Media Release:

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

March 2, 2021

PRIMARY CREDIT ANALYST

Raymond Hsu, CFA
Taipei
+886-2-2175-6827
raymond.hsu
@spglobal.com
raymond.hsu
@taiwanratings.com.tw

SECONDARY CONTACT

Anne Kuo, CFA
Taipei
+886-2-2175-6829
anne.kuo
@spglobal.com
anne.kuo
@taiwanratings.com.tw

Rating Action Overview

- Yageo is a Taiwan-based passive component manufacturer generating EBITDA of NT$15.2 billion in the first three quarters of 2020.
- We believe Yageo can sustain its above-peer-average profitability over the next two years with slightly improving product portfolio and market share through the acquisition of KEMET, as well as still favorable demand outlook. However, still significant exposure to standardized products and weaker technology capability relative to its Japanese peers, and volatile product prices constrain its competitive position.
- Yageo's relatively strong profitability and operating cash will be sufficient to fund the company's high capex and dividends, enabling Yageo to cap its debt growth and sustain its intermediate debt leverage over the next two years, without factoring in large scale acquisitions during the period.
- On March 2, 2021, Taiwan Ratings Corp. assigned its 'twA+' long-term and 'twA-1' short-term issuer credit ratings to Yageo Corp.
- The stable outlook embeds our view that favorable demand and further growth in sales of specialty products mostly through the acquisition of KEMET will help Yageo to generate stronger EBITDA and cap its debt leverage over the next 24 months.

Rating Action Rationale

KEMET acquisition enhances Yageo's overall position in the global passive component market with a more comprehensive product mix.

Yageo's position in the global multi-layer ceramic capacity (MLCC) market has improved meaningfully after the company acquiring KEMET Corp. We estimate Yageo's share in the global MLCC market could increase to about 6% in 2020 up from about 3% in 2019 in terms of sales value after fully consolidating KEMET, though Yageo's global ranking will remain unchanged at fifth. More importantly, Yageo will be able to compete in more stable and higher value-added products for applications such as auto, industrial, communications and aerospace. In terms of volume, Yageo's share of the global MLCC market was 14% in 2019, mainly consisting of commodity products for consumer electronics, computing, and smartphones.

Yageo has also gained leading positions in other product such as tantalum capacitor and bead inductors through successful acquisitions, including KEMET and Pulse Electronics Corp. Tantalum capacitors have more stable product pricing than MLCC products because they are mostly used in auto and industrial or aerospace applications due to their longer product life and better reliability. Yageo is likely to further strengthen its market position particularly in the global MLCC and tantalum capacitor markets if the company successfully materializes the synergy between KEMET's better position and product portfolio for premium segments including auto and industrial applications and Yageo's strong capability in mass production and cost management.

Yageo will sustain its solid leading position in the global chip resistor market.

We believe that Yageo's leading position in the chip resistor market is unlikely to change anytime soon because given the company's large production scale and cost efficiency. Although Yageo still largely concentrates on standardized products compared with Japanese competitors that have lower average product prices. However, we believe that the company has relatively comparable product technology particularly for IT applications such as smartphones, computing, and communications applications and is likely to increase its sales of specialty products. Competition from Chinese peers could be a risk for low-end products, but top-tier clients are less likely to switch easily because passive components are critical to product reliability, albeit accounting for a very low percentage of material costs. In 2019, Yageo had about a 14% share in the global chip resistor market in terms of sales value and a much higher share in terms of volume at over 30%.

A comprehensive product mix, good positions in various passive components segments and improving product capability are significant competitive advantages to secure stable client relationships.

We believe that a more complete product offering that provides one-stop shopping and better services to clients will increase Yageo's customer retention. Yageo offers the most comprehensive product mix compared with its foreign peers such as SEMCO, Murata Manufacturing Co. Ltd., TDK Corp., and Vishay Intertechnology. Penetration into high-end applications such as auto and industrial components is improving through strengthened in-house product development and the acquisition of KEMET. Improving technology capability and strong cost efficiency have helped Yageo directly engage with top-tier end customers particularly in the IT industry. The company's recently formed a strategic alliance with Hon Hai Precision Industry Co. Ltd. is evidence of such strength, and will expand Yageo's sales through this collaborative model for growth in specialty products for emerging market segments such as electrical vehicles. This could reduce Yageo's business volatility associated with commodity type products in the long-term.

A more diversified product portfolio and growing sales of specialty products for more stable segments will slightly tame Yageo's high business volatility.

We expect a more diversified product mix and end markets to moderately lower Yageo's business volatility over the next two to three years. Yageo had no single product category and application that exceeded 30% of the company's revenue in the third quarter of 2020 after fully consolidating KEMET. MLCC accounted for 27% of total revenue in the third quarter, followed by tantalum capacitor (24%), chip resistor (17%), wireless and power (15%), and others (17%). This compares with higher concentration in MLCC (32%), chip resistors (29%) and wireless components (33%) in the previous quarter. End markets are also shifting toward specialty products for more stable segments such as automotive. Automotive accounted for 18% of the company's total revenue in the third quarter of 2020, up from 9% in the previous quarter. Sales to other stable segments such as industrial (30%) and defense/medical (4%) in the fourth quarter also moderate Yageo's business volatility.

Yageo's well-diversified customer base with more direct sales of customized products to strategic clients will also help reduce business volatility. Yageo has no single customer accounting for more than 10% of its revenue, given the business nature of passive components. Its major billing customers are electronics manufacturing services (EMS) companies and distributors, but its end customers behind those EMS companies are top tier clients such as Apple Inc. with which Yageo directly engages for a high share of their passive component procurements. Yageo's improving technology and efforts to increase its development services and early engagement with those top-tier clients could secure a more stable revenue stream from them.

Volatility in Yageo's revenue, nonetheless, will remain significant because of still-high exposure to significant product price volatility, particularly for MLCC.

In our view, Yageo is not immune from significant cyclicality in the global passive component market. That's because of sizeable product standardization particularly for products serving the consumer electronics, computing, and communications applications. The higher capital intensity for passive component manufacturing and large swing in utilization also add to margin volatility. The sharp swing in demand and product prices for MLCC and chip resistors and consequently Yageo's profitability during 2017-2019 demonstrate such volatility risk. However, we believe that Yageo's more diversified product mix and growing sales to more stable and customized applications such as automotive and medical cannot fully mitigate such commodity price competition.

Failure to materially narrow technology gap with leading peers could hinder Yageo's efforts in growing specialty sales and reduce exposure to standardized products.

We believe that Yageo remains weaker than leading Japanese companies such as Murata in high-end products, although Yageo has narrowed the gap, particularly for the manufacturing of chip resistors. Consequently, Yageo's sales are still significantly tipped toward commodity products in our view, as evidenced the company's much lower average selling prices for MLCC and chip resistors compared with leading Japanese peers. The acquisition of KEMET is likely to improve Yageo's position in specialty products but might not be enough to significantly reduce the technology gap with leading MLCC producers. We believe that even after the acquisition of KEMET it remains a challenge for Yageo to rapidly expand its sales of specialty products and gain market share for high-end products from leading Japanese players.

Yageo can sustain above industry average profitability, despite high cyclicality.

We believe that Yageo's low-cost capacity in China and Taiwan and strong cost management could help it to continue generating stronger profitability than its peers. This is evidenced by Yageo's better cost control than its peers, including KEMET. Supported by large scale volume production and stringent cost management, Yageo has been able to generate above-average EBITDA margin and return on capital, despite the higher product prices of its Japanese peers that have higher exposure to specialized applications. We believe Yageo can improve its EBITDA margin to close to 33% in 2020 up from 27.4% in 2019, and lift its return on capital to about 20% in 2020 from 14.9% in 2019.

Yageo's EBITDA margin could decline slightly in 2021 due to KEMET's higher cost structure and likely declines in product prices. Strong demand related to remote working and remote learning during the COVID-19 pandemic is likely to wane gradually in 2021, and thus gradually pressure product prices over the coming quarters. Successful integration with KEMET could materialize cost synergies and sales growth for premium products, thereby gradually lifting Yageo's revenue and EBITDA margin. Nonetheless, this improvement will remain subject to significant execution risk, despite Yageo's past track record of smoothly integrating other subsidiaries such as Pulse.

Yageo could cap its leverage with stronger cash flow generation largely sufficient to fund near-term high capex.

Under our base case, Yageo's improving EBITDA is likely to help bring its ratio of debt to EBITDA down close to 2x over the next two years from about 2.5x in 2020, despite the company's elevated debt. Yageo's debt leverage rose significantly from 1.4x in 2019 following the surge in debt to acquire KEMET, including the issuance of a US$180 million convertible bond. We expect Yageo's debt to grow slightly over the next two years because of its planned construction of a new MLCC fab in Taiwan for high-end products. The likelihood of higher cash dividends as earnings increase could also limit cash flow for debt repayments.

However, we believe that the company will aim to gradually deleverage over the next three to five years based on management's track record of maintaining low debt leverage. Also, given management's relatively low debt appetite and caution in taking on large acquisitions, we do not assume Yageo to pursue major acquisitions in 2021-2022. However, we do expect the company to pursue some bolt-on acquisitions largely within the company's discretionary cash flow over the same period.

We view Yageo's cash flow volatility to be high, given high cyclical demand and volatile product pricing. However, we believe that Yageo's high margins, relatively low debt appetite, and intention to lower debt gradually will enable the company to maintain intermediate leverage over the next two to three years, despite likely industry volatility.

Outlook

The stable outlook reflects our view that Yageo can keep its debt to EBITDA ratio comfortably below 2.5x over the next one to two years with significant revenue and EBITDA growth driven by the acquisition of KEMET as well as a favorable demand outlook. This is despite the acquisition of KEMET and Yageo's higher capex will keep its debt level elevated over the same period.

Downward scenario

We could lower the rating on Yageo if its debt to EBITDA ratio deteriorates close to 3x for an extended period of time. This may occur if:

- Yageo's profitability weakens substantially because deep and lasting oversupply triggers significant price erosion, the company fails to keep up with technology advancement relative to market leaders or maintain cost efficiency, Yageo fails to secure cost competitive material supply, or fails to integrate KEMET resulting in lower revenue and EBITDA growth than we currently expect, or
- Yageo takes on large scale acquisitions or takes on more aggressive capex or shareholder friendly actions than we assume in our base case.

Upward scenario

We may raise the long-term rating on Yageo if:

- Yageo substantially lowers its debt and sustains its ratio of debt to EBITDA below 1.5x, likely due to significant improvement in revenue and EBITDA through strong growth in sales of high margin specialty products for more stable end markets such as auto and industrial, or the company adopts a more conservative policy on capex, acquisitions and shareholder friendly actions, enabling the company to generate sustainable discretionary cash flow.
- In a remote scenario over the next one to two years, Yageo can materially narrow its technology gap with market leaders and significantly grow its share in high-end specialty MLCC and chip resistor sales. This would be evidenced by significant growth in average sales price, or further diversification in its product mix that substantially lowers the volatility of its profitability.

Our Base-Case Scenario

- 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 4% in 2021, which lags behind projected global GDP growth over the same period, reflecting a tapering off of benefits from working-from-home. This is because many enterprises brought forward their hardware purchases to 2020.
- Taiwan Ratings' base case scenario for Yageo indicates 35%-40% sales growth in 2021 following 60.4% growth in 2020 due to the acquisition of KEMET and strong demand from remote working and learning, as well as the accelerated rollout of 5G mobile communications.
    - MLCC and tantalum capacitor demand will grow by a combined 130%-140% in 2020 and 35%-45% in 2021 due to the acquisition of KEMET and strong demand associated with remote working and learnings as well as growth in 5G communications. Growth could slow to mid-single in 2022 due to price drops before new capacity in Taiwan begins to contribute materially to revenue.
    - Chip resistor demand will grow by about 20% in 2020 and 15%-20% in 2021, but slow to low-to-mid single digit in 2022 due to tapering demand.
    - Wireless and power supply components will grow by low-to-mid single digit amid strengthening demand for 5G communications, but will be largely flat or decline slightly in 2022 amid softening IT spending.
    - Demand for other components including sensors and electrolytic components will more than double in 2020 and grow more than 50% in 2021 due to the acquisition of KEMET.
- Gross margins will grow modestly to 38%-40% in 2020 from 35.8% in 2019 due to favorable pricing, high utilization and better scale economy amid surging demand. Gross margins will likely decline moderately to 36%-39% in 2021-2022 as demand growth slows and pricing pressure returns. KEMET will also initially drag down gross margins, given its lower gross margin than Yageo's corporate average.
- Yageo's ratio of expenses to revenue to drop to 13%-14% in 2020 from 16.3% in 2019 with rapid revenue growth, but the ratio is likely to rise to 14.5%-15.5% in 2021 before starting to decline in 2022, because of the full-year consolidation of KEMET that has a higher expense ratio.

- Yageo's capex to increase to new Taiwan dollar (NT$) 12 billion-NT$14 billion annually in 2021 and 2022 from NT$5 billion-NT$6 billion in 2020 mainly for the construction of a new MLCC fab.
- Yageo's cash conversion cycle to remain largely stable or decrease slightly with KEMET's shorter conversion cycle.
- Net cash outflow of NT$41.2 billion for the acquisition of KEMET in 2020.
- We assume a cash dividend payout ratio over the next two years to remain at 60%-80%.
- We apply a 9.1% haircut ratio to calculate accessible cash.

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

- EBITDA margin of 29%-33% in 2020-2022.
- Debt to EBITDA ratio of 2.0x-2.5x in 2020-2022.
- Return on capital of 14%-17% in 2020-2022.

Liquidity

The short-term rating on Yageo is 'twA-1'. We believe that Yageo has strong liquidity to meet its needs up to September 2022, with a ratio of liquidity sources to liquidity uses slightly above 1.5x in the 12 months ended September 2021 and more than 2x in the following 12 months ended September 2022. We believe Yageo can absorb low probability, high-impact events with limited need for refinancing, underpinned by its prudent risk management characterized by high cash balance and relatively low and flexible capital expenditures and dividends. We also believe that Yageo has a generally satisfactory standing in credit markets, given its large unused unsecured long-term and short-term banking facilities as well low interest rates on its debts. Yageo also has an ample buffer for loose financial covenants on part of its bank debts.

Principal Liquidity Sources:

- Cash and short-term investments: NT$40.1 billion as of September 2020.
- Funds from operations: NT$20 billion-NT$25 billion annually over the 24 months ending September 2022.
- Unused long-term banking facilities maturing after September 2022: NT$33.4 billion as of September 2020.

Principal Liquidity Uses:

- Debt maturities: NT$40 billion over the 12 months ending September 2021 and NT$3 billion-NT$4 billion over the following 12 months ended September 2022.
- Capex: NT$10 billion -NT$14 billion annually over the 24 months ending September 2022.
- Cash dividend: NT$9 billion-NT$10 billion annually over the 24 months ending September 2022.

Rating Score Snapshot

Issuer Credit Rating: twA+/Stable/twA-1
Note: All scores are in comparison with global obligors.

Business risk: Satisfactory
- Country risk: Low
- Industry risk: Moderately high
- 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: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twa+

Related Criteria & Research

Related Criteria

- General Criteria: Principles Of Credit Ratings - February 16, 2011
- General Criteria: Group Rating Methodology - July 01, 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012

Related Research

- Taiwan Ratings' Ratings Definitions – August 10, 2020

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

Ratings List

New Ratings	
Yageo Corp.	
Issuer Credit Rating	twA+/Stable/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.