Media Release:

Asia Cement Corp. Outlook Revised To Positive On Strong Cash Flow; 'twA+/twA-1' Ratings Affirmed

September 28, 2020

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Rating Action Overview

- Taiwan-based Asia Cement Corp. is mainly engaged in the manufacture and distribution of cement in China and Taiwan, generating EBITDA of New Taiwan Dollar (NT$) 31.5 billion in 2019.
- We expect improved production discipline and steady demand growth in China to underpin the cement price and Asia Cement's profit margin over the next one to two years.
- Strong cash flow generation from Asia Cement's operation in China over the same period should enable the company to accumulate a financial buffer against potential debt-funded acquisitions or sector cyclicality.
- On September 28, 2020, we revised our rating outlook on Asia Cement to positive from stable. At the same time, we affirmed the 'twA+' long-term and 'twA-1' short-term issuer credit ratings on Asia Cement.
- The positive outlook reflects our view that sustainable free operating cash flow amid a stable market in China is likely to prevent material debt growth over the next one to two years and sustain Asia Cement's ratio of debt to EBITDA below 2.0x over the same period, despite higher capital spending.

Rationale Action Rationale

Supply-side discipline and a demand rebound should support a stable market in China's cement industry over the next two years.

We expect output volume and demand for cement to maintain a tight balance in Asia Cement's operating regions in China. In our view, demand growth will accelerate in the next several quarters as the Chinese government likely continues to release infrastructure projects and loosen controls on the housing market so as to stimulate economic growth that has halted since the first half of 2020 amid COVID-19 and widespread flooding. At the same time, capacity rationalization among cement producers will continue to constrain supply growth to a mild degree. We expect such discipline to sustain over the next one to two years, driven by strong profitability as a result of production volume control and the government's environmental control measures. These factors should help to uphold cement prices and margins over the same period.

Asia Cement's EBITDA generation will remain strong but moderate in 2020 from the peak in 2019 due to weak first-half performance.

We anticipate that the company's cement and clinker sales volume and average selling price (ASP) in China will decline by a high single digit in 2020 owing to weak performance in the first half, given the more serious hit from COVID-19 in Hubei province, one of Asia Cement's major operating regions. This will lead to a reduction of 15%-25% in EBITDA in 2020 before a mid-single digit recovery in 2021, despite a swift recovery in the second half of 2020. However, we expect the stable coal price in China and high capacity utilization of 87%-90% to underpin Asia Cement's cost competitiveness and operating efficiency. Meanwhile, we expect the operating performance of the company's Taiwan cement business to improve in 2020 thanks to low coal costs. We forecast Asia Cement to generate NT$24 billion-NT$27 billion EBITDA in 2020, a level similar to that in 2018.

Rising profit contribution from stable power generation business could add to performance stability from 2021 onwards.

We expect Asia Cement's EBITDA to improve moderately in 2021, mainly driven by a recovery in sales volume and stable selling prices at its China operations, which we estimate to contribute about 80% of the company's total EBITDA. Capacity expansion at Asia Cement's power generation subsidiary, ChiaHui Power Co. Ltd., will also contribute a stable and higher operating cash flow to Asia Cement from the first quarter of 2021. We estimate ChiaHui's EBITDA contribution will increase to 13%-15% of Asia Cement's total EBITDA in 2021, up from about 8% in 2019. Nonetheless, the improvement is partly offset by a lower cash dividend received from Asia Cement's equity investments (which we include in our adjusted EBITDA calculation) including Far Eastern New Century Corp. (FENC) and U-Ming Marine Transport Corp., due to likely performance deterioration at these companies.

Large-scale debt funded acquisitions beyond our assumption could still cause a material deterioration in credit metrics despite an increasing financial buffer.

Asia Cement's ratio of debt to EBITDA has strengthened materially to 1.5x in 2019 and 1.6x as of end of June 2020, comparted with 4.5x in 2017, driven by the company's strong cash flow from its cement operations in China under an industry upcycle. We expect Asia Cement's strong operating cash flow from China's cement business to help lower the company's debt level moderately and support a ratio of debt to EBITDA at 1.7x-1.9x over the next two years. Nevertheless, Asia Cement's strong growth appetite in its key businesses, including cement and power generation, is likely to constrain rapid deleveraging, in our view. For 2020 and 2021, we estimate capital expenditure to rise to NT$7 billion-NT$10 billion, which reflects Asia Cement's opportunistic cement capacity expansion, given its intention to increase its operating scale in China. Nonetheless, the exact degree of expansion and timeline remain uncertain. The ratio of debt to EBITDA could further rise to approach 2x if the company pursues more aggressive business growth beyond our forecast assumption.

Cement sector cyclicality lingers on overcapacity and volatility of construction activities is likely to pose uncertainty over Asia Cement's debt deleverage.

We believe Asia Cement's high risk exposure to cement sector cyclicality will continue, given its profitability is highly dependent on the cement market. In our view, overcapacity is likely to persist over the next two years, due to slow capacity retirement under the current high-selling-price environment. In addition, cement demand is highly correlated to that of the infrastructure and property market, for which prosperity is largely dependent on the Chinese government's policy direction. Therefore, the risk of a slowdown in construction activities could cast some uncertainty towards cement demand. This could lead to a quick deterioration in Asia Cement's credit metrics if the operating environment in China turns negative.

Outlook

The positive outlook on Asia Cement reflects our view that the company is likely to sustain its strong cash flow, thus enabling the company to maintain its ratio of debt to EBITDA at 1.6x-1.9x over the next one to two years. This is based on our expectation that supply-side discipline and a demand rebound will continue to support a stable operating environment in China's cement industry over the same period. Strong cash flow generated from the company's improved operation in China cement business should enable Asia Cement to accumulate a financial buffer for potential debt-funded acquisitions to expand its overseas and China cement business. However, the risk of a slowdown in construction activities in China's property market casts some uncertainty over cement demand, leading to some downside risk in cement's sales volume and average selling price. In addition, the company's higher debt appetite for business growth than we previously expected could trigger a rapid increase in its debt leverage.

Upward scenario

We may raise the long-term issuer credit rating if:

- We believe Asia Cement could sustain its ratio of debt to significantly below 2.0x for an extended period through industry cycles even if the company pursues acquisitions with a size moderately higher than our forecast assumption. This could be achieved through sustainable operating cash flow underpinned by a strong profit margin in its cement business, while at the same time the company maintains controlled capital expenditure and a prudent investment appetite.

Downward scenario

We may revise the outlook back to stable if:

- We view the company could not sustain its ratio of debt to EBITDA materially below 2.0x over the next one to two years. Several factors could lead to weakening operating cash flow. These include (1) deterioration in the company's operating environment possibly due to sluggish demand caused by weaker policy support, (2) weakening production discipline that worsens oversupply in the cement sector, or (3) a substantial increase in key operating costs without a corresponding price reflection. Similarly, a significant increase in the company's capital expenditure or acquisitions that exceeds our expectation could result in a debt level materially higher than we previously assumed.

Our Base-Case Scenario

We project 10%-15% revenue decline in 2020 because of operation disruption and weak demand in the first half due to COVID-19 and flooding in China. We expect Asia Cement's revenue to rebound robustly in 2021, given delayed and accumulated demand is expected to release in the following several quarters. The Chinese government's expansion in infrastructure investments and loosened controls on the property market will underpin solid demand. Our assumptions include:

- China's real GDP to grow 2.1% in 2020, and 6.9% in 2021. We expect China's recovering infrastructure and property investment to support steady cement demand growth in the next one to two years.
- Taiwan's real GDP to grow 1.0% in 2020 and 3.0% in 2021. We expect low-to-mid single digit cement demand growth to sustain over the next one to two years, thanks to recovery in the housing market, an increased government budget for infrastructure projects, as well as rising construction needs from the private sector.
- Revenue from the company's China cement business will decline by 10%-15% in 2020, reflecting a high-single digit ASP volume decline. These declines reflect short-term disruption in cement demand in the first half of 2020. We expect the company's cement sales to grow by 7%-12% in 2021, mainly driven by a recovery in sales volume and moderate ASP growth, but to remain lower than the price peak in 2019. We believe tight local government control on overproduction volume will continue to support a relatively high cement price over the next two years.
- Asia Cement's capacity utilization in China to lower to about 80% in 2020 from 87%-90% in 2018 and 2019, before recovering to the previous level in 2021. We expect the company's capacity utilization in Taiwan to remain at 66%-70% over the same period.
- EBITDA for the company's non-cement business to grow moderately in 2020 reflecting higher contribution from the company's power generation business despite margin deterioration in stainless steel. EBITDA from non-cement business will further grow by about 30% in 2021 considering the incremental earnings contribution from its power business capacity expansion.
- Dividend contribution from equity-method investments to lower to NT$2.8 billion-NT$3.0 billion in 2020 and further decrease to NT$1.5 billion-NT$2.0 billion in 2021. The lower dividend income mainly reflects Far Eastern New Century Corp. (FENC)'s weaker operating performance.
- Capital expenditure to be NT$5.5 billion-NT$6.5 billion in 2020, mostly related to capacity expansion in Asia Cement's power generation business. Capital expenditure to be NT$8 billion-NT$10 billion in 2021, which assumes Asia Cement will expand its cement capacity in China.
- Dividend payment of NT$10.1 billion in 2020 and NT$9 billion-NT$11 billion in 2021. The higher dividend payments reflect the company's strong operating performance during the period.
- We net 92% of Asia Cement's cash and liquid investments with its reported debt in calculating adjusted debt.

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

- EBITDA margin of 31%-33% in 2020 and 29%-31% in 2021.
- Ratio of debt to EBITDA of 1.7x-1.9x in 2020 and 1.6-1.8x in 2021.
- Ratio of discretionary cash flow to debt of 10%-15% in 2020 and -5%-0% in 2021.

Liquidity

The short-term issuer credit rating is 'twA-1'. We believe Asia Cement has adequate liquidity to meet its needs over the next 12 months, reflecting our view that its ratio of liquidity sources to liquidity uses will be around 1.3x during the period. We also believe that liquidity sources will continue to exceed uses even if Asia Cement's EBITDA were to decline by 15%. We also believe the company has a sound relationship with banks and a generally high standing in the credit market in Taiwan, supported by the company's membership of the FENC group. Asia Cement's recent issuance of a five-year and seven-year corporate bond at a low fixed rate of 0.65% and 0.73% respectively also underpins this view. There are no financial covenants associated with Asia Cement's or its subsidiaries' debt as of the end of June 2020.

Principal Liquidity sources

- Cash and short-term investments: NT63.6 billion as the end of June 2020.
- Funds from operations: NT$19 billion-NT$21 billion over the next 12 months ending June 2021.
- Undrawn bank lines (maturing beyond June 2020): NT$14 billion-NT$15 billion.

Principal liquidity uses

- Debt maturities: NT$51 billion-NT$53 billion over the next 12 months ending June 2021.
- Capital expenditure: NT$7 billion-NT$8 billion over the next 12 months ending June 2021.
- Acquisitions: NT$5.4 billion in the second half of 2020 to acquire about 40% ownership of ChiaHui Power.
- Cash dividend: NT$10.1 billion in third quarter of 2020.

Ratings Score Snapshot

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

Business Risk: Satisfactory

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

Financial Risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: twa+

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: Negative (-1 notch)

Stand-alone credit profile: twa+

Related Criteria & Research

Related Criteria

- General Criteria: Group Rating Methodology, Jul 01 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Apr 01 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec 16 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov 19 2013
- General Criteria: Methodology: Industry Risk, Nov 19 2013
- Criteria | Corporates | General: Corporate Methodology, Nov 19 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov 13 2012
- General Criteria: Principles Of Credit Ratings, Feb 16 2011

Related Research

- Taiwan Ratings' Ratings Definitions – August 10, 2020

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

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Asia Cement Corp.		
Issuer Credit Rating	twA+/Positive/twA-1	twA+/Stable/twA-1

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