Media Release:

Aerospace Industrial Development Corp. Outlook Revised To Stable On Improving Cash Flow Generation; 'twAA/twA-1+' Ratings Affirmed

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Rating Action Overview

- **Aerospace Industrial Development Corp. (AIDC)** is the sole supplier/coordinator for Taiwanese air defense projects and provides Taiwan's self-developed aircraft. The company also engages in commercial aviation business, providing aircraft parts and engine parts for global aircraft and engine manufacturers. The Taiwan government directly owns 35% of AIDC's shares. AIDC generated revenue of new Taiwan dollar (NT$) 30.24 billion and EBITDA of NT$3.05 billion in 2022.
- AIDC is likely to improve its cash flow generation over the next one to two years, mainly thanks to the rising revenue contribution from its military segment. The advanced jet trainers project is now under mass-production, with a delivery peak in 2023-2025.
- Demand recovery for commercial aircraft could gradually push up sales in the commercial aviation segment (including aircraft parts and engine parts). This is, however, slower than sales in AIDC's military segment.
- We revised our rating outlook on AIDC to stable from negative. This reflects our view that the company's ratio of debt to EBITDA could improve to 3.5x-4.5x over the next two years.
- At the same time, we affirmed our 'twAA' long-term and 'twA-1+' short-term issuer credit ratings on the company.

Rating Action Rationale

Ongoing projects from the Taiwanese military comprise the key profit and cash flow drivers for AIDC. The Taiwan government has budgeted NT$68.6 billion for 66 units under the advanced jet trainer project, which is now in mass production, with delivery to peak during 2023-2025. We expect AIDC to see a rebound in revenue and EBITDA in 2023-2025. The company reported revenue growth of 28% year-on-year on its military aircraft projects in 2022. In addition, we anticipate the company's maintenance and repair business for military aircraft will gradually improve following the delivery of the aircraft to the government. AIDC's revenue growth on that business was 14% in 2022. Although the revenue mix of AIDC on military business (48% of its revenue in 2022) is similar to that of its commercial aviation business (45%), the gross margin of the company's military business is stronger and more stable than that of its commercial aviation business. In light of cross straits tension, we estimate AIDC will continue to receive new defense-related orders from the Taiwan government over the next three to five years.

A recovery in demand post-COVID helped AIDC improve its commercial aviation business, but the recovery is slower than that of the military segment. The company's revenue from both engine parts and aircraft parts grew by 18.9% in 2022, thanks to the strong recovery in air traffic following the pandemic. AIDC's gross profit margin of commercial aircraft engine-related business improved to 11.2% in 2022, from 6.7% in 2021. However, the profitability of its aircraft parts business remained weak during 2022 because of high shipping costs. While we expect AIDC's commercial aviation business to improve, it will nevertheless trail its military business over the next two to three years.

Financial leverage will improve further, but still not reach the upgrade trigger yet. Favorable operating conditions helped AIDC generate stronger cash flow and improve its ratio of debt to EBITDA to 4.7x in 2022 from 6.3x in 2021. The company's efforts to manage working capital also helped enhance cash flow. This was especially the case for account receivables, mainly from previous government-related projects and acquired payments for the advanced jet trainer project. We forecast AIDC will generate stronger EBITDA, while maintaining lower capital expenditure (capex) over the next two years. This should help the company continue to improve its debt leverage to 3.5x-4.5x over the next two years. This, however, is still higher than our upgrade trigger of 3x.

Outlook

The stable rating outlook on AIDC reflects our expectation that the company's ratio of debt to EBITDA could continue to improve and sustain at about 3.5x-4.5x over 2023-2024. For comparison, the ratio was higher than 5x during the pandemic.

The following factors will support the improvement: AIDC's new advanced jet trainer project for the Taiwan government, mass production deliveries of which will occur in 2023-2025; the recurring business from the maintenance and repair of military aircraft; and the gradual post-pandemic recovery in the commercial aircraft-related businesses.

The stable outlook also reflects our expectation that AIDC's role and link with the Taiwan government will remain intact over the next one to two years.

Downward scenario

We could lower the long-term rating if:

- The company's debt-to-EBITDA ratio stays materially above 5x. This could result from lower-than-expected cash flow generation, given that the potential risk of supply chain disruption and bottlenecks could stall the recovery of global commercial aircraft sales and deliveries. This may have repercussions at the inventory and account receivables level. Higher inflation may affect profit margin and cash flow. A weakening debt-to-EBITDA ratio could also occur if the company incurs large losses, particularly in its business development in manufacturing parts and components for commercial aircraft. Such an event could cause a material deterioration in the company's profit margin and cash flow;
- S&P Global Ratings lowers the long-term rating on Taiwan (AA+/Stable/A-1+; unsolicited).

Upward scenario

We could raise the long-term rating if:

- AIDC enhances the ratio of debt to EBITDA to sustainably below 3x. This could happen if the company improves the aircraft parts division of its commercial aviation business; or if the company's EBITDA and cash flow exceed our current expectations for the major delivery period of the advanced jet trainer.

Our Base Case Scenario

- S&P Global Ratings' forecast for Taiwan's GDP growth is 1.5% in 2023 and 2.5% in 2024. In terms of global GDP growth, S&P Global Ratings' forecast is 2.7% in 2023 and 3.1% in 2024.
- The Taiwan government has budgeted NT$68.6 billion for the T-BE5A advanced trainer jet program; it has also F-16 maintenance service and several military projects, which will support AIDC's defense business growth and profit for the next two years.
- S&P Global Ratings estimates global air traffic will continue to rise but is unlikely to return to 2019 levels until at least 2024. However, that trend obscures significant variation by region and passenger type. Pent-up demand for air travel in 2022 should spill into 2023, and airlines will likely operate more flights in 2023. The recovery has been quicker and demand hotter for domestic and regional travel, thereby spurring the demand for narrow-body aircraft. At the same time, growing interest in international travel routes should inflate the demand for wide-body aircraft.
- We expect AIDC's revenue to grow by 9%-11% in 2023-2024, given that the company continues to produce and deliver the T-BE5A advanced trainer jet to Taiwan's air force. The peak of deliveries will be during 2023-2025; this is a major revenue source for AIDC over the next two years.
- Revenue from commercial aircraft's engine related business will keep recovering at about 7%-10% amid increasing demand for commercial aircraft.
- However, AIDC to still face losses from its commercial aircraft parts business, with negative gross margin of 7%-10% in 2023-2024; this will gradually improve to negative mid- to low single-digit level.
- AIDC's capital expenditure will be NT$600 million-NT$700 million in 2023 and NT$350 million-NT$450 million in 2024.
- We assume a cash dividend payout ratio of 60% over 2023-2024.

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

- EBITDA margin of 10%-11% in 2023 and 10.5%-11.5% in 2024, up from 10.1% in 2022.
- Ratio of debt to EBITDA of 4x-4.5x in 2023 and 3.5x-4x in 2024, compared with 4.7x in 2022.

Liquidity

The short–term rating on AIDC is 'twA-1+'. We assess AIDC's liquidity as adequate because we believe the company has sufficient cash flow to meet its needs over the next 12 months. Our assessment factors in government support in the form of state-owned bank facilities. We expect the ratio of AIDC's liquidity sources to uses will be about 1.3x in the 12 months ending December 2023. Furthermore, we believe the company will have sufficient liquidity headroom even if its forecast EBITDA declines by 15%.

We also believe the company has well-established relationships with banks and could establish new credit facilities when needed, due to its status as a government-related entity. Reflecting this are AIDC's ample borrowing facilities, with an interest rate of 0.5%-0.8% for corporate bonds, and 1.4%-1.65% for other borrowings. We believe AIDC has generally prudent risk management to ensure at least adequate liquidity. The company's loans carry no financial covenant.

Principal Liquidity Sources:

- Cash and short-term investment of NT$3.3 billion at the end of 2022.

- Funds from operations of about NT$3.4 billion in 2023.
- Ongoing government support in the form of government-related bank facilities of NT$8.5 billion to cover refinancing needs in 2023.

Principal Liquidity Uses:

- Debt maturities of NT$7.9 billion in 2023.
- Expected working capital outflow of about NT$1.9 billion in 2023.
- Capital expenditure of about NT$0.6 billion in 2023.
- Cash dividend payout about NT$1.0 billion in 2023.

Rating Scores Snapshot

Issuer Credit Rating: twAA/Stable/twA-1+

Note: The descriptors below are on a global scale.

Business risk: Fair

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: twbbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twbbb

- Sovereign rating: AA+
- Likelihood of government support: Very high (+6 notches from the SACP)

ESG credit indicators: E-2, S-3, G-2

Related Criteria & Research

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct 10 2021
- General Criteria: Group Rating Methodology, Jul 01 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Apr 01 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, Jun 25 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, Mar 25 2015

- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec 16 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov 19 2013
- General Criteria: Methodology: Industry Risk, Nov 19 2013
- Criteria | Corporates | General: Corporate Methodology, Nov 19 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov 13 2012
- General Criteria: Principles Of Credit Ratings, Feb 16 2011

Related Research

- Taiwan Ratings' Ratings Definitions – November 11, 2021

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

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Aerospace Industrial Development Corp.		
Issuer Credit Rating	twAA/Stable/twA-1+	twAA/Negative/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.