FITCH AFFIRMS VOLCAN'S RATINGS; OUTLOOK REVISED TO NEGATIVE

Fitch Ratings-Chicago-22 August 2019: Fitch Ratings has affirmed the Long-Term Foreign and Local Currency Issuer Default Rating (IDRs) of Volcan Compania Minera S.A.A. at 'BBB-'. In addition, Fitch has affirmed the 'BBB-' rating on the company's USD600 million senior unsecured 5.375% notes due 2022. The Rating Outlook has been revised to Negative from Stable.

Volcan's Negative Outlook reflects the company's failure to reduce its high debt balance relative to its cash flow generation through asset sales or other measures during the top of the zinc market in 2017 and 2018 as initially expected. Fitch expects zinc prices to decline further from its $2,692/t average through July 2019 to $2,300/t in 2020 and $2,200/t in 2021, which will further strain Volcan's capital structure.

The company's willingness and ability to reduce its net debt balance to around USD450 million compared to USD770 million as of June 30, 2019, and lessening its reliance on short-term debt, are keys to alleviating pressure on its credit profile. This level of debt reduction would decrease the company's leverage from 3.3x as of June 30, 2019 to below 2.0x. Volcan has potential asset sales through its investment in Cementos Polpaico, which could generate around USD70 million, in addition to some of its hydroelectric assets. An inability to reduce net debt balance to around USD450 million over the next 12 months could result in a downgrade.

Volcan's investment-grade rating is supported by its operations in Peru (BBB+/Stable), a country of vast mineral resources and a favorable mining jurisdictions. Volcan's 'BBB-' rating reflects its diversified revenues from five mining units encompassing eight mines in operation, seven concentrator plants and one lixiviation plant (Ag oxides) across the Central Andes region. Volcan ranks as Peru's leading lead producer, second-largest zinc producer, and third-largest silver producer. A positive credit consideration is Glencore Plc's majority voting right ownership in Volcan, due to Glencore's large scale in the zinc market and ability to influence prices by curtailing its other, higher cost zinc operations during times of supressed prices.

KEY RATING DRIVERS

Polymetallic Diversification; Moderate Scale: Volcan's ratings benefit from the company's mineral production profile concentrated toward zinc and silver, which compares favorably with single-commodity mineral producers. Volcan's sales by metal as of second-quarter 2019 were 56% zinc, 26% silver, 12% lead, 4% gold, and 2% copper. Fitch considers Volcan's scale to be moderate, as it has lower economies of scale than larger miners that generate more than USD1.0 billion of EBITDA annually. Over 50% of Volcan's revenues are derived from its Yauli operations, which consists of four underground mines and three concentrator plants.

Elevated Credit Metrics: Absent asset sales or additional equity, Fitch projects Volcan to report net debt/EBITDA of 3.4x for 2019 and 3.2x for 2020, primarily due to a softer commodity price environment. These ratios are above Fitch's financial negative rating trigger of 2.5x. Volcan's earnings are highly sensitive to zinc, lead, silver, and copper prices, which can cause volatility in cash flow generation and fluctuations in capital structure, reinforcing the importance of a low cost of production. If Volcan can reduce its net debt amount to USD450 million, its 2020 projected Net Debt / EBITDA ratio would be 2.0x if zinc prices average USD2,300/t.

Modest Cost Position: The company's consolidated operations exhibited a reasonable cost positions with a C1 cash cost of USD1,490/metric ton (MT) for zinc during 2018, which falls in the third quartile of the global zinc cost curve. Volcan's cash cost position is well below CRU's 90th percentile cash cost of around USD2,200/MT projected for 2019, which is where prices are expected to gravitate towards, due to higher global supply over the projected period. This allows Volcan to generate sound cash flow during periods of lower prices, absent significant capex and dividend payments. The company also generates material levels of cash flow from its by-products. Volcan has experienced a unit cost decrease of over 39% since 1Q13 across its operations through a focus on cost cutting initiatives.

Glencore Ownership Credit Positive: Fitch views Glencore PLC 55% ownership of Volcan's class A voting right shares as a positive credit consideration for the company, due to Glencore's global scale and stronger negotiating power. Glencore has been a shareholder in the company since 2004, and now holds 24% of the company, considering both common A and common B shares. The change in ownership has brought Volcan technical support, due to Glencore's global mining expertise, and the potential for financial support for large investment projects. Fitch's projections exclude any tangible support Volcan receives in order to improve its capital structure. If this support is forthcoming, it could lead to a stabilization of Volcan's ratings.

Weaker Free Cash Flow Generation: Fitch projects Volcan's FCF generation to be negative USD10 million during 2019 and to be relatively neutral during 2020, as weaker zinc prices will restrict cash flow growth. Based on Fitch's mid-cycle commodity zinc price of $2,300/t for 2019 and $2,200/t for 2020, Volcan will generate around USD212 million of EBITDA in 2019 and USD235 million in 2020. Should zinc prices remain flat at around $2,600/t through 2019, Fitch projects Volcan's EBITDA will be around USD245 million. Upcoming capital expenditures are expected to be around USD170 million in 2019 and USD190 million in 2020. Volcan plans to spend around USD10 million - USD15 million during 2020 on its Romina project, which is located near its Alpamarca operations. Capital allocations overall should remain low, with minimal dividends over the investment cycle, allowing FCF to return to neutral over the coming years.

Low Life of Mine: Volcan's eight years of mine life at current production rates is low compared to Fitch's mining Navigator rating factors, and is considered a constraint on the company's rating. Inclusive of reserves and inferred resources, Volcan's life of mine would be 19 years. Furthermore, Volcan owns 344,000 hectares of concessions across a region of significant geological reserves. The company is only exploiting 18% of its concessions, with a further 13% being explored. As of Dec. 31, 2018, Volcan had over 50 million metric tons of proven and probable reserves and over 294 million metric tons of additional resources (measured, indicated, and inferred).
ESG CommentaryRAC if Applicable
Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

DERIVATION SUMMARY

Volcan's investment grade rating reflects its position as the leading lead producer, second-largest zinc producer, and third-largest silver producer in Peru, a country of vast mineral resources and favorable mining regulations. Volcan benefits from a fairly diversified production of base and precious metals, similar to peers BVN and Nexa, and is more diversified than Minsur. The company's scale of operations is larger than Nexa Resources Peru S.A. (NexaPeru: BBB-/Stable) and Minsur (BBB-/Negative), yet considerably smaller than higher rated miners Industrias PEnoles S.A.B de C.V. (BBB/Stable) and Southern Copper Corporation (BBB+/Stable). Volcan has had historically weaker capital structure, as evidenced by its four-year Net Debt / EBITDA ratio of 2.4x, compared to its peer average of 2.1x.

The company's ratings continue to reflect a competitive cost position and moderate scale, with its Negative Outlook focused on its weakened capital structure and lower liquidity. Similar to peers, Volcan demonstrated a willingness and ability to reduce development and exploration expenditure during periods of lower commodity prices to preserve cash flow. The company's consolidated life of mine of eight years of reserves is also on the lower end, when compared to Peruvian and its global mining peers.

KEY ASSUMPTIONS

Fitch's Key Assumptions within Its Rating Case for the Issuer
--Average zinc price of USD2,400/tonne in 2019, and USD2,300/tonne in 2020 and USD2,200/tonne in 2021 and USD2,000 in 2022;
--Average silver price of USD16.50/ounce (oz) in 2019, USD15.00/oz in 2020 and USD15.30/oz in 2021 and USD16.60/oz in 2022;
--Lead prices at USD1,980/t in 2019, USD1,835/t in 2020, USD1,790/t in 2021, and USD1,895/t in 2022;
--Average copper price of USD6,400/tonne in 2019, USD6,500/tonne in 2019 and USD6,700/tonne in 2021; and USD7,000 in 2022;
--Average gold price of USD1,200/oz in 2019 and thereafter;
--Mineral treatment of 9.1 million tonnes in 2019 and 9.2 million tonnes in 2020 and 20121;
--Capex level of USD170 million in 2019, USD190 million in 2020 and USD200 million in 2021.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
--Fitch would stabilize Volcan's Outlook should the company reduce its total net debt to around USD450 million. This would allow the company to maintain its Net Debt / EBITDA through the cycle around 1.5x.
Developments That May, Individually or Collectively, Lead to Negative Rating Action
--Net Debt / EBITDA remaining above 2.0x over the next 12 months;
--Persistent negative FCF;
--Inability to replenish reserves and resources leading to a significantly lower mine life at key operations;
--An adverse change in the overall framework toward mining projects in Peru, and if taxes and royalties turn punitive.

LIQUIDITY

Weak Liquidity: Volcan's liquidity position is weak for an investment grade rated company. The company utilizes short-term revolving credit lines for working capital purposes that are continuously repaid or rolled over. Fitch expects the company to dial back on this strategy over the next several years in order to improve its financial flexibility, especially during times of weak operating cash flow. Volcan reported cash and equivalents of USD52 million, which compares poorly to short-term financial obligations of UDS242 million as of June 30, 2019.

Volcan's senior unsecured outstanding notes of USD535 million mature in February 2022. Fitch anticipates Volcan will focus on reducing its short-term debt exposure in addition to refinancing and partial prepaying its long-term obligations as the company focuses on liability management over the next 12-18 months.

FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings:
Volcan Compania Minera S.A.A.
--Long-Term Foreign Currency IDR at 'BBB-';
--Long-Term Local Currency IDR at 'BBB-';
--Senior unsecured long-term notes at 'BBB-'.

The Rating Outlook has been revised to Negative from Stable.

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Applicable Criteria
Corporate Rating Criteria (pub. 19 Feb 2019)
https://www.fitchratings.com/site/re/10062582