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Wens Foodstuff Downgraded To 'BBB-' On Business Deterioration And Higher Leverage; Outlook Stable

- Wens Foodstuff Group Co. Ltd.'s hog production volume declined over the past two years due to African swine flu (ASF), and the pace of recovery so far this year has been slower than we anticipated.
- The delayed recovery at a time when hog prices have entered a downcycle coupled with Wens' increased capex needs to restore capacity could push the company's leverage to 2.4x in 2021, higher than our previous expectation of 1.0x-1.2x.
- We lowered our issuer credit rating on Wens to 'BBB-' from 'BBB'.
- The stable outlook reflects our expectation that Wens will meaningfully increase its hog production over the next two years, lowering its average production cost, which would help offset some pressure from lower hog prices.

HONG KONG (S&P Global Ratings) May 18, 2021--S&P Global Ratings today took the rating actions listed above. Wens' production volume and market position are unlikely to fully recover over the next 12 months. The company's hog production volume nearly halved in 2020 to 9.5 million, and we expect the decline will continue in the first half of 2021. We attribute the slower hog volume recovery to the strategic decision on the method and timing of sow and boar herd replenishment, which caused Wens to be six months behind some domestic peers. In addition, Wens farm protection mechanism was not strong enough on the physical quarantine of its hogs against ASF. This resulted in Wens' market position sliding to No. 3 behind Muyuan Foods Co. Ltd. and Jiangxi Zhengbang Technology Co. Ltd. in 2020, from No. 1 in 2019.

Chicken price recovery should temper the pressure from lower hog price.Wens' EBITDA declined 35% in 2020. A significant drop in poultry prices was the main drag, in addition to ASF. The company lost money on each chicken sold when the average price dropped by 23%. We expect poultry prices to recover to Chinese renminbi (RMB) 13-RMB15 per kilogram (kg) in 2021 and 2022, from RMB11.6/kg in 2020. This would offset some pressure from lower hog prices as they come off an ASF-induced high. We forecast average hog prices at RMB24-RMB26 per kg in 2021 and RMB15-RMB18 per kg in 2022, from about RMB34/kg in 2020. As a result, we expect Wens' EBITDA margin to slightly improve to 16%-18% in 2021 and 2022, from 15.1% in 2020. This is through a combination of higher chicken prices and lower average hog production costs driven by better capacity utilization.

Production increase will require significant capex, resulting in sizable free operating cash flow deficit.We forecast Wens will spend RMB14 billion-RMB16 billion in 2021 mainly to restore its production, including purchasing breeding hogs and other assets as well as building new sow and boar farms. Capex will likely stay above RMB10 billion in 2022 as the company targets to increase production to 56 million hogs by 2024 under its five-year plan. It produced 9.5 million hogs in 2020 (with a capacity of more than 30 million heads). The investments include adding "corporate + farming community" inhouse production model to the existing "company + farmer" contractor model. The new model requires more up-front investments. The benefits of the inhouse production model, such as better environmental factors, higher operating efficiency, and better disease control, will take time to manifest as lower cost per hog. Wens' high capex and slower recovery in hog volume comes during a downcycle in hog prices. We expect these factors to translate to free operating cash flow deficits of RMB3.5 billion-RMB5.5 billion in 2021, reducing to RMB100 million-RMB500 million in 2022.

Wens' debt leverage will likely stay above 2.0x. The company's debt-to-EBITDA ratio could be as high as 2.4x in 2021 before declining to 2.1x-2.3x. The spike in 2021 is due to declining hog prices and debt-funded capex, while its hog production remains low. With Wens' higher production and associated scale benefits, we expect the company's EBITDA to increase about 15% in 2022, bringing down its debt leverage. The company issued a convertible bond of about RMB9.3 billion earlier this year. The convertible bond is currently out-of-the-money. In the event that Wens' stock price increases meaningfully and the convertible bond converts, the company's debt leverage could fall to 1.8x-1.9x in 2021 and 2022.

Wens' cash flows could improve later in the year as volume recovers and the number of sows increases to fully support its expansion. The company's hog production costs surged to about RMB26/kg in 2020, from about RMB11/kg in 2018 prior to ASF. Wens had to buy piglets last year because its sow herd was affected by ASF and it has lower herd quality by age and by breed. We expect continued weak cash flow in the first half of 2021, given piglets purchases are still required and external piglets cost RMB1,500 per hog compared with the RMB500 cost of a self-produced hog. We anticipate cash flows to improve in the second half of 2021 as Wens' sow and boar capacity grows to sufficiently support volume expansion. The company's herd mix is improving with high-productive sows making up 85% of the sow herd in the first quarter of 2021 compared to 70% in fourth quarter of 2020, despite limited improvement in the herd size. In addition, the size of its grand-parent herd has stabilized at 110 million since September 2020. Hogs for sale come typically come nine to 12 months after this happens.

Outlook

The stable outlook reflects our expectation that Wens will meaningfully increase its hog production volume over the next two years, lowering its average production cost, which would help offset some pressure from lower hog prices. The increase in hog production should be particularly sharp in 2022, enabling the company's debt-to-EBITDA ratio to strengthen to 2.1x-2.3x in 2022, from our forecast of 2.4x in 2021.

Downside scenario

We could lower the rating if Wens' leverage stayed above 2.5x. This could happen if:

- The company's debt-funded capex is more aggressive than we anticipate as it transitions to in-house production;

- A flare-up of ASF results in a meaningful setback in the company's efforts to increase its herd; and
- A significantly higher decline in hog or poultry prices than we expect causes Wens' profit margin and cash flow to plummet.

Upside scenario

We could raise the rating if Wens regains its market share and marketing leading position in hog production, and maintains its debt leverage at less than 2x. This will likely take some time as the company shifts to more in-house production even as competitors are aggressively investing in new facilities.

Related Criteria

- **General Criteria: Group Rating Methodology**, July 1, 2019
- **Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments**, April 1, 2019
- **Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers**, Dec. 16, 2014
- **Criteria | Corporates | General: Corporate Methodology**, Nov. 19, 2013
- **General Criteria: Methodology: Industry Risk**, Nov. 19, 2013
- **General Criteria: Country Risk Assessment Methodology And Assumptions**, Nov. 19, 2013
- **General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities**, Nov. 13, 2012
- **General Criteria: Principles Of Credit Ratings**, Feb. 16, 2011

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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