Media Release:

Dragon Steel SACP Lowered On Prolonged Weak Demand; Ratings Affirmed On Group Support; Outlook Stable

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Rating Action Overview

- **Dragon Steel Corp.**, a wholly owned subsidiary of **China Steel Corp.**, has a combined steel production capacity of six million tons, with EBITDA of new Taiwan dollar (NT$) 4.4 billion in 2023.
- Longer than expected weak demand for steel products constrains Dragon Steel's profitability and debt leverage, with moderate recovery unlikely before 2025. As a result, we have lowered our assessment of Dragon Steel's stand-alone credit profile (SACP) to 'twbbb' from 'twbbb+'.
- 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 rating outlook remains stable to reflect the stable outlook on China Steel.

Rating Action Rationale

Stagnant steel sales could persist throughout 2024, stressing Dragon Steel's profitability. We expect the recovery in steel demand to remain slow over the next few quarters, given still-weak demand from China's property market and continuing over-supply in China's steel production. This will likely sustain intense regional competition and constrain Dragon Steel's sales volume and pricing for products in the export market. We estimate the market share of imported hot-rolled coil and wire products into Taiwan increased by 4%-6% in 2023. However, Dragon Steel reported a slightly improvement in sales volume in the first quarter of 2024 from the trough it reported in 2023. Accordingly, we forecast the company's sales revenue will increase in 2024 albeit by a mere 1%-4% from 2023 supported by a mild increase in downstream inventory storage and rise by 3%-6% in 2025 amid a moderate recovery in demand.

Recovery in Dragon Steel's EBITDA margin to above 12% will take longer than we previously forecast. We now expect the EBITDA margin to recover to 5%-8% in 2024 and 6%-9% in 2025 despite the potential for weak steel demand to result in a slight decline in raw material prices over the period. That's because we forecast the company's still-weak sales momentum will limit any improvement in profitability from falling material costs. Depreciation of the new Taiwan Dollar (NT$) could further erode any improvement in profitability. Moreover, we view Dragon Steel's high concentration on HRC steel products and reliance on the volatile downstream export market as further factors constraining profitability in 2024-2025. This could make the company's profitability comparatively weaker than for regional peers with more comprehensive product lines and operating flexibility. As a result, we have lowered our assessment of the company's business risk profile to weak from fair.

Capital expenditure (capex) will increase Dragon Steel's debt in 2024-2025 and weigh on recovery in its credit metrics. The company plans capex of NT$6 billion-NT$8 billion in 2024-2025, mainly for the overhaul of its number one blast furnace and for a new water reclamation plant. We anticipate Dragon Steel will complete these projects on time which will allow the company to enhance its operating efficiency and support to realize its ESG and carbon neutrality commitments. That's despite some flexibility over the scheduling. However, Dragon Steel's weak operating performance will constrain the company's cash flow generation and could push up its debt to NT$56 billion-NT$59 billion in 2024-2025. We now forecast the company's ratio of funds from operations (FFO) to debt will decline to 8%-12% in 2024 and 2025, which is below our previous forecast of above 25%. As a result, we have lowered our assessment of the company's financial risk profile to aggressive from significant.

Continuous group support from China Steel could sustain the ratings on Dragon 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 with full integration. It also embodies our view that the parent is highly unlikely to divest Dragon Steel because 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, given our view of Dragon Steel as a core subsidiary of the parent group. The outlook reflects our view that China Steel's ratio of FFO to debt could remain at 12%-16% in 2024-2025. We believe China Steel will maintain its profitability throughout this prolonged period of weak demand, supported by mildly lower material prices and a likely gradual recovery in demand from 2025. This is despite our forecast that stressed cash flow generation and higher capex for operating efficiency enhancements and decarbonatization will increase Dragon Steel's debt in 2024-2025.

Downside scenario

We could lower the long-term rating on Dragon Steel if China Steel fails to maintain its ratio of FFO to debt above 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 remain sustainably above 30%. It could achieve such improvement 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

- S&P Global's projection for China's real GDP to grow 4.6% in 2024 and 4.8% in 2025, down from 5.2% in 2023. Asia Pacific GDP to grow 4.4% in 2024 and 4.6% in 2025, up from 4.8% in 2023. A slow-down in the growth rate could delay recovery in steel demand to 2025. Taiwan's real GDP to grow 3.0% in 2024 and 2.6% in 2025, up from 1.3% in 2023. This could provide some support to prevent a material decline for steel demand.
- Our assumption for iron ore prices of US$90/ton-US$120/ton for 2024-2025 and for coking coal prices of US$240/ton-US$280/ton for 2024, and US$230/ton-US$270/ton in 2025. These reflect our view that subdued steel demand is unlikely to boost raw material prices.
- Dragon Steel's revenue to increase mildly by 1%-6% in 2024-2025, supported by 2%-7% increase in sales volume of blast furnace products. The average selling price (ASP) could dip slightly by 1%-3%, on softer raw material prices.
- Gross margin to improve mildly to 8%-10% in 2024 and 9%-11% in 2025 from 7.3% in 2023, mainly reflecting the recovery in market demand and moderately lower raw material price.
- Sales, goods, and administration expense to remain at 2%-3% of total revenue during the forecast period, because the company's continuous cost-saving strategy could prevent a significant increase in this expense.
- Capex will increase materially to NT$6 billion-NT$8 billion in 2024-2025, mainly for large projects.
- No cash dividend payout in 2024 according to the company's announcement.

Dragon Steel Corp.– Forecast summary

Industry sector: Metals

(Mil. NT$)	2021a	2022a	2023a	2024e	2025f	2026f
Revenue	124,484.6	110,728.9	89,574.2	92,034.0	96,025.5	104,955.0
EBITDA (reported)	31,641.7	11,772.0	4,395.9	6,140.3	7,326.8	11,991.4
Plus/(less): Other	23.6	24.4	15.9	15.9	15.9	15.9
EBITDA	31,665.3	11,796.4	4,411.8	6,156.2	7,342.7	12,007.3
Less: Cash interest paid	(514.1)	(624.2)	(883.0)	(863.2)	(900.1)	(856.2)
Less: Cash taxes paid	(0.1)	(4,064.6)	(108.3)	--	--	--
Funds from operations (FFO)	31,151.0	7,107.6	3,420.5	5,293.0	6,442.6	11,151.1
Cash flow from operations (CFO)	25,916.2	(1,784.6)	7,785.6	4,606.6	5,138.8	9,260.8
Capital expenditure (capex)	2,573.1	2,708.7	3,383.4	7,742.4	6,662.1	2,922.2
Free operating cash flow (FOCF)	23,343.1	(4,493.3)	4,402.1	(3,135.8)	(1,523.3)	6,338.6
Debt (reported)	31,087.5	50,926.4	46,697.6	49,817.2	51,356.4	45,033.7
Plus: Lease liabilities debt	7,014.1	6,964.6	7,736.8	7,736.8	7,736.8	7,736.8
Debt	31,087.5	57,891.0	54,434.4	57,554.0	59,093.2	52,770.5
Cash and short-term investments (reported)	513.0	1,567.1	532.1	500.0	500.0	500.0
Adjusted ratios						
Debt/EBITDA (x)	1.2	4.9	12.3	9.3	8.0	4.4
FFO/debt (%)	81.8	12.3	6.3	9.2	10.9	21.1
Annual revenue growth (%)	62.0	(11.1)	(19.1)	2.7	4.3	9.3
EBITDA margin (%)	25.4	10.7	4.9	6.7	7.6	11.4

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 rating on Dragon Steel is 'twA-1'. We believe Dragon Steel has adequate liquidity to meet its needs up to Dec. 31, 2024, for which period we estimate the ratio of liquidity sources to liquidity uses will be around 1.2x. 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 maturing in 2024; 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$532 million as of Dec. 31, 2023.
- FFO of NT$4 billion-NT$6 billion up to Dec. 31, 2024.
- Undrawn credit facilities maturing beyond Dec. 31, 2024 of NT$20 billion-NT$25 billion.
- Issued corporate bond of NT$4.4 billion as of April 23, 2024.

Principle liquidity uses:

- Debt repayment of NT$22 billion up to Dec. 31, 2024.
- Working capital outflow of NT$100 million-NT$600 million up to Dec. 31, 2024.
- Maintenance capex of NT$4.5 billion-NT$5.5 billion up to Dec. 31, 2024.

Rating Score Snapshot

Dragon Steel Corp.		
	To	**From**
Issuer Credit Rating	twA+/Stable/twA-1	twA+/Stable/twA-1
Business risk	Weak	Fair
Country risk	Intermediate	Intermediate
Industry risk	Moderately high	Moderately high
Competitive position	Weak	Fair
Financial risk	Aggressive	Significant
Cash flow/Leverage	Aggressive	Significant
Anchor	twbbb-	twbbb+
Modifiers		
Diversification/Portfolio effect	Neutral (no impact)	Neutral (no impact)
Capital structure	Neutral (no impact)	Neutral (no impact)
Financial policy	Neutral (no impact)	Neutral (no impact)
Liquidity	Adequate (no impact)	Adequate (no impact)
Management and governance	Neutral (no impact)	Neutral (no impact)
Comparable ratings analysis	Positive (+1 notch)	Neutral (no impact)
Stand-alone credit profile (SACP)	twbbb	twbbb+
Group SACP	twa+	twa+
Entity status within group	Core (same as group SACP)	Core (same as group SACP)
Note: The descriptors are on a global scale.		

Related Criteria & Research

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology - April 04, 2024
- Criteria | Corporates | General: Corporate Methodology - January 07, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities - January 07, 2024
- 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
- General Criteria: Group Rating Methodology - July 01, 2019
- 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
- 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