Media Release

LCY Chemical Corp. Downgraded To 'twBBB/twA-2' On Acquisition By KKR; Off CreditWatch; Outlook Stable

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Overview

- Private equity investor KKR and previous major shareholder, the Lee family, have acquired and privatized LCY in a leverage buyout transaction.
- LCY's ratio of debt to EBITDA could rise to 3x-4x post the debt funded acquisition from debt free on an adjusted basis presently. However, restrictive financial covenants in the syndicated loan funding the transaction suggest LCY's leverage is unlikely to exceed 5x over the next one to two years.
- We are therefore lowering the long-term issuer credit rating on LCY to 'twBBB' from 'twA' and short-term rating to 'twA-2' from 'twA-1'.
- The rating outlook is stable to reflect our view that LCY's debt will not materially increase from the already high level and its ratio of debt-to-EBITDA will stay below 5x over the next one to two years, despite weakening market conditions.

Rating Action

Taiwan Ratings Corp. today lowered its long-term issuer credit rating on **LCY Chemical Corp.** to 'twBBB' from 'twA' and the short-term rating to 'twA-2' from 'twA-1'. The outlook on the long-term rating is stable. We removed all the ratings from CreditWatch, where we placed them with negative implications on July 24, 2018.

Rationale

The downgrade reflects LCY's heightened post acquisition financial risk including high debt to fund the transaction, and material risk of further leveraging in the next few years by Kohlberg Kravis Roberts & Co. L.P. (KKR) to maximize its return on the acquisition. KKR and the former largest shareholder, the Lee family, completed the privatization of the LCY group with total consideration of about New Taiwan dollar (NT$) 45 billion on Jan. 30, 2019. Of the total consideration, NT$27.6 billion is funded by a syndicated loan.

In this transaction, the only operating asset, LCY, will be held by several intermediate holding companies, which is very common in leverage buyout transactions. Private equity firms use this structure to acquire, control, fund or secure financing for the operating companies. We do not factor in the likelihood of support from the financial sponsor, nor any constraint from our view of the sponsor's creditworthiness. Rather, we view the creditworthiness of the intermediate holding companies and the only operating company, LCY itself, to be equal and, completely hinge on LCY's business profile and the consolidated debt of the whole holding structure. As a result, we do not assess LCY's standalone credit profile.

We expect LCY group's consolidated debt to EBITDA ratio to deteriorate to a mid-3x range post acquisition from debt free on adjusted basis pre-acquisition. In addition, LCY could take a more aggressive growth strategy over the medium term and thus increase its debt leverage further. This includes through higher investments in its core business, or large mergers and acquisitions to grow its geographic and industry exposure to maximize the financial sponsor's return. We do not expect the financial sponsor to exit in the next few years before its strategy bears fruit.

However, we believe there is limited risk that the group would increase its leverage materially over the next two to three years. The consolidated group credit profile has limited headroom for large debt additions in the tenor of the syndicated, given the restrictive debt leverage requirement of the associated financial covenants. In addition, LCY intends to pay no dividends and our base case anticipates the group will generate steady operating cash flow over the next one to two years. This could provide capacity to fund the company's expansion without a significant increase in its debt level.

We believe that the privatization of LCY will not have an immediate impact on the company's business profile. Its existing key shareholder will remain the second largest shareholder and remain significantly engaged in the management of the company. In addition, KKR's broad global network could facilitate LCY's global expansion in terms of geography, products, and technology, which we view to be credit positive to LCY in the long-term.

Our base case assumes:

Macroeconomic and industry related:

- S&P Global's prediction of China GDP growth at 6.5% in 2018 and 6.2% in 2019; Taiwan GDP growth of 2.5% in both 2018 and 2019; and U.S. GDP growth of 2.9% in 2018 and 2.3% in 2019.
- Coupled with generally stable oil prices in 2019, we believe that steady global demand from key end markets will support the performance of most chemical suppliers'. This is despite the trade tension and potentially slower GDP growth in the U.S. and China. Moreover, we anticipate global supply and demand will be generally in balance, and capacity additions will be largely absorbed. In addition, Asia chemical firms such as LCY have also benefited from capacity shutdowns in China amid environmental controls.

Business assumptions for LCY:

- Taiwan Ratings' base case scenario for LCY indicates the company's revenue will increase by about 7% in 2018 but decline moderately by a low-single-digit in 2019-2020, while at the same time, LCY will maintain its profitability at the mid-cycle range, which is slightly below the level recorded in 2017.
- Average sales prices will be high in 2018 but decline moderately over the next two years, given our expectation of moderately declining oil and chemical prices in 2019-2020.
- LCY's sales volume will increase moderately in line with industry growth and capacity expansion.
- LCY should be able to maintain its improved EBITDA margin at 10%-12% over the next two years, given 1) relatively stable chemical markets and prices and 2) continued effort on value-added and product differentiation; despite our conservative view on polypropylene and copper foil products due to the sector's increasing supply additions.

Cash flow and leverage assumptions:

- LCY's cash conversion cycle in 2018 and 2019 is the same as that for 2017.
- LCY will spend NT$2.0 billion-NT$2.5 billion per year in 2018-2019, mainly for expanding more value-added chemical products.
- LCY will pay no cash dividend after 2019 following privatization.

- NT$26.7 billion bank borrowing for the leverage buy-out will be added to the group's consolidated debt from 2019.
- NT$1.29 billion (the same amount as at the end of 2017) estimated litigation exposure for an earlier explosion accident in Taiwan's southern city of Kaohsiung is added to the adjusted debt.

Based on these assumptions, we arrive at the following credit measures for LCY

- The ratio of debt to EBITDA will be about 3.5x over 2019-2020, compared with the company's zero adjusted debt before privatization.
- Free operating cash flow will remain positive in 2019-2020.

Liquidity

The short-term rating on LCY is 'twA-3'. We believe the company has adequate liquidity with a ratio of liquidity sources to uses above 2.0x over the next 12 months. However, the limited headroom for LCY's financial covenants constrains its liquidity. We believe the company will be unable to meet the requirements of the financial covenants on its bank loans if its EBITDA declines by 30%, but has sufficient room for a 15% decline in EBITDA. The company could absorb high-impact, low-probability events with limited refinancing, largely because of LCY's relatively high cash on hand. We expect the company to have positive liquidity sources minus liquidity uses, even if forecasted EBITDA declines by 15%. We also view the company has a generally satisfactory standing in local credit market.

Principle Liquidity Sources:

- Cash and short-term investments: NT$17.7 billion at the end of September 2018.
- Funds from operations: NT$4.5 billion- NT$5.0 billion per year in 2018-2019.

Principal Liquidity Uses:

- Debt maturities plus short-term borrowing: NT$7.9 billion for the next 12 months.
- Capital expenditure: about NT$2.5 billion per year in 2018-2019.

Outlook

The stable outlook on LCY reflects our view that the company's leverage will not materially increase from its already high level over the next one to two years. This reflects on our expectation of no cash dividend payout, restrictions from its financial covenants, and relatively stable operating cash flow. We expect LCY to sustain its EBITDA by maintaining good positions in respective markets and good capability in product differentiation over the next one to two years. Based on these supporting factors, we believe the company will keep its ratio of debt to EBITDA below 5x over the next one to two years.

Downward scenario

We may lower the long-term rating on LCY if we believe LCY's re-leveraging risk is increasing with a higher debt appetite such that the company's debt-to-EBITDA ratio could rise above 5x for an extended period. This may happen because of either:

1. LCY engages in a more aggressive debt-funding expansion strategy, such as a large acquisition compared to its current business scale.
2. The company breaches the financial covenants attached to its bank loans or materially loosened without adequate compensating measures to mitigate rising financial risk;
3. A prolonged weakness in demand for LCY's products, due to either higher competition or substitution risk; or
4. Weakened profitability due to the loss of a competitive advantage or higher raw material volatility.

Upward scenario

Despite the remote likelihood of an upgrade over the next one to two years, we may raise the long-term rating on LCY if the company:

1. Can prove that it will continue to lower its debt leverage with lower influence from its financial sponsor and lower financial risk tolerance, and with a concrete roadmap for the financial sponsor's exit in the medium term, such that the company can keep its debt-to-EBITDA ratio consistently below 4x, or
2. LCY can strengthen its competitive position meaningfully, by either materially expanding its revenue base, geographic exposure, and economies of scale, or materially increasing the degree of vertical integration so that the company can improve the stability of its profitability. At the same time, the company will have to keep its debt-to-EBITDA ratio constantly below 5x.

Rating Score Snapshot

Issuer Credit Rating: twBBB/Stable/twA-2

Note: All scores are in comparison with global obligors; all scores are on GCP.

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: twbbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Financial Sponsor - 5 (no additional impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Group credit profile: twbbb

Group status: Core (SACP is not assessed)

Related Criteria

- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - June 26, 2018
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Commodity Chemicals Industry - December 31, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 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: Use Of CreditWatch And Outlooks - September 14, 2009

(Unless otherwise stated, these articles are published on www.standardandpoors.com, access to which requires a registered account)

Ratings List

Downgraded

	To	From
LCY Chemical Corp.		
Issuer Credit Ratings	twBBB/Stable/twA-2	twA/WatchNeg/twA-1