

Media Release

Unimicron Technology Corp. 'twA/twA-1' Ratings Affirmed; Outlook Remains Negative

November 28, 2018

Overview

- Unimicron's profitability has improved materially in the third quarter of 2018 with better utilization of its IC substrate capacity and the improving yield of its new products amid a seasonal peak in demand.
- However, downside risk on the sustainability of Unimicron's improved profit margin remains, given a likely slowdown in end-demand, uncertain supply and demand balance in the IC substrate market, and heightened competitive pressure.
- We are therefore maintaining the negative rating outlook on Unimicron and affirming the 'twA' long-term and 'twA-1' short-term issuer credit ratings.

Rating Action

Taiwan Ratings today affirmed the 'twA' long-term and 'twA-1' short-term issuer credit ratings on **Unimicron Technology Corp.** The outlook remains negative.

Rationale

The negative outlook reflects the uncertain prospects for Unimicron to sustain its improved profit margin and a ratio and debt to EBITDA at about 2.5x. Several factors are behind this uncertainty including a likely further slowdown in end-demand, uncertain supply and demand in the IC substrate market, undefined yield rate improvements, heightened competition, and likely rising capital expenditures. This is despite recent improvement in the company's profitability and cash flow amid a seasonal in peak demand.

Unimicron's EBITDA margin strengthened very significantly in the third quarter of 2018 to 15.9%, up from 9.6% in the first half of 2018, and 12.8% in 2017. The largest driver for the robust margin rebound is the turnaround in Unimicron's IC substrate business with better utilization. The better yield rate and rapidly growing production scale of its new HDI product with better order intakes have also enhanced the company's margins.

The demand for smaller and lightweight electronic products is on the rise. This trend could trigger rising adoption of rigid-flex printed circuit boards (RFPCB) and substrate-like printed circuit boards (SLPCB) in more smartphone models. This would enable Unimicron to maintain healthy revenue momentum on high density interconnect (HDI) products over the next few quarters. At the same time, the company's yield rate and cost efficiency for the new technologies and products could improve

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further. In addition, limited new supply and growing demand from new applications could increase the utilization rate of Unimicron's capacity for IC substrates further still, which could support the company's profitability over the next several quarters.

However, we believe likely slowing global demand for smartphones and PCs could heighten Unimicron's competition risks in the next several quarters. Demand for smartphones declined slightly in the first three quarters of 2018, and the pessimistic outlooks reported by some component suppliers could signal further weakening in premium smartphone demand, and constrain Unimicron's revenue. In addition, pricing pressures could rise and constrain Unimicron's margins further, because its top customers with strong buyer power could seek to lower their costs under weak market conditions.

In addition, Unimicron's debt leverage has only limited headroom for the ratings, given the likely volatility in its operating performance. The company is likely to maintain relatively high capital spending, in our view. We base this on our opinion of further Unimicron's investment needs to meet the demand from major client's for new products as well as to finance a facilities upgrade for IC substrates in order to stay ahead of the industry's product and technology curve. We therefore expect Unimicron to sustain its ratio of debt to EBITDA at 2.3x-2.6x over the next one to two years if it can sustain its profitability as we expect in our base case.

Unimicron's competitive position has weakened moderately over the past two to three years with more competitive technology and product offerings from its competitors. The company's lower global ranking and market share for some of its key products as well as persistently declining margins are evidence of this deterioration. We also believe Unimicron could continue to face significant industry volatility as a result of diminishing product and technology differentiation, which have led to higher market fragmentation and even stronger buyer power from its relatively concentrated customer base. This could in turn threaten a sustained recovery in the company's profitability.

Nonetheless, Unimicron's business diversity is better than most of its peers' and could continue to provide some operational stability. In addition, Unimicron is better positioned to capture the up trending demand on flip chip ball grid array (FCBGA) and high-end HDI from growing applications such as cloud computing and fifth generation mobile communications, given the company's established technology and capacity. These factors could partly alleviate the heightened business risk facing the company.

Our base case assumes:

- S&P Global Ratings' projected growth in global GDP of 3.8% in 2018, 3.7% in 2019, and 3.7% in 2020; China's GDP of 6.5% in 2018, 6.3% in 2019, and 6.1% in 2020; and U.S. GDP growth of 2.9% in 2018, 2.3% in 2019 and 1.7% in 2020.
- We expect overall growth in the IT hardware industry to be flat to slightly positive over the next 12 months, moderating from low-single-digit percent growth in 2018. The decline in global PC shipments should slow to 1%-2% in 2019, based on ongoing strength in the commercial market. We expect the smartphone market to be relatively flat in 2019 with China experiencing noticeable slowdown in demand.
- Escalating trade tensions between the U.S. and China could pose the biggest risk. In the most stressed case for the U.S. to impose tariffs on another \$250 billion or more in goods from its largest trading partner, most technology products imported from China would be affected. This could shake business and consumer confidence worldwide and hurt overall IT consumption
- Taiwan Ratings' base-case scenario for Unimicron indicates 18%-22% revenue growth in 2018, which is much stronger than the industry average due to tight supply and improving demand on its products, and slows to low-to-mid single digits growth in 2019 given a high base. We also expect the company's EBITDA margin to stay within 12.5%-13.5% over the period.

1. For IC carriers, we expect 20%-25% revenue growth in 2018 and mid-to-high single-digit growth in 2019. Robust demand growth of FCBGA driven by artificial intelligence and 5G applications, as well as limited capacity additions could keep market supply tight. This should support a relatively healthy sales momentum and drive up average selling price in the next several quarters.
 2. Revenue growth on HDI will be strong at about 20% in 2018 supported by expanding adoption of its new products by more smartphone models. Growing demand from Chinese mobile clients will also contribute partly to the company's sales growth and support mid-single-digit revenue growth in 2019.
 3. Revenue of conventional PCB will continue to decline by low single digit annually as a result of company's strategy to move toward auto PCB and other niche products in 2018 and 2019. Though we believe the magnitude of a sales contraction will diminish with the reopening of its Germany-based plant.
 4. FPC's revenue growth will largely flat or see slight improvement in the next two years with a likely contribution from potential new customers.
- Margins will be relatively stable in 2018-2019 and within 12.5%-13.5%. This will mainly reflect enhanced pricing power and material improvement in the utilization rate for IC substrates, and likely improvement in the yield and utilization rate for HDI products, which could offset the price erosion on some products under competition pressure.
 - Unimicron's capex to lower to NT\$7.5 billion-NT\$8.5 billion per year in 2018-2019, down from NT\$9.9 billion in 2017, mainly for facilities upgrades and debottlenecking for major products.
 - Higher dividend payout in 2018 for one-off income from fire insurance, but lower to NT\$400 million-NT\$500 million in 2019.
 - The same cash conversion cycle for the company in 2018-2019.

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

- EBITDA margin of 12.5%-13.5% in 2018-2019.
- Ratio of debt to EBITDA to slightly lower to 2.3x-2.6x in 2018-2019 from 2.7x in 2017.
- Ratio of free operating cash flow to debt to remain less than 5% in 2018-2019.

Liquidity

The short-term rating on Unimicron is 'twa-1'. We believe the company has adequate liquidity reflecting a ratio of liquidity sources to liquidity uses at 1.2x-1.4x for the 12 months ending September 2019. We also believe the company will have positive liquidity sources minus uses, even if the forecasted EBITDA declined by 15%.

In our view, Unimicron has sufficient headroom without breaching covenant limits due to low interest rates in Taiwan and the company's generally prudent risk management. Unimicron is also likely to absorb high-impact and low-probability events with limited needs for refinancing considering its high cash balance and a moderate level of capital expenditure. Furthermore, we believe the company has sound bank relationship supported by its generally satisfactory standing in credit market. This is also evidenced by generally low interest rates on its bank loans.

Principal Liquidity Sources:

- Cash and short-term investment: About NT\$21.8 billion as of the end of September 2018.
- Fund from operations: NT\$8 billion-NT\$10 billion over the 12-month period ending September 2019.

Principal Liquidity Uses:

- Long-term debt due in one year plus short-term debt: NT\$18 billion-NT\$20 billion over the 12 months up to September 2019.
- Maintenance capital expenditure: NT\$3 billion-NT\$5 billion for the 12 months ending September 2019.
- Cash dividend payout of NT\$400 million-NT\$500 million in 2019.

Outlook

The negative outlook reflects the uncertain prospects for Unimicron to sustain its profitability over the next one to two years despite the company's recent improvement in both revenue and profit margin. This is because likely slowing global demand for smartphones and PCs could heighten the competition risks facing the company over the next several quarters. In addition, potential pricing pressure from its top customers with strong buyer power amid weakening demand could also pose some risks to sustainability of the company's restored profitability and its debt leverage, in our view.

Downward scenario

We may lower the long-term issuer credit rating if Unimicron fails to sustain its restored profitability over the next one to two quarters with the prospect of continued weak profitability. Potential factors resulting in such a downside scenario include a further slowdown in demand, low production yield rate or utilization rate, or heightened pricing pressures from its top customers. We may also lower the rating if the company's ratio of debt to EBITDA rises materially above 2.5x. Weakening cash flow, higher aggressive capital expenditures or unexpected working capital outflows could lead to such an increase in debt leverage.

Upward scenario

We may revise the outlook to stable if we believe Unimicron can sustain its EBITDA margin significantly above 12% over the next one to two quarters. At the same time, the company would have to maintain its debt to EBITDA ratio around 2.5x on a sustainable basis.

Rating Score Snapshot

Issuer Credit Rating: twA/Negative/twA-1

Note: All scores are in comparison with global obligors.

Business risk: Fair

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

Financial risk: Significant

- Cash flow/Leverage: Significant

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: Positive (+1 notch)

Stand-alone credit profile: twa

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Technology Hardware And Semiconductors Industry - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - 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
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - June 26, 2018

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

Ratings List

Ratings Affirmed

Unimicron Technology Corp.

Issuer Credit Ratings

twA/Negative/twA-1

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