Media Release:

USI Corp. Upgraded To 'twA/twA-1' On Low Debt Leverage; Outlook Stable

November 24, 2021

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Rating Action Overview

- **USI Corp.** manufactures a wide range of commodity chemicals, generating an EBITDA of NT$ 9.2 billion in 2020.
- Strong profitability from chemical sales and completion of phase I investment in the Gulei chemical complex have helped USI to materially reduce debt and strengthen its credit metrics significantly beyond our previous assumption.
- USI's profitability is likely to remain above its past mid-cycle level over the next two years, supporting its capex needs and higher dividends.
- We have raised our long-term and short-term issuer credit ratings on USI to 'twA/twA-1' from 'twA-/twA-2'.
- The rating outlook is stable to reflect our view that USI's strong, albeit declining operating cash flow, could support higher capex and dividends while maintain the ratio of debt to EBITDA slightly below 1x over the next two years.

Rating Action Rationale

USI's strong free operating cash flow has strengthened its debt leverage significantly beyond our previous forecast. Strong cash flow generation should allow USI to reduce its debt by more than we previously assumed for the next two years. This will increase the company's financial buffer against industry volatility, support higher cash dividends, and fund higher capital expenditure (capex) and likely acquisitions aimed at strengthening USI's supply security and business scale.

We now forecast USI's ratio of debt to EBITDA will fall below 1.0x over 2021-2022 assuming no material acquisitions. This is significantly lower than in our previous forecast of 2.0x-3.0x for the same period including debt accumulated for the company's investment in a chemical complex in Gulei, China. USI's debt leverage could remain low over the next two years if the company maintains its prudent cash dividend payments, despite higher capex needs. This could provide a significant financial buffer for the group's future growth initiatives, probably through acquisitions or green field projects in China.

Profitability is likely to moderate in 2022 and 2023 from a high in 2021 but remain above the company's historical mid-cycle level. USI's profitability is likely to remain above their typical mid-cycle level over 2022-2023, supported by still-strong demand for chemicals amid an accelerating global economic recovery. Increasing global consciousness on global warming has also strengthened demand for solar power and consequently ethylene-vinyl acetate (EVA), which is used for solar panel packaging, in addition to surging needs from consumer products. We expect the strong demand for EVA from solar power and consumer products to remain and partly offset the negative effect of significant capacity additions in the industry and recovering output over the next two years after interrupted from extreme weather events in 2021. In addition, the company's sales and margins from magnetic materials used in inductors have also grown sharply due to strong demand from for equipment used in remote working and learning as well as for new technologies such as 5G communication and electrical vehicles.

Moreover, the China government's more stringent environmental requirements and carbon neutral push will curb chemical production that uses more polluting processes, particularly coal-based chemicals. This could slightly alleviate the negative effect of aggressive new chemical capacity additions in China on USI's EBITDA margins and support the profitability of some of USI's key products, particularly polyvinylchloride (PVC), over the next two to three years.

USI's new cyclic block copolymer (CBC) business could remain loss-making over the next two to three years but is unlikely to materially weaken the company's overall profitability. The development of this new business, including its product certification by potential customers, which was hindered by COVID-19 movement restrictions, could regain strength in the coming 12 months. USI group's efforts to deploy its technologies to develop consumer products such as breathable raincoats and bags for fresh food storage are unlikely to contribute materially to revenue and EBITDA anytime soon but could lower the company's long-term business volatility.

USI's investment in the Gulei complex could slightly enhance its feedstock supply security and position in the EVA market. USI will benefit from its investment in the Gulei chemical project after the complex is commissioned in phases from the third quarter of 2021. The group could moderately strengthen its position in the EVA market because the group owns the exclusive distributing and marketing rights for the complex's 300,000 tons of EVA output. In addition, USI's subsidiary, Taita Chemical Corp., will build a new expanded polystyrene plant at the complex to expand its scale with construction starting in 2022. Furthermore, USI could also secure part of its needs for ethylene and other feedstock from the complex with more stable costs, though USI will remain highly exposed to significant uncertainty in feedstock supply volume and prices over the next two to three years, given the limited volume available for USI in the first phase.

Further expansion at the Gulei complex, including by the project company, Fujian Gulei Petrochemical Co. Ltd., and USI itself, is likely to go ahead after the completion of the project's first phase, given the complex's needs to expand its scale economy as well as China's still-strong domestic chemical demand. We believe that additional expansion at the complex could further improve the security of USI's feedstock supply and further expand its scale for products such as polystyrene (PS). Nonetheless, we do not factor in any capital spending on phase 2 expansion in our base case, given the high uncertainty surrounding the scale and timeframe.

Limited production scale for USI's major product lines, weaker capability of product differentiation, exposure to volatile feedstock prices and resultantly volatile and sometimes weaker profitability constrain the ratings upside. We believe that USI's profitability could remain highly volatile, given its narrower product mix, lack of product differentiation and volatile feedstock prices. This is despite the group will invest heavily in its storage capacity to better manage its feedstock supply and price risks. In addition, the Gulei complex will only provide limited relief in the company's feedstock supply security in the project's first phase operations.

In addition, the group's growth appetite, volatile profitability, and rising cash dividends are likely to prevent further reduction in USI's debt leverage over the long term. The group will likely need to further expand its business scale and market influence through organic expansion, investments, and acquisitions, which include likely additional investments in the Gulei complex. This, together with possibly rising capex for environmental initiatives such as reductions in carbon emissions and other pollutants, could keep the group's capital spending elevated, in our view.

Outlook

The stable rating outlook on USI reflects our view that the company can largely maintain its low debt leverage over the next two years, despite a possible decline in its profitability from the historical high in 2021. Our base case forecasts that USI could see significant discretionary cashflow in 2021-2022 to lower its debt, despite higher capex and cash dividends with still relatively favorable market conditions. This could enable the company to sustain its ratio of debt to EBITDA below 1x during the period.

Downside scenario

We may lower the rating on USI if the company's ratio of debt to EBITDA rises to above 2.0x without prospects of improvement. This could occur if

- the company's profitability weakens due to higher pricing pressure caused by intensified competition along with a prolonged regional oversupply, or a significant rise in feedstock costs; or
- USI pursues a more aggressive debt-funding expansion strategy over the next two years with large investments and acquisitions that materially increase its debt level.

Upside scenario

The likelihood of an upgrade is low over the next 12-24 months, given USI's limited operating scale, weaker control on key feedstocks, and resultant volatile operating performance. However, we may still raise the rating on USI if:

- the company can significantly expand its operating scale and product mix toward specialty applications or differentiated consumer products, such that USI can withstand volatile prices for its key feedstocks and maintain relatively high and stable profitability; and
- USI keeps its ratio of debt to EBITDA constantly below 1.5x.

Our Base-Case Scenario

- S&P Global Ratings projects Taiwan's GDP growth of 5.5% in 2021 and 2.9% in 2022, for China's GDP growth of 8.0% in 2021 and 5.1% in 2022, and for Asia Pacific's GDP of 6.3% in 2021 and 5.0% in 2022.
- Our base-case assumptions for Brent crude oil are US$75/barrel (bbl) for the rest of 2021, US$65/bbl for 2022 and US$55/bbl for 2023.
- We expect chemical demand to remain strong throughout the second half of 2021, though supply and demand could become more balanced in 2022 when capacity additions resume. Downstream manufacturers like USI will continue to benefit from better spreads on some product lines supported by firm product prices and smaller growth in input costs.
- USI's revenue could grow 36%-40% in 2021 and decline by low-single digit in 2022. This is to reflect sharp price increases in 2021 from strong demand amid global economic reopening as well as supply disruptions from COVID-19, extreme weather, and power shortages. Produce prices could moderate in 2022, given significant capacity additions particularly in China and likely slowing demand growth.
  - Strong demand for solar panels and consumer products will support sharp product spread expansion for USI's EVA business in 2021. Capacity additions in China could pressure prices in 2022. PE margins will also expand significantly in 2021 with supply disruptions and strong demand amid economic reopening before softening in 2022 with rising supply.
  - PVC related revenue to grow faster than the company's average revenue growth in 2021, mainly reflecting further increases in PVC price in 2021. PVC supply from major exporting countries China and the U.S. are constrained by extreme weather, short supply in upstream feedstock, and China's policy on curbing energy intensive businesses. PVC prices and margins could decline moderately in 2022 with recovering supply, leading to a moderate decline in revenue and EBITDA.
  - ABS and PS business at one of USI's subsidiaries, Taita Chemical, could sustain revenue and high margins in 2021 because still-strong demand for IT products, food packaging, and home appliances continue to support product pricing. Margins to drop in 2022 with rising feedstock costs and capacity additions in the region.
  - ACME Electronics Corp., another subsidiary, has also experienced significant expansion in its margins since 2020 because of its improved cost efficiency and strong demand for remote working and learning equipment, as well as new technologies such as 5G mobile communications. This strength could sustain into 2022. Embossed films could experience margin erosions due to significant competition from China in 2021-2022.
- USI group's gross margin before depreciation and amortization to maintain at 24%-26% in 2021 before softening slightly to 17.5%-19.5% in 2022, compared with 25.6% in 2020 mainly driven by strong product pricing.
- The group's capex will rise to new Taiwan dollar (NT$) NT$4 billion-NT$5 billion annually in 2021-2022. The higher capital spending is for storage tank construction in southern Taiwan's Kaohsiung City, ACME's capacity expansion and Taita Chemical's EPS project at the Gulei complex in addition to regular maintenance and updates.
- We assume NT$136 million estimated litigation exposure for a chemical accident in Kaohsiung in 2014 and add this to USI's adjusted debt.
- We also assume USI group's cash dividends will increase to about NT$2.8 billion in 2021 and NT$3.6 billion-NT$3.9 billion in 2022.

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

- EBITDA margin of 17%-19% in 2021 and 11.5%-12.5% in 2022, versus 18.4% in 2020.
- Ratio of debt to EBITDA of 0.4x-1.0x in 2021-2022, versus 0.6x in 2020.
- Ratio of free operating cash flow to debt of 90%-100% for 2021 and 55%-65% in 2022, versus 145.9% in 2020.

Liquidity

The short-term rating on USI is 'twA-1'. We believe that the company has strong liquidity to meet its needs in the 24 months ending June 2023. The ratio of liquidity sources to liquidity uses will be 2.0x-2.5x over the same period and we believe the company will have positive liquidity sources minus uses, even if its forecasted EBITDA declines by 30%.

In our assessment, USI has sound and long-standing relationships with major local banks as indicated by the low interest rate on its bank loans. USI has generally prudent risk management, in our view, with a track record of maintaining high unused committed banking credit lines. We also believe USI has sufficient headroom without breaching covenant limits on its debts due to the low interest rates in Taiwan even if the company's EBITDA were to drop by 30%. Our view of USI's liquidity reflects primarily the following factors:

Principal liquidity sources

- Cash and short-term investment of about NT$16.3 billion as of the end of June 2021.
- Unused committed banking facilities of NT$10.9 billion expiring beyond Dec. 31, 2022 and NT$5.0 billion expiring beyond Dec. 31, 2023.
- FFO of NT$8.5 billion-NT$9.0 billion in 2021 and NT$6.0 billion-NT$7.0 billion in 2022.

Principal liquidity uses

- Long-term debt due in one year plus short-term debt of about NT$6.2 billion over the 12-months ending June 2022 and NT$3.6 billion over the 12 months ending June 2023.
- Capex of NT$4 billion-NT$5 billion annually in 2021-2022.
- Working capital outflow of NT$0.8 billion-NT$1.0 billion over the 12-months ending June 2022.
- Cash dividend of about NT$2.8 billion in 2021 and NT$3.5 billion-NT$4.0 billion in 2022 with a payout ratio similar to the previous year.

Ratings Score Snapshot

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

Business Risk: Fair

- Country risk: Moderately High Risk
- Industry risk: Moderately High Risk
- Competitive position: Fair

Financial Risk: Modest

- Cash flow/Leverage: Modest

Anchor: twa

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no notch)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile (SACP): twa

Related Criteria & Research

Related Criteria

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

	To	From
USI Corp.		
Issuer Credit Ratings	twA/Stable/twA-1	twA-/Stable/twA-2

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.