Media Release:

Dragon Steel Corp. SACP Lowered On Weakened Profitability; Ratings Affirmed On Group Support; Outlook Stable

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Rating Action Overview

- **Dragon Steel Corp.** is a wholly owned subsidiary of **China Steel Corp.** and has a combined steel production capacity of 6 million tons, with EBITDA of new Taiwan dollar (NT$) 11.8 billion in 2022.
- Prolonged weak demand for steel products has pressed Dragon Steel's profitability, which is likely to take longer to recover. We now expect the company's average ratio of funds from operations (FFO) to debt to range from 20%-25% over the next two years. As a result, we have lowered our assessment of Dragon Steel's stand-alone credit profile (SACP) to 'twbbb+' from 'twa-'.
- We have affirmed our 'twA+' long-term and 'twA-1' short-term issuer credit ratings on Dragon Steel to reflect our continuing view of the company's role as a core subsidiary of the China Steel group.
- The outlook remains stable, reflecting the stable outlook on its parent, China Steel Corp.

Rating Action Rationale

Steel prices to largely remain flat in H2 2023, but a moderate decline is possible in 2024-2025 amid declining material costs. Dragon Steel's average selling prices reduced by more than 10% in the first half of 2023, versus the same period of 2022. However, the Chinese government's policy to contain domestic steel output at no higher than the 2022 level could offer some support for upstream steel prices in the second half of 2023. In addition, we anticipate prices for coking coal and iron ore to remain above US$200 and US$100, respectively, per metric ton for the rest of 2023, which could support steel prices. We expect steel prices to move concurrently with the mildly declining prices for coking coal and iron ore in 2024-2025, as supply and demand gradually normalize for these materials after the previous super cycle.

Prolonged weak demand for steel products to weaken Dragon Steel's profitability and depress credit metrics. The steel maker's sales volume also dropped by about 10% in the first half of 2023 compared with the same period in 2022. This, together with the declining average selling prices, resulted in an EBITDA margin of only 5.7% compared with 17.4% in the first half of 2022. We expect a slow recovery in Dragon Steel's sales volume amid still-tepid global demand in the second half of 2023, which should help the company’s EBITDA margin to rise slightly to 8.7% for full-year 2023. In addition, we expect the company's EBITDA margin will gradually recover to 11%-12% in 2024 and 2025 as the global steel market could improve over the next one to two years. Accordingly, we estimate Dragon Steel's ratio of FFO to debt will be 13% in 2023, which is substantially weaker than our previous forecast of around 30%. Nonetheless, the ratio should gradually recover to 20%-25% in 2024 and 2025.

The ratings on Dragon Steel move in tandem with those on China Steel. We continue to view Dragon Steel as a core member of the China Steel group. This reflects China Steel's 100% ownership of Dragon Steel with full control over the company's board. Dragon Steel's crude steel production capacity represents about one-third of the entire China Steel group, and we believe it is highly unlikely to be sold as its operations are integral to the group's overall business strategy. Therefore, the long-term rating on Dragon Steel is the same as the stand-alone group credit profile, and the rating on Dragon Steel moves in tandem with the long-term rating on the parent.

Outlook

The stable rating outlook on Dragon Steel reflects the stable outlook on its parent, China Steel, because we view Dragon Steel as a core subsidiary of the China Steel group. The 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. In addition, the outlook reflects our view that 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.

Downside scenario

We could lower the long-term rating on Dragon Steel if we lower China Steel's stand-alone credit profile. This could occur if parent's ratio of FFO to debt weakens to close to 12% for an extended period, possibly due to:

- A prolonged industry downturn with contraction in demand and intense competition;
- Persistently high raw material prices that materially squeeze the company's profit margin; or,
- China Steel adopts a much more aggressive capex plan that curbs its ability to deleverage and results in elevated debt for an extended period.

Upside scenario

We may upgrade Dragon Steel if we upgrade China Steel should the parent's 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 strengthen, accompanied by a sustained demand and supply balance in the regional steel market.

Our Base Case Scenario

- Taiwan's GDP to grow by 0.5% in 2023, 3.0% in 2024 and 2.6% in 2025. Meanwhile, demand from infrastructure, logistic centers, and the Taiwan government's extension of its 'Three Major Programs for Investing in Taiwan' could underpin stable domestic steel demand over the next one to two years.
- Our iron ore price assumption is US$100/ton-US$150/ton for 2023, and US$90/ton-US$140/ton in 2024, and for coking coal prices of US$270/ton-US$320/ton for 2023, and US$250/ton-US$300/ton in 2024.
- We expect Dragon Steel's revenue will decrease by 20%-25 in 2023, because average selling price and sales volume could each drop by 10%-15% in 2023 due to sluggish market demand. Average selling price could drop up to 5% in 2024-2025, given downward-trending raw material prices, while sales volume could grow by 5%-10% in 2024-2025 as the market gradually recovers.
- Gross margin to decline to 10%-11% in 2023 from 12.5% in 2022, which is concurrent with the market downturn. Gross margin could recover to 13%-15% in 2024-2025, mainly reflecting the recovery in market demand and moderately lower raw material prices.
- Sales, goods, and administration expense to remain at 2%-3% of total revenue over the forecast period, because we see the company's continuous cost-saving strategy preventing a significant increase in this expense.
- Capex will increase to NT$3 billion-NT$4 billion in 2023 and NT$6 billion-NT$7 billion in 2024-2025, mainly due to large projects such as the major overhaul of its No.1 blast furnace and a new water reclamation plant.
- Given the minimal net income in 2022, the company announced no cash dividend payout in 2023. We do not expect cash dividend payout in 2024-2025.

Dragon Steel Corp.– Forecast summary
Industry sector: Metals

(Mil. NT$)	2020a	2021a	2022a	2023e	2024f	2025f
Revenue	76,824.3	124,484.6	110,728.9	87,153.8	91,041.1	95,225.4
EBITDA (reported)	7,825.3	31,641.7	11,772.0	7,552.5	10,451.9	11,511.3
Plus/(less): Other	12.1	23.6	24.4	24.4	24.4	24.4
EBITDA	7,837.4	31,665.3	11,796.4	7,576.9	10,476.3	11,535.7
Less: Cash interest paid	(684.5)	(514.1)	(624.2)	(912.4)	(858.3)	(764.4)
Less: Cash taxes paid	(0.2)	(0.1)	(4,064.6)	--	--	(41.1)
Funds from operations (FFO)	7,152.7	31,151.0	7,107.6	6,664.5	9,618.1	10,730.1
Cash flow from operations (CFO)	11,316.9	25,916.2	(1,784.6)	8,842.4	9,279.7	10,784.0
Capital expenditure (capex)	3,254.1	2,573.1	2,708.7	3,215.6	6,408.6	6,686.2
Free operating cash flow (FOCF)	8,062.8	23,343.1	(4,493.3)	5,626.8	2,871.0	4,097.8
Debt (reported)	53,475.6	31,087.5	50,926.4	52,051.4	41,910.3	37,836.9
Plus: Lease liabilities debt	7,765.6	7,014.1	6,964.6	6,915.4	6,866.6	6,818.1
Less: Accessible cash and liquid Investments	(446.6)	(513.0)	(1,567.1)	(8,294.5)	(1,000.0)	(1,000.0)
Debt	60,794.6	37,588.6	56,323.9	50,672.3	47,776.9	43,655.0
Cash and short-term investments (reported)	446.6	513.0	1,567.1	8,294.5	1,000.0	1,000.0
Adjusted ratios						
Debt/EBITDA (x)	7.8	1.2	4.8	6.7	4.6	3.8
FFO/debt (%)	11.8	82.9	12.6	13.2	20.1	24.6

Annual revenue growth (%)	(9.4)	62.0	(11.1)	(21.3)	4.5	4.6
EBITDA margin (%)	10.2	25.4	10.7	8.7	11.5	12.1

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 rating on Dragon Steel is 'twA-1'. We believe Dragon Steel has adequate liquidity to meet its needs up to the end of June 30, 2024, with an estimated ratio of liquidity sources to liquidity uses at around 1.3x over the period. Dragon Steel's liquidity sources should still exceed liquidity uses even if its EBITDA were to decline by 15%. The liquidity assessment also reflects our view that Dragon Steel has prudent risk management and the ability to absorb high-impact, low-probability events with limited refinancing.

In addition, we believe Dragon Steel has a generally satisfactory standing in credit markets and has sound relationships with banks in Taiwan, thanks to its association with China Steel. Dragon Steel has relatively large short-term debt maturity in 2023; however, we view its refinancing risk as low, given Taiwan's competitive banking environment and the company's solid refinancing track record.

Principal liquidity sources:

- Cash and short-term investment of NT$1 billion as of the end of June 30, 2023.
- FFO of NT$8 billion-NT$9 billion up to the end of June 30, 2024.
- Undrawn credit facilities maturing beyond June 30, 2024, of NT$35 billion-NT$40 billion.

Principle liquidity uses:

- Debt repayment of NT$30 billion-NT$35 billion up to the end of June 30, 2024.
- Maintenance capex of NT$4 billion-NT$5 billion up to the end of June 30, 2024.

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: Significant

- Cash flow/Leverage: Significant

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: Neutral (no impact)

Stand-alone credit profile: twbbb+

- Group stand-along 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: 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	
Dragon Steel Corp.	
Issuer Credit Rating	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 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.