Media Release

Unimicron Technology Corp. Outlook Revised To Stable On Improved Profitability; 'twA/twA-1' Ratings Affirmed

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Rating Action Overview

- Unimicron's strengthening IC substrate business and improving production yield for new products could sustain recent improvement in the company's profitability.
- We also expect the company's strengthening operating cash flow to support the ratio of debt to EBITDA consistently below 2.5x over the next two years, despite rising capital expenditures.
- On May 27, 2019, Taiwan Ratings Corp. revised its outlook on the long-term issuer rating on Unimicron to stable from negative to reflect sustained recovery in the company's profit margin.
- We are also affirming the 'twA' long-term and 'twA-1' short-term issuer credit ratings on Unimicron.

Rating Action Rationale

The outlook revision reflects our view that recent strengthening in **Unimicron Technology Corp.'s** profitability is likely to sustain over the next one to two years supported by a strengthened outlook for the company's IC substrate business and good progress in the production of new products. We believe that such business strengths could largely offset the negative effect of slowing global smartphone demand and rising competition in mature product segments amid escalating trade friction between China and the U.S. At the same time, Unimicron's improving operating cash flow generation should enable the company to maintain the ratio of debt to EBITDA below 2.5x over the next one to two years, despite higher capital expenditure over the same period.

We expect Unimicron to sustain its profit margin that has strengthened significantly over the past three quarters. The largest driver for the robust rebound comes from the improved performance of Unimicron's IC substrate business achieved through enhanced utilization. Meanwhile, enhanced pricing power for Unimicron's flip-chip ball grid array (FCBGA) business has also helped support the turnaround in the company's profit margin, given tightened market supply and rapidly expanding demand for emerging applications. These include high-performance computing, fifth generation (5G) mobile communications and AI. Unimicron incurred significant losses from these businesses over the past few years due to declining demand for PCs--the main application for FCBGAs. In addition, successful yield improvement in the production of advanced substrate-like printed circuit boards (SLPCB) has also contributed to the company's expanding margin.

In our view, Unimicron is well-positioned to capture the continued growth in demand for FCBGA, given the company's good market position in this segment. Unimicron possesses the highest capacity in the industry, a broad customer base in growing applications, and improved operating efficiency after the consolidation of its production facilities. We believe that growing demand driven by AI and 5G technologies will continue to outpace the industry's limited capacity additions over the next few quarters. These factors should in turn help to sustain Unimicron's high utilization and pricing power.

In addition, tense competition among major smartphone makers to make lighter and thinner smartphones with more functions could spur faster growth in sales of Unimicron's rigid-flex printed circuit boards (RFPCB) and substrate-like printed circuit boards (SLPCB) over the next one to two years. These two products should support moderate growth in Unimicron's high density interconnect (HDI) business based on the company's good competitiveness on these technologies, despite weaker sales of traditional and mature HDI products. At the same time, we expect the company's cost efficiency for the new technologies and products to improve further.

A deeper slowdown in global premium smartphone demand than we currently predict or intensified trade and technology disputes between China and the U.S. pose downside risks to our base case for Unimicron over the next few quarters. For example, pricing pressure could increase because Unimicron's biggest customers could seek to shed costs related to a potential rise in tariffs in order to sustain their margins.

Nonetheless, we believe Unimicron's enhanced profitability, particularly at its IC substrate business, should provide sufficient buffer to offset potential risks. We also expect Unimicron's above average business diversity to help the company counter significant near- and long-term industry volatility. However, diminishing product and technology differentiation, strong buyer power, and market fragmentation will also continue to constrain its long-term profitability and cash flow, despite Unimicron's recent improvement.

The rating affirmation is also based on our expectation that Unimicron could cap its ratio of debt to EBITDA below 2.5x in 2019-2021, despite substantial growth in the company's capital expenditure over the period. Unimicron's plan to spend New Taiwan dollar (NT$) 20 billion on a new plant for advanced IC substrates is likely to increase the company's total capital expenditure to NT$17 billion-NT$19 billion in 2020 and lead to material growth in its debt. Capital expenditure was NT$9 billion in 2018. However, the company's relatively low debt leverage as measured by its debt to EBITDA ratio of 1.5x in 2018, coupled with improved profitability provide significant financial buffer for Unimicron's relatively aggressive expansion plan, in our view. In addition, we believe that Unimicron has high flexibility to adjust its capital expenditure schedule to manage its debt leverage based on prevailing market conditions.

Outlook

The stable outlook reflects our view that Unimicron is likely to sustain profitability at its recently improved level over the next one to two years despite likely slowing smartphone sales and intense competition. We believe the tight supply of advanced IC substrates will support high utilization and favorable product pricing. We also expect yield improvement in the production of advanced HDI products to improve Unimicron's cost structure further.

At the same time, we expect the company to keep its ratio of debt to EBITDA ratio within 1.5x-2.2x over the next one to two years supported by its improving operating cash flow.

Downward scenario

We may lower the long-term issuer credit rating on Unimicron if the company's EBITDA margin weakens to below 12% for an extended period. Potential factors resulting in such a downside scenario include a slowdown in demand, low production yield rate or utilization, 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 and consistently above 2.5x. Weakening cash flow along with aggressive debt-funded capital expenditures or unexpected working capital outflows could lead to such an increase in debt leverage.

Upward scenario

The likelihood of an upgrade is low over the next 12 months, due to intense market competition and the company's relatively aggressive capital expenditure plan over the same period. However, we may raise the long-term rating if Unimicron could further enhance its technology competitiveness and improve its business scale, so as to improve its profitability materially and generate sustainable positive free operating cash flow. We may also raise the rating if the company can materially lower its debt level and maintain a ratio of debt to EBITDA close to 1.5x on a sustainable basis.

Our Base-Case Scenario

- S&P Global Ratings' projected growth in global GDP of 3.4% in 2019, 3.6% in 2020, and 3.6% in 2021; China's GDP growth of 6.2% in 2019, 6.2% in 2020, and 5.9% in 2021; and U.S. GDP growth of 2.2% in 2019, 1.7% in 2020, and 1.7% in 2021.
- We expect overall growth in the IT hardware industry to be flat to slightly positive over the next few quarters, 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.
- We believe slowing demand from leading smartphone brands could heighten market competition for some electronic component suppliers over the next few quarters.
- Taiwan Ratings' base-case scenario for Unimicron indicates 3%-6% revenue growth annually in 2019 and 2020, which is slightly stronger than the industry average with a stronger outlook for IC substrate sales
  - For IC carriers, we expect mid-single digit growth in 2019 and 2020. Robust demand growth of FCBGA driven by 5G applications and artificial intelligence, as well as limited capacity additions could keep market supply tight. This should support relatively healthy sales momentum and sustain average selling price over the next several quarters.
  - Revenue growth on HDI will be low-to-mid single digit per year in 2019-2020, supported by expanding adoption of its new products by more smartphone models. Likely slowing in smartphone unit sales for Unimicron's major customer could partly offset the revenue growth momentum.
  - Revenue of conventional PCBs will grow by 1%-3% annually in 2019 and 2020, driven by rising revenue contribution from its new Huangshi plant in China and growth in specialty products.
  - Revenue of flexible printed circuits will grow by 1-3% in 2019 and 2020.
- EBITDA margin will improve to 14%-15.5% in 2019-2020, up from 13.3% in 2018. This mainly reflects enhanced pricing power and material improvement in the utilization rate for IC substrates, and likely yield improvement in the production of advanced HDI products.
- Capital expenditure to rise to NT$10 billion-NT$12 billion in 2019 and NT$17 billion-NT$19 billion and 2020, from NT$8.9 billion in 2018, mainly for a new IC substrate plant.
- Dividend payout of 60%-65% in 2019-2020, similar to that in 2018.
- The same cash conversion cycle for the company in 2019-2020.

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

– EBITDA margin of 14%-15.5% in 2019-2020.
– Ratio of debt to EBITDA of 1.5-1.7x in 2019, similar to the 1.5x recorded in 2018, but to rise to 2.0x-2.3x in 2020 due to higher capital expenditure.
– Ratio of free operating cash flow to debt to lower to negative 5%-0% in 2019 and negative 25% to negative 30% in 2020.

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 1.3x-1.5x for the 12 months ending March 2020. 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. We also believe the company has generally prudent risk management to ensure continued adequate liquidity. 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 maintenance capital expenditure. Furthermore, we believe the company has sound bank relationships supported by its generally satisfactory standing in the 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$20.6 billion as of the end of March 2019.

– Fund from operations: NT$9 billion-NT$11 billion over the 12-months ending March 2020.

Principal Liquidity Uses:

– Long-term debt due in one year plus short-term debt: about NT$17.2 billion over the 12 months up to March 2020.

– Maintenance capital expenditure: NT$3 billion-NT$5 billion for the 12 months ending March 2020.

– Cash dividend payout of NT$1.165 billion in 2019.

Rating Score Snapshot

Issuer Credit Rating: twA/Stable/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 (+2 notches)

Stand-alone credit profile: twa

Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - June 26, 2018
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions - 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: Use Of CreditWatch And Outlooks - September 14, 2009

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Ratings List

Outlook Revision; Ratings Affirmed

Unimicron Technology Corp.

	To	From
Issuer Credit Ratings	twA/Stable/twA-1	twA/Negative/twA-1