Media Release:

Taiwan-Based Steel Producer China Steel Corp. Outlook Revised To Negative On Weak Demand; 'twAA-/twA-1+' Ratings Affirmed

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Rating Action Overview

- Taiwan based steel producer **China Steel Corp.** is the largest and only integrated steel manufacturer in Taiwan. The company commands over 50% domestic market share with annual crude steel capacity of about 16 million tons in 2019. Its EBITDA was NT$48.7 billion in 2019.
- A sharp decline in global economic activity as a result of COVID-19 will crimp steel demand over the next three to nine months. This in turn will cut sales volume for China Steel and force a retreat in steel's average selling price.
- We expect China Steel's credit metrics to deteriorate in 2020, primarily due to a likely plunge in operating cash flow generation with lower revenue and contraction in product margins.
- On April 16, 2020, we revised our outlook on the long-term issuer credit rating on China Steel to negative from stable. At the same time, we affirmed our 'twAA-/twA-1+' issuer credit ratings on the company. We also affirmed our 'twAA-' issue rating on the company's senior unsecured bond.
- The negative outlook reflects the likely deterioration in China Steel's credit metrics in 2020 and the downside risk surrounding the timing and strength of an eventual recovery.

Rating Action Rationale

Steel demand has slumped following the COVID-19 outbreak. We expect global steel demand to see sizeable decline in 2020, given its high correlation with economic growth. Containment measures taken by governments around the world have brought a halt to many economic activities and pushed the global economy into recession. We now project global economic growth of 0.4% in 2020, down from 2.9% in 2019. Meanwhile, Taiwan's GDP growth is also likely to slow considerably to 0.8% in 2020 from 2.7% in 2019, mainly due to the weak external environment despite effective containment of the virus domestically.

We also expect steel demand from major downstream application sectors to contract, including auto, construction, mechanical machinery, home appliances, and ship building. Domestic steel demand could be more resilient compared with global demand, on account of robust construction activities and growing demand in the domestic power generation sector. Nonetheless, this will be insufficient to offset the weakness in export markets. Resultantly, we expect China Steel's sales volume to decline by a further 7%-11% in 2020, following a year-on-year decline of 9% in 2019.

Supply glut to weigh on sales price and product margins. Oversupply in APAC will become more acute during the current economic downturn. While production in Japan, South Korea, and India is likely to drop through production curtailments, we expect output in China to remain high and possibly register mild growth in 2020. China's crude steel production has been less affected by the COVID-19 outbreak, as shown by a persistently high utilization rate in February and March 2020 when the virus' effect on China's economy was greatest. In addition, China's capacity replacement program, which allows steel makers to replace old and inefficient capacity with new capacity, could effectively increase China's total capacity. Given likely lower demand in China and an increase in export tax refunds offered by the Chinese government, there could be a surge in steel exports from China this year. We therefore believe China Steel will face escalated competitive pressure in the regional export market, leading to a depressed sales price and product margin.

Softer raw material price to offer some margin relief. Despite resilience in price for coking coal and iron ore as of the end of March 2020, we expect these prices to trend downward over the next three to six months primarily due to weak demand. We expect global demand for iron ore and coking coal to contract under global steel mill production cuts. Meanwhile, the normalization of output in Australia and Brazil and resumption of mining activities in China will lead to an increase in output. Unless key producers aggressively curtail their production, or the pandemic leads to severe disruption in mine output and raw material transportation, we expect raw material prices to soften before steel demand starts to recover.

A deterioration in credit metrics in 2020 seems inevitable. We project China Steel's funds from operations (FFO) to decrease by 23%-28% in 2020, reflecting lower revenue and shrinkage in product margin. In addition, China Steel's lower operating cash flow and high capital expenditure (capex) needs limit the possibility of debt reduction in 2020. Resultantly, the company's ratio of FFO to debt could weaken to 9%-12% in 2020, from 2019's 13.6%.

Recovery to roll in but the degree and timeframe are highly uncertain. In our base case scenario, we factor in a gradual demand recovery for steel start in late 2020, driven by a global economic recovery. China Steel is likely to realize the greatest benefit from this in 2021 with a gradual restoration in sales volume and profitability. FFO generation could rebound by 35%-40% in the year, which will help to lift China Steel's ratio of FFO to debt to above 12% again. Nonetheless, we acknowledge the substantial downside risk to our base-case, residing in the evolvement of COVID-19 and the path of economic recovery. Cash flow deterioration could go beyond our forecast or recovery could take longer to gain traction if the outbreak is prolonged, making it more difficult for the global economy to regain strength. Policy measures taken by governments globally to cushion the economic blow and limit economic dislocation will also influence the eventual path of economic recovery.

Outlook

The negative outlook reflects our view that the COVID-19 pandemic will likely cause a plunge in global steel demand, leading to further escalation in price competition and margin pressure. These unfavorable market conditions could result in a substantial decline in China Steel's operating cash flow generation, resulting in a deterioration in its ratio of FFO to debt to 9%-12% in 2020 from 2019's 13.6%.

We assume in our base-case that industry demand will recover gradually along with the recovering global economy in late 2020. China Steel's operating cash flow generation should resume its strength along with the industry. However, we acknowledge substantial downside risk, given a possible prolonged outbreak, resulting in a delayed and dampened demand recovery. This could curb China Steel's ability to restore its cash flow generation to the pre-outbreak level and to lift its ratio of FFO to debt back to above 12% over the next 12-18 months.

Downward scenario

We may lower the long-term rating if:

- China Steel's ratio of FFO to debt weakens to below 12% for an extended period, possibly due to:
  - a prolonged COVID-19 outbreak that seriously damages the global economy and curb its ability to recover, leading to an extensive industry downturn with contraction in demand and intense competition,
  - persistently high raw material prices which would squeeze the company's profit margin materially, or
  - China Steel's adoption of a much more aggressive capex plan that curbs the company's ability to deleverage and results in an elevated debt level for an extended period.
- China Steel's link with the Taiwan government weakens from our assessment of strong, which may happen if the government materially lowers its ownership stake.

Upward scenario

We may revise the outlook back to stable if:

- We see a clear recovery trend in steel demand and product margin, such that China Steel brings its ratio of FFO to debt back to 12% or above on a sustainable basis, possibly if governments effectively contain the outbreak and a subsequent economic recovery pushes the steel industry back on track over the next 12 months.

Our Base Case Scenario

- China Steel's revenue could drop by 20%-24% in 2020 due to contracting steel demand as a consequence of the global economic slowdown. Revenue could rebound by 13%-17% in 2021 through demand recovery for steel after the COVID-19 crisis abates.
- S&P Global's forecast of Taiwan's GDP growth at 0.8% in 2020 and 3.7% in 2021, and for Asia Pacific of 2.2% in 2020 and 6.9% in 2021.
- China Steel's sales volume to decline by 7%-11% in 2020, reflecting the demand shock caused by escalated virus containment measures and dampened economic growth. We

expect a volume recovery of 5%-9% in 2021, as global economic activities return to normalcy.

- Average selling price (ASP) of steel products to decline by 10%-15% in 2020, reflecting escalated competitive pressure. We project ASP to rebound by 5%-10% in 2021, underpinned by a gradual demand recovery.
- Our assumption on iron ore prices of US$75/ton-US$80/ton for 2020 and 2021, and for coking coal prices of US$140/ton-US$150/ton for 2020 and US$150/ton-US$160/ton in 2021.
- We expect China Steel's gross margin to weaken to 15%-18% in 2020, primarily reflecting the retreat in ASP and lower utilization. Gross margin could rebound to 17%-20% in 2021 as the industry recovers.
- China Steel's selling, general and administrative expense to be 4.7%-5.2% of total revenue in 2020-2021, up from 4.2% in 2019 due to a lower revenue base.
- China Steel's capex and equity investment to rise to New Taiwan dollar (NT$) 28 billion-NT$32 billion in 2020, up from about NT$27 billion in 2019, due to the high capex requirement for facility upgrades. Capex spending is likely to decline to NT$19 bilion-NT$24 billion in 2021 with lower spending at China Steel's subsidiaries.
- Cash dividend of NT$7.9 billion in 2020 but slightly decline in 2021, reflecting the tough operating environment.
- China Steel to continue providing a guarantee on debt derived from the Formosa Ha Tinh steel based on China Steel's ownership stake.

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

- EBITDA margin of 10%-13% in 2020, and 12%-15% in 2021.
- Ratio of FFO to debt of 9%-12% in 2020 and 12%-15% in 2021.
- FFO interest coverage ratio of 8x-12x in 2020 and 11x-15x in 2021.

Liquidity

The short-term corporate credit rating is 'twA-1+'. We believe China Steel has adequate liquidity to meet its needs over the next 12 months ending 2020, with a ratio of liquidity sources to liquidity uses at 1.3x-1.4x over the same period. We also believe that China Steel's liquidity sources will continue to exceed uses, even if its EBITDA were to decline by 15%.

In our view, China Steel has a high standing in credit markets and well-established and solid banking relationships in Taiwan reflected by the low interest rate on its bank loans. This is supported by the company's role as a government related entity and strong domestic market position. China Steel has some financial covenants on its bank loan; however, we expect the company to meet loose financial covenants on its bank loans. Even a breach is unlikely to significantly increase liquidity pressures such as debt repayment acceleration.

Principal liquidity sources

- Existing cash: about NT$29 billion as of the end of December 2019.
- Cash FFO: NT$28 billion-NT$33 billion in 2020.
- Committed undrawn bank lines maturing beyond 2020: NT$40 billion-NT$43 billion.
- Unused short-term credit facilities offered by SOE banks and security houses: NT$55 billion-NT$60 billion in 2020.
- A bond issuance at China Steel's subsidiary Chung Hung Steel Corp.: NT$2 billion in March 2020.

Principal liquidity uses

- Short-term and long-term debt maturity: NT$103 billion-NT$108 billion in 2020.
- Maintenance capex: NT$4 billion-NT$6 billion in 2020.
- Working capital outflow: NT$1.5 billion-NT$2.0 billion.
- Cash dividends: NT$7.9 billion in 2020.

Ratings Score Snapshot

Issuer Credit Rating: twAA-/Negative/twA-1+

Note: The descriptors below are on a global scale.

Business Risk: Satisfactory

- Country risk: Intermediate Risk
- Industry risk: Moderately High Risk
- Competitive position: Satisfactory

Financial Risk: Significant

- Cash flow/Leverage: Significant

Anchor: twa+

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 (SACP): twa+

- Unsolicited issuer credit rating on Taiwan (rated 'AA-' by S&P Global Ratings)
- Likelihood of government support: Moderate (+1 notch from SACP)

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Methodology For National And Regional Scale Credit Ratings - June 25, 2018
- 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: Reflecting Subordination Risk In Corporate Issue Ratings - March 28, 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

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

Ratings List

Ratings Affirmed; Outlook Action

	To	From
China Steel Corp.		
Issuer Credit Rating	twAA-/Negative/twA-1+	twAA-/Stable/twA-1+
Senior unsecured issue rating	twAA-	

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.