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Ratings

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Research Update:

CAP S.A. Rating Raised To 'BB+' On Stronger Cash Flow Generation, Removed From CreditWatch Positive; Outook Stable

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Table Of Contents

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Overview

- CAP S.A.'s focus on lower cost production, combined with higher average iron ore prices, will support more resilient cash flow generation and stronger financial metrics in coming years.
- We have raised the rating on CAP to 'BB+' from 'BB'.
- We have removed the ratings from CreditWatch with positive implications.
- The stable outlook reflects our view that CAP's flexibility to change product mix and focus on operating efficiency will continue to offset further iron ore price volatility and allow the company to continue presenting positive free operating cash flow (FOCF).

Rating Action

On April 12, 2017, S&P Global Ratings raised its global-scale rating on CAP S.A. to 'BB+' from 'BB'. At the same time, we raised our issue-level rating on its senior unsecured notes to 'BB+' from 'BB'. The ratings were removed from CreditWatch, where they were placed with positive implications on Jan. 18, 2017. The outlook is stable.

Rationale

The ratings on CAP reflect the company's strategy and ability to change product mix to improve efficiency of its asset-base usage, while higher average iron ore prices and fairly low capital expenditure (capex) needs will continue to drive strong cash flow generation. This and the company's fairly low debt support our view of fast improving financial metrics. Nonetheless, the company remains subject to financial metric volatility due to its exposure to iron ore prices, small scale of operations, and Chile's steel industry, which faces significant competition from imports.

CAP's flexibility to adjust its product mix between iron ore pellets, pellet feed, and fines allowed it to overcome declining iron ore prices in early 2016 and maximize profitability. This strategy is likely to continue driving cash generation in coming quarters, as we expect iron ore to average $67 per ton in 2017, above last year's $58, but to remain volatile in the short to medium term. We also expect the company's steel processing and production businesses to focus on higher-margin products, as the Chilean steel market continues to face slow demand growth and intense competition from international players.

CAP will also continue to benefit from its niche market position with higher grade iron ore products (63%-68% iron content) that drives more resilient demand and higher prices from iron ore content premiums. In our view, the company is better positioned to deal with further expected price volatility driven by global supply and demand imbalances, supporting our expectation of fairly stable EBITDA margins in the 22%-30% range over the next two years.

Further price pressures are likely in the short term, which combined with CAP's somewhat small scale of operations can add volatility to its cash generation. However, we expect CAP to continue to adjust its investment plan according to market conditions and maximize free cash generation. In our base-case scenario, we assume the company would continue to use its free cash generation to pay down maturing debt, leading to further improvement in financial metrics such as debt to EBITDA of about 1x and funds from operations (FFO) to debt of 70% in 2017. Our base-case scenario also includes the following assumptions:

- Chile GDP growth of 1.9% in 2017 and 2.2% in 2018, affecting domestic steel demand;
- Average exchange rate of 670 Chilean pesos (CLP) per $1 in 2017 and CLP680 in 2018;
- Iron ore averaging $67 per ton in 2017 and $50 in 2018 and 2019;
- Coal increasing to $75 per ton in 2017, but declining to $65 in 2018;
- Cash cost of about $31 per ton in 2017 and $32 in 2018;
- Freight cost of $12 per ton in 2017 and 2018;
- Total iron ore production of 16.6 million tons in 2017 and 17.2 million tons in 2018;
- Pellet premiums of about $30 per ton over the next two years;
- Capex of $125 million in 2017 and maintenance capex of $60 million in 2018; and
- Minimum dividend payout of 30%.

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

- Revenues of $1.76 billion in 2017 and $1.62 billion in 2018;
- EBITDA of $525 million in 2017 and $360 million in 2018;
- FFO of $375 million in 2017 and $275 million in 2018;
- FOCF of $230 million in 2017 and $150 million in 2018;
- Debt to EBITDA of about 1x over the next two years;
- FFO to debt above 65% in 2017 and 2018;
- FOCF to debt above 35% in 2017 and 2018.

Liquidity

We revised CAP's liquidity assessment to strong from adequate. The company's improved cash generation, from persistently high iron ore prices, allowed for some debt repayment and boosted its cash position in 2016. We expect average iron ore prices to allow CAP's cash generation to cover for its debt maturities and capex needs over the next 24 months. Thus, we expect sources of liquidity to exceed uses by more than 1.5x over the next 12 months, and to remain above 1x in the following 12 months. Also, 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 under the company's 4x net financial debt to EBITDA requirement at the end of 2017.

Principal liquidity sources:
- Cash and short-term investments of $785 million as of Dec. 31, 2016; and
- FFO generation of $375 million for 2017 and $275 million in 2018.

Principal liquidity uses:
- Short-term debt of $327 million as of Dec. 31, 2016;
- Peak working capital needs of $20 million;
- Capex of $125 million in 2017 and maintenance capex of about $60 million; and
- Dividend payouts of 30% of the net income.

Outlook

The stable outlook reflects our expectation that CAP will continue to be flexible with its product mix, execute capex to maximize cash generation, and mostly offset iron ore price volatility over the next 12 months. In addition, we expect the steel business to remain pressured given still-low global prices. Nonetheless, CAP will also continue to benefit from stable and predictable inflows from its water and energy transmission assets. Thus, we expect the company to continue presenting strong credit metrics over the next several quarters, such as debt to EBITDA below 1.5x, FFO to debt above 60%, and positive FOCF generation, despite expected weaker iron ore prices.

Downside scenario

A downgrade is likely if iron ore prices decline faster than we expect and CAP's offsetting measures don't prevent significant deterioration in cash flow, leading to significantly weaker credit metrics, such as debt to EBITDA near 3x and FFO to debt of about 30%.

Upside scenario

Although unlikely in the short term, we could raise the ratings if CAP presents improved scale and diversification of operations that support sustainably stronger profitability and less volatile cash flow metrics.

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: Strong
- Management and governance: Satisfactory
- Comparable rating analysis: Neutral

Related Criteria

- 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
- 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: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 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 - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Upgraded; CreditWatch/Outlook Action

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

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