Media Release:

Taiwan Water Corp. Assigned 'twAAA/twA-1+' Issuer Credit Ratings; Outlook Stable

April 6, 2020

PRIMARY CREDIT ANALYST

Raymond Hsu, CFA
Taipei
+886-2-8722-5827
raymond.hsu@spglobal.com
raymond.hsu@taiwanratings.com.tw

SECONDARY CONTACT

Irene Lai
Taipei
+886-2-8722-5825
irene.lai@spglobal.com
irene.lai@taiwanratings.com.tw

Rating Action Overview

- We believe the Taiwan government is almost certain to provide timely financial support to Taiwan Water if needed, given the company's critical policy role and integral link to the central government.
- We expect water rates to remain frozen over the next two to three years, leading to further deterioration in debt leverage with still high capex ahead despite continued capital injections from the government. Nonetheless, very strong access to the local financial market and very low interest rates moderate this financial risk.
- On April 6, Taiwan Ratings Corp. assigned its 'twAAA' long-term and 'twA-1+' short-term issuer credit ratings to Taiwan Water.
- The stable outlook reflects the stable outlook on S&P Global Ratings' unsolicited issuer credit ratings assigned to the government of Taiwan.

Rating Action Rationale

Almost certain likelihood of timely government financial support to Taiwan Water. The ratings on Taiwan Water reflect our view that the Taiwan government is almost certain to provide timely financial support to the company, if needed. That's because of Taiwan Water's critical role to maintain sufficient and reliable water supply to support the country's households and highly industrialized economy. The ratings also represent our view that the government will maintain its ownership and tight control over Taiwan Water over the next three to five years. It shares overall ownership with local governments in Taiwan.

Taiwan Water's services are critical to Taiwan's economy and living standard. We expect Taiwan Water to maintain its critical role in Taiwan's economy over the next decade because of its position as the monopoly water supplier. This includes water processing and distribution, servicing the entire country except the capital, Taipei City, and surrounding areas--a role that no other entity can undertake. As a result, we believe Taiwan Water is so critical to the country's highly industrialized economy and households that the government is unlikely to take any risk with regard to interruptions in Taiwan Water's operations. We also expect the government to ensure Taiwan Water's financial viability to minimize the associated financial risks.

The Taiwan government is unlikely to privatize Taiwan Water and will maintain tight control and monitoring over the company. We expect Taiwan Water to remain integrally linked with the central government of Taiwan, which owns 85.35% of the company with the rest owned by various local governments, without any prospect of privatization over the next decade. We expect the central government to increase its holding in Taiwan Water gradually due to its constant capital injections to support the company's capital expenditures (capex). We believe the Taiwan government has a strong influence over the company's strategic and business plans through the appointment of top managerial positions and board members, and any debt default by Taiwan Water would significantly undermine the government's reputation.

We also believe the government has a strong incentive to tightly control Taiwan Water in order to implement key government policies; mainly to provide a stable and cheap water supply. Unlike the electricity market where limited liberalization is likely to expose the monopoly provider, Taiwan Power Co.'s power generation operations to competition from independent power generators, the government currently has no plan to privatize or restructure Taiwan's water utilities. The government rules that privatization is unlikely to better serve the public welfare.

A continued freeze in water rates will weaken profitability and debt leverage further, constraining Taiwan Water's SACP. Taiwan Water's stand-alone credit profile (SACP) reflects a relatively unfavorable regulatory environment that has led to a freeze in water rates since 1994. The execution of the government's policy to extend service coverage and improve water quality and supply reliability has kept capex high and increased operating costs, leading to weakened profitability over the past few years. This is despite the company's bottom line remains positive. Debt leverage is likely to rise further, despite frequent capital injections by the government to support Taiwan Water's capex needs. The company's monopoly position in water supply for most of the nation and adequate operating efficiency partly alleviate the SACP weaknesses, in our view. In addition, Taiwan Water has minimal refinancing risks and very low interest burden benefitting from its position as a critical government-related entity, which we believe partly alleviates the associated financial risk.

Our base case scenario for Taiwan Water forecasts no water rate adjustment over the next two to three years, particularly with the growing economic impact from the global novel coronavirus pandemic. This will further weaken the company's profitability over the next few years with rising costs associated with extending service coverage and improving reliability and water quality. Taiwan Water has generated slightly negative return on its investments over the past five years, though its EBITDA margins have remained stable at 30%-35% over the same period. We expect the freeze of water rates to lower the company's EBITDA margin gradually to 31%-32% in 2022 from 34.5% in 2019, without factoring in other uncertain factors such as rainfall conditions.

The government prioritizes the provision of stable and cheap water to the public over revenue generation by Taiwan Water. We do not expect the government to raise water rates to help Taiwan Water meet the regulatory return of 5%-9% on its investments. The current water rate setting scheme, established according to the Water Supply Act, has transparent parameters linked to water utilities' operating costs, which together with water rates proposed by water utilities in Taiwan need to be reviewed by the water rate review commission every four years. However, we believe that the government is running Taiwan Water more like a government agency instead of a profit-oriented entity and does not seek to generate material revenue through Taiwan Water, similar to Taiwan Power.

In addition, the government has no urgency to regularly adjust water rates more than with electricity tariffs because Taiwan Water's cost structure is not sensitive to very volatile international energy prices. Taiwan Water has reported marginally positive bottom lines throughout most of its operating history. Nonetheless, we expect the government to take action if Taiwan Water's losses grow significantly and threaten its cash flow viability.

Monopoly position is unlikely to change and efficiency should continue to improve. Taiwan We expect Taiwan Water to remain the water supplier for most of Taiwan in the foreseeable future, except for Taipei City and some surrounding areas, as well as for outer islands such as Kimen and Matsu. Under the current legal framework and the government's current assessment of water needs, it is unlikely to introduce new operators or split Taiwan Water to promote competition. The government currently believes that market liberalization cannot enhance water services and efficiency based on the high capital intensity and scale economy needed to fulfil this service.

In addition, we expect Taiwan Water to continue to improve its operating efficiency, which could somewhat slow the deterioration in the company's profitability without water rate hikes over the next two to three years. The company has continued to spend heavily on the replacement of aging pipelines to reduce water leakage and improve water quality. Taiwan Water has reduced the leakage rate to 14.49% in 2019 from about 20% in 2011, a level materially below the global and regional average. Taiwan Water aims to lower the ratio further to 13.45% by 2022.

Regular capital injections from the government are not sufficient to cap leverage. We expect the government to continue to inject capital into Taiwan Water to support the company's projects particularly associated with public welfare, such as increasing service coverage to rural areas or developing new water resources and backup pipelines to improve supply reliability. This is despite the government is not legally bound to provide capital injections to do so. Nonetheless, the capital injections are not sufficient to fully offset the shortfall in cash flow from operations or to stem the increase in Taiwan Water's debt leverage. The government injected about New Taiwan dollar (NT$) 10 billion during 2014-2018, compared with Taiwan Water's total capex of about NT$75 billion during the same period. The government is scheduled to inject a further NT$10 billion in 2020-2022, compared with total predicted capex of about NT$50 billion over the same period.

Despite the government's continued capital injections, we expect Taiwan Water's leverage to deteriorate steadily over the next two and three years because of high capex and weakening profitability. The company's ratio of funds from operations (FFO) to debt could decline steadily to about 10% in 2022 from 11.5% in 2019. However, very low interest rates of below 1% on average should enable Taiwan Water to maintain very strong interest coverage despite rising leverage.

Outlook

The stable outlook reflects the stable outlook on the unsolicited global scale issuer credit ratings assigned by S&P Global Ratings on the government of Taiwan (AA-/A-1+). The outlook also reflects our view that Taiwan Water's critical role and integral link to the Taiwan government will not change over the next two to three years. That's because of the company's critical mission to provide a stable water supply with competitive rates. We believe that the government has minimal tolerance on water supply risk because the country's technology rich economy relies heavily on a stable and cost competitive water supply. We also expect Taiwan

Water's SACP to remain stable because of company's strong refinancing capability and strong interest coverage, despite its gradually rising debt leverage.

Downward scenario

We could lower the long-term rating on Taiwan Water if S&P Global Ratings lowers its unsolicited ratings on Taiwan. Although this is unlikely over the next two to three years, we could also lower the rating if we believe Taiwan Water's importance to or relationship with the Taiwan government has weakened materially. Such a scenario could reflect aggressive market liberalization that breaks Taiwan Water's monopoly position or a significant reduction in government ownership.

Our Base-Case Scenario

- We expect Taiwan's real GDP to slow to 0.8% in 2020 but expand by 3.7% in 2021, mainly because of the negative impact of the global COVID-19 outbreak.
- Water demand will decline marginally in 2021 because the commissioning of new water recycling plants will decrease demand from the manufacturing sector. Water demand will resume growth at 1%-2% annually in later years.
- There will be no water rate adjustments during the projection period.
- In aggregate, we expect revenues to grow 1%-2% in 2020, be largely flat in 2021, and resume low single digit growth thereafter.
- Unit raw water costs remain unchanged during the projection period.
- Processing and distribution costs will grow at a faster rate with the expansion of service coverage and facilities that increase reliability and water quality.
- Other operating and service costs to grow by a low-single digit each year.
- Capex will remain elevated at NT$16 billion-NT$19 billion annually during 2020-2022, mostly related to multi-year construction projects.
- The effective interest rate to remain relatively flat over the next two to three years.
- The government will inject equity of NT$4.9 billion in 2020, NT$3.2 billion in 2021, and NT$2 billion in 2022, based on Taiwan Water's approved capex budget.
- No cash dividend payout.

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

- EBITDA margin will decrease gradually to 31%-32% in 2022 from about 34.5% in 2019.
- Ratio of FFO to debt to fall to 11%-12% in 2020 and 10%-11% in 2021, from 12.1% in 2019.
- FFO cash interest coverage is still strong at 15x-17x in 2020-2021.

Liquidity

The short-term issuer credit rating is 'twA-1+'. We assess Taiwan Water's liquidity as adequate, given that we believe the company has sufficient cash flow to meet its needs over the next 12 months factoring in maintenance capex and ongoing government support in the form of the company's access to the local financial market. We also asses Taiwan Water's ratio of liquidity sources to uses will be about 1.1x for the12 months ended Dec. 31, 2020.

The liquidity profile incorporates our view that liquidity sources will continue to exceed uses even if Taiwan Water's EBITDA were to decline by 10% and our view that the company has a very sound relationships with banks, given its government related entity status. As a result, the company benefits from very low interest rates on its bank loans. We do not expect Taiwan Water to encounter difficulties in refinancing its maturing long-term or short-term debts or establishing new bank loan facilities, given its strong credit standing underpinned by its status as one of the most important government owned companies in Taiwan. In addition, the company's debts does not carry any financial covenants.

Principal liquidity sources

- Cash and short-term investment: NT$790 million as of the end of 2019.
- Funds from operations: NT$9.5 billion-NT$10.5 billion in 2020.
- Undrawn committed long-term credit facilities maturing beyond December 2020: about NT$6.1 billion.
- Ongoing government support, in the form of state bank facilities: about NT$26.0 billion to cover financing needs in 2020.

Principal liquidity uses

- Debt maturities: NT$24.7 billion in 2020.
- Capital expenditures: NT$18 billion-NT$19 billion in 2020.
- No cash dividend payout in 2020.

Ratings Score Snapshot

Issuer Credit Rating: twAAA/Stable/twA-1+
Note: The descriptors below are on a global scale.

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Very low risk
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: twbbb+

Modifiers

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

Stand-alone credit profile: twbbb+

- Related government rating: AA-
- Likelihood of government support: Almost certain (+7 notches from SACP)

Related Criteria & Research

Related Criteria

- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Group Rating Methodology - July 01, 2019
- 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 | General: Corporate Methodology - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - 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	
Taiwan Water Corp.	
Issuer Credit Rating	twAAA/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.