



Fitch Affirms Volcan's IDR at 'BBB-'; Outlook Negative Ratings Endorsement Policy

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Fitch Ratings-Chicago-17 December 2014: Fitch Ratings has affirmed the long-term foreign and local currency Issuer Default Rating (IDRs) of Volcan Compania Minera S.A.A. (Volcan) at 'BBB-'. Fitch has also affirmed the 'BBB-' rating on the company's USD600 million senior unsecured 5.375% notes due 2022. The Rating Outlook is Negative.

KEY RATING DRIVERS:

Deteriorating Long-Term Credit Metrics Drive Negative Outlook

Volcan's Negative Outlook reflects weaker than expected financial performance and corresponding deterioration in credit metrics. This is a result of the company's increased product concentration on silver at a time of lower silver prices exacerbating higher average costs due to lower production at its Cerro de Pasco unit. The positive momentum in zinc prices, currently at around USD2,200 per metric ton, have not been able to fully offset the decline in silver prices, currently around USD16-17/oz. These events are reflected in the company's EBITDA margin, declining to around 24%-25% during 2014 and 2013, compared to around 40%-50% historically.

These factors have increased Volcan's through-the-cycle net leverage ratios higher than previously projected by Fitch. The end of the current investment cycle should alleviate cash flow pressure in 2015, when the company is projected to return to positive free cash flow (FCF) generation following three years of large investments, but is expected to be negative in 2016 and 2017 as a result of the company's polymetallic investment project. Fitch's revised expectations include that Volcan maintains a net debt-to-EBITDA ratio of 2x or below through the commodity price cycle and that it generates positive FCF on average, with the potential for temporary FCF outflows due to capital spending on identified projects. A rating downgrade could follow should Volcan not deliver on its new production volumes and achieve these financial targets within the next 12-24 months.

Lower Profit Margins in 2014; Costs to Decrease

Higher operating costs and lower commodity prices are currently affecting the profitability of all companies in the sector and Volcan's cost structure was additionally affected by the production decline at the Cerro de Pasco unit and the increase of low-margin third-party concentrates sales. As a percentage of total sales, third-party concentrates increased their share to 25% during the nine months to Sept. 30, 2014 from 14% during the same period in 2013. The company's third-party concentrate sales are expected to wind down in 2015 due to current low prices and the focus on internal production.

Fitch expects Volcan to exhibit a lower cost of production once its investment programs conclude in 2015, alongside continued efforts on savings and cost reductions, including its goal to become 100% energy self-sufficient to achieve a recovery in profit margins by 2016. Fitch's revenue and EBITDA base case expectations for 2015 are around USD1 billion and USD270 million-USD300 million, respectively. EBITDA for the LTM Sept. 30, 2014 decreased to USD254 million from USD270 million in 2013 and USD460 million in 2012. EBITDA margins dropped to 24%, below 25% in 2013, and significantly lower than 50% achieved on average during 2010 and 2011, both years of high commodity prices.

Deleveraging Expected

Fitch expects Volcan to deleverage from current elevated debt ratio levels post-2015 when the company's EBITDA generation improves in accordance with its expansion plans, with a net debt-to-EBITDA ratio of 2x or

below during the mid-cycle. Volcan has a good track record of making early prepayments of debt and holding a comfortable cash position to maintain strong liquidity. As of Sept. 30, 2014, Volcan's cash and marketable securities was USD116 million while short-term debt was USD228 million, mainly comprised of short-term revolving credit lines for working capital purposes that are continuously repaid or rolled over.

Volcan has low refinancing risk with its next material debt maturity falling due in 2022 when its senior unsecured notes are due. The company held a net debt-neutral or positive cash after debt position prior to its February 2012 issuance of USD600 million 5.375% notes due 2022. Net debt-to-EBITDA increased to 2.8x at LTM Sept. 30, 2014 from 0.3x at December 2012. For the LTM Sept. 30, 2014, Volcan's funds from operations (FFO) adjusted leverage was 2.8x, above the respective 2013 and 2012 ratios of 2.5x and 2x.

FCF Remains Negative Due to Expansionary Capex

Volcan's large investment program to expand production has totalled approximately USD1.3 billion since 2012 and is close to reaching its conclusion, with total capex of USD390 million in 2012, USD605 million in 2013 and around USD345 million expected during 2014. The two main growth projects are the Silver Oxides plant at Cerro de Pasco and the new Alpamarca-Rio Pallanga Unit projects. These projects have been completed with the Alpamarca-Rio Pallanga unit starting operations in May 2014, while the Silver Oxides plant is in its operational-adjustment stage.

Both projects should add zinc and lead and jointly contribute approximately 8 million ounces of silver per year. As a result, capex for 2015 should fall to around a USD200 million maintenance level, but is expected to increase again during 2016 and 2017 due to Volcan's copper growth strategy through the low-cost polymetallic project at Cerro de Pasco's west face of its Raul Rojas open-pit mine. Fitch's Base Case indicates negative FCF generation for 2016 and 2017 of around USD65 million in 2016 and USD50 million in 2017, as a result of this more modest investment of around USD250 million in total. Successful completion of this project should lead to copper comprising approximately 10% of sales.

Polymetal Diversification

Volcan's operations are located in Peru (Fitch LT IDR of 'BBB+'/'Stable Outlook'), a country of vast mineral resources with a favorable mining jurisdiction. Volcan's revenues are diversified over 10 mining operations, seven concentrator plants and one lixiviation plant spread across the Cerro de Pasco, Yauli, Chungar and Alpamarca regions of the Peruvian Central Highlands. According to Thomson Reuters GFMS, the company ranks as the sixth largest zinc producer and seventh largest silver producer globally.

Volcan's revenues excluding hedging income for the LTM Sept. 30, 2014 reached USD1 billion, a similar level to 2013. Volcan's 3Q'14 revenues are diversified into zinc 52%, silver 36%, lead 8%, copper 3% and gold 1%. This breakdown differs from the distribution shown in 3Q'13 when zinc accounted for 45% and silver for 41%. The variation is mainly explained by the year-on-year 14% decline in silver prices and 23% increase in the zinc price, although silver production increased by 7% while zinc increased by only 0.6%. As a result of the dramatic fall in silver price and favorable expectations for zinc, Volcan is now focused on increasing zinc production up to 300 thousand Fine metric tons. Volcan's medium-term strategy is to diversify into copper and gold, although the contribution expected from these metals will be lower and materialize significantly later than originally anticipated.

RATING SENSITIVITIES:

Volcan's track record of delivering upon its previously stated project execution plans has not been as consistent as those of similarly rated mining peers. This has been due to a variety of reasons, such as ore grades being lower than originally anticipated and uneconomical to develop at current prices. As a result, the company has not met Fitch's prior base case leverage targets, which has resulted in the Negative Outlook. Volcan has finalized its significant capex program with additional volumes expected to materialize within the next 12 to 24 months. Should the new volumes fail to materialize as planned, with consistently negative FCF and sustained net debt-to-EBITDA elevated above 2x, a downgrade could follow. Low prices could also lead the company to lower dividends and/or decrease capex during 2015 and 2016 to strengthen its capital structure so that net leverage is at or below 2x by the end of 2016.

Substantial diversification of mines and revenues into other metals, combined with further geographical diversification and a lower consolidated cost of production, could lead Fitch to increase its leverage threshold for a 'BBB-' rating to around 2.5x for a Stable Outlook. An additional positive rating consideration would be an increased focus by the company on investor relations and market transparency, which would enhance its ability to attract capital market and other financing sources.

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Applicable Criteria and Related Research:

—'Corporate Rating Methodology' (May 28, 2014).

Applicable Criteria and Related Research:

Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage

Additional Disclosure

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