Media Release:

Outlook On Formosa Taffeta Co. Ltd. Revised To Positive On Profit Recovery, Debt Guarantee Reduction; 'twA/twA-1' Ratings Affirmed

October 22, 2021

PRIMARY CREDIT ANALYST

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

SECONDARY CONTACT

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

Rating Action Overview

- Taiwan-based **Formosa Taffeta Co. Ltd.** is a subsidiary of **Formosa Chemical & Fibre Corp.,** one of the four key Formosa group companies. Formosa Taffeta's businesses include fabric, gas station, and tire cord, with EBITDA of NT$2.36 billion in 2020.
- A reduction in the debt guarantee of Formosa Taffeta for the parent group's Vietnam-based steel mill will improve Formosa Taffeta's debt leverage with the ratio of debt to EBITDA likely to fall to below 4x over 2022-2023.
- Meanwhile, recovering profitability from Formosa Taffeta's tire-cord and fabric businesses should also strengthen the company's credit metrics. We forecast the EBITDA margin will improve to 9.5%-10.5% in 2021-2022.
- We have revised our outlook on the long-term issuer credit rating to positive from stable to reflect our view that Formosa Taffeta could improve its debt leverage over the coming year. At the same time, we affirmed our 'twA/twA-1' issuer credit ratings on the company.

Rationale Action Rationale

A faster refinancing schedule for the parent's steel mill will help to lower Formosa Taffeta's debt guarantee for the steel mill. As of the end of June 2021, the company's debt guarantee for Vietnam-based Formosa Ha Tinh Steel Corp. was new Taiwan dollar (NT$) 4.6 billion, which is significantly down from NT$6.4 billion at the end of 2020. Formosa Taffeta's share of the debt guarantee will likely continue to decline over the next one to two years. That's because of the steel mill's stronger performance in 2021, which should help it repay and refinance its debt faster through its own credit without the need for its shareholders' guarantee.

Profitability is likely to rebound in 2021-2022, but its sustainability remains challenging. Recovering demand for fabric and tire cord in the first half of 2021 has enhanced Formosa Taffeta's profitability, as shown by its EBITDA margin which improved to 11.46% for the first half of 2021 compared with 8.2% for full year 2020. Rising sales and improving utilization rates are likely to keep the EBITDA margin at 9.5%-10.5% in 2021 and 2022, despite some production challenges due to the effect of the COVID-19 pandemic in Vietnam during the second half of 2021, which is one of the company's key production sites.

Formosa Taffeta's tire cord business will be the main driver behind its improving profitability over the next one to two years, as continued recovery in the global auto industry boosts demand for Formosa Taffeta's high premium products. This is despite several obstacles facing Formosa Taffeta and the auto industry, including materials supply shortages and fluctuating car sales amid the pandemic and an ongoing chip shortage. Meanwhile, the utilization rate for the company's fabric business continues to recover supported by resumed consumption in developed countries where higher vaccination rates have allowed life to return largely to what it was before the pandemic. Nevertheless, the risks of new variants of the pandemic and rising material and labor costs could add margin pressure to Formosa Taffeta's profitability over the next one to two years.

We see the company's oil business remaining largely stable through the continuous replacement of non-profitable gas stations. We acknowledged the uncertainties facing Formosa Taffeta over the next two years despite our forecast for the firm's profit to improve over the period. These include rising competition in fabric and auto markets, and stagnant sales growth and production disturbance from labor or materials supply issues as the pandemic continues.

Stable cash flow generation should cover mild capital expenditure and cash dividend over 2022-2023 with some financial buffer. Our base case scenario assumes Formosa Taffeta will generate positive discretionary cash flow to support deleveraging in 2022-2023 and a ratio of debt to EBTIDA below 4x during the period.

The recovering performance of Formosa Taffeta's woven fabric and tire cord businesses has lifted its utilization rates; however, we believe the company will maintain mild capital expenditure for facility upgrades with minor capacity expansion for its woven fabric production in Vietnam. This considers the potential risk of volatile utilization rates during the recovery period, given the continuing backdrop of an uncertain outcome for the pandemic. We believe Formosa Taffeta will pursue a better product mix rather than aggressive capacity expansion before the global economy shows stable and solid growth. Therefore, we have only factored in NT$0.8 billion-NT$1.2 billion capital expenditure annually for 2021-2023, which is similar to the NT$983 million spent in 2020.

We see a low likelihood that Formosa Taffeta will engage in aggressive acquisitions or investment plans over the next one to two years, given the company only completed a capital investment in Europe in 2020, and it will require some time for the company to realize the benefit of the transaction. In addition, the parent Formosa companies have an expansion project in Louisiana, U.S.A. on hold amid an environmental review. Formosa Taffeta's cash outflow for this project remains very limited, given the company's very low equity investment in it.

Outlook

The positive rating outlook reflects our view that Formosa Taffeta's ratio of debt to EBITDA is likely to improve to below 4x over the next one to two years. A rebound in demand for fabric and tire-cord businesses is likely to lift the company's profitability, while at the same time, Formosa Taffeta's guarantee on the parent group's steel mill in Vietnam will significantly reduce. Nevertheless, uncertainties surrounding a potential resurgence of the pandemic and rising competition could negatively affect recovery in Formosa Taffeta's EBITDA margin over the next one to two years.

Upward scenario

We could raise the long-term rating on Formosa Taffeta if the ratio of debt to EBITDA remains below 4x consistently through business cycles. This could be achieved by:

- A continuous reduction in the company's debt guarantee over the next one to two years accompanied by consistently strong profitability; and
- Formosa Taffeta maintains conservative capital expenditure and capital investments.

Downward scenario

We may revise the outlook back to stable if Formosa Taffeta fails to maintain the ratio of debt to EBITDA substantially below 4x over the next two years. The likely scenarios for this include:

- A slower reduction in the debt guarantee reduction than under our current expectation;
- Stagnant demand growth, production disturbance due to labor or materials supply shortages, or intensifying competition that weakens Formosa Taffeta's profitability; or
- Aggressive capital expenditure or capital investment plans.

Our Base Case Scenario

- S&P Global's forecast for world real GDP to expand 5.8% in 2021, 4.4% in 2022, and 3.7% in 2023; for China at 8.0% in 2021, 5.1% in 2022, and 5.0% in 2023; and for Taiwan at 5.5% in 2021, 2.9% in 2022, and 2.6% in 2023.
- Demand for woven fabrics to continue to recover in late 2021 and 2022, supported by sustainable demand for sports brands and improving sales of outdoor brands. Sales of tire cord will moderately improve in 2021 with continued growth in 2022, supported by strong demand in the auto market despite potential chip shortages and production interruptions.
- Formosa Taffeta's overall revenue to recover by 9%-12% in 2021 and 3%-6% in 2022.
  - Sales momentum for woven fabrics to remain strong over the next two years, despite ongoing pandemic-induced volatility. We see mid-to-high single digit growth for its woven fabrics in 2021-2022.
  - Revenue for tire cord to rise by a high single digit in 2021-2022. Nylon material cost to rise amid limited supply but buoyant demand should support the company to lift its average sales price.
  - Revenue from the gas station sector to increase 19%-21% in 2021, following an oil price rally, with revenue falling by 2%-4% in 2022, given the higher base of 2021.
- A decrease in the ratio of operating cost and expenses to revenue of 2.0%-2.5% in 2021 but remain flat in 2022. This reflects gradually improving utilization rates for woven fabric and tire cord businesses and a higher contribution from premium tire cord products.
- Capital expenditure of NT$0.8 billion-NT$1.2 billion per year in 2021 and thereafter mostly to support maintenance and upgrades for woven fabric and tire cord businesses. A minor amount to be spent on capacity additions for woven fabric in Vietnam.
- An 80% cash dividend payout ratio in 2021-2023--similar to the level before 2020.

- The company will continue to provide a debt guarantee for the Vietnam steel mill proportional to its ownership share in 2020-2022, but the amount will diminish materially in 2021-2022 following the steel mill's refinancing schedule that ends the need for a guarantee.

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

- EBITDA margin of 9.5%-10.5% in 2021-2022, up from 8.2% in 2020.
- Ratio of debt to EBITDA of 3.7x-4.2x in 2021 and 3.2x-3.7x in 2022, down from 6.8x in 2020.
- EBITDA interest coverage of 19x-21x in 2021 and 21.5x-23.5x in 2022, up from 14.1x in 2020.

Liquidity

The short-term issuer credit rating is 'twA-1'. Formosa Taffeta has adequate liquidity to meet its needs over the 12 months ending June 2022, which reflects a ratio of liquidity sources to liquidity uses of around 1.8x over the same period. In addition, we believe the company's liquidity sources will continue to exceed uses, even if EBITDA was to decline by 15%. Formosa Taffeta should be able to absorb high-impact, low-probability events, with limited need of refinancing because its cash on hand and cash flow generation are sufficient for the repayment of short-term debt.

Formosa Taffeta has sound relationship with banks as evidenced by the low interest rate on its bank loans and diversified funding sources. This view is also supported by the company's satisfactory standing in the credit markets, given its position as a subsidiary of Formosa Chemical and Fibre Corp. In our view, Formosa Taffeta has generally prudent risk management to ensure continued adequate liquidity based on the company's sufficient undrawn bank credit lines and flexibility to increase bank facilities. Its bank loans carry some financial covenants, but we believe the company will meet these with sufficient headroom over the next one to two years.

Principal Liquidity Sources:

- Cash and short-term investments of T$4.6 billion as of the end of June 2021.
- Undrawn bank lines of NT$4 billion-NT$5 billion up to June 2022.
- Funds from operations of NT$3 billion-NT$3.5 billion up to June 2022.

Principal Liquidity uses:

- Long-term debt amortization plus short-term debt maturity of NT$3.3 billion-NT$3.8 billion up to June 2022.
- Working capital outflows of NT$0.5 billion-NT$1 billion up to June 2022.
- Capital expenditure of NT$1 billion-NT$1.5 billion up to June 2022.
- Cash dividend of NT$1.7 billion up to June 2022.

Ratings Score Snapshot

Issuer Credit Rating: twA/Positive/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: 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: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: twbbb+

- Group credit profile: twaa+
- Entity status within group: Moderately strategic (+2 notch from SACP)

Related Criteria & Research

Related Criteria

- General Criteria: Group Rating Methodology - July 01, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings - June 25, 2018
- 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
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings - October 10, 2021

Related Research

- Taiwan Ratings' Ratings Definitions – August 10, 2020

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

Ratings List

Outlook Revision; Ratings Affirmed

	To	From
Formosa Taffeta Co. Ltd.		
Issuer Credit Rating	twA/Positive/twA-1	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.