

Media Release

Outlook On Yulon Motor Revised To Negative On Weaker Car Sales And Credit Metrics; 'twA/twA-1' Ratings Affirmed

May 2, 2018

Overview

- We believe that shrinking sales of Yulon's own-brand Luxgen vehicles, the brand's still-weak market position, and high capital intensity could weaken Yulon's credit strength.
- We also expect Yulon's manufacturing business for Nissan-branded vehicles will face rising competition in the domestic auto market from imported brands, which could prevent Nissan from restoring its sales momentum over the next 6 to 12 months.
- We are therefore revising our outlook on the long-term rating on Yulon to negative from stable to reflect Yulon's weakening market position for Nissan- and Luxgen-branded cars, and the risk that Nissan branded cars cannot regain strength in the domestic auto market or further deterioration in its Luxgen business will increase losses over the next one to two years.
- At the same time, we are affirming the 'twA' long-term and 'twA-1' short-term issuer credit ratings on Yulon.

Rating Action

Taiwan Ratings Corp. today revised the outlook on its long-term issuer credit rating on **Yulon Motor Co. Ltd.** to negative from stable. At the same time, we affirmed the 'twA' long-term and 'twA-1' short-term issuer credit ratings on the company.

Rationale

The outlook revision reflects Luxgen's inferior sales performance despite increased auto demand in Taiwan and China, and high uncertainty over Luxgen's future sales performance due to the brand's limited brand recognition and inferior R&D capability compared with global peers'. Luxgen's high capital intensity and weak profitability are likely to push up Yulon's debt and result in further deterioration in its credit metrics over the next one to two years. The outlook revision also reflects the declining market share for Nissan-branded cars in Taiwan due to intense competition from imported brands and the risk that the brand cannot quickly restore its domestic market position through the introduction of new models.

We believe there is increasing risk that Luxgen's sales will remain sluggish in 2018 and 2019, particularly in China, due to lower sales of the brand's U5 compact Sport Utility Vehicle (SUV) model than Yulon anticipated, and sliding sales in more seasoned models. This is despite Yulon's plan to

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launch new plug-in hybrid electric vehicle (PHEV) models at the end of 2018. The positive impact on sales from new models is highly uncertain, in our view. The uncertainty stems from Luxgen's limited brand recognition and weak market position, particularly in China, and its inferior R&D capability compared with that of global peers owing to the brand's short history and knowledge accumulation. The brand's small operating scale also constrains new model marketing and channel expenses, which can further limit their sales performance. Sales volume of Luxgen vehicles in Taiwan and China declined by 8% and 50%, respectively, in 2017, despite overall industry growth in both markets over the period.

We expect Yulon to increase capital expenditure substantially in 2018 for the development of electric vehicle models. Yulon will set up two companies in China with capital injection of New Taiwan dollar (NT\$) 3.6 billion and NT\$690 million to support this development. Yulon will also inject Chinese renminbi (RMB) 1 billion (NT\$4.5 billion equivalent) capital to Luxgen Sales Co., mainly to support marketing and R&D on new models. We expect the substantial investments to push up Yulon's debt level in 2018. In addition, losses on the Luxgen brand are likely to increase over the next two years due to incremental operating costs associated with the new companies, assuming no offset from a substantial increase in sales revenue. As a result, we expect Yulon's ratio of debt to EBITDA to increase to 2x-2.5x in 2018 and 2019, from 1.6x in 2017.

We expect Nissan-branded sales to face growing competition in the domestic auto market from imported brands. This could prevent Nissan from restoring its sales momentum even with new model launches over the next 6 to 12 months. Imported brands have aggressively expanded their market share in Taiwan, underpinned by their increased price competitiveness with a stronger New Taiwan dollar exchange rate and high-grade equipment such as auto electronics and safety systems, which are more appealing to domestic car buyers. We expect imported brands' increasing market share to elevate competitive pressure in Taiwan's auto market and squeeze domestic automakers' margin, given local automakers' lower sales volume and the more aggressive marketing campaigns needed to combat competition and lift sales. Nissan's market share slid to 8.3% in the first quarter 2018, down from 9.6% in full-year 2017 and 10.2% in 2016.

The rating affirmation reflects the strong market position for Nissan vehicles in China, and our expectation that the brand will maintain modest sales growth over the next two years. We expect Nissan's robust performance in China to underpin Yulon Nissan's (Yulon's 50/40 joint venture with Nissan Motor) capability to provide increasing and sizeable cash dividend to Yulon, which will constitute around 60% of Yulon's adjusted EBITDA over the next 2 years. The rating affirmation also reflects our expectation that Yulon's debt will substantially decrease with cash inflow from property sales in the Xindian district of New Taipei City. We expect the company's ratio of debt to EBITDA to drop to below 1.5x by 2021, when the property development project is largely completed. In addition, we continue to assess Yulon's capital structure as positive, given its valuable land assets that can be disposed of easily and provide a sufficient financial buffer for the company to weather market volatility and support business developments.

Our base-case scenario assumes the following:

- Taiwan's real GDP to grow 2.7% in 2018 and 2.6% in 2019 and China's real GDP to grow 6.5% in 2018 and 6.3% in 2019.
- Taiwan's auto sales will remain relatively strong at over 400,000 units over the next two years. We expect domestic auto sales to slightly decline by 2%-3% annually in 2018 and 2019 for lower replacement demand, due to high car sales volume in the previous four years.
- Growth in passenger car sales in China to slow to 1%-3% in 2018 and 2019, due to slowing economic growth and the recovery of purchase tax to 10% in 2018.

- Yulon's revenue to decline by 3%-6% in 2018 and recover by 3%-6% in 2019, reflecting sluggish Luxgen sales and a moderate decline in Nissan sales in Taiwan in 2018. The rebound in sales in 2019 reflects sales growth from Luxgen's new PHEV model.
- Yulon's gross margin to slightly decline to 17.2%-19.2% over the next two years, reflecting margin pressure in Taiwan's Nissan business and likely higher operating expense associated with China's Luxgen business. Luxgen's cost saving measures to partly offset the cost increase should help Yulon to defend its margin.
- Lower R&D expense in 2018 and 2019 because Hua-chuang Automobile information Technical Center Co. Ltd. (Haitec) will bear most of the responsibility for Luxgen's future model development.
- Expanded sales of Nissan in China will continue to support Yulon's dividend income over the next two to three years. We assume at least 100% cash dividend payout for Yulon Nissan in 2018 and 2019.
- Construction of the company's real estate development project in Xindian will result in annual working capital outflow of NT\$2 billion-NT\$2.7 billion in 2018 and 2019.
- Capital expenditure to increase to NT\$5.3 billion-NT\$6.3 billion in 2018 before falling to NT\$3 billion-NT\$4 billion in 2019. The higher level in 2018 mainly reflects the setup cost for electric vehicle companies in China.
- Capital injection of RMB\$1 billion in Luxgen Sales Company in 2018.
- Cash dividend payout of NT\$912 million in 2018 and NT\$550 million-NT\$650 million in 2019.
- Tax rate of 17%.

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

- EBITDA margin of 6.8%-8.8% in 2018 and 7.6%-9.6% in 2019.
- Ratio of debt to EBITDA of 1.8x-2.8x in 2018 and 1.5x-2.5x in 2019.
- Ratio of free operating cash flow to debt of negative 20% to negative 30% in 2018 and 0% to positive 5% in 2019.

Liquidity

The short-term corporate credit rating is 'twA-1'. We believe that Yulon has adequate liquidity to meet its needs over the next 12 months. Our view of the company's liquidity profile incorporates our assessment that the ratio of liquidity sources to liquidity uses will be 1.2x-1.4x over the next 12 months and that liquidity sources will continue to exceed uses even if Yulon's EBTIDA were to decline by 15%. It also reflects our view that the company has generally prudent risk management, a sound relationship with banks in Taiwan, and that Yulon's debt does not carry any covenants.

Principal Liquidity Sources:

- Cash and short-term investments: NT\$29.5 billion at the end of 2017.
- Cash flow from operations: NT\$4.6 billion-NT\$5.6 billion in 2018.
- Asset sales: NT\$500 million-NT\$600 million in 2018.

Principal Liquidity Uses:

- Debt maturity: NT\$13 billion-NT\$14 billion in 2018.
- Working capital outflow: NT\$1.5 billion-NT\$2.5 billion in 2018.
- Capital expenditure: NT\$5.3 billion-NT\$6.3 billion in 2018.
- Capital injection for Luxgen Sales Co.: NT\$4.5 billion in 2018.
- Cash dividend payout: NT\$912 million in 2018.

Outlook

The negative outlook reflects Yulon's weakened market position for Nissan-branded cars in Taiwan, and the risk that the brand cannot recover its falling market share over the next 6 to 12 months due to heightened competition from imported car brands. The negative outlook also reflects the still-weak market position for Luxgen-branded cars with contracted sales volume and high performance uncertainty for new model launches. In addition, the brand's high capital intensity is likely to push up Yulon's debt leverage and weaken its credit metrics over the next one to two years.

Downward scenario

We may lower the long-term rating on Yulon if Nissan's market position in Taiwan continues to deteriorate over the next 6 to 12 months, indicated by a market share materially below 10%. We may also lower the rating even with Nissan's market share returning to close to 10%, if Luxgen sales fail to increase in scale in Taiwan and China on a sustainably basis through the successful introduction of new car models over the next 24 months. Further elevation in competition in Taiwan and Yulon's inferior capability on car model development compared with larger peers' could constrain its performance below our downside triggers. The rating will also face downward pressure if Yulon's ratio of debt to EBITDA exceeds 2x on a consistent basis, possibly due to larger investments on the Luxgen brand than we expected.

Upward scenario

We may revise outlook to stable if Yulon can restore Nissan's market position in Taiwan, indicated by a market share close to 10% and materially improve Luxgen's sales scale and market position particularly in China, while also maintaining its ratio of debt to EBITDA below 2x over the next two years. Possible scenarios include: 1) new model introduction or successful marketing that improves Nissan sales, 2) development of a popular Luxgen car model increases overall sales and reduces losses, and 3) a more conservative capital-spending plan by Yulon.

Rating Score Snapshot

Issuer Credit Ratings: twA/Negative/twA-1

Note: All scores below are in comparison with global obligors.

Business risk: Weak

- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Weak

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: twbbb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Positive (+1 notch)
- 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: twa

- Group credit profile: twa

Related Criteria

- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - November 18, 2014
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Auto And Commercial Vehicle Manufacturing Industry - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Criteria - Financial Institutions - General: Nonbank Financial Institutions Rating Methodology - December 09, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Principles Of Credit Ratings - February 16, 2011
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

(Unless otherwise stated, these articles are published on www.standardandpoors.com, access to which requires a registered account)

Ratings List

Outlook Revision; Ratings Affirmed

	To	From
Yulon Motor Co. Ltd.		
Issuer Credit Ratings	twA/Negative/twA-1	twA/Stable/twA-1

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