Media Release:

Wiwynn Corp. Assigned 'twA/twA-1' Issuer Credit Ratings; Outlook Stable

August 27, 2020

Rating Action Overview

- Wiwynn is a Taiwan-based server manufacturer generating EBITDA of NT$8.4 billion in 2019.
- We believe Wiwynn can sustain its close relationship with global leading CSPs and maintain its above-average growth and return on capital of above 25%, given its good hardware development capability; however, the company's narrow customer base and product mix, limited technology barriers, and pricing power against its clients constrain its competitive position.
- Wiwynn's relatively strong profitability and low capital intensity, together with its prudent financial management, could help to sustain its lower debt structure.
- On August 27, 2020, Taiwan Ratings Corp. assigned its 'twA' long-term and 'twA-1' short-term issuer credit ratings to Wiwynn Corp.
- The stable outlook embeds our view that Wiwynn can sustain its revenue and EBITDA growth and keep debt to EBITDA ratio comfortably below 1.5x over the next one to two years with strong market growth and an expanding customer list, despite negative discretionary cash flow for higher capex, cash dividends, and additional working needs in response to the COVID-19 crisis.

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Rating Action Rationale

Wiwynn's position as one of the leading suppliers of tailor made data center servers is mainly underpinned by its solid hardware development capability and close cooperation with cloud service titans whose server demand grows faster than the overall market.

Wiwynn is one of the first movers using the ODM-direct service model. This is where server manufacturers design and make highly customized servers for major server buyers such as cloud services providers (CSPs) without big server vendors such as Hewlett Packard Enterprises Co. and Dell in between. Wiwynn has built its position as the main supplier to the largest social media platform and the second largest cloud service provider, by leveraging its hardware development capability. We believe that the company's efficient R&D process could continue to better optimize work load efficiency and lower total operating costs for its clients than its peers are capable of achieving, with servers providing better energy efficiency, scalability, and reliability.

We believe this would in turn help the company to better retain its customers and benefit from the rapid demand growth in the global cloud computing market. According to International Data Corp., the global cloud services market will see double digit growth annually over the next two to three years--much faster than traditional IT services. Growing market concentration among top service providers such as Microsoft, Amazon.com Inc., and Facebook could further support Wiwynn's revenue growth over the next one to two years.

Efficient R&D and a capital light operating model support Wiwynn's good operating efficiency and above-average return on capital.

In our view, Wiwynn's operating efficiency is underpinned by the high-degree of cost passed through to its clients and its asset light model that supports production flexibility. The company's highly customized products and close collaboration with clients also enable a high degree of cost pass-through with a lower risk from unexpected movements in component and other operating costs, such as higher logistics costs stemming from the COVID-19 pandemic in the first half of 2020.

In addition, Wiwynn outsources the majority of its server assembly to its parent company, Wistron Corp. and its subsidiaries and focuses on higher value added design work together with its clients. This leads to a lower capital need and much higher return on capital than other EMS/ODM peers. By leveraging Wistron's global manufacturing network, Wiwynn can also better deliver products to clients in a timely and cost-effective manner, especially when facing trade frictions or public health emergencies, such as the COVID-19 pandemic. Although Wiwynn is increasing its in-house assembly capacity, we do not expect its spending on in-house capacity to materially increase Wiwynn's capital intensity, given the relative simplicity of its assembly processes.

Lack of design and technology ownership, stronger buyer power, and high customer concentration significantly constrain Wiwynn's competitive position with a risk of high business volatility.

Wiwynn makes public its technology and product designs developed under the Open Compute Project (OCP), which is an open source organization aimed at lowering the total cost of hardware ownership and promoting standardization for better efficiency, flexibility, and scalability. This lowers technology barriers for existing and potential competitors and might further intensify competition in this field because of easy access to Wiwynn and other participants' designs and technology. In addition, like most of its EMS/ODM peers, Wiwynn experiences strong buyer power from its powerful clients. We expect the company to continue to come under significant margin pressure, particularly for those products that have reached the mature stage of their product cycle. It could be difficult for the company to sustain its current margins if it fails to maintain high efficiency and speed of technology development and quickly introduce and ramp up the sales of new products such as edge computing servers.

Wiwynn's highly concentrated customer base and product mix also substantially constrain the company's competitive position in our view. Its top two clients accounted for more than 90% of its total revenue over the past three years. We do not expect its customer concentration to improve much over the next two to three years amid intense market competition. In addition, increasing concentration in the global cloud service market among a few top players such as Amazon and Microsoft will also limit room for Wiwynn to make significant customer diversification. We view that under such high customer concentration, the loss of one key client could have a material negative effect on the company's profitability and cash flow

generation capability. Furthermore, almost all of Wiwynn's revenue comes from data center servers, bundled with system integration and services. This could further expose Wiwynn's operating performance to potential competition from large and more diversified ODM/EMS companies that seek to expand in the more lucrative ODM-direct server market.

Stable margins and relatively light CAPEX will continue to support Wiwynn's financial metrics over the next one to two years, despite material working capital needs for revenue growth.

We expect Wiwynn's growing EBITDA to support its debt to EBITDA ratio at 0.4x-1.0x over the next two years, despite rising debt. We also expect strong revenue growth from its top three customers to continue drive EBITDA growth over the next one to two years. Nonetheless in our base case, we expect higher costs associated with the initial engagement with the third largest client and competition could slightly drag down Wiwynn's overall margin, assuming limited revenue contributions from new products such as edge computing servers.

Wiwynn's debt level is likely to grow moderately in 2020 with higher cash dividend payments, working capital outflow to support revenue growth, and higher inventory in response to the COVID-19 pandemic. However, we expect Wiwynn's cash flow to improve and its debt to decline gradually as inventory turnover normalizes in 2021. This is despite a moderate increase in capital expenditure (capex) for its own assembly lines and factories in Taiwan and overseas in the near future. We expect Wiwynn's capex to be relatively light for its somewhat simple assembly process without any plan currently to engage in the production of upstream components.

Nonetheless, we believe that rapidly evolving technology in the tech industry, strong buyer power, and Wiwynn's high customer and product concentration could cause high volatility in its profitability and cash flow metrics in the long term. This volatility risk indicates moderately higher financial risk than the company's current leverage implies, in our view.

Wiwynn is partly insulated from Wistron but remains highly strategic to Wistron's long-term business strategy.

We view Wiwynn as an insulated subsidiary of Wistron Group, which owns 50.7% shares in Wiwynn and our issuer credit rating on Wiwynn is capped at one notch above the group credit profile (GCP) of Wistron on S&P Global Ratings' global rating scale. This reflects our belief in Wistron's strategic need to maintain certain separation from Wiwynn in order to avoid direct competition in the server market with its major generic server clients. In addition, we believe that as a listed company with four independent directors out of nine, Wiwynn is independent in its business operation and financial performance, and does not commingle its funds, other assets and cash flow with that of Wistron. The company is also subject to additional external oversight on listed companies from regulators and investors.

However, we do not expect the parent company to fully divest of Wiwynn, given the company's significant profit contribution and importance to the group's long-term strategy to develop the server business. Wiwynn is also linked to the group's market reputation. In addition, Wiwynn continues to outsource the majority of its product assembly to Wistron. These factors indicate that Wiwynn cannot be fully delinked from Wistron in the event that Wistron experiences material financial distresses. This is despite our view that Wiwynn is increasing conducting in-house assembly and could find other EMS companies as substitutes without significant

business disruption in the event that Wistron encounters financial stress and is unable to continue providing EMS services.

We assess Wiwynn's credit profile as slightly better than Wistron's, but our issuer credit rating on Wiwynn is not capped by Wistron's credit profile at the moment. Wistron's credit profile is mainly constrained by its relatively higher debt leverage to support its aggressive capex plan and working capital needs over the next one to two years. We expect Wistron's ratio of debt to EBITDA to remain elevated at 4x-5x after adjusting a significant amount of receivable factoring to debt. This is despite our expectation of improving margins after the company disposed of part of its manufacturing facilities in China. Wistron's competitive position is restrained by its smaller scale than leading EMS players', intensifying competition in the industry, and weak bargaining power against downstream clients.

The aforementioned weaknesses can be partly offset by Wistron's satisfactory end product and geographical diversification, its significant scale economy, and some financial flexibility with liquid equity investments, which had a market value of about New Taiwan dollar (NT$) 6.5 billion as of June 30, 2020, and sizable receivables from some reputable global tech names that can be liquidated in a relatively short period of time.

Outlook

The stable outlook reflects our view that Wiwynn could sustain its revenue and EBITDA growth and keep its debt to EBITDA ratio comfortably below 1.5x over the next one to two years. This is despite our view that high costs in the initial stage of engagement with new clients will slightly reduce gross margins in 2020-2021. A lengthened cash conversion cycle, high cash dividends and higher capex will also cause temporary negative discretionary cash flow and slightly increase Wiwynn's debt leverage in 2020 before deleveraging in 2021.

Downward scenario
We may lower the rating on Wiwynn if its debt to EBITDA ratio deteriorates to above 1.5x for an extended period of time. This may occur if:

- Wiwynn's revenue or profitability weaken substantially because intense competition or deteriorating R&D strength relative to that of its peers induces severe pricing pressure from its clients or the loss of key customers; or
- The company's debt level grows significantly because Wiwynn becomes more aggressive on capex or shareholder friendly actions, or the company's cash conversion cycle lengthens materially under pressure from its clients.

We may also lower the rating if Wiwynn's profitability, as measured by return on capital declines, falls to near 12% which signals a material deterioration in the company's competitive position due to weaker advantages in technology and design against its competitors.

We may lower the long-term rating on Wiwynn if Wistron's creditworthiness deteriorates materially. This may occur if:

- Wistron's profitability deteriorates substantially due to loss of critical customers or more intense pricing competition among EMS industry; or

- Wistron's capex, equity investments or working capital needs rise significantly higher than our expectation, such that its debt to EBITDA ratio deteriorates to above 5x for an extended period.

Upward scenario
We may raise the long-term rating on Wiwynn if we raise Wiwynn's stand-alone credit profile (SACP) while at the same time Wistron's creditworthiness improves materially. This may occur if:

- Wistron substantially improves its market position in the EMS industry and at the same time significantly expands its operating scale; or
- Wistron's debt to EBITDA ratio improves to below 3x for an extended period, underpinned by its improving profitability as well as more prudent capex, working capital management, and cash dividends.
- At the same time, Wiwynn expands its operating scale substantially through diversifying its customer base so that cash flow stability can improve; or Wiwynn materially strengthens its profitability by constantly developing new products faster than its peers.

Our Base-Case Scenario

- U.S. real GDP to shrink by 5% in 2020 and grow by 5.2% in 2021, Europe's real GDP to decline by 6.7% in 2020 and grow by 5.2% in 2021, APAC's real GDP to decline by 1.3% in 2020 and grow by 6.3% in 2021.
- S&P Global expects global information technology spending to decline by 4% in 2020, and the revenue of almost all technology segments, except for software, to decline by a low to mid-single digit during the year. Shipments of servers are likely to decline by 5% in 2020; however, hardware vendors with high exposure to cloud data centers can expect strong demand for their products as the capital spending of hyper-scale cloud service providers will rise amid strong remote working and e-commerce demand.
- Wiwynn's revenue is highly correlated to the capital spending plan on hyper-scale data centers by its major clients, and we expect this momentum to be robust over the next two to three years. We expect Wiwynn's overall revenue to grow by 10%-15% in 2020 and 5%-10% in 2021.
- Growth will remain primarily from the company's top two clients while revenue from other clients and new products will take two to three years to become material.
- Gross margin to slightly decline to 7%-7.3% in 2020 and 2021 from 7.8% in the first quarter of 2020, due to pricing pressure and higher initial costs for early product development with its the third largest client.
- Sales, general and administration expense to grow along with revenue in 2020-2021 and R&D to revenue ratio to be about 1.0%-1.5% over the period.
- Capex of NT$500 million-NT$600 million in 2020 and NT$1 billion-NT$1.5 billion in 2021, mainly to support the expansion of motherboard assembly lines and factories in Southern Taiwan, Southeast Asia and the U.S., and for other office equipment.
- Cash conversion cycle lengthens due to the disruption risk stemming from the COVID-19 pandemic but gradually normalizes in 2021.
- Dividend payout ratio of about 65% in 2020 and 60% in 2021.

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

- EBITDA margin of 5.2%-5.5% in 2020 and 2021.
- Debt to EBITDA ratio of 0.3x-1.0x in 2020 and 2021.
- Return on capital of 30%-32% in 2020 and 2021.

Liquidity

The short-term rating on Wiwynn is 'twA-1'. We believe that Wiwynn has adequate liquidity to meet its needs over the upcoming 12 months ending March, 2021, with a ratio of liquidity sources to liquidity uses slightly above 1.2x over the period. We believe Wiwynn can absorb low probability, high-impact event with limited need for refinancing, underpinned by its prudent risk management characterized by limited debt usage, relatively low and flexible capital expenditures and complete hedging on foreign currency risk. We also believe that Wiwynn has a generally satisfactory standing in credit market with well-established banking relationships, evidenced by its aroundNT$10 billion of short-term undrawn bank loan as of March, 2020. Wiwynn's debt carry no financial covenants.

Principal liquidity sources:

- Cash and short-term investment: NT$12.5 billion as of March 2020.
- Funds from operations: NT$8 billion-NT$8.5 billion over the 12 months ending March, 2021.

Principal liquidity uses:

- Debt maturities: NT$9.8 billion over the 12 months ending March 2021.
- Capex: NT$600 million-NT$1 billion over the 12 months ending March, 2021.
- Cash dividend payout: NT$2.5 billion over the 12 months ending March 2021 in a stress scenario.

Ratings Score Snapshot

Issuer Credit Rating: twA/Stable/twA-1
Note: The descriptors below are on a global scale.

Business risk: Fair

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

Financial risk: Modest

- Cash flow/leverage: Modest

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: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: twa

Group credit profile:

- Entity status within group: Highly Strategic (The ICR reflects the entity's SACP of 'twa' and is currently not capped by GCP)
- We assess Wiwynn as an insulated and highly strategic subsidiary of the Wistron group. The issuer credit rating on Wiwynn can be one notch above the Wistron GCP on S&P Global Ratings' global rating scale if its SACP is one or more notches higher than the GCP.

Related Criteria

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

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

Ratings List

New Ratings	
Wiwynn Corp.	
Issuer Credit Rating	twA/Stable/twA-1

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