Research Update:

Koc Holding Outlook Revised To Negative From Stable On Similar Action On Turkey; 'BB-' Ratings Affirmed

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Rating Action Overview

- On Dec. 10, 2021, S&P Global Ratings revised its outlook on Turkey to negative from stable, reflecting uncertain policy direction and rising external risks; we also affirmed our unsolicited long-term foreign and local currency sovereign credit ratings on the sovereign at 'B+' and 'BB-', respectively.
- Our rating on Koc Holding A.S. is constrained by Turkey's transfer and convertibility (T&C) assessment, which currently stands at 'BB-' because the vast majority of its assets are domiciled in the country. At the same time, the company retains a 'bbb-' stand-alone assessment, owing to its diverse portfolio with low level of leverage.
- We therefore revised our outlook on Koc to negative from stable, while affirming our 'BB-' long-term issuer credit rating on the company.
- The negative outlook is in line with that on Turkey, given Koc's dependence on the T&C assessment.

Rating Action Rationale

The rating remains tied to our T&C assessment on Turkey. The rating action on Koc follows a similar action on Turkey (see "Turkey Outlook Revised To Negative On Uncertain Policy Direction Amid Rising External Risks; Ratings Affirmed," published Dec. 10, 2021, on RatingsDirect). While we consider that our rating on Koc could exceed the sovereign rating by two notches, we continue to cap the rating at our 'BB-' T&C assessment because most of Koc's investee companies (and consequently dividend inflows) are based in Turkey. This reflects our view that the government would be likely to restrict access to foreign-exchange liquidity for Turkish companies in a hypothetical default scenario, creating obstacles to paying foreign-currency debt. Given the lira's sharp depreciation (about 50% vis-a-vis the U.S. dollar so far this year) and increasing inflation, a higher stress in the balance of payments and rising risks of capital controls could notably lead to a lower T&C assessment.

Defensive treasury management and a sound cash position in hard currency are pivotal to sustaining the rating one notch above the Turkish sovereign rating. As of Sept. 30, 2021, Koc had a net cash position of about Turkish lira (TRY) 1.7 billion (excluding the TRY 3.5 billion investment commitment to purchase 18% of Yapi Kredi and a TRY1.8 billion additional YKB tier 1 investment), translating into our loan-to-value (LTV) ratio of negative 2.0% (positive 2% pro forma Yapi). We view this cushion as key to the company's ability to pass our sovereign default stress test, and to remain rated above the 'B+' foreign currency rating on Turkey. Our hypothetical scenario still assumes that the value of investee companies declines by about 70%, Yapi Kredi defaults, Koc's cash is 10% lower, the company has no access to capital markets, and the lira further depreciates by 50% against the U.S. dollar. Koc's gross cash as of Sept. 30 reached TRY14.9 billion, and 80% was in hard currency (placed with domestic as well as international banks) further sustaining the company's credit standing in case of a sovereign default under a scenario of currency devaluations. We anticipate that management will remain committed to tightly controlling its treasury management, which is pivotal to ensuring the company's ongoing higher credit standing than its sovereign. We view this stance as particularly relevant given that the company's $750 million unsecured notes will come due in March 2023 in a scenario of potentially less supportive refinancing conditions for companies domiciled in Turkey. The holding company has a second maturity in 2025 for $750 million.

Koc retains a 'bbb-' stand-alone credit profile (SACP), sustained by its defensive leverage and export-driven assets. Among its investee companies, Ford Otosan, Tofas, and Arcelik (50% of the combined portfolio value) derive about 78%, 49%, and 67% of their revenue, respectively, from international sales, while refinery group Tupras' sales are U.S.-dollar-linked. We believe this diversity will continue to support Koc's dividend inflows in the context of lira depreciation, which also allow Turkey-based production to remain competitive for export markets. Moreover, the company has a long track record of managing its leverage well, maintaining a net cash position over the past seven years (and therefore making the LTV negative).

Deteriorating credit conditions in Turkey represent a risk for Koc. This is one of the main risks to the company's SACP, which remains at 'bbb-'. We view the holding company's domestic investments as exposed to further Turkish lira depreciation and higher inflation risks. While we continue to assess the average credit quality of Koc's portfolio as well within the 'b' category, a deterioration toward the lower end of the category would likely pressure our SACP assessment. In addition, we see the risk that the cash dividend income could weaken, affecting the holding company's cash adequacy ratios. In 2020, Koc's cash adequacy ratio stood at 1.7x, and for now, we still expect it will normalize toward its historical average of 3.0x in 2021 and 2022.

Outlook

The negative outlook is in line with that on Turkey, given Koc's dependence on the T&C assessment.

Downside scenario

We could lower our rating on Koc if we lower our T&C assessment on Turkey to 'B+'.

Although we consider it unlikely, we could also lower our ratings on the company if it failed to pass our sovereign stress test. This could happen if its debt maturity profile were to shorten and Koc held materially less cash in hard currencies. Because it passes the sovereign stress test now, our rating may be up to two notches above that on the sovereign, capped at the T&C level.

Upside scenario

We would revise our outlook to stable if we take a similar action on the sovereign.

Company Description

Koc began operating in 1926 and has been listed on the Istanbul Stock Exchange since 1986. As of Dec. 15, 2021, its market capitalization had reached TRY91.2 billion ($6.2 billion). The company is closely controlled by the Koc family (64.3%), through its collective vehicle Temel Ticaret A.S., which benefits from double voting rights.

Koc controls many listed (directly or indirectly) and unlisted companies operating in diverse sectors. According to our estimate, the holding company's portfolio valuation as of Sept. 30, 2021, was TRY83.0 billion, or about $9.4 billion (our portfolio value excludes net cash and includes the YKB Additional Tier 1 [AT1] investment). On the same date, the company's portfolio included assets in the following sectors:

- Autos (52.5% of the portfolio's value as defined above)--Tofas, Ford Otosan and Turk Traktor joint ventures with Fiat Chrysler Automobiles N.V., Ford Motor Co. and CNH Industrial N.V., as well as Otokar. Combined revenue rose by 32% to TRY98.3 billion in 2020, from TRY74.4 billion in 2019, on strong domestic demand. The operating margin improved to 10.4% from about 7.9% in 2019.
- Energy (17.2% of the portfolio's value)--Tüpras, Aygaz, Opet, and Entek. These brands, except Entek, were hit hard by COVID-19; the segment's combined revenue fell by about 25% in 2020 to TRY115.8 billion, from TRY153.4 billion in 2019, especially due to lower revenue, mainly at Tüpras, from the decrease in oil prices and lower production. The operating margin was 0.3% in 2020, compared with 2.5% for 2019.
- Consumer durables (10.8%)--Arcelik A.S. Combined revenue increased by 30% to TRY47.2 billion from TRY36.3 billion in 2019, supported by strong domestic demand. The operating margin improved to 10.7% in 2020 from 7.6% in 2019, owing to strong domestic demand and focus on cost management.
- Finance (10.7%)--Yapi ve Kredi Bankasi A.S. Revenue decreased by 5.6% to TRY45.2 billion in 2020, from TRY47.8 billion in 2019. The operating margin increased to 13.9% from 9.6% in the prior year.
- Others (8.8%).

Our Base-Case Scenario

Assumptions

- Conservative and proactive financial policy through which Koc remains in a net cash position.
- Dividend income of TRY3.0 billion-TRY3.5 billion in 2021, compared with TRY1.2 billion in 2020.

- Operating costs of about TRY700 million in 2021, in line with 2020 levels.
- Annual interest expense of TRY700 million-TRY750 million, compared with TRY727 million in 2020.
- Dividend payment of about TRY1.8 billion in 2021, compared with TRY671 million in 2020.
- No major new investments or share buybacks.
- No significant changes to these assumptions for 2022.

Key metrics

Koc Holdings A.S.--Key Metrics*

	--Fiscal year ended Dec. 31, 2020--			
	2019a	2020a	2021f	2022f
LTV%*	(4.9)	(1.6)	Negative	0-5.0
Cash flow adequacy (x)	3.5	1.7	2.5-3.0	2.5-3.0

*S&P Global Ratings-adjusted. LTV--Loan to value. a--Actual. f--Forecast.

Liquidity

We assess Koc's liquidity as strong and anticipate that sources of funds will exceed uses by 2.6x, since the company has no upcoming maturities until March 2023, with its $750 million bond. We believe Koc has solid relationships with local and international banks--it is one of the largest investment holding companies in Turkey and has a large portfolio of listed assets on the stock exchange. In our view, Koc's financial risk management is very prudent, including monitoring foreign-exchange exposure. The company also aims to reduce the effect of currency depreciation by taking out loans in currencies that correspond with its revenue and assets. It should be able to service its debt, even without dividend income or asset disposals, due to its strong cash position and long-dated debt maturity profile.

Koc has two bonds outstanding, each $750 million, due in 2023 and 2025. We believe it would likely be able to absorb any high-impact, low-probability events in the near term without additional financing. The company's ratio of sources to uses would qualify it for a higher liquidity assessment except that it keeps the majority of its cash at lower-rated domestic banks. In addition, its standing in international credit markets would likely weaken if there were turmoil in Turkey.

Incorporating broadly similar key assumptions in our base-case scenario for 2021 and 2022, we estimate the following principal liquidity sources for the 12 months period starting Sept. 30, 2021:

- A cash balance of TRY14.9 billion.
- Dividend, interest income, and management fees of about TRY2.4 billion-TRY2.9 billion after our analytical haircut of 30% cash income.

We estimate the following principal liquidity uses for the similar period:

- No upcoming maturities.

- Operating expenses of about TRY700 million.
- Interest expense of TRY700 million-TRY750 million.
- Dividend payments of up to TRY1.8 billion.

Issue Ratings - Subordination Risk Analysis

Capital structure

Koc's capital structure comprises about $1.5 billion of senior unsecured debt issued at the holding company level. We assess the company's financial risk profile as modest.

Analytical conclusions

The issue rating on Koc's senior unsecured notes is 'BB-', in line with the issuer credit rating, because there are no significant elements of subordination risk present in the capital structure

Ratings Score Snapshot

Issuer Credit Rating: BB-/Negative/B

Business risk: Fair

- Country risk: High
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: bbb-

Modifiers

- Liquidity: Strong (no impact)
- Management and governance: Strong (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

Sovereign foreign currency rating: B+

- Transfer and convertibility (T&C): BB-
- Rating above the sovereign methodology: Capped at the level of the T&C assessment

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
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | Industrials: Methodology: Investment Holding Companies, Dec. 1, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- 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: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Turkey Outlook Revised To Negative On Uncertain Policy Direction Amid Rising External Risks; Ratings Affirmed, Dec. 10, 2021
- Koc Holding Has The Financial Flexibility To Absorb The Planned Increased Stake In Yapi Kredi, Nov. 12, 2021
- Koc Holding A.S., March 16, 2021

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Koc Holding A.S.		
Issuer Credit Rating	BB-/Negative/B	BB-/Stable/B
Senior Unsecured	BB-	BB-