Media Release:

Asia Cement Corp. Upgraded To 'twAA-/twA-1+' On Low Debt Leverage; Outlook Stable

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Rating Action Overview

- Taiwan-based **Asia Cement Corp.** is mainly engaged in the manufacture and distribution of cement in China and Taiwan, generating EBITDA of new Taiwan dollar (NT$) 27.8 billion in 2020.
- Sustained production discipline and steady cement demand in China along with Asia Cement's rising cash inflows from power generation and equity investments should support the company's EBITDA generation over the next one to two years.
- Steady cash flow, limited capital expenditure and declining debt could offer a sufficient buffer to maintain lower leverage while taking on moderate acquisitions for expansion.
- We have therefore raised our issuer credit ratings on Asia Cement to 'twAA-/twA-1+' from 'twA+/twA-1'.
- The stable rating outlook reflects our view that sustainable free operating cash flow amid a relatively stable cement market in China and rising contributions from power generation could prevent material debt growth and maintain Asia Cement's ratio of debt to EBITDA below 2.0x over next one to two years.

Rationale Action Rationale

Supply-side discipline, increasingly stringent environmental standards, and steady demand could prevent price competition in China's cement industry over the next two years. Output volume and demand in China's cement industry are likely to sustain a tight balance in Asia Cement's operating regions over the next one to two years. Capacity rationalization among cement producers could continue to constrain supply growth to a mild degree, despite some capacity growth following the replacement of inefficient capacity. Such discipline could remain over the next one to two years because the Chinese government has tightened regulations on carbon emissions and imposed tighter output controls for high carbon intensity industries such as steel and cement. There will be also tighter controls over the replacement of inefficient capacity, thereby limiting growth in the cement industry's effective capacity.

Cement demand in China is likely to remain largely flat in 2021, supported by strong rebound in the first half of the year from a demand shock induced by the COVID-19 pandemic in the same period of 2020. In addition, demand from infrastructure investments is likely to increase over the next two to three quarters and offset the negative effect of the Chinese government's tightening curbs on the housing market. Continued urbanization in China and infrastructure investments should prevent domestic cement consumption from rapidly declining over the next two to three years, in our view.

Asia Cement's EBITDA generation could decline moderately in 2021 before rebounding in 2022 because of high coal prices and lower cash dividends from equity investments. We anticipate that high coal prices will erode Asia Cement's EBITDA margin on its cement sales, particularly in China in 2021, amid relatively flat average selling prices. The company's profit margin on cement sales in Taiwan is also likely to fall materially in the second half of 2021 due to the depletion of low-cost coal procurements. We therefore anticipate the EBITDA from its cement business could drop by about 10% in 2021. This is despite our view that Asia Cement's capacity utilization in China will improve to the level in 2019, while cement output in Taiwan will continue to grow amid strong domestic demand and decreasing imports

In addition, a lower cash dividend from Asia Cement's equity investments including from Far Eastern New Century Corp. (FENC) and U-Ming Marine Transport Corp. will also weigh on the company's cash flow in 2021. These investments, which we include in our adjusted calculation of the company's EBITDA, experienced poor profitability during the height of COVID-19 pandemic in 2020. We now forecast Asia Cement's EBITDA will decline 10%-15%.

Nonetheless, coal prices could gradually normalize with the world climbing out of business interruptions caused by the pandemic. Together with likely stable cement output and selling prices, the normalizing coal price could lift Asia Cement's cement margins slightly in 2022 in China and Taiwan. We base this on our view that Asia Cement is likely to experience less constraint on its production and maintain a higher than peer average utilization in China supported by the company's better emission control and energy efficiency.

We also expect cement demand in Taiwan to remain strong with lower imports amid high freight costs and export taxes imposed by major exporters like China and Vietnam. Capacity expansion at Asia Cement's power generation subsidiary, ChiaHui Power Co. Ltd., will also contribute to a stable and higher operating cash flow to Asia Cement from the second half of 2021. We estimate ChiaHui's EBITDA contribution will increase to 15%-18% of Asia Cement's total EBITDA in 2022, up from about 10%-12% in 2021. Moreover, FENC and U-Ming's profitability could improve significantly in 2021 with strong chemical prices and surging freight rates, thus distributing more cash dividends to Asia Cement in 2022.

Robust operating cash flow could support moderate capital expenditure, dividends, and acquisitions without materially worsening Asia Cement's debt leverage over the next two years. Our base case forecast is for Asia Cement to materially lower its adjusted debt in 2021, enabling the company to sustain its ratio of debt to EBITDA at 1.5x-1.8x despite a weaker profit margin. This base case assumes Asia Cement could generate positive discretionary cash flow to lower its adjusted debt without acquisitions. In addition, the conversion of most of its US$215 million European convertible bonds by mid-September 2021, amounting to NT$6.23 billion, has also reduced its debt.

Asia Cement is likely to maintain positive discretionary cash flow in 2022-2023 with moderate capital expenditure, prudent acquisitions, and stable cash dividends. This will enable the company to continue to lower its debt slightly and further lower its ratio of debt to EBITDA to slightly below 1.5x during the period. Our base case does not forecast aggressive capital expenditure on capacity expansion or acquisitions because we believe Asia Cement will focus on profitability and return on its investments instead of market share. In addition, improving market discipline in China and Taiwan and greater EBITDA contributions from the company's power generation business will help the company to better sustain its credit metrics.

Asia Cement's growth appetite and cement sector cyclicality, lingering overcapacity and the volatility of construction activities pose uncertainty for Asia Cement's debt leverage. A significant appetite to grow its key businesses, including cement and power generation, is likely to lead to negative discretionary cash flow and raise Asia Cement's leverage, though the exact degree of expansion and timeline remain uncertain. In addition, cement prices will continue to see significant volatility because short-term factors and event risks including natural disasters and health crises could knock supply and demand off balance. This together with volatile coal prices will lead to material fluctuations in the industry's profitability.

We believe Asia Cement's high-risk exposure to cement sector cyclicality will continue, because its profitability will remain highly dependent on the cement business in which it has a relatively narrow geographical footprint. Overcapacity is likely to persist over the next two years, due to slow capacity retirement under the current high-selling-price environment. In addition, cement demand is highly correlated to that of the infrastructure and property market, for which prosperity is largely dependent on the Chinese government's policy direction. Therefore, the risk of a slowdown in construction activities could cast some uncertainty over cement demand. This could in turn lead to a quick deterioration in Asia Cement's credit metrics if the operating environment in China turns negative.

Outlook

The stable rating outlook for Asia Cement reflects our view that tight government control over cement production volume in China and the improving EBITDA of the company's cement and power generation businesses will help to sustain its EBITDA generation over the next two years. This together with limited capital expenditure and investments should enable the company to keep its ratio of debt to EBITDA at about 1.5x during the same period.

Downward scenario

We may lower the long-term issuer credit rating on Asia Cement if:

- the company's ratio of debt to EBITDA rises above 2.0x for an extended period due to a significant drop in operating cash flow or a material increase in debt. A deterioration in the operating environment possibly due to persistent oversupply in China, weakening production discipline, or a substantial increase in key operating costs without pass through to its customers could reduce Asia Cement's operating cash flow. Similarly, a significant increase in the company's capital expenditure or acquisitions that exceeds our current expectations could result in materially higher debt than we currently assume.

Upward scenario

The likelihood of an upgrade is low over the next 12 months due to Asia Cement's limited operating scale, high cyclicality in the cement business, and likely spending on business expansion. However, we may raise the long-term issuer credit rating if Asia Cement keeps its ratio of debt to EBITDA well below 1.0x through industry cycles. Controlled capital expenditure and a substantial reduction in debt using its strong operating cash flow could indicate a more sustainable improvement in its key credit metrics.

Our Base-Case Scenario

We project 10%-15% revenue growth for Asia Cement in 2021 because of recovering demand despite a cooling housing market in China. Asia Cement's revenue to grow by 2%-4% in 2022 with growing revenue from its power generation. Margins could fall moderately in 2021 with high coal costs but recover slightly in 2022-2023.

- China's real GDP to grow 8.3% in 2021, and 5.1% in 2022. Rising urbanization, tightened environmental standards, and tight production controls in China will support stable demand and disciplined output there.
- Taiwan's real GDP to grow 5.6% in 2021 and 2.7% in 2022. Cement demand growth of a low-to-mid single digit in Taiwan over the next one to two years thanks to a hot housing market and rising public and private investments.
- Revenue from the company's cement business to grow 5%-10% in China in 2021, reflecting largely flat average selling prices and moderate sales volume growth after disruption from the pandemic and flooding. Asia Cement's cement sales to decline slightly in 2022 because of likely weakening cement prices in Taiwan and China.
- Asia Cement's capacity utilization in China to improve to 87%-90% in 2021-2022, while in Taiwan it will remain at 67%-70% over the same period.
- High coal prices will weaken Asia Cement's gross margin before depreciation and amortization in China's by 5%-7% year on year in 2021 before recovering slightly in 2022-2023.
- EBITDA for the company's non-cement business to be largely flat in 2021 but grow significantly by about 30% in 2022 because of contributions from the company's new power generation capacity.
- Dividend contribution from equity-method investments to decline to NT$2.9 billion-NT$3.1 billion in 2021 but rebound to NT$3.8 billion-NT$4.0 billion in 2022. The lower dividend income mainly reflects FENC and U-Ming Marine's weaker operating performance in 2020.
- Capital expenditure of NT$4.5 billion-NT$5.5 billion in 2021, mostly related to capacity expansion in Asia Cement's power generation business and improvement and maintenance capital expenditure in China. We also assume NT$2.5 billion-NT$3.5 billion annually for potential acquisitions or investments.
- We factor in the conversion of the company's European convertible bonds with face amount of US$205 million into common shares up to Sept. 15, 2021.
- Dividend payment of NT$12 billion in 2021 and NT$9 billion-NT$11 billion in 2022.
- We net 88% of Asia Cement's cash and liquid investments with its reported debt in calculating adjusted debt.

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

- EBITDA margin of 30%-31% in 2021 and 31%-32% in 2022, versus 35.5% in 2020.
- Ratio of debt to EBITDA of 1.5x-1.7x in 2021 and 1.2-1.5x in 2022, versus 1.7x in 2020.
- Ratio of discretionary cash flow to debt of 7%-11% in 2021 and 18%-24% in 2022, versus minus 1.2% in 2020.

Liquidity

The short-term issuer credit rating is 'twA-1+'. We believe Asia Cement has adequate liquidity to meet its needs over the next 12 months ended June 30, 2021, reflecting the ratio of liquidity sources to liquidity uses of 1.5-1.8x over the period. We also believe that liquidity sources will continue to exceed uses even if Asia Cement's EBITDA were to decline by 15%. We also believe the company has a sound relationship with banks and a generally high standing in the credit market in Taiwan, supported by the company's membership of the FENC group. There are no financial covenants associated with Asia Cement's or its subsidiaries' debt as of the end of June 2021.

Principal liquidity sources

- Cash and short-term investments of NT$70.0 billion as the end of June 2021.
- Funds from operations of NT$20 billion-NT$22 billion annually over the 12 months ending June 2022.
- Undrawn bank lines maturing beyond June 2022 of NT$23.8 billion.

Principal liquidity uses

- Debt maturities of NT$50 billion-NT$51 billion over the 12 months ending June 2022.
- Capital expenditure and investments of NT$7 billion-NT$8 billion over the 12 months ending June 2022.
- Cash dividends of NT$11.9 billion in the third quarter of 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: Moderately High Risk
- Industry risk: Intermediate Risk
- Competitive position: Satisfactory

Financial Risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: twa+

Modifiers

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

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

Upgraded; Outlook

	To	From
Asia Cement Corp.		
Issuer Credit Rating	twAA-/Stable/twA-1+	twA+/Positive/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.