# CHILE

# Compañia de Acero del Pacífico (CAP)

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# PREFACE

Over the past decade, nations throughout the world have undertaken to design and implement privatization programs as part of a broader strategy to promote economic efficiency and sustain growth. The **International Privatization Group** at Price Waterhouse (PW/IPG), a venture funded by the US Agency for International Development, was created to assist developing nations to carry out the complex and dynamic process of privatization.

Technical know-how and practical experience in privatization are often a significant constraint to successful private-sector development in the developing world. PW/IPG seeks to address this problem by providing various types of technical assistance and undertaking applied research, "hands on" training and global information sharing.

In contrast to the theoretical approach of most privatization research, IPG stresses applied research that examines the many practical factors which influence privatization success and failure. Case studies of actual privatization transactions that have been completed provide one effective vehicle for encapsulating the privatization experience.

This volume of cases presents privatization transactions that have been completed in Asia, Latin America, and Eastern Europe. The cases deal with transaction-specific issues, including company valuation, structuring joint venture agreements, and policy-level concerns such as labor displacement and regulation of foreign investment. Each case provides an overview that places the transaction in a broader context, and then delves into the specifics of how the transaction was planned and implemented. Addendum, or "B" cases, are provided after each case to provide a view of actual decisions made and their consequences. Teaching notes, outlining the major issues and lessons to be learned from each case, are detailed for the instructor or training leader in a separate volume.

We are indebted to the extraordinary efforts of the case writers who participated in our pilot program, and to the many people who cooperated with them as they conducted in-country research. We also thank the people who contributed to the review and the testing of the cases and the US Agency for International Development.

International Privatization Group
Case Study #1

# COMPANIA DE ACERO DEL PACIFICO (CAP)

## CHILE

On July 21, 1985, Mr. Roberto de Andraca, president and CEO of the Chilean Compañía de Acero del Pacífico (CAP), was deeply concerned. Re-privatization of the $200 million mining and steel producing firm had stalled, and De Andraca felt that if he failed to steer the firm into majority private ownership soon, CAP would be forced to close down and liquidate huge portions of its facilities. If he succeeded in re-privatizing the firm, CAP would gain access to investment funds desperately needed to update and expand the firm's aging production process. Without these funds, however, De Andraca believed that CAP's productivity and competitiveness would plummet. By 1990, the firm would be reduced to one-tenth its current size, and most of its 7,000 employees would have to be laid off.

To accelerate the re-privatization of his firm, De Andraca would have to appraise CAP's value and sell enough of the firm's shares to displace the government's hold on majority ownership. But De Andraca faced a series of difficult problems. Although key leaders of the military government's new finance team supported CAP's re-privatization, some sectors of the military opposed selling the company. In addition, a group of CAPs's top executives had lined up against active involvement in the privatization process. Still, De Andraca felt that his biggest challenge would be to find buyers. The Chilean economy was still recovering from the worst economic crisis in its history, the steel industry was suffering from a glut of overproduction, and CAP's low profitability over the last ten years had been marked by wide swings in earnings. In this climate, De Andraca had to evaluate all possible options to sell CAP's shares and reduce the government's ownership.

### Privatization and the Chilean Economy

The Chilean privatization program was launched shortly after President Salvador Allende was deposed in a violent military coup on September 11, 1973. Led by General Augusto Pinochet, the new military government moved swiftly to reverse the central economic policies of the socialist Allende government -- a sweeping nationalization program that had dramatically increased the economic role of the state. Over the next 10 years, the privatization program formed a critical part of a much broader macroeconomic policy. This conservative program was designed to liberalize trade and financial markets, cut fiscal

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deficits, rely heavily on the market to allocate resources, and increase enterprise efficiency.

*Phase I.* From 1974 to 1985, the Chilean privatization program passed through two major phases. In the first 1974-75 phase, the government's central objectives were to reverse the statism of the Allende government, and to check inflation. Under the Allende government, the percentage of Chile's GDP controlled by the public sector had risen from 15 to 39 percent, and state subsidies to SOEs had grown to more than $500 million per year. By 1974, with fiscal deficits that rose to 25 percent of GDP, and inflation surging above 500 percent, the Pinochet government returned approximately 240 recently-nationalized enterprises to their original owners. There were no payments to or by the government.

*Phase II.* During the second, 1975-1983 phase of the privatization program, the government's finance team placed higher priority on raising fiscal revenue. In this phase the state targeted firms in which the previous government had bought shares, as well as new SOEs created from 1971-73. To facilitate privatization, the government granted purchasers a direct 8-15 year loan at an 8-12 percent real interest rate. Because company assets served as collateral for the loan, and no regulations existed to prevent purchases without adequate financial backing, large, highly-leveraged conglomerates developed to take advantage of prices widely considered low.

Although roughly 110 enterprises were divested in this second phase, the entire privatization program received a serious setback during the economic crisis of 1982-83. Despite a GDP growth rate averaging 7.2 percent from 1976-81, the combined shocks of a sharp drop in Chile's terms of trade and an equally steep rise in interest rates revealed significant shortcomings in the privatization process. Most importantly, many of Chile's highly-leveraged conglomerates collapsed, forcing the state to intervene to stave off widespread bankruptcy and exacerbating the economic crisis. As the government took control of a large number of national banks, GDP fell 15 percent in 1982, and dropped another 2 percent in 1983. By late 1983, unemployment had risen to 25 percent, inflation hovered at close to 20 percent, and GNP per capita fell back to mid-1960 levels.

## The Role of CORFO

Since 1974, the Corporación de Fomento de la Producción (CORFO) had been designated as the agency responsible for managing Chile's privatization program. Created in 1939 as a state development corporation, CORFO was originally charged with promoting productive activities through private sector loans, guarantees, and occasionally direct investment in projects. The agency grew modestly in the post-War period, and by 1970 held equity in 46 companies. Under President Allende, CORFO was transformed into the state arm for nationalization, and by the end of 1973, CORFO owned 500 state-owned corporations, including 19 commercial banks.

In 1974, the military government entrusted CORFO with overseeing and implementing the state's privatization program. By 1985, CORFO's structure consisted of

three principal units: 1) a supervisory "Council" composed of ministers of the economy, finance and the state planning agency, ODEPLAN; 2) an informal, consultative "Privatization Committee" composed of ministry representatives and three, full-time CORFO managers; and 3) a "Normalization Unit" composed of technical analysts responsible for implementing privatization policies including restructuring enterprises, screening buyers and collecting proceeds from sales. The CORFO Council held final responsibility for all privatization decisions, although the Normalization Unit performed most of the technical analysis and made recommendations to the Council that were frequently approved.

The Government in 1985

In 1985, CORFO fell under the new, more vigorous leadership of Finance Minister Hernán Buchi. Appointed to the post in February, 1985, the 36-year old Buchi was well-known as a brilliant economist firmly committed to free-market principles. Buchi had been a leader in shaping economic policy in the late-1970s, and brought to his new office wide technical experience formulating health, mining and banking policy. As the most powerful official in CORFO, Buchi's commitment to privatization gave the government's privatization program renewed impetus.

Under Buchi's leadership, the government's privatization objectives were to rapidly divest the state-controlled financial sector, screen out unstable, highly-leveraged investors, and widen share ownership. In addition, with continued economic stagnation, the government faced mounting pressures for social programs at a time when fiscal revenues had sharply decreased. With these priorities, Compañía de Acero del Pacífico emerged as an excellent privatization candidate. Explained Cristián Larroulet, Buchi's chief-of-cabinet in the Finance Ministry:

> CAP was always on the list of key enterprises to be privatized. In 1985, the state was too large, the government needed money, and the urgency of social measures was much higher than before. We needed private investment and foreign capital, and so we turned to the best companies. In terms of good resources and good management, CAP was high on the list.

Despite strong government support for CAP's privatization, however, some military leaders were opposed. Along with a number of other large industrials and utilities, CAP had been identified as a "strategic sector" of the Chilean economy that should remain under state control. Five of the 7 members of CAP's board of directors were military officers. In addition, the vice-president of CORFO, General Fernando Hormazábal, had openly expressed his opposition to CAP's privatization. Though he ranked just below Finance Minister Buchi as CORFO's vice president, Gen. Hormazábal sat on both the Privatization Committee and the Council, which had final responsibility for privatization decisions. CAP's CEO Roberto De Andraca explained:

> Hormazábal's perception was that it's very good to open up the country, to have

competition and free enterprise, but he believed that the companies under him were his regiments, and the generals who wanted to bring his regiments to the enemy were traitors.

**The Compañía de Acero del Pacífico**

Compañía de Acero del Pacífico was founded on April 27, 1946, to curb Chile's dependency on foreign sources of steel. Running over 2,000 miles along the minerals-rich Andes mountains, Chile possessed all the key raw materials necessary for steel production. With $15 million in start-up capital from CORFO, the National Treasury and private shareholders, CAP constructed an integrated steel plant near the coastal town of Huachipato, roughly 300 miles south of Santiago.

Since 1950, CAP's Huachipato plant generated its own pig iron by reducing iron ore in its blast furnaces, transforming this pig iron into steel ingots with oxygen converters, and processing the ingots to produce finished and semi-finished steel products. The production of steel products required four principal raw materials -- iron ore, coke, coal, and limestone -- as well as electrical power. Exhibit 1 shows the principal inputs and production processes utilized at the Huachipato steelmaking plant.

By 1985, CAP's products included steel reinforcing bars, plates, coils, billets, blooms, sheets and tubes, and other items. The steel products were sold primarily to consumers, manufacturers, warehouse dealers and construction firms, for uses ranging from household appliances to industrial equipment. Beginning with 160,000 metric tons of steel products in 1950, CAP's output increased to over 600,000 tons by the end of 1984. The products satisfied 85 percent of domestic demand for finished and semi-finished steel products from iron ore. The remaining 15 percent of local demand was made up primarily by imports, although there were several other small Chilean steel producers.

In 1959, CAP expanded operations to include iron ore mining, forming a new subsidiary, Compañía Minera del Pacífico (CMP). CMP's mining and commercial activities were launched in the northern Chilean mountains at La Serena with two goals: to supply the production requirements at the firm's Huachipato plant, and to export. At La Serena and other locations in northern Chile, CMP purchased and mined iron ore deposits, elaborated iron ore pellets in its plants, and shipped them domestically and abroad. CMP exported 84 percent of its sales volume.

Other CAP subsidiaries included Manganesos Atacama (MASA). By 1984, the subsidiary produced standard ferromanganese, silicomanganese and medium-grade manganese ore, selling 80 percent of its products domestically (most of these to CAP's Huachipato operations), and exporting the remainder to Colombia, Ecuador and Peru. Three additional subsidiaries were formed for supplies, commercial marketing, distribution and sales: Abastacimientos CAP, S.A. provided supplies and support services for CAP's

mining and steel operations; Pacific Ores and Trading Co. served as an agent for overseas iron and pellet sales from the firm's mining operations, and Acero Comercial marketed CAP's steel products in Chile. Exhibit 2 displays the CAP Group's company structure as of December 1980.

CAP: From Private to State-Owned

As a condition requested by CAP's largest original creditor, the U.S. Export-Import Bank, CAP was founded as a joint stock company with 53 percent private ownership. By the mid-1960s, private ownership in CAP grew to 12,000 private investors, totalling 65 percent of the company's shares. The remaining 35 percent was owned mostly by CORFO. During 1968 negotiations to extend the firm's tax-free status, however, CAP management agreed to the government's request for majority ownership, and CORFO increased its total share ownership to 54 percent.

In November 1970, the socialist government of Salvador Allende bought out almost all of the remaining private owners of CAP's shares at terms that were particularly unfavorable for large investors. Through CORFO, the government purchased CAP's shares at full market value, but only up to a certain maximum number of shares. After this number had been reached, the price paid declined progressively, with the result that investors with large numbers of shares were bought out at a fraction of the shares' market value. In addition, CORFO paid for the stock in bonds whose value was not indexed to keep pace with inflation that rose above 500 percent by late 1973. By the end of 1972, the private sector share of stock ownership fell to 0.98 percent, and to 0.40 percent the following year.

In 1974, the Pinochet government introduced measures to improve CAP's efficiency and to prepare the firm for eventual re-privatization. Driven by a macroeconomic program to curb inflation by cutting fiscal support for SOE's, in 1975 the government declared that SOE's were henceforth prohibited from hiring additional labor, and had to finance themselves through the sale of non-essential assets. In 1979, the government set limits on diversification, decreeing that SOE's could only operate in the specific activities for which they were created. Although SOE's were granted wider management autonomy, investment decisions were strictly controlled by the government. In addition to these general restrictions, CAP was prohibited from contracting additional debt.

After 1979, every new investment project that CAP or its subsidiaries proposed had to be cleared by two government agencies: the state planning agency, ODEPLAN, and the Ministry of Finance. To receive approval for investments, CAP had to submit project proposals to ODEPLAN, which analyzed the economic suitability of all investment projects submitted for SOE's and other government projects. Those projects that met or surpassed an established, minimum "social" rate of return were prioritized and submitted as candidates for funding to the Ministry of Finance, which had responsiblility for formulating the

government's macroeconomic program. The Ministry of Finance then determined how much investment money could be allocated, and selected viable projects from ODEPLAN's list as funding limits allowed. As a result of the 1982-83 economic crisis, the government's priorities focused increasingly on addressing growing social problems like unemployment, health care and education. CAP was consistently denied access to scarce investment funds.

Attempts to Re-privatize CAP

In early 1980 the government again sought to increase CAP's efficiency by restructuring the firm and increasing private ownership. CAP was instructed to decentralize operational management, and to expand its equity capital. By issuing new stock, the government aimed to reduce the firm's indebtedness and to increase private sector participation in ownership. In April of 1980, CAP's Board of Directors agreed to increase capital by $56 million, distributed in roughly 261 million shares with a nominal value of $0.25. This amounted to an equity expansion of 40.4 percent of total shares outstanding.

The government's efforts to increase private ownership in CAP, however, were not successful. In the midst of Chile's economic depression, no Chilean nationals opted to purchase CAP's shares at the $0.25 price agreed by CAP's board. Although CAP contracted Chase Manhattan Bank in an effort to find foreign investors in May, 1981, this effort also failed as CAP's 1981 earnings plummeted. In May 1983, the legal period elapsed in which the share issue had to be placed. Only 1,113,694 shares had been purchased.

In November, 1984, CORFO again requested that CAP reissue shares, and the firm expanded its equity capital by 329,794,619 shares. The shares were again valued at $0.25 per share. By July, 1985, only 52,524,000 shares, or 15.9 percent of this second share issue, had been purchased. Exhibit 3 shows changes in CAP's authorized and paid-in capital from 1980-85.

CAP's Profitability

As both a private and state-owned enterprise, CAP's operating record was consistently marked by low profitability. Although CAP posted net profits averaging $5,540 million from 1950-1969, government direct protection and hidden subsidies during this period (including tariffs and non-tariff barriers) were estimated to total $30 million annually. Moreover, as an SOE deprived of government protections after 1975, CAP recorded widely variable and negative earnings. Exhibit 4 shows that largely as a result of the firm's losses during the Chilean economic crisis of $46 million in 1981 and $65 million in 1982, CAP's consolidated earnings from 1974-1985 averaged a net loss of $7,050 million.

Although CAP's consolidated earnings improved in 1983 and 1984 and were expected to climb higher in 1985 (Exhibits 5-6), the outlook for CAP's profitability in the mid-1980's was clouded by overproduction in the steel industry. Spurred by robust world

economic growth, steel-producing countries made huge investments to expand capacity from 1960 to 1973, and worldwide production more than doubled to 730 million tons. After 1975, however, international demand for steel dropped to 640 million tons, rising only slightly over the following 6 years. By 1982, the surplus in excess worldwide steel production increased to 158 million tons. Installed steel production capacity in Latin America reached 45 million tons by 1982, with Brazil's annual production capacity topping 25 million. In comparison, CAP produced approximately 700,000 tons of finished steel products and steel ingots in 1984.

Although CAP enjoyed tariff protection ranging from 30 to 50 percent before 1976, by the end of 1979 tariffs on steel products averaged 10 percent. Though following the 1982-83 crisis tariffs rose again -- briefly reaching 35 percent in September, 1984 -- Finance Minister Hernán Buchi lowered custom duties to 30 percent in March, 1985, and to 20 percent in July, 1985. With depressed international prices, Chilean steel imports increased from 22,147,000 tons in 1983 to 73,308,000 tons in 1985.

In addition to adverse conditions in the international steel industry, by early 1985, CAP recorded low investment levels and high indebtedness. Exhibit 7 shows that as a result of government controls, CAP's five-year investments fell from over $500 million in 1974 to roughly $50 million annually from 1979-1984. By the end of 1984, meanwhile, CAP's long and short-term debt totalled $492,857,000, giving the firm a debt-equity ratio of 70 percent. Over 80 percent of this debt was contracted from foreign banks at floating rates above LIBOR, and CAP's debt service costs summed to 21.8 percent of sales in 1984. This same year, earnings before interest and taxes divided by interest costs equalled 1.09.

CAP's Decision to Re-Privatize

As early as 1982, a small group of CAP's top-level managers became convinced that re-privatization was essential for their company's survival and growth. Leading this group was Mr. Roberto de Andraca, a lifelong CAP employee who entered the firm as a commercial engineer in 1960, and worked his way up through the ranks. In August, 1983, after an extremely difficult period in which the company had lost over $100 million, De Andraca had been appointed president and CEO of CAP.

De Andraca and other top executives envisioned CAP as a diversified, internationally-competitive private firm. Like many of these executives, De Andraca's views had been shaped by his experience working in CAP's competitive export divisions, and his frustration with government interference. From 1964-1972, De Andraca served as manager of the export-oriented mining division, CMP, and from 1972-1978 he worked in Europe as president of CAP's Holland-based marketing subsidiary, Pacific Ores & Trading. Brought back to CAP Chile as Executive VP of Finance and Administration in 1978, De Andraca came to share his colleagues convictions that the government's political interventions in managerial affairs frequently resulted in unwise business decisions. He explained:

> Already in 1982, we saw that with the present government policies of controlling investment, we would not be investing, and then we saw a definite horizon in which the company would disappear. And this is a terrible concern when you are sitting here, and you have a company you plan to work in all your life. So I thought, let's get out from under this owner that doesn't want us to grow.

Although De Andraca was charismatic and widely-respected by his employees (most of whom he knew by their first names), not all of CAP's executives supported re-privatization. Over the last several months, De Andraca discovered that 6-7 of his top 25 managers firmly opposed active participation in privatizing CAP. Composed of lawyers and technocrats, this group objected on the grounds that only the company's owner, not its management, should direct the firm's privatization. To do otherwise, they maintained, would be to open CAP to legal and ethical accusations involving conflict of interest.

Despite internal opposition, De Andraca and other top management believed that re-privatization was imperative. In early 1985, CAP's managers had identified four pressing investment needs: the firm's coke plant would have to be replaced, CSH's blast furnaces needed costly repairs, a casting mill was needed to keep energy costs from rising, and CAP's merchant mill required repairs. But in order to re-privatize CAP, management would have to place all the shares of the firm's 1984 equity issue in private hands. This would bring private ownership to 49 percent, a level already approved by the government. Though full private ownership would still be far off, CAP's management believed that majority private ownership would then be within easy reach. Once private investors held majority control, De Andraca felt confident that the government would find it extremely difficult to resist full privatization.

**Privatization Decisions**

Valuation

De Andraca and his top advisors understood that one of the most important issues in selling shares from CAP's 1984 stock issue was the per-share price. If the firm's share price was too high, CAP would have an extremely difficult time finding buyers. If CAP's valuation was too low, however, the firm could be widely criticized for selling national wealth at rock-bottom prices by workers groups, intellectuals, and political opponents of the government. De Andraca knew that sufficient amount of criticism could bolster military opponents like Hormazábal and derail CAP's privatization. The first step toward re-privatization would be to accurately appraise the firm's value.

*Earnings Projections.* De Andraca requested that financial analysts of the firm's subsidiaries prepare six-year projections of total after-tax profits for steel products and iron ore. These calculations required making assumptions about international demand, supply and price changes, domestic inflation and exchange rate adjustments, interest rates (for

investments), salaries and wages and magnitude and timing of investments. In addition, these projections required assumptions about operational and financial efficiency, as well as profit margins. Exhibit 8 shows the company's six-year projections extended over a 10-year period by holding year 6 constant from 1990-1994.

*The Discount Rate*. To determine the marginal cost of equity capital for his company, De Andraca instructed his financial experts to inquire widely both within Chile and internationally. CAP was informed that the Inter-American Development Bank would require a minimum return on its investment of 10 percent, the International Finance Corporation would demand a return-on-equity of at least 18 percent, and Chilean banks would not invest in CAP's equity if the company did not expect a return of 20 to 25 percent. CAP's finance team reasoned that some midpoint between these figures would probably be correct for CAP. Exhibit 8 shows that CAP selected a 16 percent discount rate to evaluate projected earnings.

*Other Valuation Measures.* With all the uncertainty involved, CAP's management wondered how reliable a measure of CAP's value this process would yield. They pondered whether the firm's book value would reveal any insight into the accuracy of their valuation, or if they should compare his results against whatever amount they could get in liquidating CAP.

Finally, CAP's managers had to consider the firm's share value on the Chilean stock exchange. Exhibit 9 shows that at the time of CAP's equity expansion in November, 1984, the firm's share price was $0.11. As of June, 1985, CAP's shares were trading for $0.21 per share. Although CAP was founded as a joint-stock company, CORFO had held over 98 percent of CAP's shares since 1970. Trading of CAP's 1981 share issue had been extremely light. Despite distributing over 7,000 copies of the firm's prospectus, CAP's 1984 share issue had been just as poorly subscribed. In short, De Andraca and other executives feared that because of CAP's history and uncertain status as an SOE, the market was not well-informed about their company, and did not fully understand its potential.

Approaching Potential Buyers

With an equity issue totalling almost $83 million, De Andraca's highest priority was to identify and approach all potential buyers. In April, 1985, top CAP executives approached creditor banks, to whom the company owed over $500 million, to inquire if the banks would consider purchasing CAP shares. Citing the early-1980s bankruptcy of the US steel giant LTV Corp., depressed conditions in steel production worldwide, and CAP's low projected earnings, however, the banks declined to purchase any of the firm's shares. De Andraca doubted if circumstances had changed significantly over the last 3 months.

CAP's distributors and suppliers constituted another potential source of investment funds. But over the last 6 months CAP's executives had been able to generate very little interest. Despite commercial ties and common interests in CAP's survival and profitability,

only two of 10 distributors had opted to purchase the firm's shares by July of 1985. In addition, although CAP's annual purchases from its 2,000 suppliers totalled over $60 million, thus far only one supplier had agreed to purchase a significant package of 685,000 shares.

CAP's efforts to find wealthy, influential buyers amid the general public also proved unsuccessful. Accompanying groups of 10-20 Chilean business leaders personally, De Andraca had led tours of the company's Huachipato plant and discussions of the company's plans and potential in the future. By the end of July, 1985, none of these efforts had resulted in the purchase of shares. Explained De Andraca:

> We invited all the big shots, and put on quite a show -- we had lunch, we had tea, and we chatted about the company's future. But they all thought it was stupid... they thought, 'they're all public employees, they've been bureaucrats for 15 years, they can't make a cent...'

The prospects for selling CAP shares on the Chilean stock market, or attracting foreign investors, were equally dismal. De Andraca commented:

> First you have gone to Chase Manhattan in 1981, and to 400 monied investors around the world, and they laugh you out the door. And then you have two very bad years, and you try to go to the stock exchange. You are in a very tough spot. Producing steel in 1984-85 was a dirty word.

Other Obstacles

An additional problem facing CAP was that in early 1985, the Superintendent of the Administration of Pension Funds had given CAP's bonds the lowest investment rating. Because of the experience of the 1982-83 crisis, in early 1985 the government established norms to regulate investments of Chile's newly-private pension funds. Based on a financial analysis of the CAP's previous 10 years, the company's large foreign debt, and the industry's poor prospects over the next 10 years, the Superintendent gave CAP's Huachipato bonds a "D" grade. This rating denoted securities that were not recommended for investment, and required any pension fund that owned a "D"-grade security to divest within two years. CAP's management knew that this classification would not only deprive the firm of a huge pool of pension-fund investors, but would also adversely affect the market value of CAP's shares.

Efforts to place CAP's shares were further hampered by a December, 1984 government decree allowing the state-controlled financial sector to issue shares on terms that were impossible to match. Reflecting the government's priority to privatize large banks that had collapsed during the economic crisis, the decree authorized extremely generous terms to purchasers of bank stock: 5 percent down payment; zero real interest on the amount outstanding, repayable in 15 years with an additional discount for timely loan repayment; and tax breaks on both the equity investment and dividend profits. This meant

CAP would have to compete with banks that were not only widely considered safer investments, but were also offered on financial terms that CAP could not afford to equal.

Finally, at the time of CAP's re-privatization in mid-1985, the Chilean business climate remained depressed. Annual inflation was estimated at 27.5 percent, the government's foreign debt had grown to over $20 billion (per capita one of the highest in the world), and short-term real interest rates remained at 12 percent. In addition, real wages had fallen 50 percent over the last four years, dampening consumer demand. By June, annual GDP was expected to grow 2 percent.

Selling to CAP's Workers

By mid-1985, as options seemed to be closing at every turn, De Andraca and his top executives began to think more seriously about selling CAP's shares to its workers. The concept of workers as shareholders appeared sound for four principal reasons. First, with an average tenure at CAP of 21 years, the workers knew the firm and its management intimately. Management-labor relations were widely considered to be excellent, and CAP's executives felt workers would be likely to stake their savings on his vision of CAP as an internationally-competitive, diversified and profitable enterprise.

Second, CAP's managers knew that workers stood to lose a great deal if CAP's privatization failed. If the firm did not invest and renew its competitive position, many workers would have to be laid off. Third, management also felt that having workers as shareholders would further strengthen their loyalty to the company, and improve labor-management relations. This would surely yield important benefits for the firm's success and profitability. De Andraca explained:

> So we thought, 'who do we have as possible shareholders,' and we felt it's only the people who know the company from within..and these guys will feel that if they don't participate, they might be destroying the company... these are the workers, the ones that have more to do with the company in the future -- they earn a living from the company, if it disappears they will be affected. They're interested that CAP survives and grows.

Finally, the government was strongly in favor of widening share ownership of privatized firms, and involving workers' as shareholders. CAP's executives believed that enabling the firm's workers to become shareholders would help quell any military opposition in CORFO or on CAP's board. The 1982-83 economic crisis had highlighted the destabilizing effects of the highly-leveraged industrial and financial conglomerates. The government's "popular capitalism" program, launched in December 1984, was designed primarily to avoid concentration of property by selling small equity shares of privatized firms to individuals on generous credit terms.

Also in December 1984, the government issued a law initiating its "labor capitalism" program. Law 18.372 authorized employees to utilize up to 50 percent of their retirement funds to purchase shares in privatized companies. Under longstanding Chilean labor law, retirement funds were withheld by the employing firm at a rate of one month of each worker's yearly salary. To be returned to the worker upon retirement or departure from the company, this amounted to a company-specific withholding tax of approximately 8.3 percent.

Addressing Workers' Concerns

Through preliminary negotiations over the last several months with workers' representatives, it had become clear that CAP management would have to address at least four major worker's concerns to make a worker share purchase program viable. First, workers feared that a conflict of interest might arise from their double-capacity as both shareholder and laborer (over such issues as salaries, work conditions, and the right to strike).

Second, some workers opposed a share purchase plan because it was linked to the Pinochet government, which had sharply restricted civil and political liberties. Explained Oscar Bravo, a steel worker who had been with CAP over 20 years: "The idea of worker capitalism was so socialist it scared the socialists. The problem was that it came from Pinochet... so they opposed it as a lie."

Third, based on the low earnings that accrued to shareholders in the 1960s, and the losses shareholders suffered from the Allende nationalization program in 1970, workers were concerned that the shares would be a bad investment. Finally, most workers had little disposable income to devote to the purchase of shares, and local banks appeared unlikely to lend them the funds.

Advancing Retirement Funds

While CAP's management felt that they could lean on the firm's history of strong labor-management relations to address the worker's first two concerns, the question of how to finance the share purchase appeared more problematic. The government's plan constituted one alternative. Based on the "labor capitalism" law of 1984, CAP would advance its workers 50 percent of their retirement pay benefits -- on the condition that the monies be used only to purchase CAP's shares. The principal advantage to this approach was that CAP would not have to incur any expense.

Yet management knew that under Chilean labor law, retirement benefits represented an obligation of CAP, not of the government. These executives felt that the danger was that workers would rapidly sell their shares at the first sign of profits, reaping short-term gains but spending away their retirement funds. The managers anticipated that a few short years

later, the employees would expect and request full retirement benefits. The issue was sure to cause friction between unions and management.

CAP management believed that instead of advancing workers their retirement monies outright, the company could lend this money (or some portion of it) to the workers on generous terms. There were precedents for this approach in CAP. Since the early 1950s, the company had operated a lending program to allow CAP workers to purchase their own homes. This program extended loans at zero real interest over 8-year terms, repayable in 16 semi-annual installments. CAP's management anticipated that a program for purchasing shares would be viable on similar terms, with one exception -- an insurance clause for price depreciation risk. But because CAP's stock, unlike homes, carried a significant risk of loss of investment value, CAP's executives believed that some form of insurance to cover the workers' downside risk would be necessary.

Calculating the costs to CAP of extending zero real-interest, 8-year loans to the workers was dependent on two key variables: the number of shares purchased, and the share price offered. De Andraca and his top financial advisors agreed that the firm should attempt to place as much as 25 percent of the firm's shares in the hands of workers. This rough figure seemed appropriate because it would be large enough to give CAP's privatization a strong push, and ease any opposition among military or other workers' groups, while still allowing the firm to take advantage of private domestic and foreign investors' possible contributions in resources and technology.

Because reaching 25 percent worker ownership would be difficult, De Andraca asked his advisors to calculate several scenarios for the costs of a worker share purchase. He felt 15, 20 and 25 percent of the company's total authorized and paid-in capital after November, 1984, would be a useful and realistic bracketing of costs. De Andraca's financial executives informed him that real interest rates were expected to average approximately 11 percent for the next 2-3 years.

Share Repurchase

In addition to the worker share program, CAP' management had to consider another option. One month earlier, CAP's finance team had quietly proposed an unusual scheme to top management: CAP could buy back its own shares from the total authorized emission of 1984, thereby shrinking CORFO's ownership share to 51 percent. Supporters of the proposal argued that the government had already approved privatization of the company up to the level of 49 percent private ownership in July, 1984. In addition, they reasoned, the government was strapped for money, and might welcome the cash receipt. The logic appealed to De Andraca and other executives, who continued to believe that once CAP was 49 percent privately owned, majority private ownership, and then full privatization, would be much easier to attain.

But CAP's managers faced both legal and financial problems. Chilean law forbid

stock companies from acquiring or owning their own shares. CAP's lawyers, however, assured the company president that such an acquisition of shares would be legally permissible if it complied with key provisions of a rarely-applied capital reduction statute: 1) the buyback had to be tied to a reduction of capital; that is, CAP would have to annul the shares, not hold and resell them at a later date; and 2) the buyback price would have to be higher than the shares' market price.

While De Andraca agreed CAP could comply with the second provision, he wondered if a share repurchase at any price would constitute the best use of shareholders' equity. The repurchase would not only sharply reduce CAP's net worth by the amount of the repurchase, but would also divert funds from other potential uses like much-needed improvements to CAP's productions facilities.

De Andraca and other executives also wondered if the company could afford a share repurchase. Because of government restrictions on investment, CAP had generated cash savings over the last several years. Over 95 percent of these funds were placed in interest-bearing time deposits at the Central Bank. Although the government had prohibited CAP from tapping these monies for capital investments, CAP's management believed that CORFO might very well agree to allowing the company to use these funds to repurchase its shares. Still, the attractiveness of this proposal would depend on the total amount the firm could offer CORFO. This would be a function of the number of shares to be repurchased (the quantity outstanding between the worker's ownership percentage, the percentage already in private hands, and CORFO's 51 percent stake), and the price agreed per share.

**Managing Re-Privatization**

At 6 o'clock in the evening, Roberto de Andraca reclined in his chair and paused; tomorrow afternoon, he was scheduled to make presentations to CAP's top executives and the board of directors. CAP had reached a critical juncture, and De Andraca believed that re-privatization was the only reasonable course of action. But in less than 24 hours the chief executive would have to present a compelling rationale for pushing CAP's re-privatization, and a coherent strategy for carrying it out.

De Andraca's challenge was to place 49 percent of CAP's shares in private hands. From here, he and top management reasoned that majority private ownership was only a step away. But given the sheer size of the share purchases required to accomplish this objective, De Andraca would need to utilize every option at his disposal. Both the worker share program and the share buyback scheme involved significant costs for the company. As De Andraca worked through the numbers, he wondered if the costs of selling CAP's shares to its workers could be justified. In addition, he needed to know if the company could afford to repurchase its shares from the government, and if he could defend such a move from a business standpoint. To determine this, De Andraca would need to develop

various cost estimates, and weigh them against a rough calculation of the benefits that would accrue from the company's privatization. He rolled up his sleeves and set to work. It would be a long night.

Exhibit 1
COMPANIA DE ACERO DEL PACIFICO

Steelmaking Flow Chart

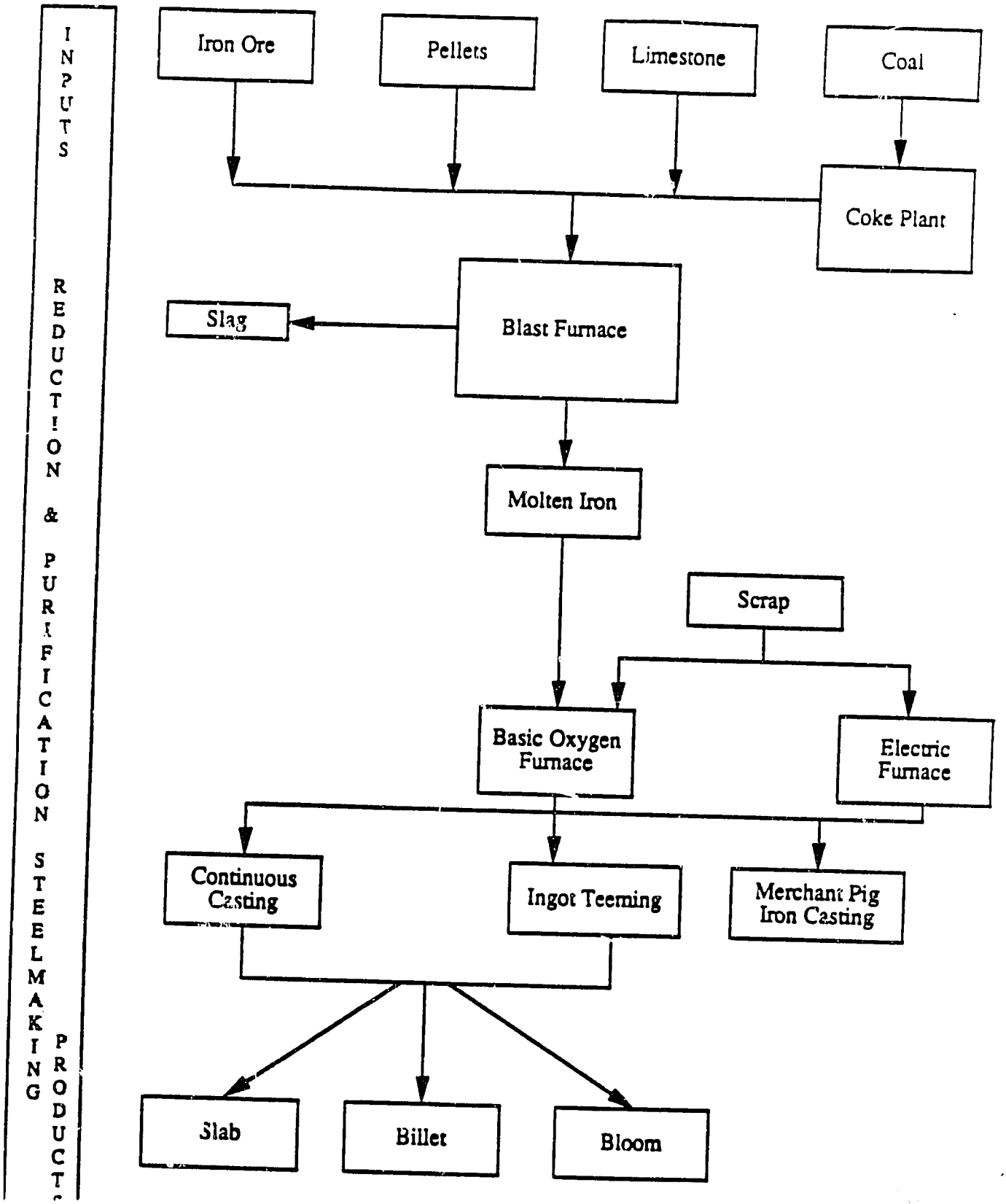


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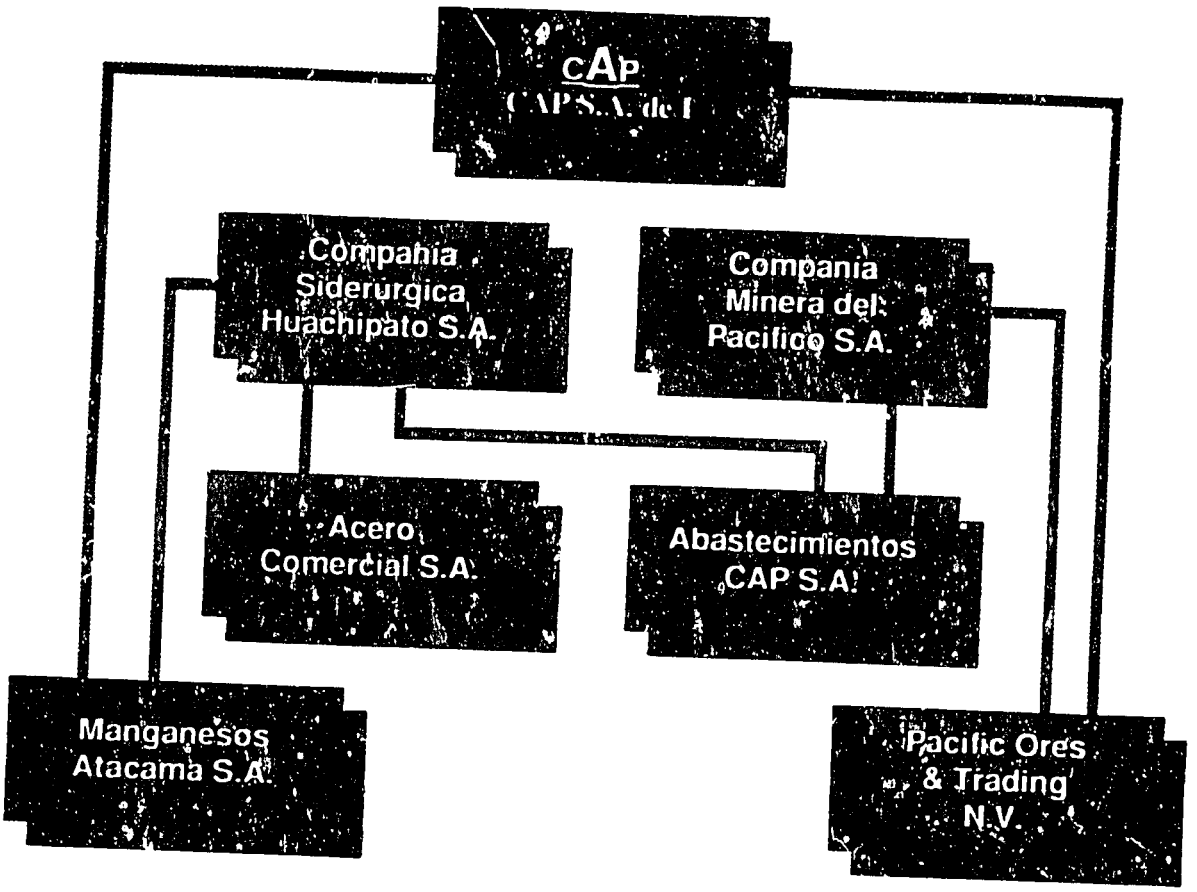
Exhibit 2
COMPANIA DE ACERO DEL PACIFICO

Holding Company and Subsidiaries
(as of December, 1980)




Source: Company 1985 Annual Report.

## Exhibit 3
## COMPANIA DE ACERO DEL PACIFICO

### Changes in Authorized and Paid-In Capital, 1980-1985

The government's efforts to partially re-privatize CAP began on April 25, 1980, when CORFO instructed the firm to issue 260,650,120 new shares at a price of $0.25. This constituted an equity capital expansion of approximately $56 million. By May, 1983, only 1,113,694 shares from this issue had been purchased by private investors.

After CAP absorbed accumulated losses and capitalized all reserves, the firm fixed paid-in capital on November 16, 1984. Again at CORFO's request, on the same day CAP reissued 329,794,619 shares, also at a price of $0.25. This share emission totalled roughly $82 million. By June, 1985, only $13,131,000 of the November 1984 share issue had been purchased.

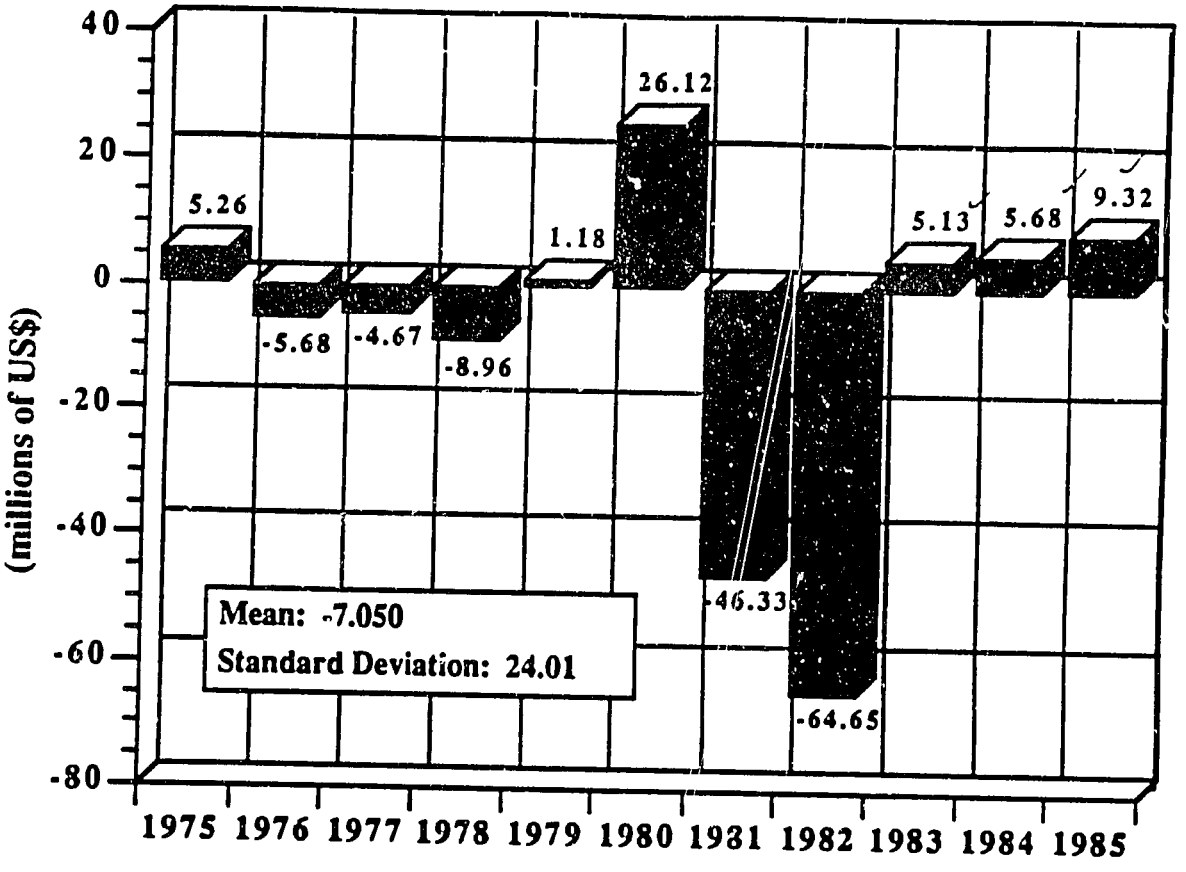
| Date and Issue | Capital | Shares |
|---|---|---|
| Fixed and paid-in capital on 12/31/79 | $384,781,000 | 343,931,767 of A and B series sh.s |
| Authorized Share Issue on 4/25/80 | $56,162,530 | 260,650,120 of B series shares |
| Fixed paid-in capital on 11/16/84* | $486,116,997 | 385,616,134 of A and B series sh.s |
| Authorized issue on 11/16/84 | $82,448,655 | 329,794,619 of no-par-value sh.s |
| Total authorized and paid-in capital | $568,565,652 | 715,410,753 of no-par-value sh.s |

*NOTE: The total shares in this row include 384,502,440 "A" series shares, which held a value of $1.00, and 1,113,694 "B" series shares valued at no less than $0.25. After this date the nominal value of all shares was eliminated and the division between "A" and "B" shares was eliminated.

Source: Company 1985 Annual Report; 1984 Prospectus.

Exhibit 4
COMPANIA DE ACERO DEL PACIFICO

Consolidated Net Earnings 1975-1985
(in millions of constant US$)




**Source: Company Annual Reports; 1984 CAP Prospectus.**

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Exhibit 5
COMPANIA DE ACERO DEL PACIFICO

Consolidated Balance Sheets
December 31, 1983, 1984, 1985*
In thousands of U.S. dollars

| ASSETS | 1985* | 1984 | 1983 |
|---|---|---|---|
| CURRENT ASSETS | | | |
| Cash and Banks | 16,034 | 17,140 | 12,324 |
| Time Deposits | 187,957 | 126,032 | 48,626 |
| Marketable Securities | 31 | 0 | 50,121 |
| Trade Accounts Receivable | 29,062 | 39,427 | 5,854 |
| Notes Receivable | 12,803 | 6,369 | 10,351 |
| Other Accounts Receivable | 9,664 | 10,263 | 92,416 |
| Inventories | 79,088 | 70,360 | 1,525 |
| Refundable Taxes | 791 | 1,082 | 583 |
| Prepaid Expenses | 1,050 | 1,301 | 171 |
| Deferred Taxes | 83 | 110 | 50 |
| Other Current Assets | 149 | 27 | 50 |
| TOTAL CURRENT ASSETS | 336,712 | 272,111 | 222,071 |
| FIXED ASSETS | | | |
| Land | 2,660 | 2,792 | 2,942 |
| Buildings | 416,189 | 417,502 | 418,631 |
| Machinery and Equipment | 886,864 | 874,788 | 881,800 |
| Construction in Progress and Other | 34,067 | 43,949 | 38,225 |
| Technical Revaluation | 262,622 | 263,118 | 263,373 |
| TOTAL FIXED ASSETS - GROSS | 1,602,402 | 1,602,149 | 1,704,971 |
| Accumulated Depreciation | (635,179) | (587,341) | (547,892) |
| TOTAL FIXED ASSETS - NET | 967,223 | 1,014,808 | 1,057,079 |
| OTHER ASSETS | | | |
| Investments in Related Companies | 52 | 41 | 90 |
| Long-term Accounts Receivable | 10,807 | 6,043 | 18,141 |
| Mining Concessions and Other Intangibles | 27,546 | 27,546 | 27,546 |
| Amortization: Mining Concessions, Intangibles | (24,107) | (23,628) | (23,026) |
| Other | 10,418 | 4,746 | 7,882 |
| TOTAL OTHER ASSETS | 24,716 | 14,748 | 30,633 |
| TOTAL ASSETS | 1,328,651 | 1,301,667 | 1,309,733 |

* Figures for 1985 are estimates as of July 15, 1985. All figures are converted into U.S. dollars at year-end current exchange rate.

Sources: Company Annual Reports.

Exhibit 5 (cont'd.)
COMPANIA DE ACERO DEL PACIFICO

Consolidated Balance Sheets
December 31, 1983, 1984, 1985*
In thousands of U.S. dollars

| LIABILITIES AND SHAREHOLDERS' EQUITY | 1985* | 1984 | 1983 |
|---|---|---|---|
| CURRENT LIABILITIES | | | |
| Banks and Financial Institutions: | | | |
| Short term | 38,132 | 29,461 | 34,635 |
| Current Portion of Long-Term Debt | 11,361 | 107,288 | 131,050 |
| Debentures | 641 | 724 | 872 |
| Current Portion of Other Long-Term Liab.s | 892 | 953 | 1,556 |
| Accounts Payable | 5,513 | 6,366 | 8,710 |
| Notes Payable | 0 | 257 | 545 |
| Sundry Creditors | 983 | 622 | 146 |
| Due to Related Companies | 2,307 | 3,092 | 2,850 |
| Provisions | 24,117 | 16,098 | 15,524 |
| Retentions | 2,628 | 1,774 | 2,201 |
| Income Taxes | 4,750 | 1,166 | 1,278 |
| Unearned Income | 158 | 0 | 1,585 |
| TOTAL CURRENT LIABILITIES | 93,769 | 169,587 | 200,952 |
| LONG-TERM DEBT | | | |
| Banks and Financial Institutions | 486,521 | 394,332 | 372,017 |
| Debentures | 19,161 | 21,737 | 26,046 |
| Accounts Payable | 843 | 1,687 | 2,703 |
| Provisions | 10,782 | 11,309 | 11,431 |
| Other | 2,300 | 792 | 0 |
| TOTAL LONG-TERM DEBT | 519,607 | 492,857 | 412,197 |
| Minority Interest | 29 | 184 | 220 |
| SHAREHOLDERS' EQUITY | | | |
| Paid-in Capital | 493,012 | 486,117 | 384,781 |
| Reserves | | | |
| Capital Revaluation | 0 | 0 | 26,956 |
| Technical Revaluation Reserve | 181,929 | 194,699 | 210,247 |
| Other Reserves | 28,318 | 15,548 | 178,246 |
| Retained Earnings | | | |
| Appropriated | 0 | 0 | 6,721 |
| Accumulated Loss | 0 | 0 | (115,712) |
| Net Income for the Year | 9,320 | 5,675 | 5,125 |
| TOTAL SHAREHOLDERS' EQUITY | 715,246 | 702,039 | 696,364 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | 1,328,651 | 1,301,667 | 1,309,733 |

* Figures for 1985 are estimates as of July 15, 1985. All figures are converted into U.S. dollars at year-end current exchange rate.

Sources: Company Annual Reports.

Exhibit 6

# COMPANIA DE ACERO DEL PACIFICO

## Consolidated Income Statements

For the years ended December 31, 1983, 1984, 1985*
(in thousands of $ U.S.)

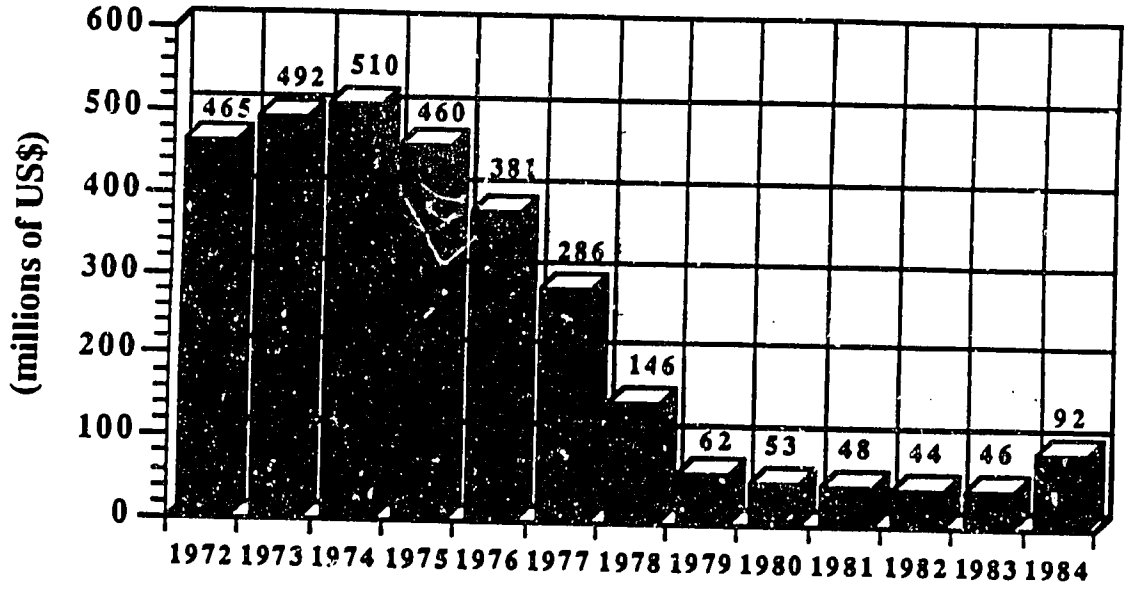
| | 1985* | 1984 | 1983 |
|---|---|---|---|
| **OPERATING INCOME** | | | |
| Sales | 300,108 | 341,925 | 316,929 |
| Cost of Sales | (236,154) | (275,688) | (262,474) |
| Gross Profit | 63,954 | 66,237 | 53,455 |
| Selling and Administrative Expenses | (10,878) | (13,264) | (10,920) |
| OPERATING INCOME - NET | 53,076 | 52,973 | 42,535 |
| **OTHER INCOME (EXPENSES)** | | | |
| Financial Income | 38,600 | 23,766 | 11,233 |
| Equity in Earnings of Affiliates | 22 | 0 | 0 |
| Other Non-Operating Income | 27,576 | 27,714 | 40,011 |
| Equity in Loss of Affiliates | (10) | (44) | (77) |
| Financial Costs | (61,480) | (74,525) | (68,861) |
| Other Non-Operating Expenses | (41,024) | (23,383) | (26,488) |
| Monetary Correction | 0 | 0 | 7,299 |
| OTHER INCOME (EXPENSES) - NET | (36,316) | (46,472) | (36,833) |
| **INCOME BEFORE TAXES AND OTHER ITEMS** | 16,760 | 6,501 | 5,652 |
| **INCOME TAXES** | | | |
| Tax Expense Before Applying Net Operating Losses Carried Forward | (8,419) | (18,290) | (465) |
| Income (Loss) Before Extraordinary Item and Minority Interest | (8,341) | (11,789) | 5,187 |
| Extraordinary Item: Tax Benefit of Net Operating Loss Carryforward | 1,035 | 17,517 | 0 |
| Income Before Minority Interest | 9,376 | 5,728 | 5,187 |
| Minority Interest in Subsidiaries | (56) | (53) | (62) |
| **NET INCOME** | 9,320 | 5,675 | 5,125 |

* Figures for 1985 are estimates as of July 15, 1985.

Sources: Company Annual Reports.

Exhibit 7
COMPANIA DE ACERO DEL PACIFICO

Five-Year Investment Programs
(by year of program initiation)




Source: Company records.

## Exhibit 8
## COMPANIA DE ACERO DEL PACIFICO

### After-Tax Earnings Projections, 1985-1994
(in millions of current $ U.S.)

| Company/Subsidiary | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|---|---|---|---|
| Compania Siderurgica Huachipato | 13,600 | 16,321 | 18,311 | 29,170 | 37,830 | 46,614 | 46,614 | 46,614 | 46,614 | 46,614 |
| Compania Minera del Pacifico | (9,418) | (13,632) | (12,191) | (17,807) | (4,899) | 4,957 | 4,957 | 4,957 | 4,957 | 4,957 |
| Acero Commercial | 395 | 508 | 562 | 621 | 654 | 714 | 714 | 714 | 714 | 714 |
| Abastacimientos CAP | 162 | 169 | 182 | 219 | 226 | 233 | 233 | 233 | 233 | 233 |
| Pacific Ores and Trading | 1,242 | 1,294 | 1,373 | 1,396 | 1,421 | 1,538 | 1,538 | 1,538 | 1,538 | 1,538 |
| Manganesos Atacama | 643 | 703 | 853 | 851 | 1,324 | 1,394 | 1,394 | 1,394 | 1,394 | 1,394 |
| CAP S.A. de Inversiones | 1,926 | 4,580 | 4,470 | 870 | 0 | 0 | 0 | 0 | 0 | 0 |
| NET PROFIT* | 8,550 | 9,943 | 13,560 | 15,320 | 36,566 | 55,450 | 55,450 | 55,450 | 55,450 | 55,450 |
| NET PROFIT# | 9,350 | 13,960 | 21,330 | 24,970 | 40,210 | 65,100 | 65,100 | 65,100 | 65,100 | 65,100 |
| Net Profit per Share in $U.S.** | 0.020 | 0.024 | 0.030 | 0.035 | 0.065 | 0.091 | 0.091 | 0.091 | 0.091 | 0.091 |

NPV @ 16% = 0.25 dollars

* Excludes income from the sale of shares from 1984 equity issue.

# Includes income from sale of shares; assumes the issue is placed evenly between April, 1985, and December, 1987; assumes that funds thus obtained are invested with an average annual profitability of 11.7 % after taxes. The return ratio was applied on a simple -- not compound -- basis, equivalent to the basic indebtedness ratio plus one point.

** This line includes income from the sale of shares and equals the ratio of the net profit of the prior line and the number of paid-in shares at the end of each of the years included in the projections. If this cash flow is multiplied by the number of shares in ten years, repeating between 1991 and 1994 the profit per share of $U.S. 0.91 of 1990, a 16 % return after taxes is attained, assuming an initial investment of $U.S. 0.25.

Exhibit 9

# COMPANIA DE ACERO DEL PACIFICO

## Shares of CAP on Santiago Stock Exchange, 1983-1985

| Date | Pesos/$U.S | No.of Shares Traded# | Share Series | Mkt. Value of Share* | $U.S./Sh. |
|---|---|---|---|---|---|
| **1983** | | | | | |
| January | 75 | 149,800 | A | 3.50 | 0.05 |
| February | 75 | 3,100 | A | 3.50 | 0.05 |
| March | 75 | 123,700 | A | 3.20 | 0.04 |
| April | 75 | 92,168 | A | 3.50 | 0.05 |
| May | 75 | 399,890 | A | 4.00 | 0.05 |
| | 75 | 24,729 | B | 3.40 | 0.05 |
| June | 77 | 112,965 | A | 3.90 | 0.05 |
| July | 78 | 1,609,012 | A | 6.30 | 0.08 |
| | 78 | 4,747 | B | 4.80 | 0.06 |
| August | 79 | 0 | | 0.00 | 0.00 |
| September | 81 | 313,656 | A | 9.50 | 0.12 |
| | 81 | 37,218 | B | 6.75 | 0.08 |
| October | 83 | 107,352 | A | 8.00 | 0.10 |
| | 83 | 19,177 | B | 6.00 | 0.07 |
| November | 85 | 81,850 | A | 8.70 | 0.10 |
| December | 87 | 4,284,304 | A | 9.00 | 0.10 |
| | 87 | 152,329 | B | 5.50 | 0.06 |
| **1984** | | | | | |
| January | 88 | 383,797 | A | 11.50 | 0.13 |
| February | 88 | 569,883 | A | 13.50 | 0.15 |
| | 88 | 39,285 | B | 8.00 | 0.09 |
| March | 88 | 241,037 | A | 15.20 | 0.17 |
| | 88 | 101,383 | B | 10.00 | 0.11 |
| April | 88 | 246,605 | A | 16.00 | 0.18 |
| | 88 | 45,617 | B | 12.50 | 0.14 |
| May | 90 | 105,634 | A | 19.00 | 0.21 |
| | 90 | 31,235 | B | 18.50 | 0.21 |
| June | 91 | 1,615,786 | A | 17.00 | 0.19 |
| | 91 | 218,520 | B | 18.50 | 0.20 |
| July | 92 | 113,070 | A | 15.50 | 0.17 |
| | 92 | 68,494 | B | 13.00 | 0.14 |
| August | 93 | 2,211 | A | 13.50 | 0.15 |
| September | 115 | 35,250 | A | 13.50 | 0.12 |
| October | 116 | 121,485 | A | 12.50 | 0.11 |
| November | 119 | 173,502 | A | 12.50 | 0.11 |
| | 119 | 3,335 | B | 11.50 | 0.10 |
| December | 123 | 2,127,887 | A | 12.50 | 0.10 |
| | 127 | 224,069 | A | 11.50 | 0.09 |
| **1985** | | | | | |
| January | 129 | 1,008,373 | A | 19.10 | 0.15 |
| February | 130 | 1,467,763 | A | 21.00 | 0.16 |
| March | 146 | 899,344 | A | 26.75 | 0.18 |
| April | 149 | 1,166,038 | A | 29.50 | 0.20 |
| May | 152 | 1,578,641 | A | 29.00 | 0.19 |
| June | 155 | 7,937,197 | A | 33.00 | 0.21 |

* In Chilean pesos, as recorded in the Santiago Bolsa de Valores.

\# In thousands.

Exhibit 10: SHARES OF CAP, S.A. DE INVERSIONES

| Date | Pesos/$U.S | No.of Shares Traded# | Share Series | Mkt. Value of Share* | $U.S./Sh. |
|---|---|---|---|---|---|
| 1983 | | | | | |
| January | 75 | 149,800 | A | 3.50 | 0.05 |
| February | 75 | 3,100 | A | 3.50 | 0.05 |
| March | 75 | 123,700 | A | 3.20 | 0.04 |
| April | 75 | 92,168 | A | 3.50 | 0.05 |
| May | 75 | 399,890 | A | 4.00 | 0.05 |
| | 75 | 24,729 | B | 3.40 | 0.05 |
| June | 77 | 112,965 | A | 3.90 | 0.05 |
| July | 78 | 1,609,012 | A | 6.30 | 0.08 |
| | 78 | 4,747 | B | 4.80 | 0.06 |
| August | 79 | 0 | | 0.00 | 0.00 |
| September | 81 | 313,656 | A | 9.50 | 0.12 |
| | 81 | 37,218 | B | 6.75 | 0.08 |
| October | 83 | 107,352 | A | 8.00 | 0.10 |
| | 83 | 19,177 | B | 6.00 | 0.07 |
| November | 85 | 81,850 | A | 8.70 | 0.10 |
| December | 87 | 4,284,304 | A | 9.00 | 0.10 |
| | 87 | 152,329 | B | 5.50 | 0.06 |
| 1984 | | | | | |
| January | 88 | 383,797 | A | 11.50 | 0.13 |
| February | 88 | 569,883 | A | 13.50 | 0.15 |
| | 88 | 39,285 | B | 8.00 | 0.09 |
| March | 88 | 241,037 | A | 15.20 | 0.17 |
| | 88 | 101,383 | B | 10.00 | 0.11 |
| April | 88 | 246,605 | A | 16.00 | 0.18 |
| | 88 | 45,617 | B | 12.50 | 0.14 |
| May | 90 | 105,634 | A | 19.00 | 0.21 |
| | 90 | 31,235 | B | 18.50 | 0.21 |
| June | 91 | 1,615,786 | A | 17.00 | 0.19 |
| | 91 | 218,520 | B | 18.50 | 0.20 |
| July | 92 | 113,070 | A | 15.50 | 0.17 |
| | 92 | 68,494 | B | 13.00 | 0.14 |
| August | 93 | 2,211 | A | 13.50 | 0.15 |
| September | 115 | 35,250 | A | 13.50 | 0.12 |
| October | 116 | 121,485 | A | 12.50 | 0.11 |
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| December | 123 | 2,127,887 | A | 12.50 | 0.10 |
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| 1985 | | | | | |
| January | 129 | 1,008,373 | A | 19.10 | 0.15 |
| February | 130 | 1,467,763 | A | 21.00 | 0.16 |
| March | 146 | 899,344 | A | 26.75 | 0.18 |
| April | 149 | 1,166,038 | A | 29.50 | 0.20 |
| May | 152 | 1,578,641 | A | 29.00 | 0.19 |
| June | 155 | 7,937,197 | A | 33.00 | 0.21 |

* In Chilean pesos, as recorded in the Santiago Bolsa de Valores.

\# In thousands.

International Privatization Group
Case Study #1

# COMPANIA DE ACERO DEL PACIFICO (B)

## CHILE

After the Compañía de Acero del Pacífico's share expansion of November 1984, re-privatization of 49 percent of CAP's total equity took almost three years. On August 1, 1985, Roberto de Andraca and CAP management launched a worker share purchase program, lending employees up to 80 percent of their retirement funds at zero real interest over 8 years. By March 1986 however, less than 10 percent of CAP's 1984 share issue had been purchased by workers. CAP then suspended its worker loan program and completed negotiations with CORFO to buy back the firm's own shares. On June 20 1986, CORFO received a check from CAP for $72,160,269 to repurchase 288,641,076 shares at $0.25 per share. CAP's shares were trading for $0.406 per share on the Santiago Stock Exchange at this time. With the share repurchase, CORFO's share ownership dropped to 51 percent, workers' ownership increased to 22 percent, and other private share ownership rose to 27 percent.

In October 1986, after lengthy negotiations and the informal intervention of General Pinochet, CORFO agreed to relinquish majority control and sell an additional 3 percent of its share ownership at a per-share price of $0.408. The market value of CAP's shares was $0.49 at this time. CORFO approved this sale on the condition that the additional shares be sold only to CAP's workers. In December, 1986, CAP initiated a new worker loan program (loans were extended to workers on the same terms as earlier, except that CAP offered no insurance against share price depreciation) and rapidly sold the authorized 3 percent, placing the firm under majority private control.

After private investors gained majority ownership, complete re-privatization of CAP moved swiftly. In early 1987, CORFO authorized selling up to 35 percent of its shares to workers and other private investors. As these shares sold quickly, in June, 1987, CORFO agreed to sell the remaining 20 percent of its share ownership on the Santiago Stock Exchange. By July 2, 1987, all of CORFO's remaining shares were purchased, leaving CAP 100 percent privately owned. Exhibit 1 shows that by November, 1988, CAP's employees owned 36.5 percent of the firm's shares, and private individuals and other investment groups held the remaining 63.5 percent of CAP's equity.

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This case was written by Charles A. Webster under the supervision of the International Privatization Group and James E. Austin Associates, Inc., as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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## Investments and Debt Restructuring

As CAP moved steadily toward private ownership, the firm was freed from the financial control of the Ministries of Planning (ODEPLAN) and Finance, and CAP embarked on an ambitious investment program. Exhibit 2 shows changes in the firm's investment programs 1971-90. In addition, as a result of mechanisms developed in 1986 by the Chilean Central Bank, CAP restructured its entire foreign debt, and reduced its financial costs significantly. Chapter XVIII of Chilean debt restructuring agreements allowed firms to repurchase debt owed to foreign creditors, taking advantage of significant discounts in the international secondary market. Although the government originally intended to exclude all SOE's from using this mechanism, CAP and a few other companies in the process of privatization were allowed to repurchase their debts. Exhibit 3 shows that the discount CAP realized from prepaying its debt averaged over 21 percent, and totalled $106,819,000.

CAP financed the prepayment of its debt through three sources: internally-generated resources, company funds held at the Central Bank held as collateral for the government's guarantee of CAP's foreign debt, and new short-term credits On its new, short-term debt, CAP secured more favorable interest rates. The result was that CAP's long-term debt-equity ratio dropped from 70 percent in 1984 to 38 percent in 1989. In addition, CAP's interest coverage (EBITDA/I) improved from 0.78 in 1984 to 3.82 in 1989. Exhibit 3 shows that CAP's financial costs of debt service fell from 21.8 percent of sales (or $74.5 million) in 1985, to 6.7 percent of sales (or $40.8 million) in 1989.

## Growth and Profitability

As private investors gained majority control of CAP, the firm was also no longer subject to the operational restrictions Chilean law imposed on state-owned enterprises, and began to aggressively diversify its commercial activities. In September, 1986, CAP acquired a pension fund. Then in 1987, the firm formed a real estate and construction company, and in 1988, CAP entered the forestry business. By 1990, CAP held 99 percent or greater equity control of 24 direct and indirect subsidiaries ranging from agriculture and forestry to furniture and the mining of gold and non-ferrous minerals.

Boosted by reduced debt-service costs and Chilean GDP growth rates averaging over 6 percent annually from 1985-90, CAP recorded significant improvements in profitability as a privatized company. Exhibit 4 shows that CAP's consolidated net earnings increased from $9.32 million in 1985 to $79 million in 1989. CAP's share price also rose significantly, jumping from $0.23 per share at the end of 1985 to $2.26 per share in 1989. Despite a decline in CAP's market share price to $2.02, the company's shareholders enjoyed not only eight-fold price appreciation since 1985, but also sharp increases in dividends. From 1986 to 1989, CAP's annual dividends grew from $0.10 per share to $1.81 per share.

Exhibit 1

# COMPANIA DE ACERO DEL PACIFICO

## CAP Share Ownership as of November 30, 1988

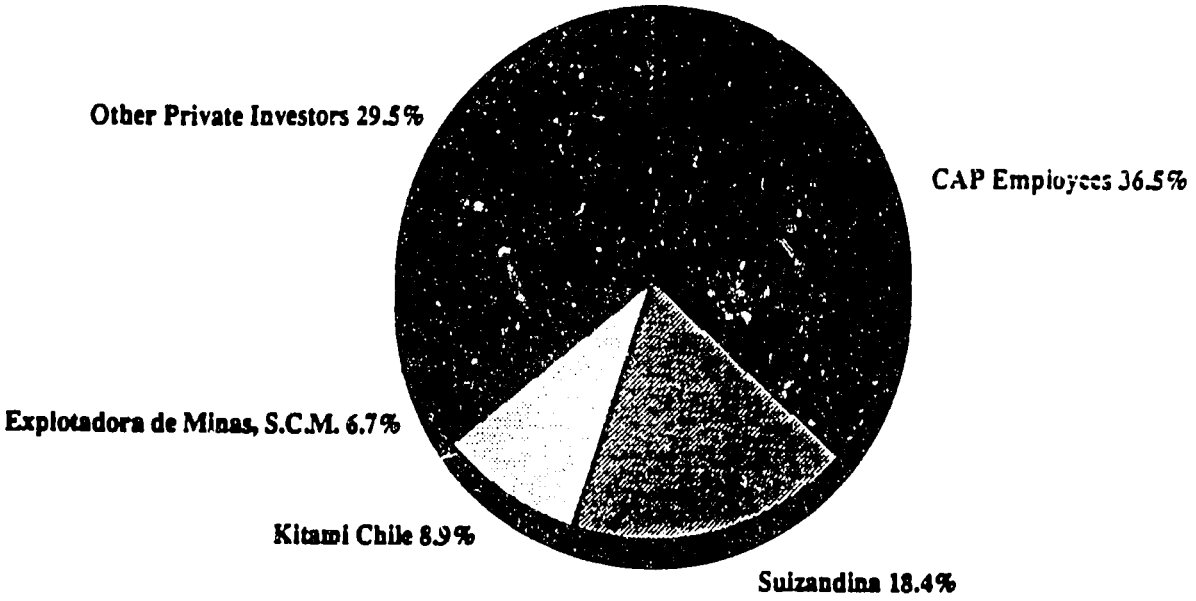



Exhibit 2

COMPANIA DE ACERO DEL PACIFICO

**Five-Year Investment Programs**
**(by year of program initiation)**

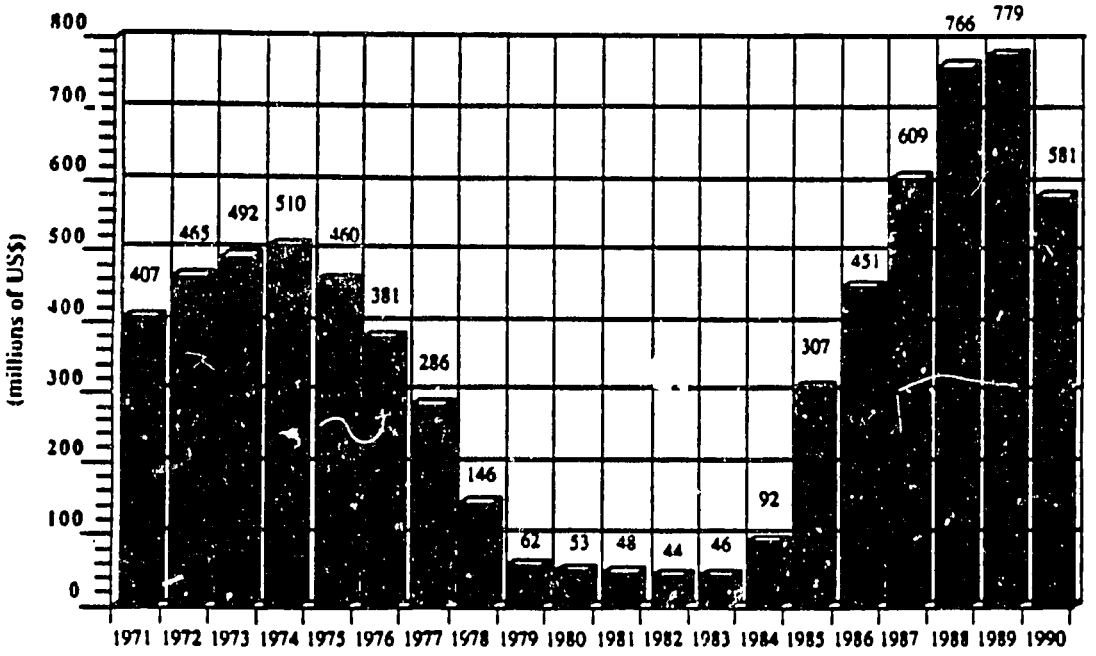


Exhibit 3
COMPANIA DE ACERO DEL PACIFICO

CAP's Financial Savings through Debt Prepayment

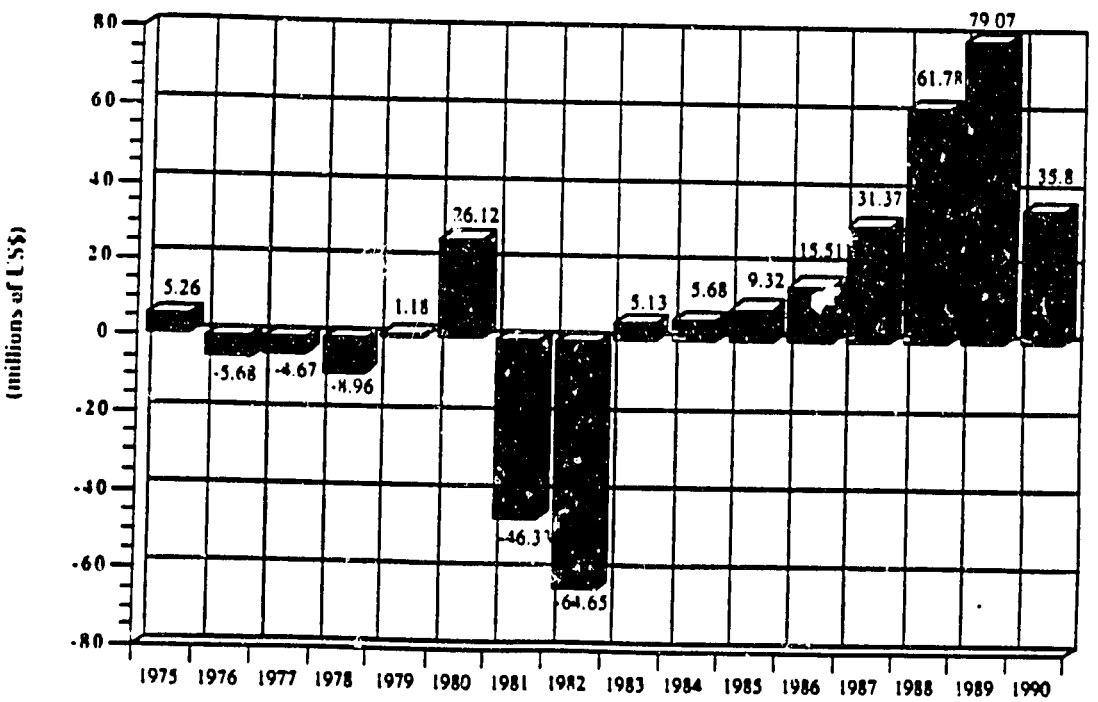
| Year | Debt Prepaid | Prepayment Discount (dollars) | Prepayment Discount (percent) | Financial Costs (dollars) | Financial Costs (% of sales) |
|---|---|---|---|---|---|
| 1984 | 0.00 | 0 | 0.0 | 74.5 | 21.8 |
| 1985 | 5.00 | 1.136 | 22.7 | 61.5 | 20.5 |
| 1986 | 55.289 | 5.726 | 10.4 | 55.0 | 17.3 |
| 1987 | 102.035 | 18.873 | 18.5 | 45.2 | 14.0 |
| 1988 | 300.968 | 74.835 | 24.9 | 39.7 | 8.7 |
| 1989 | 30.86 | 6.249 | 20.3 | 40.8 | 6.7 |
| Total | 494.152 | 106.819 | 21.6* | | |

* Average of prepayment discounts, weighted by amount of debt prepaid.

Source: Company records.

Exhibit 4
COMPANIA DE ACERO DEL PACIFICO

Consolidated Net Earnings 1975-1990
(in millions of current US$)



# About IPG

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With offices in 110 countries, Price Waterhouse has implemented more than 130 privatization projects worldwide. It has experience in privatization policy formulation, enterprise valuation, employee stock ownership plan design, public share offering structuring, and other privatization-related disciplines.

IPG Research and Training both draws on and contributes to related private-sector development projects carried on at Price Waterhouse: IPG's Technical Assistance group provides analysis and policy advice regarding all aspects of privatization at both the government agency and enterprise levels. PW's Financial Sector Development Project (FSDP) offers in-depth research and advisory services on capital market reform and financial strategy, providing the vital link between privatization and the development of adequate capital resources.

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The technical advisory arm of IPG provides US AID missions, host country governments, and state-owned enterprises with expert advice on many privatization disciplines, including strategic planning and management of privatization agencies; legal and regulatory system assessment; financial and operational appraisal; economic and financial cost/benefit analysis; valuations; public relations documentation; investor identification and solicitation; alternative financing techniques; employee share ownership program design; and market and economic analysis. For more information on IPG Technical Assistance contact Dr. Roger Leeds, Executive Director, IPG/Price Waterhouse, 1801 K St. NW, 10th Floor, Washington, DC 20006.

**Financial Sector Development Project**

FSDP, a US AID-funded project, helps developing countries optimize their financial markets. FSDP offers strategic financial sector assessment to assess each country's specific needs as well as policy, regulatory and supervisory system reform; modernization of information systems; financial institution restructuring and reform;. financial product and market development; privatization financing; debt conversion; savings mobilization; professional financial training; and support services including accounting, auditing, tax evaluation, and management consulting. For more information on FSDP, contact Mr. J. Richard Breen, Director, FSDP/Price Waterhouse, 1801 K St. NW, 10th Floor, Washington, DC 20006.

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Dr. Cao has acted as an advisor on international privatization and private sector development to numerous government agencies, supranational organizations and private corporations, including the US Agency for International Development, the World Bank, the US Departments of Commerce and Agriculture, Pepsi Cola, and Thai Pineapple, Inc. He has extensive experience as a trainer and researcher, having conducted seminars and authored studies on many aspects of the privatization process. Dr. Cao holds a Ph.D. in Finance and International Business from George Washington University.

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