Research Update:

CAP S.A. Outlook Revised To Negative On Weaker Performance, 'BB+' Ratings Affirmed

March 6, 2020

Rating Action Overview

- CAP S.A.'s leverage metric skyrocketed towards 4.2x in 2019 because of the Guacolda 2 Port accident, which shrank iron ore dispatches.
- On March 6, 2020, S&P Global Ratings revised its outlook on the rating on Chilean mining company to negative from stable. We also affirmed our global scale 'BB+' issuer credit and issue-level ratings on the senior unsecured notes.
- The negative outlook reflects the challenges to the recovery in metrics in an uncertain scenario for commodity prices. Lower cash balance, weaker credit metrics, and a lesser headroom in the company's debt payment acceleration covenants weigh on the downside scenario. Moreover, we acknowledge that debt maturity profile is shortening, with almost 50% of debt maturing in the short term and a UF6 million in bonds (approximately $200 million) amortizing in the third quarter of 2021.

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Rating Action Rationale

The Guacolda 2 Port accident contracted iron ore dispatches in 2019. As a result of the Nov. 22, 2018, fatal accident, CAP's pellets output plummeted last year. Logistics costs increased and volumes dropped 37% compared to 2018 and 43% compared with 2017, reaching at only 9.2 million tons last year. Given that the construction of the new ship loader and its assembly was completed in December 2019 and port services normalized, we now expect dispatches to recover to about 14 million tons in 2020.

Lower EBITDA took a toll on leverage and liquidity The accident reduced cash flow generation and cash position, resulting in debt to EBITDA of 4.2x in December 2019, compared with our original expectations of below 2x. Net interest coverage ratio reached 2.3x at the end of 2019 and forced the company to obtain consent to relax covenant measures to 2.5x from 2.0x for the year-end until third quarter of 2020, indicating metrics will take some time to recover.

Capital structure is weakening due to the shorter debt maturity profile The company's debt in absolute terms increased 18% in 2019 compared with 2018, almost all of the increase corresponded to short-term bank loans. As of December 2019, CAP's short-term debt accounted for 49% of total debt, with average term of slightly above two years. In addition, the company has a domestic bond for UF3 million ($115 million) maturing in July 2021 and another one for the same amount maturing in September 2021. Liquidity is still sound, given $340 million in cash position and the company's revolving credit facilities. However, we revised our liquidity assessment to adequate from strong amid a tighter covenant cushion and refinancing risks under more difficult circumstances, mainly because of larger debt maturities at the end of 2021.

Outlook

The negative outlook reflects a potential downgrade in the next 12 months if CAP's deleveraging pace deviates from our expectation of a net debt to EBITDA reaching 1.3x and free operating cash flow (FOCF) turning positive by year-end.

Downside scenario

We could lower the rating if company's performance doesn't recover as expected and liquidity deteriorates, or if debt's average term drops below two years, further weakening the company's capital structure. We could take a negative rating action if iron ore prices were to decline or the company's output doesn't stabilize, which would increase logistics costs. In that scenario, we expect debt to EBITDA remain above 2.5x and FOCF to debt below 5% in the end of 2020. A sustained weak operating efficiency could also lead us to revise the business risk profile assessment downwards.

Upside scenario

We could remove the negative outlook if CAP improves its operations and its profitability recovers amid less volatile cash flow metrics. Under this scenario, we expect debt to EBITDA consistently below 2.0x and FOCF to debt above 25%. At the same time, removing the negative outlook would require an improved capital structure with extended maturities.

Company Description

CAP is a Chilean iron ore miner and steelmaker focused on high-quality iron ore production for export markets (mainly China), steel production for the Chilean market, and steel processing for the construction, industry, and infrastructure sectors in Chile, Peru, and Argentina. The company has roughly 18 million tons of mining production capacity across four production sites (Los Colorados, El Romeral, Cerro Negro Norte, and Magnetita) and a steel production and processing capacity of about 1 million tons.

Along with its mining and steel activities, which represent about 90% of total EBITDA, CAP also operates a seawater desalination plant, which delivers water to the Cerro Negro Norte mine, magnetite plant, and to the nearby city; a power transmission line; and a multipurpose port (Las Losas). These three operations generate the remaining 10% of CAP's EBITDA.

Our Base Case Scenario

We expect CAP to reduce its leverage in 2020, as its volumes rebound amid the still supportive metals prices. Cash costs might gradually recover amid stabilizing cost operations.

Assumptions:

- Chile's GDP growth of 2.4% in 2020 and 2.9% in 2021;
- Chile's average foreign exchange (FX) rate of CLP743 per $1 in 2020 and 2021;
- Average iron ore prices of $80 per ton in 2020 and $70 per ton in 2021;
- Flat coal prices at $160 per ton in 2020 and 2021;
- Cash costs of $38-$40 per ton in 2020 and 2021;
- Freight cost of $12 per ton starting in 2020;
- Total iron ore production of 14 million tons in 2020 and 15 million tons in 2021;
- Pellet premiums of about $55 per ton in 2020 and 2021;
- Capex of about $240 million in 2020 and $240 million in 2021, including expansion capex at the Cerro Negro Norte and Los Colorados mines; and
- A dividend payout at 30% of previous-year net income.

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

- EBITDA of $506 million in 2020 and $470 million in 2021;
- EBITDA margin of about 25% in 2020 and 2021;
- FOCF close to $100 million in 2020 and $200 million in 2021;
- Debt to EBITDA around 1.3x in 2020 and 2021; and
- FOCF to debt of about 15% in 2020 and 35% in 2021.

Liquidity

We're revising our liquidity assessment to adequate from strong. Cash on hand, FFO, and available committed credit lines should exceed cash uses by slightly more than 1.5x for the next 12 months. However, the Guacolda Port accident reduced cash flow generation and overall cash balance. More importantly, it caused credit metrics to deteriorate, reducing the debt payment acceleration covenants headroom, especially the net interest coverage ratio, which settled at 2.3x at the end of 2019 and forced the company to issue consents solicitation to bondholders in order to relax that covenant to 2.5x from 2.0x for the fourth quarter of 2019 – third quarter of 2020 period.

Principal Liquidity Sources

- Cash and liquid investments of $340 million as of Dec. 31, 2019;
- FFO of about $430 million for the next 12 months; and
- $500 million in fully available committed credit facilities (of which $350 million are due 2022 and $150 million due 2023).

Principal Liquidity Uses

- Short-term debt of $468 million as of Dec. 31, 2019;
- Working capital outflows of $90 million for the next 12 months; and
- Maintenance and expansion capex of about $245 million in 2020, which includes investments in the Cerro Negro mine.

Covenant Analysis

Debt payment acceleration covenants include net debt to EBITDA of maximum of 4.0x and revised consolidated net interest coverage minimum of 2.0x until September 2020 and 2.5x afterwards. We expect a small covenant headroom on the net interest coverage ratio during the first nine months of 2020.

Issue Ratings--Subordination Risk Analysis

Capital structure

As of December 2019, CAP's capital structure mainly consisted of $637.8 million in bank loans, $229.3 million local bonds due 2021, $41.8 million in international bond due 2036, $29.7 million in financial leases, $1.2 million in financial overdrafts, and $22.1 million in hedging and other instruments. Most debt is issued at CAP's operating subsidiaries.

Analytical conclusions

We rate CAP's senior unsecured notes at the same level as the issuer credit rating, given that the notes receive a full and unconditional upstream guarantee from CAP's main cash generating subsidiaries, namely Compañía Minera del Pacífico S.A. (an iron ore mining subsidiary) and Compañía Siderúrgica Huachipato S.A. (a steel production subsidiary). Combined, these subsidiaries generate over 80% of CAP's EBITDA.

Environmental, Social, and Governance Factors

We tend to view CAP's exposure to environmental and social risks in line with the mining industry. While its mines and tailings dams are fairly remote and its access to water is covered by its own desalination plant, which in turn enhances its relationship with local communities that are served by the excess water CAP supplies to them, the company suffered the breakage of its ship loader in Guacolda in November 2018. The accident cost the life of 1 employee and severely limited the company's ability to deliver while it increased operational costs and investments.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Negative/--

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

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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 | 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, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
CAP S.A.		
Issuer Credit Rating	BB+/Negative/--	BB+/Stable/--
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 S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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