Media Release:

Zyxel Group Corp. Outlook Revised To Negative From Stable On Weak Profitability;'twA-/twA-2' Ratings Affirmed

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Rating Action Overview

- **Zyxel Group Corp.** is a telecom equipment provider in Taiwan including broadband gateway CPE, Wi-Fi access points, and enterprise network-related products. The company generated EBITDA of new Taiwan dollar (NT$)1.8 billion in 2023.
- Zyxel's weaker customer portfolio and intense competition from larger peers are likely to keep revenue and profitability weak over the next 12 months. A recovery will hinge on whether Zyxel can expand its client base and strengthen cost competitiveness and product offerings.
- Therefore, we revised our outlook on the long-term issuer credit rating on Zyxel to negative from stable to reflect our view of material risk that Zyxel may fail to significantly expand its client base and restore revenue momentum after the slowdown in growth dynamics since early 2024. Failure to achieve this could keep profitability and competitiveness lower than we assume for the ratings over the next 12-24 months.
- At the same time, we affirmed our 'twA-' long-term and 'twA-2' short-term issuer credit ratings on Zyxel.

Rating Action Rationale

The outlook change reflects material risk that Zyxel may be unable to strengthen its client base and operating performance amid persistent weak global customer premise equipment (CPE) demand. We forecast Zyxel's operating performance will remain lukewarm over the next two to three quarters due to weak demand for its key products and relatively weak client portfolios that are more susceptible to market downturns. That's because we anticipate the market for Zyxel's products may not bottom out until 2025. Order visibility for telecommunication equipment spending in Europe and the U.S. is likely to remain significantly below the level in 2022-2023. Moreover, Zyxel's revenue growth from new clients in emerging markets is also likely to perform compared below our earlier forecasts, given the company's slow progress in new client acquisitions.

Based on these factors, we believe Zyxel's sales in 2024 could drop by 15% compared to 7.8% under our previous forecast. Meanwhile, continued macroeconomic uncertainty raises the difficulty for Zyxel to effectively manage its working capital. This includes inventory impairments or credit losses from clients with weak creditworthiness. Under our base case, such impairments or credit losses would weigh on Zyxel's profitability. This, along with the company's shrinking scale economies, could constrain the EBITDA margin to 3.8% in 2024 compared with 5.9% in 2023. Our base case suggests Zyxel's margin may improve moderately to 6%-7% in 2025-2026 without significant unexpected operating losses. We base this on our view that the company's efforts to strengthen product offerings and cost management should enable the company to acquire new clients and expand revenue amid improving demand.

Nonetheless, downside risk for Zyxel remains high due to intense market competition and the company's weaker scale economies compared with its close peers, given Zyxel's significant underperformance over the past 6-12 months.

Competitiveness could weaken, leading to persistently higher business volatility and weak profitability without quick restoration in client shipment and revenue scale. Zyxel is exposed to higher margin volatility than its peers due to the company's smaller operating scale and less revenue contribution from top-tier cable and telecom clients. A lack of meaningful growth in revenue scale will continue to constrain Zyxel's pricing power against large clients and key component suppliers. The company's focus on small-to-medium size telecom operators could induce greater risk in the Zyxel's procurement process and inventory management. This is despite the company could have stronger bargaining power over these clients to secure better pricing.

Moreover, we believe Zyxel may experience more downside risk to its operating performance during market downturns than its peers that generate more sales from large telecom operators. That's because those smaller players are in general more susceptible to weak demand and macro conditions. We also believe the IT spending and related shipments of top-tier cable and telecom operators is likely to remain much healthier than the portfolio of Zyxel's small and midsize clients. In addition, Zyxel's small-to-midsize clients carry higher credit risk. That's because their generally weaker financial profiles than top-tier telecom operators increase the risk of delayed payments or defaults during economic downturns.

Strong capital structure provides sufficient financial buffer for the ratings. We anticipate Zyxel will generate slightly negative discretionary cash flow in 2024, amid weakening EBITDA generation and higher capital expenditure (capex). We forecast Zyxel's capex will increase to new Taiwan dollar (NT$) 900 million in 2024 and NT$800 million in 2025, from NT$197 million in 2023. The company will use this to support plant acquisition and the automation of manufacturing facilities. However, we believe Zyxel could generate positive discretionary cash flow in 2025 and maintain a significant net cash position in 2025-2026, despite still relatively weak profitability. This should also be sufficient to provide a buffer against moderately weaker performance than under our base case over the next 12 months.

Outlook

The negative rating outlook reflects material risk that Zyxel's profitability and revenue could stay persistently weaker than the ratings imply without significant growth in the company's client base and resultant order intakes over next 12-24 months. The company's revenue contributions from new clients in emerging markets is also likely to remain weaker than under our previous forecast, given tepid demand recovery and intense competition in these markets.

The outlook also embeds our view that a weaker client base will widen Zyxel's operating performance gap from its major peers and weaken its relative competitiveness.

Downside scenario

We could lower the rating on Zyxel Goup if the company fails to improve its operating performance materially, as measured by the EBITDA margin remaining below 4% or the absence of a significant recovery in revenue over the next one to two years. Likely scenarios for such results include:

- Lagging R&D and product development lead to the loss of customers or a failure to acquire sufficient new clients to materially expand revenues and improve scale economies; or
- The mismanagement of inventory or clients, material patent lawsuits or significantly credit losses incur than we project, thus indicating weak risk management.

We could also lower the ratings if the ratio of debt to EBITDA stays above 1x without prospects for improvement. This could happen if:

- Operating losses or rising working capital needs cause large operating outflows; or
- The company changes its conservative debt appetite and increases debt materially, possibly due to large-scale capacity expansion, acquisitions, or shareholder friendly actions.

Upside scenario

We could revise the rating outlook back to stable over the next 12 to 24 months if Zyxel can improve its EBITDA margins materially and sustainably above 4% on a consistent basis. This would also require a significant recovery in revenue, most likely through an expanding its client base or strengthened product offerings.

Our Base Case Scenario

- S&P Global Ratings' forecast for the world economy to gradually recover with the GDP growth of 3.2% in 2024 and 3.1% in 2025.
- S&P Global's forecast for global IT spending growth of 8% in 2024, up from 4% in 2023. Improving end demand and artificial intelligence (AI) applications should drive a rebound in PC, smartphone, and server shipments. However, macroeconomic headwinds remain for a cloud over the industry's short-term recovery.
- Taiwan Ratings' base case scenario for Zyxel Group indicates a 15% sales decline in 2024 due to muted sales momentum following a loss of clients and weak orders from remaining clients on persistent weak consumer demand. Zyxel could see a 6%-8% increase in 2025 because the market could bottom out from the 2025.
    - Fiber Broadband revenue to decline by 10% in 2024 dragged down by relatively conservative investments by target customers on network infrastructure. Revenue could recover by 5%-7% in 2025 under a gradual market recovery.
    - Fixed Wireless Access (FWA) revenue to grow 30% in 2024 and further raise to 55% in 2025 with increased investment in broadband deployment and higher customer penetration, mainly driven by the introduction of 5G FWA products.
    - Networking equipment sales to small and midsize enterprises will remain muted in 2024 due to tepid end market. However, sales could increase by 4%-7%in 2025. Increasing network security requirements and the growing application of software-defined wide area networks (SD-WANs) have stimulated such growth aided by Zyxel's total solutions including security and remote management capability.
- Gross margins before depreciation and amortization are likely to slightly improve to 25%-26% in 2024 and increase to 26%-27%% in 2025 compared to 23.5% in 2023.
    - The market could bottom out from second half of 2025, yet the prudent spending of small-midsize enterprises could constrain profitability.

  - The increasing penetration of fiber broadband and FWA could lower the average selling price of products in line with other matured markets. Increasing competition for FWA could also lower the average selling price.
- SG&A ratio to increase to 21%-22% in 2024 from 17.7% in 2023, because a material drop in sales will weaken Zyxel's scale economy. The ratio could dip slightly to 20%-21%in 2025.
- Capex to increase to NT$900 million in 2024 but drop back slightly to NT$800 million in 2025 from NT$ 198 million in 2023. This will be used to support the company's newly acquired plant in Miaoli and its plant in Vietnam including the automation of production facilities as well as the addition of production and R&D equipment for new technology.
- Spending on acquisitions and investments to rise to NT$300 million in 2024 and 2025.
- Cash dividend payout ratio of around 45% in 2024-2025 compared with 30.2% in 2023.
- We apply a surplus cash haircut of 2.3% which mainly reflects the discount on Zyxel's stocks investments.

Zyxel Group Corp. -- Taiwan Ratings Corp. Forecast summary.

Industry sector: High tech equipment

(Mil. NT$)	2021a	2022a	2023a	2024e	2025f	2026f
Revenue	25,682	30,516	30,380	25,861	27,695	28,728
EBITDA (reported)	1,792	2,261	1,749	982	1,678	1,911
Plus/(less): Other	50	35	35	--	--	--
EBITDA	1,843	2,296	1,784	982	1,678	1,911
Less: Cash interest paid	(23)	(69)	(88)	(41)	(27)	(26)
Less: Cash taxes paid	(86)	(309)	(457)	(71)	(158)	(188)
Funds from operations (FFO)	1,734	1,919	1,239	870	1,494	1,697
Cash flow from operations (CFO)	124	106	3,643	1,446	1,268	1,577
Capital expenditure (capex)	380	435	198	900	800	400
Free operating cash flow (FOCF)	(256)	(329)	3,446	546	468	1,177
Discretionary cash flow (DCF)	(569)	(863)	2,954	(64)	253	699
Debt (reported)	3,666	5,344	2,779	1,443	1,486	1,447
Plus: Lease liabilities debt	439	448	419	391	365	341
Less: Accessible cash and liquid Investments	(5,535)	(5,981)	(6,741)	(4,885)	(4,885)	(5,534)
Debt	--	--	--	--	--	--
Cash and short-term investments (reported)	5,826	6,295	6,899	5,000	5,000	5,665
Adjusted ratios						
Debt/EBITDA (x)	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.
FFO/debt (%)	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.
Annual revenue growth (%)	15.4	18.8	(0.4)	(14.9)	7.1	3.7
EBITDA margin (%)	7.2	7.5	5.9	3.8	6.1	6.7

All figures are adjusted by Taiwan Ratings Corp., unless stated as reported. Figures for the forecast period are based on Taiwan Ratings Corp.'s base-case scenario. a--Actual. e--Estimate. f--Forecast. NT$--new Taiwan dollar. N.M.--Not meaningful

Liquidity

The short-term rating on Zyxel Group is 'twA-2'. We believe that the company has strong liquidity as indicated by the ratio of liquidity sources to liquidity uses above 2.42x over the 12 months ending June 2025 and 4.93 in the following 12 months ending June 2026. We forecast liquidity sources will still exceed liquidity uses even with EBITDA dropping 30%.

We also believe Zyxel can absorb low probability high impact event without refinancing, underpinned by its large cash balance on hand which far exceeds the company's debt. Moreover, we believe Zyxel will maintain prudent financial risk management with a high cash balance and low debt leverage over the forecast period.

Principal liquidity sources:

- Cash and short-term investments of NT$6.9 billion as of the end of June 30, 2024.
- Fund from operations of NT$1.2 billion in the 12 months ending June 2025 and NT$1.7 billion in the following 12 months ending June 2026.

Principle liquidity uses:

- Debt maturity of NT$1.87 billion for the 12 months ending June 2025 and none in the following 12 months ending June 2026.
- Cap of NT$850 million in the 12 months ending June 2025 and NT$600 million in the 12 months ending June 2026.
- Acquisitions of NT$300 million in the 12 months ending June 2025 and NT$150 million in the following 12 months ending June 2026.
- Cash dividend payout of NT$413 million in the 12 months ending June 2025 and NT$347 million in the following 12 months ending June 2026.

Rating Score Snapshot

Issuer Credit Rating: twA-/Negative/twA-2
Note: The descriptors below are on a global scale.

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: Neutral (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twa-

Related Criteria & Research

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology - April 04, 2024
- 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
Zyxel Group Corp.		
Issuer Credit Rating	twA-/Negative/twA-2	twA-/Stable/twA-2