NON-FINANCIAL CORPORATES

RATING METHODOLOGY

STEEL INDUSTRY

OVERVIEW

The approach to rating companies in the steel industry is in line with its existing non-financial corporate rating methodology, but with industry-specific characteristics incorporated into the analysis. The steel industry is characterised by sensitivity to underlying economic conditions, highly cyclical demand, pricing pressures from raw material cost volatility and high fixed-cost structures. These factors can result in frequent earnings and cash flow volatility that act as a constraint on steel company ratings. In addition to these industry traits, an assessment of company-specific factors, including its cost structure, manufacturing process and the degree of integration, and product mix are incorporated into the rating analysis. The rating considerations in evaluating steel companies are as follows:

- Industry risk analysis;
- Business risk analysis;
- Financial risk analysis;
- Issue structure and terms; and
- Management and other qualitative factors

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INDUSTRY RISK ANALYSIS

MARC Ratings' assessment of the steel industry risks will begin with an analysis of the industry's current structure, regulations governing the industry and factors affecting its growth prospects.

Industry structure

The steel sector is highly cyclical, which is largely a result of the industry's exposure to cyclical industries. Long products such as bars, wires and wire rods are mainly used in the construction and infrastructure industry, and flat products such as hot rolled coils (HRC) and cold rolled coils (CRC) are used in the automotive, shipbuilding and electronics industries. The highly capital-intensive production of both steel and its main input, iron ore, has meant that high capital outlays to meet surges in demand may expose steelmakers to shrinkages in demand before the recovery of capital expenditure (capex), more so if it is debt funded. The commodity's low value-to-weight ratio implies that steel products are usually consumed in relative proximity to where they are produced because of high shipping costs. The domestic component of demand is particularly important, which MARC Ratings monitors along with supply trends including the size of target markets, growth potential and competition from steel imports.

Raw material costs/other costs

MARC Ratings examines the price trends of raw materials, namely iron ore, scrap steel and coking coal, which are major cost components in the manufacture of scrap substitutes, or supplements such as direct reduction iron (DRI) and hot briquetted iron (HBI). Following the adoption of a daily pricing mechanism for iron ore, prices have been volatile, depressing the margins of steel manufacturers. Strategies put in place by industry players to mitigate raw material pricing volatility will be assessed for their effectiveness.

Given the high amount of energy required in the steel manufacturing process, movements in electricity and natural gas tariffs would affect margins. In this regard, MARC Ratings will also consider the prevailing government policy on related energy tariffs for heavy industries as well as any indication of future tariff trends.

Working capital requirements

Steel manufacturers require high working capital to fund high inventory levels of raw materials, semi-finished and finished products. Inventory levels can be exacerbated during disruptions in supply and demand dynamics. In this regard, MARC Ratings will assess the position of the steel industry in the current cycle as well as products and raw material price trends for any hints of working capital pressure due to the stocking of raw materials or maintaining levels of finished goods.

Regulatory environment and government policy

MARC Ratings views government policies on pricing, support measures or liberalising trends in the steel industry to be significant factors on steel company ratings. While the highly capital-intensive nature of setting up steel manufacturing plants acts as an entry barrier, the diminishing barriers between local and global steel markets have meant that steel imports can have destabilising effects on the domestic steel sector. MARC Ratings acknowledges government policies such as anti-dumping measures to restrict cheaper steel products may not be fully effective in protecting local steelmakers. As such, MARC Ratings will evaluate any actual and potential impact on the steel sector arising from government policies on steel imports.

BUSINESS RISK ANALYSIS

In assessing the business risks, MARC Ratings considers the following company-specific rating factors, namely operating efficiency and market position. In examining the operating efficiency of the company, its cost structure, plant capacity utilisation and accessibility to resources are some of the factors considered. In respect of market position, MARC Ratings considers the market size, product mix, distribution network and degree of diversification as important rating factors.

Cost structure

MARC Ratings believes that the company's cost structure is integral in weathering cyclical downturns. As such, MARC Ratings assesses the presence of any competitive advantages in the manufacturing process chain. Steelmakers are susceptible to rising prices of raw materials and energy. These cost increases could adversely affect their unit production costs and reduce profit margins. The cost structure will benefit from the level of operational integration. MARC Ratings also views positively any benefit from control over input costs such as preferential electricity and gas tariffs, as well as lower transportation costs due to proximity to supply of raw materials and/or distribution of semi-finished and finished goods.

Capacity utilisation and operational efficiency

MARC Ratings evaluates the company's operating efficiency levels relative to its peers. The reasons for under- or over-utilisation rates are identified. The age, size and efficiency of the manufacturing plant, including the maintenance schedule, as well as flexibility in the manufacturing process are considered. Old plants may suffer frequent breakdowns that may disrupt production and entail capital expenditure. The type of technology used in the manufacturing process is also assessed from the perspective of cost and production efficiency. MARC Ratings considers any manufacturing process flexibility that would allow shifts between different products as positive.

Market position

MARC Ratings considers the company's market size and product mix as important guides to withstand cyclical downturns. A larger market share could mean that the company benefits from economies of scale.

The company's customer base, distribution network for its steel products and product diversification that may offer a buffer against supply-demand imbalances are factored into the analysis. The ability to pass cost increases to end-buyers which could ensure margins are maintained is also considered. Some steel manufacturers are only involved in the production process while sales and marketing are undertaken by related companies. As such, MARC Ratings will look at the third-party client base of the group as a whole to determine the actual marketability of its products.

FINANCIAL RISK ANALYSIS

Financial risk is evaluated through quantitative means using financial ratios and benchmarking the issuer's financials against the steel industry peers. MARC Ratings' financial risk assessment incorporates the following analyses:

- Profitability
- Cash flow protection
- Capital structure
- Financial flexibility

Profitability

In view of the volatile operating environment in which a steel company operates, MARC Ratings examines the company's profitability track record. A peer comparison and trend analysis for five years are carried out to assess the company's performance through industry cycles. The key measures of profitability such as operating profit margins, return on assets, and interest coverage are evaluated.

Given that steel companies have limited pricing power, the ability to manage costs can protect operating margins. As a measure of how assets are efficiently deployed, in particular given the capital-intensive nature of the steel industry, the return on average assets is examined. MARC Ratings will assess the total asset turnover ratio by considering working capital assets of a steel manufacturer (raw materials and inventory) as a proportion of total assets.

The interest coverage ratio which measures the number of times operating profit before interest and taxes (OPBIT) covers gross interest expense (excluding interest income and capitalised interest) is a useful measure to evaluate differences among companies within the industry.

Cash Flow Protection

MARC Ratings considers the company's cash-generating ability as a key rating factor in order to assess the company's debt service capability. MARC Ratings also takes cognisance of the prospect of customer defaults during periods of challenging economic conditions and the corresponding effect on the steelmaker's cash flows. In this regard, cash flow trends for five years are evaluated, focusing on comparison between annual cash inflow from operating and non-operating activities and cash outflow to determine the company's past reliance on external funding.

In light of the capital-intensive nature of the steel industry, MARC Ratings examines the cash flow in relation to capital requirements, including both working and fixed capital. Among the main ratios considered are cash flow from operations (CFO) interest coverage, CFO debt coverage, CFO capex, and free cash flow (FCF).

Capital Structure

MARC Ratings examines the steel company's capital structure to assess its risk orientation as reflected by the debt and equity component of its capital structure. Frequent and over-reliance on debt rather than equity as a mode of financing would have a bearing on the rating. The highly capital-intensive nature of the industry as well as significant working capital requirements have meant that steel companies in general tend to have a moderate to high leveraged position.

Among the standard leverage measures is total debt/equity, which considers all of the company's on-balance sheet debt obligations. By further segmenting it into long-term debt/equity and short-term debt/ equity, MARC Ratings can ascertain if the company faces any near-term refinancing risk.

Financial Flexibility

The strength of financial flexibility is evaluated from the perspective of availability of liquidity as an alternative source to meet financial obligations. This could take the form of cash reserves, liquid investments and/or funding lines. Accessibility to capital markets, affiliations with other entities as well as its ability to dispose assets are also important considerations.

ISSUE STRUCTURE AND TERMS

MARC Ratings evaluates the issue's principal terms and conditions to ascertain if the proposed issue is compatible with the company's business and financial profiles. In this regard, factors such as the tenure of the issue, positive and negative covenants, and ranking of the debt in the company's capital structure are assessed.

MANAGEMENT AND OTHER QUALITATIVE FACTORS

The management's role is assessed from the perspective of its ability to meet operational and financial objectives, implement strategies and adhere to strong corporate governance variables. In this respect, MARC Ratings considers the management's track record to be a key factor, assessing past performance on the basis of management skills and decisions. Pragmatic plans and policies that provide management sufficient leeway to be able to respond to changes in the operating environment would be considered favourably. In addition, actual and potential influence of shareholders on the company's business direction is also given due consideration.

This methodology should be read in conjunction with MARC Ratings' "Non-Financial Corporates" rating methodology which is available on our website at www.marc.com.my.

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