner, you can see our capex to sales ratio.

Capex to sales was 4.8% in the second quarter. On the upper-right corner, net working capital to sales ratio has been shown. The ratio increased to 24.4% as of second quarter of this year from 22.7% at first quarter, mainly due to higher inventories and FX impact. Finally, on the lower right corner, due to increased working capital requirements and capital expenditures, we generated negative free cash flow of around TRY1.2 billion.

I'll give the floor once more to Özkan Bey, for our guidance.

ÇIMEN Ö: Thank you, Mine. Based on our most recent performance and forecast, we decided to make some adjustments to our guidance. In the first six months of the year, we have posted 84% of revenue growth. And in the remainder of the year, we expect revenue growth to slow down due to the negatively affected purchasing power by the high inflationary environment, the increasing VAT and other taxes and the increasing interest rates that is reflected on credit cards.

Thanks mainly to the solid performance, a shift in the first half of the year in Turkey, we are upgrading our annual revenue growth guidance of Turkey from 45% to 60% this year. Due to the persistent decline in demand in international markets so far this year, we are revising our existing 6% growth of international revenues guidance.

In the first six months of the year, our international revenues in euro terms contracted by 4%. There are still uncertainties lying ahead of us and depending on the extent of demand improvement and the available strategic pricing opportunities during the second half of the year, we expect our international revenues end up the year in between around 2% contraction and around 2% growth.

We do not expect material cost to be discouraging in the remainder of the year, and we continue our prudent OPEX management approach despite challenging demand environment. Our EBITDA margin for the first half of the year was 10.1% already. And despite the challenging environment and contracting markets, we are upgrading our EBITDA margin guidance from around 10% to 10.5%.

We removed the lower bound of our net working capital sales ratio guidance and maintain the guidance as below 25%. And we maintain our capex guidance of around EUR300 million this year.

So, this was the end of our presentation. Now you may have your questions.

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

KILICKIRAN H: Hi, good afternoon. Thank you very much for the presentation. I have a few questions. The first one is regarding the pricing environment in your key markets. How do you see them evolving in the rest of the year?

And the second question is about the leverage. I mean, do you have a target to increase the share of Turkish lira in your leverage? And have you started to observe any easing in the borrowing environment, either from banks or local markets such as bonds?

And the third question is about the CMA decisions on Whirlpool merger? When do you expect to hear the final decision from CMA for the UK market? And do you see any risk on completion of the merger or any risk on the timing of the completion? Appreciate the comments around it. Thank you very much.

ÇIMEN Ö: Thank you for the questions. As we have tried to reflect the international market is contracting on double digits in almost all the markets or close to double digits. And this also brings the competition to be more aggressive on sales discounts and promotions to support volume growth. Therefore, up to now after the beginning of Q1 and slightly in Q2, we have been able to change some of our products' pricing strategically.

However, it is not possible to further increase these prices. And because of the inflationary impact in all those markets and increasing interest rates, the purchasing power of the households are negatively impacted. And to give one example, for example, monthly mortgage payments is also, as a percentage of share in household is also increasing, which is impacting our industry's demand as well.

Having said that, we are trying to improve our mix so that we maintain our increasing trend of gross profit margin for the rest of the year.

And second question, the leverage, Mine will reply to that.

YAZGAN M: Yes. Thank you. As you already know, Arçelik cannot utilize Turkish lira loans due to regulation right now. We did not see any kind of changes in the regulation, so it's quite impossible for us to increase Turkish lira loan or bond share within the entire loan portfolio. What we observed in the local market is the appetite of the banks, which we experienced kind of a flight to quality recently because the local banks or local presence of the multinational banks prefer to allocate their loans to large conglomerates like, Arçelik.

So, the loan market, especially in foreign currency denominated loans, was quite alive during the recent months. So, we were expecting an approval from capital market support for a Eurobond issuance, which we had yesterday. So, in the upcoming period, most probably, we're going to try to understand how the market will react to a potential Eurobond issuance. So, we're going to try to see if we'll have an opportunity window in the upcoming months. Thank you.

KILICKIRAN H: And can I ask a follow-up question here. Sorry, Özkan Bey, I just want to ask something to Mine. Mine, I mean, you have this -- I mean, your short position, net short position after the hedging was around TRY2 billion, I think, as well as I see on the balance sheet. But your FX losses are nearly twice higher than this. So, what happened here? I mean, at the current market level, should we expect much lower FX losses because of your hedging instruments? I'm trying to understand the level of…

YAZGAN M: Yes, sure. Yes. Well, the market did not allow us for quite a long time for the hedging transactions because the daily hedging transactions was quite limited. That's the reason we tried to balance our open position with different instruments, namely like OTC, NDF or using VİOP. But of course, the cost of hedging increased as well because of the scarcity in the market. So, it was quite one of the reasons.

But another reason is the short position of the subsidiaries like our sub in Pakistan or Bangladesh, where we do not have the hedging markets in place. That's the reason we had quite costly hedging operations in the last quarter.

KILICKIRAN H: But these are now hedged, right? I mean, so we can assume a relatively much better FX trends, FX losses in the second half of the year, of course, under the current sub…

YAZGAN M: Yes, correct. The market is more flexible right now. If we do not see any other reaction from the regulatory or bank appetite wise, the market is now more flexible, correct.

KILICKIRAN H: Thank you.

YAZGAN M: Welcome.

ÇIMEN Ö: I will continue with the question regarding the competition authority approval process of a potential Whirlpool transaction. There are two processes that we are following. One is the European Commission process and the other of the UK CMA process, which are pretty much in terms of the deadlines are in line moving. And right now, CMA made a public announcement to complete their market tests. So, they are gathering information from the market.

And they're going to review, and we are planning to complete the application by the end of August, which doesn't mean, of course, the approval to be completed. It is one of the phases of the approval processes. So, they will review and come back with further questions or continue to raise some questions that we need to follow-up. There is no definite time line, but what I can say is, we are going in line with the authorities processes to complete the transaction as quick as possible.

KILICKIRAN H: Thank you very much, Özkan Bey.

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 first question is, again, related to some technical sides, related to FX losses. And when again, when I put the numbers, FX related to derivatives and FX losses under financial expenses plus trading activities, I come up with TRY1.2 billion FX losses versus TRY297 million in the first quarter, just putting the real FX on both sides, trading financial and the derivatives. So, there's a big jump and how does the mechanism go?

For instance, we had a sudden increase in the last period of the month. So, could we assume that in the following quarters, the operational impact will be, you know, change in currency will be more positive? But just because of a sudden increase in the currency, we record some big losses. So, I would like to understand, as Hanzade asked the question, a similar question, I would like to understand how if we see a smoother Turkish lira depreciation, how these balances will change? Because in this quarter, we see, yes, a little bit improvement in the -- not a little bit better, you know, the improvement in EBITDA, but most of the gains in that EBITDA was just offset by the FX side. So, I would like to understand that mechanism.

And again, your credit finance charges trading activities was as big as in the first quarter, TRY544 million, it was similar. So, I would like to understand how this will go also in the third quarter? It's my first question. And then maybe after answering this question, I can ask two other questions. Thank you.

ÇIMEN Ö: Thank you, Cemal Bey. As Mine explained, our open position, we were having difficulties to close our open position because of the limited hedging mechanisms in the Q1 and partially in Q2. However, we have been able to close most of our open positions with the instruments that we have used. But those instruments are not cheap instruments, they are around 40% annually costly instruments to -- for us to hedge our positions, which was around EUR600 million, we need to assume a yearly cost of 40% almost.

That means every time we make a hedge, we need to book it as an interest expense. However, that helped us to prevent making a huge loss at the end of Q2, when the currency depreciated to euro and dollar. So, that is a mechanism, that's a costly mechanism. If the hedge markets cost comes down from 40% to 30% or even 25%, that means our FX net that you see in our P&L would be lower compared to Q2.

And credit charge, we are making some factoring to improve our liquidity, which continued in Q1 and Q2 at the same level as you mentioned. And this will probably continue to be the same as in the coming quarters.

DEMIRTAS C: But related to FX gains, could we assume a slower pace in the second half, just FX gain or losses that big number?

ÇIMEN Ö: Cemal Bey, if the cost of hedging comes down, it will come down. But if the cost of hedging is at this level, then it will be pretty much the same number.

DEMIRTAS C: And related to that, that's one of the problem in Turkey against the exporters or international, the companies which have a high international business. It's one of the difficulty we have been facing.

Do you expect any change from the regulators, those changes which had negative impact on your operations, obviously? Do you expect any change in those operations because the minister, you know, the Treasury Minister underlined that they will support the exporters and they will just support the investment. So, do you see any indication from that side?

ÇIMEN Ö: Actually, being one of the major exporters in Turkey, we are following closely on all the regulations and all the incentives that's going to be declared. Right now, we don't have any information that is very different than the current applications. However, there are some incentives, tax incentives being discussed. So, we are closing in detail. The currency actually is helping to improve our profit as well in the second quarter. And those levels would also help in the coming quarter as well. So, that's what I can say right now because we don't have any concrete incentives or any other support that we had declared.

DEMIRTAS C: Okay. And my second question is about the domestic and international front, we see strong growth in domestic, you mentioned. But do you see any softening in July or the, you know, for the future and the inventory levels of your distribution or say your system, your operation system? Do you see any decline in the inventories or any increase lately? That's the one part of the question because for the full year, we expect 60% growth in Turkey operations.

And related to international, I think, which is the key issue for us to predict Arçelik, do you -- especially in some markets, there's a slowdown, you made some price increases, but I see lower guidance on that. Is it related to weak performance in the first half? Or do you still expect the same mood to continue in the second half of the year? Or do you expect any recovery at some point, maybe in 2024? I just would like to understand your perspective for the maybe, it's a very hard question, but at least if we can elaborate that, it will be very helpful.

ÇIMEN Ö: Yes. Thank you, Cemal Bey. Let me start with the international market. The quantities are declining there is double digits in many markets. And our first half growth was, if we exclude the impact of the acquisition, it's around 4% decline in sales. And our guidance is that at the end of the year, this might be minus 2% or plus 2%. So, we do not expect a recovery in the second half. But in some of the markets, we expect that double-digit to be close to, let's say, mid-teens level. So, in some markets, this will be a long recovery period. But in some markets, it will be better than double-digit contraction.

Therefore, our guidance is that it will not be 4% at the end of the year, but it will be -- it might be minus. And if you look at the next year, we do not expect higher quantity growth than the GDP. However, as I said, there are risks, which is impacting household consumption capabilities. And this is a barrier for the further growth, which we are constantly monitoring each and every market. So, we are also, like, other players in the market, we are trying to improve the retail sales through strategic discounts and pricing methods.

When it comes to Turkey, we had a very good half year. Right now, the sales are going in the same trends, but the risks are on the board. And those risks are mainly related to -- despite the minimum wage hikes, the expected improvement in purchasing power could not be achieved due to a case storage in the market. And the rapid increase in inflation, which will follow and the hikes in the VAT and maybe in Special Consumption Tax, this all will impact the behaviors or the purchasing power of the consumers in the second half.

And there is also the interest rates and financial systems and the instalments that we are doing right now, which have been limited. This also impacts our sales. Therefore, we do not expect a strong growth as in the first half, and the pace of the growth will be slowing down in the second half of the year.

DEMIRTAS C: And the last question I would like to ask is about the tax side. Did you apply the 25% for the full first half? That's my question because there were questions about that because it's already announced. Did you apply 25% for the full year, including first quarter?

And the other one is the deferred tax expense. Is it related to you recorded deferred tax expense in this quarter? Would it be related to currency side or for the future quarters? Should we expect much less contribution from the deferred tax income? So, basically, the question is how should we -- what should we expect for the effective tax in the second half of the year? Thank you. That was my last question. Thank you very much.

ÇIMEN Ö: Thank you. For your first question, CIT rates, we haven't made any changes in our financials because it's not in place as of June. So, there is no tax in our P&L related to this change.

And the deferred tax asset, there are two reasons of the change, quarter versus the quarter 2. And one is related to increased financial costs because current regulation doesn't allow all the financing expenses to be deducted from the tax base. Therefore, with the increased FX interest rate and the FX loss, we are not able to deduct it from our tax base. Therefore, our effective rate is negatively impacted.

And second impact is coming from the incentive -- capex incentives in Turkey. In first quarter, we had a high incentive booked as a deferred tax assets. And in the second half due to the reasons that I explained, it is limited. And going forward, I think it is better to use the half year figures as a benchmark for the future.

DEMIRTAS C: But Özkan Bey, related to this 25%, the corporate tax, you mentioned that it was after June, so you don't apply. But is it, you know, so is there a flexiblity pay on that recording because in my mind...

ÇIMEN Ö: No. It does not have flexibility it is not recorded and the auditors also confirm that it shouldn't be recorded. But if you're asking the total impact, it might be around TRY250 million to TRY300 million level, if you have accounted that.

DEMIRTAS C: Thank you. Because that was important because, you know, when we talk to several companies, some of them were saying it will be implied and others. So, I just want to understand there's a specific thing on that. So, you know, of course, you don't know the other companies, but that's why I asked that question. So, the audit judgment is on that. And this number will be added in the third quarter as an expense, right? That's also because it will include the first half, right?

ÇIMEN Ö: Yes.

DEMIRTAS C: Yes, thank you. Özkan, thank you. I appreciate it.

OPERATOR: The next question is from the line of Lanka Sashank with Bank of America Merrill Lynch. Please go ahead.

LANKA S: Yes, thank you for the presentation. I just have one question. I wanted to understand about your dividends, which is delayed in the, you know, from the normal period. So, any guidance you can provide on that?

ÇIMEN Ö: Yes. The dividend in the general assembly was approved and the timing of that dividend is set as September. So, we continue with that decision.

LANKA S: We should expect the payment in September, then?

ÇIMEN Ö: Yes, exactly. The date that we announced.

LANKA S: Okay. Thank you.

ÇIMEN Ö: Thank you.

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: Thank you very much for your participation and your questions. So, hope to see you in the Q3 earnings call. Thank you.