Media Release:

Formosa Taffeta Co. Ltd. Downgraded To 'twA/twA-1' On Weak Cash Flow And Rising Debt; Outlook Stable

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Rating Action Overview

- Taiwan-based **Formosa Taffeta Co. Ltd.** (FTC) is a subsidiary of the chemical and petrochemical giant Formosa group. With diversified businesses including fabric, gas station, and tire cord. FTC had revenue of NT$37 billion in 2019.
- FTC's profitability could remain weak, given the COVID-19 pandemic will depress global fabric and tire cord demand over the next one to three quarters. Meanwhile, this will constrain FTC's margin recovery in 2020.
- We expect FTC's debt to increase in 2020 due to declining cash flow from operations, reduced cash dividend from investments, and high cash dividend payout.
- On April 30, 2020, Taiwan Ratings Corp. lowered its long-term issuer credit rating on FTC to 'twA' from 'twA+' and affirmed the short-term rating at 'twA-1'.
- The rating outlook is stable to reflect our view that FTC could sustain its ratio of FFO to debt above 12% over the next one to two years.

Rating Action Rationale

The COVID-19 outbreak is dragging on FTC's profitability recovery in the fabric sector. Revenue and margin in the fabric sector improved in 2019, supported by better product mix with fashion trend providing some tailwind. Nevertheless, COVID-19 has led governments to implement measures to control the transmission of the virus, which has largely interrupted economic activity including the cancellation or delay of big sporting events. This has significantly lessened consumption as people quarantine themselves, which will reduce FTC's cash flow generation from its fabric business in 2020. However, a decline in material costs might support stability in the sector's profit margin at a level similar to that in 2019.

Weakening global auto market also weakens the performance of FTC's tire cord business. FTC is facing a very competitive environment for tire cord. Even though the company has achieved some certification progress, the global auto market slowdown will reduce demand for FTC's product in 2020. In particular, sales volume in the Chinese auto market fell about 40% year on year for the first quarter of 2020. Although the negative impact on sales volume is reducing along with the gradual end to quarantine measures in China, it will still partly offset the margin improvement brought by better product mix in the company's tire-cord segment.

Debt will increase significantly in 2020 due to capex and cash dividend payouts. In our base-case expectation for FTC, the company is unlikely to use cash flow from its operations to gradually reduce its debt after the deconsolidation of Formosa Advanced Technologies Co. Ltd. in 2019. FTC's cash flow generation partly relies on non-operating activities, mainly supported by a cash dividend from Formosa Petrochemical Corp. (FPCC). Such a dividend will sink to New Taiwan dollar (NT$) 1.1 billion in 2020 compared with NT$1.8 billion in 2019 and NT$2.3 billion in 2018. In addition, the company's debt is likely to rise due to equity investment for Swiss-based Schoeller Textil AG by an amount of NT$1.2 billion in 2020, as well as cash dividend distribution of NT$4.2 billion this year.

Despite a likely recovery in global demand in 2021-2022, FTC's debt leverage could remain high. Although FTC is likely to improve its core businesses in 2021-2022 along with the recovery in global demand for fabric and tire-cord, the company's debt leverage is unlikely to return to the level in 2019. The recovery of FTC's core businesses reflects a restoration in sales volume and a margin improvement for higher-end products. However, we expect FTC to maintain an overall NT$2.5 billion-NT$3.5 billion cash outflow for capital expenditure (capex), dividend distribution, and investment in the parent Formosa Plastics group investments in the U.S. in 2021-2022. Thus, FTC's debt reduction in 2021-2022 is likely to be limited and its ratio of FFO to debt could still stay below 20%.

Outlook

The stable outlook reflects our view that FTC's ratio of FFO to debt will stay above 12% over the next two years, despite after a cash dividend distribution in the third quarter of 2020. We anticipate FTC will make a high dividend payout in 2020, receive less cash dividend from FPCC, and experience weakening demand due to COVID-19 which will increase FTC's debt in late 2020. However, the company is likely to improve its profitability during the post-pandemic period, supported by a better product mix for its fabric business and increasing utilization at its new tire cord facilities. This includes the assumption that there will be an easing impact of the pandemic and a recovery in global demand, despite intensifying competition and volatile raw material costs.

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 current expectation,
- the company's cash inflow cannot support FTC's dividend payout, capex, or potential equity investment in the group's expansion projects in the U.S. and in a Swiss-based textile company, which leads to rising debt. A ratio of FFO to debt materially lower than 12% for an extended period would indicate such deterioration in its financial strength, or
- FTC's market position in the fabric sector weakens due to longer term of margin recovery, rapidly changing market trends, or intensifying competition. A material deterioration in profitability of EBITDA margin lower than 8% over the next 12 to 18 months could indicate such weakening.

Upward scenario

We view the likelihood of an upgrade to be low over the next one to two years. However, we could raise the long-term rating on FTC if:

- the ratio of FFO to debt improves to above 20% on a sustainable basis and profitability materially improves for an extended period. The likely scenarios for this are substantial improvement in profitability through demand recovery for fabrics or a significant increase in demand for higher-value fabrics and tire cord products. While at the same time, more prudent capex and cash dividend payments than our current expectation could also result in the required debt reduction.

Our Base Case Scenario

- S&P Global forecasts world real GDP growth of negative 2.4% in 2020 and positive 5.9% in 2021, China's real GDP growth at 1.2% in 2020 and 7.4% in 2021, and Taiwan's real GDP growth at negative 1.2% in 2020 and positive 4.0% in 2021.
- Demand for woven fabrics to slow in 2020 as COVID-19 constrains the demand, but demand recovery to begin in the second half of 2020. Sales of tire cord will decline, amid a weakening performance in the global auto market, particularly in China. Profitability for woven fabrics and tire cord manufacturers could remain under pressure due to slowing demand, partly offset by a declining price for materials.
- FTC's revenue to decline by 13%-18% in 2020, then recover by 10%-15% in 2021 and 5%-8% in 2022. This reflects a demand interruption in 2020, but a likely recovery if governments could control the damage caused by the pandemic.
  - Sales momentum for woven fabrics is likely to slow due to the temporary closure of branded stores globally and the cancellation or delay of big sports events in 2020.
  - We expect a double-digit decline in sales of tire cord over the same period, mainly due to the weakening auto market. Despite a progress in product certification, FTC's effectiveness to uplift its average selling price could be delayed until later 2020.
  - Due to a slump of oil price, revenue from gas station sector could be a 15%-20% decline in 2020. After that, the revenue is likely to grow by 8%-13% in 2021 along with the recovering oil price.
- We forecast the ratio of FTC's operating cost and expenses to revenue to increase 0.5%-1% due to a lower utilization rate, despite the support from lower material pricing. The ratio is likely to decline 1.5%-3% in 2021 when the demand for woven fabrics and tire-cord picks up gradually.
- NT$1 billion-NT$1.5 billion capex per year in 2020 and thereafter. This is mainly to support capacity expansion for FTC's woven fabric and tire cord business in Vietnam in 2020 and thereafter.
- NT$1.4 billion of cash outflow mainly for the investment in Schoeller Textil AG in 2020. NT$500 million-NT$600 million in 2021 and thereafter for the parent group's investments in the U.S.
- NT$4.2 billion dividend payout in 2020 per FTC's announcement. A 70% dividend payout ratio in 2021 and 2022 at a similar level in years prior to 2020.
- The company will continue to provide a guarantee on Formosa Ha Tinh (Cayman) Ltd.'s debt proportional to its ownership in 2020-2021.

Based on these assumptions, we arrive at the following credit measures:
- EBITDA margin of 7%-8% in 2020, and 8%-9% in 2021, compared with 10.9% in 2019.
- FFO to debt of 11.5%-12.5% in 2020, and 14%-16% in 2021, compared with 21.8% in 2019.
- FFO cash interest coverage of 9x-10x in 2020, and 10.5x-11.5x in 2021, compared with 14.2x in 2019.

Liquidity

The short-term issuer credit rating is 'twA-1'. We believe that FTC has adequate liquidity to meet its needs over the 12 months ending December 2020, reflecting a ratio of liquidity sources to liquidity uses will be around 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 also believe the company can absorb high-impact, low-probability events, with limited need of refinancing because its cash on hand and 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 sources. This view is also supported by the company's satisfactory standing in the credit markets, given its strong Formosa Plastics group background and good market position. In our view, the company has generally prudent risk management to ensure continued adequate liquidity. This view is supported by the company's sufficient undrawn bank credit lines and flexibility to increase bank facilities. FTC's bank loans carry some financial covenants but we believe the company will meet these financial covenants with sufficient headroom over the next one to two years.

Principal Liquidity Sources
- Cash and short-term investments: NT$4.7 billion at the end of 2019.
- Undrawn bank lines: NT$6.5 billion-NT$7.5 billion in 2020.
- Funds from operations: NT$3 billion-NT$3.5 billion in 2020.
- Working capital inflow: NT$1 billion-NT$1.5 billion in 2020.

Principal Liquidity Uses
- Long-term debt amortization plus short-term debt maturity: NT$3.5 billion-NT$4 billion in 2020.
- Capex: NT$1.0 billion-NT$1.5 billion in 2020.
- Cash outflow for investment: NT$1 billion-NT$1.5 billion in 2020.
- Cash dividend: about NT$4.2 billion in 2020.

Rating Scores Snapshot

Issuer Credit Rating: twA/Stable/twA-1

Note: The descriptors below are on a global scale.

Business Risk: Satisfactory

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

Financial Risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: twbbb+

Modifiers

- **Diversification/Portfolio effect**: Neutral (no impact)
- **Capital structure**: Positive (+1 notch)
- **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-

- **Group credit profile:** twaa
- **Entity status within group**: Moderately strategic (+1 notch from SACP)

Related Criteria

- General Criteria: Group Rating Methodology - July 01, 2019
- Understanding Taiwan Ratings' Rating Definitions - 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

(Unless otherwise stated, these articles are published on www.taiwanratings.com)

Ratings List

Downgraded; Outlook

	To	From
Formosa Taffeta Co. Ltd.		
Issuer Credit Rating	twA/Stable/twA-1	twA+/Stable/twA-1

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