STANDARD &POOR'S | RATINGSDIRECT

Return to Regular Format

Research:
Corporacion Nacional del Cobre de Chile

Publication date: 24-May-2005
Primary Credit Analyst(s): Sergio Fuentes, Buenos Aires (54) 114-891-2131; sergio_fuentes@standardandpoors.com
Secondary Credit Analyst(s): Mariano Ingaramo, Buenos Aires (54) 114-891-2124; mariano_ingaramo@standardandpoors.com

ISSUER CREDIT RATING

Corporacion Nacional del Cobre de Chile	
Corporate Credit Rating	
Local currency	A+/Negative/--
Corporate Credit Rating	
Foreign currency	A/Stable/--

AFFIRMED RATING

Corporacion Nacional del Cobre de Chile	
Sr unsecd debt	
Foreign currency	A

Business profile:
Strong

Financial policy:
Aggressive

Debt maturities:
(Mil. US$--includes short-term debt and accrued interest)
2005 $117
2006 $300
2008 $300
2009 $600
2012 $600
2013 $500
2014 $500

Bank lines/Liquid assets:
Because of its top-tier position in the worldwide copper industry and its strategic importance for the Chilean Government, Codelco has very good access to the global and local financial markets. As is the common practice in Latin America, Codelco does not currently have committed lines of credit.

Collateralization:
Not meaningful

Corporate credit rating history:

	Local Currency	Foreign Currency
Jan. 14, 2004	--	A
Nov. 8, 2002	A+	A

Major Rating Factors

Strengths:

- Worldwide leading competitive position;
- Very low cost producer;
- Large and high-quality mining reserves;
- Integrated operations that include copper refining and smelting capabilities;
- Strong support from creditworthy parent (100% owned by the Republic of Chile); and
- Adequate debt maturity profile.

Weaknesses:

- Aggressive investment policy in the context of the high tax and dividend burden imposed by the Chilean government;
- Commodity type industry market; and
- Limited geographic and business diversification.

Rationale

The ratings on Corporacion Nacional del Cobre de Chile (Codelco) reflect the company's strong market position as the world's largest integrated copper mining company with ample high-grade copper ore reserves, a low cost structure, a well-diversified global client base, and the direct ownership and strategic importance to its 100% shareholder, the Republic of Chile (foreign currency 'A', local currency 'AA'). These strengths are partly balanced by the inherent cyclicality of the industry that results in volatile copper prices, a lack of geographic diversification on the production side with all operations located within Chile, and the high tax and dividend burden imposed by the Chilean government. These factors, together with Codelco's aggressive investment program, have resulted in growing debt levels not fully offset by increased cash flow.

Standard & Poor's rates Codelco according to our criteria for rating government-supported entities. As such, we assign a 'stand-alone' rating and then factor in credit for potential government support. Codelco's stand-alone creditworthiness has been deteriorating as a result of the weakening of the company's financial profile, but its ultimate rating has been supported by its strategic links to the government, including its 100% ownership and control by the Republic, its position as Chile's largest corporate employer, and its importance for the country. In 2004, Codelco represented about 5% of GDP, 20% of exports, and 15% of tax revenues. Furthermore, although Codelco's aggressive expansion strategy requires additional funding sources, in Standard & Poor's opinion privatization is unlikely. Thus, the company's close links with the government will continue to influence its credit quality.

Codelco is the world's largest integrated copper producer, accounting for approximately 12% of copper production worldwide, which is sold to a relatively well-diversified client base. The company's ample high-grade copper ore reserves account for approximately 20% of proven, probable, and possible global reserves worldwide. Although copper accounts for approximately 80%-90% of total sales, the company also benefits from its position as one of the largest worldwide producers of molybdenum. Codelco ranks among the world's lowest-cost copper producers, as evidenced by its cash production costs (C1) of about 40 cents per pound of copper (considering a conservative long-term credit from byproducts, mainly molybdenum). In addition, the main drivers for its strong competitive position are the large economies of scale and a continuous focus on increasing operating efficiencies. Although Standard & Poor's expects that Codelco's production costs will increase modestly during the next several years because of the slow natural decline in ore grade, we expect that the company's cost profile will remain in the lowest-cost quartile of the industry's cost curve worldwide.

During 2004, Codelco reported strong profitability, reflecting higher sales volume and the highly favorable pricing environment for copper and molybdenum. Codelco's revenues more than doubled year-on-year thanks to a 60% increase in the average realized price of copper to $1.30/lb. (LME) versus $0.81/lb. during 2003, coupled with higher physical sales of 43%, partly fueled by a reduction in copper inventory of about 200,000 tons. This environment favorably affected Codelco's EBITDA margin, which posted a record high of 49.6% in fiscal 2004 compared to 33.5% in 2003. However, given that Codelco's dividend policy is relatively fixed, Standard & Poor's adjusts the company's cash generation by deducting dividend payments from the company's funds from operations (FFO) in order to compare the company's cash generation capacity with its financial debt. Although traditional cash flow measures improved, Codelco's adjusted cash generation (FFO less dividends) to total debt decreased to a relatively weak 21.3% and 21.2% in fiscal 2003 and 2004, respectively, from 32.0% in 2002, mainly as a result of the 46.6% debt increase from December 2002 to December 2004.

Codelco's foreign currency rating is not higher than that of the sovereign, reflecting Standard & Poor's expectation that there is a high likelihood of the government of Chile interfering with Codelco's ability to service its debt under a sovereign default scenario.

Liquidity

Codelco's liquidity is adequate and benefits from the company's very good financial flexibility, which results from its solid credit strength and is evidenced by its fluid access to the global and local financial markets at very attractive interest rates. Codelco's liquidity is expected to remain adequate, based on the company's strong ownership and the flexibility to reduce, if necessary, its large capital expenditure plan. Codelco does not currently have committed lines of credit.

Codelco is fully in compliance with covenants--which are nonfinancial--included in its financing documents. In this sense, most of the company's long-term debt instruments contain, among other nonfinancial covenants, a change-of-control clause that provides for the acceleration of most of its debt upon the loss of majority ownership by the Chilean Republic.

Outlook

The stable outlook on Codelco's foreign currency corporate credit rating reflects that of the sovereign. The negative outlook on the local currency corporate credit rating reflects Standard & Poor´s expectation that the company's stand-alone financial profile is likely to deteriorate further in the next two to three years as a result of the company's aggressive business expansion strategy and high dividend distributions (100% payout), which in turn would result in a significant debt increase and weaker debt service coverage ratios. Specific government support actions such as reducing the dividend payout ratio, or a more moderate expansion strategy, will likely be required to maintain Codelco's local currency corporate credit rating at current levels. Standard & Poor's would lower Codelco's local currency corporate credit rating by one notch to 'A' if the company's adjusted cash generation to total debt falls to less than 20% and leverage (measured by total debt to total capitalization) exceeds 60% within the next two to three years. The change in Codelco's rating outlook does not reflect any change in Standard & Poor's view of the creditworthiness of the Republic of Chile.

Business Description

With a total production of 1.84 million metric tons of copper in 2004, Codelco is the world's largest copper producer, accounting for approximately 12% of worldwide copper production and about 20% of proven, probable, and inferred worldwide copper reserves. The company owns and operates four mine complexes in Chile (Codelco Norte, El Teniente, Andina, and Salvador), and has a 49% participation in 'El Abra' (a joint venture with the U.S. mining company Phelps Dodge Corp). In addition, Codelco is one of the largest worldwide producers of molybdenum, with a market share of about 20%.

Created in 1976 by Decree Law 1,350, Codelco is an autonomous company 100% owned by the Republic of Chile. The company's strategic importance to Chile and its high relevance to the country's GDP, exports, and fiscal revenues are key issues when considering parent support.

Business Profile

Codelco's strong business risk profile reflects the company's leading position in the worldwide copper sector, very low-cost operations, ample ore reserves, relatively high vertical integration, and strategic links to the Chilean Government. These strengths are partly offset by the company's exposure to the highly cyclical copper industry given by its business concentration.

Country risk

Codelco's operations are geographically concentrated in the Republic of Chile (foreign currency rating 'A', local currency rating 'AA'). Chile's high rating reflects its successful use of monetary, exchange-rate, and fiscal policies to reduce external vulnerability, increase economic flexibility, and sustain GDP growth. Rising standards of governance, a low public-debt burden, and a strong policy framework place Chile in the 'A' rated category of sovereigns. However, Chile's sovereign rating is constrained by a comparatively narrow economic base that leaves it vulnerable to sharp changes in the terms of trade and by the continued dependence of the private sector on external capital inflows. However, strong institutions, a favorable business climate, and prudent economic policies have helped Chile to largely avoid the volatility and economic disruption seen in other Latin American economies that rely upon commodity exports.

The Chilean economy is heavily dependent on copper production, which represented approximately 10% of the country's GDP and 50% of total exports (Codelco alone represented about 25% of total exports) in 2004, when copper prices reached a high historic level of US$1.30 per pound.

In addition, Codelco is the largest cash contributor to the Chilean Government representing about 15% of the Chilean public budget in 2004. Codelco is subject to a special tax and dividend regime, which includes, in addition to the regular 17% corporate tax applicable to private companies in Chile, a 10% tax on copper and related byproducts exports and a 40% special tax over its pretax earnings as a state-owned company. In addition, 100% of net income is commonly upstreamed to the Chilean Government as dividends, unless its retention is approved by decree.

Codeco's Board of Directors are appointed by the President of Republic of Chile and includes the Ministries of Mining and Finance. Standard & Poor's does not expect a change in ownership in the near term, which would have to be approved by Congress. A potential sell-off of a minority equity stake would trigger a revision of the level of parent support incorporated into Codelco's rating.

Industry characteristics

As a typical commodity industry, the copper sector is cyclical, reflecting the different growth nature of supply (new projects and mine reopenings, among others) and demand (related to the evolution of the worldwide economy).

Worldwide copper demand is concentrated mainly in the infrastructure and construction sectors, which are highly correlated with the evolution of each country's economic activity. The largest copper consumers are China (about 20% of worldwide demand), other Asian countries, and Western Europe and North America, which together account for about 85% of total worldwide demand. Supply is somewhat concentrated in Latin America in general, which represents about 45% of total worldwide production, and Chile in particular, which is the largest producer with about 35% of worldwide production (about 5.5 million metric tons per year). An additional 25% of worldwide production comes from copper mines located in North America, Asia, and Australia.

The combination of strong demand in China and the recovery of the U.S. and other Asian countries within a context of tight supply conditions resulted in very low inventory levels (about 125,000 metric tons as of December 2004) and significantly increased prices to an average of US$1.30 per pound in 2004 and about US$1.50 per pound in first-quarter 2005. Given current market conditions, Standard & Poor's expects copper prices to remain strong in 2005, although a downward adjustment in prices is likely to occur in the second half of the year driven by the estimated new production coming through this year coupled with the expectations of slightly lower demand growth. In 2005, total worldwide supply is projected to increase by more than one million metric tons based on expected higher production levels mainly from Freeport's mining operations in Indonesia (about 270 thousand metric tons), some mines reopening in the U.S. (240 thousand metric tons), the full-year operation of CVRD's Sossego new plant in Brazil (90 thousand metric tons), and Escondida in Chile (60 thousand metric tons) mainly from sulphide leaching plant.

Competitive strengths and operations

The company's strong market position derives from its standing as the world's largest copper producer and its large ore reserves. According to U.S. Geological Survey estimates, Codelco's proven, probable, and inferred reserves reach about 189 million metric tons and represent about 100 years of current production levels.

Codelco's cost structure is highly competitive on a worldwide basis, with an average production cash cost of about 40 cents per pound in 2004 (considering a conservative long-term credit from byproducts, mainly molybdenum). Although the expected natural decline in ore grade, which reached 0.94% on average in 2004 compared to 1.15% in 1997, could gradually increase Codelco's production costs during the next several years, Standard & Poor's expects the company to continue with its cost-reduction programs and to improve its efficiency levels to partially offset the increasing costs and maintain its low cost position.

Furthermore, and in contrast to other copper producers in Chile, Codelco's operations are vertically integrated. Integrated smelting and refining facilities allow the company to operate with some autonomy from the concentrated base of independent smelters worldwide. In addition, with the recent acquisition of Enami's smelter Ventanas, Codelco will have refining and smelting capacity to process 100% of its own copper production (concentrates and cathodes). This should allow Codelco to reduce treatment and refining costs in the short term. Nevertheless, the business plan for Ventanas is yet to be defined. Ventanas is efficient in terms of cost per material processed (sulfurous) but does not have the technology required for smelting and refining oxides with the most efficient methods like the SX-EW (solvent extraction electro-winning refining technology), which is available at Codelco Norte's division. As part of the terms of the acquisition, Codelco will continue to provide refining and smelting services to the small and midsize mining companies but will do it through a direct commercial relationship with state-owned Enami based at market prices and will in no way not subsidize the cost of providing these services to the small and midsize mining companies.

Codelco's operations are geographically concentrated in Chile. The company currently operates four separate mining units in Chile, the most important being Codelco Norte in the Northern Atacama Desert and El Teniente near the Santiago Metropolitan region. These units generated about 50% and 30% of total copper production in 2004.

Standard & Poor's does not expect the increasing cost of power in Chile and the higher risk of power supply shortages (resulting from restrictions imposed by the Argentine government to natural gas exports) to significantly affect Codelco. Although natural gas shortages have been lower in the north of Chile compared with those in other regions and the incidence of the cost of power is low over total operating costs, Standard & Poor's will closely monitor power supply risk in order to assess any potential impact on Codelco's operations.

Finally, although Codelco does not benefit from significant business diversification, it presents a well-diversified client base as its 10 largest customers account for about 30% of total sales. Although more than 90% of the company's clients are supplied under annual contracts, the majority of these clients have longer than 30-year relationships with Codelco. In addition, from a geographical standpoint, Codelco's revenues are also adequately distributed, with Asia as the largest market accounting for about 45% of total physical shipments, followed by Europe (30%), South America (15%) and North America (10%).

Peer comparison

Codelco's operating margin compares very well with those of global industry peers mainly as a result of its low cost position and large economies of scale. With the exception of Minera Escondida S.A. (a Chilean nonintegrated copper producer), Codelco's operating margins per metric ton produced and EBITDA margins per total sales are higher than those of its peers. In addition, the company has been able to maintain a strong profitability over the cycle. In the period 1997-2004 (average price of 85 cents per pound), EBITDA generation averaged 35%, reached a floor of 28% in 2001 when the average copper price reached US$0.72 cents per pound, and peaked at almost 50% in 2004 when the average price of copper reached US$1.30 per pound. Going forward, even under a more conservative price environment of US$0.95 cents per pound, EBITDA margin should remain at about 40%, benefiting from the increasing production levels and cost reductions derived from the ongoing investment program.

Table 1 Corporacion Nacional del Cobre de Chile--Peer Comparison	
Industry Sector: Chilean Copper Producers	
	--Fiscal year ended Dec. 31, 2004--

	Corporacion Nacional del Cobre de Chile	Minera Escondida
Operating Statistics		
Production (thousand metric tons)	1840	1195
Cash costs (C1)	31.7	43.3
Financial Information (Mil. US$)		
Sales	8,203.7	3,149.8
Net income from cont. oper.	1,134.2	1,726.0
Funds from operations (FFO)	1,702.0	2,154.6
Capital expenditures	893.1	398.6
Total debt	2,917.0	1,761.8
Common equity	2,871.9	1,829.6
Financial Indicators		
Oper. income bef. D&A/sales (%)	49.6	74.7
EBIT interest coverage (x)	19.9	29.9
EBITDA interest coverage (x)	28.5	32.7
Return on capital (%)	39.5	94.3
FFO/total debt (%)	58.3	122.3
Total debt/EBITDA (x)	0.7	0.7
Total debt/capital (%)	50.4	49.1

Financial Profile

Codelco's aggressive financial profile has deteriorated on a stand-alone basis as a result of the debt financing of its aggressive expansion plan (large capital expenditures) while maintaining a 100% dividend payout ratio. Within this context, Codelco's debt increased 100% in the last three years, to US$2.9 billion in March 2005 from US$1.5 billion in December 2001. Given that, under the current industry fundamentals, Codelco is expected to continue expanding, Standard & Poor's expects Codelco's debt to further increase to about US$4.0 billion by 2007. In spite of the resulting pressures on credit metrics, Codelco is expected to maintain a smooth debt maturity profile.

Profitability/cash flow adequacy

Although Codelco's profitability and cash flow are volatile because of the important fluctuations in copper prices, the company's low cost position allows it to generate adequate levels of cash even under a weak pricing scenario such as the company saw in 2002 and 2003. During 2004, Codelco posted an extraordinarily high US$4.1 billion EBITDA, which represented almost 50% of total sales and 40% of total debt as of December 2004. The high profitability and cash flow generation derived mainly from a 60% higher average copper price and a 40% increase in sales volume of its own copper compared with that of the previous year (partly resulting from the important reduction in the company's inventories accumulated during 2003). However, payments to the government for about US$3.3 billion and capital expenditures for about US$ 900 million resulted in negative free cash flow generation after dividends and a US$100 million increase in financial debt.

Given Codelco's relatively rigid 100% dividend payout, Standard & Poor's adjusted the company's cash generation by deducting dividend payments from the company's funds from operations (FFO) in order to compare the company's cash generation with its financial debt. Although traditional cash flow measures improved, Codelco's adjusted cash generation (FFO less dividends) to total debt decreased to a relatively weak 21.3% and 21.2% in fiscal 2003 and 2004, respectively, from 32.0% in 2002 mainly as a result of the 46.6% debt increase from December 2002 to December 2004. In addition, adjusted FFO interest coverage decreased to 5.3x in 2004 compared with 9,3x in 2002. Although Standard & Poor's projects that Codelco will be even more aggressive with a strong increase in the already-high capital expenditures and financial debt under current dividend policy, debt coverage measures are projected to remain relatively stable at about 20% and 4.5x during the next five years, benefiting from the projected additional depreciations and amortizations from ongoing investments. On the other hand, given that remittances to the government are based largely on profits, they suffer the volatility of copper prices whereas the company-retained cash flow is quite similar to depreciation plus amortization levels and tends to be relatively stable.

Codelco has defined a very aggressive preliminary capital expenditure plan of about US$8 billion for the five-year period of 2005-2009. Nevertheless, the plan should be viewed as a frontier of investment to monetize efficient reserves and could be significantly lower if the market environment for copper changes. In addition, if the Chilean government decides to significantly reduce dividend payments or carries a downward revision of investments, Codelco's adjusted debt service coverage ratios could significantly improve.

Capital structure./financial flexibility

Codelco's aggressive financial strategy resulted in an increasing leverage in the past several years. Total debt to capitalization reached 49.4% as of March 31, 2005 (compared to 35% in 2001) and is relatively high for the company's rating level. Nevertheless, the company has a healthy debt maturity profile as debt maturities do not exceed at any time the annual adjusted FFO.

As a result of the company's very aggressive investment plan, Codelco's capital structure is expected to further deteriorate. To partly offset that, Codelco is currently analyzing different financing alternatives (which include associations with third parties and/or guaranteed future supply contracts with China's state own company, MinMetals). In the past, in some instances Codelco has entered into joint ventures with international partners (like the El Abra project) to reduce project risk and investment requirements for mine development.

Although most of Codelco's debt is in U.S. dollars, foreign exchange risk is adequately covered because most of the company's cash generation is strongly linked to foreign currency. In addition, the company has a low exposure to variable interest rates because about 80% of its debt (mostly bonds) have fixed-rate interest averaging 5.7%. Going forward, Standard & Poor's expects the company to continue with this low exposure.

Table 2 Corporacion Nacional del Cobre de Chile Financial Statistics

	--Three months ended March 31--		--Fiscal year ended Dec. 31--				
(Mil. $)	2005	2004	2004	2003	2002	2001	2000
Sales	2,255.4	1,859.0	8,203.7	3,781.8	3,489.9	3,564.0	3,822.3
Net income from cont. oper.	389.0	208.6	1,134.2	89.2	48.5	25.6	205.4
Funds from operations (FFO)	501.8	244.9	1,702.0	650.9	587.3	531.6	617.6
Capital expenditures	205.4	230.5	893.1	895.0	844.0	585.8	543.8
Total debt	2,916.0	2,829.3	2,917.0	2,819.2	1,989.0	1,498.0	1,375.6
Common equity	2,990.0	2,887.6	2,871.9	2,821.4	2,733.1	2,699.9	2,776.8
Ratios							
Oper. income bef. D&A/sales (%)	57.3	47.9	49.6	33.5	29.8	27.7	34.6
EBIT interest coverage (x)	23.1	14.8	19.9	4.4	2.7	2.5	5.4
EBITDA interest coverage (x)	31.6	24.6	28.5	12.0	13.5	9.9	12.1
Return on capital (%)	13.0	7.2	39.5	3.2	2.9	3.6	11.5
FFO/total debt (%)	17.2	8.7	58.3	23.1	29.5	35.5	44.9
Total debt/EBITDA (x)	2.3	3.2	0.7	2.2	1.9	1.5	1.0
Total debt/capital (%)	49.4	49.5	50.4	50.0	42.1	35.6	33.1