Media Release:

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

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Rating Action Overview

- Taiwan-based steel manufacturer **Dragon Steel Corp.** is a wholly owned subsidiary of **China Steel Corp.** and has a combined steel producing capacity of six million tons, with EBITDA of NT$7.8 billion in 2020.
- We expect strong steel demand to sustain in 2021 and support strong growth in Dragon Steel's sales volume. Meanwhile, rising material cost could bolster steel product prices.
- We expect Dragon Steel's credit metrics to recover in 2021, mainly due to robust revenue growth and improving product margins along with a conservative dividend policy.
- On April 23, 2021, we revised our outlook on the long-term issuer credit rating on Dragon Steel to stable from negative. The stable outlook reflects the likely recovery in the parent company's credit metrics in 2021.
- At the same time, we affirmed the 'twA+' long-term and 'twA-1' short-term issuer credit ratings on Dragon Steel.

Rationale Action Rationale

The ratings and outlook on Dragon Steel move in tandem with those on its parent. We revised the outlook on Dragon Steel to stable following our similar outlook revision on its parent to reflect the strong recovery in the global steel industry. We believe this recovery will largely support an improved operating performance for China Steel and Dragon Steel over the next 12-24 months. China Steel's ratio of funds from operations (FFO) to debt could improve to 25%-28% in 2021, up from 13% in 2020, supported by recovering sales and profit margin with declining debt guarantees. Despite this, China Steel's operating momentum could moderate in 2022, when steel output ramps up globally. Competition could also intensify and bring downward pressure on steel prices as well as China Steel's profit margin, which would bring down its ratio of FFO to debt to 20%-23% in 2022.

Steel product prices have hit record highs along with sales volume growth which could improve Dragon Steel's margin. We now project global economic growth of 5.7% in 2021 after widespread economic recession globally in 2020 due to the impact of COVID-19. We believe the economic recovery could sustain high steel prices over the next two to three quarters, supported by strong demand for downstream steel products used in construction or infrastructure projects. Meanwhile, pandemic induced disturbances have constrained supply and prevented the full ramp-up of capacity worldwide along with Chinese government curbs on steel output to improve air pollution in some provinces. We believe that these factors combined with the rising cost of iron ore amid constrained supply could bolster steel price to a new high in 2021. This could in turn improve Dragon Steel's margin after the company's weak performance in 2020. However, rising material costs could constraint such margin improvement.

Debt is likely to decline through a conservative dividend policy. We anticipate Dragon Steel will see working capital outflow of new Taiwan dollar (NT$) 3.5 billion-NT$4.5 billion in 2021 due to strong revenue recovery. Despite this, the company's surging revenue with an improving profit margin and conservative dividend policy could generate sufficient cash flow to lower its debt. This could create a greater buffer for Dragon Steel's debt leverage to weather the ups and downs of the steel industry. We believe Dragon Steel's ratio of FFO to debt could improve to 22.5%-24.5% in 2021-2022, up from 11.8% in 2020.

Moderate capital expenditure (capex) to support Dragon Steel's development under stricter environmental requirements. We expect the company to invest moderate capex of NT$3 billion–NT$4.5 billion over the next two to three years. The main project among these investments is an indoor materials storage facility. Dragon Steel is likely to maintain its capex at a similar level to maintain its operating efficiency and cover the cost of tightening environment requirements over the longer term. In our view, Dragon Steel is able to generate sufficient cash flow through recovering operating business strength and a conservative dividend policy to avoid a surge in debt.

Outlook

The stable outlook on Dragon Steel reflects the stable rating outlook on its parent, China Steel, because we view Dragon Steel as a core subsidiary of the China Steel group. The stable outlook on the parent reflects our expectation of a recovery in China Steel's ratio of FFO to debt to 25%-28% in 2021 from 13% in 2020, spurred by solid demand recovery, strong operating cash flow generation, and declining debt guarantees. However, such improvement could slow down when steel output ramps up globally in 2022. Competition could also intensify and place downward pressure on steel prices as well as China Steel's profit margin, which could lower the company's ratio of FFO to debt to 20%-23% in 2022.

Downward scenario

We may lower the long-term rating on Dragon Steel if:

- We lower the standalone credit profile (SACP) of China Steel. This could occur if China Steel's ratio of FFO to debt weakens to close to 12% for an extended period such as if the company's profitability weakens significantly due to (a) an extensive industry downturn with shrinkage in demand and intense competition, (b) persistently high raw material prices that weaken the company's margin materially, or (c) China Steel takes on aggressive capital expenditures or investments.
- We may also lower the rating if we believe China Steel's support for Dragon Steel weakens.

Upward scenario

We may upgrade the long-term rating on Dragon Steel if:

- We raise the long-term ratings on China Steel because the company's ratio of FFO to debt remains materially above 25% on a sustainable basis. This could happen if China Steel maintains its debt reduction program through strong operating cash flow generation without aggressive investments and capex. A further strengthening of China Steel's cost competitiveness and product mix, and a sustained demand and supply balance in the regional steel market could also help the company to achieve such improvement.

Our Base Case Scenario

- S&P Global Ratings forecast for Taiwan's GDP to grow by 4.2% in 2021 and 2.7% in 2022, and for China’s GDP to grow 8.0% in 2021 and 5.1% in 2022. We expect the strong economy recovery to sustain steel demand in 2021.
- Our assumption on 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 of US$115/ton-US$135/ton for 2021, and US$125/ton-US$155/ton in 2022.
- ASP continues to surge with double digit growth in 2021, given the booming demand for hot-rolled coil products. This is in line with rising regional steel prices due to resurgent demand but slower supply pick-up following disruption amid COVID-19. However, ASP could decline by 8%-12% in 2022, reflecting an increase in competition with the restoration of steel supplies as well as a likely price correction for iron ore over the next 12-24 months. ASP for H-beam products will also surge by a double digit in 2021 following a price recovery. Moreover, sustainable local demand from construction and infrastructure projects could support elevated H-beam prices over the next two years.
- Dragon Steel's revenue is likely to grow by 38%-42% in 2021 due to a rebound in steel demand. Revenue could soften by 11%-15% in 2022, given the high base in 2021 and ramp-up of regional capacity.
- Sales, goods and administration expense to remain at around 2.5% of total revenue in 2021 and 2022.
- Capex of NT$3.0 billion-NT$4.5 billion in 2021-2022, mainly for the project to build an indoor storage facility for raw materials.
- No dividend payout in 2021 and a conservative dividend payout of 60% in 2022, given consecutive operating losses in 2019-2020.

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

- EBITDA margin of 12%-14% in 2021 and 11%-13% in 2022, compared with 10.2% in 2020.
- FFO to debt of 22.5%-24.5% in 2021-2022, compared with 11.8% in 2020.
- FFO cash interest coverage of 27x-29x in 2021 and 26x-28x in 2022, compared with 11.8x in 2020.

Liquidity

The short-term rating on Dragon Steel is 'twA-1'. We believe the company has adequate liquidity to meet its needs up to the end of 2021, with an estimated ratio of liquidity sources to liquidity uses at above 1.2x over the period. We believe the company's liquidity sources will still exceed liquidity uses even if its EBITDA were to decline by 15%. The liquidity assessment also reflects our view that the company has prudent risk management and the ability to absorb with limited refinancing, high-impact, low-probability events.

In addition, we believe Dragon Steel has a generally satisfactory standing in credit markets and has sound business relationships with banks in Taiwan, thanks to its association with China Steel. Most of the company's mid-to-long term loan facilities will expire before 2022, as well as its current bank loans. However, we view Dragon Steel's refinancing risk as low, given the company's standing in credit markets and access to its parent group's funding pool.

Principal Liquidity Sources

- Cash and short-term investment: NT$446 million as of the end of 2020.
- FFO: NT$13 billion-NT$15 billion up to the end of 2021.
- Unused committed bank loans: NT$23 billion-NT$24 billion up to the end of 2021.

Principal Liquidity Uses

- Debt repayment of NT$24 billion-NT$25 billion up to the end of 2021.
- Working capital outflow: NT$4 billion-NT$5 billion up to the end of 2021.
- Maintenance capex: NT$2 billion-NT$2.5 billion up to the end of 2021.

Ratings Score Snapshot

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

Note: The descriptors below are on a global scale.

Business Risk: Fair

- Country risk: Intermediate
- Industry risk: Moderately high
- Competitive position: Fair

Financial Risk: Significant

- Cash flow/Leverage: Significant

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: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twbbb+

- Group stand-alone credit profile: twa+
- Entity status within group: Core (the same as the group stand-alone credit profile)

Related Criteria & Research

Related Criteria

- General Criteria: Principles Of Credit Ratings - February 16, 2011
- General Criteria: Group Rating Methodology - July 01, 2019
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012
- 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

Related Research

- Media Release: China Steel Corp. Outlook Revised To Stable From Negative On Solid Demand Recovery; 'twAA-/twA-1+' Ratings Affirmed, April 23, 2021
- Taiwan Ratings' Ratings Definitions – August 10, 2020

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

Ratings List

Ratings Affirmed; Outlook Revised

	To	From
Dragon Steel Corp.		
Issuer Credit Rating	twA+/Stable/twA-1	twA+/Negative/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.