Media Release:

Acer Inc. Assigned 'twA/twA-1' Issuer Credit Ratings; Outlook Stable

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Rating Action Overview

- Acer is a Taiwan-based information technology company generating EBITDA of about NT$6.1 billion in the first three quarters of 2020.
- Acer's much smaller market share and weaker brand name than that of its larger peers in the mature global PC market and relatively low profitability constrain its competitive position. However, Acer could take advantage of fast growing gaming PC and Chromebook demand to sustain its market share with moderately strengthening profitability over the next two years.
- Acer could generate positive free operating cash flow and sustain its net cash position on an adjusted basis in 2020-2022, without taking aggressive investments or shareholder returns based on its low appetite for financial leverage.
- On March 4, 2021, Taiwan Ratings Corp. assigned its 'twA' long-term and 'twA-1' short-term issuer credit ratings to Acer Inc.
- The stable outlook embeds our view that Acer could continue to register faster growth in Chromebook and gaming PC sales to sustain its revenue and margins, enabling the company to generate satisfactory positive free operating cash flow and sustain a net cash position over the next one to two years.

Rationale Action Rationale

Acer's limited share in the relatively mature PC market constrains its business profile.

Acer has a limited market position in the global PC market, particularly in the more stable enterprise PC segment. The company's market share has remained low and stagnant due to strong competition from larger peers such as Lenovo Group Ltd. and HP Inc. In 2020, Acer had a 6.9% share of the global PC market, up from 6.4% in 2019, according to International Data Corp. (IDC). The share is materially below market leaders, including Lenovo (24% in 2020), HP (22.4%) and Dell Technologies Inc. (16.6%). Global PC demand rebounded by 13.1% in 2020 because of strong consumer PC and Chromebook demand for remote working and remote learning amid the global COVID-19 pandemic. However, we expect overall PC demand could start to decline, and negatively affect Acer's shipments and revenue in 2022 with waning demand for remote working and remote learning.

Acer generates most PC related revenue from hardware sales without material service content, given its limited presence in the enterprise market. Without significant differentiation through software and services, this leaves Acer most exposed to intense price competition and a significant product substitution risk by other mobile devices such as mobile phones and tablets in the consumer PC. Acer's concentration in the consumer PC segment contributes to the company's stagnant market share and lower average selling price. This, in turn, leads to lower gross margins for Acer than for its larger peers, in addition to Acer's weaker scale economy, in our view.

Acer's well-established brand name and extensive global presence partly alleviate the risk associated with product concentration and a relatively weak market position.

Acer's high business concentration aggravates its business risk in our view. PC sales account for about 75% of Acer's total revenues and 72%-73% of the company's gross profits. Including display products, the ratios will both move closer to 90%. Acer generates the rest of revenue from cyber security, IT services, and electronics distribution. We do not expect those businesses to change Acer's business composition materially over the next two to three years, with PCs and peripherals continuing to contribute the vast majority of its cash flow generation. This is despite our expectation that those businesses, particularly cyber security and IT services, have higher long-term growth than Acer's core businesses because of the company's good positions in the domestic market.

However, we believe that Acer's well-established brand name, comprehensive global distribution channel, and good service reputation partly alleviate its disadvantage in terms of scale and business diversity. The company maintains a balanced geographical coverage without exposure to fluctuations in a single market. The company held about a 7% market share in Pan America, 8% in EMEA, and 7% in Asia Pacific in the second quarter of 2020, according to IDC. The U.S. remains Acer's largest single market and accounted for about 22% of its revenue in 2019, followed by Taiwan at about 14%.

Acer's focus on growing gaming PC and Chromebook segments should help the company sustain its revenue and market share

We expect Acer's better position in the fast growing segments including ultra-slim notebook PCs, gaming PCs and Chromebook could support its PC sales and help the company sustain its market share over the next two years. Chromebook demand nearly doubled in 2020 as the COVID-19 pandemic stimulated demand for cheaper devices for remote learning that do not require high performance. This demand is likely to remain strong in 2021 with the still raging pandemic and growing popularity of PC gaming. Stay-at-home orders around the world have also stimulated sales of gaming PCs with a much higher growth rate than for the overall PC market during the COVID-19 pandemic. We expect that strengthening gaming performance and global PC gaming eco-systems promoted by major PC vendors will continue to drive growth in global gaming PC sales over the next two years.

We believe that Acer's focus on growth segments will enable the company to sustain its revenue growth in 2021, and thus sustain its market share in the global PC market. Acer has increased its R&D spending over the past few years and concentrated its efforts on differentiated technology such as thermal management and software for its focused segments. The company was ranked the sixth in Taiwan in terms of total patents granted and was much ahead of its domestic PC peers. This is despite the company's ratio of R&D expenses to revenue at 1.1% in 2019, was below the average of its domestic peers.

Technologically competitive gaming notebook PCs and focused marketing efforts have helped Acer build a leading market share in some countries such as the U.S., Canada, and Brazil in the third quarter of 2020, according to IDC.

Acer will also continue to leverage its early entry advantage and unique software capability to benefit from continued demand growth for Chromebooks, in our view. Nonetheless, while Acer has slightly better positions in its focused segments, competition risk from its foreign and domestic competitors remains hefty. Despite significant growth in 2019-2020, we estimate that Acer's market share of global gaming notebook PC sales remained slightly below 10% in 2020. In addition, Acer also saw its market share in terms of Chromebook unit shipments slip gradually over the past few quarters, as its larger peers such as HP and Lenovo increased their penetration of this segment.

Margins could remain thin and volatile.

Acer's profitability is likely to remain weak and significantly below that of its larger peers, despite likely improvement in 2020-2022. Acer's weaker brand name and presence in the enterprise market and lack of material service and software content have resulted in a lower average selling price. In addition, we believe that growing gaming PC and Chromebook revenue are unlikely to significantly increase Acer's gross margins because of limited product differentiation and intense competition. Service revenue for cyber security and IT services could generate higher margins, but is unlikely to enhance Acer's overall margins materially over next two to three years, given the limited revenue contribution from these. However, Acer's enlarged revenue scale and tight expense control could enhance its EBITDA margin moderately to 3%-4% in 2020-2022, up from 2.0% in 2019. Acer's return on capital (ROC) could also improve to 10%-14% in 2020-2022 from 6.6% in 2019.

Acer's profitability demonstrated very high volatility during 2013-2019 because of significant asset write-offs for past acquisitions and the cost of entry into new product lines in 2013 and 2016. We expect the volatility of its profitability to moderate slightly over the next three to five years because we expect the company to focus on organic growth in its core current business portfolio. We do not expect Acer to take aggressive effort through price competition to gain market shares from leading vendors in traditional consumer and commercial PCs. Nonetheless, competition, fluctuating revenues, and occasional supply and pricing issues for key components such as CPUs will continue to cause higher volatility in the company's EBITDA margin.

Acer could sustain minimal debt leverage, despite significant volatility in its cash flow

We believe that Acer can sustain its net cash positon on an adjusted basis over the next two years because of its high cash balance, improving profitability, and stronger free operating cash flow. That's because of strong market demand and a tight supply of key components. We also expect Acer to maintain a low appetite for acquisitions and debt leverage in 2021-2022, as well as a stable cash dividend payout ratio, and repay its debt through discretionary operating cash.

However, the company's operating cash flow is likely to remain highly volatile because of volatile profitability and work capital movement. We believe that high cash flow volatility means higher financial risk for Acer than its currently strong balance sheet suggests. Acer's cash conversion cycle lengthened materially in 2017-2019, mostly due to shorter payment terms and higher inventory days to maintain a high inventory level for key components, mainly

CPUs, due to a shortage and the trade war between the U.S. and China. This resulted in significant working capital outflow even with lower revenues during the period. We expect such volatility risk to persist with Acer's continued concentration in the highly cyclical and competitive PC business.

Outlook

The stable outlook reflects our expectation that Acer will see moderate revenue growth and generate satisfactory free operating cash flows, enabling the company to sustain a net cash position on an adjusted basis, as it registers faster growth in the Chromebook and gaming PC segments.

Downward scenario

We could lower the rating on Acer if:

- Acer's PC business deteriorates with significant market share losses, or the company mismanages its supply chain, inventory or distribution network, thus weakening the company's profitability or cash flow.
- We could also lower the rating if the company's leverage increases and sustains above 1.0x due to aggressive debt-funded investments, including mergers and acquisitions, sustained growth in working capital needs, or aggressive shareholder returns.

Upward scenario

The likelihood of an upgrade is low over the next 24 months because of Acer's limited global market position and business concentration in the highly competitive PC market. However, we could raise the rating if:

- Acer significantly expands its scale particularly through faster growth in non-PC business, such as cyber security service and IT service and integration businesses, and materially improves its EBITDA margin close to 5% on a sustainable basis
- At the same time, Acer would have to maintain its ratio of debt to EBITDA materially below 1x.

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 growth in global GDP over the same period, which suggests that the benefits from remote working will begin to taper off. This is because many enterprises brought forward their hardware purchases into 2020.
- S&P Global's forecast for total shipments to be flat in 2021 as the demand for remote working and remote learning wanes gradually after surging since the third quarter of 2020. Global PC revenue growth is likely to be slower than global IT spending in the long-term, given already high penetration of PCs and lengthening replacement cycles.
- Taiwan Ratings' base case scenario for Acer indicates 5%-9% sales growth in 2021 following 18.3% growth in 2020 because of still strong PC demand for Windows 10 upgrades and remote working and remote learning, but revenue could fall by a mid-single digit in 2022 as COVID-19 induced demand starts to wane.
    - We expect Acer's PC shipments to grow 21%-23% and its global market share to expand slightly in 2020 mainly because of strong growth in gaming PCs and

Chromebook segments. Shipments should grow by a mid-single digit in 2021 with still-strong growth in Acer's focused areas, but decline in 2022 due to waning remote working and remote learning demand. Average selling prices will rise by a low single digit in 2020-2021 because of tight supply, but decline slightly in 2022 as demand softens.

  - Display revenue to grow by near double digits in 2020 and grow largely in line with overall PC shipments thereafter.
  - Revenue at non-PC businesses, including cyber security, electronics distribution, and IT services and integration, will grow by a mid-single digit annually in 2021-2022 after a moderate decline in 2020.
- The company's gross margin will remain stable at marginally above 10% in 2020-2022 mostly as prudent inventory and selling price management will largely secure PC and display margins.
- Acer's expense ratio will decline to about 8% in 2020 and stay near at 8% in 2021-2022 because of larger revenue scales and tight expense control.
- We expect minimal capex for Acer of around NT$200 million because the company will maintain its manufacturing free business model.
- Acer's cash conversion cycle to shorten with significant working capital inflow in 2020 because of strong demand and supply constraint that lead to faster turnovers, but the cash conversion cycle could normalize gradually in 2021, leading to working capital outflow in 2021.
- We assume the company will maintain stable dividend payout ratios during the projection period.
- We apply a 7.2% haircut ratio to calculate accessible cash.

Based on the assumptions, we arrive at the following credit measures:
- EBITDA margin of 2.5%-3.5% in 2020-2022.
- Debt free on an adjusted basis in 2020-2022.
- Return on capital of 10%-14% in 2020-2022.

Liquidity

The short-term rating on Acer is 'twA-1'. We believe that the company has exceptional liquidity. The ratio of liquidity sources to liquidity uses will be slightly over 4x over the 24 months ended September 30, 2022. We expect liquidity sources will still exceed liquidity uses even if Acer's EBITDA declines by 50%. We also believe the company has good banking relationship and satisfactory credit standing in the capital market. The low interest rates on the company's bank loans and significant unused banking facilities are evidence of such credit strength. Moreover, we believe that Acer can absorb high impact, low probability event without refinancing, given its high cash balance on hand. In addition, the company has no financial covenants in its borrowings.

Principal Liquidity Sources:

- Cash and short-term investments of NT$36 billion as of September 30, 2020.
- Cash flow from operations of about NT$6 billion–NT$7 billion annually in the 24 months ending September 30, 2022.

Principal Liquidity Uses:

- Debt of NT$ 2.3 billion–NT$3.3 billion maturing annually in the 24 months ending September 30, 2022.
- Working capital needs: NT$1.2 billion–NT$3.1 billion annually in the 24 months ended September 30, 2022.
- Capex of about NT$200 million–NT$300 million annually in the 24 months ended September 30, 2022.
- Dividend payment of NT$4 billion–NT$5 billion annually during the same period.

Rating Score Snapshot

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

Business risk: Weak

– Country risk: Low
– Industry risk: Moderately high
– Competitive position: Weak

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: Exceptional (no impact)
– Management and governance: Fair (no impact)
– Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twa

Related Criteria & Research

Related Criteria

– General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012
– Criteria | Corporates | General: Corporate Methodology - November 19, 2013
– Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
– 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: Group Rating Methodology - July 01, 2019
– 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

New Ratings

Acer Inc.	
Issuer Credit Rating	twA/Stable/twA-1