Media Release

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

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Rating Action Overview

- Systex Corp. has inferior technology capability and product mix as well as a smaller operating scale than its global peers have, which results in lower profitability. Taiwan's fragmented market structure and intense competition also constrain its market position.
- The company's system integration capability along with domain know-how grant Systex a competitive edge in some niche domestic segments. The company also has a strong balance sheet with zero net debt although debt could rise over the next three years to support the company's aggressive growth plan.
- We have assigned our 'twA-' long-term and 'twA-2' short-term issuer credit ratings to Systex Corp.
- The rating outlook is stable to reflect our view that Systex could generate growing operating cash flow with a relatively stable EBITDA margin over the next two years and maintain the ratio of debt to EBITDA below 2x over the period.

Rationale Action Rationale

Established in 1997, Systex Corp. is a Taiwan-based IT software and service provider, offering software distribution services, system integration, and industry specific application solutions. These segments accounted for 49%, 31%, and 20%, respectively, of the company's revenue in 2020. Systex's business covers a wide range of sectors, including the financial service, technology hardware and general manufacturing, retail, and local governments. The company has expanded its business scope through active strategic investments and merger and acquisitions over the past 20 years.

Weaker technology capabilities and narrower service offering constrain Systex's competitive position and profitability. Systex has a narrow solution and service offering compared with large global peers' and is constrained by the company's less comprehensive technology capabilities. This is reflected in the low number of patents and much lower research and development spending compared with its global peers which have consistently made sizeable investments to expand their technology edge. These factors limit Systex's ability to obtain complex and high-margin projects, which are usually undertaken by leading global peers such as IBM and Accenture in Taiwan.

Systex's service range is confined to less-value-added services that expose the company to intense competition and limit its operating scale and EBITDA margin. Systex's product mix weighs on its blended EBITDA margin. That's because the company's low-margin software distribution service accounted for about 50% of total revenue in 2020. In addition, the ratio of Systex's operating expense to revenue is higher than that of its peers, owing to Systex's smaller scale. This scale disadvantage restricts its ability to spread the cost of software development and overhead cost over a broad client base. Systex's EBITDA margin therefore routinely ranges from only 4%-6%, which is below average for the industry. EBITDA margins in the global IT service sector are typically 10%-30% depending on the service area.

The fragmented market structure in Taiwan further squeezes the company's profit margin. Taiwan's IT software and service industry is highly fragmented with numerous small and medium sized companies competing rigorously in small market segments where they hold particular strengths. This is due to the industry's low entry barriers and is reflected in the low capital requirement for new entrants and Taiwan's abundant talent in computer programming. Systex is the largest company in terms of revenue in this industry but holds a market share of less than 10%, according to our rough estimate based on the company's revenue. Systex is short of meaningful brand equity and solution differentiation constrains its pricing power while at the same time exposing the company to fierce price competition in most of its service segments. The industry's favorable growth trend, including the shift to digitalization, cloud computing, and mobile communication could somewhat lessen this competitive pressure.

System integration capability along with domain knowhow provide a competitive edge in several niche segments. Systex has established a modest degree of brand equity in several sub-sectors where it can command a certain price premium. The company holds a market share of over 90% in financial information and price quotation systems for securities trading, underpinned by its high system reliability and service standard. It also has a good standing in Taiwan's education and training industry, supported by its long operating track record and accumulated client base and know-how. In addition, Systex has above average win rates in system integration projects, where it can take advantage of its software development capability, industry domain know-how, and solid relationship with key software providers. For instance, Systex is Microsoft Corp.'s largest licensing solutions provider in Taiwan. Systex has also established a sound client base comprised of major Taiwan financial institutions and technology companies.

Adequate recurring revenue, but geographic concentration tempers the strength. Systex's annual recurring revenue accounts for roughly 40% of its total revenue, and this weighting could further increase to 50% over the next three years. This underpins a relatively stable and predictable revenue stream. Continuous enhancement and maintenance requirements for applications developed by the company reduce clients' willingness to switch vendors. However, the switching cost for its maintenance service on vendor software is usually low and may still cause some client losses. The renewal rate of Systex's annual recurring revenue contracts is about 90%, which is slightly lower the minimum 95% for most of its peers.

Systex's adequate revenue diversity across a wide range of industries and low customer concentration also support its revenue stability, in our view. However, high geographic concentration with about 75% of revenue sourced from Taiwan and the remainder from China could invite revenue volatility. The more severe second wave of the COVID-19 infections in

Taiwan, if prolonged, could lead to lower IT spending and budget cuts that result in muted growth for Systex in 2021. The company will likely continue to search for suitable investments for overseas expansion, but these are likely to be small in scale and the diversification benefit is limited.

Strong balance sheet and limited debt support the ratings but leverage could rise to fund growth. We project Systex will maintain a net cash position in 2021 and 2022, which mainly reflects the company's high cash balance and light capital expenditure needs over the period. However, Systex has a history of growing through mergers and acquisition, and the company could increase such activity to fulfill its more aggressive expansion target over the next three years.

In addition, we consider Systex's cash dividend policy to be relatively aggressive, with a payout ratio sometimes exceeding 100% to maintain a flat absolute amount per share. Accordingly, Systex could generate consistently negative discretionary cash flow, leading to a modest deterioration in its credit metrics. We forecast Systex's ratio of debt to EBITDA could reach 0.5x-1.0x by 2023 if the company was to spend a total of new Taiwan dollar (NT$) 5 billion on mergers and acquisitions over the next three years. Nevertheless, we believe Systex will maintain a prudent financial policy and only execute such activity within its financial capability. We also forecast the company will gauge the magnitude of its rising debt and maintain the ratio of total liabilities to assets below 50%.

Outlook

The stable rating outlook reflects our view that Systex's relatively strong system integration capability, accumulated industry know-how and potential acquisitions will underpin an upward trend in EBITDA generation over the next two years. Meanwhile, the company's recurring revenue, low single-client concentration, and adequate vertical diversity should support a relatively stable EBITDA margin. The outlook also reflects our projection that the ratio of debt to EBITDA will remain below 1.0x over the next two to three years, underpinned by a high cash balance and likely higher cash flow generation.

Downward scenario

We may lower the rating if:

- The ratio of debt to EBITDA exceeds 2x for an extended period, possibly due to an overly aggressive growth strategy as indicated by a large-scale acquisition that exceeds the company's financial capability, or a sustained and material increase in its cash dividend payout ratio that results in a substantial increase debt; or
- deterioration in profitability, possibly due to unsuccessful acquisitions, substantial bad debt losses, escalating competition, or a prolonged industry downturn resulting in lower utilization.

Upward scenario

The likelihood of an upgrade is remote over the next two years, given Systex's low market share and thin margin. However, we may raise the rating if:

- the company could maintain its ratio of debt to EBITDA comfortably below 2x and at the same time materially expand its revenue scale and improve its product mix through offering more value-added services, such that the EBITDA margin can improve toward 10% on a sustainable basis.

Our Base-Case Scenario

- Taiwan's GDP to grow 5.6% in 2021 and 2.7% in 2022, and China's real GDP to grow 8.3% in 2021 and 5.1% in 2022. Strong expansion in China and Taiwan's economies support demand for IT spending.
- Taiwan's IT services and software industry will benefit from favorable long-term dynamics, supporting revenue growth at or above GDP growth because of mega trends like digitalization, virtualization, cloud computing, and mobile communication.
- Systex's revenue to expand 5%-8% in 2021 and 10%-15% in 2022, reflecting healthy organic growth amid a favorable industry trend and external acquisitions. Lower growth in 2021 reflects possible delays in project progress and new project intake amid COVID-19.
- Gross margin to remain flat at 25.7%-26.1% in 2021 and improve slightly to 26.2%-26.6% in 2022. Margin improvement is driven by product mix adjustment with higher revenue sourced from higher-value-added services.
- Selling, general and administrative expense to increase 8%-11% annually over the next two years, mainly driven by staff expansion.
- R&D to account for 2.0%-2.5% of revenue.
- Systex could spend NT$1.0 billion-NT$1.5 billion every year over the next three years to acquire companies that provide complementary businesses or innovative technology solutions.
- Flat cash dividend of NT$1.34 billion over the next two years.
- A 14% haircut on surplus cash.

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

- EBITDA margin of 5.0%-6.0% in 2021 and 2022.
- Ratio of debt to EBITDA of 0x in 2021 and 2022 with a net cash position.
- Discretionary cash flow to debt of 0% in 2021 and 2022 with a net cash position.

Liquidity

The short-term rating on Systex is 'twA-2'. We assess the company has adequate liquidity based on our projection that the ratio of liquidity sources to liquidity uses will be 1.5x-1.7x in 2021. We also project Systex will have sufficient liquidity sources to cover liquidity uses, even if forecasted EBITDA declines by 15%.

We believe the company can absorb low probability high impact events with limited need for refinancing, underpinned by its net cash position. Furthermore, we believe Systex has sound banking relationships, as evidenced by the relatively low interest rates on its bank loans. None of its debt obligation carry financial covenants.

Principal Liquidity Sources:

- Cash and short-term investment of about NT$6.3 billion as of the end of March 2021.
- Funds from operations of NT$1.0 billion-NT$1.3 billion over the 12 months ending March 2022.

Principal Liquidity Uses:

- Debt maturity of about NT$1.3 billion over the 12 months ending March 2022.
- Working capital outflow of NT$300 million-NT$400 million over the 12 months ending March 2022.
- Capex and acquisitions of NT$1.0 billion-NT$1.7 billion over the 12 months ending March 2022.
- Cash dividend payout of NT$1.3 billion over the 12 months ending March 2022.

Ratings Score Snapshot

Issuer Credit Rating: twA-/Stable/twA-2

Note: The descriptors below are on a global scale.

Business risk: Weak

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

Related Research

- Taiwan Ratings' Ratings Definitions – August 10, 2020

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

Ratings List

New Ratings

Systex 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.