Media Release:

Taiwan Railways Administration, MOTC Ratings Affirmed At 'twAAA/twA-1+'; SACP Revised Down To 'twbbb+'; Outlook Stable

December 8, 2020

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Rating Action Overview

- The slow progress of **Taiwan Railways Administration, MOTC's** (TRA) land development program, still-high capital expenditure (capex), and TRA's increasing labor cost could erode its financial strength over the next two to three years. We have therefore lowered its stand-alone credit profile (SACP) to 'twbbb+' from 'twa-'.
- We continue to see an almost certain likelihood of timely financial support for the agency from the Taiwan government.
- On December 8, 2020, Taiwan Ratings Corp. affirmed its 'twAAA' long-term and 'twA-1+' short-term issuer credit ratings on TRA.
- The stable outlook reflects the stable outlook on S&P Global Ratings unsolicited issuer credit ratings on the government of Taiwan and our view of TRA's critical policy role and integral link to the Taiwan government.

Rationale Action Rationale

Improvement in TRA's cash flow generation is likely to be limited due to the slow progress of land development projects over the next two years. TRA owns many land or property assets surrounding its 241 train stations, which generated over New Taiwan dollar (NT$) 3.8 billion of rental income in 2019. We believe TRA could sustain its rental income at close to NT$4 billion in 2020-2021, supported by an active domestic property market and existing contracts. Although rental income has improved over the past five years, the resultant cash flow generation is not sufficient to cover the agency's cash outflows. TRA expects to leverage these assets to significantly improve its revenue base and cash flow generation over the next five years. However, there remains high uncertainty over the timeframe and magnitude of its land development projects, given how complicated administrative procedures tend to slow the development process.

Despite investment from the government, TRA's operating cash flow cannot fully cover its capex. TRA's annual capex was NT$13 billion-NT$18 billion in 2018-2019. Of the numerous expansion capex projects, the Taiwan government covers 70%-100% of the related costs and TRA undertakes responsibility for the rest. In addition, annual maintenance capex was NT$2.5

billion-NT$3.5 billion in the past five years, which TRA covered itself. We expect the agency to sustain its maintenance capex in accordance with its government-approved budget report. In our view, such capex will further pressure the agency's debt leverage over the next two to three years.

Increasing labor cost is unlikely to pass through to passengers due to frozen fare rates. TRA's labor cost accounted for about 73% of its operating cost and expense (excluding depreciation and amortization) in 2019. We expect the ratio to climb above 73% in 2020-2022 due to an increase in employee numbers to reflect the improved security needs of its rail operations. We project labor cost could rise by 4%-5% annually over the next two years; however, we believe it unlikely that TRA will pass through the additional labor cost to customers. That's because the government has frozen TRA's fares for the last 25 years, and we see limited likelihood of an upward adjustment over the next one to two years, due to the complexity and level of difficulty in gaining approval from various governmental bodies.

TRA's critical role providing public transportation services and integral links with the Taiwan government underpin the credit rating. We believe TRA performs a critical role to the government, given it is the sole conventional rail infrastructure provider and railroad operator in the nation. TRA owns a comprehensive rail network, conveniently located train stations, and a dominant position on the east coast of Taiwan. In addition, TRA has an integral link with the government of Taiwan and is a government business entity under the MOTC. Therefore, we believe the Taiwan government is almost certain to provide timely and sufficient extraordinary support in the event that TRA experiences financial distress.

Potential SACP changes for the financial risk profile scenario. We lowered TRA's stand-alone credit profile (SACP) to 'twbbb+' from 'twa-' to reflect the growing risk that slow progress in the agency's land development program coupled with still-high capex and increasing labor costs could erode TRA's financial strength over the next two to three years. We may further revise down the SACP if TRA's credit metrics deteriorate considerably due to slower progress in its land development projects or a surge in the agency's operating costs, although we view the likelihood of such a revision as low over the next one to two years. A weakening of the ratio of funds from operations (FFO) cash interest coverage to close to 2x could indicate such deterioration.

Outlook

The stable outlook on TRA reflects our view that the agency's creditworthiness is equal to that of the Taiwan government. That is because of the agency's critical policy role in managing and operating the nation's conventional rail network on behalf of the government, and our view that TRA's integral link with the government will remain unchanged over the next two years.

However, a slump in passenger traffic and policy burden has weighed on TRA's financial strength, given its very weak cash flow generation and high debt level in 2020. The agency's FFO cash interest coverage ratio is likely to soften to 3x-6x in 2020-2022, compared to 6.3x in 2019. We expect the weak credit metrics to last until the agency is permitted to make a significant increase in rail fares or TRA's substantial asset development programs progress sufficiently to improve its cash flow generation.

Downward scenario

Downgrade risk is very remote over the next two years because any material change in TRA's role and link to the government is unlikely to occur during the period. However, we would lower long-term rating on TRA if:

- S&P Global Ratings lowered its unsolicited issuer credit rating on Taiwan by more than one notch, or
- there is a weakening of TRA's policy role or link to the Taiwan government such that we see a reduced likelihood of extraordinary government support. Privatization of the rail infrastructure would indicate such a weakening of potential support.

Our Base-Case Scenario

- Growth in Taiwan's real GDP of 1.6% in 2020, 2.9% in 2021, and 2.5% in 2022. GDP growth is likely to support improved ridership over the next two years, following recovery from the Covid-19 pandemic.
- TRA's revenue to decrease by 7.5%-9.5% in 2020 due to lower passenger volume. However, we expect TRA's revenue to rebound in 2021 by 8%-10% following the recovery in passenger numbers since the second half of 2020. For 2022, revenue is likely to grow moderately at 1.5%-3.5% due to increasing passenger revenue and rental income.
- Seat utilization to drop significantly by about 10 percentage points and passenger revenue to decline by 13.5%-15.5% in 2020 due to weaker demand amid the pandemic. We expect seat utilization to greatly recover to 63%-64% in 2021, given the likelihood that the pandemic will be brought under control through widely available vaccination programs from mid-2021. However, seat utilization could be slightly lower than that of 2019 due to the increasing capacity of new passenger cars.
- Rental income to grow slowly at 1%-3% per year in 2020-2022.
- Government subsidies for non-profitable routes and stations of NT$574 million from 2020 onwards, which pushes up revenue of other affiliated businesses (except rental income) to above NT$4 billion a year.
- TRA's costs to increase by 2%-4% annually in 2020-2022 to fill over 1,000 new staff positions and reflecting higher staff costs to apply looser working shifts and double-driver systems while maintaining the current level of service.
- Government approval of the agency's expansionary capex of NT$24.3 billion in 2020, NT$26.3 billion in 2021, and NT$34.6 billion in 2022, among which NT$17.8 billion, NT$21.3 billion, and NT$29.9 billion, respectively, will be funded by the government.

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

- EBITDA margin of 11%-14% in 2020 and 18%-21% in 2021-2022, down from 21.5% in 2019.
- Ratio of FFO to debt of 0.5%-1.0% in 2020 and 1.5%-2.5% in 2021-2022, down from 2.5% in 2019.
- FFO cash interest coverage of 3x-4x in 2020 and 4x-6x in 2021-2022, down from 6.3x in 2019.

Liquidity

The short-term rating on TRA is 'twA-1+'. We believe TRA has adequate liquidity based on our expectation that the agency will continue to benefit from its status as an essential government related entity, the importance of which is evidenced by the ongoing and strong financial support provided by the Taiwan government.

Based on TRA's track record, when private-owned banks are unwilling to roll over the agency's short-term debt due to very thin margins, state-owned banks will step in and provide additional short-term refinancing needs. Moreover, the government will provide its budgeted funds earlier to help TRA roll over its short-term debt when needed. Hence, we believe TRA will continue to benefit from preferential access to banking facilities, as demonstrated by its strong debt rollover capabilities in the past and low interest rate on its bank loans and commercial papers. These factors underpin our view that the entity has the ability to achieve a ratio of liquidity sources to uses above 1.2x up to the end of September 2021. TRA has no covenant placed on its debt.

Principal Liquidity Sources

- Cash and short-term investments: NT$379.5 million at the end of September 2020.
- Ongoing government support (credit lines of government related banks): NT$163 billion-NT$168 billion up to September 2021.
- Government investment: NT$18 billion-NT$22 billion up to September 2021.
- Asset sale and working capital inflow: NT$0.9 billion-NT$1.1 billion in up to September 2021.

Principal Liquidity Uses:

- Debt maturities: NT$134.9 billion up to September 2021.
- Cash FFO: NT$300 million-NT$500 million up to September 2021.
- Working capital outflow: NT$2.0 billion–NT$3.0 billion up to September 2021.
- Maintenance capex: NT$3.0 billion-NT$3.5 billion up to September 2021.

Ratings Score Snapshot

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

Business risk: Satisfactory
- Country risk: Intermediate
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Aggressive
- Cash flow/leverage: Aggressive

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: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: twbbb+
- Related government rating: AA-
- Likelihood of government support: Almost certain (+7 notches from SACP)

Related Criteria & Research

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Group Rating Methodology - July 01, 2019
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Infrastructure Industry - November 19, 2013
- 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: Principles Of Credit Ratings - February 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

Taiwan Railways Administration, MOTC	
Issuer Credit Rating	twAAA/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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