

## Celulosa Arauco y Constitucion S.A.

**Primary Credit Analyst:**

Amalia E Bulacios, Buenos Aires (54) 11-4891-2141; amalia.bulacios@spglobal.com

**Secondary Contact:**

Luisa Vilhena, Sao Paulo (55) 11-3039-9727; luisa.vilhena@spglobal.com

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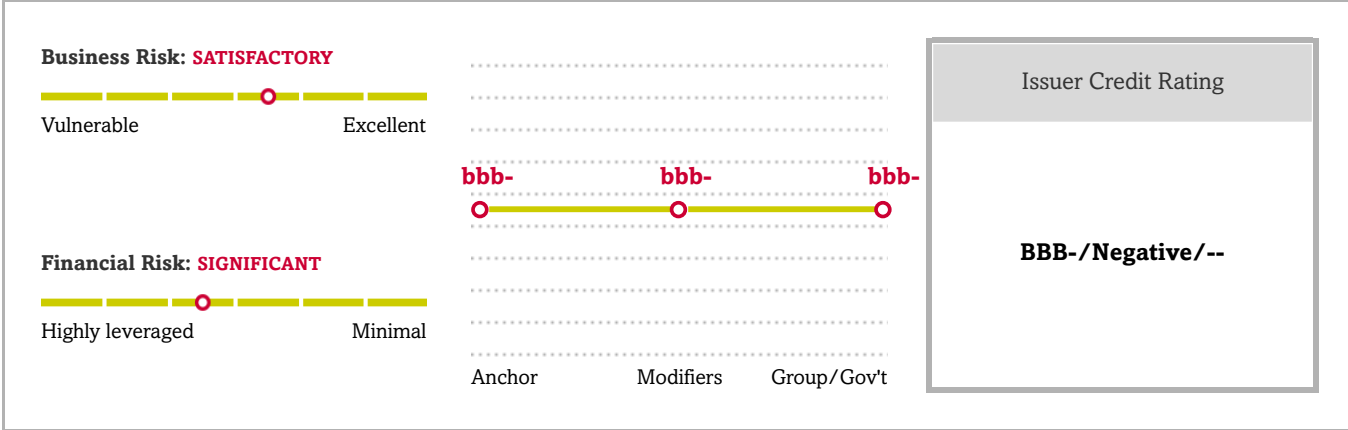
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Related Criteria

# Celulosa Arauco y Constitucion S.A.



## Credit Highlights

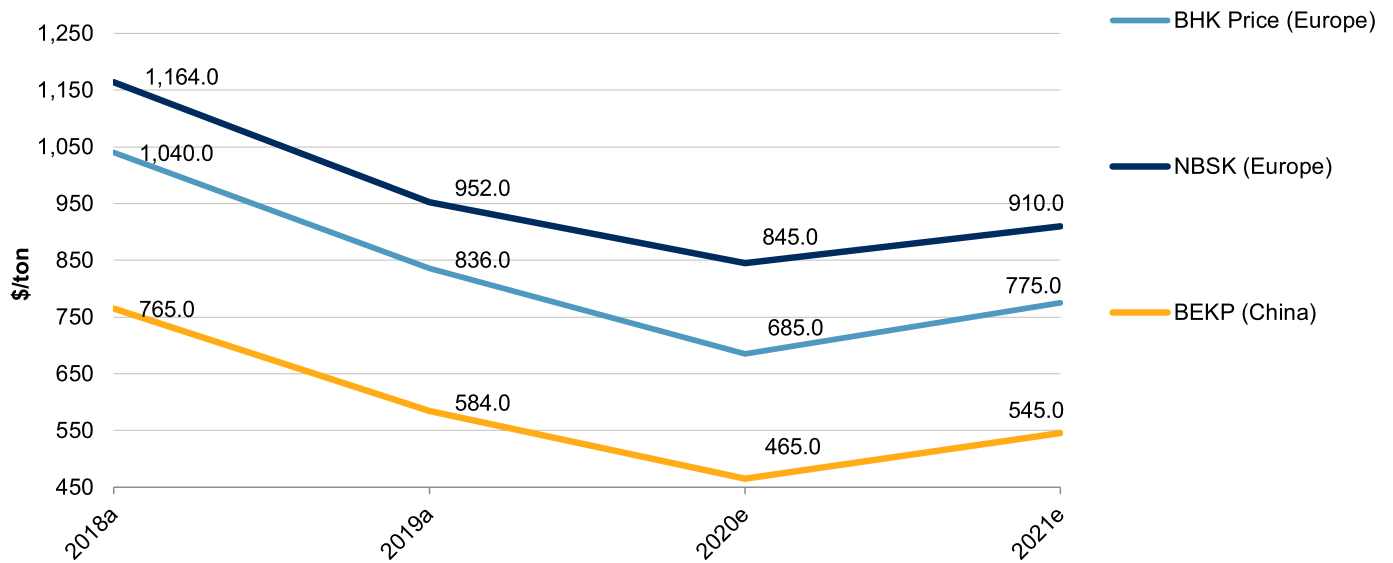
### Overview

Key strengths	Key risks
Solid market position, given that Celulosa Arauco y Constitucion S.A. (Arauco) is one of the largest global pulp and panel producers.	Exposure to commodity-price volatility.
A low-cost pulp producer.	High committed capital expenditure (capex) needs in 2020 and 2021 for the pulp expansion project.
Substantial liquidity.	

**COVID-19 has delayed price hikes, pressuring the company's results in 2020.** Pulp prices dipped in 2019 after reaching record-high levels in 2018, and we expect average realized prices to be 15%-20% lower in 2020. Although pulp prices started the year below cash cost of less efficient producers in China, while demand for tissue and certain types of packaging has been resilient, the pandemic and global recession have caused a massive drop in demand for graphic paper and other types and generated significant uncertainty for paper producers. Therefore, prices have remained largely stable, with some downward pressure in China, for most of the second and third quarters of 2020. We have started to see some seasonal price hikes in certain fibers in October, and we expect some momentum to remain during the fourth quarter and price hikes to resume towards the end of the first quarter of 2021. But the overall price recovery will remain mild as economic uncertainty depresses demand. Under this scenario, we now expect average pulp benchmark prices of \$465 and \$545 per ton for hardwood kraft delivered in China in 2020 and 2021, respectively, along with \$845 and \$910 per ton, respectively, for bleached softwood kraft pulp delivered in Europe. Additionally, the extensive lockdowns across the world took a toll on demand for Arauco's wood and panel products during the second quarter of the year. Although the company registered an impressive recovery of the woods business during the third quarter, we still expect revenue in this segment to fall 8%-10% in 2020.

Chart 1

**Benchmark Pulp Prices Assumptions**



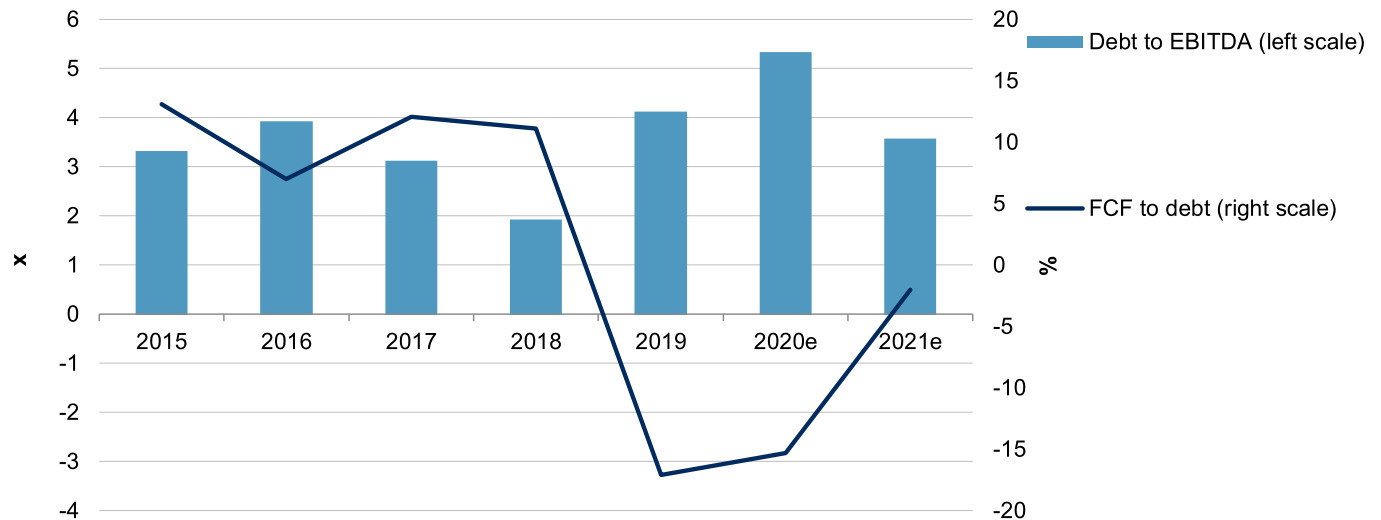
a--Actual. e--Estimate. Source: S&P Global Ratings.

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**Leverage will peak at 5.2x-5.4x but should fall sharply next year.** We expect the COVID-19 outbreak and the world recession to contract the company's EBITDA by about 15% to \$950 million - \$1.0 billion. This, combined with capex needs of about \$1.7 billion this year, including about \$1.1 billion for the MAPA project, will result in a wide cash deficit, leading to a leverage peak at 5.2x-5.4x in 2020. However, we expect the free operating cash flow (FOCF) deficit to start narrowing and leverage to drop in 2021 amid EBITDA recovery to \$1.3 billion - \$1.4 billion as pulp prices and the panel business rebound and MAPA starts its ramp up.

Chart 2

## Arauco's Leverage



e--Estimate. Source: S&P Global Ratings.

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***The capital increase shows commitment to investment-grade rating but could be insufficient if market conditions remain challenging.*** On May 19, 2020, Empresas Copec S.A. (E-Copec; BBB-/Stable/--) committed to increase Arauco's capital by up to \$700 million until 2021, \$250 million of which was disbursed in September. The capital increase will support Arauco's investment plan, strengthen its financial flexibility, and reduce leverage, all of which have been considerably hurt by the sharp fall in pulp prices and the impact of COVID-19. We believe amid better operating results, coupled with the capital increase, leverage could fall to about 3.5x in 2021. Although the capitalization signaled Arauco's commitment to maintain a 'BBB-' rating, the announced delay in MAPA, which reduces pulp volumes, slightly pressures credit metrics and we consider the following as credit risks:

- Pulp price recovery could lag behind our base-case expectations.
- Momentum in the woods and panel business could lose steam, further weakening EBITDA and cash flows.
- Significant increases in capex needs for MAPA.

## Outlook

The negative outlook on Arauco reflects our expectation that it will post very high leverage in 2020, between 5.2x and 5.4x, and that downside risks in 2021 could cause the metric to remain above 3.5x.

### Downside scenario

We would downgrade Arauco if we believe its debt to EBITDA would remain above 3.5x and funds from operations (FFO) to debt would be below 20% in 2021. This could materialize if:

- We were to expect average realized pulp prices below \$580 per ton in 2021;
- weaker panels and wood business pushes EBITDA to below \$1.3 billion in 2021;
- Arauco incurs higher capex than we expect; or
- The company doesn't receive full capitalization from its shareholders.

### Upside scenario

We could revise our outlook on Arauco to stable in the next 12 months if we see stronger cash flows and debt to EBITDA drops below 3.5x in 2021. This could occur if:

- Arauco completes its investments as expected;
- Pulp prices increase 12%-16% next year; and/or
- The company receives full capitalization of \$700 million.

## Our Base-Case Scenario

### Assumptions

- COVID-19 and global recession will prevent pulp prices from rising significantly. We assume average realized prices of about \$520 per ton in 2020, and \$590-\$600 in 2021.
- Pulp production of 3.6 million - 3.7 million tons in 2020, including Arauco's share in Montes del Plata in Uruguay. With the ramp-up of MAPA, we expect total production to reach 3.9 million - 4.0 million tons in 2021. The mill should be fully operational by 2022, resulting in total pulp volumes of about 5 million tons.
- A decline of 5% in sold panels volume in 2020, and a 10%-12% growth in 2021. This includes capacity additions from the gradual ramp-up at the Grayling plant in the U.S., and about 500,000 cubic meters (m3) at the acquired facilities in Mexico.
- Lower average panel price of \$290-\$295 per m3 in 2020 due to weaker demand and depreciation of regional currencies and \$303-\$310 in 2021.
- As a result of these factors, Arauco's consolidated revenue should fall about 11% in 2020 and rise 16%-18% in 2021.
- Minor drop in EBITDA margins to 20%-21% in 2020 from 21.6% in 2019 and improve to 24%-25% in 2021.
- Approximately \$1.75 billion in capex for 2020, consisting of about \$550 million in maintenance and forestation, and \$1.2 billion for MAPA. In 2021, \$1.1 billion, consisting of almost \$670 million for MAPA and \$450 million for maintenance and forestation.
- No dividend payments in 2020 and 2021.
- The capital increase of \$250 million in 2020 and \$450 million in 2021.

## Key Metrics

### Celulosa Arauco y Constitución S.A.--Key Metrics\*

	--Fiscal year ended Dec. 31--				
(Mil. US\$)	2018a	2019a	2020e	2021f	2022f
EBITDA	1,836.5	1,150.4	950-1000	1300-1400	1600-1800
Debt to EBITDA (x)	1.9	4.1	5.2-5.4	~3.5	~2.5
FFO to debt (%)	46.0	11.3	13-16	20-25	~30
FOCF to debt (%)	11.1	(17.1)	-15 to -18	~ -5	~ 15

a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. FOCF--Free operating cash flow. \*All figures adjusted by S&P Global Ratings.

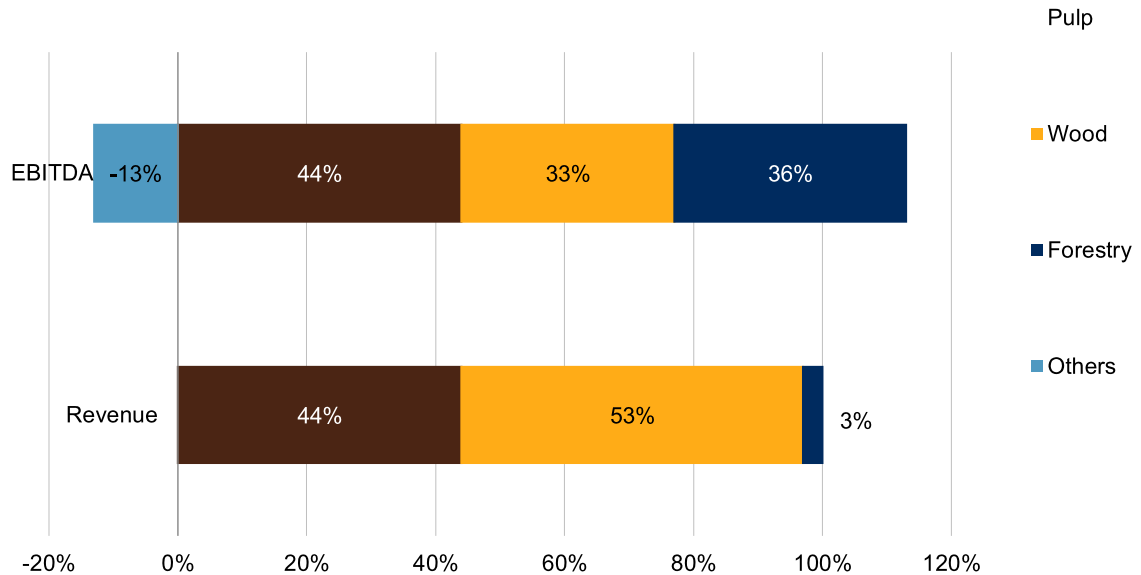
## Company Description

Chile-based Arauco, a wholly owned subsidiary of E-Copec, focuses on forest management, the production, and sale of market pulp and wood products. The company operates five pulp mills in Chile, one in Argentina, and has a 50% stake in a pulp mill in Uruguay. It's among the world's largest pulp producers, with a capacity of 4 million tons of bleached and unbleached kraft pulp (on an attributable basis). Arauco has 30 panel mills across the world (given its 50% stake in Sonae Arauco) with 10 million m3 in production capacity.

### Chart 3

#### Revenue And EBITDA Breakdown

As of June 2020



Source: S&P Global Ratings.

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## Business Risk

Arauco is one of the largest pulp and wood panel producers in the world. We view Arauco's operating efficiency as a credit strength thanks to its rapidly growing forestry, which translates into a cost-efficient operation. Arauco's efficient logistics (with relatively short distances from forests to mills and from mills to ports), and self-sufficiency in its energy consumption also favor its business profile. The inherent volatility of forest product prices, which heavily depend on consumer spending cycles--especially pulp that's also subject to speculative demand patterns in Asian markets--represents the main risks to Arauco's business, in our view.

Arauco's activities are divided into three main businesses: pulp, wood products (panels and solid wood) and forestry, and a complementary business of energy. However, the pulp and wood segments represent around 97% of the company's total revenue. Arauco has 4 million tons of pulp capacity and 10 million m3 of panels capacity as of June 2020 (including 50% of the Sonae Arauco joint venture), and approximately 1 million hectares of planted forest.

We believe the company has a successful track record of investing in, and expanding, its asset base, underpinning its market position in these two main business lines. Its acquisition of panel assets in Mexico and the new Grayling plant in the U.S. have improved Arauco's production capacity, maintaining its position as one of the world's largest forest products players. The MAPA project will add close to 1.3 million tons of pulp to Arauco's existing capacity.

## Peer comparison

**Table 1**

Celulosa Arauco y Constitucion S.A.--Peer Comparison				
Industry sector: Paper/forest products				
	Celulosa Arauco y Constitucion S.A.	Empresas CMPC S.A.	Suzano S.A.	Klabin S.A.
Ratings as of Oct. 21, 2020	BBB-/Negative/--	BBB-/Stable/--	BBB-/Negative/--	BB+/Stable/--
--Fiscal year ended Dec. 31, 2019--				
(Mil. \$)				
Revenue	5,329.2	5,670.3	6,471.5	2,555.4
EBITDA	1,150.4	1,122.2	2,648.3	931.9
Funds from operations (FFO)	529.8	572.8	1,809.0	579.1
Interest expense	253.4	199.1	847.7	369.8
Cash interest paid	290.8	146.4	741.9	301.8
Cash flow from operations	424.7	500.4	1,883.8	730.3
Capital expenditure	1,223.4	248.1	1,210.1	633.4
Free operating cash flow (FOCF)	(798.7)	252.4	673.7	96.8
Discretionary cash flow (DCF)	(980.8)	49.5	522.6	(143.3)
Cash and short-term investments	1,560.0	619.6	2,338.5	2,420.8
Debt	4,676.9	3,579.6	14,751.6	3,696.1
Equity	7,369.4	8,135.6	4,499.9	1,617.4
Adjusted ratios				
EBITDA margin (%)	21.6	19.8	40.9	36.5
Return on capital (%)	5.5	5.3	6.0	12.9



**Table 1**

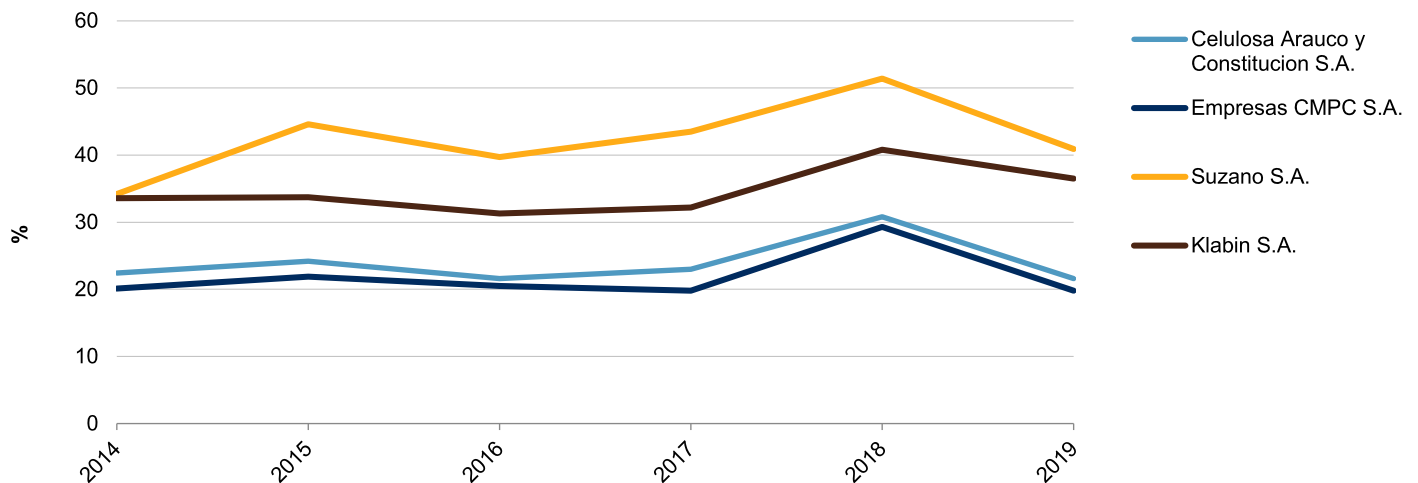
**Celulosa Arauco y Constitucion S.A.--Peer Comparison (cont.)**

<b>Industry sector: Paper/forest products</b>				
	<b>Celulosa Arauco y Constitucion S.A.</b>	<b>Empresas CMPC S.A.</b>	<b>Suzano S.A.</b>	<b>Klabin S.A.</b>
EBITDA interest coverage (x)	4.5	5.6	3.1	2.5
FFO cash interest coverage (x)	2.8	4.9	3.4	2.9
Debt/EBITDA (x)	4.1	3.2	5.6	4.0
FFO/debt (%)	11.3	16.0	12.3	15.7
Cash flow from operations/debt (%)	9.1	14.0	12.8	19.8
FOCF/debt (%)	(17.1)	7.1	4.6	2.6
DCF/debt (%)	(21.0)	1.4	3.5	(3.9)

We consider other Chilean and Brazilian pulp producers as close peers of Arauco, given that they also benefit from access to superior natural resources. Compared with peers, Arauco has sizable production capacity (although considerably smaller than that of Suzano Papel e Celulose S.A.) and product diversification. Brazilian peers generate stronger EBITDA margins than Arauco due to several factors. On one hand, Arauco has higher pulp cash costs, which is mainly due to the higher exposure to softwood, which is costlier to produce than hardwood. Arauco's pulp mills are older than those of the Brazilian players, which also result in slightly higher cash costs and maintenance capex. Finally, integration into the lower-margin panel business reduces average EBITDA but curbs some volatility. Fluctuating pulp prices tend to take a bigger toll on peers with strong or exclusive focus on commoditized pulp business.

**Chart 4**

**EBITDA Margin Comparison**



Source: S&P Global Ratings.

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## Financial Risk

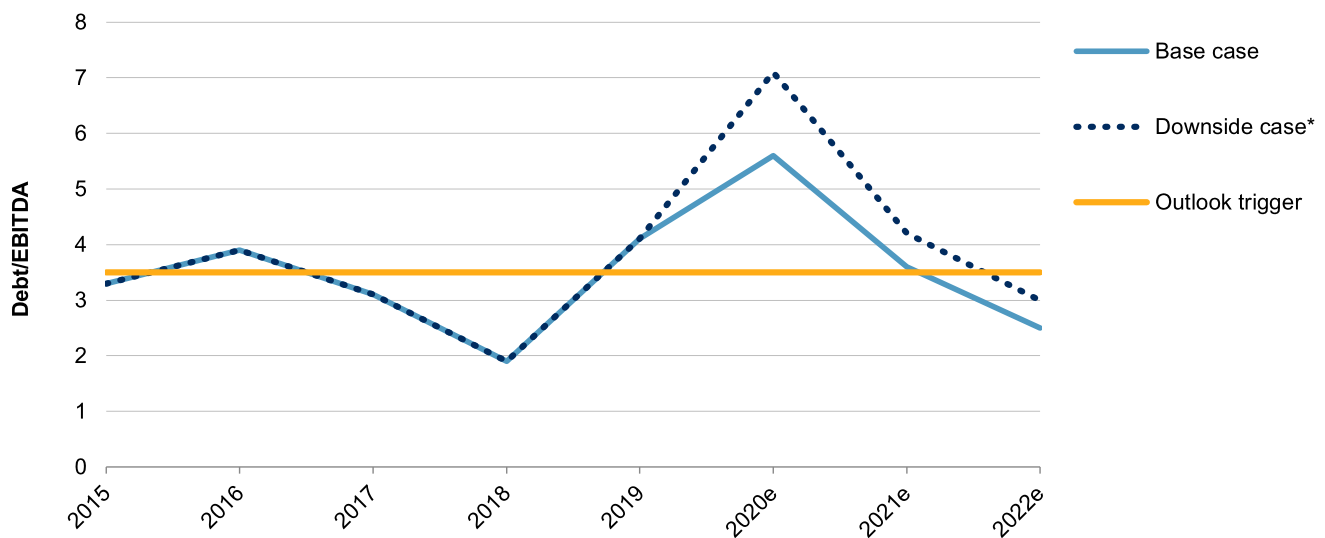
Arauco's financial profile is characterized by its ample, but volatile, operating cash generation, resulting from its reliance on commodity prices and its record of significant investments, which often result in FOCF shortfalls. Arauco's large forest base, which supports the company's capitalization may provide additional cash sources through prudent land divestitures during these periods.

The company is currently undergoing through an industry cycle downturn, with pulp prices at historic low, while it's completing the construction of a new pulp plant. Therefore, we expect Arauco to post weak credit metrics, with leverage above the rating thresholds in 2020, following poor performance in 2019. Amid some recovery in pulp prices, the strong recovery in woods and panels business, and the capital increase, we believe the company's metric will rapidly converge to the rating threshold. Our base-case scenario assumes EBITDA of \$0.9 billion - \$1.0 billion in 2020, and to climb \$1.3 billion - \$1.4 billion in 2021 with net debt to EBITDA of 5.2x-5.4x in 2020 and about 3.5x in 2021.

Nevertheless, Arauco has a tight cushion on its 2021 metrics to absorb either execution risks or market volatility. We believe the company might need to implement additional countercyclical efforts, such as asset sales.

**Chart 5**

### Leverage Sensitivity



e--Estimate. \*10% fall in pulp prices. Source: S&P Global Ratings.

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## Financial summary

Table 2

### Celulosa Arauco y Constitucion S.A.--Financial Summary

Industry sector: Paper/forest products

	--Fiscal year ended Dec. 31--				
	2019	2018	2017	2016	2015
<b>(Mil. \$)</b>					
Revenue	5,329.2	5,954.8	5,238.3	4,761.4	5,146.7
EBITDA	1,150.4	1,836.5	1,206.9	1,030.2	1,245.0
Funds from operations (FFO)	529.8	1,635.1	902.2	732.5	925.5
Interest expense	253.4	192.4	263.4	221.6	234.4
Cash interest paid	290.8	188.7	266.8	213.8	231.8
Cash flow from operations	424.7	1,275.3	1,074.1	776.2	858.1
Capital expenditure	1,223.4	881.5	621.9	494.7	319.5
Free operating cash flow (FOCF)	(798.7)	393.8	452.2	281.5	538.6
Discretionary cash flow (DCF)	(980.8)	136.4	330.6	150.9	395.6
Cash and short-term investments	1,560.0	1,075.9	589.9	592.3	500.0
Gross available cash	1,560.0	1,075.9	589.9	592.3	500.0
Debt	4,676.9	3,557.4	3,742.5	4,025.8	4,117.5
Equity	7,369.4	7,339.0	7,116.9	6,999.3	6,646.4
<b>Adjusted ratios</b>					
EBITDA margin (%)	21.6	30.8	23.0	21.6	24.2
Return on capital (%)	5.5	13.2	7.2	6.0	8.1
EBITDA interest coverage (x)	4.5	9.5	4.6	4.6	5.3
FFO cash interest coverage (x)	2.8	9.7	4.4	4.4	5.0
Debt/EBITDA (x)	4.1	1.9	3.1	3.9	3.3
FFO/debt (%)	11.3	46.0	24.1	18.2	22.5
Cash flow from operations/debt (%)	9.1	35.8	28.7	19.3	20.8
FOCF/debt (%)	(17.1)	11.1	12.1	7.0	13.1
DCF/debt (%)	(21.0)	3.8	8.8	3.7	9.6

## Liquidity

We view Arauco's liquidity as adequate. In the next 12 months, we expect sources of liquidity to exceed uses by more than 30% and to cover uses even if EBITDA were to fall 15% below our base-case assumptions. We believe Arauco has ability to absorb high-impact, low-probability events with limited need for refinancing given some flexibility to postpone capex or flexibility to sell some forest assets. We believe Arauco has a good standing in domestic and international debt markets, and it has a very comfortable cushion under its incurrence covenants for the next three years. Moreover, E-Copec has shown strong commitment to support the company if needed.

### Principal Liquidity Sources

- Cash and cash equivalents of \$1.17 billion as of September 2020;
- Committed credit facility of \$375 million maturing in 2025;

- Cash FFO of about \$1.0 billion in the next 12 months; and

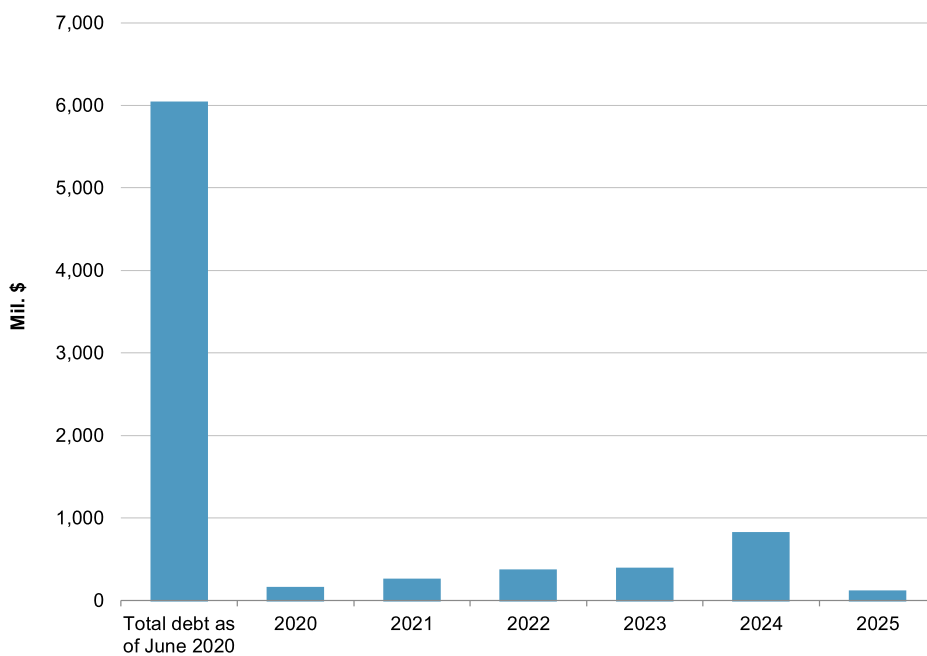
**Principal Liquidity Uses**

- Short-term debt maturities of \$274 million as of September 2020;
- Working capital needs of \$30 million - \$60 million in the next 12 months; and
- Capex of about \$1.3 billion in the next 12 months.

**Debt maturities**

**Chart 6**

**Debt Maturities**



Source: S&P Global Ratings.

**Covenant Analysis**

**Compliance expectations**

We expect Arauco to maintain a very comfortable cushion under its incurrence covenants for the next two years--more than a 50% cushion under its debt to equity, and more than a 100% cushion under minimum interest coverage one.

## Requirements

Arauco's international bonds don't have covenants. On the other hand, other debts have limits on the incurrence of additional debt and liabilities through the following covenants:

- Debt to equity ratio of maximum of 1.2x; and
- Interest coverage ratio of minimum of 2x.

## Environmental, Social, And Governance

We view Arauco's exposure to environmental factors as similar to that of its industry peers. Arauco benefits from favorable climate conditions that underpin its competitive position. The company's efficient and rapidly growing forest assets, sustainable forest management practices, and well-invested asset base support the credit rating. With planted forests of radiata, taeda, and elliottii pine and eucalyptus in Chile, Argentina, Brazil, and Uruguay, the company benefits from large harvesting yields and is among the lowest-cost (in terms of cash) producers in the world, only behind Brazilian peers. The company's EBITDA margins also benefit from its 100% energy self-sufficiency. On the one hand, Arauco is one of the largest unconventional renewable energy producers in Chile and sells excess capacity to the national energy grid, and expects to be certified as the sector's first carbon-neutral company in 2020. On the other hand, its Chilean forests are exposed to wildfires that have caused considerable losses in the past. For instance, a massive fire in 2017 destroyed about 7% of Arauco's planted area, but didn't cause credit metrics to deteriorate. The company subsequently launched a forest renovation plan in Chile, and strengthened its insurance coverage, fire prevention, and suppression programs. These investments didn't have a material impact on its profitability.

## Group Influence

Arauco is a privately held subsidiary of E-Copec, the Chilean holding company controlled by AntarChile S.A. (not rated). E-Copec's main assets also include the Chilean fuel distributor, Compañía de Petróleos de Chile Copec S.A. (COPEC; BBB-/Stable/-). The Angelini family ultimately owns AntarChile. We view Arauco as highly strategic to E-Copec because we believe the parent is highly unlikely to sell Arauco, given that it's an integral asset for the group's strategy. Our assessment also reflects our opinion that the group has incentives to support Arauco because it contributes a meaningful stream of cash (about 63% of the group's EBITDA), and it's closely linked to the group's reputation, because it's been the flagship company of the Angelini portfolio since its inception. The recent capital increase also confirms our view that E-Copec would support Arauco under almost all foreseeable circumstances.

## Issue Ratings - Subordination Risk Analysis

### Capital structure

As of September 2020, Arauco's capital structure consisted of about \$4.6 billion in senior unsecured bonds issued at the level of holding company (Arauco), and slightly more than \$1.2 billion in bank loans of which about half is at the operating subsidiaries' level. Its secured obligations were minimal.

## Analytical conclusions

We rate Arauco's senior unsecured notes at the same level as the issuer credit rating because we don't believe there are material financial obligations that would rank ahead of the company's unsecured debt by way of structural or contractual subordination in a default scenario. Arauco's secured obligations represent less than 1% of consolidated debt, and unsecured debt at the level of operating subsidiaries is less than 25% of total debt.

## Reconciliation

**Table 3**

**Celulosa Arauco y Constitucion S.A.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. \$)**

--Rolling 12 months ended June 30, 2020--

**Celulosa Arauco y Constitucion S.A. reported amounts**

	Debt	Shareholders' equity	Revenue	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations	Dividends	Capital expenditure
Reported	6,364.7	6,901.6	4,766.5	657.9	22.1	233.2	977.8	790.0	0.1	1,474.4
<b>S&amp;P Global Ratings' adjustments</b>										
Cash taxes paid	--	--	--	--	--	--	(79.7)	--	--	--
Cash interest paid	--	--	--	--	--	--	(286.5)	--	--	--
Reported lease liabilities	220.3	--	--	--	--	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	50.6	--	--	6.6	6.6	6.6	--	--	--	--
Accessible cash and liquid investments	(1,266.9)	--	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	30.2	(30.2)	(30.2)	--	(30.2)
Dividends received from equity investments	--	--	--	4.0	--	--	--	--	--	--
Nonoperating income (expense)	--	--	--	--	33.9	--	--	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	--	(226.0)	--	--
Noncontrolling interest/minority interest	--	29.4	--	--	--	--	--	--	--	--
COGS: Valuation gains/(losses)	--	--	--	311.1	311.1	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	--	150.1	150.1	--	--	--	--	--
EBITDA: Other income/(expense)	--	--	--	16.6	16.6	--	--	--	--	--
EBITDA: Other	--	--	--	(168.4)	(168.4)	--	--	--	--	--

Table 3

Celulosa Arauco y Constitucion S.A.--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. \$) (cont.)										
Depreciation and amortization: Other	--	--	--	--	39.3	--	--	--	--	--
Total adjustments	(996.0)	29.4	0.0	319.9	389.1	36.8	(396.4)	(256.2)	0.0	(30.2)
S&P Global Ratings' adjusted amounts										
	Debt	Equity	Revenue	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Dividends	Capital expenditure
Adjusted	5,368.7	6,931.0	4,766.5	977.8	411.2	270.0	581.4	533.8	0.1	1,444.2

## Ratings Score Snapshot

### Issuer Credit Rating

BBB-/Negative/--

### Business risk: Satisfactory

- **Country risk:** Intermediate
- **Industry risk:** Moderately high
- **Competitive position:** Satisfactory

### Financial risk: Significant

- **Cash flow/leverage:** Significant

Anchor: bbb-

### Modifiers

- **Diversification/portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : bbb-

- **Group credit profile:** bbb-
- **Entity status within group:** Highly strategic (no impact)

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

### Business And Financial Risk Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
<b>Satisfactory</b>	a/a-	bbb+	bbb/bbb-	<b>bbb-/bb+</b>	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

### Ratings Detail (As Of November 18, 2020)\*

#### Celulosa Arauco y Constitucion S.A.

Issuer Credit Rating BBB-/Negative/--

Senior Unsecured BBB-

#### Issuer Credit Ratings History

15-Oct-2019 BBB-/Negative/--

27-Mar-2013 BBB-/Stable/--

17-Sep-2012 BBB-/Negative/--

#### Related Entities

##### Compania de Petroleos de Chile COPEC S.A.

Issuer Credit Rating BBB-/Stable/--

##### Empresas Copec S.A.

Issuer Credit Rating BBB-/Stable/--

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