Media Release

USI Corp. Affirmed At 'twA-/twA-2' On Recovering Cash Flow; Outlook Stable

November 28, 2019

Overview

- We expect declining raw material costs and stronger EVA demand to sustain USI's restored profitability over the next one to two years.
- Recovering cash flow should alleviate the negative effect on USI's leverage from its large investments in the Gulei chemical complex, and help USI to keep its ratio of debt to EBITDA at about 3x in 2020 and lower afterward, assuming no other major investments.
- On Nov. 28, 2019, Taiwan Ratings Corp. affirmed its 'twA-' long-term and 'twA-2' short-term issuer credit ratings on USI.
- The rating outlook is stable to reflect our view that strengthening cash flow and lower capital spending after the Gulei investment should enable USI to lower its ratio of debt to EBITDA gradually after peaking at about 3x in 2020.

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Rating Action Rationale

USI could cap its ratio of debt to EBITDA at about 3x in 2020 before deleveraging through likely strengthening cash flow, despite continued capital injections into the Gulei project.

Lower feedstock cost and likely improving demand for part of USI Corp.'s major products (i.e. EVA and PVC) will support improvements in the company's product spread. At the same time, we do not expect **USI Corp.** to take on significant additional investment or capital expenditure in the next two years other than the project in China's Gulei. These factors could support a gradual debt deleverage and sustain its ratio of debt to EBITDA at about 3x or lower in 2019-2020 before further deleveraging.

We expect lower feedstock costs due to easing supply tightness to support margin recovery in the following several quarters.

USI's margin eroded significantly in the second half of 2018, due to a sharp price increase in ethylene, a major feedstock of its chemical products. However, we believe ethylene prices are likely to come under pressure over the next few quarters with large new capacity additions and weak demand. Furthermore, pricing pressure on polyethylene (PE) due to significant build-up of new capacity in the U.S. could further soften the ethylene price. We also expect the cost of other raw materials, such as ethylene dichloride (EDC) to lower, compared with the higher level in the first half of 2019 due to a supply interruption. In our view, lower material costs should help restore USI's operating cash flow generation over the next one to two years. We expect USI's EBITDA margin to improve to 8%-9% in 2019 and 2020, up from 6.6% in 2018.

Strong demand on EVA and PVC could partly alleviate uncertainty related to the ongoing trade war between the U.S. and China.

We believe growing demand for Ethylene-vinyl acetate (EVA) from the solar power industry could support pricing and product spreads over the next one to two years. In our view, USI is well-positioned to capture continued demand growth in this field because its major customers are leading players in the solar segment. We also expect robust demand of Polyvinyl Chloride (PVC), particularly from strong infrastructure needs in China, India, and Southeast Asian countries, as well as limited supply growth, to support a healthy demand-supply balance over the next one to two years. We believe these could provide some buffer to offset potential volatility in feedstock costs and market uncertainty over the next one to two years stemming the ongoing U.S.-Sino trade war. Nevertheless, we believe the unresolved trade dispute could remain a threat to USI's product demand in the coming few quarters. This is because major end applications for some of USI's products such as home appliances, auto parts, and toys are affected items under the trade spat.

Further investments in the Gulei project add to USI's debt pile and diminish rating headroom, despite a likely moderate recovery in its cash flow over the next two years.

In our view, USI's large investment in Gulei, an evenly split joint venture by Sinopec Fujian Petrochemical and Taiwanese petrochemical producers as well as other investors, could keep USI's debt leverage high over the next one to two years. USI holds the majority shareholding of the 50% ownership among Taiwanese entities, with the group's projected total investment amount of US$437.7 million. USI will further inject about New Taiwan dollar (NT$) 4.5 billion in 2019-2020. This together with still-high capital expenditure of NT$2.0 billion-NT$2.5 billion in 2019-2020 for the construction of new storage tanks will materially increase the company's debt. However, we expect improving profitability and cash flow could cap USI's ratio of debt to EBITDA at about 3x in 2019-2020. This leaves little rating headroom for any unexpected deep downturns in its operations or other major investment projects without hurting the ratings.

We expect USI to deleverage and lower its ratio of debt to EBITDA to materially below 3x in 2021 and thereafter because of more cash flow stability and lower capital spending.

Nonetheless, we believe USI's investment appetite will be prudent in evaluating potential opportunities and will focus on maximizing the return of its investments including the Gulei project and new Cycle Block Copolymer product line without involvement in further large investment projects. USI could also improve the security of its ethylene supply with lower costs and lower the volatility in its profitability after the Gulei complex becomes fully operational in the second half of 2021. Improved operation integration will lessen USI's performance volatility, in our view. USI's profitability is highly volatile because of its lack of vertical integration and secure a cheap supply of ethylene particularly after its recent expansion. In addition, oversupply and limited product differentiation make it difficult for USI to pass through rising material costs. This is evidenced by the company's weak performance in 2018, following a sharp increase in ethylene prices.

Outlook

The stable outlook on USI reflects our expectation that the company could sustain its restored profitability over the next one to two years. Improved spreads as a result of lower feedstock costs and improving demand for EVA and PVC will underpin its ongoing profitability. We also anticipate that USI is likely to lower its debt leverage gradually after 2020 once it completes the capital injection for the Gulei project. These factors are likely to help USI to lower its ratio of debt to EBITDA materially below 3.0x after peaking in 2020 at about 3x.

Downward scenario

We may lower the long-term rating on USI if ratio of debt to EBITDA remains above 3.0x without prospects for improvement. This could occur if the company's profitability weakens due to unexpected market downturns including higher pricing pressure caused by intensified competition or a significant rise in feedstock costs. This could also occur if the company pursues a more aggressive debt-funding expansion strategy over the next two years. This could include investment in material new projects, significant capital expenditure that exceeds our base case, or larger investments in the Gulei project than we currently expect.

Upward scenario

We believe the likelihood of an upgrade is low over the next two years, given USI's relatively high leverage. However, we may raise the rating if the company lowers its ratio of debt to EBITDA consistently below 2.0x. Such improvement could occur if USI strengthens its profitability and cash flow generation by further improving its product mix or the performance of the group's non-polyethylene (PE) product lines, or enhancing its operating efficiency with secure and low cost raw material supply. At the same time, USI would need to maintain modest capital spending and cash dividends to lower its debt after its large investments in the Gulei project.

Company Description

USI is a petrochemical group based in Taiwan. In addition to the parent company's multiple PE-related products, the USI group covers polymers including PVC, acrylonitrile butadiene styrene (ABS), polystyrene (PS), and PE film via its subsidiaries with some extension to downstream plastic processing. The group has also diversified into the production of electronic materials.

Our Base-Case Scenario

- S&P Global Ratings' projected growth for China's economy of 6.2% in 2019, 5.8% in 2020, and 5.7% in 2021; Taiwan's GDP growth of 2.0% in 2019 and 2020, and 2.3% in 2021; and APAC GDP growth of 5.0% in 2019, 2020, and 2021.
- Weakening prices will likely continue to pressure regional chemicals players in the upcoming months. The softening outlook on regional growth and the risks from U.S.-China trade tension could continue to drag on chemical prices and sector margins. Modest demand combined with capacity additions planned for China and other regions in Asia will likely be a double blow to chemicals players in the coming few months.
- We expect high single-digit revenue decline for USI in 2019. This is to reflect continued average selling price pressure and demand uncertainty. We forecast flat to a slight decline on revenue in 2020, reflecting uncertain prospects of average selling price recovery, particularly on PE, EVA and ABS products.
- We expect USI's EBITDA margin to recover to 8%-9% in 2019 and 2020, mainly driven by lower feedstock costs.
    - A lower ethylene price should support expanded product spreads and margin recovery for USI's EVA business. Strong solar demand could also partly offset pricing pressure. However, we expect margin on PE to remain depressed mainly due to intense competition caused by large capacity additions.
    - The group's PVC business will recover from the second half of 2019. Lower feedstock cost and recovered demand from China, India, Bangladesh, Brazil and SEA are the major drivers of the recovery. The relatively healthy demand-supply balance over the next one to two years is likely to sustain in our view.
    - We expect USI's ABS business to remain under pressure amid rising inventory with uncertain prospects of recovery. Demand for ABS in Asia, especially in China, remains soft, mainly

reflecting unresolved trade tension between U.S. and China. A likely ease in supply tightness for raw materials could provide some relief on USI's margin pressure. On the other hand, we expect low feedstock price, USI's enhanced product mix, the shutdown of loss-making production plants, and limited supply additions to support a moderate margin improvement on PS.

- The group's 2019 capital expenditure will remain similar to the level of NT$1.9 billion-NT$2.2 billion in 2018, but increase to NT$2.4 billion-NT$2.7 billion in 2020. The higher capital spending is partly for new storage tanks in Southern Taiwan's Kaohsiung.
- USI's total equity investment in the Gulei project is likely to be US$437.7 million based on the group's current plan. We expect capital injections of NT$3.48 billion in 2019 and NT$1.4 billion-NT$1.6 billion in 2020.
- We assume about NT$200 million estimated litigation exposure for a chemical accident in Kaohsiung city in 2014 and add this to USI's adjusted debt.
- We assume similar amount of cash dividend distribution in 2019 and 2020 as that in 2018.

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

- EBITDA margin of 8%-9% in 2019-2020.
- Ratio of debt to EBITDA of 2.7x-3.0x in 2019, down from 3.5x in 2018, but to rise slightly to 2.9x-3.2x in 2020 due to capital investment in Gulei and higher capital expenditure overall.
- Ratio of free operating cash flow to debt of 23%-28% in 2019 and 9%-14% in 2020.

Liquidity

The short-term rating on USI is 'twA-2'. We believe that the company has adequate liquidity to meet its needs in the 12 months ending September 2020. The ratio of liquidity sources to liquidity uses will be 1.3x-1.5x over the same period. The company will have positive liquidity sources minus uses, even if its forecasted EBITDA declines by 15%.

In our assessment, USI can absorb high-impact, low-probability events with limited need for refinancing, given its high cash balance compared with lower short-term debt usage. We also believe the company has sound relationship with banks as evidenced by the low interest rate on its bank loans. This view is also supported by the company's generally satisfactory standing in the credit markets. In our opinion, USI has generally prudent risk management to ensure continued adequate liquidity. The company's flexibility to increase bank facilities support this view. We also believe the company has sufficient headroom without breaching covenant limits due to low interest rates in Taiwan even if its EBITDA were to drop by 15%.

Principal liquidity sources

- Cash and short-term investment: about NT$14.3 billion as of the end of September 2019.
- Funds from operations: NT$3.7 billion-NT$4.2 billion in the 12-month period ending September 2020.

Principal liquidity uses

- Long-term debt due in one year plus short-term debt: NT$7.9 billion-NT$8.2 billion over the 12-month period ending September 2020.
- Capital expenditure: NT$2.4 billion-NT$2.7 billion in 12-month period ending September 2020.
- Capital investment in Gulei project: about NT$1.5 billion in 12-month period ending September 2020.
- Cash dividend payout to be similar to previous year: NT$0.9 billion-NT$1.1 billion in 12 months ending September 2020.

Related Criteria

- General Criteria: Group Rating Methodology - July 01, 2019
- 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
- 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 - November 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

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Ratings List

Ratings Affirmed

USI Corp.	
Issuer Credit Rating	twA-/Stable/twA-2

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.