Rating Indian Mining Companies

Sector Credit Factors for National Ratings

Special Report

This report is an addendum to the master report, "Corporate Rating Methodology", dated September 2012. The report describes the criteria applied by India Ratings in assigning corporate ratings. This addendum provides a high-level overview of how those criteria are most frequently observed in application to companies in this sector. Users are referred to the "Limitations" section of this report.

Specific Rating Factors: This report addresses India Ratings and Research Private Limited's (India Ratings) specific rating factors used when analysing Indian mining companies. The rating factors draw largely from the global mining sector credit factors available on www.indiaratings.co.in, but also capture the nuances which are unique to the local market.

Natural Rating Territory: After describing the sector risk profile, it defines and groups the ratings of companies operating in the sector into a "natural rating territory", based on India Ratings' view of the inherent risk profile of the sector as a whole. The report then examines company-specific traits which may influence the rating, and so more finely categorises companies by rating level. Finally, the report explains how a company's financial profile (credit metrics) influences its creditworthiness and final rating.

Figure 1
Key Credit Factors

• Scale of operation	• Financial Profile
• Cost position	○ Revenue and profitability
• Commodity diversification	○ Cash flow and liquidity
• Reserve life	○ Cash balance
• License validity	
• Government regulation	
• Transparency, disclosure and corporate structure	

Source: India Ratings

Sector Risk Profile

Sector Risk Profile: Representative companies rated in this sector range from 'IND AAA' to 'IND A'. This reflects a sector where participants benefit from the low cost of operations in India and strong domestic demand, which, despite the cyclicality of the industry, can generate strong profitability, free cash flows and high cash balances across a full price cycle. These characteristics are applicable across most of the individual commodity sub-sectors (eg, iron ore, coal, and manganese ore) of the mining industry in India.

Regulatory Issues: The mining sector is exposed to regulatory issues such as the renewal of lease licences, environmental clearances, and land acquisition. The sector also faces problems with the low quality of Indian infrastructure in the transportation of commodities

Barriers to Entry: Industry regulation and long periods in getting approvals from the government to operate mines represent obstacles to new entrants. This means that only public sector entities can easily operate mines for most minerals. Consequently, investments by the private sector have remained limited.

Industry Structure: In India, most of the private companies engaged in mining consume the products captively for making value-added products. However, there are a few entities with standalone mining operations. Most of them are owned by state-owned enterprises (SoEs), with a few older private companies.

Related Criteria

Corporate Rating Methodology (September 2012)

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Building Blocks - India Mining Sector

	Sector Risk Profile	Company-Specific Traits						Financial Profile (historical where relevant and forecast)		
		Sub sector	**Cost position in commodity cost curve (Operating cost)**	**Commodity diversification**	**Licences validity**	**Reserve life**	**Scale of operations**	Size - Annual EBITDAR (INRbn)	Op. EDITDAR margin (%)	CFO margin (%)
IND AAA	• Low cost of operations • Domestic end user demand relatively less cyclical due to demand growth and supply constraints • Significant production controlled by Government owned entities	• > GOI owned benefit from size, scale and lower regulatory risks	• 1st quartile or amongst the 2 lowest cost producers in India	• Diversified: Top 5 in 1 commodity Single: Top 3	• No renewal risk for 5 years	• >20 years at major mines	• >INR50bn	>INR25bn	>50%	55%
IND AA			• 2nd quartile	• Single: Top 10 Producer	• No affect on overall rating <50% • Overall rating lowered by one to two notches – 50% to 100%	• 10 - 20 years at major mines	• INR20bn - INR50bn	INR10bn - INR25bn	30% - 50%	35%
IND A		• Private sector entities exposed to risks non-renewal of licences	• 3rd quartile	• Single commodity	• Overall rating lowered by atleast 2 notched – 100%	• 5-10 years at major mines	• <INR 20bn	<INR10bn	<30%	20%
IND BBB & below			• 4th quartile			• <5 years				

General
- Essential material for industrial uses
- Efficient production typically requires economies of scale
- Exposed to regulatory issues such as renewal of lease licences, environmental clearances, land acquisition
- High barrier to entry

Indicative factors observed or extrapolated for rated issuers. Ratio levels refer to the mid-point of a through-the-cycle range; actual observations are likely to vary from these. Certain sub-sectors may contain a small number of observations; where no observations currently exist, guidelines for a category are extrapolated based on India Ratings judgement. The factors give a high-level overview and are neither exhaustive in scope nor uniformly applicable. Additional factors will influence ratings, particularly where group relationships constrain or enhance a rating level.

Company-Specific Traits

India Ratings examines a number of sector-specific qualities and outlines rating categories for companies that display these characteristics under company-specific traits.

It is rare that a company will track exactly to the same rating category for each trait or ratio. While rating committees take all factors into consideration, they will weight some of the factors more heavily than others, such as the cost position of operations, liquidity and financial profile. India Ratings also considers the current industry dynamics for a given commodity, which it discusses annually in its industry outlook reports.

Scale of Operations

Overall company size and the size of a company's individual operations are often a good indicator of mining company rating levels. While a smaller scale does not limit a company's ability to operate efficiently and profitably, larger scale as viewed in terms of absolute revenue, EBITDAR and cash flow levels, is often associated with other favourable characteristics such as higher commodity diversification and low operating costs (an explanation of which follows below). In addition to assessing scale in an absolute sense, India Ratings also considers a company's scale relative to peers in individual commodity segments.

Scale can also be associated with greater financial and operational flexibility and the ability to withstand operational disruptions (ie, larger companies will typically operate several mines and are less affected by problems at a particular site).

Figure 2 shows an example of scale as a differentiating factor, in this instance showing indicative absolute revenue and EBITDAR levels.

Figure 2
Scale of Operations

	Revenues (INRbn)	EBITDAR(INRbn)	Rating category
Large	>50	>25	IND AAA
Medium	20-50	10-25	IND AA
Small	<20	<10	IND A / IND BBB

Source: India Ratings

Cost Position

Even in more consolidated mining sectors, companies are typically price takers with a limited ability to influence prices. Mining companies therefore rely for their long‑term competitiveness on having low operating costs at their key operations. Low‑cost producers generate higher cash flows/profit margins than higher-cost producers at all metal price points, which can be then used to develop new projects and/or undertake acquisitions.

Figure 3
Operating Cost

Rating category	Cost quartile of industry cost curve
IND AAA	1st quartile
IND AA / IND A	2nd quartile
IND BBB	3rd quartile
Below IND BBB	4th quartile

Source: India Ratings

Low‑cost producers will also typically maintain production volumes during cyclical downturns when higher‑cost producers may stop or idle their operations. As shown in Figure 3, India Ratings assesses companies' cost position based on the industry cost curve where available. This information may be sourced from published industry cost curves, from rated issuers or, as an alternative, from an assessment of relative profitability levels of different companies across a sub‑sector. With industry cost curves typically stated in US dollar terms, currency fluctuations have the potential to temporarily improve or weaken companies' cost positions. India Ratings would typically evaluate cost profiles on a long-term sustainable basis.

Commodity Diversification

In India, except for a few entities, most of the mining companies are single-commodity operators. Commodity diversification provides a number of benefits, including greater growth potential through the sharing of cash flows between projects in various stages of exploitation. It also brings generally lower earnings/cash flow volatility through the spreading of commodity risk and because of the somewhat varying demand/price cycles of individual commodities (although in general there is a strong price correlation between commodity segments).

In assessing commodity diversification, India Ratings considers not only a company's presence in a particular commodity sector, but also the scale of that presence. A lack of diversification may not necessarily affect ratings on the national scale.

Figure 4
Commodity Diversification

Rating category	Level of diversification
IND AAA	Diversified: Top-five producer in at least one commodity Single commodity: Top-three producer
IND AA	Single commodity: Top-10 producer
IND A and below	Single commodity

Source: India Ratings

Reserve Life

An ongoing issue for companies operating in the mining sector is the replacement of mined reserves in order to maintain future production volumes. Accordingly, the period to depletion of a company's key mines is an important rating factor. Effective mine life can be computed as: proven plus probable ore reserves divided by current year production.

Figure 5
Reserve Life

Observations	Mine life at key operations (on average across companies portfolio)
IND AAA	>20 yrs
IND AA	15-20 yrs
IND A	10-15 yrs
IND BBB and below	<10 yrs

Source: India Ratings

License Validity

The validity of mining licenses is an important indicator of rating level. Many companies in India operate on "deemed licences", which while legal, can be terminated by state governments at any time. Companies with valid mining licenses therefore have better revenue visibility than companies operating on deemed licenses.

Figure 6
License Validity

Observations	Percentage of mines under deemed renewal (%)
No effect on overall rating	< 50
Overall rating lowered by one notch	50 to 100
Overall rating lowered by at least two notches	100

Source: India Ratings

Government Regulation

The mining industry is a highly regulated industry and the business is vulnerable to changes in government regulation on the use of natural resources, on the environment, as well as changes in taxes and duties.

The profit margins of companies with a high level of export sales vary directly in relation to changes in duties/taxes, as most Indian miners are price takers in the international markets. In addition, the government of India has been encouraging value addition within the country. As most mining licences are linked to captive consumption, this may also require higher capital expenditure by miners.

The regulatory bill to be placed before parliament proposes that 26% of mining companies' net profit and 100% of the royalty paid to the states would be used for reconstruction and rehabilitation activities. This would reduce the cash flows for all mining companies, but could also reduce the time required to develop a mine.

Transparency, Disclosure and Corporate Structure

Many of the private mining companies in India are closely held. This would usually lead to ratings one to two notches lower than would otherwise be the case. However, India Ratings' assessment of the quality of the accounts and other information could either increase or compress the level of notching.

Financial Profile

Following the sector risk profile outline and the company‐specific traits, India Ratings' analysis of the company's current and projected financial profile narrows down the range of each rating category. India Ratings's master "*Corporate Rating Methodology*" lists the main ratios used in rating companies, and explains adjustments for features such as operating leasing and pensions.

The mining sector is highly capital-intensive and across the price cycle typically cash-generative. Accordingly, quantitative measures which define final sector rating categories focus on EBITDAR margins, funds from operations (FFO) cash generation, leverage and interest cover, as well as free cash flow (FCF) generation.

It is important to stress that financial metrics can alleviate only some of the pressures from the sector risk profile and company traits, and do not enable the company to completely detach itself. Conversely, a company with strong company traits may be burdened by high leverage which may exert a strong pressure on rating levels.

In its forecasts for mining companies, India Ratings models a variety of price scenarios. One approach is to model cyclical movements in price. For example, if prices are believed to represent a cyclical peak, then the agency will model various gradual or cyclical price reduction scenarios. Another approach is to use long‐term average or mid‐cycle prices. This approach can help to assess the long‐term sustainable profitability and cash flow generation of companies by removing the impact of cyclical price movements. This approach also helps to identify fundamental changes in the operational profile of companies (eg, commissioning of a new low‐cost mine or a permanent increase in operating costs).

Revenue and Profitability

Revenue and profitability levels serve a number of analytical functions. They can be an indicator of several operational factors. For example, consistently high absolute and relative profitability can indicate a low operating cost position, while declining margins over time may indicate rising costs of production. They also set the pattern for cash flow dynamics. Mining companies with consistently higher profitability levels are also better positioned to invest in future growth and reserve replacement without jeopardising their financial profile.

Figure 7
EBITDAR Margin

Rating category	EBITDAR (INRm)	Op. EBITDAR margin (%)

IND AAA	>25	>50
IND AA	10-25	30-50
IND A - IND BBB	<10	<30

Source: India Ratings

Cash Flow and Liquidity

The agency's analysis is focused on stability and sustainability of earnings and cash flow, which underpin a company's ability to repay debt and finance operations. Cash flow from operations (CFO) is a more robust credit protection than external sources of capital. Given the inherent cyclicality in the sector, and potential for wide fluctuations in cash flow performance between cyclical peaks and lows, India Ratings focuses on the stability and sustainability of cash flow measured by CFO margin through the cycle. The ability to generate CFO and FCF is key to financial flexibility.

Figure 8

Cash Flow From Operations Margin

Rating category	Cash flow from operations margin – mid point (%)
IND AAA	55
IND AA	35
IND A - IND BBB	20

Source: India Ratings

In addition to the analysis of a mining company's ability to generate cash flow, India Ratings also assesses actions related to cash outflows. These include investment programmes, acquisitions, as well as shareholder-friendly actions (ie, dividends and/or share buybacks), which can leave companies with negative FCF, and thus lead to external borrowing.

In its analysis of liquidity, India Ratings compares the company's FCF, available cash and undrawn committed facilities against near-term debt-service requirements. Entities rated 'IND AA' and above should generally have limited volatility through the cycle, illustrating management's ability to maintain financial flexibility through cash preservation measures and to maintain access to external funding during downturns.

Entities rated 'IND AA' and above should generally be expected to fund capex and dividends from internal sources across the commodity price cycle (this assumes some scaling back in both during weaker price periods). Lower‐rated entities would typically experience periods of negative FCF during downturns.

Cash Balances

All mining companies in India are cash rich and maintain substantial cash balances, almost always in excess of debt. This has provided significant comfort in assigning ratings, The possible use of cash, either for distributing as dividends, or for investment in group companies/projects could, however, negatively affect the ratings.

Limitations

This sector credit factor report describes indicative features observed for rated issuers in India. Ratio levels refer to the mid-point of a through-the-cycle range, and as a result actual observations are likely to vary from these. The weighting factors will vary substantially based over time for a given issuer and between issuers based on relative significance agreed upon by the rating committee. The factors described give a high-level overview as a convenience for rating users, and are neither exhaustive in scope nor uniformly applicable. These may vary for a given rating category.