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Research Update:

Ratings On CAP S.A. Lowered To 'BB' From 'BB+' On Still Weak Market Conditions; Off Watch Negative, Outlook Stable

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Ratings On CAP S.A. Lowered To 'BB' From 'BB+' On Still Weak Market Conditions; Off Watch Negative, Outlook Stable

Overview

- Volatile iron ore and steel prices will continue to pressure CAP's profitability over the next few quarters, resulting in weak financial metrics.
- We are lowering our ratings on CAP to 'BB' from 'BB+'.
- We have removed the ratings from CreditWatch negative. The outlook is now stable, reflecting our expectation that the company's robust liquidity and cash flow protection measures will partly offset further price volatility, in the next few quarters.

Rating Action

On March 21, 2016, Standard & Poor's Ratings Services lowered its corporate credit ratings on CAP S.A. to 'BB' from 'BB+'. We have also lowered the issue level rating on the company's senior unsecured bonds to 'BB' from 'BB+'. We have removed the ratings from CreditWatch negative. The outlook is now stable.

Rationale

The ratings on CAP reflect the company's niche market position as a premium pellet producer and steelmaker in Chile. Its debts are, on average, low cost, but this only partially mitigates the risks spawning from its small scale of operations and exposure to the volatile iron ore and steel markets, which have a significant global oversupply. Iron ore and steel prices continued to deteriorate during the last few quarters, and have led us to revise our iron ore price deck to $40 per ton in 2016 and 2017, and $45 in 2018. As a result, we expect CAP's financial metrics to remain around current levels through 2017, while it generates minimal free cash flows.

Over the past several quarters, CAP has focused its efforts on improving operating efficiency in order to offset the effect of rapidly decreasing iron ore prices. The company's initiatives to reduce costs, combined with lower fuel prices and some gains from the depreciation of local currency in Chile, has resulted in a significant reduction in the overall cash cost for its mining operation. In addition, lower coal prices have also contributed to lower steel production costs. However, these positive factors only partially offset the effects of decreasing prices, and CAP's margins have contracted somewhat, so we expect cash generation to remain weak over the next few quarters. We still expect the company to struggle with greater margin volatility, largely due to its small scale.

We believe there is potential for credit metrics to improve a bit if current spot prices stay the same for the next few quarters, although improved metrics would still be aligned with the current category and ratings. Nevertheless, we believe the downside potential is meaningful, as the supply glut in iron ore markets continues to be a major threat. Under these conditions, CAP is focused on protecting cash, reducing capital expenditure (capex) levels to maintenance levels. Still its capacity to generate free cash flow under current market circumstances is negligible, so a potential reduction of the financial leverage is unlikely-–at least from internal cash generation. In our base-case scenario, we also include the following assumptions:

- Chile's GDP increasing by 2.3% in 2016, and 2.8% in 2017.
- Exchange rate of Chilean peso (CLP) 725 per $1 in 2016, and CLP720 in 2017.
- Average iron ore prices of $40 for the rest of 2016, $40 in 2017, and $45 in 2018, in line with our price deck.
- Lower coal costs of about $50 per ton on average throughout the next few years.
- Cash cost decreasing to $31 per ton in 2016, reflecting the exchange rate in Chile, lower oil prices, and lower costs in more-efficient mines.
- Total output of about 15.5 million tons for 2016.
- EBITDA contribution from water and transmission lines of $55 million.
- Pellet premiums resilient at $30 per ton, and content premium of $2.5 per ton.
- Average steel prices of about $560 per ton in 2016 and 2017.
- Capex of $53 million in 2016 and 2017.

As a result of these assumptions we reach the following metrics:
- EBITDA of about $200 million in 2016 and 2017.
- FFO of $160 million to $170 million in 2016 and 2017.
- FOCF of about $100 million in 2016 and $85 million in 2017.
- Debt to EBITDA of about 4.0x in 2016 and 2017.

Liquidity

We view CAP's liquidity as adequate. The company touched down at year-end 2016 with a robust cash position that is more than enough to deal with debt maturities over the next 12 months. Furthermore, because of low capex and interest costs, the company is expected to have some positive free cash generation. We do not expect covenant pressures, given the current headroom under the company's 4.75x net financial debt to EBITDA requirement over the next few quarters; however, covenant headroom will tighten to 4.0x net debt to EBITDA in 2017, leaving less comfortable headroom under our calculations.

Principal Liquidity Sources:
- Cash and short-term investments of $668 million as of December 2015, of which we consider about $50 million to be restricted.

- FFO generation of $175 million for 2016 and $162 million for 2017.

Principal Liquidity Uses:
- Short-term debt of $370 million as of December 2015.
- Peak working capital needs of $25 million.
- Maintenance capex of $53 million in the next years.
- Dividend payouts of 30% of the net income.

Outlook

The stable outlook reflects our view that, even though prices should remain volatile in the near future, CAP's sound cash position, low capex level, and interest expenses should allow the company to offset cash flow pressures over the next few quarters. Despite weak prices--that we expect to lead the company to have debt to EBITDA of about 4.0x and FFO to debt of 20% in 2016--we expect positive free cash generation in 2016.

Downside scenario

We could downgrade CAP if price pressures on iron ore and steel continue to offset the company's efforts to reduce costs, resulting in debt to EBITDA and FFO to debt persistently above 4.0x and below 20%, respectively, and if FOCF turns negative.

Upside scenario

We could raise CAP's ratings if the company is able to present stronger than expected profitability, either due to improved market conditions or more efficient operations, resulting in consistently improved credit metrics, such as debt to EBITDA of about 3.0x and FFO to debt above 30%.

Ratings Score Snapshot

Corporate credit rating: BB/Stable/--
Business Risk Profile: Fair

- CICRA: Moderately High
- Competitive Position: Fair

Financial Risk Profile: Significant

- Cash flow/Leverage: Significant

Anchor: bb

Modifiers:
- Diversification/Portfolio Effect: Neutral
- Capital Structure: Neutral

- Financial Policy: Neutral
- Liquidity: Adequate
- Management and Governance: Satisfactory
- Comparable Rating Analysis: Neutral

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Metals And Mining Upstream Industry, Dec. 20, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
CAP S.A.		
Corporate Credit Rating	BB/Stable/--	BB+/Watch Neg/--
Senior Unsecured	BB	BB+/Watch Neg

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.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.