Media Release:

Far Eastern New Century And Yuan Ding Investment Outlooks Revised To Negative On Lower Operating Cash Flow; Ratings Affirmed

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Rating Action Overview

- **Far Eastern New Century Corp.** (FENC) is a major fiber and textile manufacturer in Taiwan, with various investments including **Far EasTone Telecommunications Co. Ltd.** FENC's EBITDA was NT$44 billion in 2019.
- Surging additions of PTA capacity and diminishing demand for downstream textiles and garments slashed by widespread lockdowns and store closures worldwide could keep FENC's profitability and cash flow materially weaker over the next one to two years.
- Leverage headroom could diminish materially in 2020 and 2021 due to weak operating cash flow if the COVID-19 pandemic does not abate such that FENC's cash flow takes longer to recover, or if the company does not take action to ease its debt burden.
- On Aug. 4, 2020, Taiwan Ratings Corp. revised its outlook on the long-term issuer credit rating on FENC and its investment holding company, **Yuan Ding Investment Corp.** to negative from stable to reflect the uncertainty over FENC's ability to recover its EBITDA, cap its debt growth, and bring its ratio of debt to EBITDA below 6x on a sustained basis.
- At the same time, we affirmed our 'twA/twA-1' issuer credit ratings on the companies.

Rating Action Rationale

Massive increase in PTA capacity in China and tumbling demand will keep cash spreads depressed. The industry's aggressive capacity expansion plans in China are likely to sustain double-digit global supply growth in 2020 and 2021. This will further swell excess supply as downstream polyester demand has yet to recover from the devastating demand shock caused by COVID-19. We expect FENC's purified terephthalic acid (PTA) business to remain loss making over the next two years, though the magnitude of losses is likely to narrow as demand returns gradually. We also expect the business's inventory loss, which accounted for over 50% of its registered operating loss of New Taiwan dollar (NT$) 1.44 billion in the first quarter of 2020, to reduce substantially as the Brent crude oil price rebounds to around US$40 per barrel.

Sluggish demand could lead to prolonged operating losses on FENC's textile business. FENC's textile business is likely to experience substantial order cuts as global sports brands suffer from a sharp sales drop and the resulting high inventory levels. As the number of infected cases continues to climb globally, stores could remain closed in many parts of the world and sport events curtailed for a longer period. These factors underpin our conservative demand outlook on knitted fabric and apparel for 2020. Demand could gain traction in 2021 when governments bring the infection rate under control and sports events, such as the Summer Olympics, are open to the public. However, the recovery trajectory remains highly uncertain.

Resilient demand for PET to provide some relief. We expect COVID-19 to have a lesser effect on the demand for polyethylene terephthalate (PET), which is used primarily for drink bottling. This is because bottled water and drinks are essential goods, and FENC's PET factories remained open during lockdowns to ensure a stable supply for bottles. In addition, the increasing demand for recycled PET, spurred by the go-green strategies adopted by many global brands such as Coca-Cola and PepsiCo, and FENC's expanding capacity in recycled PET production is likely to drive growth in EBITDA over the next two years.

5G could gradually turn around the declining trend in ARPU. In our view, the fierce price competition on unlimited 4G data plans in Taiwan will continue to pressure Far EasTone's average revenue per user (ARPU) and operating cash flow in 2020. The operator's recent launch of 5G services could turn around the declining ARPU trend, given that 5G data plans charge a higher monthly rate starting of NT$1,399/month, compared with the current average ARPU of around NT$700/month. However, the 5G adoption rate is likely to be low in the initial stage, given the proliferation of affordable 4G data plans and the significant price gap between 4G and 5G data plans. In addition, 5G network coverage will not be as comprehensive as that of 4G in the initial stage. Therefore, we expect only a modest uplift in Far EasTone's ARPU in 2021.

FENC's debt will remain elevated over the next two years. We expect FENC's and Far EasTone's high capital expenditure (capex) needs and cash dividend to result in negative discretionary cash flow for 2020 and 2021. This view is supported by FENC's investment plan in PTA and PET production in the United States, though the scheduling could be delayed due to COVID-19. The company also plans to further expand its capacity in recycled-PET in Asia Pacific. Meanwhile, we expect Far EasTone to invest in network infrastructure to improve its 5G network coverage. We believe the funding needs of these projects and relatively high cash dividend payments will keep FENC's debt elevated through 2021, even taking into account possible asset disposals.

Performance could recover which supports the current ratings but uncertainty remains. Under our base case scenario, FENC could recover its EBITDA by 9%-13% in 2021 compared with 2020, which leads to an improvement in the ratio of debt to EBITDA to slightly below 6x over the same period, though its debt level could still rise slightly year on year from 2020. Narrower losses on FENC's PTA business and a turnaround in its textile business will drive the bulk of this improvement. A likely increase in EBITDA contribution from telecommunication and polyester businesses through a pickup in APRU and growing demand for recycled PET also underpins our assessment of a potential operating cash flow recovery. We also expect FENC to actively mitigate the risk of weak operating cash flow through the sale of assets, such as a residential property project in Banqiao of New Taipei City, and the deferral of some capex. Nonetheless, we acknowledge the downside risks to our base-case. A severe second wave of infection overseas could taper off economic activities again, which will undermine recovery prospects for FENC's textile and PTA businesses. In addition, a delayed sale of its residential property beyond our current estimate, or lower 5G adoption rate in Taiwan could lead to weaker improvement in EBITDA over the coming 18 months.

Outlook

The negative rating outlook reflects our view that the weakened operating environment for PTA and textile products could lower FENC's EBITDA substantially, and result in a weakening in the company's ratio of debt to EBITDA to 6.3x-6.5x in 2020. The negative outlook also reflects the risk of a persistently high debt level for FENC, which could keep the company's ratio of debt to EBITDA above 6x beyond 12 months without a substantial recovery in performance. This is despite possible asset disposals and cash inflow from the sale of a residential property development project in New Taipei City over the next two years. The prospect of a demand recovery remains highly uncertain, in our view, given the risk of a second wave of infection overseas and resultantly a protracted recovery in the global economy.

Downward scenario

We may lower the long-term issuer credit rating on FENC if the company's adjusted ratio of debt to EBITDA remains above 6x over the next two years, which could result from:

- FENC's profitability fails to recover over the next one to two years, due to a prolonged industry downturn in the polyester product chain or worsening oversupply in PTA that devastates the company's profit margin;
- Considerably higher capex on the company's major businesses than under our base case, or
- FENC's management exhibits a continued high degree of debt tolerance, as indicated by a lack of active debt management, such as capping debt growth through asset disposals or additional prudency in capital spending.

Upward scenario

We may revise the outlook back to stable if FENC could improve its ratio of debt to EBITDA to below 6x on a consistent basis. This could be achieved if:

- FENC could lower the operating loss on its PTA and textile businesses supported by a recovery in demand;
- A more conservative financial policy regarding capex and cash dividend, or a large-scale asset disposal, such that the company's debt level could decrease substantially, or
- A material increase in the contribution from premium products, such as recycled PET, which can help to uplift the company's operating cash flow and profitability on a sustainable basis.

Our Base-Case Scenario

We project FENC's revenue and EBITDA to decline by 17%-21% and 12%-16%, respectively, in 2020, driven by related declines at the company's production and telecommunication businesses. We project a 9%-13% rebound in revenue and EBITDA in 2021, which reflects a rise in contribution from Far EasTone's 5G service as well as demand recovery in FENC's polyester and textile businesses. Our base case assumptions for FENC include:

- Taiwan's real GDP to grow 0.6% in 2020 and 3.2% in 2021. China's real GDP to grow 1.2% in 2020 and 7.4% in 2021. Asia Pacific's real GDP to contract by 1.3% in 2020 and grow 6.9% in 2021.
- The current soft crude oil price and S&P Global's Brent crude oil price assumption of US$50 per barrel for 2021, suggests commodity chemical prices will fall sharply in 2020 and rebound moderately in 2021.
- Momentum in the domestic telecom industry to be weaker than Taiwan's GDP growth due to market saturation and stiff competition. We project a 6%-8% revenue decline and 3%-5% EBITDA decline for Far EasTone in 2020, reflecting a continued decline in ARPU. Far EasTone's revenue and EBITDA could recover in 2021 to levels similar to those in 2019 through consumers' gradual adoption of 5G services, which charges a higher rate compared with 4G services.
- The loss on FENC's PTA business to widen substantially in 2020 due to heavy inventory losses and a narrow cash spread resulting from overcapacity. Cash spread on PTA is likely to remain narrow in 2021, due to China's sizeable new capacity launches in 2020 and 2021.
- Operating profit on polyester business to decline by about 10% in 2020, reflecting relatively stable PET performance but lower sales in staple fiber and polyester filament. This is despite strong demand for hygiene products, such as facemasks. Operating profit for 2021 is likely to recover as demand for staple fiber and polyester filament recovers.
- Textile business to incur an operating loss in 2020 due to aggressive order cuts by major sportswear brands, which are facing a high inventory level and uncertain demand outlook. The business could return to profit in 2021 with recovering demand following the resumption of sports games and the delayed Summer Olympics.
- Sales recognition and operating income from its residential property project of NT$4.3 billion-NT$4.7 billion and NT$2.2 billion-NT$2.6 billion, respectively in 2021. This incorporates our view that the company can sell most of the units in 2021.
- Cash dividend received from equity-method investment to remain at an elevated level of NT$4.0 billion-NT$4.3 billion in 2020, and decline to NT$2.1 billion-NT$2.5 billion in 2021 due to sluggish performance of the invested companies in 2020.
- Capex to increase significantly in 2020 to NT$63 billion-NT$67 billion, due to high spending on the 5G spectrum auction. We project capital spending to remain elevated at NT$26 billion-NT$30 billion in 2021 to support further investment in 5G network infrastructure and capacity expansion in FENC's petrochemical business.
- Asset sales of NT$3.5 billion-NT$4.0 billion in 2020 and NT$1.8 billion-NT$2.2 billion in 2021.
- Cash dividend of NT$8 billion in 2020 and NT$5 billion-NT$7 billion in 2021.

Based on these assumptions, we arrive at the following credit measures for FENC:
- Revenue of NT$200 billion-NT$206 billion in 2020 and NT$223 billion-NT$229 billion in 2021.
- EBITDA margin of 18%-19% in 2020 and 2021.
- Ratio of debt to EBITDA of 6.3x-6.5x in 2020 and 5.7x-6.1x in 2021.
- Ratio of funds from operations (FFO) to cash interest coverage of 9x-11x in 2020 and 2021.

Liquidity

The short-term rating on FENC is 'twA-1'. We believe the company has adequate liquidity, which reflects a ratio of liquidity sources to liquidity uses of 1.2x-1.3x over the next 12 months. We also believe the company will have positive liquidity sources minus uses, even if its EBITDA were to decline by 15%.

We believe the company has a sound relationship with banks as evidenced by the low interest rate on its bank loans. In addition, we believe FENC has a high standing in the credit markets, which is demonstrated by a recent NT$2.2 billion five year and NT$3 billion seven year corporate bond at a fixed rate of only 0.77% and 0.85%, respectively, in June 2020.

FENC has generally prudent risk management to ensure continued adequate liquidity, in our view. The company's sufficient undrawn bank credit lines and flexibility to increase bank facilities support this view. We also believe FENC has sufficient headroom without breaching covenant limits due to low interest rates in Taiwan, even if the company's EBITDA were to drop by 15%.

Principal liquidity sources:
- Cash and short-term investments: about NT$49.6 billion as of the end of March 2020.
- FFO: NT$33 billion-NT$35 billion over the 12 months ending March 2021.
- Undrawn mid-to-long term bank lines maturing beyond March 2021: NT$32 billion-NT$36 billion.
- FENC's corporate bond issuance: NT$11.2 billion in April and June 2020.

Principal liquidity uses:
- Debt maturity of NT$92.3 billion over the 12 months ending March 2021.
- Maintenance capex: about NT$10 billion over the 12 months ending March 2021.

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 - June 26, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Telecommunications And Cable Industry - June 23, 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

Outlook Revision; Ratings Affirmed

	To	From
Far Eastern New Century Corp.		
Yuan Ding Investment 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.