TRIS RATING
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CHAI WATANA TANNERY GROUP PLC

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CORPORATES

Company Rating: BB+
Outlook: Stable

Last Review Date: 20/06/18

Company Rating History:

Date	Rating	Outlook/Alert
20/06/18	BB+	Stable

Contacts:

Rapeepol Mahapant
rapeepol@trisrating.com

Tulyawat Chatkam
tulyawat@trisrating.com

Suchada Pantu, Ph. D.
suchada@trisrating.com

RATIONALE

TRIS Rating affirms the company rating on Chai Watana Tannery Group PLC (CWT) at "BB+". The rating reflects the company's small scale, volatile profitability, and moderate level of financial leverage. The rating also takes into consideration CWT's proven track record as a leather tanner, especially in the auto leather segment. The predictable cash flows the company receives from its power projects should partially offset the volatile results in the auto leather and tannery segments. A recent expansion into a new segment, the design and trading of aluminum body vehicles, should not materially affect the rating in the near term. Successful expansions will take time to be evident.

KEY RATING CONSIDERATIONS

Small, but growing revenue

CWT's revenue is small compared with other companies rated by TRIS Rating. In addition to fluctuations in the prices of raw material, the small scale, coupled with high fixed operating expenses, make the company's operating performance volatile. Total operating revenue has ranged from Bt900-Bt2,000 million over the past five years while EBITDA (earnings before interest, tax, depreciation, and amortization) has ranged from Bt70-Bt260 million. The auto leather segment accounts for about 70% of revenue.

TRIS Rating forecasts a rise in total operating revenue. Total operating revenue will reach Bt2,500 million within the next three years, up from Bt1,983 million in 2018. Revenue in the auto leather segment will rise as automakers will introduce new car models. The company's first biomass power plant will be in operation for a full year starting in 2019, boosting revenue in the power segment. The third revenue driver is Sakun C Innovation Co., Ltd. (SKC), a designer and trader of aluminum body vehicles. CWT owns 50% of SKC. SKC will officially launch a mini-bus model this year. SKC and Hino Motors Sales (Thailand) Co., Ltd. jointly designed and assembled the first mini-bus model with aluminum body. The performance of this segment will take time to be evident.

Long track record as leather tanner

TRIS Rating believes CWT's long and proven track record will help keep its competitive edge. The company has been a tanner for over 40 years. It has supplied automotive leather to Japanese automakers since 2013. 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 has been well accepted by these clients.

Going forward, TRIS Rating believes that the auto leather segment will remain the major revenue contributor of the company. As CWT is a member of the automotive supply chain, the revenue stream is likely to be secure. Automakers generally choose one, or at most a few, suppliers of leather for the life of a car model which is approximately four to six 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 works closely with automakers to ensure that it will be selected as the leather supplier for new car models.

Profit margin is volatile

Although revenue stream in the auto leather segment is likely to be secure, the profit margin in this segment varies significantly. CWT is unable to pass through increases in the production costs of auto leather. Production contracts for automotive leather are made on a fixed-price basis, but 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, making costs and profits more volatile. The company is also exposed to fluctuations in exchange rates. It imports almost half of its raw materials and pays in foreign currencies, mostly in US dollars. However, nearly all of the finished products are priced in Thai baht.

Changes in the prices of raw hides have affected the gross margin significantly. During the last five years, the gross margin has swung from 14% to 21%. The operating margin (operating income as a percentage of total operating revenues) has varied widely, ranging between 5%-16%. The operating margin has risen lately, climbing to double digits. The rise is due mainly to a slump in the prices of raw hides and a greater contribution from the power segment. CWT is also striving to increase its production efficiency. TRIS Rating forecasts the operating margin will be higher from the past levels and less volatile over the next three years, ranging between 11%-13%, supported by the higher contribution from the power segment.

Power segment stabilizes cash flows and improves operating performance

CWT's expansion into the power segment will make cash flow more stable and raise margins. The company has two renewable power projects, a solar power plant and a biomass power plant, with a combined contracted capacity of 13 megawatt (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, cash flows CWT receives from its power plants are predictable. The production costs of the biomass power plant are less volatile than those of the base business, automotive leather and tannery. The power segment also yields superior margins. Over the next three years, TRIS Rating forecasts the operating margin of the power segment will be 30%-40%, versus 8%-10% for the other segments. EBITDA from the power segment should account for 30%-40% of total EBITDA during 2019-2021.

The benefits are weighted down by an increase in leverage and the execution risk associated with the power projects. Leverage has increased significantly. CWT spent about Bt1,500 million on the two power plants during 2016-2018. The company also has no track record of operating power projects. A biomass-fueled power plant uses technology rather complicated. Biomass plants carry environmental risk from the production process and other risks such as a shortfall in the fuel supply or low-quality raw materials. Output can vary based on the type of fuel. The biomass plant, the largest power generation in the power segment, started operations in April 2018. Both the solar plant and biomass plant have performed satisfactorily since start-up. However, the long-term performance of the power segment will take time to be evident.

Moderate level of financial leverage

TRIS Rating expects an improvement in financial leverage. The large investments in the two power plants raised the debt to capitalization ratio to 53.2% as of March 2019, up from less than 40%. The debt to capitalization ratio should decline gradually to about 50% over the next three years. TRIS Rating's base case forecast assumes annual capital expenditures will range between Bt50-Bt100 million during 2019-2021, dropping from Bt500-Bt800 million during 2016-2018. However, debt will not fall significantly. The company will need more funds to support an increase in working capital as revenue will grow. The debt to EBITDA ratio is likely to drop to 6.0-6.5 times over the next three years, down from 7.3 times in 2018.

Manageable liquidity

TRIS Rating expects CWT will manage liquidity properly. The company has no significant pressure on liquidity this year. In 2019, debts of about Bt580 million will come due, around 70% of which are short-term loans for working capital. The company had undrawn credit facilities, plus cash and marketable securities of about Bt560 million, as of December 2018. FFO (funds from operations) should be about Bt160 million in 2019. As a result, sources of cash will total Bt720 million, which is sufficient to cover all the debts due in 2019. In 2020, debentures worth Bt631 million will come due. This raises concerns over refinancing risk due to possible cash flow shortfalls. However, TRIS Rating believes CWT should be able to refinance the debentures as the operating performance should stay firm over the next three years.

A key financial covenant in CWT's debentures requires the net interest-bearing debt to equity ratio to stay below 3 times. The ratio as of 31 March 2019 was 1.2 times. Thus, the company was in compliance with this key financial covenant. TRIS Rating believes that the company will stay in compliance over the next 12 to 18 months.

BASE-CASE ASSUMPTIONS

- Total operating revenue will grow by 8% per annum over the next three year.
- The operating margin will range between 11%-13%.
- Capital expenditures will fall to Bt50-Bt100 million per annum.

RATING OUTLOOK

The “stable” outlook reflects the expectation that the automotive leather segment will remain the major source of revenue. CWT’s strategy to work closely with car manufacturers will help it secure supply contracts for new car models. In addition, the higher contribution from the power segment should keep the operating margin above 10% over the next three years. The debt to EBITDA ratio will range between 6.0-6.5 times.

RATING SENSITIVITIES

The rating upside case could occur if cash flow increases significantly and leverage holds steady. Successful expansions into the new segments, power and aluminum vehicles, would be a positive factor. In contrast, the rating and/or outlook could be downgraded if the operating performance drops significantly or if the financial profile deteriorates. These should be in the case that the new segments perform worse than expectations or CWT makes aggressive new 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 2019, the Chaiteerath family held a 36.8% 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 2003. CWT has recently expanded into other segments, power generation and aluminium body vehicles.

During the past five years, automotive leather has made the largest contribution to revenue. Automotive leather accounted for almost 70% of revenue, followed by tannery products (15%), dog chew toys (7%), power generation and wood chips (6%), and leather furniture (4%). Revenue from the design and trading of aluminium body vehicles, boats and minibuses, was minimal.

KEY OPERATING PERFORMANCE

Table 1: Revenue Breakdown

Unit: %

	2014	2015	2016	2017	2018
Revenue (Bt mil.)	**918**	**1,348**	**1,599**	**1,910**	**1,947**
Automotive leather	51.3	64.2	67.0	76.9	69.2
Tannery	32.2	21.3	13.8	10.9	8.8
Dog chew toy	11.8	7.9	6.1	5.0	5.4
Leather furniture	4.7	6.6	3.2	2.6	2.8
Power and woodchips	-	-	9.9	4.7	12.7
Aluminum body boat and mini-bus	-	-	-	-	1.1
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: CWT

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: Bt million

	Jan-Mar 2019	--------------- Year Ended 31 December ---------- 2018	2017	2016	2015
Total operating revenues	559	1,983	1,935	1,612	1,361
Operating income	89	253	152	90	86
Earnings before interest and taxes (EBIT)	70	163	126	55	44
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	96	261	180	97	74
Funds from operations (FFO)	64	127	90	51	34
Adjusted interest expense	26	100	54	31	31
Capital expenditures	74	506	751	542	48
Total assets	3,935	3,958	3,553	2,660	1,908
Adjusted debt	1,823	1,890	1,321	846	426
Adjusted equity	1,606	1,486	1,367	1,200	903
Adjusted Ratios					
Operating income as % of total operating revenues (%)	15.94	12.76	7.84	5.60	6.31
Pretax return on permanent capital (%)	6.25 **	5.08	4.87	2.93	3.15
EBITDA interest coverage (times)	3.69	2.61	3.31	3.18	2.35
Debt to EBITDA (times)	5.80 **	7.25	7.35	8.69	5.78
FFO to debt (%)	9.84 **	6.73	6.85	6.02	8.00
Debt to capitalization (%)	53.17	55.98	49.14	41.34	32.04

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

RELATED CRITERIA

- Key Financial Ratios and Adjustments, 5 September 2018
- Rating Methodology – Corporate, 31 October 2007

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