Fitch Rates Net Holding A.S. ‘B’; Outlook Stable

Fitch Ratings has assigned Turkish gaming group Net Holding A.S a Long-Term Issuer Default Rating (IDR) of ‘B’ with Stable Outlook.

The IDR of ‘B’ reflects Net Holding' sustainable business model, which has shown resilience over the past years despite sharp depreciation of the Turkish lira (TRY), and deleveraging capacity by 2020 after a planned sizeable investment phase, with adequate financial flexibility. It also reflects its small size relative to rated peers, significant exposure to Northern Cyprus as well as execution risks around the group’s current strategy.

The Stable Outlook reflects our expectation that Net Holding’s resilience should continue over the next few years, as the company plans to improve geographic diversification into new regions through a different asset-light operating model, helping to broaden its scale through successful strategy execution, when the planned investment starts generating additional revenues.

KEY RATING DRIVERS

Sustainable Business Model: Net Holding has shown resilient performance in recent years, particularly against a sharp depreciation of TRY following significant geopolitical events. Customers have continued to pay in hard currencies, driving sound revenue growth and profitability improvements given that the group's cost base is predominantly in TRY. We expect revenue to continue growing, to over TRY800 million by 2019, and EBITDA margins to improve to 33% in the same period (from 26.9% in 2016).

Net Holding' business remains quite small and has limited geographic diversification with nearly all the group's EBITDA generated from, and material assets located in, the Turkish Republic of Northern Cyprus (TRNC). These factors are a rating constraint.

Execution Risks Persist: The group is planning a sizeable investment in Northern Cyprus to add new bedrooms to existing hotels due to an expected pick-up in growth at the more premium Merit Royal Hotel. Given the large debt requirement to fund this, Net Holding' deleveraging capacity will be reduced if the group fails to translate the additional capacity into revenue growth, while operating leverage associated with the asset-heavy strategy may slow profitability improvements. The risk of slower deleveraging could also materialise if construction is delayed. However, management has stated that there are no commitments regarding this expenditure and the timing and amount are discretionary.

Net Holding is looking to expand its casino offering into Eastern Europe, using an asset-light strategy. The latter may pose new challenges, given management’s current experience at mainly operating an asset-heavy model in Northern Cyprus.

Cash Generation Influenced by Capex: The group's free cash flow (FCF) generation has been volatile in recent years, affected by high levels of capex and one-off outflows relating to a bid for the Turkish Lottery. We forecast that FFO will improve in line with continued growth of revenue and profitability but FCF to remain negative until 2020 if the planned investment in additional bedrooms goes ahead. FCF margins should, however, turn positive if management is successful in translating the additional capacity into profitable revenue growth, assuming no further unexpected large-scale investments in the future.

Deleveraging Capacity: Given Net Holding's potential financing requirements linked to the planned investments we expect FFO-adjusted gross leverage to remain in line with the ‘B’ rating category. While we expect some deleveraging towards levels that are more commensurate with a higher rating, the small size of the group and execution risks associated with its plan implies that an upgrade is unlikely over the next few years. Leverage headroom will remain low up to 2020 given the group's weak cash generation. This will make a refinancing more difficult if the group's growth does not materialise. However, once the large capex phase is complete the group should generate stronger cash flows, accelerate deleveraging on a net basis and refinancing will be more manageable, even with higher interest rates.

Adequate Financial Flexibility: We expect that management will be disciplined with their investment policy and view financial flexibility as currently adequate for the rating level, with estimated FFO fixed charge coverage of about 2.0x at end-2017. We forecast that this will improve slightly over the next few years, as stronger FFO offset higher interest costs due to additional debt and rental expenses for new casino openings.

Unencumbered Asset Base Supports Rating: We view the group's unencumbered owned hotels and casinos, valued on the balance sheet at around TRY1 billion, as high-quality properties. However, the group's assets are almost entirely located in Northern Cyprus, which is subject to a disagreement between Turkey and other countries in terms of recognition as an independent state. This may reduce their value, or potentially result in less certainty in valuation via lower international investor appetite.

Corporate Governance Needs Improvement: Fitch considers Net Holding's corporate governance rather weak. The Board composition constrains the rating due to a limited number of independent members. Net Holding has recently simplified its group structure although it remains somehow complex with some related-party transactions but with reasonable economic rationale. Management has expressed its intention to improve the Board composition in the near future, as well as deleverage the company as soon as FCF generation materialises.

DERIVATION SUMMARY

Net Holding' rating of 'B' reflects a weaker credit profile than rated casino peers, Crown Resorts Limited (BBB/Stable), Las Vegas Sands (BBB-/Stable), and MGM Resorts International (BB/Stable), who all have much larger operations, more valuable properties and a more diversified geographic and product offering in larger more developed gaming markets. Compared with European peer Intralot S.A. (B+/Stable), Net Holding is still small, with EBITDAR of roughly USD43 million in 2016, in comparison to USD204 million for Intralot. Intralot's business profile is stronger with geographic diversification and a large share of long-term contracted EBITDA. This balances a weaker financial profile due to higher FFO-adjusted gross leverage.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

-Healthy growth of revenue to TRY800 million by 2019. This will be driven by a combination of improving hotel revenue, with additional benefit coming from the depreciation of the TRY against hard currencies, as well as contribution from new casinos starting in 2017 and accelerating in 2018;

-Improvements in profitability, as the group benefits from the impact of operating leverage due to a large fixed cost base and improving revenue. We forecast that Fitch-adjusted EBITDA margins will trend towards 33% by 2019, up from 26.9% in 2016;

-Tax as per management guidance at 16.7% plus an additional amount of TRY28 million per annum relating to deferred taxes;

-Interest payments increasing due to new financing requirements;

-Annual working capital outflows linked with the increase in revenue;

- Significant capex over the period 2018-2020 due to investment in new bedrooms at the Merit Royal Hotel.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Improvements in the group's business profile, evidenced by continued growth in the Northern Cyprus business, coupled with successful growth of new casino businesses in Eastern Europe and the Balkans enhancing geographic diversification and reducing specific idiosyncratic risks associated with Northern Cyprus.

- FFO-adjusted gross leverage falling below 4.0x on a sustained basis as a result of continued improvements in profitability with Fitch-adjusted EBITDA rising towards TRY400 million.

- FFO fixed charge coverage remaining above 2.5x on a sustained basis.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- Unsuccessful expansion plans resulting in sales remaining well below the Rating Case for a sustained period.

- FFO-adjusted gross leverage remaining above 5.5x on a sustained basis, possibly as a result of a failure to convert revenue growth into profitability improvements.

- FFO fixed charge coverage falling below 1.8x on a sustained basis

- Lack of financial discipline, including opportunistic financing or investment activities, which may lead to pressure on FCF generation and liquidity in future.

LIQUIDITY

Satisfactory Liquidity: The group will have limited readily available cash (as defined by Fitch) on balance sheet at year-end should its planned equity buybacks take place, and failure to continue recent strong performance could put additional strain on liquidity. However, once the investment phase is complete, the group should start generating positive FCF and liquidity should improve.

The group has some upcoming maturities (around TRY120 million over the next 12 months) which will require refinancing. It has access to a domestic private short-term bond programme of TRY500 million, which largely covers the upcoming maturities. Although uncommitted, management is confident about raising domestic bonds in current trading conditions.

Liquidity will be backed up by a EUR50 million facility from Denizbank as well as EUR30 million of committed facilities from Northern Cyprus banks. There is currently EUR19 million available under the Denizbank facility while the other committed facilities are undrawn.

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Summary of Financial Statement Adjustments –

Rental expenses capitalised using multiple of 7.0x. This is due to the rented properties being mainly located in Eastern Europe – Bulgaria (7.0x), Croatia and Turkey (5.0x)

We include TRY35 million as restricted cash, which is locked up at casinos due to legal requirement

We have excluded the impact of the finance sector activities from the P&L, BS and CF statement in 2016 due to it having only been around for one year and been discontinued early this year.

We have made adjustments to group EBITDA to strip out income and costs associated with FX movements

We have added back TRY26.4 million to EBITDA in 2015 relating to a one-off cost relating to a bid for the Turkish Lottery

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.