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Research Update:

CAP S.A. 'BB+' Ratings Affirmed; Outlook Remains Stable

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Issue Ratings--Subordination Risk Analysis

Related Criteria

Ratings List

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CAP S.A. 'BB+' Ratings Affirmed; Outlook Remains Stable

Overview

- High pellet premiums, stable cash cost, and an efficient product mix will allow CAP to maintain its resilient cash generation and low leverage, which will provide a cushion for potentially volatile iron ore prices and expected higher capex levels over the next couple of years.
- We're affirming our 'BB+' global scale corporate credit ratings on the company. We are also affirming the company's 'BB+' issue-level rating on its senior unsecured notes.
- The stable outlook reflects our view that CAP's focus on improving operating efficiency by adding marginal capacity to its current operations, along with its flexibility to change its product mix to optimize margins. This will allow it to offset iron ore prices and pellet premium volatility, and to continue posting positive free operating cash flow (FOCF) despite higher investments.

Rating Action

On April 26, 2018, S&P Global Ratings affirmed its global-scale rating on CAP S.A. at 'BB+'. We have also affirmed our issue-level rating on CAP's senior unsecured notes at 'BB+'. The outlook on the corporate rating is stable.

Rationale

The affirmation reflects our expectations that the company will continue to present strong financial metrics backed by resilient free cash flow generation and overall low indebtedness. We expect the company to continue focusing on improving the efficiency of its assets, which will partly offset the effects of volatile iron ore prices and pellet premiums. However, improvements will demand an increasing investment pipeline over the next few years and fairly stable leverage. We also expect the company to continue benefiting from its niche market position, with higher grade iron ore products (63%-68% iron content), some integration into the steel market, and an overall prudent capital expenditures (capex) strategy, to offset the risks inherent to the iron ore industry--especially when considering its small scale of operations and the impact on EBITDA and cash generation in downward pricing cycles.

Persistently high iron ore prices over the last few quarters have allowed CAP

to improve its cash flow generation, reduce indebtedness, and maintain strong liquidity through 2017. Although we continue to see some pressures on iron ore prices over the medium term, we believe that average prices over the next two years will remain somewhat stable in the \$65-\$60 per ton range. As a result, we expect CAP to focus its investments on increasing the production of its assets, even if marginally, especially Cerro Negro Norte. We believe that CAP's overall production cost will continue to reflect the efficiency of the company's concentration and pelletizing operations, which compensate for the high cash cost of CAP's mines. We also expect CAP to benefit from its partial integration into steel, and believe that its logistics and infrastructure operations will contribute 26%-30% range to consolidated EBITDA margins in 2018 and 2019.

The company has reduced capex in recent years in response to soft market conditions, and to protect its cash flows and financial metrics. With persistently higher prices, we expect capex to increase somewhat over the next few years, but the company should still be able to generate positive FOCF in that period. In our base case scenario, we assume CAP will largely fund its capex plan with internal cash generation, while only partially refinancing its annual maturities. As a result, we expect further improvement in financial metrics, such as debt to EBITDA of about 0.6x and funds from operations (FFO) to debt of 112% in 2018 (0.8x and 90%, respectively, in 2019) as iron ore prices decline. Our base-case scenario also includes the following assumptions:

- Chile's GDP grows 3.3% in 2018 and 3.1% in 2019, affecting domestic steel demand;
- Exchange rate of Chilean peso (CLP) 615 per \$1 in 2018 and CLP635 per \$1 in 2019;
- Average iron ore prices of \$65 per ton for the remainder of 2018, \$60 per ton in 2019, and \$55 per ton in 2020;
- Coal prices increasing to \$85 per ton in 2018, but declining to \$80 in 2019;
- Cash cost of about \$38-\$40 per ton from 2018 onwards;
- Freight cost of \$16 per ton from 2018 onwards;
- Total iron ore production of 16.2 million tons in 2018, increasing to 17.6 MT in 2019;
- Pellet premiums of about \$55 per ton over the year, gradually declining to \$50 in 2019;
- Capex of about \$150 million in 2018 and \$290 million in 2019; and
- Dividend payout of 50% from 2018 onwards.

As a result of these assumptions, we reach the following financial metrics:

- Revenues of \$1.9 billion in 2018 and 2019;
- EBITDA of \$562 million in 2018 and \$495 million in 2019;

- Funds from operations (FFO) of \$404 million in 2018 and \$365 million in 2019;
- FOCF of \$224 million in 2018 and \$50 million in 2019;
- Debt to EBITDA of 0.6x in 2018 and 0.8x in 2019;
- FFO to debt above 100% in 2018 and 90% in 2019; and
- FOCF to debt around 60% in 2018 and declining to 12% in 2019.

Liquidity

We view CAP's liquidity as strong. The company has maintained resilient cash generation, which stems from persistently high iron ore prices and pellet premiums, as well as its focus on improving operating efficiency and sustainability of cash cost levels. This has allowed for some debt repayment and has boosted its cash position in recent quarters. Likewise, we expect CAP's cash generation to cover its debt maturities and capex needs over the next 24 months. In this sense, we expect sources of liquidity to exceed uses of liquidity by more than 1.5x over the next 12 months, and to remain above 1.0x in the following 12 months. In addition, we expect sources of liquidity to continue to exceed uses even if EBITDA declines by 30%. We also do not expect covenant pressures, given the current headroom of more than 80% under the company's 4.0x net financial debt to EBITDA requirement at the end of 2018.

Principal Liquidity Sources:

- Cash and short-term investments of \$700 million as of Dec. 31, 2017;
- FFO generation of about \$400 million for 2018; and
- \$500 million fully available committed credit facilities in 2018 (of which \$350 million are due in 2022 and \$150 million in 2023).

Principal Liquidity Uses:

- Short-term debt of \$489 million as of Dec. 31, 2017.
- Working capital outflows of \$25 million in 2018;
- Capex of about \$150 million in 2018; and
- Dividend payouts of 50% of previous years' net income.

Outlook

The stable outlook reflects our expectation that CAP will be able to increase investments in its current operations thanks to its resilient cash generation and flexibility in its product mix, as well as efficiency in producing higher value-added products to offset the volatility of iron ore prices over the next 12 months. We expect that the company's steel, infrastructure, and logistics businesses will continue to contribute positively to CAP's cash generation. Thus, we expect credit metrics to remain strong over the next several quarters, such as debt to EBITDA of about 0.6x, FFO to debt above 100%, and

positive FOCF generation in 2018, despite higher capex levels. Our current analysis does not incorporate any material acquisition or sizeable new projects in the medium term.

Downside scenario

We could take a negative rating action if iron ore prices were to decline more quickly than we expect, and CAP's offsetting measures were not sufficient to prevent significant deterioration in its cash flows. In that scenario, we would expect to see significantly weaker credit metrics, such as debt to EBITDA above 2x, FFO to debt below 45%, and FOCF to debt below 5%.

Upside scenario

Although unlikely in the short term, we could raise the ratings if CAP improves its operational scale and diversification to more sustainably support stronger profitability and less volatile cash flow metrics.

Ratings Score Snapshot

Corporate Credit Rating: BB+/Stable/--

Business risk profile: Fair

- Country Risk: Intermediate
- Industry Risk: Moderately high
- Competitive position: Fair

Financial risk profile: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Strong
- Management and governance: Satisfactory
- Comparable rating analysis: Neutral

Issue Ratings--Subordination Risk Analysis

Capital structure

CAP's capital structure mainly consist of a \$433.1 million local bond, \$33 million in international bonds, \$97.6 million in financial leases, \$3.5 million in financial overdrafts, \$20 million in hedging instruments, and \$490.7 million in bank loans. Most debt is issued at CAP's operating subsidiaries.

Analytical conclusions

We rate CAP S.A.'s senior unsecured notes at the same level as the corporate credit rating, given that the notes receive a full and unconditional upstream guarantee from CAP's subsidiaries, namely Compañía Minera del Pacífico S.A. (CMP), CAP's mining subsidiary and Compañía Siderúrgica Huachipato S.A. (CSH), CAP's steel production subsidiary. Combined, these subsidiaries generate over 85% of CAP's EBITDA.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Metals And Mining Upstream Industry, Dec. 20, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - Industrials: Methodology For Standard & Poor's Metals And Mining Price Assumptions - November 19, 2013

Ratings List

Ratings Affirmed

CAP S.A.

Corporate Credit Rating BB+/Stable/--

CAP S.A.

Senior Unsecured BB+

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 the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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