Media Release:

Outlook On Aerospace Industrial Development Corp. Revised To Negative On COVID-19 Impact And Rising Debt; 'twAA-/twA-1+' Ratings Affirmed

May 29, 2020

Credit Rating Overview

- Taiwan-based AIDC could see weak cash flow generation over the next few quarters, given likely lower sales and profit margin due to the negative impact of COVID-19 and unresolved safety issues at Boeing.
- AIDC's debt to EBITDA ratio could remain above 5x in 2020-2021 before potential deleveraging reduces it in 2022, due to hefty working capital needs for national defense projects and weaker profitability.
- We are therefore revising our outlook on AIDC to negative from stable to reflect the downside risk for the debt to EBITDA ratio to remain high for a longer period if the COVID-19 crisis continues or AIDC fails to recover working capital related to defense projects.
- At the same time, we are affirming our 'twAA-' long-term and 'twA-1+' short-term issuer credit ratings on the company.

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Credit Rating Rationale

Coronavirus and Boeing's grounded 737 Max will deeply hit AIDC's performance in 2020. The rating action reflects challenging market conditions particularly for Aerospace Industrial Development Corp.'s (AIDC's) commercial businesses over the next few quarters and the resultant weaker profitability and cash flow generation than our previous assumption.

We expect AIDC's revenue to decline by about 15% in 2020. This is mainly due to the impact from further delays in the resumption of Boeing 737 Max production, as well as the more comprehensive impact of the COVID-19 pandemic on almost all of AIDC's commercial aircraft and engine clients such as Boeing, Airbus, GE, and Rolls-Royce. For the same reasons, we expect AIDC's commercial businesses to see a decline of 3%-5% in gross margin in 2020, largely due to lower utilization rates and higher costs associated with manufacturing aircraft parts and engine parts. The Taiwan government's subsidy of New Taiwan dollar (NT$) 540 million in 2020 will partly offset the decline in AIDC's profitability.

Under our base case assumption, we expect the company's revenue to recover by 15%-20% in 2021 and largely normalize in 2022, with the negative effect of COVID-19 to fade away gradually. In addition, the profitability of AIDC's core businesses is likely to recover from 2021 onward with recovering revenue and growing contribution from military projects. Nonetheless, material downside risk to our base case persists if the COVID-19 crisis persists longer and causes more long-lasting damage to the global aviation industry.

Debt leverage could remain high to meet working capital needs. There is high risk that AIDC's debt leverage could remain elevated over the next few quarters, if the company fails to shorten its cash conversion cycle under currently weak market conditions. The company's cash conversion cycle has lengthened materially over the past two years because of new national defense projects and deteriorating payment terms with its major commercial aviation clients. However under our base case, we still expect the company to recover a major part of receivables from the Taiwanese government and lower its account receivable level to NT$10 billion-NT$11 billion at the end of 2020 from NT$14 billion a year ago. Nevertheless, AIDC's inventory level is likely to grow further in 2020, to support the production of the domestic advanced trainer jet, which will likely hinder AIDC's deleveraging efforts, particularly if profitability does not recover as we expect.

Military businesses could provide more stable and predictable cash flow to cap debt leverage in 2022 and beyond. We still expect businesses from the Taiwanese military to support AIDC's long-term growth and earnings, because those business are relatively predictable, recurring and carry higher margins. We expect AIDC to deliver the domestic advanced trainer jet project on schedule and for the project to bring a major revenue and profit contribution from 2022. The Taiwan government has budgeted NT$68.6 billion for 66 units of the rainer jets, which this could bring NT$10 billion annual sales to AIDC during the peak years of delivery in 2023-2026. As for the ROC Air Force's F-16 upgrade project, the subsequent business opportunity from maintenance and repair could also be substantial, because AIDC is highly likely to take over such service from the Air Force after the company finishes the upgrade project in 2023.

Outlook

The negative outlook reflects the downside risk that AIDC's debt to EBITDA ratio could remain above 5x for a prolonged period. We expect the ratio to decline to around 5x in 2021 from about 6x in 2020, supported by the collection of receivables from the Taiwan government and the fading impact of the COVID-19 pandemic. However, downside risk will remain significant if governments worldwide cannot bring the COVID-19 pandemic fully under control over the next one to two quarters.

Downward scenario

We could lower the long-term rating if:

- AIDC fails to lower its debt to EBITDA ratio to close to 5x over the next 12 to 24 months. This could result from lower-than-expected cash flow generation due to 1) a prolonged negative effect of COVID-19 on global aircraft sales and deliveries, or 2) fewer deliveries or even outright cancelation of the Boeing 737 Max model due to further delays in certification or difficulties in delivering aircraft. AIDC's debt to EBITDA could also remain above 5x if the company cannot materially reduce its working capital to lower debt over the next few quarters.

Upward scenario

We may revise the outlook back to stable if:

- AIDC improves its debt to EBITDA ratio to below 5x over the next one to two years. This could be achieved if the company can moderately restore its profitability and cash flow generation amid the current market downturn, or if it can materially lower its debt through shortening its cash conversion cycle.

Our Base-Case Scenario

- Given that the wider global spread of COVID-19 will prolong its economic fallout, we project Taiwan's real GDP growth to be negative 1.2% in 2020, and rebound by positive 4.0% in 2021; In terms of global GDP, S&P Global Ratings forecasts negative 2.4% growth in 2020 and positive 5.9% in 2021.
- Taiwan's national defense budget will account for 1.72% of Taiwan's forecast GDP in 2020. In addition, the government has budgeted NT$68.6 billion for domestic advanced jet trainers program, which will support AIDC's defense business growth and profit for the next several years.
- The impact of the coronavirus on global air travel could materially hurt aircraft deliveries in 2020. Airlines around the world have significantly reduced capacity to address lower demand and government travel restrictions due to the coronavirus. This could result in a high number of deferrals or cancellations of aircraft orders. Sales of aftermarket parts and services are also likely to be hurt due to the lower level of flying.
- AIDC's revenue to decline by 15% in 2020 but to recover by 15%-20% in the following year. AIDC's EBITDA margin will be 13%-14% in 2020 (supported by a government subsidy) and 12.5%-13.5% in 2021, compared with 13.7% in 2019. We expect AIDC's performance to recover as the coronavirus impact moderates and there is a growing revenue contribution from military projects.
- AIDC's capital expenditure will be about NT$1.8 billion to NT$2 billion in 2020 and about NT$1.3 billion to NT$1.5 billion in 2021.
- We expect moderate improvement in AIDC's cash conversion cycle, because the company is likely to recover a major part of receivables from the government in 2020.
- We assume 60% cash dividend payout ratio in 2020-2021.

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

- Ratio of debt to EBITDA of above 5.5x-6.5x in 2020 but improve to close to 5x in 2021.
- Ratio of EBITDA interest coverage of 13%-16% over 2020-2021, compared with 17.9% in 2019.

Liquidity

The short–term rating on AIDC is 'twA-1+'. We assess the company's liquidity as adequate because we believe AIDC has sufficient cash flow to meet its needs over the next 12 months, factoring in government support in the form of state-owned bank facilities. We expect the ratio of AIDC's liquidity sources to uses will be slightly above 1.2 times in the 12 months ending December 2020. Furthermore, we believe the company will have sufficient liquidity headroom even if its forecast EBITDA declines by 15%.

In addition, we believe AIDC has well-established relationships with banks and could establish new credit facilities when needed due to its status as an important government related entity, as evidenced by AIDC's average interest rate of only 1% in 2019. We believe AIDC has generally prudent risk management to ensure at least adequate liquidity, because the Ministry of Economic Affairs must approve the company's operational and financial budget and the budget remains under the government's surveillance. The company's loans carry no financial covenant.

Principal Liquidity Sources

- Cash and short-term investment: NT$ 3.6 billion as end of 2019.
- Funds from operations: About NT$ 2.2 billion in 2020.
- Expected working capital inflow: About NT$ 1.1 billion.
- Ongoing government support in form of government related bank facilities: NT$ 15 billion to cover refinancing needs in 2019.

Principal Liquidity Uses

- Debt maturities: NT$ 13.3 billion in 2020.
- Capital expenditure: About NT$2 billion.
- Cash dividend payout: About NT$ 1.1 billion.

Rating Scores Snapshot

Issuer Credit Ratings: twAA-/Negative/twA-1+
Note: All scores below are in comparison with global obligors.

Business risk: Fair

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

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: twbbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile (SACP): twbbb

- Sovereign rating: AA-
- Likelihood of government support: Very high (+5 notches from the SACP)

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Understanding Taiwan Ratings' Rating Definitions - June 26, 2018
- General Criteria: Group Rating Methodology - July 01, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Aerospace And Defense Industry - March 25, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

(Unless otherwise stated, these articles are published on www.taiwanratings.com)

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Aerospace Industrial Development Corp.		
Issuer Credit Rating	twAA-/Negative/twA-1+	twAA-/Stable/twA-1+

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