

Classical Insights -- Emerging Markets

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Emerging Market Bullet Points November 5, 2009

VESBE TI -- 2.72

all data in Turkish lira

Sales and earnings

	2008	2009e	2010e	2011e
Sales (TRL mn)	1259	1303	1486	1664
Sales growth		3%	14%	12%
EPS	0.16	0.64	0.58	0.65
Cash flow	0.42	0.90	0.85	0.93
FCF	0.24	0.79	0.61	0.65
Cons. EPS		0.49	0.47	

Target price & valuation data

Our 12-mo. target	5.18	(based on 8x 2011 EPS)	
Upside to target	90%		
Mkt cap (TRL mn)	517	Enterprise value	528
P/sales (2009e)	0.40	EV/sales (2009e)	0.40
P/E (2009e)	4.3	EV/EBITDA (2009e)	2.4
P/E (2010e)	4.7	EV/EBITDA (2010e)	2.7
P/E (2011e)	4.2	EV/EBITDA (2011e)	2.5

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

Vestel White Goods posted great Q3 earnings of 0.24 lira/share and the firm's shares now trade at 4.3x current-year EPS. VESBE shares have *fallen* nearly 20% in the week since the earnings were released, and now offer 90% upside. The new target is 5.18 lira/share (was 4.64). Given that shares of rival Arcelik have fallen 15% over the past week, VESBE's decline likely reflects macro concerns rather than anything company specific. Macro risks include a) rising steel prices and b) rising interest rates. Steel is a particular concern because it represents the bulk of COGS. I'm taking a very conservative approach and assuming next year's gross margin falls 4.5 percentage points to 13.7% (from Q3's 18.2%), due to higher input costs. That's a big decline, and it would put gross margin in the middle of its historical average. Rising top-line sales should offset most of the negative impact, though, allowing earnings to start growing again in 2011.

Here are the new EPS estimates:

Changes to VESBE earnings estimates

	was	is
2009e	0.58	0.64
2010e	0.58	0.58
2011e	0.59	0.65

Source: Churchill Research estimates

The consensus has been too bearish on this stock all year. As of August, the consensus EPS for 2009 was just 0.17 lira/share. Through September, the firm has already earned 0.49 lira/share. I think consensus estimates are still too low, most likely because analysts are too paranoid about the prospects for top-line growth in 2010 and 2011. VESBE has managed to post spectacular earnings this year *despite a 15.5% decline in volumes*. When those volumes come back (which they should in 2010-11), sales should rise sharply, offsetting a good portion of any margin deterioration.

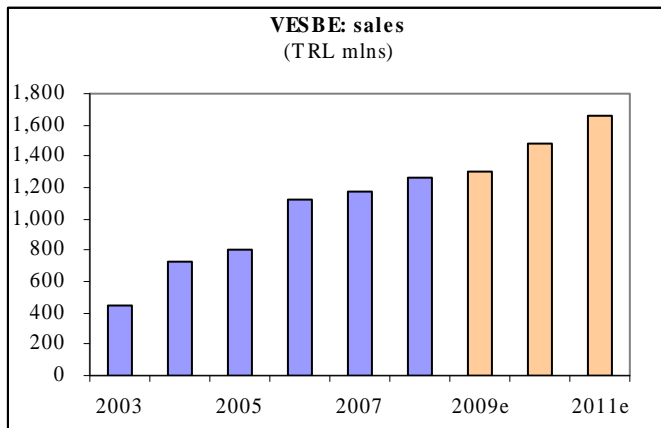
On that note, an easy way to hedge against potential margin decline at VESBE would be to buy shares of Turkish steelmaker Kardemir, which are attractive in their own right, trading at about 50% of sales, 8x consensus 2010 earnings and with little debt. If steel prices rise enough to really hurt VESBE's earnings, Kardemir's earnings should climb accordingly.

Points:

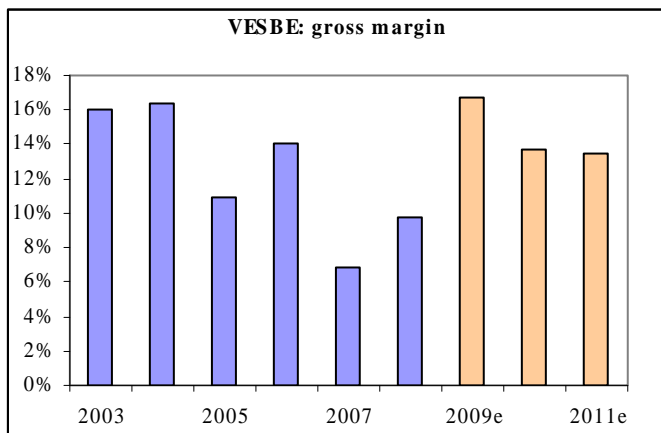
1) VESBE is an OEM manufacturer of refrigerators, ovens, washing machines and dishwashers. It carries very little debt and has been consistently profitable since 2003. VESBE shares are still nearly 50% below their pre-crash high in US\$ terms, even after rallying 120% this year.

2) Sales rose 2.9% YoY in lira terms in the third quarter, but volumes fell 8%. Importantly, volumes improved some vs. their super-weak H1 levels. In Europe, which is VESBE's key export market, Q3 volumes fell 11% YoY, marking an improvement from the 14% YoY decline posted in H1.

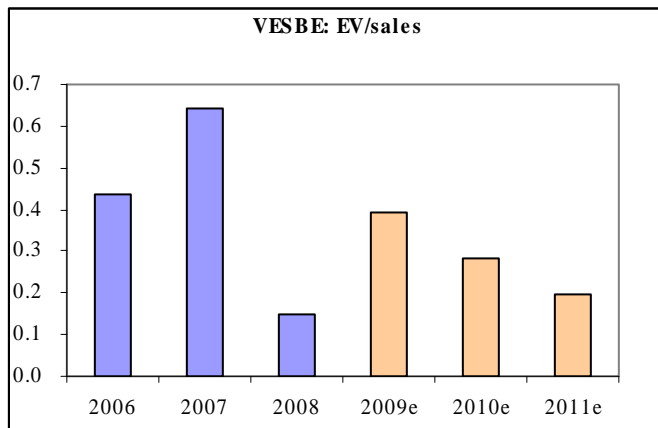
For the full year 2009, I'm now expecting a 3.5% increase in sales in lira terms (was 5%). For 2010, I'm modeling for a 14% gain, driven chiefly by a rebound in volumes (and perhaps also some pricing). Conceptually, this sales forecast could prove conservative.



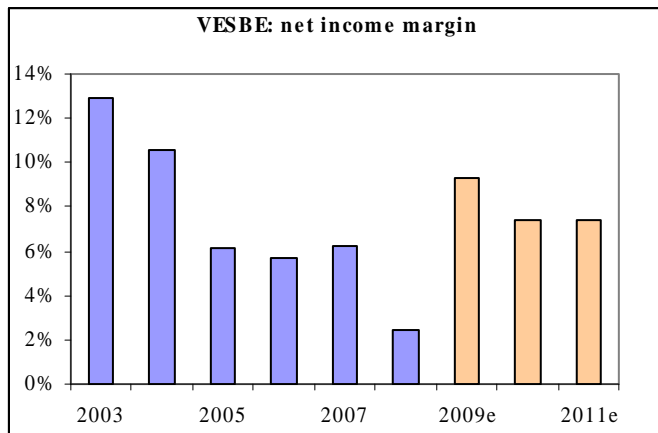
3) VESBE's margins were extremely high in Q3, at 18.2% (up from 18.1% in Q2). For the year, I'm now expecting a gross margin of 16.7% (was 13.8%). That implies a sequential decline in gross margin in Q4 to 16.4% (due to the mild strengthening of the lira and higher steel costs). I am modeling for gross margin to fall to 13.7% in 2010 (was 13.5%) and to ease to 13.5% in 2011 (was 13%). Those levels would be in line with historical norms:



4) VESBE has high earnings leverage by virtue of its low EV/sales ratio (0.40x). That ratio is on track to fall to just 0.20x by the end of 2011 if VESBE hits my estimates (and assuming 75% of free cash flow stays on the balance sheet):



5) My model now assumes a 7.4% net-income margin for 2010-11, roughly in line with historical norms. From 2003-2007, VESBE's net-income margin ranged between 5.7% and 12.9%. Objectively speaking, however, one would have to say a 7.4% net income margin for an appliance company is a bit on the high side. A 6% margin would seem more sustainable over the longer term. Partly for that reason, my target is based on an 8x multiple (rather than, say 10x).



Bottom line: VESBE is an easy-to-understand company with two natural competitive advantages: low costs of production and close proximity to Western Europe (which matters when you're shipping bulky items like washing machines). Its EV/sales ratio is much lower than global peers, which doesn't really make sense given the firm's advantages. Conceptually, there's no reason VESBE couldn't rise to trade at, say, 0.6x EV/2011 sales, or 6.2 lira/share, over the 18 months.

The Classical Insights EM portfolio holds VESBE and Kardemir.

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