CAP: still waiting for a clear answer

CAP, a Chilean steel and iron company with a US$ 6 billion market value at present time, has finally completed a strategic financial transaction with Mitsubishi, one of its owners, that has allowed the Japanese group to get a preponderant controlling position in the company. The big question is who gets benefited from it and who does not and how we can eventually correct it.

To put this transaction into perspective, CAP now owns the major iron ore mines to be developed in Chile (3.2 billion tons in iron mineral resources) which would enable it to more than duplicate, under competitive conditions, its approximate 10.6 million ton iron production in 2010. Its steel production capacity, 1.4 million tons per year, heavily relies on the Chilean domestic market with a 60% participation mainly shared with an affiliate of Brazilian firm Gerdau, which globally produced 14 million tons of steel last year.

To put these figures into perspective, world steel production is around 1.200 million tons per year, for which it approximately needs 1.800 million tons of iron. While steel capacity is replicable, iron ore resources are not and have become increasingly scarce. It is this scarcity what makes the iron division of CAP an asset worth fighting for, particularly so when it can trade in the 1.000 million ton seaborne iron market where BHP Billiton, Rio Tinto and Vale are the main producers and China its main consumer. In Quingdao, China, iron ore prices at 62% Fe are now trading around US$ 140 per ton.

But that necessary competitive process did not take place. From the beginning and precluding any other possible partners, CAP entered into an exclusive negotiation with its biggest individual shareholder Mitsubishi – 19.3% ownership - which simultaneously was and will continue being an important creditor, a pellet plant supplier, a coal supplier and no less important an iron trader for CAP. Basic prudence would have dictated otherwise.

Transaction related documents even explicitly stated a search for “consensus” between CAP and Mitsubishi as “they had done in the past”, revealing the existence of a de facto shareholders´ agreement between them before the proposed transaction was to be voted and which they later formally neglected when questioned by Securities Laws authorities. However, consistent behavior and converging interests usually reveal more about past and expected future performance than a mere formal agreement which is altogether denied. In that sense, facts are stronger evidence than formalities.

Other details, when looked upon together, make this transaction appear even more questionable. The independent evaluation, as required by law, was made by an investment bank that recognized that in the recent past had helped Mitsubishi buy “strategic” share investments in CAP; the new shareholders´ agreement, fully disclosed only under pressure from the same Securities Laws authorities, requires commercial, production, operational, financial, supply and transportation decisions in the iron division to be approved by Mitsubishi; the administration of CAP continues insisting it nonetheless controls the iron division. Again, facts vs formalities.

In other words, the case points to a de facto shareholders´ agreement existing before the transaction which would not have been disclosed as such.

¿What if price conditions were reasonable, in spite of this? That does not change the fact that conditions could have been even better for all shareholders if the iron transaction had been open to third parties competing for it. A potential withholding of information is certainly not a value maximizing avenue and third parties could reasonably feel their rights were not respected properly.

¿Is this case valid even if pension funds approved of the transaction? Certainly, because they could argue they did not clearly recognize the change in controlling arrangements that was taking place and which had transformed Mitsubishi in the central player in any transaction over CAP from now on. That centrality would allow it to extract a rent that was and should be due to all shareholders and not just to some of them. In the race to control CAP, a needless intermediary with a "poison pill" has been created.

If finally deemed incorrect, a three step solution to this transaction would be forthcoming. Rescinding the shareholders´ agreement would be the minimum first step. The next step would be to require transparency on the prices CAP receives for its different iron products and pays for its transport and coal supplies, to be compared with Australian and Brazilian mining firms. And the last step, to open its iron division to the market for liquidity, transparency and capital increases for the development of its iron resources.

Almost half a year has gone since the first transaction approvals went through. It is high time to revisit the whole process if we really expect capital markets to efficiently work. The actors involved might have big economic and lobbying networks across the mining, electricity and financial sectors which might explain the apparent passivity from many, but at least the Securities Laws authority should be clear about this whole process. Silence is not and if finally approved, so be it from a public policy perspective. Price transparencies would then be the best way to protect the interests of all shareholders.

Manuel Cruzat Valdés

Santiago, Chile

September 1st, 2010