Media Release:

Outlook On TECO Revised To Positive From Stable On Improved Profitability; twA+/twA-1 Ratings Affirmed

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Rating Action Overview

- **TECO Electric & Machinery Co. Ltd.** is one of the largest motor manufacturers globally, with diversified businesses covering commercial air-conditioners, home appliances, and energy and engineering construction services. TECO generated EBITDA of new Taiwan dollar (NT$) 6.7 billion in the first nine months in 2023.
- The global energy transition trend and TECO's strengthened product offering could improve the profitability of its green mechatronic solution business and help maintain TECO's overall EBITDA margin at 14%-14.5% in 2024-2025.
- We forecast TECO could maintain its debt to EBITDA ratio below 0.5x over the next two years, given we see the company supporting its investments in solar power through its net cash position as of 2023 and free operating cash flow before cash dividends.
- We have revised our outlook on the long-term issuer credit rating on TECO to positive from stable. This reflects our assessment that TECO will maintain enhanced profitability and low debt leverage over the next two years.
- At the same time, we affirmed our 'twA+/twA-1' issuer credit ratings on the company.

Rating Action Rationale

The upward outlook revision mainly reflects our view that the strengthened profitability of TECO's green mechatronic solution business could sustain the company's overall EBITDA margin at slightly above 14% in 2024-2025. The strengthening green mechatronic solution sector has driven TECO's margin expansion over the past two years. Several factors support the sector's growth, including the ongoing electrification trend in the oil and gas industry in North America, growing requirements for energy efficiency, and a surge in demand for electrical motors under the U.S. government's fiscal stimulus policies such as the U.S. inflation Reduction Act and the infrastructure bill. We project the segment to show 5%-10% annually revenue growth over the next two years.

TECO's improving product mix with reliable and energy-efficient products also enable the company to sustain its margins, despite cost inflation pressures. These characteristics are crucial to TECO's downstream clients in oil and gas, metal and mining or petrochemical industries, which together account for most of TECO's large motor sales. The company has also developed higher value-added system solutions, such as power houses, which help downstream clients to reduce carbon emissions and save operating costs.

Furthermore, TECO's recent efforts to diversify its overseas production sites to India and Mexico should help shorten its supply chain and create a more competitive cost structure while at the same time reduce the risk from increased global protectionism. These factors should support stable profitability generation for TECO's small motor segment and help the company to weather more intense competition in this segment, particularly from Chinese competitors.

Nonetheless, other non-motor businesses are likely to generate low, albeit slightly improving profitability. Sales in the air and intelligent life sector could rebound in 2024-2025, following a 10%-15% decline in 2023. TECO has maintained or even slightly improved its market position in Taiwan's home and commercial air conditioner segment through strengthened products that feature high energy efficiency. However, the company could continue to face margin pressure in the home appliance sector, given the saturated domestic market and intense competition from global brands, especially from Japan.

Meanwhile, TECO's engineering and construction (E&C) business could post stronger revenue growth over the next two years amid strong new contract intake, mainly for electrical substations used in offshore windfarms, the upgrade of Taiwan Power Co.'s national power grid, and Taoyuan Airport's third terminal. Nonetheless, we do not expect significant improvement in the profitability of the company’s E&C businesses over the next two years.

Headwinds could derail TECO's business momentum beyond our current expectation, particularly for the profitability of its green mechatronic solution business. These include slowing electrical motor demand in North America and Europe, where high interest rates could slow economic momentum, particularly for investment in the oil and gas segment. In addition, a potential slowdown in the China economy and intense competition from Chinese competitors could weaken TECO’s sales in Asia. Moreover, inadequate power infrastructures could constrain TECO's efforts to increase sales of system solutions such as power houses. Nonetheless, our base case forecast for TECO sees the company coping with these risks through its stronger product offering and wider global footprint without seeing its margins significantly eroded.

Sustainable operating cash flow should enable TECO to maintain low debt leverage, despite its rising investment in solar power. We believe TECO will maintain a prudent financial policy and keep its investments and capital expenditure (capex) within the company's net cash position and operating cash flow over the next two to three years. This is despite TECO plans to significantly increase its solar power capacity over the period. This investment, together with spending on its core business and the construction of a biotech-park in Taipei City's Nangang district and an office building in Taipei will lift its overall capex needs, particularly from 2025. Nonetheless, we project TECO will generate NT$5.5 billion-NT$6.5 billion operating cash flow in 2024-2025 through tightened working capital management and improved profitability. Along with TECO's relatively stable cash dividends, the company should therefore be able to keep its debt-to-EBITDA ratio below 0.5x over the period.

Outlook

The positive rating outlook reflects our view that TECO could maintain its enhanced EBITDA margin along with a sound capital structure over the next two years. Ongoing demand for energy-efficient electric motors under global decarbonization efforts and TECO's enhanced product mix support this view. Our base case also forecasts TECO maintaining a conservative debt appetite and keeping its ratio of debt to EBITDA below 0.5x over the next two years. This is despite the company's increasing investment in new business and its high cash dividend payout ratios over the same period.

Upside scenario

We may raise the long-term issuer credit rating on TECO if:

- The company could sustain its EBITDA margin above 14% through business cycles. This could happen if TECO continues to strengthen its profitability by improving its core technology or an increasing sales contribution from premium system solutions at its electric motor business; and
- At the same time, the company maintains a prudent investment and capex plan along with the ratio of debt to EBITDA comfortably and sustainably below 1.5x.

Downside scenario

We may revise the outlook back to stable if:

- We believe TECO cannot sustain its EBITDA margin above 14% through business cycle. This may occur due to weaker demand than we predicted, the company's inability to manage volatility in input costs, or rising competition especially at its electric motor business such that this significantly erodes TECO's profitability and cash flow; or
- The company becomes more aggressive on capex or investments in new businesses than we currently assume. A ratio of debt to EBITDA above 1.5x for an extended period would indicate such deterioration.

Our Base-Case Scenario

Assumptions

- S&P Global Ratings' forecast for Taiwan's real GDP to grow 3.0% in 2024 and 2.6% in 2025, U.S. real GDP to grow by 1.5% in 2024 and 1.4% in 2025 and China real GDP to grow 4.6% in 2024 and 4.8% in 2025.
- Continued growth in TECO's overall revenue of 5%-8% in 2024-2025 supported by the global trend for energy transition and carbon neutralization. Green mechatronic solutions and intelligence energy segments will continue to serve as the company's two main growth engines over the next two years.
- Sales in the green mechatronic solution sector to sustain growth at 5%-8% in 2024-2025, mainly driven by sound demand for big motors in North America and TECO's business expansion into system solutions.
- Sales in the air and intelligent life segment to resume growth of 4%-7% in 2024-2025 after declining 10%-13% in 2023. The home and commercial air-conditioner segments will lead growth in the home appliances sector, while the performance of TECO's three subsidiaries, including Information Technology Total Services (ITTS), Tecom Co. Ltd., and Taiwan Pelican will remain subdued over the next two years.
- Sales in the intelligence energy sector to grow 7%-10% in 2024-2025, mainly underpinned by demand from offshore wind farms and Taiwan Power's power grid upgrade plan.

- TECO's gross margin to remain at 27%-28% in 2024-2025. Meanwhile, the ratio of SG&A to revenue will remain lower at 13%-14%, compared to historical level of over 15%.
- Capex for core business and investment for solar power business total at NT$2 billion-NT$3 billion in 2024 and NT$4 billion-NT$5 billion in 2025.
- Dividend payout ratio to remain at 70%-80% of the previous year's net income in 2024-2025.

TECO Electric & Machinery Co. Ltd.--Forecast summary

Industry sector: Capital goods

(Mil. NT$)	**2020a**	**2021a**	**2022a**	**2023f**	**2024e**	**2025f**
Revenue	45,351	51,248	58,315	59,539	62,730	66,812
EBITDA (reported)	5,067	5,563	6,877	8,639	8,756	9,492
Plus/(less): Other	94	88	138	106	131	136
EBITDA	5,160	5,651	7,015	8,746	8,888	9,628
Less: Cash interest paid	(158)	(133)	(129)	(238)	(235)	(331)
Less: Cash taxes paid	(491)	(696)	(1,238)	(1,956)	(1,953)	(2,083)
Funds from operations (FFO)	4,512	4,821	5,649	6,551	6,699	7,214
Cash flow from operations (CFO)	6,068	4,961	7,506	4,936	5,951	6,277
Capital expenditure (capex)	1,025	2,309	2,905	2,150	2,359	4,675
Free operating cash flow (FOCF)	5,043	2,653	4,601	2,786	3,592	1,602
Debt (reported)	14,086	13,685	11,749	11,701	11,552	13,623
Plus: Lease liabilities debt	4,887	5,062	5,072	5,083	5,093	5,103
Less: Accessible cash and liquid Investments	(18,523)	(17,553)	(19,097)	(18,330)	(17,763)	(17,400)
Debt	449	1,194	--	--	--	1,327
Cash and short-term investments (reported)	21,792	20,651	21,950	21,069	20,417	20,000
Adjusted ratios						
Debt/EBITDA (x)	0.09	0.21	--	--	--	0.1
FFO/debt (%)	1003.8	403.9	N.M.	N.M.	N.M.	543.8
Annual revenue growth (%)	(5.1)	13.0	13.8	2.1	5.4	6.5
EBITDA margin (%)	11.4	11.0	12.0	14.7	14.2	14.4

All figures are adjusted by Taiwan Ratings Corp., unless stated as reported. a--Actual. e--Estimate. f--Forecast.

Liquidity: Exceptional

The short-term rating on TECO is 'twA-1'. We believe the company has exceptional liquidity with a ratio of liquidity sources to liquidity uses of 3.1x over the next 12 months ending Sep. 30, 2024, and 2.0x over the subsequent 12 months. We also believe TECO has well-established banking relationships and a generally high standing in domestic credit market. In our view, the company can absorb high-impact, low probability events without financing, supported by its low debt leverage level. Moreover, we assess TECO has sufficient headroom on its financial covenants over the next two years.

Principal liquidity sources:

- Cash and short-term investment of about NT$23.1 billion as of Sep. 30, 2023.
- Funds from operations of NT$6.5 billion-NT$7.5 billion per year in 2024-2025.

Principal liquidity uses:

- Long-term debt maturity plus short-term debt repayment of NT$1.9 billion in the 12 months ending Sep. 30, 2024, and NT$4.1 billion in the following 12 months.
- Capex plus investment of NT$2.0 billion-NT$3 billion in 2024 and NT$4 billion-NT$5.0 billion in 2025.
- Cash dividend payout over the next two years of 70%-80% of the previous year's net income.

Ratings Score Snapshot

Issuer Credit Rating: twA+/Positive/twA-1

Note: The descriptors below are on a global scale.

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Intermediate
- 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: Exceptional (no impact)
- Management and governance: Neutral (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: twa+

Related Criteria & Research

Related Criteria

- Criteria | Corporates | General: Corporate Methodology - January 07, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities - January 07, 2024
- General Criteria: National And Regional Scale Credit Ratings Methodology - June 08, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings - October 10, 2021
- General Criteria: Group Rating Methodology - July 01, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Principles Of Credit Ratings - February 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
TECO Electric & Machinery Co. Ltd.		
Issuer Credit Rating	twA+/Positive/twA-1	twA+/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.