Research Update:

Hon Hai Precision Industry Co. Ltd. 'twAA+/twA-1+' Ratings Affirmed On Recovering Performance; Outlook Stable

October 29, 2020

PRIMARY CREDIT ANALYST

Anne Kuo, CFA
Taipei
+886-2-8722-5829
anne.kuo
@spglobal.com
anne.kuo
@taiwanratings.com.tw

SECONDARY CONTACT

Raymond Hsu, CFA
Taipei
+886-2-8722-5827
raymond.hsu
@spglobal.com
raymond.hsu
@taiwanratings.com.tw

Rating Action Overview

- Hon Hai Precision Industry Co. Ltd. is the world's largest electronics manufacturing services (EMS) provider, generating EBITDA of New Taiwan dollar (NT$) 186.7 billion in 2019.
- Hon Hai could see revenue and EBITDA resume growth in 2021 after a COVID-19 induced recession in 2020, given the company's growing higher-margin IIDM services and still-vast advantage in scale, manufacturing technology, and vertical integration.
- We expect Hon Hai to generate positive discretionary cash flow and sustain a net cash position over the next two years based on our view that Hon Hai's capacity expansion in Vietnam, India, and the U.S. will not materially increase its capital expenditure (capex) needs.
- On October. 29, 2020, Taiwan Ratings Corp. affirmed its 'twAA+' long-term and 'twA-1+' short-term issuer credit ratings on Hon Hai, as well as the 'twAA+' issue rating on Hon Hai's senior unsecured common corporate bonds.
- The stable outlook reflects our expectation that Hon Hai could largely withstand business uncertainty associated with COVID-19 and ongoing trade tension between the U.S. and China, and remain debt-free on an adjusted basis over the 12-24 months.

Rationale Action Rationale

Revenue growth could regain momentum in 2021 following a mild slump induced by COVID-19. We expect Hon Hai's revenue to decline by a low-to-mid single digit in 2020. The COVID-19 outbreak and a deep global recession led to a revenue decline of 7% in the first three quarters of 2020. That's despite robust demand from cloud service providers that has helped to offset the general demand slowdown, as well as the demand for computing and communication devices spurred by large-scale remote working and distance learning globally. The delayed launch of new iPhone models which is about one to two months behind normal cycles, further put back Hon Hai's sales recovery to the fourth quarter. However, we expect increasing iPhone sales, the accelerated implementation of fifth generation (5G) mobile communications, and steady growth in enterprise and component segments to support moderate growth in Hon Hai's revenue in 2021.

Margins could improve slightly in late 2020 and early 2021. Extra COVID-19 related costs, intense competition, and lower capacity utilization, led to Hon Hai's weak performance in the first quarter of 2020 with EBITDA dropping 36.3% year on year. We therefore expect Hon Hai's EBITDA margin will weaken slightly in 2020; this is despite our view that stronger iPhone sales and further improvement in FIH Mobile Ltd. (a 61.9%-owned subsidiary of Hon Hai mainly engaged in the manufacturing of communication devices)'s performance will help revive Hon Hai's margins slightly in the second half. We believe the company's drive to expand high-margin sales from segments such as components and servers, and new technologies such as new generation communications, AI, and robotics could help ease margin pressure in 2021. Slower wage growth, and increasing automation could also help to offset the negative effect of pricing pressure from weak consumer demand and support a mild margin recovery.

Hon Hai could sustain its significant market leadership despite Apple's ongoing supplier diversification. Hon Hai could face rising competitive pressure over the next two years as Apple Inc. continues to broaden its outsourcing partners for assembly services and component suppliers. Apple is also likely to expand its order allocation to Chinese makers to better withstand rising risks from trade disputes between the U.S. and China. However, we do not expect Apple's diversification plan to significantly weaken Hon Hai's operating performance over the next one to two years, given Hon Hai's leading manufacturing technology and efficiency. We also expect Hon Hai's sizeable market share leadership will remain intact over the same period. Nonetheless, this could continue to cap Hon Hai's margins before the company can significantly increase its revenue from differentiated components and design services.

Hon Hai's return on capital will likely remain at 13%-16% over the next two years. We believe Hon Hai's traditional EMS operations will continue to generate stable and strong profitability. This is despite its EBITDA margin could fluctuate with changes in the company's product mix and the pricing of its customers' new products. We believe that stronger sales of Apple Inc.'s 5G-enabled iPhone models and other mobile devices will also help to slightly improve Hon Hai's profits over the next 12 months.

Strong operating cash flow could support a net cash position in 2020-2021. We expect stronger profitability and tight working capital management to continue to support Hon Hai's strong operating cash flow in 2020-2021. In addition, Hon Hai's capex is likely to decline slightly to New Taiwan dollar (NT$) 50 billion-NT$60 billion per year in 2020 and 2021, down from NT$77.5 billion in 2019. As a result, Hon Hai could generate strong free operating cash flow and stay debt free on an adjusted basis over the next one to two years. However, uncertain consumer demand, particularly for new iPhones amid the prolonged COVID-19 pandemic could cause significant volatility in Hon Hai's free operating cash flow. Hon Hai has a vast financial buffer to absorb such volatility.

Outlook

The stable outlook reflects our view that Hon Hai could moderately restore its profit margin over the next few quarters. This could be supported by improving iPhone sales, the company's growing Integration, Innovation, Design, Manufacturing business model (IIDM), and demand for higher-margin products such as cloud servers in 2021-2022 following a mild recession in 2020 amid COVID-19. This also reflects our base case assumption that Hon Hai can largely withstand profitability pressure and sustain its return on capital at 13%-16% over the next

one to two years. The stable outlook also reflects our view that Hon Hai could generate significant free operating cash flow and sustain a net cash position on an adjusted basis over the same period.

Downward scenario

The ratings could come under pressure if:

- Hon Hai's profitability, in terms of return on capital, falls below 12% due to deteriorating cost and technology advantages, loss of key customers, or aggressive expansion into IIDM businesses associated with competitive product segments such as smartphones.
- The company takes on a more aggressive financial policy such that its ratio of total debt to EBITDA increases to more than 1.5x for an extended period. This could result from Hon Hai taking on more debt due to overly aggressive capex needs, overseas investments, or acquisitions, worsening working capital management, or from weakening competitive advantages that erode Hon Hai's margins.

Upward scenario

The likelihood of an upgrade is low over the next 24 months, given the low odds of a significant strengthening in the company's profitability and balance sheet. However, we may raise the rating if:

- Hon Hai can materially strengthen its profitability and sustain its strong free cash flow. The company would also have to maintain a conservative balance sheet with a sizeable net cash position to keep a sufficient buffer against potential business volatility from intense competition and customer and product concentration. Success in new technologies such as robotics, automation, 5G mobile communications and component manufacturing, as well as a prudent policy on shareholder distributions and investments could enable such enhancement in profitability and financial strength.

Company Description

Hon Hai is the world's largest EMS provider by revenue and market share. The company offers a wide range of products from components and modules to system assembly services. Hon Hai's customers are mostly large corporations in the global computer, communications, and consumer electronics sectors. In particular, Hon Hai's revenue from the consumer electronics sector has contributed about half of its total revenue over the past few years, mainly due to growth in the popularity of mobile devices such as smartphones and tablet PCs.

Our Base-Case Scenario

Assumptions

- Global GDP will contract 3.8% in 2020 and expand 5.2% in 2021.
- Global IT spending to decline 3% this year. However, we expect 2020 hardware sales to be more resilient than we had previously anticipated. While the work-from-home benefit will dissipate through the third quarter, we now project PC sales will decline 4% in 2020, less than our April forecast of a 10% drop. Our forecast for smartphone shipments has also improved to negative 7% from negative 9% as China demand improves and 5G phone launches continue.
- Hon Hai's revenue to decline 3%-5% in 2020 mainly due to a deeper COVID-19 impact in the first quarter before a rebound of 3%-5% growth in 2021. We expect improving iPhone and iPad sales will mostly drive revenue growth in 2021. We also assume Hon Hai will largely keep its majority share of Apple's hardware outsourcing in 2020-2022.
- Moderate revenue growth from products from servers, networking, and components. Hon Hai's revenue from other products including PCs and consumer electronics will be largely in line with the industry performance of a low single digit decline because we expect Hon Hai to maintain its market share.
- Hon Hai's profitability in 2020 will deteriorate slightly due to extra costs and lower utilization under the impact of COVID-19. However, we expect Hon Hai's margin to recover in 2021 to a level similar to that in 2019 supported by growing contributions from high-margin products and improving production efficiency with rising levels of automated production helping to ease pricing pressure.
- Cash conversion cycle to remain largely flat in 2020 and 2021, indicating a much smoother working capital movement because of improving iPhone sales.
- Capex and equity investments of NT$70 billion-NT$90 billion annually in 2020-2021 to support regular facility updates, equipment for new products, and various overseas investments including those in the U.S.
- Cash dividend payout and capital reductions combined in 2020-2021 will be similar to the level in previous years (40%-45% of the previous year's net income).

Based on these assumptions, we arrive at the following key metrics:

- EBITDA margin of 3.2%-3.5% in 2020 and 3.4%-3.8% in 2021.
- Debt free on an adjusted basis in 2020-2021.

Liquidity: Strong

The short-term rating on Hon Hai is 'twA-1+'. We believe that the company has strong liquidity as reflect by a ratio of liquidity sources to liquidity uses of 1.7x-1.9x over the next 12 months. The ratio will exceed 3.0x over the next 12-24 months with limited long-term debt maturity. We expect Hon Hai's liquidity sources would still exceed liquidity uses even if the company's EBITDA dropped by 30% during the period. We also believe the company has strong banking relationship, a high credit standing, and can absorb high-impact, low-probability events without refinancing, which is evidenced by the low interest rates on its bank loans and bonds. Hon Hai has vast headroom for its financial covenants on a small portion of its bank loans.

Principal Liquidity Sources:

- Cash and short-term investment: About NT$1,006 billion as of the end of June 2020.
- Fund from operations: NT$160 billion-180 billion per year in 2020-2021.

Principal Liquidity Uses:

- Long-term debt due in one year plus short-term debt: about NT$503.4 billion at the end of June 2020.
- Capex plus investments: NT$70 billion-NT$90 billion annually in 2020-2021.
- Cash dividend payout plus capital reductions for 2020-2021 similar to those in previous years (totaling 40%-45% of the previous year's net income).

Issue Ratings--Subordination Risk Analysis

Capital structure

Hon Hai has consolidated debt of about NT$683.5 billion as of the end of 2019, with about NT$302.8 billion at the parent level that is all unsecured, and the rest is at subsidiaries.

Analytical conclusions

The issue ratings are not notched down from the issuer credit rating on Hon Hai because the company's debt leverage is very low and we assess its financial risk profile as modest, suggesting low subordination risk to senior unsecured debt holders.

Ratings Score Snapshot

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

The below descriptors are based on the global scale.

Business risk: Strong

- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Excellent

Financial risk: Modest

- Cash flow/leverage: Modest

Anchor: twaaa

Modifiers

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

Related Criteria & Research

Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings - June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings - March 28, 2018
- General Criteria: Guarantee Criteria - October 21, 2016

- 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
- 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: Principles Of Credit Ratings - February 16, 2011

Related Research

- Taiwan Ratings' Ratings Definitions – August 10, 2020

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

Ratings List

Ratings Affirmed

Hon Hai Precision Industry Co. Ltd.	
Issuer Credit Rating	twAA+/Stable/twA-1+
Subordinated corporate bonds	twAA+

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