TRIS RATING
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QTC ENERGY PLC

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CORPORATES

Company Rating:	BB+
Outlook:	Stable

Last Review Date: 15/01/18

Company Rating History:

Date	Rating	Outlook/Alert
06/01/17	BBB-	Stable
24/12/14	BBB	Stable

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RATIONALE

TRIS Rating downgrades the company rating on QTC Energy PLC (QTC) to "BB+" from "BBB-". The downgrade reflects a further drop in the operating results in the transformer segment and a dismal outlook for the domestic market for electrical transformers.

The rating reflects QTC's moderate competitive position, growth opportunities in export markets, and predictable cash flows from the solar power segment. However, these strengths are weighed down by the intense competition in the domestic transformer market, and the execution risks associated with new power projects. In addition, QTC's strategic direction remains unclear due to changes in shareholders during the past few years.

KEY RATING CONSIDERATIONS

Operating performance slides in transformer segment

The rating downgrade is built on an ongoing drop in operating performance. Efforts to revive have not yet paid off. Earnings before interest, tax, depreciation, and amortization (EBITDA) did increase from Bt3 million in 2017 to Bt54 million in the first nine months of 2018. However, this rise fell short of our expectation. QTC's business turnaround tends to draw out.

TRIS Rating holds the view that QTC has a fair competitive position in the industry. Like other domestic producers of transformers, QTC has been hurt by an industry-wide slowdown and intensified competition. The domestic transformer market tumbled since 2016. Two lingering effects of the downturn are a sales slump and heavy markdowns, taken by makers of electrical transformer, in an effort to spur sales.

The industry slump led to a drop in production at QTC. For the first nine months of 2018, transformer sales declined by 16% year-on-year (y-o-y), far below our expectation. Profitability weakened further. The gross margin of transformers nearly halved, plunging to 7% in the first nine months of 2018, down from 13% in full year of 2017. Domestic transformer sales, account for the largest (70%) portion of sales. This segment reported a negative gross margin of 2% in the first nine months of 2018, compared with positive 6% for all of 2017. Gross profit of state enterprises segment, an important customer segment, remains mired.

TRIS Rating has slashed the outlook for the domestic transformer market, even though demand for electricity is rising. The domestic producers of transformers must contend with delays in bidding and the awarding of contracts by state-owned electricity authorities. Demand from clients in the private sector has flagged as well.

New opportunities abroad

Despite the poor results in the domestic segment, export markets were one bright spot for QTC. Export sales rose to a record Bt243 million in 2017. The export segment continued to grow, delivering Bt183 million in sales for the first nine months of 2018, a 7% y-o-y rise. The majority of QTC's export customers are in Australia and Japan. The gross margin from export sales has ranged between 20%-30% over the past few years. TRIS Rating believes the key to QTC's turnaround is greater export sales.

The domestic market continues to account for the vast majority of sales. As a result, TRIS Rating does not expect a quick turnaround in QTC's transformer segment. Given the gloomy outlook, TRIS Rating expects transformer sales will range from Bt800-Bt950 million annually during 2018-2021. Tough competition will continue to pressure profitability. The gross margin for transformers could gradually recover to 12%-16%. Even if this rebound happens, the gross margin would be far below the 23%-27% levels recorded during 2012-2015.

Solar power segment yields predictable cash flows

In an effort to offset the poor fortunes of the transformer segment, QTC acquired a solar power producer, Q Solar 1 Co., Ltd. (QS1). QS1 owns and operates a solar farm. QS1 has a long-term power purchase agreement with the Provincial Electricity Authority (PEA). The solar power project generates predictable cash flows because the tariff is specified in the contract. Payment risk is minimal because the buyer of the power is a state-owned enterprise. In addition, the solar power plant carries low operational risk. QTC has consolidated QS1's performance since late September 2017.

TRIS Rating expects EBITDA from the solar power segment will be around Bt120 million a year. That said, TRIS Rating holds the view that the performance boost from the solar power segment is not sustainable in the long term. EBITDA will fall sharply after the adder tariff expires in December 2021. In addition, QTC paid a high price to acquire QS1. As a result, QTC incurred a hefty allowance for impairment of Bt193 million. This allowance exacerbated the loss reported in 2017.

Execution risks of new power projects

QTC tries to expand by becoming a producer of electricity. This effort is another bid to decrease the volatility in the company's revenue stream. However, QTC's track record in the power segment is very limited. Although the diversification effort could boost revenue, the company faces significant execution risks as it undertakes new projects. QTC will be exposed to country risk, regulatory risk, counter-party risk, and more should it choose to expand abroad. A recent event is illustrative. In the first quarter of 2018, QTC called off its investment in the Minbu project, a 220-megawatt (MW) solar power project in Myanmar. The long delays in development threatened the viability of the project. QTC lost about Bt20 million when it cancelled the project.

QTC has conducted feasibility studies and due diligence for several projects, including hydro-power plants in the Lao People's Democratic Republic (Lao PDR) and a solar power plant in Japan. TRIS Rating believes there are remote chances of any new power projects abroad taking off in the near term.

Changes in major shareholders cause loss of strategic direction

QTC's shareholding structure changed significantly over the past few years. The changes brought lingering concerns over the continuity and strength of QTC's core business. The new ventures carry significant execution risks.

The shareholding structure changed significantly after the company raised new equity capital through private placements in 2016 and 2017. QTC also issued new shares to Loxley PLC (LOXLEY) and Leonics Co., Ltd (Leonics) to pay for the acquisition of QS1. As of December 2018, the new shareholders (comprising seven individual investors) owned 57%, while LOXLEY and Leonics held 6%. Mr. Poonphiphat Tantanasin and his family held 7%, diluted from 62% at the end of May 2016. In the wake of the significant changes in shareholding, the management team and QTC's strategy are expected to change.

Acceptable leverage and liquidity

Leverage remains low, given the series of capital increases. Total debt stood at Bt309 million as of September 2018. The total debt to capitalization ratio was low at 15%. The company has ample liquidity; cash and short-term investments amount to Bt520 million. QTC has around Bt460 million in short-term investments, the cash remaining from the recent capital increases.

In TRIS Rating's base case forecast, we assume that QTC will invest some of its excess cash in a power project. The project carries a cost of approximately Bt1.2 billion.

Total revenue will grow from Bt1.0 billion in 2018 to Bt1.3 billion by 2021. The operating margin (operating income before depreciation and amortization as a percentage of sales) will increase from around 8% in 2018 to 16%-18% by 2021. EBITDA will grow from Bt80 million to Bt220 million over the forecast period. The investment in the new power project will squeeze QTC's financial profile in the near term, but the project will yield recurring income to offset lower profits in the transformer segment.

In all, TRIS Rating expects that QTC will not overinvest and will maintain leverage and liquidity at acceptable levels. We forecast that the total debt to capitalization ratio could rise to nearly 40% and the ratio of debt to EBITDA could increase to 5 times while the power project is under development. Both ratios should decline steadily once the new project begins to pay off.

BASE-CASE ASSUMPTIONS

- We assume transformer sales will carry a gross margin of around 16%. Overall gross margin will range between 20%-23%. The operating margin will range between 16%-18%.
- We assume QTC will invest some spare cash in a Bt1.2 billion power project. The investment would be made in 2019 and 2020.
- Revenues will grow by around 3%-15% per annum over the next three years.

RATING OUTLOOK

The "stable" outlook reflects the expectation that QTC will maintain its competitive position in the electrical transformer industry. QTC is expected to secure more orders as the market recovers. QTC should conduct prudent assessments of the associated risks of any new investment to ensure the returns are satisfactory and consistent with the plans.

RATING SENSITIVITIES

QTC's credit rating could be upgraded if the operating performance improves significantly. Downward rating pressure would emerge if the company undertakes any sizeable debt-financed investments which cause further deteriorations in the balance sheet and cash flow protection. The rating could also be revised downward if operating performance worsens.

COMPANY OVERVIEW

QTC was established in 1996 by Mr. Poonphiphat Tantanasin. It was listed on the Market for Alternative Investment (MAI) in July 2011. QTC is a medium-sized manufacturer of electrical transformers, providing products under its own brand "QTC". QTC can produce transformers at power levels from 1-30,000 kilovolt-amperes (KVA) at system voltages of up to 72 kilovolts (kv).

QS1, a subsidiary, owns and operates a solar power plant located 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 8 MW, QS1 receives 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 11 months of 2018 were Bt130 million and Bt106 million.

For the first nine months of 2018, QTC's revenue came from sales of distribution transformers (81% of total revenue), solar power (16%), and the rest from services. During the same period, QTC's transformer customers comprised state enterprises (18%), private companies including agents (47%), and export customers (35%).

KEY OPERATING PERFORMANCE

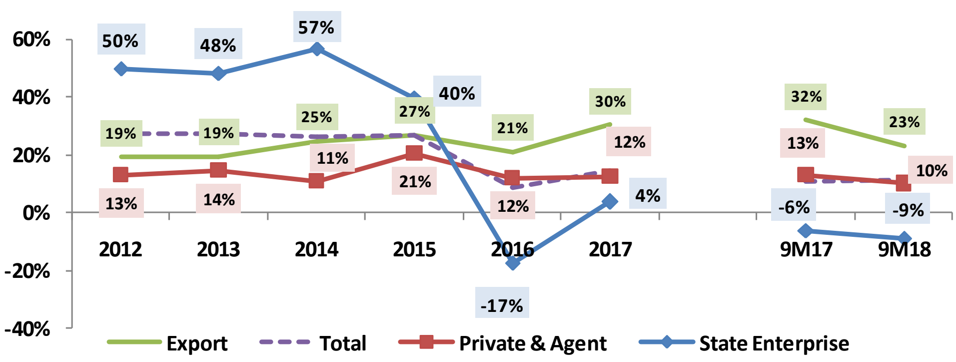
Table 1: QTC's Revenue Breakdown

Unit: %

By Product segment	2013	2014	2015	2016	2017	9M18
Transformers	97	97	97	97	93	81
Solar power	-	-	-	-	4	16
Services	2	2	2	2	2	3
Others	1	1	1	1	1	1
Total	100	100	100	100	100	100
Sales (Bt mil.)	**800**	**761**	**1,229**	**531**	**902**	**642**

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

		--------------Year Ended 31 December -----------			
	Jan-Sep 2018	2017	2016	2015	2014
Total operating revenues	655	912	538	1,235	768
Operating income	51	1	(50)	199	111
Earnings before interest and taxes (EBIT)	(1)	(45)	(92)	159	77
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	54	3	(48)	199	116
Funds from operations (FFO)	22	(6)	(37)	159	93
Adjusted interest expense	12	15	8	9	8
Capital expenditures	60	57	44	22	47
Total assets	1,867	2,037	1,221	1,069	713
Adjusted debt	242	380	56	139	34
Adjusted equity	1,389	1,442	758	573	488
Adjusted Ratios					
Operating income as % of total operating revenues (%)	7.77	0.07	(9.33)	16.13	14.47
Pretax return on permanent capital (%)	2.16	(2.98)	(9.66)	22.18	12.67
EBITDA interest coverage (times)	4.35	0.23	(6.10)	22.36	15.09
Debt to EBITDA (times)	2.41	111.80	(1.15)	0.70	0.29
FFO to debt (%)	25.21	(1.51)	(67.08)	113.91	278.56
Debt to capitalization (%)	14.82	20.86	6.83	19.54	6.43

RELATED CRITERIA

- Key Financial Ratios and Adjustments, 5 September 2018
- Rating Methodology – Corporate, 31 October 2007

QTC Energy PLC (QTC)

Company Rating:	BB+
Rating Outlook:	Stable

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