Media Release:

# Dragon Steel Corp. Outlook Revised To Stable Following Similar Parent Action; 'twA+/twA-1' Ratings Affirmed

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## Rating Action Overview

- **Dragon Steel Corp.** is a wholly owned subsidiary of **China Steel Corp.** and has a combined steel producing capacity of six million tons, with EBITDA of NT$11.8 billion in 2022.
- We see further downward revision in the average steel price in 2023, following likely materials price corrections which could ease the pressure on Dragon Steel's profit margin. Meanwhile, demand should recover slightly, but prolonged pressure from high inflation and interest rates could constrain the degree of margin easing in 2023.
- We have revised our outlook on the long-term issuer credit rating on Dragon Steel to stable from positive following similar action on the parent, China Steel.
- At the same time, we affirmed the 'twA+' long-term and 'twA-1' short-term issuer credit ratings on Dragon Steel.

## Rating Action Rationale

*The ratings and outlook on Dragon Steel move in tandem with those on its parent, China Steel.* We revised the outlook on Dragon Steel to stable following our outlook revision on its parent. The action was to reflect China Steel's weakened debt leverage in terms of the ratio of funds from operations (FFO) to debt which we believe will not recover to above our upward rating trigger of 30% over the next two years, due to slower recovery of steel demand. China Steel's increased capital expenditure (capex) of NT$36 billion-NT$41 billion in 2023-2024 for facility upgrades and carbon emission control could also add to China Steel's debt burden and constrain rating upside over the next two years. This compares with capex of NT$31.5 billion in 2022.

*Likely price correction for raw materials could weigh on the average steel price but could ease Dragon Steel's margin pressure.* We forecast the price for coking coal will continue to decline in 2023-2024, as demand spurred by the energy crisis in Europe should gradually reduce. In 2022, over demand for thermal coal led to overall price increases in every coal category and lifted Dragon Steel's averaged coal cost. Although the crisis is not yet resolved, we believe its impact will decline in 2023 as governments in Europe have some time to resolve the energy shortage before the next winter.

Dragon Steel's average selling price could decline by 5%-10% in 2023 and a further 3%-8% in 2024 to reflect the lower raw material cost. We forecast Dragon Steel's ratio of FFO to debt could improve to 28%-33% in 2023 and 38%-43% in 2024, up from 13% in 2022.

*Capex will remain elevated over the next two years to support equipment upgrades and ESG-related investment.* Our base case incorporates our view that Dragon Steel's major capex projects such as the major revamping of its number one blast furnace and water reclamation plant will result in materially higher capex of NT$5 billion-NT$7 billion in 2023 and NT$4 billion-NT$5.5 billion in 2024. This is up from NT$2.7 billion in 2022. Nevertheless, we expect Dragon Steel to be able to generate sufficient operating cash flow while maintaining a conservative dividend policy to prevent a significant debt increase during the period.

## 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. The outlook revision also reflects our view that China Steel's debt will remain flat due to 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 China Steel'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 further strengthen, accompanied by a sustained demand and supply balance in the regional steel market.

## Our Base Case Scenario

- Taiwan's GDP to grow by 1.5% in 2023, 2.5% in 2024 and 2.6% in 2025. Meanwhile, demand from infrastructure, logistic centers, and the government's extension of its 'Three Major Programs for Investing in Taiwan' could underpin stable steel demand in Taiwan over the next one to two years.
- Our assumption for iron ore prices of 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 to decrease by 3%-8% in 2023 and remain flat in 2024, and that the average selling price (ASP) could drop 5%-10% in 2023 and 3%-8% in 2024, given the

downward-trending raw material price. Meanwhile, sales volume could grow 2%-5% in 2023 and 3%-6% in 2024 as markets continue to recover.
- Gross margin to range from 15%-20% in 2023 and 17%-22% in 2024, mainly reflecting the recovery in market demand and declining raw material price.
- Sales, goods, and administration expense to remain at around 2% of total revenue during the forecast period, as we view the company's continuous cost-saving strategy could prevent a significant increase of this expense.
- Capex will materially increase to NT$5 billion-NT$7 billion in 2023 and NT$4.0 billion-NT$5.5 billion in 2024, mainly due to large projects such as a major revamping of the company's number one blast furnace and a new water reclamation plant.
- Given the company's minimal net income in 2022, Dragon Steel has announced no dividend payout in 2023. We expect the dividend payout to remain at 75%-80% from 2024 and beyond.

Based on these assumptions, we arrived at the following credit measures:
- EBITDA margin of 14%-16% in 2023 and 16%-18% in 2024, up from 10.7% in 2022.
- FFO to debt of 28%-33% in 2023 and 38%-43% in 2024, up from 13% in 2022.
- FFO cash interest coverage of 15x-20x in 2023 and 20x-25x in 2024, compared to 19.2x in 2022.

## Liquidity

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 2023, with an estimated ratio of liquidity sources to liquidity uses at above 1.2x over the period. We believe Dragon Steel's liquidity sources will 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. Although Dragon Steel has relatively large short-term debt maturity in 2023, we view its refinancing risk as low, given the company's standing in credit markets.

Principal liquidity sources:

- Cash and short-term investments of NT$1.5 billion as of the end of 2022.
- FFO of NT$13 billion-NT$15 billion in 2023 up to the end of 2023.
- Undrawn credit facilities maturing beyond 2023 of NT$18 billion-NT$22 billion.

Principle liquidity uses:
- Debt repayment of NT$24 billion-NT$28 billion up to the end of 2023.
- Maintenance capex of NT$4 billion-NT$5 billion up to the end of 2023.

# 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: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: twa-

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: twa-

- Group stand-along credit profile: twa+
- Entity status within group: Core (the same as the group stand-alone credit profile)

ESG credit indicators: E-3, S-2, G-2

# Related Criteria & Research

## Related Criteria

- 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
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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; Outlook Action**

| | To | From |
|---|---|---|
| **Dragon Steel Corp.** | | |
| Issuer Credit Rating | twA+/Stable/twA-1 | twA+/Positive/twA-1 |

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