

QTC ENERGY PLC

No. 1/2020
7 January 2020

CORPORATES

Company Rating: BB+
Outlook: Stable

Last Review Date: 11/01/19

Company Rating History:

Date	Rating	Outlook/Alert
11/01/19	BB+	Stable
06/01/17	BBB-	Stable
24/12/14	BBB	Stable

Contacts:

Suchana Chantadisai
suchana@trisrating.com

Nauwarut Temwattanangkul
nauwarut@trisrating.com

Parat Mahuttano
parat@trisrating.com

Monthian Chantarklam
monthian@trisrating.com



WWW.TRISRATING.COM

RATIONALE

TRIS Rating affirms the company rating on QTC Energy PLC (QTC) at “BB+” with a “stable” rating outlook. The rating reflects QTC’s fair competitive position, growth opportunities in export markets, predictable cash flow from electricity sales, and satisfactory financial profile. However, these strengths are weighed down by the company’s high susceptibility to market downturns, intense competition in the domestic transformer market, and the execution risks associated with new power projects.

KEY RATING CONSIDERATIONS

Fair competitive position

TRIS Rating holds the view that QTC has a fair competitive position in the domestic transformer market. QTC is a medium-sized manufacturer of electrical transformers, producing distribution transformers under its own brand. QTC’s market status is underpinned by its expertise in this field, product development strengths, and manufacturing know-how.

The company’s brand recognition is built on its track record of successful contract bidding and execution of projects for state-owned utilities. The domestic market comprises about 30 manufacturers of distribution transformers. QTC has held a market share of around 9% for several years.

Despite its strengths, QTC exhibits a significant customer concentration. Around 40%-50% of sales come from three major customers, comprising the two state-owned electricity distributors and an export agent in Australia. QTC is also highly susceptible to market downturns, given the scope of its product offerings. Added to that, the company has limited ability to pass on increases in production costs, in light of the intense competition. This results in untenable profitability.

Operating performance on the mend

QTC has demonstrated improved results in its core business. For the first nine months of 2019, QTC’s operating performance exceeded our estimates, due in large part to its heightened gross margin on transformer sales. Sales of transformers grew by 10% year-on-year (y-o-y), while gross margin rose markedly to about 31%, in contrast to about 13% in the previous two years. Earnings before interest, tax, depreciation, and amortization (EBITDA) of the transformer segment improved considerably, to Bt130 million for the first nine months of 2019 from Bt17 million in 2018. However, the sustainability of such heightened performance is questionable as the outlook for the transformer market remains gloomy.

Meager outlook for the transformer industry

TRIS Rating has slashed its outlook for the domestic transformer market. Demand for electrical transformers hinges primarily upon the expansions of power infrastructure. This includes increases in installed production capacity, expansion of transmission systems, and growth of private investment for industrial and residential purposes.

In our view, domestic demand for electricity will continue to grow, but at a slow pace. Domestic transformer producers will continue to endure the slow-moving procurement proceedings and delayed bidding of the electricity authorities. Meanwhile, private-sector investment remains sluggish. For the first nine months of 2019, both public and private investments were lower

than expected, representing a mere 2.6% growth y-o-y.

We hold the view that QTC is highly susceptible to the impact of a sluggish market. The previous downturn illustrates the view. The domestic market tumbled in 2016, resulting in a sales slump and intense competition. Like most of other producers, QTC experienced a precipitous falloff in sales and heavy markdowns of its merchandises.

Export market is a key driver for a turnaround

QTC's export sales have consistently grown over recent years. For the first nine months of 2019, export sales amounted to Bt185 million, a 2% increase y-o-y. In our view, export sales represent the key driver for a turnaround in QTC's performance. The company's main overseas bases are Australian and Japanese markets where QTC can offer premium products. The gross margin for exports ranges from 20% to 30%. Added to the higher profit margin, the geographically diversified revenue base will help offset weaker sales in the languishing domestic market.

Predictable cash flows from solar power

In addition to revenue from transformer sales, QTC generates predictable cash flow from its solar power business. The company owns a solar farm, which operates under a long-term power purchase agreement (PPA) with the Provincial Electricity Authority (PEA). Cash flow from the solar farm is predictable, thanks to the committed tariff and low operational risks. Payment risk is minimal and the PPA is non-firm basis.

The performance of QTC's solar farm is considered satisfactory. EBITDA from the solar power business is expected to reach around Bt120 million per year. However, such sizable cash flows are not sustainable in the long term. EBITDA will decline steeply after the incentive adder expires in December 2021. TRIS Rating forecasts QTC's EBITDA for the solar power business to drop to around Bt20 million in 2022, representing an 83% decrease from the current level.

Execution risks of new power projects

In a bid to countervail the wavering profits in its transformer business, QTC has attempted to invest in new power projects. However, since the acquisition of its first solar project, these efforts have not carried through. Given QTC's limited experience in the power sector, TRIS Rating does not expect the company to engage in green-field developments. Instead, the company is likely to acquire operating projects from existing owners, which generally bring in less attractive returns. Furthermore, the tariffs for new renewable power projects in Thailand are becoming less attractive as the domestic power supply market becomes increasingly competitive.

With diminishing growth opportunities in the domestic market, QTC has looked for growth in neighboring countries. However, overseas ventures will expose the company to higher project risks, including counterparty risk, regulatory risk, curtailment risks, and more. Given the company's limited resources, we do not expect any overseas power projects taking off in the near term.

Satisfactory financial profile

QTC's leverage remains low, following a series of capital increases. Total debt stood at Bt189 million as of September 2019, while the total debt to capitalization ratio was a low 11%. QTC holds a comfortable liquidity position, with cash and short-term investments of Bt640 million as of September 2019.

In our base case forecast for 2020-2022, we assume transformer sales to grow at 5% each year. The gross margin for transformer sales is anticipated to be at least 16%. As a result, QTC is expected to generate around Bt1.0 billion in revenue per year. With no new power projects forecast, EBITDA is projected to be around Bt160 million per year in 2020 and 2021, before declining sharply to around Bt60 million in 2022 following the expiration of incentive tariffs for solar power.

We expect QTC to remain prudent in its investment strategy. Leverage is expected to remain minimal while the company should maintain sufficient liquidity for its operational needs. In the event of new investments, we expect the outlays will not materially hurt QTC's financial profile.

BASE CASE ASSUMPTIONS

- Sales of transformers to grow by 5% each year.
- Gross margin for transformer sales to be 16%.
- Revenue from solar power to be in the range of Bt140-Bt150 million per year in 2020-2021, and Bt50 million in 2022.
- Overall gross margin to be 24% in 2020 and 2021, and 15% in 2022.
- No major investments during the forecast period. Maintenance capital expenditure to be Bt55 million per year.

RATING OUTLOOK

The “stable” outlook reflects the expectation that QTC will maintain its competitive position in the distribution transformer segment. QTC is expected to secure more orders as the market recovers and continue to expand its export sales. In expanding its power business, QTC should conduct prudent assessments of the associated risks involved in any new investments to ensure the returns are satisfactory and consistent with targets. Any investment spending should not jeopardize the company’s financial profile.

RATING SENSITIVITIES

QTC’s rating could be upgraded if operating performance improves significantly on a sustained basis. Downward rating pressure would emerge if the company undertakes any sizeable debt-financed investments which cause significant deteriorations in capital structure and cash flow protection. The rating could also be revised downward if operating performance worsens and the return on new projects is unsatisfactory.

COMPANY OVERVIEW

QTC was established in 1996 by Mr. Poonhiphat Tantanasin. It was listed on the Market for Alternative Investment (MAI) in July 2011. The shareholding structure changed significantly after the company raised new equity capital through private placements in 2016 and 2017. As of November 2019, the new shareholders (comprising seven individual investors) owned 51%, while Loxley PLC and Leonics Co., Ltd. held 6%. Mr. Poonhiphat Tantanasin and his family held 7%.

QTC is a medium-sized manufacturer of electrical transformers. QTC’s products comprise distribution transformers, small power transformers, super low loss transformers, and special transformers. QTC can produce transformers at power levels from 1-30,000 kilovolt-amperes (KVA) at system voltages of up to 72 kilovolts (kV).

QTC has branched into the power business by investing in a solar power project, in a bid to offset declining earnings from the transformer segment. QTC acquired solar power producer, Q Solar 1 Co., Ltd. (QS1), which owns and operates a solar power plant in Prachinburi province. QS1 secured a multi-year power purchase agreement with the PEA under the Very Small Power Producer (VSPP) scheme. With contractual capacity of eight megawatts (MW), QS1 receives an adder of Bt8 per kilowatt hour (kWh) on top of the power tariff for 10 years, starting from its commercial operating date since December 2011. QS1’s revenue and EBITDA in the first ten months of 2019 were Bt120 million and Bt105 million, respectively.

For the first nine months of 2019, QTC’s revenues were derived from sales of distribution transformers (82% of total revenue) and solar power (15%), with the remainder coming from services. During the same period, QTC’s transformer customers comprised state enterprises (35%), private companies including agents (33%), and export customers (32%).

KEY OPERATING PERFORMANCE

Table 1: QTC's Revenue Breakdown

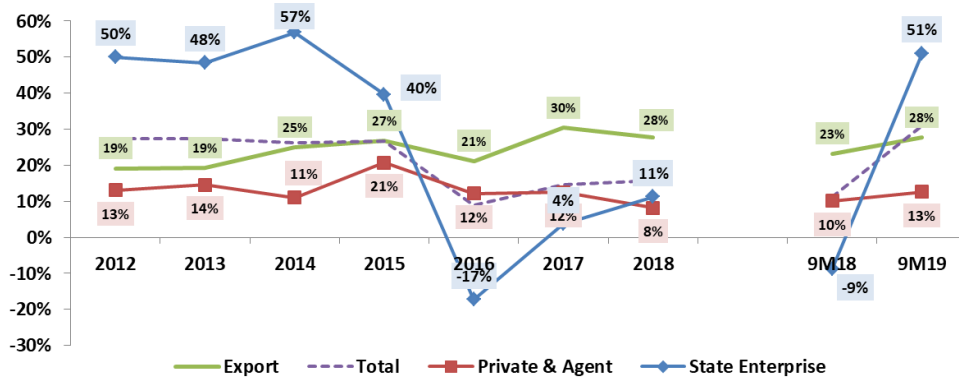
Unit: %

By Product Segment	2014	2015	2016	2017	2018	Jan-Sep 2019
Transformers	97	97	97	93	82	82
Solar power	-	-	-	4	15	15
Services	2	2	2	2	2	2
Others	1	1	1	1	1	1
Total	100	100	100	100	100	100
Sales (Bt million)	761	1,229	531	902	958	702

Note: Consolidated basis

Source: QTC

Chart 1: QTC's Transformer Gross Margin by Customer



Source: QTC

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS *

Unit: Bt million

	Jan-Sep 2019	-----Year Ended 31 December -----			
		2018	2017	2016	2015
Total operating revenues	714	973	912	538	1,235
Earnings before interest and taxes (EBIT)	166	56	(44)	(92)	159
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	223	131	4	(48)	199
Funds from operations (FFO)	211	98	(5)	(37)	159
Adjusted interest expense	7	16	15	8	9
Capital expenditures	41	70	57	44	22
Total assets	1,935	1,919	2,037	1,221	1,069
Adjusted debt	0	0	380	56	139
Adjusted equity	1,593	1,442	1,442	758	573
Adjusted Ratios					
EBITDA margin (%)	31.23	13.46	0.41	(9.01)	16.08
Pretax return on permanent capital (%)	12.65 **	3.02	(2.95)	(9.66)	22.18
EBITDA interest coverage (times)	31.49	8.43	0.25	(6.10)	22.36
Debt to EBITDA (times)	0.00 **	0.00	100.51	(1.15)	0.70
FFO to debt (%)	n.m. **	n.m.	(1.41)	(67.08)	113.91
Debt to capitalization (%)	0.00	0.00	20.86	6.83	19.54

* Consolidated financial statements

** Annualized from the trailing 12 months

n.m. Not meaningful

RELATED CRITERIA

- Rating Methodology – Corporate, 26 July 2019
- Key Financial Ratios and Adjustments, 5 September 2018

QTC Energy PLC (QTC)

Company Rating:	BB+
Rating Outlook:	Stable

TRIS Rating Co., Ltd.

Silom Complex Building, 24th Floor, 191 Silom Road, Bangkok 10500, Thailand Tel: 0-2098-3000

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