Media Release

Asia Cement Corp. Upgraded To 'twA+/twA-1' On Strengthened Operating Cash Flow; Outlook Stable

September 19, 2018

Overview

- The demand and supply balance for cement in China has improved, which we expect will sustain an elevated cement price and support a high profit margin for Asia Cement over the next two years.
- In turn, we expect the company's strong profitability to support positive discretionary cash flow generation over the period, despite a likely increase in capital expenditure to support capacity expansion at its power plant.
- We are therefore raising our long-term issuer credit rating on Asia Cement to 'twA+' from 'twA' and affirming the short-term issuer credit rating at 'twA-1'.
- The rating outlook is stable to reflect our view that improved production discipline and the Chinese government's more intense efforts to control pollution will support a higher cement price and Asia Cement's profit margin over the next two years.

Rating Action

Taiwan Ratings Corp. today raised its long-term issuer credit rating on **Asia Cement Corp.** to 'twA+' from 'twA', and affirmed the short-term issuer credit rating at 'twA-1'. The outlook on the long-term rating is stable.

Rationale

The upgrade reflects our view that Asia Cement is likely to maintain an improved profit margin and strong operating cash flow generation over the next one to two years. We base this on our expectation of a sustained higher cement price in China under an improved supply and demand balance, a high capacity utilization rate for Asia Cement, and a relatively stable cost structure in China. We also expect the company's strong operating cash flow to help lower its debt level moderately and improve its ratio of debt to EBITDA to around 3x over the next two years. That's despite likely higher capital spending to expand capacity at the company's independent power plant.

We expect cement output and demand to remain at a tight balance in the regions where Asia Cement operates in China, which will sustain the cement price at a higher level over the next two years. Demand and supply levels will likely remain largely unchanged over the next two years in China, in our view. Nonetheless, moderate investment growth in property and other fixed assets will continue to support cement demand in Asia Cement's operating regions, particularly Jiangxi and Sichuan provinces.

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Meanwhile, we view production discipline among cement producers, evidenced by better control over production volume and inventory levels through periodic production stoppages, will constrain growth in cement output and support the price for cement. We believe this discipline will sustain over the next two years, driven by the substantial profitability recovery because of production volume controls and the China government's intensified efforts to control pollution and monitor this more effectively.

Nevertheless, we believe that overcapacity will persist over the next two years, albeit declining, due to slow capacity retirement under a high-selling-price environment. More frequent environmental inspections and more stringent capacity replacement policies--that is to say permitted new capacity is only a fraction of retired capacity--will support the decline in overcapacity, in our view.

In our assessment, Asia Cement's profitability and operating cash flow generation will remain strong over the next two years, mainly driven by the robust cement price, high capacity utilization, and only a moderate increase in production cost in China. We expect China's coal price to stabilize in 2018 and 2019, given steady demand and the government's control over production volume and price. We also expect a slight increase in Asia Cement's capacity utilization in China to around 90%. This should underpin Asia Cement's operating efficiency and cost competitiveness, in our opinion.

However, we expect profitability to deteriorate in Taiwan's cement business, albeit with a manageable impact, given that it is likely to contribute around just 18% of Asia Cement's revenue in 2018. The declining profitability will mainly be due to a higher international coal price and more intense competition from higher imports of cement that will constrain a price increase.

We assess Asia Cement's strong operating cash flow will help to lower its debt level moderately and support a ratio of debt to EBITDA at around 3x over the next two years, despite likely higher capital expenditure on Asia Cement's power generation business. We expect overall capital expenditure to increase to New Taiwan dollar (NT$) 4.5 billion-NT$5 billion in 2018, which mainly reflects potential capacity expansion at Asia Cement's power generation subsidiary Chiahui Power Corp.

Capital expenditure may rise to NT$7.5 billion-NT$8 billion in 2019, which reflects Asia Cement's opportunistic cement capacity expansion in China, given its intention to expand the scale of operations there. Nonetheless, the exact degree of expansion and timeline remains uncertain. We do not expect a hypothetical acquisition of additional shares in Shanshui Cement to have a material negative effect on Asia Cement's credit profile. We also do not expect Asia Cement to take over Shanshui Cement over the next two years due to Shanshui Cement's complex shareholding structure.

We expect Asia Cement to receive higher cash dividends from its investments in 2018 and 2019, mainly as the result of better performance at **Far Eastern New Century Corp.** (FENC) and U-Ming Marine Transport Corp. In addition, we expect Asia Cement's holdings in other FENC group member companies as well as investments in financial instruments and properties will continue to support its financial flexibility. Asia Cement's non-current publicly listed equity holdings had a market value of about NT$58.2 billion as of June 30, 2018 and has about NT$35.8 billion investment in property at the same time. Any disposal of these assets could improve Asia Cement's capital structure materially, given the company's adjusted debt of about NT$65.9 billion at the end of June 2018. Accordingly, we are maintaining our positive assessment on Asia Cement's capital structure.

Our base case assumes the following:

- China's real GDP to grow 6.5% in 2018 and 6.3% in 2019. We expect stable to slightly lower demand for cement in China in 2018 and 2019, due to moderating growth in investments that have a high correlation with cement demand.
- Taiwan's real GDP to grow 2.8% in 2018 and 2.5% in 2019. Demand for cement will remain stable in 2018 and 2019, due to the mature cement market and still-sluggish housing market.

- Asia Cement's revenue from its cement business will increase by 17%-20% in 2018 reflecting growth in cement revenue in China and remain largely flat in 2019. We anticipate a rise in the average selling price (ASP) will drive such growth.
- The company's blended ASP in China to increase by 20%-24% in 2018 and remain flat in 2019. We believe cement producers' efforts in controlling production along with a more concentrated market structure will continue to support the cement price at a relatively high level over the next two years.
- The company's selling price for cement in Taiwan to remain largely flat over the next two years due to more intense competition from imported cement, despite a substantial increase in the coal price.
- Asia Cement's capacity utilization in China to increase slightly to around 90% in 2018 and 2019, underpinned by robust demand in Jiangxi and Sichuan. We expect the company's capacity utilization in Taiwan to stabilize at 66%-70% over the same period.
- The EBITDA margin on Asia Cement's China business to strengthen to 31%-36% in 2018 and 2019, underpinned by a strong cement price and only mild increases in major cost items. We expect the EBITDA margin on the company's cement in Taiwan to weaken slightly over the same period due to higher coal costs, which is not reflected in the cement selling price.
- EBITDA for the company's non-cement business to increase by 5%-8% in 2018 and remain flat in 2019, mainly reflecting a higher contribution from the company's power generation business.
- Dividend contribution from equity-method investments to increase to NT$2.3 billion-NT$2.4 billion in 2018 and NT$2.8 billion-NT$3.1 billion in 2019. The higher dividend income mainly reflects FENC and U-Ming's stronger operating performance.
- Capital expenditure of NT$4.5 billion-NT$5 billion in 2018, mostly reflecting potential capacity expansion in its power generation business. Capital expenditure of NT$7.5 billion-NT$8 billion in 2019, assuming the company expands cement capacity by two million tons in China.
- Dividend payment of NT$4 billion in 2018 and NT$5.5 billion-NT$6 billion in 2019. The higher dividend payment in 2019 reflects 2018's stronger operating performance.
- We net 75% of Asia Cement's cash and liquid investments with debt.

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

- EBITDA Margin of 27%-29% in 2018 and 2019.
- Ratio of debt to EBITDA of 2.8x-3.2x in 2018 and 2019.
- EBITDA interest coverage ratio of 10x-12x in 2018 and 2019.

Liquidity

The short-term corporate credit rating is 'twA-1'. We believe Asia Cement has adequate liquidity to meet its needs over the next 12 months, which reflects our view that the ratio of liquidity sources to liquidity uses will be around 1.3x over the period and that liquidity sources will continue to exceed uses even if Asia Cement's EBITDA were to decline by 15%. Liquidity sources include a likely issuance of overseas convertible bonds worth US$215 million by the end of September 2018. We also believe the company has a sound relationship with banks and a generally high standing in the credit market in Taiwan, supported by the company's membership of the FENC group. There is no financial covenant associated with Asia Cement's or its subsidiaries' debt as of the end of June 2018.

Liquidity sources

- Cash and short-term investments: NT21.6 billion as the end of June, 2018.
- Funds from operations: NT$17 billion-NT$19 billion over the next 12 months.
- Undrawn bank lines (maturing beyond 12 months): NT$22.5 billion-NT$23.5 billion over the next 12 months.
- Overseas convertible bond issuance: NT$6.665 billion over the next 12 months.

Liquidity uses

- Debt maturities: NT$45 billion-NT$47 billion over the next 12 months.
- Maintenance capital expenditure: NT$0.9 billion-NT$1.1 billion over the next 12 months.
- Working capital outflow: NT$2 billion-NT$2.3 billion over the next 12 months.
- Cash dividend: NT$3.9 billion-NT$4.1 billion over the next 12 months.

Outlook

The stable outlook on Asia Cement reflects our view that improved production discipline and the Chinese government's more intense effort in controlling pollution will over the next one to two years help to sustain an elevated price for cement in China. This, together with steady cement demand in China and steady operating cost underpin our view that Asia Cement can sustain an improved profit margin and strong cash flow generation capable of supporting a ratio of debt to EBITDA at around 3x over the next two years.

Downward scenario

We may lower the long-term rating on Asia Cement if the company's ratio of debt to EBITDA weakens to close to 4x for an extended period, due to a significant drop in operating cash flow or a material increase in debt level. This could result from deterioration in the operating environment possibly due to sluggish demand, weakening production discipline or a substantial increase in key operating costs without a corresponding price reflection, leading to a decline in operating cash flow. This could also occur if the company's capital expenditure or acquisitions significantly exceed our current expectations, leading to a debt level materially higher than we had assumed.

Upward scenario

The likelihood of an upgrade is low over the next 12 months. However, we may raise the long-term issuer credit rating if Asia Cement could improve its ratio of debt to EBITDA to around 2x on a sustainable basis. Controlled capital expenditure or a substantial reduction in cash dividend payouts while maintaining a strong level of profitability could bring about such improvement.

Rating Score Snapshot

Issuer Credit Rating: twA+/Stable/twA-1
Note: All scores are in comparison with global obligors.

Business risk: Satisfactory
- Country risk: Moderately High Risk
- Industry risk: Intermediate Risk
- Competitive position: Satisfactory

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: twa

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Positive (+1 notch)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twa+

Related Criteria

- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - June 26, 2018
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Building Materials Industry - December 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - 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 And Insurers - November 13, 2012
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

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Ratings List

Upgrade

	To	From
Asia Cement Corp.		
Issuer Credit Ratings	twA+/Stable/twA-1	twA/Stable/twA-1