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

Global Credit Research - 24 Feb 2016

Peru

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	B2
Senior Unsecured	B2

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Key Indicators

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

	9/30/2015(L)	12/31/2014	12/31/2013	12/31/2012	12/31/2011
Revenues (USD Billion)	$0.9	$1.0	$1.2	$1.2	$1.2
EBIT Margin	16.8%	18.3%	24.0%	31.2%	41.4%
Return on Average Tangible Assets	6.0%	8.7%	13.8%	23.5%	42.4%
EBIT / Interest Expense	3.6x	6.4x	13.5x	10.7x	208.3x
Debt / EBITDA	2.5x	2.4x	1.8x	1.4x	0.1x
Debt / Total Capital	33.4%	33.3%	30.9%	31.5%	4.3%
(CFO - Dividends) / Debt	25.6%	19.7%	27.8%	22.8%	575.5%

[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

? Falling commodities prices pressuring revenues, margins and cash flow generation

? Leading producer of zinc, lead and silver globally

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

? Cash position supports liquidity in the near term

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 12 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 full year 2015, it had revenues of USD 795 million. 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 B2 ratings reflect Volcan's competitive cost position, good mine diversity, its operational diversity in terms of number of metals produced, mines, complexes and concentrators and the company's position as a leading producer of zinc, silver and lead globally.

Constraining the company's ratings are its narrow liquidity position to cover its short-term debt and negative free cash flow due to a combination of lower base and precious metal prices and high capex spent in the past years to expand production. Volcan's low geographic diversity and its relatively modest 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 full year 2015, Volcan's sales per metal (including third-party fines) were distributed as follows: zinc (49%); silver (40%); lead (8%), copper and gold (3%).

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 12 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. Not only average LME prices for zinc of USD 1,938/ton in 2015 decreased 11% compared with previous year, but also average silver prices of USD 15.71/oz represent a drop of 18% in the period, and remaining at even lower levels of USD14-USD 15/oz. As a consequence, the company's EBIT margin (as defined by Moody's) fell to 12% during 1H2015 and deteriorated further in the 3Q15 (-4.3%). Although 4Q15 results already brought a recovery, pressure on margins should continue through 2016. Important cost reductions were observed through 2015, with unitary production costs falling 16% in comparison to the previous year. The reduction in operating cost comes from a continued cost reduction program in all of mine units, which allowed for optimization of raw material consumption, energy usage and other expenses. FX depreciation also supports lower operating costs, as about 40% of costs are in local currency.

RESERVE POSITION AIDED BY VALUABLE EXPLORATION PROPERTIES AND EXPANSION PROJECTS

Volcan has a reserve position of approximately 8 years at 2015 production levels. However, the company holds significant exploration properties in mineral rich locations and there is a high potential to improve over time as long as the company continues its exploration activities and strategic investments.

Exploration projects comprise ongoing economic viability studies at Cerro de Pasco, a rich polymetallic reserve unit, four brownfield explorations and four greenfield explorations, distributed along the existing mining units (Yauli, Chungar and Cerro de Pasco, Alpamarca). However, expansions will be analyzed in a selective manner under current market conditions. The company completed its expansion projects, which include the new mining unit, Alpamarca-Río Pallanga (started-up in 2Q14), and a new oxide-treatment plant at Cerro de Pasco. As a result, capital spending in the next couple of years will be mostly limited to sustaining expenditures. As part of its strategy, Volcan reduced third-party sales of concentrate (volumes decreased 56% through 2015 if compared to previous year).

POLITICAL LANDSCAPE SURROUNDING PERUVIAN'S MINING SECTOR IS UNCERTAIN

In Peru presidential elections are scheduled for April 10, 2016 and the front-runner candidate is Keiko Fujimori, followed by Pedro Pablo Kuczynski and Cesar Acuña. Giving that all the leading candidates prioritize the Peruvian's GDP growth and are all focused on attracting new investment to the country, we expect no increase in political risk.

For the mining sector, no significant changes in policies are expected. As mining is an important engine of growth for Peru, our view is that the new president will be committed to supporting the continued development of the industry. Still, social conflicts will likely continue to happen. There have been major social conflicts last year that resulted in delays of mining projects such as Southern Copper's (Baa2 RUR-Down) Tia Maria, and Newmont's (Baa2 RUR-Down) and Buenaventura's (Ba1 RUR-Down) Conga project

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, and most of the social conflicts have taken place in the Northern and Southern regions, where mining competes with agriculture.

Liquidity Profile

Volcan's liquidity is currently tight with USD 192 million of cash and cash equivalent at December 31, 2015, which covers its short-term debt of USD 199 million by 96%%. Apart from short-term maturities, debt profile is quite comfortable as the bonds due 2022 represent 71% of total debt.

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. However, liquidity risk may increase should prices further deteriorate. 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 remain 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

A near-term upward rating movement is unlikely, given the magnitude of the market downturn, and would require Volcan to improve liquidity cushion and interest coverage metrics to levels of at least 2x on a sustained basis.

What Could Change the Rating - Down

Ratings could be negatively impacted if profitability and cash flow from operations materially weaken. A marked deterioration in the company's liquidity position could also precipitate a downgrade. Specifically, if EBIT margin falls below 3.5%, with negative free cash flow, ratings could be downgraded. Negative pressure could also result from increase in debt levels leading to Total Debt to EBITDA above 5x on a sustained basis.

Other Considerations

Volcan's grid-indicated rating from Moody's global mining industry methodology maps to the "Ba1" rating category for the three-year period ending September 30, 2015. This is driven by its good 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 coverage and high leverage 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 9/30/2015**		[3]**Moody's 12-18 Month Forward ViewAs of 2/20/2016**	
Factor 1 : Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Revenues (USD Billion)	$0.9	Caa	$0.5 - $0.8	Ca

Factor 2 : Business Profile (20%)				
a) Business Profile	Ba	Ba	Ba	Ba
Factor 3 : Profitability and Efficiency (15%)				
a) EBIT Margin (3 Year Avg)	19.2%	A	13% - 16%	A
b) Return on Average Tangible Assets (3 Year Avg)	9.4%	Baa	5% - 8%	Ba
Factor 4 : Leverage and Coverage (35%)				
a) EBIT / Interest Expense (3 Year Avg)	6.6x	Baa	2.5x - 4x	Ba
b) Debt / EBITDA (3 Year Avg)	2.2x	Baa	2x - 3x	Baa
c) Debt / Total Capital	33.4%	A	30% - 35%	A
d) (CFO - Dividends) / Debt (3 Year Avg)	24.8%	Ba	15% - 21%	Ba
Factor 5 : Financial Policy (10%)				
a) Financial Policy	Ba	Ba	Ba	Ba
Rating:				
a) Indicated Rating from Grid		Ba1		Ba2
b) Actual Rating Assigned		B2		B2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 9/30/2015(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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