Media Release:

Unizyx Holding Corp. Assigned 'twA-/twA-2' Ratings; Outlook Stable

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Rating Action Overview

- Unizyx Holding Corp.'s small operating scale, weak brand name, low bargaining power against major clients, and weak and volatile profitability will continue to constrain its business profile. The Taiwan-based passive networking equipment manufacturer generated EBITDA of about NT$1.7 billion in 2020.
- Unizyx's satisfactory technology capability, improving competitive environment, and early entry in the 5G home gateway market partly offset these weaknesses. The company's strengthened profitability should enable it to generate significant positive discretionary cash flow and expand its net cash position and financial buffer over the next one to two years.
- On May 10, 2021, Taiwan Ratings Corp. assigned its 'twA-' long-term and 'twA-2' short-term issuer credit ratings to Unizyx.
- The stable outlook embeds our view that Unizyx could sustain strengthened profitability and maintain a net cash position over the next two years because of strong demand from remote working, remote learning, and 5G communications.

Rationale Action Rationale

Unizyx's small operating scale, weak brand name, and low bargaining power against big telecom companies and original design manufacturer (ODM) clients could lead to volatile profitability. In our view, intense competition and Unizyx's low profitability in the fragmented broadband gateway customer premises equipment (CPE) segment will continue to constrain its competitive position. The company has also limited pricing power against large telecom operators and ODM clients, given its weak brand name and limited product differentiation for CPE products. Moreover, Unizyx faces intense competition for its broadband gateway and passive optical network (PON) businesses from larger integrated telecom and networking equipment suppliers such as Cisco Systems Inc., Huawei Technologies Co. Ltd., and ZTE Corp. These companies can provide full solutions ranging from central office equipment to CPE.

Unizyx has generally low single digit global market shares in various networking equipment segments except for digital subscriber line (xDSL) gateways, for which it had an about 10% global share in 2019. We expect the company to remain highly reliant on broadband gateway CPE for its revenue and EBITDA over the next few years with faster growth in sales of 5G fixed wireless access (FWA) gateways. However, Unizyx can grow its branded networking equipment sales to small-medium size enterprise with products differentiated with software and services. The company generates 44% of its revenue from home gateway products, 29% from PON, 13.7% from enterprise networking, and 13.3% from other segments. Customer concentration could also continue to cause volatility if the company fails to develop competitive products. In 2020, Unizyx's top ten clients accounted for about 52% of its revenue.

Unizyx's satisfactory software and hardware development capability should help the company to take advantage of booming new communications technology to penetrate large telecom operators and grow branded businesses over the next two years. Unizyx's competency in software development and hardware design, as well as its in-house manufacturing allow a high degree of customization and shortens turnaround time for product development. We expect the company's early introduction of 5G FWA gateways to enable it to acquire new large telecom operators as clients; Unizyx has increased emphasis on sales to large telecom operators to improve its economy of scale and business stability. This strategy should also help the company diversify from mature xDSL home gateway, and PON businesses.

Unizyx has also been able to develop software-based networking equipment and integrate security features to generate high recurring revenue with high margins. We expect such services to grow significantly and contribute to the company's revenue and EBITDA. However, the contribution will likely remain limited over the next one to two years. Nonetheless, Unizyx's technology and R&D resources remain significantly weaker than that of large global networking equipment vendors, given its small scale, though R&D expenses constantly accounted for 7% of its revenue.

The growing penetration of direct sales to large telecom operators will also reduce Unizyx's dependence on ODM business. The ODM business has been generating lower margins and is less flexible when facing market adversity such as rising component prices. The company can only pass through much less unexpected cost increases to its ODM clients than that of its branded businesses. Unizyx experienced some margin losses in 2018, partly due to its inability to pass through sharply rising passive component prices to its ODM customers.

Unizyx will benefit from tail winds from the tech war between the U.S. and China, and growing reception of open network standards. The tech war between the Chinese and the U.S. government's clean network program will prevent Chinese network equipment suppliers from competing in the U.S., and to some extent in Europe. This will significantly reduce competition for Unizyx from Chinese telecom equipment suppliers such as Huawei and ZTE and other smaller Chinese players, particularly for 5G communications and optical networks. In addition, the U.S. blockade on the access to semiconductors of Chinese telecom suppliers could hinder those competitors' product developments.

Taiwanese networking and security equipment suppliers including Sercomm Corp. and Unizyx have benefited from such development and saw competition from Chinese competitors in developed markets decline since 2018. We expect the improving competitive landscape to stay as the dispute between the U.S. and China is unlikely to resolve over the next two to three years. Unizyx generated 46% of its revenue from Europe, about 23% from north America, and the rest from emerging markets and Asia-Pacific in 2020.

The increasing adoption of open industry standards such as open radio access network (open RAN) for 5G networks and OMCI (ONU Management and Control Interface) for optical networks will also help CPE makers to better compete with larger integrated equipment suppliers that bundled sales of central office equipment and CPE. The de-bundling of COE and CPE sales in the optical networking market share could particularly benefit Unizyx, given that the market is more dominated by integrated players.

Remote working and remote learning and 5G communications will keep driving global spending on broadband infrastructure and sustain Unizyx's improving profitability with reducing volatility. We believe remote working and learning will continue to drive strong market demand for networking equipment globally, despite significant progress in global vaccine rollout. In addition, we believe the implementation of 5G communications will accelerate as a part of infrastructure stimulus in developed countries. This, together with Unizyx's successful introduction of new products such as 5G FWA home gateways, could sustain the company's profitability, which has recovered significantly since 2019. We expect Unizyx to grow its revenue by about 20% in 2021, which is capped partly by undersupply in electronics components. Its EBITDA margin, nonetheless, could drop slightly in 2021 before improving in 2022 due to high component costs and lower initial margins from new products in 2021.

In addition, we expect Unizyx's business volatility to come down slightly because of the company's broadening products and services, tightening management control, a more favorable competitive landscape, and growing sales to large telecom operators in developed markets. Unizyx had weak profitability during 2015-2018 because of intense competition, volatile sales to small operators, mismanagement on inventory, and a patent lawsuit regarding its xDSL products. A business restructuring to separate its operations serving the telecom operator market and the enterprise networking market, both under its own brand also hurt its efficiency.

However, tightening management control on inventory and better patent protection for new products such as 5G communications could lower Unizyx's business volatility. Nonetheless, we believe the company will continue to experience significant volatility because of cyclical demand, volatile component costs, high product and customer concentration, as well as rapid product evolution.

Unizyx's strong balance sheet and conservative financial policy provide a moderate buffer for business volatility. These are key supporting factors for the ratings. We expect the company to generate positive discretionary cash flow and sustain its significant net cash position over the next two years, despite a moderate increase in its capital expenditure (capex) for the automation of its manufacturing facilities and investments in R&D facilities. Unizyx could sustain its positive free operating cash flow, given its low capital intensity and prudent cash dividend payments, in our view. We also do not expect the company to take on any material acquisitions in the next 24 months. Unizyx has a cash balance of NT$4.7 billion versus NT$2.0 billion in reported debt at the end of 2020. In addition, the majority of the company's reported debt is denominated in euros and it has significant euro-denominated revenue generated in Europe.

Outlook

The stable outlook reflects our expectation that Unizyx's EBITDA will grow significantly in 2021-2022 with strong home working and remote learning demand, growing sales of 5G communications related products, and improving economy of scale. The stable outlook also embeds our view that the company will generate positive discretionary cash flow and maintain a growing net cash position over the next two years, despite higher capital spending.

Downward scenario

We may lower the ratings on Unizyx if:

- Lagging R&D and product development lead to material losses of customers, revenues, and margins,
- Mismanagement of inventory or clients or material patent lawsuits keeps EBITDA margins below 4%, or
- Operating losses or rising working capital needs cause large operating outflows, or the company change its conservative debt appetite and increases its debt leverage materially, possibly due to large-scale capacity expansion or shareholder friendly actions, that causes its ratio of debt to EBITDA to exceed 1.0x for an extended period.

Upward scenario

The rating upside is limited over the next two years because of Unizyx's weak market position and small scale in the global networking equipment market. However, we may still upgrade the ratings if:

- Unizyx could expand its operating scale substantially with significant growth its market share in the global broadband CPE market, and improve its brand power such that profitability and cash flow stability improve materially. An EBITDA margin sustaining above 10% consistently together with very significant revenue expansion could indicate such strengthening.

- At the same time, the company continues to keep its ratio of debt to EBITDA below 1.5x.

Our Base-Case Scenario

- S&P Global's projection for world GDP growth of 5.6% in 2021 and 4.0% in 2022.
- S&P Global forecast for global IT spending to increase by about 5.8% in 2021, which is in line with projected global GDP growth over the same period, reflecting continued demand from working-from-home.
- Taiwan Ratings' base case scenario for Unizyx indicates 15%-20% sales growth in 2021 and 10%-15% in 2022, following a 7.4% decline in 2020 because of strong growth in 5G CPE shipments and growing networking equipment demand amid continued home working and remote learning induced demand. In particular, we believe:
  - Broadband CPE revenue will grow 40%-50% in 2021 with strong COVID-19 induced demand and successful customer penetration mainly driven by successful introduction of 5G FWA products. Growth could slow slightly to 20%-30% in 2022 with fast 5G FWA shipment growth offset by flat fixed line broadband CPE sales.
  - PON revenue to grow 8%-12% in 2021 with demand from accelerated networking infrastructure investments and the shipment of new GPON products. Revenue could fall by a high single digit in 2022 because of uncertainty on ODM contract acquisitions.
  - Networking equipment sales to small-medium size enterprises will grow strongly by a high double digit annually in 2021-2022. Home working demand, increasing network security requirements, and the growing application of software defined wide area

network (SD-WAN) have stimulated such growth aided by Unizyx's total solutions including security and remote management capability.

- Gross margins before depreciation and amortization will likely decline moderately to 24%-25% in 2021 from 26% in 2020 before improving in 2021. The initial margins for sales of new products to tier 1 operators such as 5G FWA will generate lower margins. The appreciation of the new Taiwan dollar and rising component prices will also negatively affect margins, though the company can mostly pass through rising costs for its branded sales. Better production scale with rising ODM revenue, better production efficiency, and growing recurring revenue related to subscribed services could partly offset the initial lower margins from new products.
- SG&A expense to grow by close to 10% annually in 2021-2022 but the ratio to revenue will decline slightly to around 20% in 2021-2022.
- Moderate working capital outflow along with growing revenue in 2021-2022 with stable cash conversion cycle.
- Capex will rise to NT$500 million-NT$600 million annually in 2021-2022 for the automation of Unizyx's production facilities and the addition of production and R&D equipment for new technology.
- Cash dividend payout ratio of around 50%.
- Surplus cash haircut of 5% is applied.
- Positive discretionary cash flow in 2021-2022.

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

- EBITDA margin of 6.0%-8.0% in 2021-2022.
- Debt free on an adjusted basis in 2021-2022.
- Return on capital of 15%-20% in 2021-2022.

Liquidity

The short-term rating on Unizyx is 'twA-2'. We believe Unizyx has strong liquidity to meet its needs over the 24 months up to the end of 2022. The ratio of liquidity sources to liquidity uses will be 1.7x-2x in 2021 and 2.5x-3x in 2022. Liquidity sources will still exceed liquidity uses even with EBITDA dropping 30%.

We believe Unizyx can absorb a low probability high impact event without refinancing, underpinned by its large cash balance on hand far exceeding its debt. In addition, we believe the company will continue to maintain its prudent financial risk management with a high cash balance and low debt leverage. None of Unizyx's debt carry financial covenants.

Principal Liquidity Sources:

- Cash and short-term investments: NT$4.6 billion at the end of 2020.
- Cash flow from operations: NT$1.4 billion-NT$1.8 billion in 2021 and NT$1.6 billion-NT$2.0 billion in 2022.

Principal Liquidity Uses:

- Debt maturity: NT$1.96 billion in 2021 and none in 2022.
- Working capital outflow: NT$450 million-NT$550 million annually in 2021-2022.
- Capex: NT$500 million-NT$600 million annually in 2021-2022.
- Cash dividend: NT$400 million-NT$600 million annually in 2021-2022.

Rating Score Snapshot

Issuer Credit Rating: twA-/Stable/twA-2
Note: All scores are in comparison with global obligors.

Business risk: Weak
- Country risk: Moderately high
- 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: Strong (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 For National And Regional Scale Credit Ratings - June 25, 2018
- General Criteria: Group Rating Methodology - July 01, 2019
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria | Corporates | General: Corporate Methodology - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- General Criteria: Principles Of Credit Ratings - February 16, 2011xxx

Related Research

- Taiwan Ratings' Ratings Definitions – August 10, 2020

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

Ratings List

New Ratings

Unizyx Holding Corp.	
Issuer Credit Rating	twA-/Stable/twA-2

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.