Media Release:

Formosa Taffeta Co. Ltd. 'twA+/twA-1' Ratings Affirmed On Deconsolidation Of IC Packaging And Testing Subsidiary; Outlook Stable

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Rating Action Overview

- FTC's reduced shareholding in its main subsidiary FATC and the resultant deconsolidation of the subsidiary from FTC's accounts could weaken FTC's EBITDA margin and debt leverage over the next 12 months.
- However, the deconsolidation should enhance FTC's business risk profile, given the previous negative impact of the highly cyclical nature and technologically intensive semiconductor packaging and testing industry in which FATC operates.
- On Dec. 19, 2019, Taiwan Ratings Corp. affirmed its 'twA+' long-term and 'twA-1' short-term issuer credit ratings on FTC.
- The rating outlook remains stable, to reflect the potential that FTC could still sustain its weighted debt to EBITDA at 3.5x-4x in 2020-2021, despite the deconsolidation of FATC and potential investments in the FP group's U.S. expansion projects and in a Swiss-based textile company.

Rating Action Rationale

The affirmation reflects the impact of **Formosa Taffeta Co. Ltd.'s** (FTC's) announcement that it would reduce its shareholding in Formosa Advanced Technologies Co. Ltd. (FATC) from 46.68% to 30.68% by transferring a 16% stake to other **Formosa Plastics Corp.** (FP) group companies for New Taiwan dollar (NT$) 2.5 billion in cash. The transfer was completed on Dec. 16, 2019. This move will deconsolidate FATC from FTC's main business structure because FTC's remaining shareholding in FATC no longer represents a controlling interest in the IC packaging and testing company. In our view, the deconsolidation improves FTC's business risk because the IC packaging and testing business has inherently higher volatility than for FTC's fabric business.

In addition, we view that declining profitability after deconsolidating FATC will weaken FTC's debt leverage. This also reflects the lower cash on hand and weaker operating cash flow, which the cash inflow from the shareholding sale could only partly offset. We believe FTC's decision to reduce its shareholding could cause its debt leverage to weaken temporarily to 3.8x-4.2x in 2020. However, the ratio is likely to improve to 3.3x-3.8x in 2021, due to less capital expenditure and dividend payout.

We assess FTC's remaining 30.68% shareholding in FATC to be credit positive because FTC could improve its debt leverage significantly by disposing of the remaining shareholding to reduce its debt. We estimate the remaining shares to be worth about NT$4.84 billion based on the price of the recent transaction, which is a material amount compared to FTC's likely debt of NT$13.2 billion–NT$13.8 billion in 2020. Meanwhile, we have revised our assessment on the company's business diversification to neutral from positive. This reflects our view that FTC's fabric business will in future contribute over half of the company's EBITDA through business cycles, which leads to higher concentration risk than under the previous business structure.

Outlook

The stable outlook on FTC reflects our view that despite the deconsolidation of FATC, the company could sustain a weighted ratio of debt to EBITDA of 3.5-4.0x over the next one to two years supported by its continued strong cash dividends from Formosa Petrochemical Co. Ltd. and recovering profitability. In addition, the outlook reflects our view that the improvement in the product mix of FTC's fabric business and increasing utilization at its new tire cord facilities should sustain its EBITDA margin. That's despite our view that intensifying competition, volatile raw material costs, and unfavorable exchange rates could continue to constrain FTC's profitability.

Downward scenario

We may lower the long-term rating on FTC if the EBITDA margin of its fabric and tire cord businesses deteriorates materially or FTC receives less dividend income from equity investments than in our previous expectation. We may also lower the rating if the company's cash flow cannot support FTC's potential equity investment in the group's expansion projects in the U.S and in a Swiss-based textile company. A rise in the ratio of debt to EBITDA to over 4x for an extended period would indicate such deterioration in debt leverage. We may also lower the rating if FTC's market position weakens due to rapidly changing market trends or intensify competition. A materially deterioration of profitability could indicate this.

Upward scenario

We believe the likelihood of an upgrade is low over the next one to two years. However, we would raise the long-term rating on FTC if the company's ratio of debt to EBITDA falls below 3x for an extended period. The likely scenarios for this are substantial improvement in profitability through demand recovery for woven fabrics or a significant increase in demand for higher-value fabrics and tire cord products. A more conservative investment plan or more prudent capital expenditure and cash dividend payments than we previously expected in combination with stronger profitability could also result in such deleveraging.

Our Base-Case Scenario

- Global real GDP to grow 3.1% in 2019, 3.3% in 2020, and 3.4% in 2021; Taiwan's real GDP to grow 2.5% in 2019, 2.4% in 2020, and 2.2% in 2021; and China's real GDP to grow 6.2% in 2019, 5.7% in 2020, and 5.6% in 2021.
- Demand for woven fabrics will slowly recover with improving global GDP growth. Sales growth for tire cord could be weak due to a declining auto market, particularly in China. Profitability for woven fabrics and tire cord manufacturers could remain under pressure due to slowing demand, ongoing competitive pressure, and material price volatility.
- FTC's over revenue to grow by low-to-mid single digit percentage in 2019, reflecting sustainable demand for value-added products and capacity expansion, but following the deconsolidation of FATC revenue will decline nearly 20% in 2020, partly offset by revenue growth in fabric and tire-cord business.

    - Sales growth for woven fabrics is likely to slow down to 7%-10% in 2019 and 2%-5% in 2020-2021, given the higher base of 2018, despite healthy demand growth for sports wears.
    - We expect 0%-3% sales growth for tire cord over the same period, mainly supported by a higher utilization rate and higher average selling price, despite slowing auto demand and intense competition.
    - We forecast the ratio of FTC's operating cost and expenses to revenue will decline slightly by 0.5%-1.0% in 2019 but increase 4.0%-5.0% in 2020-2021. In our view, improving demand and FTC's better product mix could largely offset pricing pressure and volatile raw material costs in 2019. The deconsolidation of FATC will weaken FTC's profitability from 2020.
- NT$2.5 billion-NT$3.0 billion capital expenditure in 2019 and NT$0.8 billion–NT$1.2 billion in 2020 and thereafter. This is mainly to support capacity expansion for FATC in 2019 and for woven fabrics and tire cord business in Vietnam in 2020 and thereafter.
- Cash inflow from sale of shareholding in FATC of NT$2.5 billion.
- A similar dividend payout ratio of about 75% as in previous years from 2019 onwards.
- FTC will continue to provide a guarantee on Formosa Ha Tinh (Cayman) Ltd.'s debt proportional to its ownership in 2019-2021.

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

- EBITDA margin at 11.5%-12.5% in 2019 and 8.5%-9.5% in 2020-2021.
- Ratio of debt to EBITDA at 2.5x-3x in 2019, 3.8x-4.2x in 2020, and 3.3x-3.8x in 2021.

Liquidity

The short-term issuer credit rating is 'twA-1'. We believe that FTC has adequate liquidity to meet its needs over the next 12 months, reflecting a ratio of liquidity sources to liquidity uses of 1.2x–1.5x over the same period and our view that the company's liquidity sources will continue to exceed uses, even if FTC's EBITDA were to decline by 15%.

We believe FTC can absorb high-impact, low-probability events, with limited need of refinancing because its sufficient cash holdings and steady cash flow generation are sufficient for the repayment of short-term debt. We also believe FTC has sound relationship with banks as evidenced by the low interest rate on its bank loans and diversified funding source. This view is also supported by the company's satisfactory standing in the credit markets, given it is part of Formosa Plastics group and FTC's good market position. In our view, the company has generally prudent risk management to ensure continued adequate liquidity. FTC's sufficient undrawn bank credit lines and flexibility to increase bank facilities support this view. FTC's bank loans carry some financial covenant but we believe the covenants could be met with sufficient headroom over the next one to two years.

Principal liquidity sources:

- Cash and short-term investments (excluded cash in FATC): NT$3.6 billion at the end of September 2019.
- Funds from operations: NT$5 billion-NT$5.5 billion up to September 2020.
- Disposal of shareholdings: NT$2.5 billion in December 2019

Principal liquidity uses:

- Long-term debt amortization plus short-term debt maturity: NT$4.0 billion-NT$4.5 billion up to September 2020.
- Working capital outflow: NT$100 million-NT$500 million up to September 2020.
- Capital expenditure: NT$1.0 billion-NT$1.5 billion up to September 2020.
- Investments overseas: NT$1.0 billion-NT$1.3 billion up to September 2020.
- Cash dividend: about NT$2.0 billion-NT$2.5 billion up to September 2020.

Related Criteria

- General Criteria: Group Rating Methodology - July 01, 2019
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - June 26, 2018
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- 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

Formosa Taffeta Co. Ltd.	
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.