Media Release

Taiwan Ratings Assigns Sercomm Corp. 'twA-/twA-2' Ratings; Outlook Stable

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Rating Action Overview

- Sercomm's solid software development capability coupled with in-house manufacturing underpins its market position in the telecom equipment industry. However, the company's limited pricing power, small operating scale, and less-favorable product mix with low profit margin constrain its competitive position.
- Sercomm's conservative debt usage and financial policy helps the company to better withstand market volatility and control financial risk.
- On May 29, 2019, Taiwan Ratings Corp. assigned its 'twA-' long-term and 'twA-2' short-term issuer credit ratings to Sercomm.
- The rating outlook is stable to reflect our expectation that Sercomm will generate positive discretionary cash flow with a recovery in EBITDA, and remain debt free after surplus cash adjustment over the next two years.

Rating Action Rationale

We believe Sercomm Corp.'s accumulated strength in software development coupled with hardware design and in-house manufacturing underpin its market position in the telecommunication equipment industry. Moreover, Sercomm's conservative debt usage and financial policy should help the company to better withstand market volatility and control financial risk, in our view. Nonetheless, the company's limited pricing power against its clients, small operating scale, and less-favorable product mix with a still-high contribution from low-margin businesses could continue to constrain its profitabilty and competitiveness.

Founded in 1992, Sercomm designs and manufactures telecom equipment, including broadband gateway consumer premise equipment (CPE), WiFi access point, business routers, and Internet of Things (IoT) related products. Broadband CPE is the company's biggest business segment, which contributed about 72% of revenue in 2018. Enterprise network and IoT business contributed about 14% and 12%, respectively. Sercomm is among the top three global broadband CPE provider, conveying a global market share in the high-single-digit percentage. The company also has a leading market position in certain niche market, including a market share of 20%-25% in IP camera in the U.S., and a global market share of 8%-10% in business wireless router. The company has production base in China (60%), Taiwan (20%), and Philippine (20%) as of May 2019.

Sercomm's competency in software development coupled with hardware design and in-house manufacturing allows a high degree of customization and shortens turnaround time for product development. Sercomm has more than 1,200 R&D engineers and R&D expenses has accounted for 4%-5.5% of revenue over the past three years. The company has enhanced its production efficiency through the adoption of automation and AI, which increased output per labor by roughly 50% over the past five years. In addition, Sercomm's agility in moving production capacity overseas in the face of increasing trade friction and rising import taxes in the U.S. demonstrates its flexibility in managing capacity and lowering cost. These factors underpin Sercomm's capability in delivering new products to clients in a timely and cost-effective manner, which is critical to market success.

In our view, Intense competition and low profitability in the fragmented broadband CPE segment constrains Sercomm's competitive positon. The company has limited pricing power against its clients, particularly because of its small scale. Although Sercomm's strong R&D capability may grant it a price premium for new products in the initial launch stage, this premium gradually declines as products enter their mature life cycle. This means that original design manufacturers (ODM) compete for orders largely based on price and the switching cost for customers is low in most cases. We expect Sercomm to experience continued margin pressure resulting from market competiton. In 2018, low-margin CPE business accounted for about 38% of revenue.

We expect Sercomm's product mix to improve with a lower contribution from low-margin CPE business, as the company pursues the 'Go Direct' strategy. This strategy is to supply broadband CPEs directly to network service providers (because it carries better margin) instead of selling through vendors. The strategic shift would require the company to establish relationships with carriers in the U.S., China, and Southeast Asia that were previously served indirectly. If successfully executed, Sercomm would see profitability improvement and better customer diversity. Nonetheless, this could take some time and uncertainty exists. Another drawback is that Sercomm is likely to face order cuts from CPE vendors, which could drag down the company's revenue growth over the next 12 months. These vendors were the company's largest clients in the past.

Sercomm's low debt leverage and conservative financial policy are key supporting factors for the ratings. The company has a net cash position as the end of 2018 with New Taiwan dollar (NT$) 6.1 billion cash and liquid investment and NT$2.8 billion of debt. The company also takes a conservative approach in managing account receivables and foreign currency risk. Almost all Sercomm's account receivables are covered by insurance and foreign orders are locked using currency forwards once confirmed. We believe such a conservative financial policy will help the company to better withstand market volatility and control financial risk.

Nevertheless, market volatilities could still have a significant impact on Sercomm's cash flow generation and profitability. The volatility may stem from the company's small scale and still relatively high customer concentration that makes it cash flow sensitive to orders from a single client. Material input cost changes, price pressure, and the lumpy nature of capital expenditure by carriers may also lead to such volatility. In addition, constant technology evolution is likely to stir up volatility in final sales prices and margins periodically, while shortening product life cycles provide less stability in earning streams.

Outlook

The stable outlook reflects our expectation that Sercomm's EBITDA will recover in 2019 and 2020 with the introduction of next-generation products, progress on the company's product mix, expansion of its customer base, and rationalization of input costs. The stable outlook also reflects our view that the company will generate positive discretionary cash flow and remain debt free after surplus cash adjustment over the next two years.

Downward scenario

We may lower the long-term rating on Sercomm if ineffective R&D or product design leads to loss of business or if the company increases debt usage substantially, possibly due to large-scale capacity expansion or shareholder friendly actions that cause its ratio of debt to EBITDA to exceed 1.5x for an extended period. We may also lower the rating if the company's profitability weakens as a result of more intense price competition or persistent increases in raw material costs, leading to a return on capital of below 10%.

Upward scenario

We view the likelihood of an upgrade as relatively low over the next one to two years. However, we may raise the rating if Sercomm could expand its operating scale substantially with an enlarged and more diversified customer base such that its cash flow stability improved with less impact from a single client. We may also raise the rating if Sercomm could strengthen its profitability materially, likely through broadening the scope of product offerings and optimization of its product mix by increasing the contribution from high-margin products.

Our Base-Case Scenario

We expect Sercomm's revenue to grow 4%-6% in 2019 and 15%-20% in 2020, mainly underpinned by anticipated higher growth in enterprise network business for next-generation products and IoT business amid increasing application demand.

- U.S. real GDP to grow 2.2% in 2019 and 1.7% in 2020, Europe's real GDP to grow 1.3% in 2019 and 1.9% in 2020, and Asia-Pacific real GDP to grow 5.2% in 2019 and 5.3% in 2020.
- Broadband CPE sales will decline by a low-single digit in 2019, mainly due to Sercomm's strategy shift toward supplying directly to network service providers instead of through CPE vendors, which is likely to cause order drop from CPE vendors. CPE revenue could grow again in 2020, driven by geographic sales expansion and product upgrades.
- Other business lines will have faster growth in the double digit range in 2019-2020. The introduction of the new Wifi 6 standard and continued customer base expansion is behind our anticipation of strong sales growth in Sercomm's enterprise business. New product launches in surveillance equipment and the introduction of new IoT applications could also boost the company's IoT business sales over the same period.
- Gross margin to recover to 15.5%-16.5% in 2019 and 2020 from 15.2% in 2018, driven by a likely decline in input cost and lower contribution from low-margin home gateway business.
- Sales and general administrative expenses to grow by a mid-single-digit percentage in 2019-2020 with the setup of new overseas sales offices for geographic expansion.
- R&D cost to increase by double-digits in 2019-2020 to support new product development. R&D to revenue ratio will be 5%-6% over the period.
- Capital expenditure of NT$0.7 billion-NT$0.8 billion in 2019 and NT$1 billion-NT$1.4 billion in 2020. Higher capital expenditure in 2020 reflects planned capacity expansion domestically and overseas.
- Cash dividend payout of around 72% of previous year's net income.
- We apply a surplus cash haircut of 6%, mainly to reflect the discount on stock investments.
- Positive discretionary cash flow in 2019 and 2020 and largely flat reported debt.

Based on these assumptions, we arrive at the following credit measures:

- EBITDA margin of 5%-6% in 2019 and 2020.
- Ratio of debt to EBITDA of 0x in 2019 and 2020.
- Ratio of free operating cash flow to debt of 0x in 2019 and 2020.

Liquidity

The short-term rating on Sercomm is 'twA-2'. We believe Sercomm has strong liquidity to meet its needs over the next 24 months up to the end of 2020. The ratio of liquidity sources to liquidity uses will be 1.5x-2x in 2019 and 2.5x-3x in 2020. The company's liquidity sources will still exceed liquidity uses even with EBITDA drops by 30%. We also believe Sercomm can absorb a low probability high impact event without refinancing, underpinned by its prudent risk management characterized by a high cash balance, low debt usage and high insurance coverage on its account receivables. In addition, we believe Sercomm has good banking relationships as evidenced by the low interest rates on its bank loans. None of Sercomm's debt carry any financial covenants.

Principal Liquidity Sources:

- Cash and short-term investments: NT$6.1 billion at the end of 2018.
- Cash flow from operations: NT$1.5 billion-NT$2 billion in 2019 and NT$2 billion-NT$2.5 billion in 2020.

Principal Liquidity Uses:

- Debt maturity: NT$2.7 billion in 2019 and NT$20 million-NT$30 million in 2020.
- Working capital outflow: NT$100 million-NT$150 million in 2019.
- Capital expenditure: NT$0.7 billion-NT$0.8 billion in 2019 and NT$1.1 billion-NT$1.4 billion in 2020.
- Cash dividend: NT$612 million in 2019 and NT$700 million-NT$800 million in 2020.

Rating Score Snapshot

Issuer Credit Rating: twA-/Stable/twA-2

Note: All scores below are in comparison with global obligors.

Business risk: Weak
- Country risk: Moderately High
- Industry risk: Moderately High
- Competitive position: Weak

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: twa-

Modifiers
- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Strong
- Management and governance: Fair
- Comparable rating analysis: Neutral

Stand-alone credit profile: twa-

Related Criteria

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - June 26, 2018
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Technology Hardware And Semiconductors Industry - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012

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Ratings List

New Rating

Sercomm Corp.

Issuer Credit Ratings	twA-/Stable/twA-2