Media Release:

Chung Hung Steel Corp. Stand-alone Credit Profile Raised On Rapid Debt Reduction; '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 with 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. The company had EBITDA of NT$1.5 billion in 2020.
- Surging profitability and limited capital expenditure will accelerate Chung Hung Steel's debt reduction in 2021 and help the company maintain a ratio of funds from operations to debt above 30% over the next two years. We also view the company's land assets as credit positive that provides extra financial flexibility during industry downturns.
- We have raised the stand-alone credit profile (SACP) of Chung Hung Steel to 'twbbb+' from 'twbbb-'. At the same time, we affirmed our 'twA/twA-1' issuer credit ratings on the company to reflect China Steel Corp. group's stand-alone group credit profile of 'twa+' and our view that Chung Hung Steel is a highly strategically important subsidiary of the group.
- The outlook remains stable to reflect the stable outlook on its parent China Steel Corp.

Rating Action Rationale

Buoyant steel demand and tight supply to support record-high operating cash flow generation in 2021. Strong demand momentum for steel products in Taiwan is likely to persist over the next two to three quarters, underpinned by a robust recovery in downstream manufacturing sectors as well as solid demand from construction. Meanwhile, tight steel supply in the Asia Pacific region should help to keep steel prices elevated over the period. China could cut production by about 10% in the second half of 2021 to fulfill its target of annual steel output on par with the 2020 level. In addition, China removed export rebates on 23 steel products in August 2021 to discourage excessive steel production and export. Russia has also introduced a minimum of 15% export duties on ferrous and major base metals, effective from August 2021. Consequently, Taiwan's steel imports are likely to decline, given the measures China and Russia have taken, and the fact that most exporting countries in Asia Pacific are prioritizing their own domestic demand.

We project a 57%-63% elevation in Chung Hung Steel's average selling price in 2021, pushing revenue up by 50%-55%. The soaring steel price could more than offset a likely sharp price hike for slab and boost the company's EBITDA to new Taiwan dollar (NT$) 6.0 billion-NT$6.5 billion in 2021, up from NT$1.5 billion in 2020.

The anticipated strengthening in Chung Hung Steel's profitability and limited capex will accelerate deleveraging. The SACP uplift reflects an anticipated acceleration in Chung Hung Steel's pace of deleveraging, underpinned by the company's very strong operating cash flow and projected limited capital expenditure (capex) of NT$400 milion-NT$600 million annually in 2021 and 2022. We project the company will generate NT$3.0 billion-NT$3.5 billion of discretionary cash flow for 2021, allowing it to lower its debt level to around NT$8.1 billion by the end of 2021, down from NT$11.2 billion at the end of 2020. This should allow Chung Hung to maintain its ratio of funds from operations (FFO) to debt above 30% over the next two years. However, deleveraging beyond 2021 could decelerate, constrained by likely high cash dividend payouts and a normalized profit margin.

Valuable land assets provide additional financial flexibility. Chung Hung Steel's large, underused land assets in southern Taiwan could provide significant financial flexibility for the company to manage its debt leverage. The company's land assets had a market value of about NT$10 billion at the end of 2020. This compares with adjusted debt of NT$8.1 billion at the end of June 2021. The disposal of these assets could have a material positive impact on Chung Hung Steel's capital structure if the company uses the proceeds to pay down its debt. Our upward revision of Chung Hung Steel's SACP reflects this benefit.

The ratings on Chung Hung Steel move in tandem with those on China Steel. We view Chung Hung Steel 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, which enables China Steel to control the company's board of directors. Chung Hung Steel's operations are very important to the group to maintain its dominant share in the domestic market. Therefore, the long-term rating on Chung Hung Steel at one notch below China Steel's stand-alone group credit profile, and the rating on Chung Hung move in tandem with those on its parent.

Outlook

The stable rating outlook for Chung Hung Steel reflects the stable rating outlook on its parent, China Steel, give our view of Chung Hung Steel 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 hit record high 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 Steel 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 Steel if we lower the stand-alone group 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 that 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 elevated 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 Steel or reduces its control of Chung Hung Steel's board.

Upward scenario

We could raise the long-term rating on Chung Hung Steel if we raise the stand-alone group 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) 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 5.6% in 2021 and 2.7% in 2022 and Asia Pacific GDP to grow 7.1% in 2021 and 5.2% in 2022. The faster economic growth will foster demand growth for steel products.
- Chung Hung Steel's sales volume to decline by 4%-7% in 2021, constrained by a slab supply shortage. The company's sales volume will likely remain largely flat in 2022.
- Robust demand along with a supply shortage and high raw material prices will support high steel prices in 2021. Chung Hung Steel's average selling prices for steel products will increase by 57%-63% in 2021. However, prices could decline by 7%-11% in 2022, reflecting an increase in competition with the return of steel supplies as well as lower raw material prices driven by a price correction on iron ores.
- Slab price to jump up by 66%-70% in 2021, considering a tight supply condition. Soaring coking coal prices and relatively high iron ore prices to keep input costs for slab production high in 2022.
- Chung Hung Steel's gross margin to strengthen to 12%-14% in 2021 from 7.1% in 2020, mainly through elevation in steel prices. Gross margin could decline to 7%-12% in 2022 with high slab prices and stiffening competition.
- Selling, general and administrative expense at 1.8%-2.1% of total revenue in 2021-2022.
- The company's capex will remain limited at NT$400 million-NT$600 million over the next two years.
- Cash dividend of NT$430.7 million in 2021 and a dividend payout ratio of 70%-80% in 2022.

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

- EBITDA margin of 9%-13% in 2021, and 5%-10% in 2022, up from 4.1% in 2020.
- Ratio of FFO to debt of 70%-80% in 2021 and 40%-45% in 2022, up from 12.7% in 2020.
- Discretionary cash flow to debt of 35%-45% in 2021 and (10%)-0% in 2022, compared with 42% in 2020.

Liquidity: Adequate

The short-term issuer credit rating is 'twA-1', reflecting the long-term issuer credit rating and our assessment of the company's adequate liquidity. This assessment reflects a ratio of liquidity sources to liquidity uses of 4.0x-5.0x in the 12 months ending June 2022. We also believe that Chung Hung Steel's liquidity sources will continue to exceed uses, even if its EBITDA were to decline by 15%.

In our view, Chung Hung Steel 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. 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 of about NT$2.0 billion as of the end of June 2021.
- Undrawn bank lines maturing beyond June 2022 of NT$7.0 billion-NT$8.0 billion.
- Cash flow from operations of NT$4.8 billion-NT$5.2 billion over the 12 months ending June 2022.
- Funding access provided by China Steel Group of NT$300 million-NT$500 million over the 12 months ending June 2022.

Principal liquidity uses

- Debt maturities of about NT$1.5 billion over the 12 months ending June 2022.
- Working capital outflow of NT$0.6 billion-NT$1.0 billion over the 12 months ending June 2022.
- Capex of NT$400 million-NT$600 million over the 12 months ending June 2022.
- Cash dividend of 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: Significant

- Cash flow/Leverage: Significant

Anchor: twbbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Positive (+1 notch)
- 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: 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: 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
- 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;

Chung Hung Steel Corp.	
Issuer Credit Rating	twA/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.