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Research Update:

Koc Holding Ratings Lowered To 'B+' From 'BB-' After Similar Rating Action On Turkey; Outlook Negative

April 12, 2022

Rating Action Overview

- On April 1, 2022, S&P Global Ratings lowered its local currency sovereign rating and transfer and convertibility (T&C) assessment on Turkey to 'B+' from 'BB-', reflecting the country's weakening balance of payments, increasing inflation, and dollarization of the economy. The outlook on Turkey remains negative.
- Our rating on Koc Holding A.S. remains constrained by Turkey's T&C assessment, because the vast majority of its portfolio is domiciled in the country.
- We therefore lowered our issuer credit rating on Koc and issue rating on the company's unsecured notes to 'B+' from 'BB-'.
- The outlook remains negative, in line with that on Turkey given Koc's dependence on the T&C assessment.
- The company retains a 'bbb-' stand-alone assessment, owing to its diverse portfolio with low level of leverage; we estimate that as of April 1, Koc's loan-to-value (LTV) ratio reached negative 0.7%.

PRIMARY CREDIT ANALYST

Florent Blot, CFA
Paris
+ 33 1 40 75 25 42
florent.blot
@spglobal.com

SECONDARY CONTACT

Marta Bevilacqua
Milan
+ (39)0272111298
marta.bevilacqua
@spglobal.com

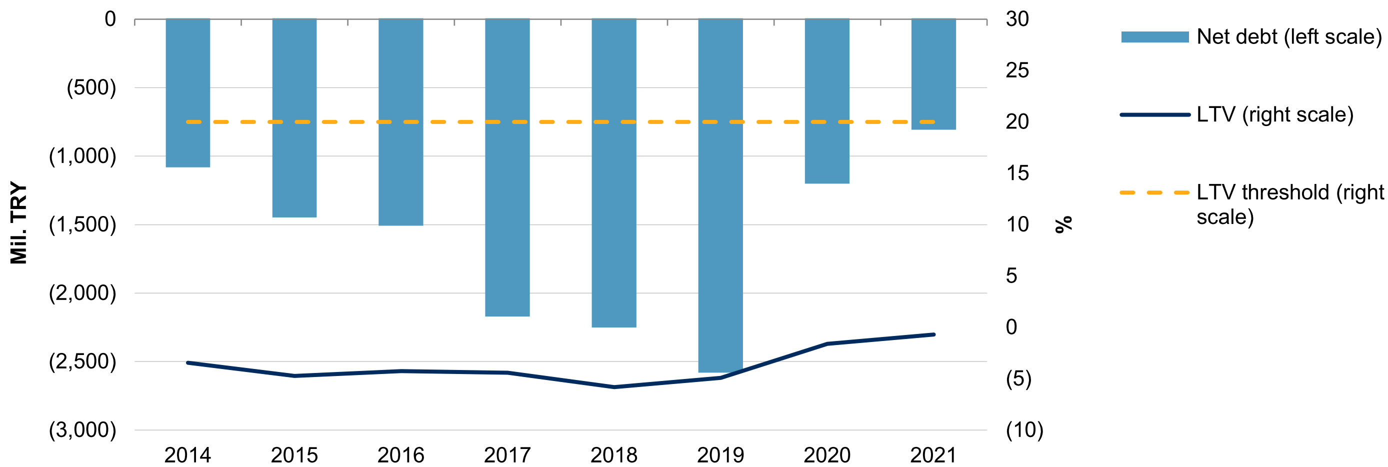
Rating Action Rationale

The rating remains tied to our T&C assessment on Turkey. The rating action on Koc follows a similar action on Turkey (see "Turkey Long-Term LC Rating Lowered To 'B+' From 'BB-'; FC Rating Affirmed At 'B+'; Outlook Remains Negative," published April 1, 2022, 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 'B+' 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 Turkish lira's (TRY) sharp depreciation (about 43% vis-a-vis the U.S. dollar over the past 12 months) and increasing inflation, rising balance-of-payments and financial stability risks could materialize over the next 12 months amid the economic fallout from Russia's military intervention in Ukraine, global monetary tightening, and possible policy missteps in the run-up to Turkey's parliamentary and presidential elections in mid-2023. This could notably lead to a lower sovereign rating and T&C assessment on Turkey.

Defensive treasury management and a sound cash position in hard currency are pivotal to address upcoming debt maturities. We estimate that as of April 1, 2022, Koc had a net cash position of about TRY1.0 billion (pro forma the TRY3.5 billion purchase of the 18% stake in Yapi Kredi and excluding a TRY3.0 billion additional YKB tier 1 investment), translating into our LTV ratio of negative 0.7%. We estimate that Koc's gross cash as of April 1 reached TRY22.4 billion, with about 80% in hard currency (translating to about $1.2 billion equivalent, placed with domestic as well as international banks). In our view, this would sustain the company's credit standing in case of a sovereign default under a scenario of further currency devaluation. We anticipate management will remain committed to tightly controlling its treasury management, which is pivotal to ensuring the company's strong liquidity profile as it faces a sizable debt maturity in the next 12 months. Koc's $750 million unsecured notes are coming due in March 2023 in a scenario of potentially less supportive refinancing conditions for companies domiciled in Turkey. We view the company's estimated cash position in hard currency of about $1.2 billion as sufficient to absorb this debt obligation in case it would choose not to refinance it. Koc has a second maturity in March 2025 for $750 million. While the holding doesn't currently have enough cash in hard currency to fully cover this obligation, we expect Koc's conservative financial policy, characterized by moderate dividend payouts and possibly selected asset disposals, to support its cash needs.

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 (about 50% of the combined portfolio value) derived about 77%, 67%, and 70% of their revenue, respectively, from international sales in 2021, 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 (making the LTV negative).

Koc Holding Has Maintained A Net Cash Position Since 2014



TRY--Turkish lira. LTV--Loan to value. Source: S&P Global Ratings.

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Deteriorating credit conditions in Turkey represent a risk for Koc. This is one of the main risks to the company's SACP. We view the holding company's domestic investments as exposed to further 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. We still anticipate that Koc will receive cash dividends, management fees and interest income of TRY7 billion-TRY8 billion in 2022. At the same time, we see the risk that this income could weaken from a further deterioration in Turkey's economic conditions, affecting the holding company's cash adequacy ratios. In 2021, Koc's cash adequacy ratio stood at 2.6x, and, we still expect it will normalize toward its historical average of around 3.0x this year.

Outlook

The negative outlook is in line with that on Turkey, given Koc's dependence on the T&C assessment. The negative outlook on Turkey reflects rising balance-of-payments and financial stability risks over the next 12 months amid the economic fallout from Russia's military intervention in Ukraine, global monetary tightening, and possible policy missteps in the run-up to Turkey's parliamentary and presidential elections in mid-2023.

Downside scenario

We could lower our rating on Koc if we lower our T&C assessment on Turkey.

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 Borsa Istanbul since 1986. As of April 6, 2022, its market capitalization had reached TRY101.1 billion ($6.9 billion). The company is closely controlled by the Koc family (64.3%), through direct shares and 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 April 1 was TRY146.9 billion, or about $9.9 billion (our portfolio value excludes net cash and includes the YKB additional tier 1 [AT1] investment). On the same date, Koc's portfolio included assets in the following sectors:

- Autos (47.9% of the portfolio's value as defined above)--Tofas, Ford Otosan and Turk Traktor--joint ventures with Stellantis N.V., Ford Motor Co. and CNH Industrial N.V., respectively--as well as Otokoc and Otokar. Combined revenue rose by 41% to TRY139.0 billion in 2021, from TRY98.3 billion in 2020, on strong export performance (supported by currency tailwinds) and a favorable product mix. The operating margin improved to 13.3% from about 10.4%.
- Energy (19.0% of the portfolio's value)--Tüpras, Aygaz, Opet, and Entek. The segment's combined revenue nearly doubled, to TRY229.6 billion in 2021 from TRY115.8 billion in 2020, supported by a strong rebound in crack margins, domestic demand and inventory gains. The operating margin was 1.5% in 2021, compared with 0.3% in 2020.
- Finance (14.7%)--Yapi ve Kredi Bankasi A.S and KocFinans. Revenue rose by 63% in 2021, reaching TRY73.5 billion from TRY45.2 billion in 2020 on lower net cost of risk and strong fee income. The operating margin increased to 18.3% from 13.9% a year earlier.
- Consumer durables (11.1%)--Arcelik A.S. Combined revenue increased by 63% to TRY76.9 billion in 2021, from TRY47.2 billion in 2020, supported by strong demand, both international and domestic, and contributions from acquisitions. The operating margin dipped to 9.3% in 2021 from 10.7% in 2020, owing to higher raw material prices.
- Other (7.3%).

Our Base-Case Scenario

Assumptions

- Conservative and proactive financial policy, through which Koc remains in a net cash position.
- Dividend, management fees, and interest income of TRY7.0 billion-TRY8.0 billion in 2022, compared with TRY4.9 billion in 2021.
- Operating costs of about TRY1.2 billion in 2022, increasing from about TRY1.0 billion in 2021.
- Annual interest expense of about TRY1.3 billion in 2022, compared with TRY0.9 billion in 2021.
- Dividend payment of TRY2.75 billion in 2022, compared with TRY1.8 billion in 2021.
- No major new investments or share buybacks.

Key metrics

Koc Holding A.S.--Key Metrics*

	2019a	2020a	2021a	2022f
LTV (%)	(4.9)	(1.6)	(0.7)	Negative
Cash flow adequacy (x)	3.5	1.5	2.6	2.5-3.5

*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 1.7x in the next 12 months. 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 March 2023 and March 2025. We believe it would likely be able to absorb any high-impact, low-probability events in the near term without additional financing due to its sizable cash position in hard currency (estimated at about $1.2 billion as of April 1, 2022).

We estimate the following principal liquidity sources for the 12 months started April 2, 2022:

- A cash balance of TRY22.4 billion.
- Dividend, interest income, and management fees of TRY5.0 billion-TRY6.0 billion after our analytical haircut of 30% cash income.

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

- About TRY11 billion due under the $750 million bond maturing in March 2023, at current spot exchange rate of 14.7 TRY per U.S. dollar.
- Operating expenses of about TRY1.3 billion.
- Interest expense of about TRY 1.4 billion.
- Dividend payment of TRY2.75 billion.

Environmental, Social, And Governance

ESG credit indicators: E-3, S-2, G-2

Environmental factors are a moderately negative consideration in our credit rating analysis of Koc. This is because its portfolio has material stakes in companies exposed to high GHG emissions such as Ford Otosan, Otokoc, Turk Traktor, Tofas, and Otokar. Also, Koc is exposed to refineries through its stake in Tupras. These assets make up slightly more than 60% of the total portfolio value, with the remainder in less exposed sectors like finance and consumer durables. Koc's governance is exposed to high country risk in Turkey, a negative factor compared with that of other investment holdings in Europe, but we view positively the group's extensive strategic planning process, its track record of delivering on its strategy, and very comprehensive risk-management and performance-monitoring procedures.

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 'B+', in line with the issuer credit rating, because there are no significant elements of subordination risk in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: B+/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+

- T&C: B+
- 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: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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 Long-Term LC Rating Lowered To 'B+' From 'BB-'; FC Rating Affirmed At 'B+'; Outlook Remains Negative, April 1, 2022
- Global Economic Outlook Q2 2022: No Cause For Complacency As The Russia-Ukraine Conflict Modestly Dents Growth, March 31, 2022
- Economic Outlook EMEA Emerging Markets Q2 2022: Weaker Growth, Higher Inflation, Tighter Financing Conditions, March 28, 2022
- Turkish Domestic Appliance Maker Arcelik Outlook Revised To Negative On Likely Higher Domestic Funding Costs, Dec. 20, 2021
- Koc Holding A.S., March 16, 2021

Ratings List

Downgraded; Ratings Affirmed

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

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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