Media Release:

Chung Hung Steel SACP Lowered On Still-Weak Profitability; Ratings Affirmed On Group Support; Outlook Stable

September 20, 2024

PRIMARY CREDIT ANALYST

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

SECONDARY CONTACT

James Hung, CFA
Taipei
+886-2-2175-6828
james.hung@spglobal.com
james.hung@taiwanratings.com.tw

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 new Taiwan dollar (NT$) 37.8 billion in 2023.
- Prolonged weak demand for steel products has constrained Chung Hung's profitability and ability to improve debt leverage. We expect the company's average ratio of funds from operations (FFO) to debt to be well-below 12% over the next two years.
- We lowered our assessment of Chung Hung's stand-alone credit profile (SACP) to 'twbb+' from 'twbbb-'.
- 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 subsidiary of highly strategic importance to the parent **China Steel Corp.** group.
- The rating outlook remains stable to reflect the stable outlook on China Steel Corp.

Rating Action Rationale

Rising competitive pressure from imported Chinese steel goods and in Chung Hung's export markets is unlikely to ease significantly over the next two years. Lower-priced imported steel products from China are likely to continue to pressure margins in Taiwan's steel market. Weak demand for steel products in China due to the country's still-weak property market has led to a spillover of Chinese steel products into neighboring markets, including Taiwan. Anti-dumping investigations into Chinese imported steel products could reduce the negative impact for Taiwan steel makers in 2025. However, we believe this may not be enough to significantly reverse Chung Hung's weakening profitability amid persistently weak steel demand in Taiwan.

Declining prices for coking coal and iron ore could help Chung Hung's cost position through lower slab prices. Meanwhile, the company is also adjusting its business strategy to focus on the domestic market with more tailor-made products and services. However, strengthening end-demand will be crucial for recovery in Chung Hung's credit profile.

Prolonged weak demand for steel products continues to weigh on Chung Hung's profitability and cash flow generation, with a material recovery unlikely over the next one to two years. While the company's sales volume has improved since reaching a trough in 2022, it has yet to make a significant turnaround. Indeed, sales volume declined 7%-9% year on year in the first half of 2024, with average selling price (ASP) also trending down. Chung Hung's EBITDA margin narrowed to just 0.3% in the first half of 2024, down from 1.9% in 2023 despite lower slab prices over the period. This reflects intensifying competition from lower cost imported Chinese steel products. Chung Hung's relatively small operating scale and limited product offering also constrain its operating margin.

We believe Chung Hung's sales volume could recovery to above 2 million tons per year after 2026. That's because we assume no material changes in the market's oversupply condition with higher steel output and weak steel demand from China's property market persisting into 2025-2026. As a result, we forecast Ching Hung's ratio of FFO to debt will be very weak at 5%-6% in 2024-2025.

The ratings on Chung Hung will continue to move in tandem with those on China Steel. We continue to view Chung Hung as a highly strategic member of the wider 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 parent group to maintain its dominant share of the domestic steel product market. Therefore, the long-term rating on Chung Hung is one notch below China Steel's stand-alone group credit profile, and the rating on Chung Hung will move in tandem with the long-term rating on the parent.

However, we could lower our assessment of Chung Hung's stand-alone credit profile if the company's competitive ability is unable to restore its profitability to the level we anticipate, perhaps due to persistent oversupply, or if the company's financial risk rises due to a material increase in debt or interest over the next one to two years.

Outlook

The stable rating outlook on Chung Hung Steel reflects the stable outlook on China Steel, given our view of Chung Hung Steel as a highly strategic subsidiary. The outlook reflects our view that China Steel could maintain its profitability during this prolonged period of weak demand, supported by mildly lower material prices and a likely gradual recovery in demand from 2025. This is despite a possible rise in China Steel's debts in 2024-2025 amid stressed cash flow generation and higher capital expenditure (capex) for operating efficiency enhancements and decarbonatization over the period. We anticipate China Steel's ratio of FFO to debt will remain at 12%-16% in 2024-2025.

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; or
- We believe the link between China Steel and the Taiwan government has weakened from our current assessment of strong, which may happen if the government materially lowers its ownership stake in China Steel. However, we view this scenario to be remote over the next two years.

- We may also lower the rating on Chung Hung if 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 over Chung Hung's board of directors.

Upward scenario

We may raise the long-term rating if:

- China Steel could maintain its profitability and reduce debt, such that the ratio of FFO to debt remains sustainably above 30%. 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 4.0% in 2024 and 2.1% in 2025; and for Asia Pacific GDP to grow by 4.4% in 2024-2025.
- Chung Hung's sales volume to decline by 8%-12% in 2024 due to reducing sales volume amid persistent weak demand, but to remain flat in 2025 because we expect some volume recovery to slightly offset the weak demand trend.
- ASP could decline by 1%-3% in 2024 and 2%-4% in 2025 to reflect downward revision in steel prices due to lower prices for coking coal and iron ore.
- Slab cost to decrease by 13%-16% in 2024, mainly due to lower sales volume with a minor slab price correction. Slab cost could increase by 3%-5% in 2025, following the same degree of growth in sales volume.
- Chung Hung Steel's gross margin to continue to restore to 3.0%-5.5% in 2024-2025, mainly due to a price decline in slab despite a minor inventory revaluation loss.
- Selling, general and administrative expense to remain stable at 1.4%-1.7% of total revenue in 2024-2025.
- Capex will remain limited at NT$300 million-NT$500 million over the next two years.
- Cash dividend of NT$143.6 million in 2024 and a dividend payout of 65%-75% in 2025.
- Surplus cash haircut at 100%.

Chung Hung Steel Corp. – Taiwan Ratings Corp. Forecast Summary

Industry sector: Metal and mining

(Mil. NT$)	2021a	2022a	2023a	2024e	2025f	2026f
Revenue	53,744	44,504	37,764	33,685	34,098	37,402
EBITDA (reported)	7,277	(1,043)	667	902	1,064	1,715
Plus/(less): Other	44	36	54	54	54	54
EBITDA	7,322	(1,006)	721	956	1,118	1,769
Less: Cash interest paid	(47)	(117)	(220)	(211)	(221)	(223)
Less: Cash taxes paid	(7)	(653)	(62)	(1)	(1)	(12)
Funds from operations (FFO)	7,267	(1,776)	439	743	896	1,535
Cash flow from operations (CFO)	1,679	446	2,000	876	1,283	892
Capex	353	322	391	398	398	398
Free operating cash flow (FOCF)	1,325	125	1,609	478	885	494
Debt (reported)	10,386	17,659	14,817	15,522	15,011	15,027

Plus: Lease liabilities debt	64	49	70	101	101	101
Plus/(less): Other	522	244	88	88	88	88
Debt	10,972	17,952	14,974	15,710	15,199	15,216
Cash and short-term investments (reported)	2,681	6,056	2,969	3,000	3,000	3,000
Adjusted ratios						
Debt/EBITDA (x)	1.5	(17.8)	20.8	16.4	13.6	8.6
FFO/debt (%)	66.2	(9.9)	2.9	4.7	5.9	10.1
FFO cash interest coverage ratio (x)	154.9	(14.2)	(3.0)	4.5	5.0	7.9
Annual revenue growth (%)	46.1	(17.2)	(15.1)	(10.8)	1.2	9.7
EBITDA margin (%)	13.6	(2.3)	1.9	2.8	3.3	4.7

All figures are adjusted by Taiwan Ratings Corp., unless stated as reported. Figures of forecast period are based on Taiwan Ratings Corp.'s base-case scenario. a--Actual. e--Estimate. f--Forecast. NT$-- new Taiwan dollar. N.M.--Not meaningful.

Liquidity: Adequate

The short-term issuer credit rating on Chung Hung Steel is 'twA-1' to reflect the long-term issuer credit rating on the company and our assessment of Chung Hung Steel's liquidity as adequate over the 12 months ending June 2025. The liquidity assessment reflects our view that the company's ratio of liquidity sources to liquidity uses will be 1.6x-1.8x over the same 12-month period. We also believe that Chung Hung Steel'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 banking 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 carries some financial covenants with a sufficient buffer on its bank loans as of the end of June 2024.

Principal liquidity sources

- Cash and short-term investments of about NT$3.6 billion as of June 30, 2024.
- Undrawn bank lines maturing beyond June 30, 2025, of NT$9 billion-NT$10 billion.
- Cash flow from operations of NT$0.5 billion-NT$1.5 billion for the 12 months ending June 30, 2025.

Principal liquidity uses:

- Debt maturities of about NT$7.7 billion for the 12 months ending June 30, 2025.
- Capex of NT$300 million-NT$450 million for the 12 months ending June 30, 2025.
- Cash dividend of NT$143 million in 2024.

Ratings Score Snapshot

Chung Hung Steel Corp.		
	To	From
Issuer Credit Rating	twA/Stable/twA-1	twA/Stable/twA-1
Business risk	Weak	Weak
Country risk	Intermediate	Intermediate
Industry risk	Moderately high	Moderately high
Competitive position	Weak	Weak
Financial risk	Highly leveraged	Aggressive
Cash flow/Leverage	Highly leveraged	Aggressive
Anchor	twbb	twbbb-
Modifiers		
Diversification/Portfolio effect	Neutral (no impact)	Neutral (no impact)
Capital structure	Positive (+1 notch)	Positive (+1 notch)
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	Neutral (no impact)	Negative (-1 notch)
Stand-alone credit profile (SACP)	twbb+	twbbb-
Group stand-alone credit profile (which excludes external support)	twa+	twa+
Entity status within group	Highly strategic (one notch below GSACP)	Highly strategic (one notch below GSACP)
Note: The descriptors are on a global scale. GSACP--Group stand-alone credit profile.		

Related Criteria & Research

Related Criteria

- General Criteria: National And Regional Scale Credit Ratings Methodology - June 08, 2023
- 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: 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	
Chung Hung 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.