

# CHAI WATANA TANNERY GROUP PLC

No. 76/2021

13 May 2021

## CORPORATES

Company Rating:	BB+
Outlook:	Stable

Last Review Date: 25/09/20

### Company Rating History:

Date	Rating	Outlook/Alert
25/09/20	BB+	Stable
12/05/20	BB+	Alert Negative
20/06/18	BB+	Stable

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## RATIONALE

TRIS Rating affirms the company rating on Chai Watana Tannery Group PLC (CWT) at “BB+”, with a “stable” outlook. The rating reflects CWT’s proven track record as a leather tanner, especially for the automotive sector, plus the high profit margins and predictable cash flows of its power business. However, the rating is weighed down by the company’s small business scale and its exposure to volatile margins and customer concentration associated with the leather tanning business. The rating also incorporates a potential rise in the execution risks and financial leverage due to new investments.

## KEY RATING CONSIDERATIONS

### Growing, yet small business scale

CWT’s business scale is growing but remains small. The company’s total operating revenue has ranged from THB1.6-THB2 billion over the past five years. Its earnings before interest, taxes, depreciation, and amortization (EBITDA) have grown to about THB350 million in 2019 and 2020, from less than THB100 million in 2016, due to higher revenue and earnings contributions from the power business.

In 2020, the power business accounted for about 22% of revenue but contributed almost half of total EBITDA. The leather tanning business, with products covering automotive leather, bleached leather, dog chew toys, and leather furniture, remained the main revenue contributor. Automotive leather accounted for about 60% of its total revenue.

We expect a flat or small growth in CWT’s revenue over the next three years. Our base case forecast projects its total operating revenue will range from THB1.6-THB2.2 billion per annum during 2021-2023. Annual EBITDA should range from THB290-THB350 million over the forecast period. Revenue and earnings contribution from its new ventures, aluminum boat and minibus as well as waste-to-energy (WTE) project remain uncertain, depending on the success of the ventures.

### Proven track record as a leather tanner for the automotive sector

We expect CWT to remain competitive in the leather tanning business, especially the automotive leather segment. The company has supplied automotive leather to Japanese automakers since 1995. As a tier-2 supplier, the company supplies products to tier-1 suppliers of major automakers like “Honda”, “Isuzu”, and “Toyota”. The quality of its products is well-accepted by automakers, as evidenced by the continuation of orders from these clients.

We believe automotive leather will remain the main source of CWT’s revenue over the next three years. As the company 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 finished products. CWT’s close relationships with automakers have helped secure its chances of being selected as the leather supplier for new car models.

### **Exposure to customer concentration**

CWT's strength as a proven automotive leather tanner is offset by its high business concentration. As the domestic automotive industry is dominated by a few automakers, the company relies heavily on a few clients. The top three clients have contributed about 60% of its total 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.

### **Higher contribution from power business lowers earnings volatility**

The higher profit margins and more stable cash flows of the power business, compared with the leather tanning business, help improve and stabilize its earnings. The company's gross margin soared to 28% in 2020 from 16% in 2016, boosted by the addition of a solar power plant in 2017 and a biomass power plant in 2018. The EBITDA margin (EBITDA as a percentage of total operating revenue) increased to 21% from 6% during the same period. The power business yields a superior EBITDA margin of 30%-40%, versus 5%-15% for the leather tanning business. Our base-case forecast assumes the EBITDA margin will stay above 14% over the next three years, supported by the high and stable earnings of the power business. In addition to the increasing importance of the power business, a slump in the prices of raw hides and the company's efforts to increase productivity have uplifted profit margins of the leather tanning business.

CWT currently has two renewable power projects in operation, 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 are predictable. On the contrary, profit margins of the leather tanning business are rather volatile, subject to fluctuations in the prices of raw materials. Raw hides are the major raw material, comprising 40%-50% of the total cost of production. As a commodity, the prices of raw hides tend to swing widely. As the leather tanning business remains the company's major revenue contributor, CWT's profitability will continue to be subject to changes in the prices of raw hides.

### **New investments to raise execution risk and financial leverage**

CWT recently expanded into the aluminum boat and minibus business. The company invested about THB300 million in Sakun C Innovation Co., Ltd. (SKC), a designer and trader of aluminum vehicles during 2018-2020. In addition, the company plans to invest in a WTE project, producing up to 10 MW of electricity from refuse-derived fuel (RDF). The project cost is around THB1.3 billion in total. With no operating track record, these new ventures could turn out to be both challenges and opportunities for the company. The aluminum boat and minibus business remains at a nascent stage. An absence of long-term sales contracts and an acceptance of product quality are key challenging factors for the success of this business. The investment in the WTE project will help enlarge CWT's power portfolio. However, the investment amounts, in case of no new equity injection, could burden the company's balance sheet. CWT will also be exposed to execution risks, stemming from potential 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. Once the company starts the second phase of the WTE project, its debt to EBITDA ratio could increase to 7-8 times from 5-6 times. However, we expect CWT to increase its capital to reduce pressure on its capital structure. 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 31 December 2020 was 0.9 times. The investment in the second phase of the WTE project using 100% debt could raise its net interest-bearing debt to equity ratio to 1.4 times.

### **Liquidity to be manageable**

We expect CWT to be able to manage its near-term liquidity despite our view of a significant risk. The company has two debenture issues worth about THB516 million in total coming due this year. CWT plans to repay the total outstanding amount of the CWT205A debentures worth THB235.97 million, due on 23 May 2021, with new long-term bank loans of THB141 million. The remaining about THB95 million could be covered by cash on hand and existing available short-term facilities. CWT plans to refinance the CWT21NA debentures worth THB280 million, due on 23 November 2021, with bank loans and debenture issuance.

## BASE-CASE ASSUMPTIONS

- Total operating revenue to range from THB1.6-THB2.2 billion per annum during 2021-2023.
- EBITDA margin to stay above 14% over the forecast periods.
- Capital expenditures to range from THB0.1-THB0.6 billion per annum over the forecast periods.

## RATING OUTLOOK

The “stable” outlook reflects our expectation that automotive leather will remain the main source of CWT’s revenue. The company’s close working relationship with automobile manufacturers should help it secure supply contracts for new car models. The power business should help maintain the company’s EBITDA margin above 14% over the next three years. In addition, the company is expected to handle its liquidity properly.

## RATING SENSITIVITIES

The prospect of a rating upgrade is limited during the period of planned large investments and a liquidity risk. However, it could occur if CWT can enlarge its cashflow base and maintain its debt to EBITDA ratio at or below 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 impacts of Coronavirus Disease 2019 (COVID-19) turn out to be more severe than anticipated or CWT enters into 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 2021, the Chaiteerath family held a 37.6% stake in CWT. Since its 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 businesses including power generation and aluminum vehicles.

During the past five years, automotive leather has made the largest contribution to the company’s revenue. Automotive leather accounted for 67% of its revenue, followed by power generation and wood chips (11%), bleached leather (10%), dog chew toys (6%), leather furniture (3%), as well as aluminum boats and mini buses (2%).

## KEY OPERATING PERFORMANCE

**Table 1: Revenue Breakdown**

*Unit: %*

Business	2016	2017	2018	2019	2020
Automotive leather	67.0	76.9	68.9	59.5	60.4
Bleached leather	13.8	10.9	9.2	8.8	6.7
Dog chew toys	6.1	5.0	5.4	7.3	6.2
Leather furniture	3.2	2.6	2.8	1.4	3.0
Power and woodchips	9.9	4.7	12.6	17.1	21.7
Aluminum boats and mini buses	-	-	1.1	5.9	2.0
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Total revenue (mil. THB)</b>	<b>1,599</b>	<b>1,910</b>	<b>1,956</b>	<b>2,009</b>	<b>1,566</b>

Source: CWT

**FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS\***
*Unit: Mil. THB*

	----- Year Ended 31 December -----				
	2020	2019	2018	2017	2016
Total operating revenues	1,601	2,046	2,014	1,935	1,612
Earnings before interest and taxes (EBIT)	227	239	174	126	55
Earnings before interest, tax, depreciation, and amortization (EBITDA)	336	350	271	180	97
Funds from operations (FFO)	212	215	138	90	51
Adjusted interest expense	93	102	100	54	31
Capital expenditures	82	180	506	751	542
Total assets	3,811	3,838	3,958	3,553	2,660
Adjusted debt	1,461	1,741	1,890	1,321	846
Adjusted equity	1,732	1,631	1,486	1,367	1,200
<b>Adjusted Ratios</b>					
EBITDA Margin (%)	20.98	17.09	13.46	9.29	6.04
Pretax return on permanent capital (%)	6.70	6.92	5.41	4.87	2.93
EBITDA interest coverage (times)	3.61	3.42	2.71	3.31	3.18
Debt to EBITDA (times)	4.35	4.98	6.97	7.35	8.69
FFO to debt (%)	14.51	12.34	7.29	6.85	6.02
Debt to capitalization (%)	45.75	51.62	55.98	49.14	41.34

\* Consolidated financial statements

**RELATED CRITERIA**

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

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**Chai Watana Tannery Group PLC (CWT)**

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<b>Company Rating:</b>	BB+
<b>Rating Outlook:</b>	Stable

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