Media Release:

China Steel Corp. Outlook Revised To Stable From Negative On Solid Demand Recovery; 'twAA-/twA-1+' Ratings Affirmed

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PRIMARY CREDIT ANALYST

Jin Dong, CFA
Taipei
+886-2-2175-6821
jin.dong
@spglobal.com
jin.dong
@taiwanratings.com.tw

SECONDARY CONTACT

Irene Lai
Taipei
+886-2-2175-6825
irene.lai
@spglobal.com
irene.lai
@taiwanratings.com.tw

Overview

- Taiwan-based steel producer **China Steel Corp.** is the largest and only integrated steel manufacturer in Taiwan. The company commands over 50% domestic market share and had annual crude steel capacity of about 16 million tons and EBITDA of NT$36.5 billion in 2020.
- We expect strong demand recovery for steel products to bolster China Steel's sales volume and product prices, leading to strengthened operating cash flow generation in 2021.
- We anticipate the company's debt guarantee on Formosa Ha Tinh Steel's loan to decline rapidly over the next two years, which could accelerate China Steel's progress in deleveraging and increase rating headroom.
- On April 23, 2021, we revised our outlook on the long-term issuer credit rating on China Steel to stable from negative. At the same time, we affirmed our 'twAA-/twA-1+' issuer credit ratings on the company. We also affirmed our 'twAA-' issue rating on the company's senior unsecured bond.
- The stable outlook reflects our expectation that solid steel demand and an acceleration in debt reduction will help sustain China Steel's ratio of FFO to debt at 21%-27% over the next two years.

Rating Action Rationale

Buoyant demand outlook to support strong operating cash flow generation in 2021. The strong demand momentum for steel products is likely to persist over the next two to three quarters. This is because downstream manufacturing sectors are generating stronger than expected recovery following the COVID-19 pandemic. Steel demand for use in construction is also likely to remain elevated for several other reasons. These include domestic public infrastructure projects, record-high new-starts in the residential property market, and reshoring activities by Taiwanese companies that have increased demand for commercial properties. At the same time, steel imports could decline as major steel exporting countries in the APAC region take measures to prioritize their own higher domestic demand.

These factors support our assumption of a 7%-9% increase in sales volume for China Steel in 2021. Furthermore, the resulting supply shortage underpins our assumption of a 26%-30% rise in steel prices for 2021, which more than offset a likely increase in raw material costs over the period. Consequently, we anticipate China Steel can generate strong operating cash flow over the next couple of quarters, with EBITDA surging to new Taiwan dollar (NT$) 67 billion-NT$72 billion in 2021 from NT$36.5 billion in 2020.

Nonetheless, steel prices could level off over the next 12-24 months as output ramps up globally following disruptions due to COVID-19. Imported steel volume could rise again when the regional market returns to oversupply. In the meantime, steel demand stemming from restocking needs and pent-up demand during the pandemic will diminish gradually. Our base case assumes a 7%-11% decline in China Steel's average selling price and 4%-6% decline in sales volume in 2022. Under these assumptions, we estimate the company's EBITDA generation to decrease to NT$50 billion-NT$54 billion in 2022.

An acceleration in debt reduction adds to China Steel's rating buffer. China Steel's guarantee on debt derived from the Formosa Ha Tinh steel project in Vietnam is likely to decline rapidly over the next two to three years, given the steel mill has recently obtained a US$2.5 billion syndicated loan. We expect Ha Tinh Steel to subsequently pay down the guaranteed loan using the new funding. We project China Steel's guarantee debt to decline by NT$14 billion-NT$15 billion in 2021 and by a further NT$8 billion-NT$11 billion in 2022. We also expect China Steel's strong operating cash flow over the next 12 months to facilitate debt reduction. A lower debt level adds to China Steel's ability to weather industry volatility and support its ratio of FFO to debt at 21%-27% over the next two years.

Persistently high capex constrains rating upside. We expect costs associated with China Steel's 51% owned 300-megawatt offshore wind farm to increase the company's capital expenditure (capex) to NT$35 billion-NT$38 billion in 2022, up from NT$24 billion-NT$27 billion in 2021, which are mainly for facility upgrades. In addition, China Steel may seek to strengthen its production competency by enhancing production diversity or vertical integration over the medium term. We believe overseas expansion could help China Steel to expand its presence in the export market and mitigate tariff disadvantages faced by Taiwan steel makers. However, these potential investments could add to China Steel's debt burden and constrain its rating upside.

Outlook

The stable outlook reflects our expectation that China Steel's sales and profit margin will rebound in 2021, underpinned by solid demand recovery in steel products. We also expect the company's debt to decline through strong operating cash flow generation and a rapid decline in guarantee debts. These factors could lead to a strengthening in China Steel's ratio of funds from operations (FFO) to debt to 25%-28% in 2021. However, we expect the operating momentum to moderate in 2022, when steel output ramps up globally. Competition could intensify and bring downward pressure on steel prices as well as China Steel's profit margin, thereby bringing down its ratio of FFO to debt to 20%-23% in 2022.

Downward scenario

We may lower the long-term rating if:

- China Steel's ratio of FFO to debt weakens to close to 12% for an extended period, possibly due to (a) an extensive industry downturn with contraction in demand and intense competition, (b) persistently high raw material prices which would squeeze the company's profit margin materially or (c) China Steel's adoption of a much more aggressive capex plan curbs the company's ability to deleverage and results in an elevated debt level for an extended period; or
- China Steel's link with the Taiwan government weakens from our assessment of strong, which may happen if the government materially lowers its ownership stake.

Upward scenario

We may raise the long-term rating if:

- China Steel could sustain its profitability and lower its debt, such that the ratio of FFO to debt stays materially above 25% on a sustainable basis. Such improvement could be achieved by (a) continued debt reduction through strong operating cash flow generation without aggressive investments and capex or (b) China Steel's cost competitiveness and product mix further strengthen, accompanied by a sustained demand and supply balance in the regional steel market.

Our Base Case Scenario

- S&P Global Ratings forecast for Taiwan's GDP to grow 4.2% in 2021 and 2.7% in 2022 and Asia Pacific GDP to grow 7.3% in 2021 and 4.9% in 2022. The faster economic growth will foster demand growth for steel products.
- China Steel's sales volume to increase by 7%-9% in 2021, fueled by robust demand domestically and in export markets. However, we expect sales volume to subsequently decline by 4%-6% in 2022 when restocking demand post COVID-19 diminishes.
- Robust demand along with a supply shortage and higher iron ore prices will support steel prices in 2021. We expect the company's average selling price (ASP) for steel products to increase by 26%-30% in 2021. However, ASP could decline 7%-11% in 2022, reflecting an increase in competition with the restoration of steel supplies as well as a likely price correction for iron ores over the next 12-24 months.
- Our assumption for iron ore prices of US$140/ton-US$160/ton for 2021, and US$100/ton-US$130/ton in 2022. Our assumption on coking coal prices is US$115/ton-US$135/ton for 2021, and US$125/ton-US$155/ton in 2022.
- China Steel's gross margin to strengthen to 19%-22% in 2021 from 15.4% in 2020, through elevation in ASP and sales volume. Gross margin could decline to 16%-20% in 2022 amid stiffer competition.
- Selling, general and administrative expense at 3.6%-4.1% of total revenue in 2021-2022.
- China Steel's capex and equity investment of NT$24 billion-NT$27 billion in 2021, mainly used for facility upgrades. Capex spending on its offshore wind farm could drive up the company's capex to NT$35 billion-NT$38 billion in 2022.
- Cash dividend of NT$4.7 billion in 2021 and NT$16 billion-NT$18 billion in 2022.
- China Steel's debt guarantee to decline to about NT$20 billion at the end of 2021 and NT$10 billion-NT$12 billion at the end of 2022. This reflects our view that Formosa Ha Tinh Steel will pay down its guaranteed loan over the next few years.

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

- EBITDA margin of 16%-18% in 2021 and 13%-15% in 2022, up from 11.6% in 2020.
- Ratio of FFO to debt of 25%-28% in 2021 and 20%-23% in 2022, up from 13.0% in 2020.
- FFO interest coverage ratio of 23x-26x in 2021 and 19x-22x in 2022, up from 11.4x in 2020.

Liquidity

The short-term issuer credit rating is 'twA-1+'. We believe China Steel has adequate liquidity to meet its needs over the next 12 months ending 2021, with a ratio of liquidity sources to liquidity uses at 1.35x-1.45x over the same period. We also believe that China Steel's liquidity sources will continue to exceed uses, even if its EBITDA were to decline by 15%.

In our view, China Steel has a high standing in credit markets and well-established and solid banking relationships in Taiwan reflected by the low interest rate on its bank loans. This is supported by the company's role as a government related entity and strong domestic market position. China Steel has some financial covenants on its bank loan; however, we expect the company to meet loose financial covenants on its bank loans.

Principal liquidity sources

- Cash and short-term investments: about NT$29 billion as of the end of December 2020.
- Cash FFO: NT$57 billion-NT$61 billion in 2021.
- Committed undrawn bank lines maturing beyond 2021: NT$43 billion-NT$47 billion.
- Unused short-term credit facilities offered by state owned banks and bill finance companies: NT45 billion-NT$48 billion in 2021.

Principal liquidity uses

- Short-term and long-term debt maturity: NT$76 billion-NT$81 billion in 2021.
- Capex: NT$24 billion-NT$27 billion in 2021.
- Working capital outflow: NT$20 billion-NT$24 billion in 2021.
- Cash dividends: NT$4.7 billion in 2021.

Ratings Score Snapshot

Issuer Credit Rating: twAA-/Stable/twA-1+

Note: The descriptors below are on a global scale.

Business Risk: Satisfactory

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

Financial Risk: Significant

- Cash flow/Leverage: Significant

Anchor: twa+

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 (SACP): twa+

- **Unsolicited issuer credit rating on Taiwan** (rated 'AA/Positive/A-1+' by S&P Global Ratings)
- **Likelihood of government support**: Moderate (+1 notch from SACP)

Related Criteria & Research

Related Criteria

- General Criteria: Principles Of Credit Ratings - February 16, 2011
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Methodology For National And Regional Scale Credit Ratings - June 25, 2018
- General Criteria: Group Rating Methodology - July 01, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- Criteria | Corporates | General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings - March 28, 2018
- 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

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
China Steel Corp.		
Issuer Credit Rating	twAA-/Stable/twA-1+	twAA-/Negative/twA-1+
Issue Credit Rating	twAA-	

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.