Media Release:

Outlook On Pegatron Corp. Revised To Stable From Negative On Improving Profitability; 'twAA-/twA-1+' Ratings Affirmed

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Rating Action Overview

- **Pegatron Corp.** is mainly engaged in electronic manufacturing services (EMS) including communication, computing and consumer electronic products. The company generated EBITDA of about NT$35.5 billion in 2019.
- We expect Pegatron's return on capital will sustain at above 10% over the next two years, underpinned by the company's improving production efficiency, turnaround in the performance of two major subsidiaries, and product mix enhancement.
- On January 21, 2021, Taiwan Ratings Corp. revised its rating outlook on Pegatron Corp. to stable from negative, reflecting our view that the company will be able to sustain its profit margin over the next one to two years.
- At the same time, we affirmed the 'twAA-' long-term and 'twA-1+' short-term issuer credit ratings on Pegatron.

Rating Action Rationale

Pegatron's return on capital will sustain at above 10% over the next two years, underpinned by an improving profit margin. The company's profitability has been improving over the past few quarters, supported by increasing demand for PCs and tablet during the outbreak of Covid-19, new products launches of iPhone and game consoles, as well as the improving performance of its two subsidiaries, Casetek Holdings Ltd. and Kinsus Interconnect Technology Corp. We believe Pegatron's profitability will slightly improve over the next one to two years, mainly supported by the company's improving production efficiency with better capacity management, coupled with business expansion in to higher margin business, including electric vehicle (EV) related products. This is despite still-intense competition in the global EMS market and potentially increasing costs related to production base diversification.

Better capacity allocation to help maintain Pegatron's utilization rate as well as margin. We expect Pegatron to utilize its EMS capacity more efficiently over the coming year largely because of the assembly of new and legacy iPhone models at meaningful volume. In addition, Pegatron is likely to coordinate with Apple Inc., which is its largest client, to better allocate production capacity to meet the client's expectation while maintaining the ability to quickly adjust production according to demand. Accordingly, we expect Pegatron to better manage its labor cost, particularly as labor wages continue to rise in China.

Two major subsidiaries are likely to see profit improve. We believe that after nearly two years of business and portfolio adjustments, the performance of Casetek and Kinsus likely made a turnaround in 2020 and will remain profitable at least over the next one to two years. After suffering losses in 2019, Kinsus has re-focused on its IC substrate core business. Amid strong 5G demand and a supply side tightness, the company is likely to see profit growth over the next one to two years. Meanwhile, Casetek's utilization rate is also likely to improve, supported by strengthening of its existing smartphone casing business as well as new product expansion, such as phone modules and wearable devices.

Increasing EV applications could support Pegatron's profitability over the longer term. Pegatron will continue to grow its auto electronics business with leading global EV manufacturers to provide products, such as car computers, body controllers, and other electronic components. Given the strong growth prospects for EV cars as well as the likelihood of increasing orders from its current client, we expect the contribution from such business to grow substantially over the next two years from the current single digit percentage of revenue. We also believe this new business could benefit Pegatron's overall profitability, because business expansion in the EV-related products field which have a long life cycle will help to sustain Pegatron's utilization rate and improve its profit margin.

Nonetheless, increasingly strong competition from Chinese peers and additional costs derived from production base relocation could pressure Pegatron's margin. Apple has continuously diversified its EMS suppliers, which could squeeze Pegatron's market share in future. However, we view the short-term impact on Pegatron to be limited, given that Pegatron's expertise in delivering its products with a short turnaround and in large volume is still critical to its clients. Therefore, we expect the company to largely maintain its order allocations from Apple, particularly for iPhone models, at the current level for the next two years.

In addition, as Pegatron continues to diversify its production bases outside of China in response to US-China trade tension, there might be additional costs associated with production inefficiency. However, we expect subsidies from its major clients as we as local governments will partly offset this margin pressure. Currently, 95% of Pegatron's capacity is in China with the remaining 5% in Taiwan and Indonesia. The company has also announced its intention to invest in Vietnam and India over the next two years. Pegatron plans to relocate 10%-15% of overall capacity to new production bases over the next three to five years, but the majority of its production volume will remain in China.

Outlook

The stable outlook reflects our view that Pegatron will be able to improve its profitability over the next one to two years. This is mainly supported by the company's better capacity allocation, performance turnaround at its two key subsidiaries, and business diversification into higher-margin products. Hence, we expect Pegatron's return on capital to hover at around 13.0%-13.5% in 2021 and 2022. We also expect Pegatron to maintain a net cash position on an adjusted basis over the same period, underpinned by the company's conservative investment plan, stable cash dividend payout, and abundant cash on hand. This is despite our expectation of the company's higher capital expenditure (capex) in 2021-2022, mainly to support overseas investment for production base diversification.

Downward scenario

We could lower the long-term issuer credit rating if:

- Pegatron's profitability, in terms of return on capital, falls consistently below 10% due to rising cost structure, weakening technology advantages amid increasing competition in the EMS industry or a lower capacity utilization rate possibly due to the loss of key customers or,
- the company takes on a more aggressive financial policy such that its debt to EBITDA ratio increases to more than 1.5x for an extended period. This could result from either Pegatron taking on more debt due to overly aggressive capex or overseas investment for production base diversification, or a weakening competitive advantage that erodes Pegatron's margin.

Upward scenario

Despite the likelihood is low over the next two years, we may raise the long-term issuer credit rating if:

- Pegatron continues to make material gains its EMS market share, while meaningfully lowering its business concentration. At the same time, its capex or investment plan remain prudent and keep its debt to EBITDA ratio comfortably below 1.5x.

Our Base-Case Scenario

Macro and industry assumptions:

- S&P Global's projection for world GDP growth of 5% in 2021 and 4% in 2022.
- S&P Global forecast for global IT spending to increase by about 3.4% in 2021, which lags behind projected growth in global GDP of 5% over the same period, reflecting our view that benefits from working-from-home begins to taper off. This is because many enterprises brought forward their hardware purchases into 2020; in addition, the prevalence of Covid-19 cases will continue to direct the pace of global economic recovery.

Company specific:

- Taiwan Ratings' base case scenario for Pegatron indicates 3%-3.5% sales growth in 2021 followed by a decline of 2.5%-3.0% in 2022.
  - Smartphone sales to grow by 3.5%-4.0% in 2021, fueled by the delayed launch of new iPhone models in late 2020 as well as increasing demand for 5G smartphones. We expect Pegatron's sales to decline by 5%-7% in 2022, reflecting a possible market share decline for iPhone assembly business due to intense competition in the EMS industry.
  - Consumer electronics revenue to increase by 4.5%-5.5% over 2021-2022, mainly supported by the launch of new console products and business expansion into Internet of Things (IoT) and auto electronics.
  - Revenue from PCs to decline by 1.5%-2.5% in 2021 and a further 2.5%-3.5% in 2022 because we expect working-from-home demand to slow down.
- Pegatron's margin is likely to improve slightly in 2021-2022, underpinned by better capacity allocation, product diversification into applications with higher profitability, as well as improving profits from subsidiaries.

- We expect capex to increase to New Taiwan dollar (NT$) 20 billion-NT$25 billion in 2021 and 2022, including the possible diversification of overseas production bases.
- We factor in NT$14.5 billion to acquire the remaining shares of Casetek in 2021.
- We expect cash dividend payout ratio over the next two years to remain the same as in 2020 at around 60%-65%.

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

- Net cash position on an adjusted basis in 2021 and 2022.
- Return on capital of 13%-13.5% in 2021 and 2022.

Liquidity: Adequate

The short-term rating on Pegatron is 'twA-1+'. We assess the company's liquidity to be adequate and we expect Pegatron's ratio of liquidity sources to liquidity uses to be 1.24x in the 12 months ending September 2021. We also believe the company's liquidity sources will still exceed liquidity uses even if Pegatron's EBITDA drops by 15%. In addition, we assess the company to have strong banking relationships and a high credit standing domestically. Pegatron's issuance of five-year and seven-year corporate bonds in 2020 with interest rates of 0.43% and 0.58%, respectively, underpins our view. We also believe Pegatron can absorb high-impact, low-probability events with limited refinancing, due to its abundant cash on hand.

As of the end of September 2020, Pegatron had about NT$150 billion cash balance. Moreover, we believe the company has sufficient headroom on its financial covenants over the next two years.

Principal Liquidity Sources:

- Cash and short-term investment: About NT$164 billion as of the end of September 2020.
- Fund from operations: NT$30 billion-NT$40 billion per year in 2021 and 2022.

Principal Liquidity Uses:

- Long-term debt due in one year plus short-term debt: about NT$130 billion at the end of September 2020.
- Maintenance capex of NT$10 billion-NT$20 billion over the 12 months ending December 2021.
- Cash dividend payout of 65%-70% of the previous year's net income in 2021.

Rating Score Snapshot

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

Note: The descriptors below are on a global scale.

Business risk: Satisfactory

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

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: twaa

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: Negative (-1 notch)

Related Criteria & Research

Related Criteria

- 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; Outlook Action

	To	From
Pegatron Corp.		
Issuer Credit Rating	twAA-/Stable/twA-1+	twAA-/Negative/twA-1+

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.