FitchRatings

RATING ACTION COMMENTARY

Fitch Revises KCE's Outlook to Negative; Affirms at 'A-(tha)'

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Fitch Ratings - Bangkok - 11 May 2020: Fitch Ratings (Thailand) Limited has revised KCE Electronics Public Company Limited's (KCE) Outlook to Negative from Stable and affirmed its National Long-Term Rating at 'A-(tha)'.

The Negative Outlook reflects evolving risks from the COVID-19 pandemic that may prolong the recovery in KCE's revenue and profitability to beyond 2022. Fitch expects revenue in Thai baht terms to return to close to the pre-pandemic level by 2022, with EBITDA margin of above 13%. Failure to meet this expectation could indicate a weakened business profile, which may result in a negative rating action.

The affirmation reflects Fitch's expectation that KCE should be able to maintain its position as one of the global leading producers of printed circuit boards (PCBs) for the automotive industry, and the company's strong financial profile. Fitch believes the company's free cash flow (FCF) margin will remain above 3%, assuming rationalised capex plan and dividends, despite further weakening in revenue and earnings in 2020. The company's funds from operations (FFO) net leverage is likely to stay healthy at below 1.5x over the medium term.

KEY RATING DRIVERS

Pandemic to Reduce Revenue: Fitch expects KCE's revenue to fall by 20%-25%. We expect revenue to recover only gradually and a return to pre-pandemic levels could take two to three years. The automotive industry and its supply chain are under pressure on several fronts, including lower demand from the economic downturn, fuel emission regulatory risk and a potential fine for European car manufacturers, as well as a potential delay in the technology shift to electric powertrains from traditional combustion engines due to low fuel prices.

Weaker Margins: Fitch expect KCE's EBITDA margin to narrow to 8%- 10% in 2020 (2019: 15.9%) due to weaker capacity utilisation from lower sales. However, the EBITDA margin should gradually improve to 14%-16% in 2022 as the effects from the pandemic wane. Fitch believes that a ramp-up of KCE's new capacity and increasing sales of high-margin, multi-layered automotive PCBs should support the margin improvement, although Fitch does not expect KCE to regain its historic EBITDA margin of above 20% over the medium term.

Margins Subject to Currency Volatility: KCE was highly exposed to foreign-exchange fluctuations, which resulted in volatile EBITDA margins over the past six years. KCE is an exporter and its earnings generally hurt when the baht appreciates, as around 80%-90% of its revenue is in US dollars and euros, while around 50%-60% of costs are in Thai baht, which are mostly unhedged.

In addition, fixed costs ensure that lower production utilisation reduces profit margins. KCE's EBITDA margin declined to 15.4% in 2019 from 20.2% in 2018, after the baht appreciated by around 4% against the US dollar and sales volume fell by 11% during the period.

Strong Financial Profile: Fitch expects KCE to maintain a strong financial profile in the medium term despite weaker cash flows. The company's currently low financial leverage (0.5x at end-2019) and ability to generate FCF margin of above 3% should provide some cushion during the challenging operating environment. However, this is based on our expectation that KCE will pursue disciplined capital spending and dividend payments that track the availability of its cash flows.

Leading Auto PCB Producer: KCE's rating reflects its leading position in the automotive PCB business, which has longer product cycles and deeper customer engagement, providing higher barriers to entry and wider margins than those of

consumer electronic PCBs. The company is one of the world's top-10 automotive PCB makers, with revenue market share of around 5%.

Automotive PCBs have potential for growth over long term due to increasing penetration of electronics content in automobiles, despite near-term economic cyclicality. New applications, such as safety, driver assistance and infotainment systems, which were previously available only in luxury cars, are becoming standard in the mass middle market.

Reduced Customer Concentration: The expansion of KCE's high-density interconnect (HDI) segment, including non-automotive products, is likely to gradually decrease its customer concentration over the medium term. The company's five largest customers contributed about 50% of its total PCB revenue in 2019, reducing from about 65% in 2010.

DERIVATION SUMMARY

KCE's business profile is moderate relative to nationally rated Thai peers, but its financial profile is stronger. KCE's business and financial profiles are comparable with those of Polyplex (Thailand) Public Company Limited (PTL; A−(tha)/Stable), which is one of the top-10 polyester film producers in the world by revenue. PTL operates in a higher-risk industry, with the majority of its products being standard films that are commodities and face high competition. KCE focuses on the niche segment of automotive PCBs, which has higher barriers to entry. However, PTL has more geographically diversified operations and a broad customer base. Both companies have low financial leverage with net debt-to-EBITDA of below 1.5x. The ratings are therefore the same.

Eastern Polymer Group Public Company Limited (EPG, A-(tha)/Stable) and KCE both have businesses that supply the automotive industry, but different product offerings. EPG is a manufacturer of polymer and plastic automotive parts and accessories for utility trucks, which accounted for about 50% of its total revenue. EPG has a more diversified customer base across diverse end-user segments than KCE, given its diversified core businesses in thermal insulation and food and beverage plastic packaging. KCE and EPG have comparable operating scale but KCE generally has better EBITDA margin and FCF margin. With comparable business profile and similarly low financial leverage, their ratings are the same.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

Revenue to decline by around 30% in 2020 (2019: -13.5%), mainly due to the drop in automotive PCB demand following automotive manufacturing shutdowns in response to the coronavirus pandemic in 2Q20. Revenue to recover gradually by 13% in 2021 and 5%-6% in 2022.

EBITDA margin to deteriorate to 8%-10% in 2020 (2019: 15.9%). EBITDA margin to recover to 14%-15% in 2022 as utilisation improves and a higher proportion of sales from multi-layered PCB products.

Copper prices to decline in 2020, given a meaningful copper oversupply

Capex plan limited to maintenance and necessary technological upgrade of THB200 million-400 million per year over 2020-2022 (2019: THB634 million). No major expansion plan.

No dividend payment during the weak operating performance in 2020-2021.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The rating Outlook could be revised to Stable if KCE can maintain sound operating performance post-COVID-19, which may be evident in a recovery of its EBITDA margin to above 13%, while maintaining FFO net leverage below 1.5x on a sustained basis.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Lower cash flows or higher-than-expected investments or acquisitions leading to FFO net leverage above 1.5x on a sustained basis.

Decline in operating EBITDA margin below 13% over a sustained period.

A weakening in the company's market position or loss of key customers.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Manageable Liquidity: KCE had THB1.3 billion of debt due within one year as of end-2019. Most short-term debt is packing credits (bank loans for financing export activities), while THB259 million of long-term loans are due in 2020. The company has a cash balance of nearly THB1.0 billion, while its liquidity needs for working capital are supported by uncommitted revolving facilities of THB18.9 billion and USD83 million at end-2019.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING

ENTITY/DEBT	RATING		
KCE Electronics Public Company Limited	Natl LT	A-(tha)	Affirmed

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Ratings Criteria (pub. 18 Jul 2018)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 01 May 2020)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

KCE Electronics Public Company Limited -

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Technology, Media, and Telecom Corporate Finance Asia-Pacific Thailand

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