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Research Update: Codelco 'A+' Local Currency Rating Placed On CreditWatch Negative

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Local Currency
Foreign Currency
Credit Rating:
A+/Watch Neg/--
A/Stable/--

Rationale

On July 18, 2006, Standard & Poor's Ratings Services placed its 'A+' local currency rating on Chile-based copper producer Corporación Nacional del Cobre de Chile (Codelco) on CreditWatch with negative implications, reflecting the ongoing deterioration of the company's stand-alone financial risk profile.

At the same time, Standard & Poor's affirmed its 'A' foreign currency rating with a stable outlook on Codelco, mainly reflecting the company's strong business risk profile and its 100% ownership and strategic importance for the Republic of Chile (foreign currency A/Stable/A-1; local currency AA/Stable/A-1+). The foreign currency rating on Codelco is not higher than that on the sovereign, reflecting our expectation that the government of Chile is highly likely to interfere with Codelco's ability to service its debt under a sovereign default scenario.

The CreditWatch action on the local currency rating indicates that the rating could be lowered or affirmed. If lowered, we expect it would be by one notch to 'A', at which point it would be equal to the foreign currency rating. Specific government support actions in the very short term, such as reducing the dividend payout ratio or moderating the expansion strategy, will likely be necessary to maintain the local currency corporate credit rating at current levels.

Codelco's stand-alone financial risk profile has been gradually deteriorating, mainly since fiscal 2002, as a result of its aggressive and growing debt levels deriving from the combination of its high capital expenditures and dividend payments. This has been in spite of its high cash flow generation deriving from the strong increase in copper prices since 2004.

The Codelco ratings reflect the company's strong market position as the world's largest integrated copper mining company with ample high-grade copper ore reserves, its highly competitive cost structure on a global basis, and its direct ownership by and strategic importance to its 100% shareholder, the Republic of Chile. These strengths are partly balanced by the inherent cyclicality of the industry, which results in volatile copper prices and cash flow generation; a lack of geographic diversification on the production side, with all operations located in Chile; and the high tax and dividend burden imposed by the Chilean government. These factors, together with Codelco's very aggressive investment program, have resulted in growing debt levels despite the strong cash flow generation in the past two years derived from high copper prices worldwide.

Standard & Poor's rates Codelco according to our criteria for rating government-related entities. As such, we assign a stand-alone rating and then factor in the government's potential credit support. Codelco's stand-alone creditworthiness has been deteriorating as a result of the weakening of the company's financial risk profile, but the ultimate rating has been supported by the company's strategic links to the government, including its 100% ownership and control by the Chilean government and its importance to the country. Furthermore, although Codelco's aggressive expansion strategy in a context of high dividend payments requires additional funding sources, we deem privatization unlikely. Thus, the company's close links with the government will continue to influence its credit quality.

Codelco accounts for approximately 11% of copper production worldwide, which is sold to a relatively well-diversified client base. Copper accounts for approximately 80%-90% of total sales, but the company also benefits from its position as the world's largest producer of molybdenum. Codelco's ample high-grade copper ore reserves, which account for approximately 20% of proven, probable, and possible global reserves worldwide, allow it to achieve large economies of scale and rank among the world's lowest-cost copper producers. Although we expect Codelco's production costs to 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 2005 and the first quarter of 2006, Codelco continued reporting very high profitability and cash flow generation as a result of the favorable pricing environment for copper and molybdenum. Nevertheless, debt continued increasing as Codelco devoted most of the increase in cash flows to funding very high capital expenditures and dividends. Codelco's EBITDA margin reached records of 57.7% in 2005 and 58.5% in the 12 months ended March 31, 2006 (compared with 49.6% in fiscal 2004 and 33.5% in 2003), mainly reflecting the significant increase in the average copper price to $2.24 per pound in the first quarter of 2006 compared with $1.67 per pound in 2005, $1.30 per pound in 2004, and 81 cents per pound in 2003. Given that Codelco's dividend policy is relatively fixed, we adjust the company's cash generation by deducting dividend payments from the company's funds from operations (FFO) to compare its 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 weak 19.7% in 2005 and 21.2% in 2004 from 32% in 2002, mainly as a result of the 86% debt increase from December 2002 to December 2005 (27% in 2005 alone).

In March 2006, Codelco and China's state-owned Minmetals Nonferrous Metals Co. Ltd. signed a long-term commercial agreement through which Codelco will sell 55,750 tons per year for 15 years to a joint venture 50% owned by each of the companies. The agreement also includes an option for Minmetals to participate in the equity of the Gaby project if that takes place. This transaction involves only a minor portion of Codelco's production and does not significantly affect its cash flows or credit quality.

Liquidity

Codelco's liquidity is adequate and benefits from the company's very good financial flexibility, which results from its solid business risk profile and 100% ownership by and strategic importance to the Republic of Chile, and which is evidenced by its fluid access to the global and local financial markets at very attractive interest rates. However, the company routinely has significant negative free cash flow due to the 100% dividend payout to the government-owner and high capital expenditures, which are debt-financed as noted above. Codelco has a favorable debt structure, with manageable debt maturities of about US$300 million in 2006 and around US$300 million in 2008. Codelco does not currently have committed lines of credit. Most of the company's long-term debt instruments contain, among other nonfinancial covenants, a change-of-control clause that allows for the acceleration of most of its debt upon the loss of majority ownership by the Chilean Republic.

Ratings List

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Rating Placed On CreditWatch
                 To                  From
Corporación Nacional del Cobre de Chile
Local currency
Corp cred rtg     A+/Watch Neg/--     A+/Negative/--

Rating Affirmed

Corporación Nacional del Cobre de Chile
Foreign currency
Corp cred rtg     A/Stable/--
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