Media Release:

Chung Hung Steel Corp. SACP Lowered On Weakening Profitability; 'twA/twA-1' Ratings Affirmed On Group Support; Outlook Positive

September 7, 2022

Rating Action Overview

- Taiwan-based steel producer **Chung Hung Steel Corp.** is a specialized downstream steel processor with production capacity of 2.4 million tons for hot-rolled coils. The company had EBITDA of NT$7.3 billion in 2021.
- Weakening steel product demand and a higher working capital requirement to support higher slab prices could bring Chung Hung Steel's ratio of FFO to debt down below 25% over the next two years.
- We have lowered our SACP assessment for Chung Hung Steel to 'twbbb' from 'twbbb+'. At the same time, we affirmed our 'twA/twA-1' issuer credit ratings on the company to reflect our continuing view of Chung Hung Steel 's role as a highly strategically important subsidiary to China Steel group.
- The outlook remains positive to reflect the positive outlook on its parent, China Steel Corp.

Rating Action Rationale

Higher slab price cannot be passed through to customers due to weak demand. Chung Hung Steel faces the challenge of slower digestion of its large highly priced slab inventory amid slowing demand. We forecast Chung Hung Steel's sales volume could decline by 10%-15% in 2022. That's because most of its clients already hold relatively high stock levels due to uncertainty over the impact of the Russia-Ukraine conflict on global supplies. We project Chung Hung Steel's sales volume could recover by 6%-10% in 2023 when slab prices normalize. The steel producer's average selling price (ASP) could decline by 1%-4% in 2022 and by 5%-9% in 2023, given the market's forecast of a gloomy outlook for the macroeconomy in 2023. Accordingly, we forecast Chung Hung Steel's EBITDA margin could drop to 0%-5% in 2022 and 2023 from 13.6% in 2021.

Higher working capital requirement to support its high-cost slab inventory has elevated Chung Hung Steel's debt. The company's debt climbed to new Taiwan dollar (NT$) 11 billion as of June 30, 2022, up from NT$8.1 billion as of June 30, 2021, amid still-high inventories of expensive slab. Higher working capital needs since the end of 2021 have weakened Chung Hung Steel's operating cash flow generation and pushed up its debt. Sluggish profitability could compress the company's cash flow generation over the next few quarters even if inventory levels fall over the same period.

PRIMARY CREDIT ANALYST

Beatrice Chen
Taipei
+886-2-2175-6829
beatrice.chen
@spglobal.com
beatrice.chen
@taiwanratings.com.tw

SECONDARY CONTACT

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

Strong interest coverage cannot cover the company's weakening cash flow generation. Chung Hung Steel's key credit ratio--funds from operations (FFO) to debt--could weaken to 1%-5% in 2022 and 8%-18% in 2023 from 66.2% in 2021. That's despite our view that the company's interest coverage remains strong thanks to its association with the parent China Steel group and the low interest environment in Taiwan. Accordingly, we have lowered our assessment of Chung Hung Steel's stand-alone credit profile (SACP) to reflect the company's likely weakening cash flow generation and financial strength over the next one to two years.

The ratings on Chung Hung Steel continue to move in tandem with those on China Steel. We still view Chung Hung Steel as a highly strategic member of the China Steel group. This reflects China Steel's ownership stake of about 40% of Chung Hung Steel, which makes it the single largest shareholder and gives China Steel control over the company's board of directors. Chung Hung Steel's operations are very important to China Steel group to maintain its dominant share in the domestic market. Therefore, the long-term rating on Chung Hung Steel is one notch below our assessment of China Steel's stand-alone group credit profile, and the ratings on Chung Hung Steel move in tandem with those on its parent.

Outlook

The positive rating outlook on Chung Hung Steel reflects the positive rating outlook on its parent, China Steel, given our view of Chung Hung Steel as a highly strategic subsidiary of the parent group. The outlook on China Steel reflects an acceleration in the company's deleveraging, which was boosted by ultra-strong performance in 2021.

The outlook also reflects likely continued robust operating cash flow for China Steel amid solid steel demand and tight global steel supply for the rest of 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 inherent cyclicality in the steel industry and the need 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 maintains its profitability and cuts debt that keeps the ratio of FFO to debt above 30% on a sustainable basis. Possible scenarios leading to such improvement are:

- Continued debt reduction through strong operating cash flow generation without aggressive investments and capital expenditure (capex); or
- China Steel strengthens its cost competitiveness and product mix, accompanied by a sustained demand and supply balance in the regional steel market.

Downward scenario

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 2.8% in 2022 and 2.7% in 2023; and for Asia Pacific by 4.2% in 2022 and 5.0% in 2023.
- Chung Hung's sales volume to decrease by 10%-15% in 2022, constrained by weak demand due to clients' high inventory levels. The company's sales volume could recover by 6%-10% in 2023.
- Slowing demand will drag down steel prices in 2022. We expect the company's ASP for steel products to decline by 0%-4% in 2022. ASP could further decrease by 4%-8% in 2023, reflecting sluggish momentum amid a gloomy macroeconomic outlook.
- Slab cost to increase by 10%-13% in 2022 due to volatile market conditions under the Russia-Ukraine conflict. Slab cost could decline by 6%-10% in 2023 because of potentially lower input costs for slab production in 2023.
- Chung Hung Steel's gross margin to weaken to 3%-6% in 2022, mainly due to rising slab cost and slowing shipment volume. Gross margin could stay within 4%-7% in 2023 under a relatively conservative demand forecast.
- Selling, general and administrative expense to be 1.6%-2.0% of total revenue in 2022-2023.
- Capex will remain limited at about NT$350 million-NT$550 million over the next two years.
- Cash dividend of NT$4 billion in 2022 and a dividend payout of 55%-65% in 2023.
- Surplus cash haircut at 100%.

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

- EBITDA margin of 0%-5% in 2022 and 2023, down from 13.6% in 2021.
- Ratio of FFO to debt of 1%-5% in 2022 and 8%-18% in 2023, down from 66.2% in 2021.
- FFO cash interest coverage of 5x-7x in 2022 and 18x-20x in 2023, compared with 155x in 2021.

Liquidity: Adequate

The short-term issuer credit rating on Chung Hung Steel is 'twA-1', reflecting the long-term issuer credit rating on the company and our assessment of Chung Hung Steel's liquidity as adequate. The liquidity assessment reflects our view that the company's ratio of liquidity sources to liquidity uses will be 1.2x-1.5x in the 12 months ending December 2022. We also believe that Chung Hung Steel's liquidity sources will continue to exceed its uses, even if EBITDA was to decline by 15%.

In our view, Chung Hung has well-established bank relationships and a generally satisfactory standing in credit markets supported by its close association with China Steel. This is reflected by the low interest rate on Chung Hung Steel's bank loans and issued bonds. The company does not have any financial covenants on its bank loans as of the end of 2021.

Principal liquidity sources

- Cash and short-term investments of about NT$2.34 billion as June 30, 2022.
- Undrawn bank lines maturing beyond June 30, 2023 of NT$6.0 billion-NT$7.0 billion.
- Cash flow from operations of NT$0.5 billion-NT$1.5 billion for the 12 months ending June 30, 2023.
- Funding access provided by China Steel group of NT$2 billion-NT$2.5 billion for the 12 months ending June 30, 2023.

Principal liquidity uses:

- Debt maturities of about NT$4.8 billion for the 12 months ending June 30, 2023.
- Capex: NT$400 million-NT$500 million for the 12 months ending June 30, 2023.
- Cash dividend: NT$4 billion in 2022.

Ratings Score Snapshot

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

Business Risk: Weak

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

Financial Risk: Significant

- Cash flow/Leverage: Significant

Anchor: twbbb

Modifiers
- **Diversification/Portfolio effect**: Neutral (no impact)
- **Capital structure**: Positive (+1 notch)
- **Financial policy**: Neutral (no impact)
- **Liquidity**: Adequate (no impact)
- **Management and governance**: Fair (no impact)
- **Comparable rating analysis**: Negative (-1 notch)

Stand-alone credit profile: twbbb
- Group stand-alone credit profile (which excludes external support): twa+
- Entity status within group: Highly strategic (one notch below the group's stand-alone credit profile)

ESG credit indicators: E-2, S-2, G-2

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
- 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 – November 11, 2021

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

Ratings List

Ratings Affirmed

Chung Hung Steel Corp.	
Issuer Credit Rating	twA/Positive/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.