Media Release:

Delta Electronics Inc. Assigned 'twAA/twA-1+' Ratings; Outlook Stable

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Rating Action Overview

- Delta is a Taiwan-based power electronics, automation and infrastructure power solutions provider generating EBITDA of about NT$36.8 billion in the first three quarters of 2021.
- Delta could sustain its leading position in the global power supply and thermal component market and maintain near 10% revenue growth over the next two years. However, high material costs and fast growth in less profitable electric vehicles (EVs) and building automation could weaken its overall margin slightly.
- The company will likely continue to generate strong free operating cash flow to meet its moderate mergers and acquisition and cash dividend needs while staying debt free on an adjusted basis over the next one to two years, despite higher working needs for component shortage and growing branding business over the same period.
- On Feb. 25, 2022, Taiwan Ratings Corp. assigned its 'twAA' long-term and 'twA-1+' short-term issuer credit ratings to Delta Electronics Inc.
- The stable rating outlook embeds our view that Delta's strong position in the power electronics market and strengthening new EV and automation businesses could help the company to generate good profitability and strong free operating cash flow that would support a net cash position over the next 24 months.

Rating Action Rationale

Delta's leading position in the global power supply and thermal component markets for information technology applications could sustain the company's relatively strong profitability and anchor the ratings. Delta could sustain its leading market position in the global power supply market for information technology applications, based on its good design and manufacturing capability through higher R&D investment than its peers have made, and much larger production scale than its domestic and foreign peers possess. We believe that Delta could maintain a market share that is materially higher than its closest peers with strong customer relationship over the next one to two years.

Delta also has built a solid position in the thermal component market with a high market share in direct-current fans and heat dissipation modules for IT applications. This wide product offering with synergy in power and thermal management should enable more stable client relationships which in turn support the company to generate stronger and more stable profitability from its power electronics segment than its close competitors can make. Power electronics including EV parts, contributed about 67% of the company's operating income in the first three quarters of 2021.

Nonetheless, Delta remains susceptible to competition in the power supply market with limited technology barriers for its major products and the stronger bargaining power of its large original equipment manufacturing clients such as Apple Inc. We believe that Delta's patents cannot prevent its competitors from competing for orders from its key clients and causing pricing pressure, despite Delta's higher spending on R&D than its major competitors in this subsegment. The company's pricing power is also limited, as indicated by lagging and insufficient passthrough of rising component costs in 2021 that will likely continue in 2022. In addition, growth in power electronics revenue, excluding EVs, is likely to slow over the next two to three years. This is due to receding demand from remote working and remote learning, despite continued recovery in the global economy.

Faster growth in EV parts, automation and infrastructure businesses could materially increase Delta's business diversity and long-term growth. The accelerating global drive to lower carbon emissions, increasing demand for automation amid the prolonged COVID-19 pandemic, and Delta's early investments in expanding these new businesses will drive faster growth in the company's revenue from its EV, automation, and energy infrastructure businesses. We expect those businesses to surpass Delta's revenue from power electronics for IT applications and further diversify the company's business portfolio over the next two to three years. However, these businesses are likely to generate below-average profit margins compared with the company's other business lines over the next two to three years until heavy investments can significantly enlarge their business scale, supply chain strength, and value added.

Delta's position in the global automation and infrastructure power system markets is still relatively weak with very low market shares. These sectors remain dominated by more established global giants including Rockwell Automation and Schneider Electric. Unlike its global peers, Delta is still largely a product-offering-company without competitive capability to provide total solutions through its own brands for various end-applications. This is despite Delta has a strong position in the telecommunications power infrastructure segment, which has particularly benefited from the rollout of 5G mobile communications.

The company has invested heavily in expanding its technology and capability to increase solutions revenue through acquisitions by its industrial and building automation businesses over the past few years. These acquisitions include Infinova Corp. for video surveillance and Universal Instruments Corp. for industrial automation. Both acquisitions were announced in November 2021. However, we believe it will take significant time for Delta to materially enhance its market share and service offerings, although shifts to new open industry standards offer new opportunities for latecomers like Delta.

Long certification periods, delay in its clients' new product launches, competitive pricing to lock-in customers amid intense competition from both new and traditional and well-established auto part suppliers, and the lack of an adequate supply chain have kept Delta's EV business loss-making. However, rapid growth in revenue from EV parts and the gradual improvement in the company's supply chain should improve its cost structure significantly over the next two years. Similarly, Delta's building automation business is also in the early investment stage and it is unlikely to generate material profits with heavy investments still needed to build a competitive product portfolio and business scale in this segment.

Delta could sustain strong free operating cash flow over the next two to three years, despite elevated capex and the likely long-term impact from the company's strategy to become a branded solutions provider. We expect Delta's profitability to remain relatively strong over the next one to two years despite high material costs and weaker profitability from its EV and automation businesses, and the costs associated with its new production facilities. We believe that Delta could initially pass-through costs related to new production facilities outside of China . That's because of strong demand and its clients' needs to diversify their supply chain to mitigate rising geopolitical risk and avoid supply disruptions caused by unexpected events such as the COVID-19 pandemic. Delta could also strengthen its competitive position with higher entry barriers if the company can further diversify its production footprints globally without significantly impairing its cost efficiency.

Delta's positive free operating cash flow is sustainable in our view because of its low capital intensity, relatively high margins, and moderate working capital needs as a power supply supplier. That's despite Delta plans to maintain high capital expenditure (capex) mainly to diversify its production sites over the next two to three years. Delta's product manufacturing carries lower inventory and receivables than other electronics manufacturing or original design manufacturing services providers. In addition, the company's manufacturing process is relatively asset light, mainly engaging in final assembly.

Delta's plan to develop its own brand and solutions business could cause some uncertainty for its long-term profitability and potentially increase its working capital needs, and thus weaken its free operating cash flow. The company's inventory level increased significantly in 2020 to cope with the COVID-19 pandemic and to prepare for rising EV parts and branded sales. This, together with the company's growth appetite, could cause some volatility in the company's leverage in the long term.

Delta is likely to maintain a sound capital structure despite significant appetite for growth through investments and M&As. Delta should be able to maintain debt free on an adjusted basis over the next two years, backed by strong positive free operating cash flow and a prudent cash dividend policy. Delta has a clear strategy to accelerate its new business developments through merger and acquisitions (M&As) or equity investments to maintain about 10% annual growth, given the maturing power supply market for IT applications and the company's already high market share. Nonetheless, the company is likely to maintain its low appetite for financial leverage and to keep its spending on M&As largely within its discretionary cash flow over the next two years. We also believe that the company will maintain its moderate dividend policy to support its growth spending while still maintaining a strong balance sheet. The company's cash dividend payout ratio of 50%-60% of the previous year's net income is largely consistent with those of other leading technology hardware and semiconductor companies.

Outlook

The stable rating outlook reflects our view that Delta can sustain its profitability and net cash position over the next two years, supported by strong power electronics demand from cloud and telecom infrastructure as well as improving profitability of its EVs and other new businesses. The outlook also reflects our view that the company will pursue moderate M&As and capacity expansion without overstretching its financial strength.

Downward scenario

We may lower the rating on Delta if its debt-to-EBITDA ratio deteriorates to above 1x for an extended period. This may occur if:

- Delta's profitability weakened substantially due to intense competition and stronger buyer power triggering significant margin erosion;
- The company fails to maintain its technology leadership in new product introduction, or fails to develop new businesses including EV, building automation, or energy storage in a profitable manner; or
- Delta takes on large scale acquisitions that exceed our current expectation or becomes more aggressive on its capex needs or shareholder friendly action than we assume in our base case.

Upward scenario

Alternatively, we could upgrade Delta if:

- The company further strengthens its products and services toward high value-added products and solutions, and substantially strengthens the profitability and market shares of its EVs, automation, and infrastructure businesses, such that Delta can materially increase its revenue scale and sustain its EBITDA margin above 18%; and at the same time
- Maintain its ratio of debt to EBITDA consistently below 1x, which could be achieved through a prudent policy on capex, acquisitions, and cash dividend payouts that enables Delta to sustainably improve its positive discretionary cash flow.

Our Base-Case Scenario

- S&P Global's projection for world GDP growth of 4.6% in 2022 and 3.7% in 2023 following 5.6% growth in 2021.
- S&P Global forecast for global IT spending to increase by about 6.1% in 2022, which exceeds projected growth in global GDP over the same period and reflects our view that corporate IT spending could pick up and offset the likely tapering of remote working and learning demand for PC and other devices. The EV market will grow faster amid growing global efforts to slow global warming.
- Taiwan Ratings' base case scenario for Delta indicates about 10% sales growth annually in 2022-2023 following 11.5% growth in 2021, supported by strong EV demand and the company's growing sales in electronics components and automation equipment. In addition:
  - Delta's power electronics revenue could grow 8%-10% annually in 2022-2023 following about 20% growth in 2021, as weakening demand for equipment for remote working and learning partly offset the strong growth in the EV market.
  - Delta's automation revenue could grow 14%-18% annually in 2021-2023 as demand for industrial and building automation recovers from the pandemic disruption in 2020. The company's aggressive investments in building automation capability could also facilitate such growth. The acquisition of Infinova Corp. in December 2021 will also add slightly to business growth in 2022.
  - The continued rollout of 5G mobile communications infrastructure along with the growing construction of data centers could help Delta's infrastructure revenue increase 7%-10% annually in 2022-2023 after a high single-digit decline in 2021. Demand for

outdoor EV chargers will also grow but is subject to uncertainty related to government policies around the world along with EV demand. New business and other smaller business segments such as networking gear are unlikely to contribute significant revenue growth.

- Gross margin will decline slightly to about 29% in 2021 due to high material costs and lower margins from its fast-growing EV-related revenue. Delta's gross margin could decline further to 27%-29% in 2022-2023 because persistent high component costs and slowing demand for power electronics could offset improving margins for industrial automation. Faster growth in EVs and building automation business could also slightly dilute Delta's margins.
- Expense ratio will decline to about 19% in 2021 and further to 17.5%-18.5% in 2022-2023 with faster revenue growth from new business development such as EVs and building automation.
- Capex of new Taiwan dollar (NT$) 17.5 billion–NT$18.5 billion annually in 2021-2023 mainly for new business development and to increase capacity particularly outside of China.
- Delta has completed the acquisition of Infinova Corp. in December 2021 by US$114 million. Delta could undertake further small-to-medium size M&As to strengthen its new business developments totaling US$400 million-US$500 million annually in 2022-2023, including US$88.9 million for the acquisition of Universal Instruments announced in December 2021.
- Delta's cash conversion cycle to remain largely stable after lengthening in 2020-2021 because the longer cash conversion cycle for solutions and own brand businesses could offset the lower inventory level at the company's existing businesses when component shortage eases.
- We assume Delta will maintain a stable cash dividend payout ratio of 50%-60% of the previous year's net income during the projection period.

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

- EBITDA margin of 15%-16% in 2021 and 14%-15% in 2022-2023.
- Debt free on an adjusted basis in 2021-2023.
- Return on capital of 17%-20% in 2021-2023.

Liquidity

The short-term rating is 'twA-1+'. We believe that Delta has strong liquidity to meet its needs over the next 24 months. We forecast the company's ratio of liquidity sources to liquidity uses at over 3x in the 12 months ending September 30, 2022 and about 1.5x in the following 12 months. We estimate the company will have positive liquidity source minus uses even if forecasted EBITDA declined by 30%. Delta can also absorb high-impact, low-probability events without refinancing, given its large net cash position. We believe that the company has solid banking relationships and generally high credit standing to support its financial flexibility, as indicated by the very low interest rates on its bank loans and large amount of undrawn long-term credit lines. The company's debts carry no financial covenants.

Principal Liquidity Sources:

- Cash and short-term investments of NT$59.7 billion at the end of September 2021.
- Funds from operations of NT$42 billion–NT$47 billion annually in the 24 months ending Sept. 30, 2023.
- As of the end of September the company 2021 had undrawn long-term credit facilities of NT$37.8 billion maturing beyond Sept. 30, 2022; and NT$2.9 billion maturing beyond Sept. 30, 2023.

Principal Liquidity Uses:

- Long-term debt maturity plus short-term debt repayment of about NT$2.9 billion in the 12 months ending Sept. 30, 2022 and NT$29.6 billion in the 12 months ended Sept. 30, 2023.
- Capital expenditures of about NT$18 billion annually in the 24 months ended Sept. 30, 2023.
- M&As worth NT$8 billion-NT$12 billion annually in the 24 months ended Sept. 30, 2023.
- Working capital outflows of NT$0.6 billion-NT$1.0 billion annually.
- Cash dividend payout of NT$14 billion-NT$15 billion annually.

Rating Score Snapshot

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

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: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twaa

Related Criteria & Research

Related Criteria

- General Criteria: Principles Of Credit Ratings - February 16, 2011
- 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
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings - October 10, 2021

Related Research

- Taiwan Ratings' Ratings Definitions – August 10, 2020

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

Ratings List

New Ratings	
Delta Electronics Inc.	
Issuer Credit Rating	twAA/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.