

Anglo American and Codelco's call option: false or misleading information sent to shareholders?

On January 2<sup>nd</sup>, 2012 Codelco completed the exercise of the call option it had over 49% of Anglo American Sur (AAS). This step followed the procedure as set up in the Call Option agreement - valid for 50 years - dated January 24<sup>th</sup>, 1978 between Enami and Exxon and which was later modified on November 13<sup>th</sup>, 2002 between Enami and Anglo American (AA). Enami later transferred this call option to Codelco in December 2008. The call option exercise process was initiated on July 29<sup>th</sup>, 2011 when AA informed Codelco, as contractually established, the estimated and provisional exercise value of US\$ 6.100 million to buy 49% of AAS. The final and definitive exercise value for this 49% stake was to be determined at the end of fiscal year 2011. On October 28<sup>th</sup>, 2011 Codelco informed to the market and Chilean securities regulator that its Board had decided to complete the exercise of the full 49% call option initiated on July 29<sup>th</sup>, 2011. AA has been legally disputing the completion of this call option contract and on November 9<sup>th</sup>, 2011 it announced to the market the sale of 24.5% of AAS to Mitsubishi, suggesting that Codelco's call option would then decrease to 24.5% of AAS. As of today, a legal battle in Chilean courts and under Chilean laws is unfolding between both parties involved.

If Codelco's 49% call option is valued using the latest transaction parameters over AAS between AA and Mitsubishi, which prices AAS equity at US\$ 22.000 million, and we assume the US\$ 6.100 million exercise value as definitive, it reaches US\$ 4.680 million<sup>1</sup>. This is the net gain realized by Codelco out of this call option contract and it obviously constitutes an equivalent net loss to be realized by Anglo American shareholders. Given AA market capitalization around US\$ 48.000 million, the loss to them today represents approximately 10% of their equity.

What did AA's shareholders know about this option contingency in the meantime?

At the Annual Report 2010 of AA, dated February 18<sup>th</sup>, 2011 and which was approved by the Board of Directors and signed on its behalf by Cynthia Carroll as Chief Executive and René Médori as Finance Director, there was a reference to this option under "Embedded Derivatives / Anglo American Sur" in the "Financial Risk Management and Derivative Financial Assets/Liabilities" section. At the end of the explanation, it stated the following: **"Based on the range of scenarios for these key variables, it has been concluded that the option has insufficient value to warrant recognition on the balance sheet as at 31 December 2010"**.

Later on, in the Half Year Financial Report for the 6 months ended 30 June, 2011, released on July 29<sup>th</sup>, 2011 by order of the Board and again signed by Cynthia Carroll as Chief Executive and René Médori as Finance Director, under "Derivative financial liabilities – Anglo American Sur", they similarly stated the following: **"Notwithstanding this wide range, based on valuations determined using assumptions considered within a reasonable range, it has been concluded that the option has insufficient value, as determined by the applicable accounting standard, to warrant recognition on the balance sheet at 30 June 2011"**.

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<sup>1</sup> Call option value for 49% of AAS, in US\$ million:  $22.000 \times 0.49 - 6.100 = 4.680$

On November 9<sup>th</sup>, 2011 AA announced the completion of its sale of a 24.5% interest in AAS, comprising certain of AA's copper assets in Chile, to Mitsubishi Corporation for US\$ 5.39 billion. On November 10<sup>th</sup>, 2011 Mitsubishi Corporation informed too about this transaction in equivalent manner. What none of them informed to the market is that by then Codelco had already announced – October 28<sup>th</sup>, 2011 -its decision to complete the exercise of the 49% call option whose process was initiated on July 29<sup>th</sup>, 2011.

On November 11<sup>th</sup>, 2011 Cynthia Carroll declared in an interview with local newspaper La Tercera<sup>2</sup> that "I started to talk with Diego Hernández in January" - Diego Hernández is Codelco's CEO and January is referred to January 2011 -. Then she mentioned numerous internal meetings to solve this issue. In another interview, this time with local newspaper El Mercurio<sup>3</sup>, also dated November 11<sup>th</sup>, 2011, she again said that since January 2011 they had had numerous meetings with Codelco executives over AAS.

But interestingly enough, one does not negotiate many times, with increasing intensity since January 2011, over an asset or liability – depending on who owns the call option – that has insufficient value to warrant recognition on the balance sheet. Most importantly, a negotiation over such an irrelevant asset or liability would not take place between both CEO's. There might certainly be more important issues to take care of than this supposedly irrelevant one. The truth is that AAS, at US\$ 22.000 million equity valuation is equivalent to almost half of AA's own equity and any call option over it eventually has an important economic impact over AA, more so when the exercise value is cheap.

To make matters worse, there were some verbal offers to buy this call option by AA to Codelco during these negotiations in the first half of the year 2011 that were apparently up to US\$ 1 billion. This last offer has not been disputed either by Codelco or AA to this day, nor the timing of them having taken place before the release of AA Interim Results on July 29<sup>th</sup>, 2011. More so, AA knew that those offers, particularly the US\$ 1 billion offer, were all rejected by Codelco for their low value. In other words, AA already knew by the time it released the Interim Results on July 29<sup>th</sup>, 2011 that the Codelco call option liability was far bigger than what was being disclosed as insufficient value to warrant recognition in the financial statements. And this information was particularly known by the Chief Executive of AA who directly participated in these negotiations, as she told reporters on November 11, 2011. She also happens to sign AA Interim Results that were released to shareholders on July 29<sup>th</sup>, 2011, as well as those of AA Annual Report 2010, released on February 18<sup>th</sup>, 2011.

In other words, what did AA shareholders knew during 2011? That this AAS call option liability was irrelevant to warrant recognition on the Balance Sheet. What did AA's CEO knew and possibly AA's Board? That this liability was reasonably far bigger than what was being stated in both the Annual Report 2010 and Interim Results First 6 Months ended June 2011. What was AA's real liability? A loss of approximately US\$ 4.680 million, based on AA transaction with Mitsubishi over AAS on November 9<sup>th</sup>, 2011.

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<sup>2</sup> See website <http://diario.latercera.com/2011/11/11/01/contenido/negocios/10-90024-9-cynthia-carroll-codelco-no-puso-sobre-la-mesa-sus-intenciones-ni-fue.shtml>

<sup>3</sup> See website [http://www.mch.cl/noticias/imprimir\\_noticia\\_neo.php?id=34798](http://www.mch.cl/noticias/imprimir_noticia_neo.php?id=34798)

Why is this description so relevant? Because it could carry grave consequences to the company and officers that eventually do not comply with UK Securities Laws. In June 2008 the Financial Services Authority (FSA) released a document titled “Why market abuse could cost money”. In it there is a description of market abuse and some examples are given to better understand its meaning. One that constitutes market abuse is the following: “Dissemination – giving out information that conveys a false or misleading impression about an investment or the issuer of an investment where the person doing this knows the information to be false or misleading”.

It turns out that article 397 of the Financial Services and Markets Act 2000, about misleading statements and practices, applies to a person who makes a statement, promise or forecast which he knows to be misleading, false or deceptive in a material particular; who dishonestly conceals any material facts whether in connection with a statement, promise or forecast made by him or otherwise; who recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular. It also says that a person guilty of an offense under this section is liable on summary conviction, to imprisonment for a term not exceeding six months or a fine not exceeding the statutory maximum, or both; on conviction on indictment, to imprisonment for a term not exceeding seven years or a fine, or both.

At least, a formal investigation in the UK over this gross discrepancy between what was being informed and what was really happening is due. Moreover, this lack of transparency could end up making untenable AA’s present opposition to Codelco’s exercising its full 49% call option. AA shareholders might be understandably upset, but their problem is closer to them in the UK than to Codelco, for they were the ones not being correctly informed about this option, which was already priced and discounted for when they bought AAS from Exxon back in 2002. AA might have stated in its recent Financial Statements that they were negotiating under confidentiality agreements to lower the impact of this liability on its shareholders; it just did not do so and went further, stating that the liability was null, even though it already had information that proved that wrong. The case in defense for CEO Cynthia Carroll and AA’s Board is clearly delicate, it worsens their “good faith contractual case” in Chilean courts if found guilty in the UK on eventual market abuse misconduct practices and could only prove more damaging if these misleading or false statements were shown to be instrumental for the purpose of getting hold over an asset which was not legally and contractually theirs and which they knew Codelco had on its sight and was prepared and able to purchase under its attractively low exercise price.

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