

CHAI WATANA TANNERY GROUP PLC

No. 80/2018
20 June 2018

CORPORATES

Company Rating: BB+
Outlook: Stable

RATIONALE

TRIS Rating assigns the company rating of Chai Watana Tannery Group PLC (CWT) at “BB+”. The rating reflects the company’s long track record in the tannery business, its position as a tier-2 supplier to major car manufacturers, and a growing revenue contribution from the power segment. The rating is weighed down by the vulnerability of profits, mainly due to low bargaining power with its major customers. Also, CWT is exposed to fluctuations in raw material prices and exchange rates. The rating also takes into consideration a recent rise in leverage, resulting from large investments in power plants.

KEY RATING CONSIDERATIONS

Long track record

CWT has had a presence in the tannery business for over 40 years. Originally a producer of leather, the company expanded into the automotive leather segment. The company started to supply automotive leather to Japanese car makers in 2013. As a tier-2 supplier, CWT supplies products to tier-1 suppliers. The company’s ultimate clients are Isuzu, Honda, and Toyota. Its product quality has been accepted by these clients. During the past five years, revenue from the automotive leather segment has made up the largest portion of revenue (65%).

Automotive supply chain membership helps secure revenue

The expansion into the automotive leather segment provided two benefits. CWT could add more value to its products, and its revenue stream became more secure. Generally, an automaker chooses one or at most a few suppliers of leather for the life of a car model. The life of a car model is approximately four to six years. CWT has attempted to work closely with car manufacturers to ensure it will be selected as the leather supplier for new car models. Revenue has increased steadily during the past five years as CWT received more orders from its major customers. Revenue reached a record high of about Bt1,900 million in 2017. TRIS Rating expects revenue from the automotive leather segment will continue to drive growth, considering a positive momentum on domestic car production.

Volatile profitability

Profitability is volatile. The operating margin (operating income before depreciation and amortization as a percentage of sales) has varied widely from 0.4% to 6.9% during the past five years. The operating margin fell to 3.6% in the first quarter of 2018, from 6.5% in 2017. Pre-operating expenses at the biomass power project cut profits.

The thin and volatile profit margin results from low bargaining power with car manufacturers, fluctuations in the prices of raw hides, and fluctuating exchange rates. Production orders are fixed-price contracts. This means the company has to absorb additional costs if raw material prices increase or if the Thai baht depreciates drastically.

Raw hides are CWT’s major raw material, comprising 40%-60% of the total production costs. The company imports almost half of its raw materials and pays in foreign currencies, mostly in US dollars. However, nearly all of its finished products are priced in Thai baht. To mitigate impacts from fluctuating

Contacts:

Rapeepol Mahapant
rapeepol@trisrating.com
Pravit Chaichamnapai
pravit@trisrating.com
Suchada Pantu, Ph. D.
suchada@trisrating.com



exchange rates, CWT hedges some of the net exposure using forward contracts.

Power segment will stabilize cash flows and improve operating performance

CWT's recent move into the power segment is expected to enhance its business profile. The power segment will bring predictable cash flows and high margins. The company's two renewable power projects, a solar power plant and a biomass power plant, should stabilize and boost its operating performance. The two power plants have secured multi-year power purchase agreements (PPAs) with a state-owned electricity distributor, and each PPA contains a committed tariff.

In 2017, the solar power project generated revenue of Bt42 million, with an operating margin of almost 75%. The biomass power project commenced operations in April 2018. TRIS Rating assumes the biomass power project will add revenue of Bt200-Bt250 million per annum. The operating margin of the biomass power project is expected to be 30%-50%. The actual performance of the biomass power project is needed to be proven over the long term.

TRIS Rating's base-case forecast assumes CWT's overall operating margin will increase, reaching about 10% over the next three years. The power segment will boost probability. Earnings before interest, tax, depreciation and amortization (EBITDA) will increase to about Bt245 million per annum during 2018-2020, up from less than Bt150 million in the past.

Along with the benefits, the power projects raise execution risks. CWT has no track record of developing and operating power projects. In addition, a biomass power plant carries environmental risk from the production process and inventory risk from a shortfall in the fuel supply or low-quality raw materials. Output can also differ from expectations. The calorific value (or heat value) produced by the feedstock may vary. Different types of biomass fuels provide different heat values. The biomass power plant is designed to produce electricity from eucalyptus, wood chips, palm bunches, and other agricultural residue.

Leverage will hold at around the current level

Leverage rose recently, following the expansion into the power segment. CWT has spent about Bt1,300 million during the last two years to build the two power plants. As a result, the debt to capitalization ratio increased to 53.7% as of March 2018, from 45.1% in 2016. TRIS Rating expects the leverage ratio will increase slightly in 2018, before falling to about 50% in 2020. CWT plans to spend Bt130 million in 2018 to complete construction of the biomass power plant and increase the production capacity for automotive leather. Going forward, cash flow protection will improve as the biomass power plant is in full operation. TRIS Rating expects funds from operations (FFO) will climb steadily to about Bt150 million by 2020, raising the FFO to total debt ratio to about 9%.

According to TRIS Rating's meeting with CWT's management, CWT should not make significant investments over the next three years. CWT's board of directors recently approved an investment in Sakun C Innovation Co., Ltd. (Sakun C). CWT will pay Bt0.5 million for a 50% equity stake in this company. Sakun C is a designer and assembler of aluminum boats and other vehicles in Thailand. Sakun C has plans to manufacture minibuses. CWT may benefit by supplying car seats for this project.

Refinancing risk remains

CWT is exposed to refinancing risk. In 2018, debts of Bt1,121 million will come due. CWT had undrawn credit facilities of Bt370 million, plus cash and marketable securities of Bt342 million. FFO in 2018 is projected to be Bt124 million. As a result, sources of cash will total Bt836 million. The gap between the cash needs and the sources of cash, amounting to Bt285 million, raises concerns over refinancing risk. However, working capital of approximately Bt490 million will be another source of cash to close the gap.

A key financial covenant in CWT's debentures requires the net interest-bearing debt to equity ratio to stay below 3 times. The ratio at the end of 2017 was 0.9 times. Thus, the company was in compliance with this key financial covenant. TRIS Rating believes that the company will stay in compliance for the next 12 to 18 months.

RATING OUTLOOK

The "stable" outlook reflects the expectation that the automotive leather segment will continue to make major contribution to CWT's revenue. CWT's strategy to work closely with car manufacturers will help it secure orders for new car models.

RATING SENSITIVITIES

CWT's rating upside could occur if cash flow improves significantly and becomes more stable and if leverage declines from the current level. Success in the power segment would also be a positive factor for the rating. In contrast, the rating and/or outlook could be downgraded if CWT's operating performance drops significantly from the current level. The rating and/or

outlook could also be revised downward if the biomass power project performs significantly below expectations and hurts the company's overall financial profile.

COMPANY OVERVIEW

CWT was established in 1972 by the Chaiteerath family, and listed on the Stock Exchange of Thailand (SET) in 1991. As of March 2018, the Chaiteerath family held a 34.7% stake in CWT. Since its inception, CWT has owned and operated a tannery to produce leather. The company introduced a line of dog chew toys (dog chews) in 1985, and a line of leather furniture in 1987. It became a supplier of automotive leather in 2003. CWT has been a tier-2 supplier in the automotive supply chain, and listed on the approved vendor list of many major car manufacturers in Thailand.

CWT, through a subsidiary, recently entered into the power business. It invested in two renewable energy projects, a biomass power project and a solar power project. The company also has a waste-to-energy project, worth Bt1.5 million, in the pipeline. However, this project has been delayed.

In August 2016, CWT, through its wholly-owned subsidiary, Chai Watana Green Co., Ltd. (CTWG), acquired a 100% equity stake in Kokcharoen Green Energy Co., Ltd. The acquisition cost CTWG Bt70 million. CTWG invested about Bt960 million more to build its first biomass power plant. The biomass power plant produces up to 9.9 megawatts (MW) of electricity from eucalyptus, wood chips, palm bunches, and other agricultural residue. The plant sells 8 MW of electricity to the Provincial Electricity Authority (PEA), under a feed-in tariff (Fit) contract. The power plant was commercialized in April 2018.

In November 2016, CTWG acquired a 49% equity stake of Blue Solar Farm 3 Co., Ltd., which holds a PPA, under the Fit scheme, with the PEA. CTWG paid about Bt76 million for the purchase, and invested about Bt360 million more to complete construction of this 5-MW solar power project. The solar power project sells 5 MW of electricity to the PEA, under a Fit contract. It was commercialized at the beginning of 2017.

During the past five years, automotive leather has made the largest contribution to revenue. Automotive leather accounted for 65% of total revenue, followed by leather (20%), dog chew toys (8%), leather furniture (4%), and wood chips and power (3%). Revenue from the automotive leather segment has risen over the past five years. Honda, Isuzu, and Toyota are the major ultimate clients. Nearly all, or over 90%, of revenue from the automotive leather segment came from these three automakers.

KEY OPERATING PERFORMANCE

Table 1: Revenue Breakdown

Unit: %

	2013	2014	2015	2016	2017
Revenue (Bt mil.)	905	918	1,348	1,599	1,910
Automotive leather	48.0	51.3	64.2	67.0	76.9
Leather	34.4	32.2	21.3	13.8	10.9
Dog chew toy	12.0	11.8	7.9	6.1	5.0
Leather furniture	5.5	4.7	6.6	3.2	2.6
Wood chips and power	-	-	-	9.9	4.7
Total	100.0	100.0	100.0	100.0	100.0

Source: CWT

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: Bt million

	Jan-Mar 2018	----- Year Ended 31 December -----			
		2017	2016	2015	2014
Revenue	479	1,910	1,599	1,348	918
Gross interest expense	20	54	30	31	30
Net income from operations	(16)	11	7	16	21
Funds from operations (FFO)	15	118	63	36	42
Capital expenditures	133	748	536	48	44
Total assets	3,525	3,553	2,660	1,908	1,523
Total debts	1,620	1,572	984	622	457
Shareholders' equity	1,397	1,367	1,200	903	755
Operating income before depreciation and amortization as % of sales	3.58	6.52	4.71	5.13	6.94
Pretax return on permanent capital (%)	3.44 **	3.94	2.61	4.03	4.34
Earnings before interest, tax, depreciation, and amortization (EBITDA) interest coverage (times)	1.23	2.71	2.62	2.66	2.81
FFO/total debt (%)	6.82 **	7.48	6.43	5.79	9.21
Total debt/capitalization (%)	53.69	53.49	45.05	40.78	37.72

* Consolidated financial statements

** Adjusted with trailing 12 months

Chai Watana Tannery Group PLC (CWT)

Company Rating:	BB+
Rating Outlook:	Stable

TRIS Rating Co., Ltd.

Silom Complex Building, 24th Floor, 191 Silom Road, Bangkok 10500, Thailand Tel: 02-098-3000

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