Media Release:

Far EasTone Telecommunications Co. Ltd. Downgraded To 'twA+/twA-1' On Surging Capital Expenditure; Outlook Stable

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Rating Action Overview

- The ratings on Far EasTone are capped at one notch above the **Far Eastern New Century Corp.** (FENC) group credit profile. We recently downgraded FENC and lowered our assessment of the group credit profile due to the surging cost of 5G spectrum bandwidth that will significantly raise the group's financial leverage.
- We have also lowered Far EasTone's SACP to 'twaa-' from 'twaa+', given our assumption of Far EasTone's rising debt, which will push the company's ratio of debt to EBITDA up to around 2.5x in 2020 and 2021 from about 1.2x in 2019.
- On Jan. 21, 2020, Taiwan Ratings Corp. lowered its issuer credit ratings on Far EasTone to 'twA+/twA-1' from 'twAA-/twA-1+'. We also lowered our issue rating on the company's senior unsecured corporate bond to 'twA+' from 'twAA-'.
- The rating outlook is stable to reflect our stable outlook on FENC. This incorporates our view that Far EasTone's stable operating cash flow generation will help to contain the group's rising debt and cap the rise in its ratio of debt to EBITDA at 5.3x-5.7x over the next two years.

Rating Action Rationale

Weaker group credit profile assessment due to high capex needs. Our downgrade of Far EasTone reflects our downward assessment of the parent FENC group credit profile and our downgrade of FENC. We expect the overheated bidding process and resultant surge in fifth generation (5G) spectrum license costs will increase FENC's debt substantially in 2020. We also expect FENC's debt to remain elevated over the next two years, given the group's high capex needs and our view that the group's dividend policy is likely to remain largely unchanged over the period. This supports our projection that FENC's ratio of debt to EBITDA will rise to 5.3x-5.7x in 2020 and 2021, up from about 4.5x in 2019. We have therefore lowered our assessment of the FENC group credit profile to 'twa' from 'twa+'. For more details please refer to the separate media release for the downgrade on FENC.

The rating on Far EasTone is capped at one notch above the FENC group credit profile. We continue to assess Far EasTone as an insulated and strategically important subsidiary of the FENC group. The long-term issuer credit rating on Far EasTone is capped at one notch above the FENC group credit profile, given that Far EasTone is a highly independent entity in respect of its financial performance, funding prospects, and corporate structure. In addition, Far EasTone does not comingle its funds, other assets, liabilities or cash flows with those of any other group entity. Moreover, we believe the group's strategy with respect to Far EasTone is clear and that the group has a compelling economic incentive to preserve Far EasTone's credit strength.

We have cut Far EasTone's SACP by two notches to reflect growing 5G-related investment. We expect investments in the 5G spectrum license and network infrastructure to push up Far EasTone's debt level to New Taiwan dollar (NT$) 70 billion-NT$75 billion in 2020 and 2021, up from NT$37 billion in September 2019. Nevertheless, these significant investments are unlikely to generate a meaningful increase in the operator's EBITDA over the same period, due to a likely low 5G adoption rate in the initial stage. We expect 5G adoption in the consumer segment to take longer than adoption of 4G services, given the proliferation of affordable 4G data plans in Taiwan and likely significant price gap between 4G and 5G data plans.

Meanwhile, new revenue opportunities in business segments, such as new uses related to Internet of Things and industrial applications, will also take time to develop. Furthermore, Far EasTone is likely to retain a dividend policy largely resembling that in previous years, which is likely to slow its progress to deleverage over the next two years. Therefore, we have lowered Far EasTone's anchor to 'twa+' from 'twaa+' , based on our projection that the operator's ratio of debt to EBITDA will increase to 2.5x-2.6x in 2020 and 2021, up from about 1.2x in 2019.

Notwithstanding Far EasTone's high funding needs to support capital spending on 5G and dividends, we believe the operator will be able to lower its debt gradually through stable operating cash flow. Far EasTone's ratio of debt to EBITDA could decline gradually to around 2x in three to four years. We have therefore upwardly revised our comparable rating analysis for Far EasTone to positive from neutral, leading to a stand-alone credit profile of 'twaa-', compared with 'twaa+' previously.

Outlook

The stable outlook on FET reflects the stable rating outlook on its parent, FENC, as well as FET's stable stand-alone credit profile, and our expectation that FET will maintain a close relationship with its parent group with no material change in the group's shareholdings over the next one to two years.

Downward scenario

We may lower the rating on FET if we lower the rating on FENC. This may happen if FENC's profitability deteriorates substantially or its capital expenditure exceeds our expectations significantly, such that its adjusted ratio of debt to EBITDA rises above 6x for an extended period. Such a ratio could result from severe industry downturns or higher capital expenditures for the company's major businesses than we predicted. Higher capital spending could include cash outflows for merger and acquisitions and 5G related investments, such as spectrum and network infrastructure investment.

Upward scenario

We may raise the rating on FET if we raise the rating on FENC. The likely scenarios for this include if FENC improves its ratio of debt to EBTIDA to close to 4.5x on a sustainable basis. Sustainable and material improvement in FENC's profitability and cash flow in its chemical business, as well as prudent capital expenditure and dividend payouts or reducing debt through asset disposals could indicate such a scenario. It could also occur if FENC could substantially enhances the competitive position of its PTA, polyester, and textile businesses by increasing its product diversity and exposure to high-end products without impairing its debt leverage.

Company Description

FET is one of the three leading telecommunications companies in Taiwan's stable oligopoly wireless telecommunications market with a subscriber market share of about 24.5%, lagging behind market leader Chunghwa Telecom Co. Ltd. by about 12%. Mobile services accounted for about 84% of FET's total service revenue base, with the remainder from its fixed-line business in the first three quarters of 2019.

Our Base-Case Scenario

We project FET's revenue to increase moderately by 0.5%-2.5% in 2020 and 2021, through the commercial roll out of 5G services, following a 3.2% decline in 2019. Meanwhile, we project the company's EBITDA margin to decline to 33.0%-33.5% in 2019-2021 from 34.3% in 2018, as a result of stiff competition in the domestic telecommunication market. Our base-case assumptions are:

- Taiwan's real GDP to grow 2.4% in 2020 and 2.2% in 2021.
- Momentum in the domestic telecom industry could remain weaker than Taiwan's GDP growth, constrained by consistent pricing pressure and declining revenue from traditional fixed-line services. We expect flat to low-single-digit percentage growth in revenue for the telecom sector over the next one to two years.
- Far EasTone's postpaid subscriber base to remain largely flat in 2020 and 2021, after experiencing a mild year-on-year growth of 1%-2% in 2019.
- The launch of 5G services in 2020 could help to uplift average revue per user (ARPU) despite intense pricing competition, but we expect the degree of benefit to be modest in the initial launch stage. The company's postpaid ARPU has declined by a high-single-digit percentage in 2019 as a result of fierce price competition in unlimited data plans among local service providers.
- Far EasTone's fixed-line revenue could experience moderate growth in 2019-2021, underpinned by rapid growth in the operator's information communication technology business.
- EBITDA margin to weaken to 33.0%-33.5% in 2019-2021, which primarily reflects margin pressure from a downward trending ARPU. We believe Far EasTone will remain disciplined on handset subsidies; however, the company's sales expense could increase noticeably to promote 5G adoption during the launch period.
- Capex of NT$7.5 billion-NT$8.5 billion in 2019, NT$50 billion-NT$60 billion in 2020, and NT$11 billion-NT$13 billion in 2021.
- Cash dividend of NT$10 billion-NT$11 billion in 2020 and 2021.

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

- EBITDA margin of 33.0%-33.5% in 2019-2021.
- Ratio of debt to EBITDA of 1.1x-1.3x in 2019 and 2.4x-2.7x in 2020 and 2021.
- Ratio of free operating cash flow to debt of 38%-42% in 2019, negative 37%-43% in 2020 and positive 17%-23% in 2021.

Liquidity

The short-term rating on Far EasTone is 'twA-1'. We believe the company has adequate liquidity to meet its needs up to September 2020, represented by a ratio of liquidity sources to liquidity uses of 2x-2.5x up to September 2020 without incorporating the cash outflow related to 5G spectrum cost. We also believe Far EasTone can absorb high-impact, low-probability events, with limited need for refinancing, given the company's high cash balance compared with its short-term debt. Far EasTone has solid banking relationships in Taiwan and a very high standing in credit markets as evidenced by the low funding cost of its bank loans and bonds. The company issued a NT$2.6 billion seven-year bond and a NT$500 million 10-year bond in December 2019, with a coupon rate of 0.8% and 0.85%, respectively. Far EasTone has no financial covenants on its debts.

Principal liquidity sources:

- Cash and short-term investments: about NT$6.3 billion as of the end of September 2019.
- Funds from operations: NT$25 billion-NT$26 billion for the 12 months ending September 2020.
- Undrawn mid-to-long term bank lines maturing beyond September 2020: about NT$34 billion.
- Corporate bond issuance in December 2019: NT$3.1 billion.

Principle liquidity uses:

- Debt maturity: NT$8.0 billion-NT$8.5 billion over the 12 months ending September 2020.
- Capex (excluding 5G spectrum cost): NT$9 billion-NT$11 billion for the 12 months ending September 2020.
- Working capital outflow: NT$1.0 billion-NT$1.5 billion over the 12 months ending September 2020.
- Cash dividend: NT$10 billion-NT$11 billion over the 12 months ending September 2020.

Ratings Score Snapshot

Issuer Credit Rating: twA+/Stable/twA-1

Note: The descriptors below are on a global scale.

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

Anchor: twa+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: twaa-

- Group credit profile: twa
- Entity status within group: Strategically important (-1 notches from SACP)
- We have assessed FET as an insulated and strategically important subsidiary of the FENC group. The issuer credit rating on FET can be above the group credit profile of the FENC group, but is subject to a cap of one notch above the group credit profile.

Related Criteria & Research

Related Criteria

- General Criteria: Group Rating Methodology, Jul 01 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Apr 01 2019
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings,com, Jun 26 2018
- General Criteria: Methodology For National And Regional Scale Credit Ratings, Jun 25 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, Mar 28 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec 16 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Telecommunications And Cable Industry, Jun 22 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov 19 2013
- General Criteria: Methodology: Industry Risk, Nov 19 2013
- Criteria | Corporates | General: Corporate Methodology, Nov 19 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov 13 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sep 14 2009

Related Research

- Media Release: Far Eastern New Century Corp. And Yuan Ding Investment Corp. Downgraded To 'twA' On Surging Capital Expenditure; Outlook Stable - Jan. 21, 2020

(Unless otherwise stated, these articles are published on www.standardandpoors.com, access to which requires a registered account)

Ratings List

Rating Downgraded

	To	From
Far EasTone Telecommunications Co. Ltd.		
Issuer Credit Rating	twA+/Stable/twA-1	twAA-/Stable/twA-1+
Senior unsecured issue credit rating	twA+	twAA-

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.taiwanratings.com for further information. Complete ratings information is available to subscribers of Rating Research Service at rrs.taiwanratings.com.tw. All ratings affected by this rating action can be found on Taiwan Ratings' public website at www.taiwanratings.com.