Media Release:

China Steel Corp. Outlook Revised To Stable On Weaker Demand, Rising Capex; '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$) 53.8 billion in 2022.
- Muted demand in the second half of 2022 has weakened China Steel's profit margin and led significant working capital outflow while at the same time raising debt leverage.
- Prolonged pressure from high inflation and interest rates in 2023-2024 could still constrain China Steel's profitability despite demand recovery following China's softening stance on COVID-19. In addition, China Steel's high capex needs over the next two years could constrain any improvement in debt leverage.
- We have revised our outlook on the long-term issuer credit rating on China Steel to stable from positive to reflect our view that weakened debt leverage in terms of the FFO to debt ratio could take one to two years to recover to close to 30%, due to slower demand recovery.
- 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 corporate bond.

Rating Action Rationale

Uncertain economic outlook will delay demand recovery. High inflation and interest rates will continue to dampen the economic outlook in 2023 and constrain demand from manufacturing sectors . This has resulted in slow demand recovery as downstream players take longer to reduce their inventory, especially in overseas markets where economic growth remains stagnant. After a sharp decline in sales volume in the second half of 2022, steel demand recovery remains slow and insignificant, as reflected in China Steel's low sales volume in the first quarter of 2023. Nonetheless, ongoing investments in Taiwan's infrastructure should support continued domestic demand and bring some relief against weak overseas demand, despite a cooling local property market.

China Steel's debt leverage buffer has shrunk following high working capital outflow. A demand shock in the second half of 2022 led to NT$21.7 billion working capital outflow and pushed up the company's debt by 22% to NT$214.4 billion by the end of 2022. This compares with NT$175.8 billion at the end of 2021. The high working capital outflow combined with a weakened profit margin dragged down China Steel's ratio of funds from operations (FFO) to debt to 17.3% at the end of 2022, greatly down from 62.2% at the same time in 2021. We expect the company's working capital trend to reverse and lead to positive cash flow in full year 2023 due to a decline in the price of materials; however, this will not be sufficient to reduce China Steel's debt significantly.

Materials price corrections could lower steel prices, but ease margin pressure. We see the price for coking coal continuing its downward trend in 2023-2024, amid a gradual reduction in demand spurred by the energy crisis in Europe. Higher demand for thermal coal in 2022 led to overall price increases in every coal category and lifted China Steel's average coal cost. Although the European fuel crisis is not yet resolved, its impact will decline in 2023 as governments in Europe have some time to resolve the energy shortage before the next winter.

Meanwhile, we see China Steel's average selling price (ASP) declining by 8%-12% in 2023 and a further 3%-7% in 2024 to reflect likely material price corrections. However, we expect the company's raw material cost per ton of steel production to decline by 15%-20%, which should support margin improvement over the next two years. We also forecast China Steel's FFO generation to increase by 31%-36% in 2023-2024 compared with 2022, which will help to lift its ratio of FFO to debt to 20%-25%. Nevertheless, it is still below our rating upside trigger of 30%.

Persistently high capex could also constrain rating upside. We expect China Steel's capital expenditure (capex) to increase to NT$36 billion-NT$41 billion in 2023-2024, up from NT$31.5 billion in 2022. This will mainly to be used for facility upgrades, construction of China Steel's offshore wind farm, and to fund part of the prework for a blast furnace revamping planned in 2025. Additionally, the application of a carbon tax and carbon credits will force China Steel to spend heavily on carbon emission control. The company plans to engage a NT$40 billion project of blast furnace replacement before 2030 with other potential investments in hot briquetted iron production companies. We have not factored this project in our base case for China Steel because its major construction timeframe is out of our projection period with high uncertainty in the construction procedures and facility structure design. However, these expenses could add to China Steel's debt burden and constrain its rating upside.

Outlook

The stable rating outlook reflects our view that China Steel's profitability could recover gradually in 2023-2024, underpinned by delayed demand recovery for steel products from the second half of 2023. We anticipate China Steel's debt will remain flat due to improving operating cash flow generation over the same period, despite rising capex. These factors could strengthen China Steel's ratio of FFO to debt to 20%-25% in 2023-2024.

Downward scenario

We could lower the long-term rating on China Steel if:

- The ratio of FFO to debt weakens to close to 12% for an extended period, possibly due to (a) a prolonged industry downturn with contraction in demand and intense competition; (b) persistently high raw material prices that materially squeeze the company's profit margin; or (c) China Steel adopts a much more aggressive capex plan that curbs its ability to deleverage and results in elevated debt for an extended period; or
- China Steel's link with the Taiwan government weakens from our current assessment of strong, which may happen if the government materially lowers its ownership stake. However, we view this scenario to be remote over the next two years.

Upward scenario

We may raise the long-term rating if China Steel could improve 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.

Our Base Case Scenario

- S&P Global's projection for Taiwan's real GDP to grow 1.5% in 2023 and 2.5% in 2024. A slow-down in the growth rate could reflect a slower demand recovery over the next one to two years, despite sustainable infrastructure investments. Asia Pacific GDP to grow 4.6% in 2023 and 4.7% in 2024, up from 3.9% in 2022.
- China Steel's sales volume to slightly recover by 1%-4% in 2023, supported by better domestic demand recovery from the second half of 2023. Sales volume could increase by 5%-7% in 2024 as pressure from high inflation risk and interest rate eases.
- Steel prices could decline in 2023 to reflect likely price correction for coking coal prices with mild demand recovery. The company's ASP for steel products could decrease by 8%-12% in 2023 then decline by 3%-7% in 2024, reflecting continuous price corrections for raw materials.
- Our assumption for iron ore prices of US$90/ton-US$120/ton for 2023, and US$85/ton-US$115/ton in 2024. Our assumption for coking coal prices of US$260/ton-US$300/ton for 2023, and US$220/ton-US$260/ton in 2024.
- China Steel's gross margin to improve to 12%-15% in 2023 and 13%-16% in 2024 from 12% in 2022, reflecting better utilization rate with lower raw material prices. This is despite uncertainty over a demand rebound with potential competition from increasing production in Southeast Asia.
- Selling, general and administrative expense at 3.2%-3.8% of total revenue in 2023-2024.
- China Steel's capex and equity investment of NT$36 billion-NT$41 billion in 2023 and 2024, mainly to be used for facility upgrades, construction of China Steel's offshore wind farm and for part of prework for a blast furnace revamping planned in 2025.
- Cash dividend of NT$15.8 billion in 2023 and NT$10.0 billion-NT$15.0 billion in 2024.
- We apply haircut ratio of 10.4% on China Steel's cash and cash equivalents.

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

- EBITDA margin of 12.5%-16.5% in 2023 and 13%-17% in 2024, up from 12% in 2022.
- Ratio of FFO to debt of 20%-24% in 2023 and 21%-25% in 2024, up from 17.3% in 2022.
- Discretionary cash flow to debt of 3%-8% in 2023 and 0%-6% in 2024, up from negative 24.9% in 2022.

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 Dec. 31, 2023, with a ratio of liquidity sources to liquidity uses at 1.2x-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 reflected by the low interest rate on its bank loans. This is supported by the company's role as a government related entity and strong domestic market position. China Steel has some financial covenants on its bank loan; however, we believe the company will meet the loose financial covenants on its bank loans.

Principal liquidity sources

- Cash and short-term investments of about NT$41.8 billion as of Dec. 31, 2022.
- Cash FFO of NT$49 billion-NT$53 billion in 2023.
- Working capital inflow of NT$2 billion-NT$4 billion in 2023.
- Committed undrawn bank lines maturing beyond 2022 of NT$66 billion-NT$69 billion.
- Unused short-term credit facilities offered by state owned banks and bill finance companies to China Steel of NT35 billion-NT$39 billion in 2022.

Principal liquidity uses

- Short-term and long-term debt maturity of about NT$105.4 billion in 2023.
- Capex of NT$37 billion-NT$40 billion in 2023.
- Cash dividends of NT$15.8 billion in 2023.

Ratings Score Snapshot

Issuer Credit Rating: twAA-/Stable/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)

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: Reflecting Subordination Risk In Corporate Issue Ratings, Wed Mar 28 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, Wed Mar 25 2015
- 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 – November 11, 2021

(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-/Stable/twA-1+	twAA-/Positive/twA-1+
Issue Credit Rating	twAA-	