Media Release:

China Steel Corp. Outlook Revised To Positive From Stable On Accelerated Deleveraging; 'twAA-/twA-1+' Ratings Affirmed

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Rating Action Overview

- **China Steel Corp.** is the only integrated steel manufacturer in Taiwan and commands over 50% domestic market share with annual crude steel capacity of about 16 million tons and EBITDA of new Taiwan dollar (NT$) 113.6 billion in 2021.
- Supply shortage for steel products due to the Russia-Ukraine conflict could bolster China Steel's sales volume and product prices, supporting operating cash flow generation over the next 12 to 24 months.
- Relatively strong operating cash flow generation and the elimination of its debt guarantee on Formosa Ha Tinh Steel's loan could accelerate China Steel's deleveraging.
- We have revised our outlook on the long-term issuer credit rating on China Steel to positive from stable to reflect our expectation that solid steel demand and an acceleration in debt reduction could help sustain China Steel's ratio of funds from operations (FFO) to debt above 30% over the next two years.
- At the same time, we affirmed our 'twAA-/twA-1+' issuer credit ratings on the company as well as our 'twAA-' issue rating on the company's senior unsecured bond.

Rating Action Rationale

Supply shortage and robust domestic demand support strong operating cash flow generation in 2022. Domestic demand for steel products is likely to remain relatively strong over the next 6 to 12 months, underpinned by public infrastructure projects, ongoing reshoring activities by Taiwanese companies that have increased demand for commercial properties, as well as demand from manufacturing sectors. Meanwhile, steel supply shortage spurred by the Russia-Ukraine conflict could persist and boost Taiwan's steel exports. As Taiwan's only upstream steel producer, China Steel is likely to benefit from downstream steel producers' increasing export needs. These factors should help sustain China Steel's sales volume and high steel prices.

However, high raw material prices could weigh on China Steel's profit margin. Raw material prices for steel production have been surging to record highs--particularly for coking coal--up by about 300% year on year as of mid-April 2022. China Steel may not be able to pass on the higher costs fully to its customers. Our base case assumes China Steel's average selling price (ASP) will rise by 11%-15% and raw material cost per ton of steel production will rise by 35%-40% in 2022.

Acceleration in debt reduction to strengthen China Steel's financial profile. China Steel has reduced its debt by new Taiwan dollar (NT$) 71.3 billion-NT$175.8 billion in 2021 through its record high earnings. Likely strong operating cash flow over the next 12 months could facilitate further debt reduction. Additionally, the guarantee on debt derived from the Formosa Ha Tinh steel project in Vietnam is likely to be eliminated by the end of 2022 with full repayment of the debt. A lower debt level and relatively strong operating cash flow generation could support China Steel's ratio of FFO to debt at 30%-42% over the next two years.

China Steel's ability to build financial buffer is key to an upgrade. Despite our projection of a ratio of FFO to debt above 30% over the next two years, China Steel is exposed to inherent cyclicality and price volatility in the steel sector. These risks can materially weaken earnings and thus a company's financial metrics as seen in the 2020 industry down cycle. Higher inflationary pressure worsened by the Russia-Ukraine conflict and other spillover effects could cloud the outlook for steel demand over the next few years. The recent escalation in COVID-19 infections in China could also decelerate steel demand there, thus contributing further to lower global steel demand growth.

In addition, tightening regulatory policies on carbon emissions are urging China Steel to transform toward more green steel production. This transformation will involve heavy capital expenditure (capex), including facility upgrades, research and development, and new technology investment such as hydrogen-based steel production. Capex above our base case could result in a slower deleveraging progress for China Steel and narrow the company's financial buffer. China Steel's ability to build sufficient buffers in its credit metrics to weather industry cyclicality will be crucial for a higher rating.

Outlook

The positive rating outlook reflects an acceleration in deleveraging boosted by ultra-strong performance in 2021. The outlook also reflects likely continued robust operating cash flow amid solid steel demand and tight global steel supply in 2022, which could sustain China Steel's ratio of FFO to debt at 38%-42%. Nonetheless, the sustainability of this ratio above our upside trigger with sufficient buffer remains to be tested. That's because of the inherent cyclicality of the steel industry and the necessity for China Steel to reduce its carbon emissions, which could result in higher capital spending than we currently forecast.

Upward scenario

We may raise the long-term rating if China Steel could sustain its profitability and lower its debt, such that the ratio of FFO to debt stays above 30% on a sustainable basis. Such improvement could be achieved by:

- Continued debt reduction through strong operating cash flow generation without aggressive investments and capex; or
- China Steel's cost competitiveness and product mix further strengthen, accompanied by a sustained demand and supply balance in the regional steel market

Downward scenario

Conversely, we could revise the outlook on China Steel back to stable if the ratio of FFO to debt falls below 30% over the next two to three years, possibly due to:

- A contraction in demand and intense competition;
- Persistently high raw material prices that squeeze the company's profit margin; or
- China Steel adopts a much more aggressive capex plan that curbs its ability to deleverage.

Our Base Case Scenario

- S&P Global Rating'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 and property sectors underpin relatively strong demand over the next one to two years.
- Asia Pacific GDP to grow 5.4% in 2022 and 4.9% in 2023. The faster economic growth will foster demand growth for steel products.
- China Steel's sales volume to remain largely flat in 2022 supported by robust demand domestically and in some export markets, such as Europe. Sales volume could decline by up to 3% in 2023 when supply shortage eases.
- Robust demand along with a supply shortage and higher coking coal prices will support steel prices in 2022. The company's average selling price for steel products could increase by 11%-15% in 2022 but then decline by 12%-16% in 2023, reflecting easing supply shortage and a likely price correction for raw materials.
- Our assumption for iron ore prices of US$130/ton-US$160/ton for 2022 and US$100/ton-US$140/ton in 2023 and for coking coal prices of US$360/ton-US$400/ton for 2022 and US$280/ton-US$320/ton in 2023.
- China Steel's gross margin to decline to 17%-20% in 2022 from 27.3% in 2021, reflecting margin compression as a result of the high raw material prices. Gross margin could decline to 15%-18% in 2023, amid stiffening competition.
- Selling, general and administrative expense at 3.2%-3.8% of total revenue in 2022-2023.
- China Steel's capex and equity investment of NT$31 billion-NT$34 billion in 2022 and 2023, mainly to be used for facility upgrades and construction of China Steel's invested offshore wind farm.
- Cash dividend of NT$48.8 billion in 2022 and NT$25 billion-NT$30 billion in 2023.
- China Steel's debt guarantee to decline to NT$0.5 billion-NT$1 billion at the end of 2022, reflecting our view that Formosa Ha Tinh Steel will pay down all its guaranteed loan by the end of 2022.

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

- EBITDA margin of 14%-18% in 2022 and 11%-15% in 2023, down from 24.3% in 2021.
- Ratio of FFO to debt of 38%-42% in 2022 and 29%-33% in 2023, down from 62.2% in 2021.
- Discretionary cash flow to debt of negative 5-10% in 2022 and positive 5%-10% in 2023, down from 28.5% in 2021.

Liquidity

The short-term issuer credit rating is 'twA-1+'. We believe China Steel has adequate liquidity to meet its needs over the 12 months ending December 2022, with a ratio of liquidity sources to liquidity uses at 1.25x-1.3x over the same period. We also believe that China Steel's liquidity sources will continue to exceed uses, even if its EBITDA were to decline by 15%.

In our view, China Steel has a high standing in credit markets and well-established and solid banking relationships in Taiwan. This is indicated by the low interest rate on the company's bank loans. These strengths are supported by China Steel's role as a government related entity and its strong domestic market position. China Steel has some financial covenants on its bank loan; however, we believe the company can meet these loose financial covenants.

Principal liquidity sources

- Cash and short-term investments of about NT$36.1 billion as of the end of December 2021.
- Cash FFO of NT$74 billion-NT$78 billion in 2022.
- Committed undrawn bank lines maturing beyond 2022 of NT$49 billion-NT$53 billion.
- Unused short-term credit facilities offered by state owned banks and bill finance companies to China Steel Corp. of NT48 billion-NT$52 billion in 2022.

Principal liquidity uses

- Short-term and long-term debt maturity of NT$70 billion-NT$74 billion in 2022.
- Capex of NT$31 billion-NT$34 billion in 2022.
- Working capital outflow of NT$11 billion-NT$16 billion in 2022.
- Cash dividends of NT$48.8 billion in 2022.

Ratings Score Snapshot

Issuer Credit Rating: twAA-/Positive/twA-1+

Note: The descriptors below are on a global scale.

Business Risk: Satisfactory

- Country risk: Intermediate Risk
- Industry risk: Moderately High Risk
- Competitive position: Satisfactory

Financial Risk: Significant

- Cash flow/Leverage: Significant

Anchor: twa+

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: Neutral (no impact)

Stand-alone credit profile (SACP): twa+

- Unsolicited issuer credit rating on Taiwan (rated 'AA' by S&P Global Ratings)
- Likelihood of government support: Moderate (+1 notch from SACP)

Related Criteria & Research

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Methodology For National And Regional Scale Credit Ratings - June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings - March 28, 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
China Steel Corp.		
Issuer Credit Rating	twAA-/Positive/twA-1+	twAA-/Stable/twA-1+
Issue Credit Rating	twAA-	

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.