

Media Release:

# Dragon Steel Corp. Outlook Revised To Positive; SACP Raised On Accelerated Debt Reduction; 'twA+/twA-1' Ratings Affirmed

April 28, 2022

## Rating Action Overview

- Steel manufacturer **Dragon Steel Corp.** is a wholly owned subsidiary of **China Steel Corp.** and has a combined steel producing capacity of six million tons, with EBITDA of NT\$31.7 billion in 2021.
- Steel price is likely to elevate in 2022 due to tight supply amid the Russia-Ukraine conflict and high raw material prices. Meanwhile, sustainable domestic demand should underpin Dragon Steel's sales volume over the next two years. We expect the company's strong cash flow generation with limited capital expenditure (capex) to support further deleveraging over the next two years.
- We have revised our outlook on the 'twA+' long-term issuer credit rating on Dragon Steel to positive from stable to reflect our outlook on China Steel.
- We have revised Dragon Steel's stand-alone credit profile (SACP) to 'twa-' from 'twbbb+'. At the same time, we affirmed our 'twA+/twA-1' issuer credit ratings on the company.

## Rating Action Rationale

*The outlook revision on Dragon Steel reflects that on its parent.* We revised our rating outlook on Dragon Steel to positive following our similar outlook revision on its parent, which reflects an acceleration in China Steel's deleveraging. This includes China Steel's elimination of its debt guarantee on Formosa Ha Tihn Steel through its very strong operating cash flow by the end of 2022. The outlook revision also reflects a tight steel supply due to the ongoing Russia-Ukraine conflict that could sustain China Steel's sales volume and product prices at elevated levels. However, there are several negative headwinds that will test the sustainability of China Steel's ratio of funds from operations (FFO) to debt to stay at or above 30% over the next two years. China's economic fallout because of strict lockdowns to combat COVID-19 along with the negative impact of high raw material prices could be difficult to fully pass through to China Steel's customers. In addition, China Steel could invest more heavily than our expectation to pursue greener steel production.

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***We have raised Dragon Steel's SACP to 'twa-' from 'twbbb+' to reflect continuing deleveraging.***

This mainly reflected strong improvement in profitability with strengthening cash flow generation. Dragon Steel's average sales price (ASP) increased by over 60% in 2021, supported by rising material prices and a moderate increase in demand. EBITDA margin recovered to 25.4% in 2021, up from 10.2% in 2020. Improved profitability strongly uplifted cash flow generation after capex and cash dividend distribution, which largely reduced the company's debt by 38% to new Taiwan dollar (NT\$) 37.6 billion as end of 2021.

We anticipate Dragon Steel will maintain strong operating cash flow generation at over NT\$20 billion per year in 2022-2023, despite downward pressure on steel prices from 2023. This could fully cover the company's capex and cash dividend distribution at NT\$12 billion-NT\$18 billion per year. Thus, Dragon Steel could continue to lower its debt and create a greater buffer for debt leverage to weather the industry volatility.

***Limited capex to support Dragon Steel's deleveraging.*** In addition to its maintenance capex, most of Dragon Steel's capex for the next two to three years is for an indoor materials storage facility and water reclamation plant. We forecast Dragon Steel will invest NT\$4.0 billion-NT\$5.5 billion in 2022 and NT\$2.5 billion-NT\$3.5 billion in 2023. Thanks to improving operating cash flow, we forecast its capex plans for the next two to three years will not hinder its deleveraging plan.

## Outlook

The positive rating outlook on Dragon Steel reflects the positive rating outlook on its parent, China Steel, because we view Dragon Steel as a core subsidiary of the China Steel group. The positive outlook on the parent reflects our expectation of 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 Ratings forecast for Taiwan's GDP to grow by 2.8% in 2022 and 2.6% in 2023, and for Asia Pacific GDP to grow 5.1% in 2022 and 4.7% in 2023. The faster economic growth in APAC will foster demand growth for steel products. Meanwhile, infrastructure, residential, and commercial property sectors underpin relatively strong demand in Taiwan over the next one to two years.
- Our assumption for iron ore prices of US\$130/ton-US\$160/ton for 2022 and US\$100/ton-US\$140/ton in 2023, while for coking coal prices of US\$360/ton-US\$400/ton for 2022 and US\$280/ton-US\$320/ton in 2023.
- Average selling price (ASP) continues to surge with 11%-15% growth in 2022, given the booming demand for hot-rolled coil (HRC) products with a supply shortage and higher coking coal prices. However, ASP could decline by 10%-14% in 2023, reflecting an easing of the supply shortage and likely price correction for raw materials. ASP for H-beam products will also surge by 3%-7% in 2022, also supported by high material prices. Sustainable local demand from construction and infrastructure projects could support H-beam prices over the next two years.
- Dragon Steel's revenue is likely to grow by 10%-14% in 2022, due to a steel price increase with largely flat sales volume. Revenue could soften by 12%-16% in 2023 due to a likely price correction for raw materials and an easing of the supply shortage.
- Sales, goods, and administration expense to remain 2.0%-2.2% of total revenue in 2022 and 2023, which is close to the level of 2.0% in 2021, given our view that the company's continuous cost-saving strategy could prevent a significant increase in expenses.
- Capex of NT\$4 billion-NT\$5.5 billion in 2022 and NT\$2.5 billion-NT\$3.5 billion in 2023, mainly to build an indoor storage facility for raw materials.
- Dividend payout of 75%-80% in 2022 and beyond.

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

- EBITDA margin of 18%-20% in 2022 and 16%-18% in 2023, down from 25.4% in 2021.
- Funds from operations (FFO) to debt of 73%-78% in 2022 and 78%-83% in 2023, down from 82.9% in 2021.
- FFO cash interest coverage of 78x-81x in 2022 and 82x-85x in 2023, up from 61.6x in 2021.

## Liquidity

The short-term rating on Dragon Steel is 'twA-1'. We believe the company has adequate liquidity to meet its needs over the next 12 months, with an estimated ratio of liquidity sources to liquidity uses at about 1.5x over the period. This is despite continuous capex and cash dividend distribution constrain a better liquidity assessment. We believe the company's liquidity sources will still exceed liquidity uses even if its EBITDA were to decline by 15%. The liquidity assessment also reflects our view that the company has prudent risk management and the ability to absorb with limited refinancing, high-impact, low-probability events.

In addition, we believe Dragon Steel has a generally satisfactory standing in credit markets and has sound business relationships with banks in Taiwan, thanks to its association with China Steel. Most of the company's mid-to-long term loan facilities will expire by the end of 2023, as well as its current bank loans. However, we view Dragon Steel's refinancing risk as

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low, given the company's standing in credit markets and access to its parent group's funding pool.

### Principal Liquidity Sources

- Cash and short-term investment of NT\$513 million as of the end of 2021.
- FFO of NT\$26 billion-NT\$27 billion up to the end of 2022.
- Unused committed bank loans of NT\$24 billion-NT\$26 billion up to the end of 2022.

### Principal Liquidity Uses

- Debt repayment of NT\$11.5 billion-NT\$12.5 billion up to the end of 2022.
- Working capital outflow of NT\$3.5 billion-NT\$4.5 billion up to the end of 2022.
- Caex of NT\$4 billion-NT\$5 billion up to the end of 2022.
- Dividend payout of NT\$13.4 billion up to the end of 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:** Intermediate

- **Cash flow/Leverage:** Intermediate

**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:** twa-

- Group stand-alone credit profile: twa+
- Entity status within group: Core (the same as the group stand-alone credit profile)

## 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
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings - October 10, 2021

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- 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

- Media Release: China Steel Corp. Outlook Revised To Positive From Stable On Accelerated Deleveraging; 'twAA-/twA-1+' Ratings Affirmed
- Taiwan Ratings' Ratings Definitions – August 10, 2020

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## Ratings List

### Ratings Affirmed; Outlook Revision

	To	From
<b>Dragon Steel Corp.</b>		
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](http://www.taiwanratings.com) for further information. Complete ratings information is available to subscribers of Rating Research Service at [rrs.taiwanratings.com.tw](http://rrs.taiwanratings.com.tw). All ratings affected by this rating action can be found on Taiwan Ratings' public website at [www.taiwanratings.com](http://www.taiwanratings.com).

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