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Media Release:

Chung Hung Steel SACP Lowered On Weakened Profitability; Ratings Affirmed On Group Support; Outlook Stable

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Rating Action Overview

- **Chung Hung Steel Corp.** is a specialized downstream steel processor with production capacity of 2.4 million tons for hot-rolled coils and revenue of NT$44.5 billion in 2022.
- Prolonged weak demand for steel products has stressed Chung Hung's profitability, which is likely to longer to recover. We now expect the company's averaged ratio of FFO to debt to remain below 20% over the next two years.
- As a result, we have lowered our assessment of Chung Hung's stand-alone credit profile (SACP) 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 stable to reflect the stable outlook on its parent, **China Steel Corp.**

Rating Action Rationale

Prolonged weak demand for steel products continues to weigh on Chung Hung's profitability, which is unlikely to make a material recover over the next few quarters. The company's sales volume remained low in the first half of 2023 compared to the same period in the last three to four years. As a result, Chung Hung's EBITDA margin remained low at about 3% in the first half of 2023. In addition, the company's profitability is increasingly volatile, as indicated by the widening of Chung Hung's EBITDA margin to negative 2.3% in 2022 from positive 13.6% in 2021. This deterioration reflects the company's relatively small operation scale and limited product offering. We expect the recovery in Chung Hung's sales volume to remain slow up to the end of 2024, due to prolonged weakness in global demand. Nonetheless, we forecast the ratio of funds from operations (FFO) to debt will gradually improve to close to 12% from negative 9.9% in 2022.

Steel prices are unlikely to change much in H2 2023, but a mild decline is possible in 2024-2025. The Chinese government's policy to lower domestic steel output in 2023 to no higher than the 2022 level could offer limited support for upstream steel prices in Q4 2023. In addition, we anticipate coal prices remaining above US$200 per metric ton for the rest of 2023, which could support steel prices from a material decline over the same period. However, this also means limited downward revision for Chung Hung's slab cost. A sluggish demand recovery could make it difficult for the company to fully transfer its slab cost into final steel prices to improve its profitability materially.

We expect prices for coking coal and iron ore to drop slightly in 2024-2025, followed by steel prices and Chung Hung's slab cost. Meanwhile, demand growth could remain slow. This would require more time than under our previous forecast for Chung Hung to restore its profitability and improve the ratio of FFO to debt to sustainably above 20% during the current industry cycle.

Improving working capital inflow amid gradual inventory destocking should help to lower debt. We expect a reduction in the company's inventory from the higher base in 2022 to support working capital inflow of new Taiwan dollar (NT$) 1.0 billion-NT$1.5 billion in 2023 and below NT$0.5 billion in 2024. This should help to improve cash flow from operations to NT$1.7 billion–NT$2.3 billion in 2023-2024 which will more than cover Chung Hung's projected capital expenditure (capex) of less than NT$ 0.8 billion and cash dividend distribution. As a result, we expect Chung Hung's debt to gradually decline in 2023-2025.

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

Outlook

The stable rating outlook on Chung Hung reflects the stable outlook on China Steel, given our view of Chung Hung as a highly strategic subsidiary. The outlook reflects our view that China Steel's profitability could recover gradually in 2023-2024, underpinned by a delayed demand recovery for steel products from the second half of 2023. We anticipate China Steel's debt will remain flat amid improving operating cash flow generation, 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 if:

- China Steel's 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;
- 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; or
- We believe China Steel's support for the subsidiary has weakened. This could happen if China Steel significantly lowers its ownership in Chung Hung or reduces its control of Chung Hung's board of directors.

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

Our Base Case Scenario

- S&P Global Ratings' forecast for Taiwan's GDP to grow by 0.5% in 2023 and 2.5% in 2024; and for Asia Pacific by 4.4% in 2023 and 4.6% in 2023.
- Revenue to decline by 14%-17% in 2023 but increase by 2%-5% in 2024, from a decline of 17.2% in 2022.
- Chung Hung's sales volume to remain flat in 2023 following a near 14% decline in 2022 due to prolonged weak demand but recovery mildly by 6%-10% in 2024.
- Slowing demand will drag down the average sales price for steel products by 10%-15% in 2023. We expect this to also decline by 4%-8% in 2024, reflecting lower upstream material cost.
- Slab cost to decrease by 12%-15% in 2023, due to a large price revision in the first half of 2023 amid muted demand. Slab cost could further decline by 4%-9% in 2024 because of potentially lower input costs for slab production.
- Chung Hung's gross margin to restore to 3%-6% in 2023, up from negative 0.9% in 2022, mainly due to a material decline in slab cost and the reverse of an inventory revaluation loss. Gross margin could stay at 4.5%-7.5% in 2024 amid a mild recovery in steel demand.
- Selling, general and administrative expense to remain stable at 1.4%-1.8% of total revenue in 2023-2024.
- Capex will remain limited at NT$250 million-NT$450 million over the next two years.
- Cash dividend of NT$502 million in 2023 and NT$300 million-NT$500 million in 2024.

Chung Hung Steel Corp. – Forecast summary

Industry sector: Metal and mining

(Mil. NT$)	2020a	2021a	2022a	2023e	2024f	2025f
Revenue	36,790.2	53,744.0	44,503.5	37,250.9	38,184.7	38,904.5
EBITDA (reported)	1,500.5	7,277.4	(1,042.8)	1,133.3	1,874.2	2,465.2
Plus/(less): Other	0.0	44.3	36.4	36.4	36.4	36.4
EBITDA	1,500.5	7,321.7	(1,006.4)	1,169.6	1,910.6	2,501.6
Less: Cash interest paid	(79.4)	(47.2)	(116.5)	(204.6)	(175.4)	(143.8)
Less: Cash taxes paid	0.1	(7.4)	(653.3)	(75.0)	(122.4)	(237.3)
Funds from operations (FFO)	1,421.2	7,267.1	(1,776.3)	890.0	1,612.8	2,120.5
Cash flow from operations (CFO)	5,122.5	1,678.6	446.3	2,335.0	1,990.9	2,774.5
Capex	396.1	353.2	321.6	278.9	298.9	298.9
Free operating cash flow (FOCF)	4,726.4	1,325.4	124.7	2,056.1	1,692.0	2,475.6
Debt (reported)	10,422.6	10,385.6	17,659.5	15,559.5	13,759.6	10,131.8
Plus: Lease liabilities debt	79.1	63.9	49.2	37.9	29.1	22.4
Less: Accessible cash and liquid Investments						
Plus/(less): Other	683.1	522.0	243.8	243.8	243.8	243.8
Debt	11,184.9	10,971.6	17,952.5	15,841.2	14,032.6	10,398.0
Cash and short-term investments (reported)	1,350.9	1,681.3	4,256.1	3,565.5	2,967.4	1,000.0
Adjusted ratios						

Debt/EBITDA (x)	7.5	1.5	(17.8)	13.5	7.3	4.2
FFO/debt (%)	12.7	66.2	(9.9)	5.6	11.5	20.4
Annual revenue growth (%)	(9.1)	46.1	(17.2)	(16.3)	2.5	1.9
EBITDA margin (%)	4.1	13.6	(2.3)	3.1	5.0	6.4

All figures are adjusted by Taiwan Ratings Corp., unless stated as reported. a--Actual. e--Estimate. f--Forecast. NT$-- new Taiwan dollar.

Liquidity: Adequate

The short-term issuer credit rating on Chung Hung is 'twA-1', reflecting the long-term issuer credit rating on the company and our assessment of Chung Hung's liquidity as adequate over the 12 months ending June 2024. The liquidity assessment reflects our view that ratio of liquidity sources to liquidity uses will be 1.4x in the 12 months. We also forecast Chung Hung'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 in the low interest rate on Chung Hung's bank loans and issued bonds. The company does not have any financial covenants on its bank loans as of the end of 2022.

Principal liquidity sources

- Cash and short-term investments of about NT$1.8 billion as of June 30, 2023.
- Undrawn bank lines maturing beyond June 30, 2024 of NT$11 billion-NT$12 billion.
- Cash flow from operations of NT$0.5 billion-NT$1.5 billion for the 12 months ending June 30, 2024.
- Working capital inflow of NT$0.5 billion-NT$1.0 billion for the 12 months ending June 30, 2024.

Principal liquidity uses:

- Debt maturities of about NT$10.6 billion for the 12 months ending June 30, 2024.
- Capex of NT$200 million-NT$400 million for the 12 months ending June 30, 2024.
- Cash dividend: NT$502 million in 2023.

Ratings Score Snapshot

Issuer Credit Rating: twA/Stable/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: Aggressive

- Cash flow/Leverage: Aggressive

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 credit profile)

Related Criteria & Research

Related Criteria

- General Criteria: Group Rating Methodology - July 01, 2019
- General Criteria: National And Regional Scale Credit Ratings Methodology - June 08, 2023
- 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/Stable/twA-1