Media Release

CTCI Corp. Assigned 'twA/twA-1' Ratings; Outlook Stable

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Rating Action Overview

- We expect CTCI's sustained domestic market leadership, expanding overseas operating scale, and improving business diversity to underpin its competitive position in the next one to two years. The company's smaller operating scale compared with its global large-scaled EPC peers' and weaker profit margin in its overseas EPC business partly temper these strengths.
- We expect high volatility in CTCI's working capital movement and rising capex to constrain material improvement in financial debt leverage over the next one to two years.
- On Oct. 16, 2019, Taiwan Ratings Corp. assigned its 'twA' long-term and 'twA-1' short-term issuer credit ratings to CTCI.
- The rating outlook is stable to reflect our view that CTCI's improving operating cash flow driven by robust revenue growth, could partially offset the pressure on its credit metrics from higher working capital and capex needs. This could enable CTCI's ratio of debt to EBITDA to maintain at 2.0x-3.0x in the next one to two years.

Rating Action Rationale

The ratings on CTCI reflects the company's market leadership in Taiwan's engineering, procurement and construction (EPC) sector, satisfactory market position in its focused overseas markets including Southeast Asia and the Middle East, proven technical expertise in the implementation of large complex projects, and improving diversity in end market and product offerings. Tempering these strengths are the company's smaller revenue scale compared with those of global peers, relatively limited overseas presence constrained by intense competition with large global players, weaker margin in its core EPC business, and high working capital requirements.

Founded in 1979, CTCI is the leading EPC services provider in Taiwan, with a considerable gap ahead of the second largest domestic player in terms of revenue scale. CTCI specializes in the hydrocarbon industry, and actively participates in international power, environmental, transportation and industrial markets. According to Engineering News-Record (ENR), CTCI ranked 76 out of the top 250 international contractors in 2018.

CTCI has a presence in 15 countries. The company's consolidated revenue stood at New Taiwan dollar (NT$) 27.1 billion for the first two quarters of 2019, with about 36% derived from Southeast Asia, 33% from Taiwan, 11% from the Middle East and 10% from China. In our view, CTCI's improving geographic diversity could help to mitigate the structurally high cyclicality of its EPC business. Furthermore, CTCI's recent penetration into the U.S. market could bring the company further growth potential, given the positive prospects of the hydrocarbon industry in that region. This is despite our view that the company will continue to adopt a prudent appetite in new market expansion over the next one to two years, given its unfamiliarity with local practices and inherent execution risks in the U.S market.

We expect CTCI to sustain its dominant domestic market share in its core competence area for the next two to three years, particularly in the hydrocarbon and power sector. We base this on our view that the company's rich expertise and solid operating track record of implementing large and technically complex landmark projects will underpin its competitive strengths, making it difficult for domestic competitors to catch up over the next two years. We also expect CTCI's EPC business in other sectors to have moderate growth thanks to the company's technological capabilities, established global network, reputation, and brand recognition.

We have high visibility over CTCI's future revenue, supported by a solid order book, with a backlog-to-revenue ratio of 2x-3x. Solid demand from hydrocarbon, environmental, and transportation both domestically and abroad largely drive this revenue. We also believe CTCI's increasing business diversity by providing wider end-market exposure could somewhat offset risks related to its core EPC business, which is cyclical and volatile. As of the end of August 2019, environmental services accounted for 41% of CTCI's backlog value, 30% came from hydrocarbon business, industrial (11%), power (10%), and transportation (8%).

We believe rising the revenue and profit contribution from environmental services could add stability to CTCI's future revenue streams for its recurring income under the protection of long-term contracts. In our view, CTCI could sustain its strong position as one of the largest operation and maintenance service provider of incinerators in Taiwan in terms of capacity provided. We base this on our view that the domestic oligopolistic market structure will maintain or further consolidate because smaller players are likely to exit the market due to lack of economies of scale. This will benefit CTCI by solidifying its market position and supporting its good profit margin. We also believe the group's engineering capability is a strong backup for its environmental services because of its superior operation and maintenance expertise and better access to fixed assets. However, CTCI could expand at a slower rate in this business segment overseas because of higher entry barriers for non-local operators.

In our view, CTCI's EBITDA margin is likely to remain slightly weaker than the globally industry average, but largely in line with that of its close peers that have a higher focus on the hydrocarbon sector. Intense competition in a highly fragmented EPC industry and volatile cost fluctuations that are difficult to pass through to its customers under lump-sum contracts are likely to constrain material improvement in CTCI's profitability in the next two years. However, the rising contribution from the company's environmental business could be positive to its overall margin trend. We believe the industry nature of high entry barriers and switching costs driven by complex regulatory permits could hinder competition and help maintain an oligopolistic structure in the domestic environmental services market. This could in turn allow CTCI to sustain a higher operating margin over the same period.

Despite our view of steady revenue growth momentum with expanding overseas footprints, CTCI's operating scale could remain smaller than its larger global peers' considering slowing growth in the domestic market, the company's prudent expansion appetite, and high fragmentation in the global industry. We also expect CTCI to face margin pressure and earnings instability for its EPC business. Inherent operating and execution risks that contractors bear, including the complexity of project implementation, potential cost overruns, and misjudging project timing and expenses, could cause significant cost increases that CTCI cannot pass on for most of the projects under fixed-cost contracts and amid intense competition in the company's focused areas. CTCI's good operational standards and risk controls partly offset such risks, in our view. These factors constrain our assessment on CTCI's business risk profile.

We expect CTCI to maintain its ratio of debt to EBITDA at 2.0x-3.0x in 2019-2020, weakening from the company's net cash position at the end of 2017. This reflects working capital swings that resulted in significant cash outflow during the past several quarters, and weaker operating cash flow in 2018, given about 10% revenue decline. In our view, the company's operating cash flow generation will grow robustly in 2019, driven by 8%-12% revenue growth with healthy new orders in 2018. However, we do not expect any material change in CTCI's high working capital needs and associated debt burden over the next one to two years, because of likely slower cash collections from several large projects. In addition, the company's likely higher capital expenditure in the next one to two years could also constrain improvement in its financial risk profile.

Meanwhile, we believe the company's cash flow protection measures could remain volatile, given CTCI's smaller operating scale and high volatility in working capital movements. Nonetheless, we expect CTCI to maintain strong interest coverage ratios. That is because we believe low interest rates in Taiwan and CTCI's high credit standing in the local financial market backed by the group's reputation and market leadership will continue to support CTCI's favorable funding costs.

Taiwan Ratings' base-case scenario for CTCI indicates 8%-12% annual revenue growth in 2019 and 2020, following a 10% revenue decline in 2018. Our assumptions for this are:

- Taiwan's GDP growth of 2% in 2019 and 2020; APAC's GDP growth of 4.9% in 2019 and 4.8% in 2020; and GDP growth for the Middle East and North Africa of 2.1% in 2019 and 3.7% in 2020.
- We expect the global EPC market to grow modestly in 2019 and 2020. S&P Global Ratings' positive outlook for the global oil and gas industry could support stronger demand growth in North America. We also expect demand from general industrial and environmental segments to remain steady.
- CTCI's revenue declined by about 10% in 2018, due to lower new contracts taken in 2017 but we expect the company's revenue to grow robustly at 8%-12% in 2019 and 2020, which is stronger than the industry average. This reflects CTCI's healthy new order backlog in 2018 amid good prospects for the hydrocarbon and general industrial sector in its key markets. These include Taiwan, Southeast Asia and the U.S., in which market the group was awarded the first hydrocarbon project in 2018.
- We expect CTCI's backlog value to rise further in 2019 and 2020 from a high base as of the end of 2018, considering the number of potential mega projects on which the company plans to bid.
- We expect CTCI's EBITDA margin to recover to 5.8%-6.5% in 2019 and 2020, from 5.6% in 2018, through strong revenue growth and the company's more selective bidding strategy for higher-margin projects going forward, given its currently high workforce loading.
- We expect working capital outflow of NT$1 billion-NT$3 billion in 2019 and 2020 because of slow cash conversion from large projects.
- Capital expenditure (capex) to increase significantly to NT$2.5 billion-NT$ 3.5 billion in 2019 and NT$1 billion-NT$2 billion in 2020 from NT$982 million in 2018.
- Long-term investments of NT$1.3 billion in 2019 mainly for capital injections into newly-established entities to take government projects.
- We assume the group's dividend payout ratio will remain similar with those in previous years.

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

- EBITDA margin of 5.8%-6.5% in 2019 and 2020.
- Ratio of debt to EBITDA at 2.0x-3.0x in 2019 and 2020.
- Ratio of free operating cash flow (FOCF) to debt to be negative in 2019, and to be positive 5%-15% in 2020.

Liquidity: Adequate

The short-term issuer credit rating is 'twA-1'. We believe the company has adequate liquidity reflecting a ratio of liquidity sources to liquidity uses of 1.4x-1.5x over the 12-month period ending June 2020. We also believe the company will have positive liquidity sources minus uses, even if its EBITDA declined by 15%.

In our assessment, CTCI can absorb high-impact, low-probability events with limited need for refinancing, given its high cash balance and steady cash flow generation. We also believe the company has a sound relationship with banks as evidenced by the low interest rate on its bank loans. The company's high standing in local credit markets because of its domestic market leadership also supports this view. In our opinion, CTCI has generally prudent risk management to ensure continued adequate liquidity. The company's sufficient undrawn bank credit lines and flexibility to increase bank facilities support this view. CTCI does not carry any financial covenants on its debts.

Principal Liquidity Sources:

- Cash and short-term investments: about NT$18 billion as of the end of June 2019.
- Funds from operations: NT$3.4 billion-NT$3.7 billion for the 12-month period ending June 2020.

Principal Liquidity Uses:

- Debt maturities: about NT$10.8 billion for the 12-month period ending June 2020.
- Maintenance capital expenditure: NT$300 million-NT$600 million.
- Working capital outflow: NT$1 billion-NT$3 billion for the 12-month period ending June 2020.
- Cash dividend: about NT$1.7 billion in 2019.

Outlook

The stable outlook reflects our expectation that CTCI's solid domestic market position and increasing contribution from higher margin environmental services should enable the company to improve its profit margin slightly in the next one to two years. We also expect CTCI to restore its revenue growth at 8%-12% per year in 2019 and 2020, underpinned by an already secure backlog and new project intake. These factors could enable the company to generate improving operating cash flows and maintain its ratio of debt to EBITDA within 2.0x-3.0x over the next two years. This is despite our view that CTCI's working capital swings will remain significant, and its capex and long-term investments could be higher for the construction of the second headquarter and equity investments for the new projects intake.

Downward scenario

We could lower the long-term rating if the group's ratio of debt to EBITDA weakens to above 3x persistently without prospects of recovery. This could happen if the company fails to achieve effective collection of working capital that results in larger cash outflow than we originally expected, CTCI incurs large losses in the implementation of a project, or if the company faces more intensified competition that results in a material deterioration in its profit margin. This could also happen if CTCI's debt burden materially rises due to consolidation of debt-heavy build-operate-transfer projects operated by its subsidiaries.

Upward scenario

We could upgrade CTCI if the company could improve its ratio of debt to EBITDA to close 1.5x. This could happen if CTCI reduces its working capital volatility materially through more effective management. This may also happen if the company could improve its profit margin further, possibly through stronger project management, or an increasing contribution from higher-margin products such as environmental services.

Rating Score Snapshot

Issuer Credit Rating: twA/Stable/twA-1

Note: All scores are in comparison with global obligors.

Business risk: Fair

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

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: twa

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twa

Related Criteria

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- ARCHIVE | General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Engineering And Construction Industry - November 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Environmental Services Industry - February 12, 2014
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- ARCHIVE | Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology - November 19, 2013
- Understanding Taiwan Ratings' Rating Definitions - June 26, 2018

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

Ratings List

New Ratings	
CTCI Corp.	
Issuer Credit Rating	twA/Stable/twA-1

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.taiwanratings.com for further information. Complete ratings information is available to subscribers of Rating Research Service at rrs.taiwanratings.com.tw. All ratings affected by this rating action can be found on Taiwan Ratings' public website at www.taiwanratings.com.