Media Release:

Taiwan Cement Corp. Outlook Revised To Negative On Lower Profitability; 'twA+/twA-1' Ratings Affirmed

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Rating Action Overview

- **Taiwan Cement Corp.'s** EBITDA could tumble due to China's property market downcycle that could persist throughout 2022, and a high coal price that erodes the company's profit margin.
- This, together with aggressive capital spending on green businesses could keep Taiwan Cement's discretionary cash flow negative over the next two years.
- We have revised our outlook on the long-term issuer credit rating on Taiwan Cement to negative from stable. At the same time, we affirmed our 'twA+/twA-1' issuer credit ratings on the company.
- The negative outlook reflects a one-in-third chance that Taiwan Cement's ratio of debt to EBITDA could stay above 3.5x persistently over the next three years. This could be due to weak operating cash flow generation during the period and uncertainty about the pace of recovery in China's cement market and the development of the company's new businesses such as the manufacturing of lithium-ion batteries.

Rating Action Rationale

Sluggish demand from China's property market and a high coal price will erode Taiwan Cement's profitability. New housing builds and overall construction activity in China is likely to remain weak for most of 2022, despite the China government's loosening measures to help stabilize the domestic residential property market. The slowdown in activity is due to sluggish housing sales in China and property developers' constrained access to financing channels. Meanwhile, worsening COVID-19 infections in China that have caused regional lock downs could further decelerate China's economic growth and put downward pressure on cement demand. We therefore project Taiwan Cement's cement sales volume will decline by 10%-13% in 2022. This is despite our view that the China government is likely to increase infrastructure projects to stabilize the economy.

Adding to Taiwan Cement's profitability pressure is the high cost of coal globally. The Russia-Ukraine conflict has resulted in a supply shortage amid booming demand driven by the global economic recovery. Taiwan Cement is unlikely to fully pass through the cost increases through adjusting its sales prices, given the stagnant demand in China. Additionally, cash dividends from Taiwan Cement's coal-fired independent power producer, Ho-Ping Power Co., is likely to shrink substantially amid sharply higher coal costs.

Aggressive capital spending will sustain negative discretionary cash flow and require significant external funding over the next two years. Taiwan Cement plans to transform itself into a more sustainable business model by investing heavily in green initiatives to reduce carbon emissions from cement production. These initiatives include renewable energy plantation, energy storage, and battery manufacturing. Taiwan Cement plans to install 200-megawatt hours of renewable power over the next three years, mainly through solar and wind power installation. The company is also constructing a 1.8-gigawatt hour battery production site in Taiwan's southern city of Kaohsiung to supply high-power and high-capacity batteries, which is likely to come online in 2023.

Furthermore, Taiwan Cement plans to expand installation of energy storage systems in Taiwan as well as overseas through its subsidiary NHOA S.A. Taiwan Cement will also continue to invest in waste management, which could provide a coal alternative to help reduce carbon emissions. These projects will push up Taiwan Cement's capital expenditure (capex) to new Taiwan dollar (NT$) 22 billion-NT$26 billion in 2022 and NT$16 billion-NT$20 billion in 2023.

Taiwan Cement's credit metrics could deteriorate substantially in 2022-2023. EBITDA generation is likely to decline to NT$17 billion-NT$20 billion in 2022 and NT$19 billion-NT$22 billion in 2023, from the previous cement upcycle of NT$33 billion-NT$35 billion in 2018 to 2020, due to weak demand in China and rising production costs. This could lead to negative discretionary cash flow of NT$9 billion-NT$11 billion in 2022 and NT$6.5 billion-NT$8.5 billion in 2023 based on Taiwan Cement's high planned capex over the period.

We forecast the company will take action to limit its debt growth, including its plan to issue 420 million shares of global depositary receipts. However, we forecast Taiwan Cement's ratio of debt to EBITDA could still deteriorate to 3.9x-4.3x in 2022 and 2023, from 2.8x in 2021 but recover to below 3.5x afterwards. Anticipated recovery in China's cement market and rising EBITDA from the company's green investments could support this mild recovery. Nonetheless, significant downside risk remains to our base case, given rapidly evolving market conditions and intense competition for Taiwan Cement's new businesses as well as uncertainty about the company's equity funding plan.

Outlook

The negative rating outlook reflects a one third chance that Taiwan Cement could fail to lower its ratio of debt to EBITDA to below 3.5x after topping out at about 4x in 2022-2023 as in our base case if the company's high capex and weaker profitability persist. The negative outlook also reflects our view that declining cement demand in China and a higher coal price are likely to lower Taiwan Cement's EBITDA generation over the next two years and it will take time for the company's aggressive investments in green projects to generate meaningful EBITDA contributions.

Downward scenario

We could lower the rating on Taiwan Cement if:

- the company's ratio of debt to EBITDA stays above 3.5x for a prolonged period without signs of improvements. This could occur if Taiwan Cement adopts a more aggressive

business expansion strategy or dividend policy, leading to a substantial increase in debt, or its operating environment deteriorates possibly due to sluggish demand, weakening production discipline, or a substantial increase in key operating costs without a corresponding price reflection, or Taiwan Cement's aggressive investments in green businesses could not contribute significant EBITDA as expected.
- the company fails to actively manage its debt leverage through measures such as raising additional equity.

Upward scenario

We could revise the outlook on Taiwan Cement back to stable if the company could maintain its ratio of debt to EBITDA below 3.5x. This could happen if:

- the company controls its debt leverage, such as through equity raising to reduce its reliance on debt funding, or it takes a more conservative approach to capital spending and cash dividend payouts, and
- EBITDA generation to recover, possibly brought by green businesses and a demand rebound on cement in China.

Our Base-Case Scenario

- S&P Global's projection for China's real GDP to grow 4.9% in 2022 and 5.0% in 2023. The downcycle of China's residential property market could constrain cement demand over the next one to two years.
- S&P Global's projection for Taiwan's real GDP to grow 2.8% in 2022 and 2.6% in 2023. Taiwan's resilient economy and demand from infrastructure, residential, and commercial property sectors underpin largely stable industry demand over the next two years.
- Sales volume in China to decline by 9%-13% in 2022 due to sluggish demand from the property sector. Demand could recover by 5%-9% in 2023 along with a property market recovery. Sales volume in Taiwan to remain flat in 2022 and decline by 3%-7% in 2023 amid a cooling housing market.
- Cement price to rise by 4%-8% in Taiwan and China in 2022, on the back of a higher thermal coal price. The China government could further tighten cement production to rein in air pollution amid heightening environmental awareness, which will support average selling price at elevated levels in 2023.
- Cement gross margin in China and Taiwan to decline by 8%-10% in 2022 compared with that in 2021 due to a much higher coal price in 2022. A possible decline in thermal coal price in 2023 could partially recover the gross margin on Taiwan Cement's cement business.
- Capex of NT$22 billion-NT$26 billion in 2022 and NT$16 billion-NT$20 billion 2023, mainly to support capacity expansion in battery business. We also believe the company will continue to invest in green businesses to reduce greenhouse gas emissions over the period.
- Cash dividend of NT$6.1 billion in 2022 and we assume a cash dividend payout ratio of 60% for 2023.
- We factor in NT16 billion-NT$18 billion proceeds from Taiwan Cement's planned issuance of global depositary receipts in 2022.
- We net 88% of Taiwan Cement's cash and liquid investments with debt.

- Ho-Ping Power's dividend contribution to Taiwan Cement to decline substantially in 2022 and 2023 due to weaker operating results in 2021 and 2022. The power plant's cash flow is likely to remain weak in 2022 due to a higher thermal coal price.
- We deconsolidate Ho-Ping Power and include its cash dividend to Taiwan Cement as EBITDA in deriving our financial forecasts for Taiwan Cement. This is because we view Ho-Ping Power as an insulated subsidiary

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

- EBITDA margin of 18%-23% in 2022 and 2023, compared with 29.6% in 2021.
- Ratio of Debt to EBITDA of 3.9x-4.3x in 2022 and 2023, compared with 2.8x in 2021.
- Funds from operations cash interest coverage ratio of 6x-10x in 2022 and 2023, compared with 11.2x in 2021.

Liquidity

The short-term issuer credit rating is 'twA-1'. We believe Taiwan Cement has adequate liquidity to meet its needs over the next 12 months, which reflects our view that the ratio of liquidity sources to uses will be 1.45x-1.51x over the next 12 months ending 2022. It also reflects our belief that liquidity sources will continue to exceed uses even if Taiwan Cement's EBITDA was to decline by 15%.

In addition, we view the company has a sound relationship with banks and a generally high standing in the credit market in Taiwan, as indicated by the firm's ability to obtain low-cost funding through banks and capital markets. Moreover, Taiwan Cement and its subsidiaries could meet financial covenants over the next two years with sufficient headroom, underpinned by the company's high cash balance and satisfactory cash flow generation.

Principal Liquidity Sources

- Cash and short-term investments of about NT124.6 billion as the end of 2021.
- Funds from operations of NT$14 billion-NT$17 billion in 2022.

Principal Liquidity Uses

- Debt maturities of NT$60 billion-NT$64 billion in 2022.
- Capex of NT$22 billion-NT$24 billion in 2022.
- Cash dividend of about NT$6.1 billion in 2022.

Ratings Score Snapshot

Issuer Credit Rating: twA+/Negative/twA-1
Note: The descriptors below are on a global scale.
Business risk: Satisfactory

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

Financial risk: Significant

  - Cash flow/Leverage: Significant

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: 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 Affirmed; Outlook Action

	To	From
Taiwan Cement Corp.		
Issuer Credit Rating	twA+/Negative/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.