TRIS RATING
A Strategic Partner of S&P Global

CreditNews ข่าวเครดิต

CHAI WATANA TANNERY GROUP PLC

No. 144/2020
25 September 2020

CORPORATES

Company Rating:	BB+
Outlook:	Stable

Last Review Date: 12/05/20

Company Rating History:

Date	Rating	Outlook/Alert
12/05/20	BB+	Alert Negative
20/06/18	BB+	Stable

Contacts:

Rapeepol Mahapant

rapeepol@trisrating.com

Pravit Chaichamnapai, CFA

pravit@trisrating.com

Parat Mahuttano

parat@trisrating.com

Sauwarot Jirachaipithak

sauwarot@trisrating.com

WWW.TRISRATING.COM

RATIONALE

TRIS Rating removes the “CreditAlert” with “negative” implication and affirms the company rating on Chai Watana Tannery Group PLC (CWT) at “BB+”. At the same time, TRIS Rating assigns a “stable” outlook to the rating. The rating action reflects the easing of the near-term liquidity risk as the company extended the maturity date of the CWT205A debentures and replaced the CWT209A debentures with new debentures.

The “BB+” rating continues to reflect CWT’s volatile margins, high business concentration, execution risks associated with new investments, and a potential surge in debt load. However, the company’s proven track record as a leather tanner, especially in the auto leather business, and the predictable cash flows from the power business help support the rating.

KEY RATING CONSIDERATIONS

Reduced near-term liquidity risk

CWT reached an agreement with debenture holders to amend the terms and conditions of the CWT205A debentures worth THB337.1 million. Under the agreement, the company repaid 30% of the total outstanding amount of the debentures, or THB101.13 million, on 23 May 2020. The remaining principal amount of THB235.97 million was rescheduled to be repaid one year thereafter on 23 May 2021. In addition, CWT successfully refinanced the CWT209A debentures of THB294.3 million, due on 1 September 2020, with the issuance of new debentures.

CWT should be able to manage its liquidity sufficiently for the remainder of 2020. During the second half of 2020, total debt obligations excluding the CWT209A debentures worth THB357 million will come due. As of 30 June 2020, the company had cash and marketable securities of THB36 million, unused credit facilities of THB100 million, and working capital of about THB382 million. We expect its funds from operations (FFO) during the second half of 2020 to be around THB80 million. Overall, sources of cash are estimated at THB598 million, which should be sufficient to cover all debts due.

Proven track record as leather tanner

We believe CWT will be able to keep its competitive edge based on its proven track record in the tannery business. It has supplied automotive leather to Japanese automakers since 1995. As a tier-2 supplier, the company supplies products to tier-1 suppliers. The company’s ultimate clients are “Honda”, “Isuzu”, and “Toyota”. The quality of its products is widely accepted.

Going forward, the auto leather business should remain the major revenue contributor of the company. As CWT is a member of the automotive supply chain, the revenue stream should remain secure. Automakers generally choose one, or at most a few, suppliers of leather for the lifecycle of a car model (approximately 4-6 years). Automakers are unlikely to change suppliers during the life of a car model as they need to ensure the quality of their finish products. CWT’s close relationships with automakers help secure its chances of being selected as the leather supplier for new car models.

As the Coronavirus Disease 2019 (COVID-19) has dampened auto demand, we forecast CWT’s total operating revenue to drop to about THB1.5 billion in

2020, from THB2 billion in 2019. Revenue from auto leather fell by 35.6% year-on-year (y-o-y) to THB339 million in the first half of 2020. We expect the company's total operating revenue to recover in 2021 and reach THB2.4 billion in 2022, boosted by increasing orders for auto leather and additional revenue from its new aluminum boat and mini bus business.

Volatile margins

Although revenue stream from the auto leather business is likely to remain secure, profit margins in this business have been volatile. CWT cannot pass on increases in production costs to auto makers. While production contracts for automotive leather are made on a fixed-price basis, the company faces fluctuations in the prices of raw hides. Raw hides are the major raw material, comprising 40%-50% of the total cost of production. Raw hides are a commodity, with fluctuating prices. The company is also exposed to fluctuations in exchange rates. It imports almost half of its raw materials and pays in foreign currencies, mostly US dollars. On the other hand, nearly all finished products are priced in Thai baht.

Changes in the prices of raw hides have affected the company's gross margin significantly. During the last five years, the gross margin has swung between 14% and 28%. The margin of earnings before interest, tax, depreciation, and amortization (EBITDA) as a percentage of total operating revenue has varied widely, ranging from 5%-19%. The EBITDA margin has risen lately due mainly to a slump in the prices of raw hides and a greater contribution from the high-yield power business. CWT is also striving to increase its production efficiency. Our base-case forecast projects the EBITDA margin to stay above 13% over the next three years.

High business concentration

The strength in the auto leather business is also weighed down by CWT's high business concentration. As the domestic automotive industry is dominated by a few automakers, the company relies heavily on a few clients. The first three clients have contributed 60%-70% of its revenue over the past five years. A loss of one major client or a slump in the sales performance of one ultimate client could have a material impact on the company's operating performance. However, long established relationships with tier-1 suppliers and automakers have lessened concerns over client loss. CWT's power projects with long-term power sales contracts should help cushion any adverse impacts of a down cycle in the auto industry.

Power segment stabilizes cash flows

CWT's power segment has stabilized cash flows and raised margins. The company currently has two renewable power projects in the operational phase, a solar power plant and a biomass power plant, with a combined contracted capacity of 13 megawatts (MW). Both projects have secured multi-year power purchase agreements (PPAs) with the Provincial Electricity Authority (PEA). Each PPA contains a committed tariff. As a result, the cash flows CWT receives from its power plants tend to be predictable. The production costs of the biomass power plant are less volatile than those of the base businesses of automotive leather and tannery. The predictable cash flows of the power segment partially offset the volatile results in the base businesses.

Although requiring heavy investment, the power business yields superior margins. The EBITDA margin of the power segment ranged from 30%-40%, versus 6%-12% for the other segments. EBITDA from the power segment has increased recently after CWT's first biomass project started operations in April 2018. This company's largest power project has performed well, in line with our expectations. EBITDA from the power segment made up about 45% of total EBITDA in 2019.

New investments to raise execution risk and financial leverage

As its growth strategy, CWT expanded into the power business and the aluminum boat and mini bus business. It invested about THB1.5 billion in the first two renewable power plants during 2016-2018 and poured about THB330 million into Sakun C Innovation Co., Ltd. (SKC), a designer and trader of aluminum vehicles during 2018-2019. With no operating track record, these new ventures have recently elevated CWT's execution risks. Additionally, a biomass-fueled power plant carries environmental risk from the production process and other risks such as shortfall in fuel supply or low-quality raw materials. The aluminum boat and mini bus business also carries market risk due to the absence of long-term sales contracts. The performance of both businesses will take time to be evident clearly. Successful expansion could be a plus to the credit rating.

CWT's on-going investments raise further concerns. The company plans to invest in a waste-to-energy (WTE) project, producing up to 10 megawatts (MW) of electricity from refuse-derived fuel (RDF). The project is estimated to cost THB1-THB1.3 billion in total, representing about 30% of CWT's total assets. This sizable investment will put pressure on its balance sheet and have significant impact on overall operating performance. It will also enlarge CWT's exposure to execution risks, stemming from construction delays, environmental issues, local resistance, and operational risks. The WTE project involves construction of a waste management facility (the first phase) and a power generation facility (the second phase). Under the first phase, the project will receive municipal solid waste from Nakhon Sawan province, before processing and selling it as recycled products. It will also receive tipping fees with respect to the waste management. Before starting the second phase, CWT needs to obtain a PPA. For this reason, our base case forecast covers the first phase only. The project's first phase should require an investment cost of THB300-THB350 million. In addition to this WTE project, CWT intends to expand further in biomass power.

We expect the company's further expansion into the power generation business to strain its balance sheet and cash flows over the next three years. We hold the view that the company will need a capital increase if it starts the second phase of the WTE project. Aggressive debt-funded investments could put a pressure on the rating. Even without the impact of the second phase of the WTE project, the company's debt to EBITDA ratio is projected to rise to 6-8 times over the next three years.

A key financial covenant of CWT's debentures requires the net interest-bearing debt to equity ratio to stay below 3 times. The ratio as of 30 June 2019 was 0.95 times. We believe that the company will comply with the covenant over the next 12-18 months.

BASE-CASE ASSUMPTIONS

- Total operating revenue to range around THB1.5-THB2.4 billion per annum during 2020-2022.
- EBITDA margin to stay above 13%.
- Capital expenditures to range from THB0.2 billion to THB0.5 billion per annum.
- Debt to EBITDA ratio to range around 6-8 times.

RATING OUTLOOK

The "stable" outlook reflects TRIS Rating's expectation that CWT's automotive leather business will remain the major source of revenue. CWT's close working relationship with automobile manufacturers should help it secure supply contracts for new car models. In addition, the increasing contribution from the power business should help keep the EBITDA margin above 13% over the next three years.

RATING SENSITIVITIES

The prospect of a rating upgrade is limited during the period of planned large investments. However, it could occur if cash flows against debt improve significantly. For example, the company's debt to EBITDA ratio drops to 5 times on a sustained basis. In contrast, the rating and/or outlook could be revised downward if the operating performance drops significantly or if its financial status and liquidity profile deteriorate more than expected. These could be the case if the COVID-19 impact turns out to be more severe than anticipated or the new power and aluminum boat and mini bus ventures underperform or CWT makes excessive debt-funded investments.

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 2020, the Chaiteerath family held a 37.6% stake in CWT. Since inception, the company has owned and operated a leather tannery. It became a tier-2 supplier in the Japanese automotive supply chain in 1995. CWT has recently expanded into other segments, power generation and aluminium vehicles.

During the past five years, automotive leather has made the largest contribution to revenue. Automotive leather accounted for 67% of revenue, followed by tannery products (12%), power generation and wood chips (10%), dog chew toys (6%), leather furniture (3%), and aluminium boats and mini buses (2%).

KEY OPERATING PERFORMANCE

Table 1: Revenue Breakdown

Unit: %

	2016	2017	2018	2019	Jan-Jun 20
Revenue (mil. THB)	**1,599**	**1,910**	**1,956**	**2,009**	**692**
Automotive leather	67.0	76.9	68.9	59.5	57.6
Tannery	13.8	10.9	9.2	8.8	7.4
Dog chew toys	6.1	5.0	5.4	7.3	7.6
Leather furniture	3.2	2.6	2.8	1.4	2.3
Power and woodchips	9.9	4.7	12.6	17.1	24.9
Aluminum boats and mini buses	-	-	1.1	5.9	0.2
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: CWT

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: Mil. THB

	Jan-Jun 2020	2019	2018	2017	2016
		-------------- Year Ended 31 December ------------			
Total operating revenues	704	2,046	2,014	1,935	1,612
Earnings before interest and taxes (EBIT)	72	239	174	126	55
Earnings before interest, tax, depreciation, and amortization (EBITDA)	136	350	271	180	97
Funds from operations (FFO)	82	215	138	90	51
Adjusted interest expense	48	102	100	54	31
Capital expenditures	69	180	506	751	542
Total assets	3,677	3,838	3,958	3,553	2,660
Adjusted debt	1,542	1,741	1,890	1,321	846
Adjusted equity	1,674	1,631	1,486	1,367	1,200
Adjusted Ratios					
EBITDA Margin (%)	19.29	17.09	13.46	9.29	6.04
Pretax return on permanent capital (%)	4.76 **	6.92	5.41	4.87	2.93
EBITDA interest coverage (times)	2.84	3.42	2.71	3.31	3.18
Debt to EBITDA (times)	5.52 **	4.98	6.97	7.35	8.69
FFO to debt (%)	10.30 **	12.34	7.29	6.85	6.02
Debt to capitalization (%)	47.95	51.62	55.98	49.14	41.34

* *Consolidated financial statements*
** *Adjusted with trailing 12 months*

RELATED CRITERIA

- Rating Methodology – Corporate, 26 July 2019
- Key Financial Ratios and Adjustments, 5 September 2018

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