Media Release:

Taiwan-Based Chung Hung Steel Corp. Outlook Revised To Negative On Weak Demand Prospects; SACP Lowered; 'twA/twA-1' Ratings Affirmed

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Overview

- Taiwan-based steel producer Chung Hung Steel Corp. is a specialized downstream steel processor, owning production capacity of 2.4 million tons (Mt) of hot-rolled coils, 0.45 Mt of cold-rolled coils, 0.25 Mt of steel piping, and 0.3 Mt of galvanization capacity. Its EBITDA was NT$996 million in 2019.
- A sharp decline in global economic activity as a result of the COVID-19 pandemic will dampen steel demand over the next three to six months, which in turn will cut Chung Hung Steel's sales volume and force a retreat in the selling price.
- We expect Chung Hung's credit metrics to deteriorate in 2020, primarily due to a likely plunge in operating cash flow generation with lower revenue and shrinkage in product margins.
- On April 16, 2020, we lowered the stand-alone credit profile (SACP) on Chung Hung Steel to 'twbb' from 'twbbb-' and revised our outlook on the long-term issuer credit rating to negative from stable. At the same time, we affirmed our 'twA/twA-1' issuer credit ratings on the company.
- The negative outlook reflects the outlook on Chung Hung's parent, China Steel Corp., which factors in a likely deterioration in China Steel's credit metrics in 2020 and the downside risk surrounding the time frame and strength of the company's operating recovery.

Rating Action Rationale

Negative outlook revision follows that on China Steel, given a likely drop in operating cash flow generation. The outlook revision incorporates our view that global steel demand will see a sizeable decline in 2020 due to the high correlation with economic growth. We expect the containment measures taken by governments around the globe to push global economic growth toward zero this year. Resultantly, we expect China Steel's sales volume to decline by 7%-11% in 2020. Furthermore, oversupply in Asia-Pacific will become more acute during the current downturn, and the supply glut will weigh on product sales price and margin. These factors lead to our projection of a 23%-28% year-on-year decline in China Steel's operating cash flow generation and a ratio of FFO to debt of below 12% in 2020.

The negative outlook also reflects the substantial downside risk on our projection of a demand recovery in 2021, residing in the evolvement of the pandemic and the path and timeframe of economic recovery. Cash flow deterioration could go beyond our forecast or recovery could take longer to take hold, if the outbreak is prolonged. This would make it more difficult for the global economy to regain strength. For more details please refer to the separate media release of the outlook revision for China Steel.

We have cut Chung Hung's SACP to 'twbb' from 'twbbb-' to capture the anticipated deterioration in the steel maker's demand and margins. We expect Chung Hung to face considerable demand risk, especially in the export market, which made up about 52% of its sales volume in the first three quarters of 2019. Demand for hot and cold-rolled coil is likely to plunge due to demand contraction at key downstream sectors, including auto, mechanical machinery, home appliances, and ship building. The current oil price war will also crimp pipe demand in the U.S. over the next one to two years, which is the company's key pipe export destination. Domestic steel demand could be more resilient compared with global demand, on account of robust construction activities and growing demand in the power generation sector. Nonetheless, this is insufficient to offset the weakness in export markets. Overall, we expect an 8%-12% decline in sales volume in 2020.

Meanwhile, production curtailments at steel mills are likely to fall short of the plummet in demand, especially for China. The resulting supply glut could further escalate price competition, leading to a depressed sales price and product margin. We expect softer raw material prices to offer some margin relief, but this is unlikely to offset the adverse impact from price competition.

Widespread impact of COVID-19 dampens the possibility of a timely restoration in Chung Hung Steel's credit metrics. Chung Hung's funds from operations (FFO) could turn negative over the next two to three quarters amid growing market turbulence. We expect the company's operating performance to normalize gradually, driven by a rebound in sales volume and profitability as demand recovers. Nevertheless, it could take one to two years before the company fully restores its operating cash flow generation to pre-pandemic levels. Downside risk remains high in terms of the recovery time frame and strength. In our base case, we factor in a mild recovery in FFO generation to New Taiwan dollar (NT$) 0.9 billion-NT$1.1 billion in 2021, which is still considerably below Chung Hung's average of NT$2.9 billion in 2017-2019. Stagnant operating cash flow generation is likely to keep Chung Hung's ratio of FFO to debt below 12% in 2020 and 2021.

The ratings on Chung Hung move in tandem with those on China Steel. We view Chung Hung as a highly strategic member of the China Steel group. This reflects the fact that China Steel owns about 40% of the company and is the single largest shareholder, allowing it control of the company's board of directors. Chung Hung's operations are very important to the group to maintain its dominant share in the domestic market. Therefore, we assess the long-term rating on Chung Hung at one notch below China Steel's stand-alone credit profile, and the rating and outlook on Chung Hung move in tandem with its parent.

Outlook

The negative rating outlook on Chung Hung reflects the negative rating outlook on its parent, China Steel, because we view Chung Hung as a highly strategic subsidiary of the parent group. The outlook on China Steel reflects our view that the COVID-19 pandemic is likely to cause a plunge in global steel demand, leading to further escalation in price competition and margin pressure. The unfavorable market conditions are likely to result in a substantial decline in China Steel's operating cash flow generation, leading to a deterioration in its ratio of FFO to debt to 9%-12% in 2020 from 13.6% in 2019's.

Downward scenario

We may lower the long-term issuer credit rating on Chung Hung if we lower the stand-alone credit profile of China Steel, which could occur if:

- China Steel's ratio of FFO to debt weakens to below 12% for an extended period perhaps due:
  - to a prolonged pandemic outbreak that could seriously damage the global economy and curb its ability to recover. This may lead to an extensive industry downturn with contraction in demand and intense competition
  - persistently high raw material prices, which squeeze the company's profit margin sharply
  - China Steel adopts a much more aggressive capex plan that curbs the company's ability to deleverage, which will keep its debt at an elevated level for an extended period, or
- If we believe China Steel's support for the subsidiary has weakened, possibly if China Steel significantly lowers its ownership in Chung Hung or reduces its control of Chung Hung's board of directors.

Upward scenario

We may revise the outlook to stable if we revise outlook on China Steel to stable, which could happen if:

- we see a clear recovery trend in steel demand and product margins, such that China Steel can bring its ratio of FFO to debt back to 12% or above on a sustainable basis, assuming COVID-19 can be effectively contained and a subsequent economic recovery pushes the steel industry back on track over the next 12 months.

Our Base Case Scenario

Chung Hung's revenue could decline by 18%-22% in 2020 due to declining demand as a consequence of a global economic slowdown. Revenue could rebound by 12%-17% in 2021 through recovering steel demand after the COVID-19 crisis abates. Our assumptions are:

- 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.
- Chung Hung's sales volume will decline by 8%-12% in 2020, reflecting a demand shock caused by escalated virus containment measures and dampened economic growth. We expect volume to recover by 5%-9% in 2021, as global economic activity returns to normal.

- 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.
- Slab cost to fall by 10%-15% in 2020, incorporating our view that the key raw material prices will fall over the course of the year. Slab cost will rebound by a mid-single-digit percentage in 2021 with a recovery in steel demand and raw material prices. Our assumption for iron ore prices is US$75/ton-US$80/ton for 2020 and 2021 and for coking coal prices of US$140ton-US$150ton for 2020, and US$150ton-US$160/ton in 2021.
- We expect Chung Hung's gross margin to weaken to 2%-5% in 2020, primarily reflecting retreat in ASP and lower utilization. Gross margin could rebound to 6%-9% in 2021 as industry recovers.
- Chung Hung's selling, general and administrative expense to be 4.0%-4.5% of total revenue in 2020-2021, up from 3.6% in 2019, due to a lower revenue base.
- The company's capital expenditure will remain limited at about New Taiwan dollar (NT$) 350 million-NT$550 million over the next two years.
- We do not net the company's debts with its cash and cash equivalents.
- No cash dividend payment in 2020 and 2021

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

- EBITDA margin of negative 3% to positive 1% in 2020, and 1%-5% in 2021.
- Ratio of FFO to debt of negative 5% to positive 0% in 2020 and 4%-9% in 2021.
- FFO interest coverage ratio of negative 5x to positive 0x in 2020 and 8x-13x in 2021.

Liquidity

The short-term issuer credit rating is 'twA-1'. We assess Chung Hung's liquidity as less than adequate, given that we expect the company's ratio of liquidity sources to liquidity uses to be 0.8x-1.0x over the next 12 months up to 2021. However, we believe Chung Hung has fair headroom to manage its liquidity risk even if the company's performance fluctuates. We base this on our view that Chung Hung will continue to maintain sound relationships with banks supported by its close association with China Steel. We do not expect Chung Hung to face difficulties rolling over its short-term debts or securing new bank loan facilities. In addition, the company could access the group's cash pool and get funding from other group members, if needed. The company does not have any financial covenants on its bank loans as of the end of 2019.

Principal liquidity sources

- Cash and short-term investments: about NT$1 billion as of the end of 2019.
- Undrawn bank lines maturing beyond 2021: NT$3.0 billion-NT$3.5 billion.
- Working capital inflow: NT$600 million-NT$1 billion over the 12 months up to 2021.
- Bond issuance: NT$2 billion in March 2020.

Principal liquidity uses

- Debt maturities: about NT$7.4 billion over the 12 months up to 2021.
- Negative cash flow from operations: NT$300 million-NT$500 million over the 12 months up to 2021.
- Maintenance capex: NT$100 million-NT$300 million over the 12 months up to 2021.

Ratings Score Snapshot

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

Business Risk: Weak

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

Financial Risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: twbb

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twbb

- Group stand-alone credit profile: twa+
- Entity status within group: Highly strategic (one notch below the group stand-alone credit profile)

Related Criteria & Research

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

Related Research

- Media Release: Taiwan-Based Steel Producer China Steel Corp. Outlook Revised To Negative On Weak Demand; 'twAA-/twA-1+' Ratings Affirmed, www.taiwanratings.com – April 16, 2020

(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
Chung Hung Steel Corp.		
Issuer Credit Rating	twA/Negative/twA-1	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.