Media Release:

Outlook On Formosa Taffeta Co. Ltd. Revised To Stable From Positive On Constrained Profitability; 'twA/twA-1' Ratings Affirmed

October 24, 2022

PRIMARY CREDIT ANALYST

Susan Chen
Taipei
+886-2-2175-6817
susan.chen
@spglobal.com
susan.chen
@taiwanratings.com.tw

SECONDARY CONTACT

Irene Lai
Taipei
+886-2-2175-6825
irene.lai
@spglobal.com
irene.lai
@taiwanratings.com.tw

Rating Action Overview

- Taiwan-based Formosa Taffeta Co. Ltd. is a subsidiary of Formosa Chemical & Fibre Corp., one of the four key companies of the Formosa Plastics group. Formosa Taffeta's businesses include fabric, tire cord, and gas station, with EBITDA of about NT$3.5 billion in 2021.
- The EBITDA margin faces pressure over the next one to two years because it is increasingly difficult to pass through rising costs to customers amid weakening demand. This could keep the company's ratio of debt to EBITDA above 4x in 2023.
- Accordingly, we have revised our rating outlook on the long-term issuer credit rating on Formosa Taffeta to stable from positive. At the same time, we affirmed our 'twA/twA-1' issuer credit ratings on the company.
- The stable rating outlook reflects our view that despite declining profitability, prudent capex and a material reduction in the company's debt guarantee in Vietnam could prevent further deterioration in Formosa Taffeta's debt leverage and cap debt to EBITDA at below 5x.

Rating Action Rationale

Slowing global demand could pressure Formosa Taffeta's profitability over the next one to two years. Inflationary pressure and the rising likelihood of a global recession could turn consumers more selective with their discretionary spending. As a result, Formosa Taffeta could find it more difficult to fully pass through its rising raw material costs. The company's EBITDA margin declined to 7.4% in the first half of 2022 from 10.8% in 2021 due to higher input and energy prices. Although we previously projected generally lower oil and energy prices for 2023 than in 2022, our forecasts are still relatively high compared with the historical average. We therefore believe that cost inflation and waning downstream demand could lower the company's EBITDA margin to 6.5%-7.0% in 2023.

The Russia-Ukraine conflict, China's zero COVID policy and inflationary pressure have constrained the pace of recovery in revenue for Formosa Taffeta's fabric business in 2022. A potential global recession could further dampen sales volume in 2023 and hurt the company's utilization rate for this segment.

Meanwhile, growth is relatively muted for the company's tire cord segment in 2022. That's due to an ongoing shortage of automotive chips and supply chain disruption amid COVID lockdowns in China. We also see gloomy demand prospects for 2023 due to the China government's cut to the purchase tax on internal combustion engine vehicles in 2022, which has pulled forward domestic auto demand. We see the country's auto sales recovery weakening if the tax cut proves to be only temporary and does continue throughout 2023. Farther afield, rising interest rates and high inflation will likely hurt auto demand in the U.S. and Europe. These factors together with intensifying competition from Chinese players could make it difficult for Formosa Taffeta's tire cord segment to sustain the materially improved profitability level that it recorded in 2021.

Credit metrics could weaken in 2023. We forecast the ratio of debt to EBITDA will weaken to 4x-4.3x in 2023, due to declining revenue and margin contraction, along with a likely much lower cash dividend contribution from Formosa Taffeta's investment holdings. That's despite our view that the ratio could dip temporarily below 4x in 2022 supported by rising revenue and cash dividend contributions from equity investments, mainly in Formosa Advanced Technologies Co. Ltd. and from its shareholding in Formosa Petrochemical Corp.

Declining debt guarantee could partly help reduce Formosa Taffeta's debt burden. Formosa Taffeta no longer provides a debt guarantee for the Formosa group's Vietnam-based Formosa Ha Tinh Steel Corp. This makes a significant difference to Formosa Taffeta's debt burden, given the debt guarantee was new Taiwan dollar (NT$) 2.2 billion at the end of 2021. The steel began to generate stable operating cash flow in 2021, which has helped it to refinance its debt faster without the need from its shareholders' guarantee. Formosa Taffeta has about a 3.85% ownership in the steel mill. This end to the debt guarantee will materially ease pressure on Formosa Taffeta's overall leverage during a potential economic downturn over the next one to two years.

Prudent capital expenditure (capex) and conservative investment plans could prevent abrupt deterioration in leverage. In our view, Formosa Taffeta should be able to generate positive discretionary cash flow over the next one to two years, despite weaker profitability. That's thanks to the company's planned low capex level at below NT$1 billion over the same period. Formosa Taffeta’s capex in 2022-2024 is mainly for facility upgrades and minor capacity expansion for its fabric production in Vietnam in 2022-2024.

The company plans to expand its revenue base through diversifying its client base and developing higher-premium products for fabrics and tire cord, rather than aggressively expanding capacity. Formosa Taffeta is also less likely to engage in aggressive acquisitions or investment plans over the next two years, in our view. The profit turnaround for its investment in Switzerland-based Schoeller Textiles AG will likely be the company's top priority over the period. We therefore forecast that any deterioration in Formosa Taffeta's ratio of debt to EBITDA could be capped at below 5x.

Outlook

The stable rating outlook reflects our view that Formosa Taffeta's ratio of debt to EBITDA will remain below 5x in 2022-2023. The company's EBITDA margin could come under pressure during the period, given weaker downstream demand under a possible economic recession, higher input costs and rising competition. However, the end of the company's guarantee for the Vietnam steel mill and prudent capex and investment plans should help to offset the risk of weakening profitability and cap its leverage at below 5x.

Downward scenario

We may lower the long-term rating on Formosa Taffeta if the company's adjusted ratio of debt to EBITDA rises to above 5x on a sustainable basis, which could result from:

- The EBITDA margin of its fabric and tire cord businesses deteriorating materially due to slower demand recovery, rapidly changing market trends, and intensifying competition, or if Formosa Taffeta receives lower dividend income from its equity investments than under our base case; or
- The company's cash inflow cannot support its dividend payout, capex or investments, which pushes up debt.

Upward scenario

We view the likelihood of an upgrade is low over the next 12 months due to a gloomy economic outlook globally. However, we could raise the long-term rating on Formosa Taffeta if its debt to EBITDA ratio improved to sustainably below 4x through business cycles. This could happen if:

- Its profitability improves because of demand recovery for its main businesses or a significant increase in demand for higher value-added fabrics or tire cord products, and
- At the same time, the company maintains prudent capex or investment plans.

Our Base Case Scenario

- S&P Global's forecast for world real GDP growth at 3.1% in 2022, 2.4% in 2023, and 3.2% in 2024; for China at 2.7% in 2022, 4.7% in 2023, and 4.8% in 2024; and for Taiwan at 2.2% in 2022, 1.5% in 2023, and 2.5% in 2024.
- S&P Global's forecast for Brent oil price at US$100 per barrel (bbl) for the rest of 2022, US$85 per bbl in 2023 and US$55 per bbl in 2024.
- Formosa Taffeta's revenue to grow by 7%-10% in 2022 and decline by 5%-8% in 2023, reflecting a recovery in downstream demand in 2022 but will start facing downside pressure amid a subdued growth outlook from late 2022 to 2023.
- Gross profit margin to come under pressure in 2022-2023 and decline to 14.0%-14.5% from 16.8% in 2021. Despite uplift for average selling prices of fabrics and tire cord, it could be hard to fully pass-through incremental input costs amid weaker downstream demand.
- Capex of NT$0.5 billion-NT$1.0 billion in 2022 and annually thereafter, mostly to support maintenance and upgrades for manufacturing equipment and for replacement of energy-saving equipment.
- Dividend payout ratio at 75%-80% of the previous year's net income in 2022-2024.
- The company no longer needs to provide a debt guarantee for the Vietnam steel mill.

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

- EBITDA margin of 7.5%-8.0% in 2022 and 6.5%-7.0% in 2023, down from 10.8% in 2021.
- Ratio of debt to EBITDA of 3.4x-3.7x in 2022 and 4x-4.3x in 2023, up from 3.4x in 2021.

Liquidity

The short-term issuer credit rating is 'twA-1'. We believe that Formosa Taffeta has adequate liquidity to meet its needs over the 12 months ending June 30, 2023. The calculated ratio of liquidity sources to liquidity uses is about 1.8x over the same period. In addition, we see the company's liquidity sources will continue to exceed uses, even if EBITDA was to decline by 15%. Furthermore, we believe that Formosa Taffeta should be able to absorb high-impact, low-probability events, with limited need of refinancing because its cash on hand and cash flow generation are sufficient for the repayment of short-term debt.

Formosa Taffeta has a sound relationship with banks as indicated by the low interest rate on its bank loans and diversified funding sources. This view is also supported by the company's satisfactory standing in credit markets, given its position as a subsidiary of the four key Formosa group companies. In our view, Formosa Taffeta has generally prudent risk management to ensure continued adequate liquidity based on the company's sufficient undrawn bank credit lines and flexibility to increase bank facilities. Its bank loans carry some financial covenants, but we believe the company will meet these with sufficient headroom over the next one to two years.

Principal Liquidity Sources:

- Cash and short-term investments of NT$5.5 billion as of June 30, 2022.
- Funds from operations of NT$3.0 billion-NT$3.5 billion up to June 30, 2023.
- Undrawn bank lines maturing beyond 12 months of NT$4.5 billion-NT$5.0 billion.

Principal Liquidity uses:

- Long-term debt amortization plus short-term debt maturity of NT$4.6 billion up to June 2023.
- Capex of NT$0.5 billion-NT$1.0 billion up to June 2023.
- Cash dividend of NT$1.7 billion up to June 2023.

Rating Score Snapshot

Issuer Credit Rating: twA/Stable/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: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: twbbb

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: Positive (+1 notch)

Stand-alone credit profile: twbbb+

- Group credit profile: twaa
- Entity status within group: Moderately strategic (+2 notch from SACP)

ESG credit indicators: E-3, S-2, G-2

Related Criteria & Research

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Sun Oct 10 2021
- General Criteria: Group Rating Methodology, Mon Jul 01 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Mon Apr 01 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, Mon Jun 25 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Tue Dec 16 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Tue Nov 19 2013
- General Criteria: Methodology: Industry Risk, Tue Nov 19 2013
- Criteria | Corporates | General: Corporate Methodology, Tue Nov 19 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Tue Nov 13 2012
- General Criteria: Principles Of Credit Ratings, Wed Feb 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
Formosa Taffeta Co. Ltd.		
Issuer Credit Rating	twA/Stable/twA-1	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.