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Research Update:

CAP 'BB+' Ratings Affirmed And Off CreditWatch Negative On Likely Stronger Credit Metrics, Outlook Stable

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Research Update:

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Overview

- Chile-based steel and iron ore producer CAP should continue benefiting from resilient pellet premiums, lower costs, and investments, which would help cushion the blow from lower iron ore prices.
- We are affirming our 'BB+' ratings on CAP and removing them from CreditWatch with negative implications, where we placed them on April 13, 2015.
- The stable outlook reflects our expectations that the company's credit metrics will be in line with current ratings in the next two years.

Rating Action

On May 7, 2015, Standard & Poor's Ratings Services affirmed its 'BB+' ratings on CAP S.A. At the same time, we removed the ratings from CreditWatch negative, where we placed them on April 13, 2015, following our iron-ore price deck revision. The outlook is stable.

Rationale

The rating actions reflect our expectation that the company's credit metrics will gradually improve. This stems from CAP's high-quality iron ore products that were less sensitive to price drops, which in turn resulted from a severe supply glut in the lower-quality iron ore. In addition, lower coal prices and cost-cutting initiatives are likely to generate positive EBITDA at the company's 700,000-ton steel unit. Other significant sources of cash flows are CAP's fairly new water desalination plant and its power transmission lines, both of which should contribute about $50 million to consolidated EBITDA in 2015. Those factors, coupled with capital expenditures (capex) at maintenance levels, would result in relatively stable credit metrics in the next two years.

The company's focus on its more profitable operations has reduced the production at its 1.5 million-ton El Romeral pit and slowed the Cerro Negro Norte mine's expansion. The company also has the flexibility to temporarily suspend operations at El Romeral if weak market conditions persist. These actions would reduce volumes by 12% from our previous forecast over the next few years. However, in our view, they will bolster the company's balance sheet by reducing the mining operating costs and increase operating cash flow. These

positive factors continue to offset most of the risks associated with CAP's smaller scale and narrower asset and product portfolio than those of its peers with higher ratings.

CAP's financial metrics weakened during 2014 mainly due to the sharp drop in iron ore prices, to which the company struggled to adjust. Furthermore, CAP's recently completed expansion plan weakened the free operating cash flow to debt ratio, which hasn't been fully captured in the company's results. In our base-case scenario, we expect CAP's cost-cutting initiatives and lower coal, fuel, and energy prices to improve its profitability, despite the weak global iron ore and steel prices. These factors would bolster the company's credit metrics and keep them in line with the "intermediate" financial risk profile assessment. Our base-case scenario also incorporates the following assumptions:

- Average iron ore prices of $50 per ton in 2015 (consisting of $45 per ton for the remainder of the year and higher average in the first quarter), $50 in 2016, and $55 in 2017 (for 62% content delivered in China), in line with our price deck.
- Coking coal prices of $70 per ton on average through the next few years.
- Cash cost for pellet production decreasing to $38 per ton in 2015 (FOB), reflecting a weaker Chilean currency and lower operating costs at the company's more efficient mines.
- Total output of about 14 million tons for 2015 and 15 million tons in 2016.
- EBITDA contribution from water business of $43 million -consolidated effect although the company's share in that business is 51%.
- Pellet premiums staying at $32 per ton, and content premium of $2.5 per ton, despite the likely increase in global output of pellets over the next few years.
- Moisture discounts of 8%.
- Own steel production volumes to remain flat , but reduction in processed steel for third parties.
- Lower steel prices compensated by better product mix.
- Capex of $138 million in 2015 and $100 million in 2016.

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

- EBITDA of $310 million in 2015 and $325 million in 2016.
- Debt to EBITDA slightly above 3x in 2015 and below 3x in 2016.
- Funds from operations (FFO) to debt of about 26% in 2015 and closer to 30% in 2016.
- Free operating cash flow generation of $150 million in 2015 and 2016.

Liquidity

We view CAP's liquidity as "adequate." The company has some concentration of debt maturities in the short term, but has a sound cash position and availability under its committed credit facility, combined with an expected annual cash generation. Therefore, sources over uses comfortably exceed 1.2x, even if EBITDA were to decline by 20%. We expect the company's liquidity sources to exceed uses by more than 20% in the next 24 months.

Principal Liquidity Sources:

- Cash and short-term investments of $348.2 million as of December 2014
- Full availability under its committed credit lines of $350 million that go through 2017
- FFO generation of $245 million for 2015 and $250 million for 2016
- Working capital inflows of $65 million in 2015

Principal Liquidity Uses:

- Short-term debt of $359.5 million as of December 2014
- Peak working capital needs of $50 million per year
- Minimum annual maintenance capex of $60 million in the next few years
- Dividend payouts of 30% of the net income

CAP is subject to covenants under its debts, including a net debt-to-EBITDA requirement of below 4.0x and minimum EBITDA interest coverage of 2.5x, which we expect the company to meet with comfortable headroom, even if EBITDA were to fall by 30%.

Outlook

The stable outlook reflects our expectations that CAP's actions to relieve pressures on its cash flows should result in a gradual debt reduction throughout 2016 despite the metrics likely to be weak for the "intermediate" financial risk profile category in 2015. We expect the company's debt to EBITDA to be about 3.1x and FFO to debt of about 26% while gradually improving FOCF to debt to close to 20%, despite still weak market fundamentals for iron ore and steel.

Downside scenario

We could downgrade CAP's if its efforts to reduce costs aren't sufficient to mitigate the effects from lower iron ore prices, resulting in debt to EBITDA of more than 3.0x and FFO to debt of less than 30%.

Upside scenario

We could raise the ratings if the company's profitability recovers, either due to improved market conditions or more efficient operations, resulting in debt to EBITDA of below 2.0x and FFO to debt above 45% on a sustained basis.

Ratings Score Snapshot

Corporate credit rating: BB+/Stable/--

Business Risk Profile: Fair

- CICRA: 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: Adequate
- Management and Governance: Satisfactory
- Comparable Rating Analysis: Neutral
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Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios and Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013

Key Credit Factors Published For The Metals And Mining Upstream Industry, Dec. 20, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

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

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