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Credit Opinion: Volcan Compañía Minera S.A.A. y Subsidiarias

Global Credit Research - 12 May 2014

Peru

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Baa3

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Key Indicators

[1]**Volcan Compañía Minera S.A.A. y Subsidiarias**

	12/31/2013	12/31/2012	12/31/2011	12/31/2010	12/31/2009
EBIT Margin	**24.1%**	**31.3%**	**42.5%**	**44.5%**	**33.3%**
Return on Average Tangible Assets (EBIT / Avg. Tangible Assets)	**13.9%**	**23.5%**	**39.8%**	**34.0%**	**18.2%**
Debt / Book Capitalization	**30.8%**	**31.5%**	**4.3%**	**3.4%**	**7.7%**
Debt / EBITDA	**1.8x**	**1.4x**	**0.1x**	**0.1x**	**0.3x**
EBIT / Interest Expense	**9.7x**	**10.4x**	**152.2x**	**110.8x**	**48.2x**
FCF / Debt	**-30.0%**	**-10.1%**	**358.4%**	**431.1%**	**173.1%**
(CFO - Dividends) / Debt	**29.6%**	**22.8%**	**575.5%**	**647.8%**	**236.7%**

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Leading producer of zinc, lead and silver in Peru

- Diversified polymetallic platform with unique mix of low-correlation base metals and silver content

- Capex should reduce going forward with two main projects concluded in 2014

- Relatively modest revenue size as compared to global peers, and low geographic diversity

Corporate Profile

Volcan is a Peruvian mining company with mining, concentrating and commercial operations. It primarily produces zinc and lead concentrate and some copper concentrate. These concentrates have a high silver content. The company operates through four operational complexes with a total of 10 mines and 7 concentrate plants. All of Volcan´s operations are located in Peru (Baa2 positive). For the twelve months ended December 2013 it had revenues of USD 1.2 billion. During 2013, silver represented 37% of total sales, zinc 46%, lead 11.5%, copper 4% and gold 0.5%.Volcan is a holding company listed in the stock exchanges of Lima and Chile and in Madrid's Latibex. Virtually all of the company's shares are traded on the Peruvian stock exchange, the Bolsa de Valores de Lima.

SUMMARY RATING RATIONALE

The Baa3 senior unsecured rating reflects: i) Volcan's relatively strong credit metrics; ii) its competitive cost position, which should support the company's earnings and credit metrics even at a moderating metal prices environment; iii) its operational diversity in terms of number of metals produced, mines, complexes and concentrators; and iv) its position as a leading producer of zinc and silver globally.

Constraining the company's ratings are: i) its negative free cash flow due to high capex to grow production; iii) its low gegraphic diversity; and iv) its relatively modest revenue size, as compared to global peers.

DETAILED RATING CONSIDERATIONS

DIVERSITY OF METALS AND MINES SUPPORTS ITS Baa3 RATING

Volcan is the leading producer of zinc and silver in Peru, and a major player for these metals globally. Moreover, the company has a favorable mix of metals, which provides good diversification and low price correlations in a normalized environment. At the end of the 1Q14, Volcan's sales per metal were distributed as follows: 1) zinc (52%); 2) silver (34%); 3) lead (10%), 4) copper (4%) and gold (1%). In 2013, while the average silver and copper prices dropped the most compared to 2012, at -23.4% and -7.9%, respectively, lead prices were 3.9% higher, while zinc average prices decreased by modest 1.95%.

Volcan also enjoys good operational diversity, with four main operational units at Yauli, Chungar, Cerro de Pasco and Alpamarca-Rio Pallanga, in the central region of Peru. It produces its metals from 10 different mines and also has seven concentrate plants and one leaching plant for silver oxides production.

MARGINS HAVE DECLINED DUE TO LOWER METAL PRICES AND ARE CURRENTLY WEAKLY POSITIONED IN ITS RATING CATEGORY

Volcan enjoys relatively higher historic margins compared to its local and global peers due to its overall low-cost production position. The company's three-year average mining EBIT margin (as defined by Moody's) ending in December 31st, 2013 was 32.7% from 39% in 2012, which still maps to an Aaa in our Mining Industry Rating Methodology. The declining trend reflects mainly the lower prices for its main metals and, more recently, the higher percentage of sales from trading of third-party concentrates (30% in 1Q14 vs. 15% in 1Q13) compared to direct-sales. As a result, reported EBITDA margin dropped to 23.1% in 1Q14 from 32.2% in 1Q13. Should margins remain this low on a sustainable basis, there is likely negative pressure on Volcan's current Baa3 rating level.

OPERATING CHALLENGES EXPECTED AS THE INDUSTRY GOES THROUGH A DOWNCYCLE

Recent operating performance continues to be mainly impacted by the lower metal price environment that is partly due to slower growth rates in most countries, especially China, combined with oversupply in some categories.

During 2013, unit costs increased due to the suspension of production of the Raul Rojas Open Pit at Cerro de Pasco. Important cost reductions can be observed when comparing 1Q13 and 1Q14 results. The reduction in operating cost comes from reduced fixed costs at Cerro de Pasco, a company-wide cost-reduction program implemented in April 2013 and increased capacity at several plants as a result of expansion investments.

Despite cost improvements and efficiency gains, margins remained under pressure during 1Q14 due to the delay in additional production from the new oxide plant at Cerro de Pasco and the new unit Alpamarca-Rio Pallanga. The fall in the price of silver and the increase in the lower-margin trading business also contributed to decreasing margins.

BALANCING GROWTH STRATEGY AND LEVERAGE WILL BE KEY FOR MAINTAINING IT´s RATING

Volcan's long-term strategy, driven by metal diversification and operational efficiency, is defined in three main pillars: improvement in the production level of its current mining operations, development of exploration projects within the nearly 350,000 hectares of mining concessions it owns and acquisition of new projects and mining units. The production-improvement pillar is centered in the development of its new (fourth) mining unit, Alpamarca-Río Pallanga, and a new oxide-treatment plant, Cerro de Pasco, which are expected to improve Volcan's cash generation capacity over 2014 and add to its metal-production capacity of silver, zinc, lead and copper. Volcan's total capex projects for the next two years are earmarked at around USD 600 million, but with 2014 being more capital intensive than 2015.

Volcan's ratings also reflect our expectations that the company will follow prudent financial policies under a challenging price scenario. During 2008 - 2009, when lower global metal prices pushed revenues down, the company maintained a balanced financial approach with both shareholders and creditors by paying dividends but also reducing debt. For LTM ended March 31st, 2014, the company's reported leverage measured by the debt / EBITDA ratio was 2.1x, higher than historical levels. Considering that Volcan's two large capital expenditure projects were completed in 2014 and will be fully operational, we anticipate that leverage should come down again in 2015.

RESERVE POSITION AIDED BY VALUABLE EXPLORATION PROPERTIES AND EXPANSION PROJECTS

Volcan has a reserve position of approximately 11.5 years at 2013 production levels. However, the company holds significant exploration properties in mineral rich locations and we expect its reserve position to improve over time as it continues its exploration activities and strategic investments.

Exploration projects comprise ongoing economic viability studies at Cerro de Pasco, a rich polymetallic reserve unit, five brownfield explorations and two greenfield explorations, distributed along the existing mining units (Yauli, Chungar and Cerro de Pasco) and prospective mining sites (Lima and Alpamarca).

The brownfield operations are Zoraida and Oyama (Yauli), Islay (Chungar), Rio Pallanga and Carhuacayán (Alpamarca). Besides, the high-potential ongoing greenfield projects are Palma (Lima) and Carhuacayán Porphyry (Alpamarca).

New acquisitions may be analyzed in the context of maintaining its leadership in zinc, silver and lead markets, while improving its positioning as a copper and gold producer, but will be treated in a selective manner, given the main goals of improving cash generation and margins, as well as cost savings in a difficult and declining metal price environment.

POLITICAL LANDSCAPE SURROUNDING PERUVIAN'S MINING SECTOR IS LESS UNCERTAIN

President's Humala administration has been keen to ensure that mining projects move forward as it views the sector as one of Peru's main drivers of economic growth and essential for the goal of increasing social programs. Early during this administration, a new mining royalties act was put in place. The act increased the government's revenue take, but was deemed reasonable by the mining industry, as it followed a consultation process.

However, there have been major social conflicts that resulted in delays of mining projects such as Southern Copper's (Baa2 stable) Tia Maria , and Newmont's (Baa1 stable) Conga. Moreover, these conflicts have prompted reshuffling in the President's cabinet. Currently, although the government still faces challenges to address these social conflicts, we consider that there is a lower political event risk in Peru than before. Our view is based on our expectations that Humala's administration will remain committed to prudent fiscal and macroeconomic policies and to supporting the continued development of the mining industry. Additionally, we consider that Volcan's geographic footprint also offsets political risk, since it operates in the central highlands of Peru, a region with a strong mining tradition. Because of the extreme altitude, economic development is challenging, mining is the main engine of growth in this remote region. Most of the recent social conflicts have taken place in the Northern and Southern regions, where mining competes with agriculture, for instance.

Liquidity Profile

Volcan's liquidity is currently tight with only USD 56 million of cash and cash equivalent at March 31, 2014, but should improve as two of its major projects (Oxides and Alpamarca) were concluded in 2014 and are lower-cost units that should help overall margins going forward. The company raised USD 600 million from global bonds issued in January 2012 and due in 2022, which represent the bulk of its outstanding debt. Over the next 12 months, cash on hand and cash from operations are expected to be enough to cover working capital, capex, dividends and immaterial short-term debt.

Moreover, cash generation should strengthen as Volcan's capex needs are gradually reduced and the new projects that are lower cost are fully operational. We expect the company to maintain a minimum amount of cash on hands of USD 100 million for operating purposes.

Rating Outlook

The stable outlook is based on our view that zinc, copper, lead and silver prices, while expected to be lower than historical level averages, will nonetheless remain at levels that would generate good earnings and cash flow and support the increased investment amounts. The outlook also assumes that, should prices retreat further than anticipated, the company will make the necessary adjustments in its capital spending to maintain its financial profile.

What Could Change the Rating - Up

Upward rating movement is limited due to the company's moderate reserve position and revenue size. To the extent that the company is able to successfully complete planned developments, further diversifying its metal revenue base and enhancing its reserves, the outlook or rating could be positively impacted. In addition, should the company be able to maintain its free cash flow to debt ratio at 8% or better, the ratings could be favorably impacted.

What Could Change the Rating - Down

Ratings could be negatively impacted if profitability and cash generation capacity materially deteriorates, for example, due to a combination of a drop in metals prices and increase in production costs significantly exceeding our expectations, with negative impact on liquidity and on interest coverage metrics. Specifically, if EBIT margin falls towards a 15%-20% range with cash generation being negative on a sustained basis, ratings could be downgraded. Negative pressure could also result from material debt financed acquisitions.

Other Considerations

Volcan's grid-indicated rating from Moody's global mining industry methodology maps to the "A3" rating category for the three-year period ending December 31, 2013. This is driven by the strength in metal prices during this time frame and the absence of any material debt amounts in the capital structure for most of this period. However, the rating captures the increased debt profile and debt service requirementsand overall future expectations.

Rating Factors

Volcan Compañía Minera S.A.A. y Subsidiarias

Mining Industry Grid [1][2]	**Current FY 12/31/2013**		**Moody's 12-18 Month Forward View**	
Factor 1 : Reserves (8%)	**Measure**	**Score**	**Measure**	**Score**
a) Reserves (Years)	11.5	Ba	11.5	Ba
Factor 2: Cost Efficiency & Profitability (17%)				
a) Mining EBIT Margin (3-year Average)	32.7%	Aaa	30 - 22.5%	Aa
b) Return on Average Tangible Assets (3-year Average)	23.8%	Aaa	10 - 5%	Baa
Factor 3: Financial Policies (17%)				
a) Debt / Book Capitalization	30.8%	A	20 - 30%	Aa
b) Debt / Mining EBITDA (3-year Average)	1.0x	Aaa	1.25 - 1.75x	Aa
Factor 4: Financial Strength (25%)				
a) Mining EBIT / Interest (3 year Average)	17.2x	Aaa	12 - 9x	Aa
b) FCF / Debt (3-year Average)	-4.7%	Caa	< 0%	Caa
c) (CFO - Dividends) / Debt (3-year Average)	48.6%	Aa	50 - 40%	Aa
Factor 5: Business Diversity & Size (33%)				
a) Business Diversity Score	3	Baa	3	Baa
b) Net Consolidated Sales (USD billions)	$1.2	Ba	$1 - 0.5	B
Factor 6: "Other" Liabilities Adjustments				
a) "Other" Liabilities to Book Equity	0.0%	Aaa	0%	Aaa
Rating:				

Indicated Rating from Grid Factors 1-5		A3		Baa2
Notch Adjustment from Factor 6	0.0	0.0	0.0	0.0
a) Indicated Rating from Grid		A3		Baa2
b) Actual Rating Assigned		Baa3		Baa3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2013; Source: Moody's Financial Metrics

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