

Media Release:

# Taiwan-Based Dragon Steel Corp. Outlook Revised To Negative On Weak Demand Prospects; 'twA+/twA-1' Ratings Affirmed

April 16, 2020

## Rating Action Overview

- Taiwan-based steel manufacturer Dragon Steel Corp. is a wholly owned subsidiary of China Steel Corp. and has a combined six million tons steel producing capacity.
- A substantial decline in global economic activity will depress steel demand over the next three to nine months and cause a slump in Dragon Steel's sales volume and further downward pressure on its product pricing.
- We expect Dragon Steel's credit metrics to deteriorate in 2020, primarily due to a likely plunge in operating cash flow generation with lower revenue and shrinking product margins.
- On April 16, 2020, we 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 Dragon Steel.
- The negative outlook reflects the outlook on China Steel Corp. and the likely deterioration in the parent company's credit metrics in 2020, as well as the downside risk surrounding the timing and strength of an operating recovery.

## Rating Action Rationale

**The ratings and outlook on Dragon Steel move in tandem with those on its parent.** We revised the outlook on **Dragon Steel Corp.** to negative, following our similar outlook revision on its parent company, **China Steel Corp.**, to reflect the weakening fundamentals in the global steel industry. This is likely to negatively affect the operating performance of China Steel and Dragon Steel over the next 12-24 months. China Steel's ratio of funds from operations (FFO) to debt could fall below 12% in 2020, due to the slump in steel demand amid the expanding COVID-19 pandemic and potential oversupply mainly from China.

### **Slumping demand and weakening margins could erode Dragon Steel's product margins.**

Global steel demand is likely to decline significantly in 2020 amid the widening impact of COVID-19. Containment measures by governments around the world have halted many economic activities and pushed the global economy into recession period. We now project global economic growth of 0.4% in 2020, down from 2.9% in 2019. We expect steel demand from major downstream application sectors to suffer a decline, including auto, construction, mechanical machinery, home appliances, and ship building. Meanwhile, oversupply in Asia Pacific will become more acute during the current downturn. In addition, the capacity replacement program in China could uplift domestic supply through improved efficiency,

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which could in turn lead to a surge in China's steel exports. We expect this to escalate competitive pressure in the regional steel market and depress steel's selling price and product margin.

**Group members are likely to dampen the volume slump in 2020-2021.** Chung Hong Steel Corp., another Taiwan-based subsidiary in the China Steel group, is adjusting its materials supply chain amid declining volume from its main supplier over the next five years. We expect the sales volume of steel slabs to increase 10%-15% to satisfy Chung Hong Steel's demand despite the company is also experiencing a downturn. This increased demand could partly offset the impact of downward pricing pressure and softer demand for other hot roll coiled products during the downturn.

**Product diversification for its electric arc furnace could dampen the impact of weakening performance for blast furnace products.** Despite overall pricing decline, the slump in demand for electric arc furnace products is likely to be less than for blast furnace products. In particular, we expect the volume of H-beams could remain relatively stable, given that we see sustainable downstream demand for the near term. Moreover, as construction periods usually last two to three years, the impact of COVID-19 could be smaller for H-beam demand in Taiwan. The construction of new manufacturing plants amid recent trade tension and the government's investment in infrastructure projects are likely to support H-beam demand in Taiwan over the next 12-18 months.

**Recovery to roll in but degree and timeframe are highly uncertain.** Our base case scenario factors in a gradual demand recovery for steel beginning in the fourth quarter of 2020, driven by a global economic recovery. We expect the China Steel group to see the most benefit from this recovery in 2021 with gradually recovery in sales volume and profitability. FFO generation could rebound and help to uplift China Steel's and Dragon Steel's ratio of FFO to debt to once more above 12%. Nonetheless, we acknowledge substantial downside risk to our base-case, residing in the evolution of COVID-19 and the path of economic recovery. Cash flow deterioration could go beyond our forecast or recovery could take longer to take hold if the pandemic prolongs, which would make it more difficult for the global economy to regain strength. Policy measures taken by governments to cushion the economic blow and limit economic dislocation will also influence the path of economic recovery.

## Outlook

The negative outlook on Dragon Steel reflects the negative rating outlook on its parent, China Steel, because we view Dragon Steel as a core subsidiary of the China Steel group. The negative outlook reflects our expectation of a deterioration in China Steel's ratio of funds from operations (FFO) to debt to 9%-12% in 2020 from 13.6% in 2019. Substantial downside risk due to a possibly prolonged outbreak could lead to a delayed and dampened demand recovery. This could in turn curb China Steel's ability to restore its cash flow generation to the pre-outbreak level or to uplift 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 on Dragon Steel if:

- we lower the standalone 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 such as if the

company's profitability weakens significantly. The potential reasons for this weakening are:

- A prolonged COVID-19 outbreak that seriously damages the global economy and curbs its ability to recover, leading to an extensive industry downturn with shrinkage in demand and intense competition,
  - Persistently high raw material prices that weaken the company's margin materially, or
  - China Steel's adoption of 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.
- we believe China Steel's support for Dragon Steel weakens.

### Upward scenario

We may revise the outlook on Dragon Steel to stable if:

- we revise the outlook on China Steel back to stable to reflect improvement in China Steel's ratio of FFO to debt back to 12% or above on a sustainable basis. This could happen if governments are able to effectively contain the COVID-19 and a subsequent economic recovery pushes the steel industry back on track over the next 12 months.

## Our Base Case Scenario

- Dragon Steel's revenue is likely to decline by 18%-22% in 2020 due to diminishing steel demand. Revenue could recover by 13%-17% in 2021 along with the improving demand after the impact of COVID-19.
- Taiwan's GDP growth of 0.8% in 2020 and 3.7% in 2021, and for China of 2.9% in 2020 and 8.4% in 2021.
- Regional price of most steel products is likely to deteriorate in 2020, given weakening demand, but to recover in 2021.
- Iron ore prices sliding to US\$70/ton-US\$80/ton for 2020-2021 compared with US\$90/ton in 2019, because of stagnant economic activity under the COVID-19 outbreak. However, there is uncertainty over the robustness of price stability if supplies from Australia or Brazil again are disrupted again.
- Our assumption for coking coal price of US\$140/ton-US\$150/ton for 2020 and US\$150/ton-US\$160/ton in 2021.
- Average selling price (ASP) to continue to slide by a double digit percentage in 2020, given the downward pressure on the pricing of hot-rolled coil products and a gradually recovery in 2021-2022. This reflects oversupply in Asia Pacific amid weakening demand. The ASP of H-beam products to also see a double digit decline in 2020 following a downward price revision from competitors due to lower material costs.
- Sales, goods and administration expense to maintain at around 2.6% of total revenue in 2020 and 2021.
- Capital expenditure of New Taiwan dollar (NT\$) 3 billion-NT\$4 billion in 2020-2021, mainly construct indoor storage facilities for raw materials.
- No dividend payout in 2020-2021, given the weak performance of 2019-2020.

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

- EBITDA margin of 9%-11% in 2020 and 12 %-14% in 2021, compared with 10.5% in 2019.
- FFO to debt of 7%-9% in 2020 and 13%-16% in 2021, compared with 9.7% in 2019.
- FFO cash interest coverage of 8x-10x in 2020 and 13x-15x in 2021, from 9.4x in 2019.

## Liquidity

The short-term rating on Dragon Steel is 'twA-1'. We believe the company has adequate liquidity to meet its needs up to the end of 2020, with an estimated ratio of liquidity sources to liquidity uses at above 1.2x over the period. We believe the company's liquidity sources will still exceed liquidity uses even if its EBITDA were to decline by 15%. The liquidity assessment also reflects our view that the company has prudent risk management and ability to absorb with limited refinancing, high-impact, low-probability events.

In addition, we believe Dragon Steel has a generally satisfactory standing in credit markets and has sound business relationships with banks in Taiwan, thanks to its association with China Steel. Most of the company's mid-to-long term loan facilities will expire before 2021, as well as its current bank loans. However, we view Dragon Steel's refinancing risk is low, given its standing in credit markets and accessibility to the funding pool of its parent group.

### Principal Liquidity Sources

- Cash and short-term investment: NT\$403 million as of the end of 2019.
- FFO: NT\$5 billion-NT\$7 billion up to the end of 2020.
- Unused committed bank loans: NT\$26 billion-NT\$27 billion up to the end of 2020.
- Working capital inflow: NT\$1 billion-NT\$2 billion up to the end of 2020.

### Principal Liquidity Uses

- Debt repayment of NT\$25 billion-NT\$26 billion up to the end of 2020.
- Maintenance capex: NT\$2.5 billion-NT\$3.5 billion up to the end of 2020.

## Ratings Score Snapshot

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

Note: The descriptors below are on a global scale.

**Business Risk:** Fair

- **Country risk:** Intermediate
- **Industry risk:** Moderately high
- **Competitive position:** Fair

**Financial Risk:** Significant

- **Cash flow/Leverage:** Significant

**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+

- **Group stand-alone credit profile:** twa+
- **Entity status within group:** Core (the same as the group stand-alone credit profile)

## Related Criteria & Research

### 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

### Related Research

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

	To	From
<b>Dragon Steel Corp.</b>		
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.

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