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

Global Credit Research - 11 Feb 2015

Peru

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba1
Senior Unsecured	Ba1

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Key Indicators

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

	9/30/2014(L)	12/31/2013	12/31/2012	12/31/2011	12/31/2010
Revenues (USD Billion)	$1.1	$1.2	$1.2	$1.2	$1.0
EBIT Margin	12.6%	24.1%	31.3%	42.5%	44.5%
Return on Average Tangible Assets	6.8%	13.9%	23.5%	39.8%	34.0%
EBIT / Interest Expense	4.0x	9.7x	10.4x	152.2x	110.8x
Debt / EBITDA	3.0x	1.8x	1.4x	0.1x	0.1x
Debt / Total Capital	33.5%	30.8%	31.5%	4.3%	3.4%
(CFO - Dividends) / Debt	28.1%	29.6%	22.8%	575.5%	647.8%

[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 globally

- Falling base and precious metal prices pressuring margins and cash generation

- Reduced capex going forward following completion of two major projects

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

- Narrow liquidity and higher leverage

Corporate Profile

Volcan is a Peruvian mining company with exploration, mining, concentrating and commercial operations. It primarily produces zinc and lead concentrate and some copper concentrate, all with high silver content. The company operates through four operational complexes with a total of 10 mines, 7 concentrate plants and one leaching plant for silver oxides production. All of Volcan´s operations are located in Peru (A3 stable) and, for the twelve months ended September 2014, it had revenues of USD 1.1 billion. During this period, silver represented 43% of total sales, zinc 40%, lead 12% and copper 4%.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 Ba1 corporate family ratings reflect Volcan's competitive cost position, which should support acceptable credit metrics and cash flow from operations even in a moderating metal prices environment. The company´s operational diversity in terms of number of metals produced, mines, complexes and concentrators, as well as its position as a leading producer of zinc, silver and lead globally, are additional credit positives.

Constraining the company's ratings are its narrow liquidity position and negative free cash flow due to a combination of lower base and precious metal prices and high capex to expand production. Volcan's low geographic diversity and its relatively modest reserve and revenue size, as compared to global peers, are further considerations.

DETAILED RATING CONSIDERATIONS

DIVERSITY OF METALS AND MINES SUPPORTS ITS CREDIT PROFILE

Volcan is the leading producer of zinc, silver and lead 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. In the first 9M14, Volcan's sales per metal (excluding third-party fines) were distributed as follows: zinc (48%); silver (40%); lead (10%) and copper (2%).

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.

LOWER BASE AND PRECIOUS METAL PRICES PRESSURING MARGINS AND CASH GENERATION

Volcan has in the past enjoyed relatively higher margins compared to its local and global peers, mainly due to its overall low-cost production position. However, as prices for base and precious metals have softened in the last years, margins have deteriorated to levels not commensurate with the Baa3 rating category. Even though average LME prices for zinc of USD 1,948/ton during 2014 (until September) were above 2012 levels, average silver prices of USD 19.9/oz represent a drop of over 36% in the period, and remain at even lower levels of USD 17/oz. As a consequence, the company's EBIT margin (as defined by Moody's) fell to 12.6% during the LTM ended September 30, 2014, which compares to 31.3% in 2012.

Important cost reductions were observed through 2014 results, with unitary production costs falling 6% during 9M14 in comparison to the previous year. 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. FX depreciation also supports lower operating costs, as about 40% of costs are in local currency.

Despite cost improvements and efficiency gains, margins remained under pressure during 2014 due to falling silver prices and higher sales of low-margin third-party fines, and to a lesser extent the delay in additional production from the new oxide plant at Cerro de Pasco.

LOWER CAPEX GOING FORWARD TO EASE PRESSURE ON CASH FLOW

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 currently centered in its new (fourth) mining unit, Alpamarca-Río Pallanga (started-up in 2Q14), and a new oxide-treatment plant at Cerro de Pasco (recently started operations), which are expected to improve Volcan's production profile as it add to its metal-production capacity of silver, zinc, lead and copper. As a result of the projects' completion, capital spending will be mostly limited to sustaining expenditures until 2017, when development of its West Wall unit is set to begin. The increased production will also decrease the relative share of lower margin, more volatile sales of third-party fines, which are expected to diminish from 2015 onwards.

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 the LTM ended September 30, 2014, the company's leverage as measured by adjusted debt / EBITDA ratio was 3.0x, which compares to 1.8x at FY'13. We expect leverage to remain high as the benefits arising from Volcan's two recently completed large capital expenditure projects should only partially offset the softer pricing environment for base and precious metals (particularly silver).

RESERVE POSITION AIDED BY VALUABLE EXPLORATION PROPERTIES AND EXPANSION PROJECTS

Volcan has a reserve position of approximately 9 years at 2014 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 key brownfield operations are Islay (Chungar) and Rio Pallanga, currently under development; Zoraida and Oyama (Yauli), and Carhuacayán (Alpamarca), in feasibility study stage. 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 (Baa2 negative) and Buenaventura's (Baa3 stable) Conga project. Moreover, these conflicts have prompted reshuffling in the President's cabinet. 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, and 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. Although the regional elections held in October 2014 brought changes to the ruling parties in the regions of Junin and Pasco - where Volcan's mining sites are located - no significant changes in policies are expected.

Liquidity Profile

Volcan's liquidity is currently tight with USD 116 million of cash and cash equivalent at September 30, 2014, which covers its short-term debt of USD 228 million by only 51%. Apart from short-term maturities, debt profile is quite comfortable as the bonds due 2022 represent 74% of total debt.

Moreover, cash generation should remain at acceptable levels as Volcan's capex needs are reduced going forward, dividend payments are prudently managed and the new lower-cost projects contribute further to earnings. 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 continue to be pressured by weakening global macroeconomic growth indicators, will nonetheless remains at levels above Volcan's cash costs, and that Volcan will benefit from higher volumes coming from the recently completed investments. The outlook also assumes that should prices retreat further, the company will make the necessary adjustments in its capital spending to maintain its financial profile.

What Could Change the Rating - Up

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 a good liquidity position, reduce its reliance on short term debt and maintain interest coverage (measured by EBIT to Interest Expense) metrics of 4x 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 5%-8% 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 "Baa3" rating category for the three-year period ending September 30, 2014. This is driven by its high profitability given the strength in metal prices during this time frame, which should decrease going forward as lower margins in light of more depressed zinc and silver prices, as well as lower leverage and coverage metrics, are fully factored into the grid metrics.

Rating Factors

Volcan Compañía Minera S.A.A. y Subsidiarias

Mining Industry Grid [1][2]	**Current LTM 9/30/2014**		**[3]Moody's 12-18 Month Forward ViewAs of 2/5/2015**	
Factor 1 : Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Revenues (USD Billion)	$1.1	Caa	$0.9 - $1.1	Caa
Factor 2 : Business Profile (20%)				
a) Business Profile	Ba	Ba	Ba	Ba
Factor 3 : Profitability and Efficiency (15%)				
a) EBIT Margin (3 Year Avg)	24.1%	Aa	10% - 15%	Baa
b) Return on Average Tangible Assets (3 Year Avg)	15.3%	A	4% - 6%	Ba
Factor 4 : Leverage and Coverage (35%)				
a) EBIT / Interest Expense (3 Year Avg)	8.9x	A	2x - 5x	Ba
b) Debt / EBITDA (3 Year Avg)	1.9x	A	2.5x - 3.5x	Ba
c) Debt / Total Capital	33.5%	A	30% - 35%	A
d) (CFO - Dividends) / Debt (3 Year Avg)	27.4%	Baa	10% - 20%	Ba
Factor 5 : Financial Policy (10%)				
a) Financial Policy	Ba	Ba	Ba	Ba
Rating:				

a) Indicated Rating from Grid		Baa3		Ba3
b) Actual Rating Assigned		Ba1		Ba1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 9/30/2014(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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