FITCH AFFIRMS MEXICHEM IDRS AT 'BBB'; OUTLOOK NEGATIVE

Fitch Ratings-Chicago-20 November 2017: Fitch Ratings has affirmed Mexichem, S.A.B. de C.V.'s (Mexichem) Long-Term Local and Foreign Currency Issuer Default Ratings (IDRs) at 'BBB'. In addition, Fitch affirms the company's Long-Term National Scale ratings at 'AA+(mex)'. The Rating Outlook is Negative. A complete list of rating actions follows at the end of this release.

The ratings reflect Mexichem's geographically diversified operating base and strong business position in polyvinyl chloride (PVC) pipes throughout Latin America and Europe, as well as its strong position in fluorspar globally. The company's financial profile is underpinned by high profitability and strong cash flow generation. Further factored into Mexichem's ratings are its strong liquidity position and manageable debt amortization schedule. The ratings are tempered by the company's exposure to volatile industries such as infrastructure and construction.

Fitch assigned Mexichem's ratings a Negative Outlook after the company reached a definitive agreement in August 2017 to acquire 80% of drip irrigation firm Netafim for a total enterprise value of USD1.895 billion. Fitch estimates that Mexichem's adjusted pro forma net leverage will rise to 3.0x after the closing of the transaction, which is expected to occur before year-end. This compares with Fitch's prior expectations of leverage of around 2.5x in 2017.

KEY RATING DRIVERS

Strong Business Position: Mexichem is a large producer of PVC resins and pipes and one of the world's largest producers of fluorspar and hydrofluoric acid. The company is also the largest producer of high-density polyethylene (HDPE) conduit and pressure pipes and a leading European producer of high-impact suspension PVC resins. Its strong market position coupled with vast vertical integration, which extends from the mine to the final consumer, provides it with increased business flexibility and expanded cross-selling opportunities. These features support long-term revenue and cash flow expansion and have given the company relatively high operating margins.

High Leverage: Total adjusted net leverage will be high for the current rating category at 3.0x immediately after the transaction. This compares with Fitch's prior expectations of 2.5x in 2017 and 2.2x in 2018. Fitch expects Mexichem's EBITDA to expand to USD1.1 billion in 2017 from USD884 million in 2016 and Netafim should add around USD130 million. Mexichem's EBITDA growth during 2017 is primarily a result of the start-up of its ethylene cracker and recovering PVC resin spreads. Robust demand for fluorite has also been positive. Deleveraging to levels of 2.5x over the 12 to 24 months following the closing of the transaction would be considered in line with the rating level and result in a revision of the Outlook to Stable.

Acquisition Moderately Positive for Business Profile: The integration of Netafim's operations should moderately improve Mexichem's business profile. Netafim would transform Mexichem's irrigation business, which currently generates only about USD120 million in annual revenue, into a global leader of drip irrigation with sales of more than USD1 billion. The acquisition would diversify Mexichem's cash flow generation, as agricultural-related products would represent more than 10% of its EBITDA.

Top Share of Niche Market: Netafim enjoys leading market positions in drip irrigation in several markets. Drip is one of several forms of irrigation. In flood and center-pivot, the most common irrigation methods, water is applied to the surface either by entirely covering the surface by ponded water or by applying water through rotating sprinklers. In contrast, drip systems, which are more expensive but increase crop yields, apply water and fertilizer directly to a plant's roots under low pressure. This reduces water consumption.

Mitigated U.S. Trade Risk: U.S. President Donald Trump's proposed cancelation or renegotiation of NAFTA and other increased trade protectionism measures should have a limited effect on Mexichem's results. The company generates 15% of revenue from the U.S., more than two-thirds of which it generates from the sale of high density polyethylene products, and compounds, which are made in the U.S. and mostly sourced from U.S. raw materials. Mexichem's exports to the U.S. from Mexico are mostly fluorite products where the U.S. has very limited production. The company enjoys a low cost advantage in producing this mineral that should limit negative effects from potential protectionist policies.

DERIVATION SUMMARY

Mexichem is well positioned relative to peers such as Alpek, S.A.B. de C.V. (BBB-/Rating Watch Negative) and Braskem S.A. (BBB-/Stable Outlook) in terms of the degree of product and geographic diversification. Backward integration of Mexichem's PVC and fluorite businesses, which extend from the mine to the final consumer, is another factor that distinguishes Mexichem from companies in the chemicals sector. Integration reduces the volatility of cash flows as prices of final products tend to be more stable. The ratings are tempered by the company's exposure to volatile industries such as infrastructure and construction, as well as by its high leverage relative to peers.

Westlake (BBB/Stable), the third-largest global chlor-alkali and PVC producer, has added scale to its PVC resin and vinyl-based building products through an acquisition. Although Mexichem's PVC production is smaller in scale compared with Westlake's, it benefits from the backward integration and diversification of its PVC and fluorite businesses which have a relatively higher component of finished products. Both Westlake and Mexichem pro forma have high leverage as calculated by Fitch. Westlake's leverage is expected to decrease to levels consistent with its rating in the next 12-24 months.

KEY ASSUMPTIONS

Fitch's key assumptions within the agency's rating case for the issuer include:

--Mexichem's stand-alone EBITDA expands to USD1.1 billion in 2017;
--Capex does not exceed 6% of revenue over the intermediate term;
--Yearly shareholder dividends slightly above USD100 million over the intermediate term.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

--Possibility of a ratings upgrade is limited due to the company's leverage levels as well as its exposure to more cyclical construction-related end markets.
--Expectations of net adjusted debt/operating EBITDA consistently below 1.5x; capital spending discipline that generates consistent positive free cash flow (FCF) margins above 3%, and a significant increase in operating EBITDA to levels greater than USD1.5 billion would be viewed positively.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

--Expectations of net adjusted leverage above 2.5x beyond 2019 would result in a downgrade.

--A change in fluorspar dynamics globally or a global recession, which affects the company's profitability, cash flow and leverage levels, including expectations of EBITDA margins consistently below 15% and meaningful erosion of FCF, could pressure the rating.

LIQUIDITY

Strong Liquidity: The company faces no large debt maturities until 2022, when USD918 million of capital market debt is due. As of third-quarter 2017, cash on hand was USD740 million, which together with a USD1.5 billion undrawn committed credit facility maturing in 2019 adequately covers USD832 million of short-term debt maturities, including financial leases and letters of credit. This facility is contingent upon Mexichem maintaining total debt/consolidated EBITDA below 3.0x. Letters of credit with maturities of less than 180 days of USD737 million are excluded from covenant leverage calculations.

Mexichem expects to fund the Netafim acquisition with the proceeds from the USD1 billion of notes issued in October 2017, USD300 million in cash and USD200 million of bank debt, which would be repaid with the cash flow generated during 2018. Fitch expects Mexichem's funds from operations (FFO) to expand to about USD700 million in 2018 from USD622 million as of the latest 12 months (LTM) ended Sept. 30, 2017. Expectations of robust FFO generation have been a key driver supporting Mexichem's 'BBB' ratings.

FULL LIST OF RATING ACTIONS

Fitch affirms Mexichem's ratings as follows:

--Long-Term Foreign Currency IDR at 'BBB';
--Long-Term Local Currency IDR at 'BBB';
--Long-term National Scale rating at 'AA+(mex)';
--USD350 million senior unsecured notes due 2019 at 'BBB' (outstanding balance USD83 million);
--USD750 million senior unsecured notes due 2022 at 'BBB';
--USD500 million senior unsecured notes due 2027 at 'BBB';
--USD400 million senior unsecured notes due 2042 at 'BBB';
--USD750 million senior unsecured notes due 2044 at 'BBB';
--USD500 million senior unsecured notes due 2048 at 'BBB';
--MXN3,000 million Local Certificados Bursatiles due 2022 at 'AA+(mex)'.

The Rating Outlook is Negative.

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Fitch treats letters of credit as debt for analytical purposes as this form of financing increases Mexichem's payment terms related to raw materials, contributes to higher profitability metrics and carries a financial cost.

Letters of credit with maturities of less than 180 days of USD738 million as of third-quarter 2017 are excluded from covenant leverage calculations.

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Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017)
https://www.fitchratings.com/site/re/901296