Media Release:

Chung Hung Steel Outlook Revised To Stable From Negative On Solid Demand Recovery; SACP Raised; 'twA/twA-1' Ratings Affirmed

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Rating Action Overview

- Taiwan-based steel producer **Chung Hung Steel Corp.** is a specialized downstream steel processor, owning production capacity of 2.4 million tons (Mt) of hot-rolled coils, 0.45 Mt of cold-rolled coils, 0.25 Mt of steel piping, and 0.3 Mt of galvanization capacity. Its EBITDA was NT$1.5 billion in 2020.
- Strong demand recovery for steel products will bolster Chung Hung Steel's sales volume and product prices, thereby strengthen its operating cash flow generation in 2021.
- Limited capex and a conservative cash dividend policy support further deleveraging over the next two years.
- On April 23, 2021, we raised the stand-alone credit profile (SACP) on Chung Hung Steel to 'twbbb-' from 'twbb' and revised our outlook on the long-term issuer credit rating to stable from negative. At the same time, we affirmed our 'twA/twA-1' issuer credit ratings on the company.
- The stable outlook reflects our expectation that solid steel demand and continued debt reduction will help sustain Chung Hung Steel's ratio of FFO to debt above 20% over the next two years.

Rating Action Rationale

Stable outlook revision follows similar action on parent China Steel Corp. and reflects solid demand recovery and likely debt reduction. The outlook revision incorporates our view that the strong demand momentum for steel products is likely to persist over the next two to three quarters, underpinned by a stronger than expected recovery in downstream manufacturing sectors as well as solid demand from construction. Steel supply could fall short of such demand as global steel producers need time to recover production to pre-pandemic levels. This underpins our assumption of a 26%-30% rise in China Steel's average selling price and 80%-90% increase in EBITDA generation for 2021. The outlook revision also reflects our expectation that China Steel will accelerate its debt reduction, mainly through a decline in its guarantee on debt derived from Vietnam-based Formosa Ha Tinh Steel. Accordingly, China Steel's ratio of FFO to debt could improve to 21%-27% over the next two years, up from 13% in 2020.

We have raised Chung Hung's SACP to 'twbbb-' from 'twbb' to reflect the anticipated strengthening in the steel maker's profitability and continued deleveraging. Like China Steel, we expect Chung Hung's average selling price and profitability to rebound sharply, supported by strong steel demand. We project a 30%-35% rise in the company's ASP (average selling price) for 2021, which more than offsets a likely price increase in slabs during the year. However, the company's sales volume could remain flat in 2021 despite strong demand, due to tight slab supply in the APAC region. The SACP uplift also reflects Chung Hung's less leveraged balance sheet. The company's debt declined to new Taiwan dollar (NT$) 11.2 billion in 2020 from N$15.7 billion in 2019, and we expect Chung Hung to deleverage further with limited capital expenditure (capex) and a conservative cash dividend policy. Accordingly, we project a rally in Chung Hung's ratio of funds from operations (FFO) to debt to 28%-33% in 2021, up from 12.7% in 2020.

However, the company's ratio of FFO to debt is likely to decline in 2022, because we anticipate steel prices will level off from their peak over the next 12-24 months when output ramps up globally following an end to disruptions. In addition, imported steel 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 period will diminish gradually. Our base case assumes a 7%-11% decline in Chung Hung Steel's average selling price and 3%-5% decline in sales volume, leading to an EBITDA of NT$2.0 billion-NT$2.5 billion in 2022, down from NT$4.2 billion- NT$4.6 billion in 2021.

The ratings on Chung Hung move in tandem with those on China Steel. We view Chung Hung as a highly strategic member of the China Steel group. This reflects the fact that China Steel owns about 40% of the company and is the single largest shareholder, allowing it control of the company's board of directors. Chung Hung's operations are very important to the group to maintain its dominant share in the domestic market. Therefore, we assess the long-term rating on Chung Hung at one notch below China Steel's stand-alone credit profile, and the rating and outlook on Chung Hung move in tandem with those on its parent.

Outlook

The stable rating outlook on Chung Hung Steel reflects the stable rating outlook on its parent, China Steel, give our view of Chung Hung as a highly strategic subsidiary of the parent group. The outlook on China Steel incorporates our view that the company's sales and profit margin will rebound in 2021, underpinned by a solid demand recovery in steel products. We also expect China Steel's debt to decline through strong operating cash flow generation and a rapid decline in guarantee debts. These factors could help sustain China Steel's ratio of FFO to debt above 20% over the next one to two years. The stable outlook on Chung Hung also reflects our view that the company will maintain its close association with China Steel and remain a highly strategic subsidiary of the group over the next two to three years.

Downward scenario

We may lower the long-term issuer credit rating on Chung Hung if we lower the stand-alone credit profile of China Steel, which could occur if:

- China Steel's ratio of FFO to debt weakens to close to 12% for an extended period perhaps due to (a) an extensive industry downturn with contraction in demand and intense competition, (b) persistently high raw material prices which squeeze the company's profit margin sharply, or (c) China Steel adopts a much more aggressive capex plan that curbs the company's ability to deleverage and keeps its debt at an elevated level for an extended period; or

- We believe China Steel's support for the subsidiary has weakened, possibly if China Steel significantly lowers its ownership in Chung Hung or reduces its control of Chung Hung's board of directors.

Upward scenario

We could raise the long-term rating on Chung Hung if we raise the stand-alone credit profile of China Steel, which could occur 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 of 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.
- Chung Hung's sales volume to remain largely flat in 2021, constrained by a slab supply shortage. The company's sales volume will likely decline by 3%-5% 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. Chung Hung's ASP for steel products will increase by 30%-35% in 2021. However, ASP could decline 7%-11% in 2022, reflecting an increase in competition with the return of steel supplies as well as likely price correction on iron ores over the next 12-24 months.
- Slab price to soar by 34%-38% in 2021, considering a tight supply condition. In addition, iron ore prices are likely to remain resilient while coking coal price could recover gradually as global steel production gathers pace. Slab price could decline by 5%-10% in 2022 as supply loosens.
- We expect Chung Hung's gross margin to strengthen to 10%-13% in 2021 from 7.1% in 2020, mainly through elevation in ASP. Gross margin could decline to 6%-10% in 2022 amid stiffer competition.
- Selling, general and administrative expense at 2.5%-2.8% of total revenue in 2021-2022.
- The company's capex will remain limited at about NT$350 million-NT$550 million over the next two years.
- Cash dividend of NT$430.7 million in 2021. We assume a dividend payout ratio of 55%-65% in 2022.

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

- EBITDA margin of 7%-11% in 2021, and 4%-7% in 2022 from 4.1% in 2020.
- Ratio of FFO to debt of 37%-41% in 2021 and 20%-24% in 2022 from 12.7% in 2020.
- FFO interest coverage ratio of 65x-70x in 2021 and 37x-42x in 2022 from 18.9x in 2020.

Liquidity

The short-term issuer credit rating is 'twA-1', reflecting the long-term issuer credit rating and our assessment of the company's liquidity as adequate. The adequate assessment reflects a ratio of liquidity sources to liquidity uses of 1.7x-1.9x in the 12 months ending December 2021. We also believe that Chung Hung's liquidity sources will continue to exceed uses, even if its EBITDA were to decline by 15%. In our view, Chung Hung has well-established bank relationships and generally satisfactory standing in credit markets supported by its close association with China Steel. This is reflected by the low interest rate on its bank loans and issued bonds. The company does not have any financial covenants on its bank loans as of the end of 2020.

Principal liquidity sources

- Cash and short-term investments: about NT$1.35 billion as of the end of 2020.
- Undrawn bank lines maturing beyond 2021: NT$7.0 billion-NT$8.0 billion.
- Cash flow from operations: NT$4.2 billion-NT$4.6 billion over the 12 months ending December 2021.
- Funding access provided by China Steel Group: NT$700 million-NT$900 million over the 12 months ending December 2021.

Principal liquidity uses

- Debt maturities: about NT$4 billion over the 12 months ending December 2021.
- Working capital outflow: NT$2.6 billion-NT$3.0 billion over the 12 months ending December 2021.
- Capex: NT$400 million-NT$600 million over the 12 months ending December 2021.
- Cash dividend: NT$431 million in 2021.

Ratings Score Snapshot

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

Business Risk: Weak

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

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: Neutral (no impact)

Stand-alone credit profile: twbbb-

- Group stand-alone credit profile (which excludes external support): twa+
- Entity status within group: Highly strategic (one notch below the group credit profile)

Related Criteria & Research

Related Criteria

- General Criteria: Principles Of Credit Ratings - February 16, 2011
- 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
- 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

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 Action

	To	From
Chung Hung 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.