ACRA

Principles of Assessing Industry Factors in the Rating Analysis of Non-financial Corporations

Mining (Excluding Oil and Gas)

This document is part of the Methodology for Assigning Credit Ratings to Non-financial Corporations under the International Scale (hereinafter, the Methodology) and describes the specifics in conducting rating analyses of the operational profile and financial profiles of mining companies (excluding oil and gas).

The document provides lists of indicators used, factor weights, assessment score boundaries for quantitative factors, and the principles of assessing qualitative factors for companies in the industry.

1 Industry Companies

The assessment approaches described in this document are applicable to companies whose core business is the extraction of minerals (excluding oil and gas).

2 Rating Factor Structure

Creditworthiness analyses of rated entities in the mining industry (excluding oil and gas) are based on assessing eight indicator blocks, which are combined in two profiles and have their own weights totaling 100%. The weights presented in Table 1 are base weights, i.e., they may change depending on the assessment scores derived for factor blocks (see Subsection 4.1.3 of the Methodology for a description of the floating weights concept).

Table 1. Scorecard for the mining industry (excluding oil and gas)

Profile	Factors	Factors weighting	Sub-factors
Operational profile	Business profile	20%	Market position and production efficiency
			Product and geographic diversification
	Financial policy and corporate governance	10%	Financial policy
			Corporate governance
Financial profile	Size	20%	Revenue (USD bln)
			Proven reserves (in years of production)
	Profitability	10%	EBIT margin
	Leverage	15%	Total debt to funds from operations (FFO) before interest payments
			Qualitative leverage assessment
	Coverage	15%	FFO before interest payments to interest payments
	Liquidity	5%	Liquidity ratio
			Qualitative liquidity assessment
	Cash flow	5%	Free cash flow (FCF) margin
			Qualitative assessment of FCF stability

Source: ACRA

3 Operational Profile

The following describes the basic factors in the rating analysis of the operational profile, the degree of their influence when determining the credit rating of a non-financial corporation and assessment specifics.

To assess operational profile qualitative indicators for rated entities in the industry, ACRA uses a set of characteristics specific to the industry that translate into a qualitative assessment category.

Operational profile indicator weights are shown in Table 4.

3.1. Business Profile

The mining industry is highly cyclical and exhibits volatility of financial performance and high capital costs incurred both to maintain current production volumes and to develop new deposits. Companies operate in a constantly changing market context, including demand and price fluctuations, so it is important to assess their ability to adapt costs to changes in environment. A company's competitive advantages, such as low production costs, good product diversification and scale of operations, improve its financial stability.

The business profile is assessed taking into account the following subfactors subject to qualitative assessment.

3.1.1. Market position and production efficiency

A high market share secures access to additional resources and, consequently, ensures a higher creditworthiness of major players. The quality of the resource base of a mining company is determined by the level of production costs. Assessment of the cost of production involves taking into account logistics, among other things, as the need for lengthy transportation to key markets or processing/beneficiation centers can significantly increase the ultimate cost and reduce the profitability of business.

The qualitative assessment category for the market position and production efficiency is determined according to Table 2.

Table 2. Qualitative assessment of the market position and production efficiency

Assessment category	Main features
I	In the 1st quartile of the global cost curve;[1] global market leader with significant logistic advantage
II	In the 2nd quartile of the global cost curve; key player in the global market with logistic advantage
III	In the 3rd quartile of the global cost curve, with a stable share in the global market and a minimal logistic advantage
IV	In the 4th quartile of the global cost curve; global market share is insignificant and volatile; no logistic advantage
V	Negative cash margin production; global market share is minimal; logistical constraints make it difficult to transport products to target markets and processing/beneficiation centers

Source: ACRA

[1] The global cost curve is a graph showing the industry's production capacity and costs on the global scale. The horizontal axis reflects the accumulated capacity of all producers, ranked on the vertical axis according to unit production cost. The global cost curve allows the impact of changes in capacity utilization, fluctuations in demand and production costs on prices to be predicted, as well as the impact of price changes on the global volume of products offered by the industry.

3.1.2. Product and geographic diversification

If a mining company concentrates on a single product, it increases the risk of its financial performance being highly dependent on both the volatility of prices for that product and long-term periods of low demand for it. Therefore, higher diversification of the product portfolio of a mining company provides better protection against price fluctuations for a particular product and more predictability of its operating and financial performance, and enables it to overcome phases of cyclic decline. Assessment of product diversification is affected by the characteristics of the extracted commodity (e.g., various coal and ore grades). Mining companies with the highest assessment score for the product diversification subfactor are global conglomerates that have a significant impact on the supply and demand balance in the global market for at least two commodities.

Geographic diversification is assessed both in terms of having production assets in several countries, and in terms of not concentrating production on one field or a limited number of fields.

The qualitative assessment category for product and geographic diversification is determined according to Table 3.

Table 3. Qualitative assessment of product and geographic diversification

Assessment category	Main features
I	Producer of at least four products; assets located in three or four countries; high diversification of production (at a large number of fields)
II	Producer of more than three products; assets located in two or three countries; moderately high diversification of production (at several fields)
III	Producer of no more than three products; assets located in one or two countries; reasonable diversification of production (at more than one field)
IV	Producer of a single product; assets located in one country; weak diversification of production (mostly concentrated in one field)
V	Producer of a single product; assets located in one country; production concentrated in one field

Source: ACRA

3.2. Financial Policy and Corporate Governance

To assess the financial policy and corporate governance of rated entities in the industry, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all industries (for a general description of the corporate governance qualitative assessment, see Section 5 of the Methodology). The assessment of financial policy and corporate governance is carried out according to Table 4.

4 Financial Profile

The following describes the basic factors in the rating analysis of the financial profile, the degree of their influence when determining the credit rating of a non-financial corporation and assessment specifics.

To assess the qualitative indicators in the financial profile of rated entities in the industry, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all industries (for a general description of the qualitative assessment of financial profile indicators, see Section 6 of the Methodology).

Quantitative indicators in the financial profile are assessed in points based on being part of a particular range, with qualitative indicators, based on qualitative assessment categories according to Table 5.

4.1. Size

To assess the business scale of companies in the industry, ACRA uses the size of their revenue, which is important for the creditworthiness of rated entities and the size of proven reserves (in years of production).

Large companies with higher levels of revenue can operate more efficiently than smaller players, which ensures reduction of overall production costs and greater effectiveness of corporate governance with regard to both business processes and financial, tax, legal and accounting issues. In addition, larger companies can generate more substantial cash flows to fund capital investments and reduce leverage, and they may have better access to capital markets, which, in turn, reduces the cost of borrowing.

The proven reserves indicator (in years of production) reflects a company's ability to maintain the current level of production on a long-term basis, which ensures the stability of its operating performance.

Holding a license for a large deposit with a good resource base and low cost of production is a necessary condition for stable long-term operations at that field. A company's ability to expand the resource base over the surrounding deposits without significant additional capital investment in infrastructure increases its creditworthiness and attractiveness to investors.

4.2. Profitability

Profitability is assessed based on EBIT, which ACRA believes to reflect the efficiency of operating cost management. Given that the industry is highly cyclical, companies often have to adapt their production rate and operating expenditures to maintain profitability. High profitability assessment scores show that a company is able to optimize expenditures in a volatile environment.

4.3. Leverage

Leverage is a key factor in analyzing the financial sustainability of companies in the industry due to its significant capital intensity and extremely unstable price dynamics.

To assess leverage, ACRA uses an indicator calculated as the ratio of total debt to FFO before interest payments and qualitative characteristics of leverage.

4.4. Coverage

To assess coverage, ACRA uses an indicator calculated as the ratio of FFO before interest payments to interest payments.

4.5. Liquidity

To assess liquidity, ACRA uses the short-term liquidity ratio and qualitative characteristics of liquidity.

4.6. Cash Flow

To assess cash flow, ACRA uses the FCF indicator, as well as the qualitative assessment of FCF stability.

The ability to fund an investment program with operating cash flow is extremely important to companies in the industry, especially in unfavorable pricing environments. In this context, companies in higher rating categories can generate positive FCF even during the periods of adverse price dynamics.

Dividend payouts made by the company are analyzed separately. Amid high capital costs, high dividend payments can exert significant pressure on FCF.

Table 4. Operational profile factors

Factors	Sub-factors	Sub-factors weighting	Sub-factors score				
			5	4	3	2	1
Business profile	Market position and production efficiency	50%	V	IV	III	II	I
	Product and geographic diversification	50%	V	IV	III	II	I
Financial policy and corporate governance	Financial policy	50%	V	IV	III	II	I
	Corporate governance	50%	V	IV	III	II	I

Source: ACRA

Table 5. Financial profile factors

Factors	Sub-factors	Sub-factors weighting	Sub-factors score				
			5	4	3	2	1
Size	Revenue, USD bln	70%	[0;1)	[1;5)	[5;10)	[10;50)	[50; ∞)
	Proven reserves (in years of production)	30%	[0; 10)	[10; 20)	[20; 30)	[30; 40)	[40; ∞)
Profitability	EBIT margin	100%	(−∞; 5%)	[5%; 10%)	[10%; 20%)	[20%; 30%)	[30%; ∞)
Leverage	Total debt to FFO before interest payments	70%	(6; ∞)	(4; 6]	(2.5; 4]	(1; 2.5]	[0; 1]
	Qualitative leverage assessment	30%	V	IV	III	II	I
Coverage	FFO before interest payments to interest payments	100%	(−∞; 2)	[2; 4)	[4; 8)	[8; 15)	[15; ∞)
Liquidity	Liquidity ratio	50%	(−∞; 0.8)	[0.8; 1)	[1; 1.25)	[1.25; 1.5)	[1.5; ∞)
	Qualitative liquidity assessment	50%	V	IV	III	II	I
Cash flow	FCF margin	50%	(−∞; −10%)	[−10%; 0%)	[0%; 5%)	[5%; 10%)	[10%; ∞)
	Qualitative assessment of FCF stability	50%	V	IV	III	II	I

Source: ACRA

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