Proposed Corpbanca Itau Chile bank merger: an institutional failure

Last January 29th, 2014 Corpbanca and Itau Chile announced a US$ 6 billion merger and capital increase proposal that would give birth to a bank to be controlled by Itau Unibanco. The negotiation process for Corpbanca was conditioned on having its present controlling party, CorpGroup, as a relevant partner in the future merged entity and on avoiding a US$ 2 billion tender offer open to its minority shareholders.

Corpbanca had been under great financial stress during the third quarter of 2013, mainly due to market doubts about the financial health of CorpGroup and a related retail firm, SMU, with direct and indirect loan exposure to it. It even led up to the Central Bank of Chile to make public its concerns about Corpbanca and its then fragile financing structure.

But it so happened that the merger proposal had additional features, in favor of CorpGroup only, to be later on disclosed under both the Shareholders´ Agreement and Transaction Agreement. Those features included the sale of CorpGroup´s participation in Corpbanca Colombia for US$ 329 million to Corpbanca Chile, along with other shareholders on the same conditions; a US$ 950 million – later raised to US$ 1.200 million - seven year loan to be provided by Itau Unibanco; minimum and guaranteed – by Itau Unibanco – annual dividends to CorpGroup in the amount of US$ 122 million for an eight year period; financing over 6.6% of merged bank equity - US$ 400 to US$ 500 million, approximately – using shares that could be bought back by CorpGroup either privately or publicly under its sole discretion using a five year call option structure with no reciprocal put from Itau Unibanco; financing over undefined future capital increases under the same five year call[1] and no reciprocal put option structure in favor of CorpGroup. All these features, amounting close to US$ 2.000 million, excluding minimum dividends and future undefined capital increases, were additional to the standard first offer, tag along and drag along clauses between Itau Unibanco and CorpGroup usually considered in this kind of transactions.

Would a third party agree to offer these loans, guarantee minimum dividends and freely deliver five year call and no reciprocal put options, constituting a whole financial package with a valuable upside to the debtor, without being involved in the merger itself or compensated some other way? If the answer is **no**, as expected, than a **two price transaction** would in fact be born, one price to CorpGroup and the other one, lower, to minority shareholders that would not have access to this attractive financing and call and no reciprocal put options structure. This is where the essence of the problem lies. It is not an interest rate over the loans argument as if it really captured the value; it is the legitimate question as to who else, if anyone at all, would willingly offer this whole financial package with such a valuable upside in favor of the debtor on its own merit.

What have authorities said until now? Both the Securities and Banking authorities stated last November[2] that the merger proposal did not necessarily elicit a tender offer in favor of minority shareholders. As far as it is known, they would not have addressed the issue of a two price transaction proposal. Even though the laws involved are not as clear cut as would be desired for this complex transaction, their meaning should be understood to protect those who cannot protect for themselves. These authorities formal standing should have been guided by what those laws were intended to mean: a third party was willing to take control of a bank under relevant additional features available to one other party only, with the expected result that the core merger transaction could not be but distorted by these abovementioned valuable collateral features. They should have known there was no free lunch in this world. However, in the *realpolitik* arena, they might have favored a transaction that could financially

[1] A five year call option as this one would be worth between 9% and 18% of par value under Black Scholes formula.
[2] La Tercera, 14 de noviembre 2014, “SBIF y SVS concluyen que fusión entre Corpbanca e Itau no requiere OPA”.

support a weakened economic group working under a stressed and decelerated economy over price differences that, while existing, would not have been in their view big enough to justify endangering the whole transaction. Before both authorities made public their standing, Itau Unibanco had made it officially known[3] that they would quit the transaction if they were forced to initiate a tender offer.

What have other shareholders done? The most relevant, IFC, surprisingly announced this last month it would not veto the transaction, after local authorities had already made public their position over tender offer requirements. The terms under which it might have finally agreed to the merger are unknown, but if there were any new clauses with the new controlling party that could in some way represent an exclusive compensation for them for this price difference, that would not only be wrong but also inconsistent with its self proclaimed Goals and Values: "We have a long history of setting a good example – of demonstrating the rewards of investing in challenging markets"[4]. Other shareholders, also creditors to CorpGroup or its affiliates, have also expressed their support for the transaction, but usually mixing their global interests in shares and credits, blurring the stand alone share valuation fairness.

The most fervent critic of the merger transaction, Cartica, after local Securities and Banking authorities did not demand a tender offer and the IFC did not exercise its veto option on the merger, regretted what had happened and decided for the moment not to further insist in the Courts to correct for the transaction. They were alone, but they were right.

So far, institutions have basically failed, including the IFC. While there is no perfect solution and every transaction has its own complexities, going over minority shareholders´ rights as it could regrettably happen in this case would mainly constitute a short run gain for some and a long run loss for everybody. Let us hope a correction is duly offered before the transaction is finally implemented. If these collateral features do not have a relevant net economic value, as suggested by some consultants hired by Corpbanca[5], just eliminate them and correspondingly readjust the exchange ratio in the merger. Shareholders will be waiting for at least one independent valuation to be delivered at the Shareholders´ Assembly to be convened to approve of the transaction, where the consent of two thirds of shares would be needed. These valuations and written opinions from all bank directors are requested by Law given the related party transaction nature of loans and options between the two main shareholders who are also key participants in the merger itself. At the end of the day, minority shareholders and Securities and Banking authorities could still have a final word, dismantling the still alive price difference among shareholders.

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[3] Diario Financiero, November 13th, 2014, Interview of Mr. Ricardo Marino from Itau Unibanco.
[4] IFC, Member of World Bank Group, About IFC, Our Goals and Values.
[5] Group led by Mr. Dieter Linneberg, Corporate Governance and Capital Markets Center, Universidad de Chile.