An iron company in need of an Iron Chancellor

CAP is a steel and iron Chilean producing company, born out of 1980's privatizations, that is on the verge of change. Or at least it should be. Its present controlling stake, a convenient agreement between former and present employees and a mine fond investor that holds over one third of the company, goes back to those times. It was later reinforced by the entry of Mitsubishi, the Japanese group, into the property of one of the main iron mines in the 1990's with a 50% stake along with a direct investment in the equity of the company that today reaches over 19%.

At present time, the company has a market value of US$ 2.5 billion. It has a capacity to produce 11 million tons of iron – 6 million tons under the Mitsubishi joint venture - and 1.3 million tons of steel per year. Its net financial debt amounts to US$ 500 million. Its mineral resources are close to 3.000 million tons, with ore grades between 35% and 55% of Fe and strategic distances shorter than 200 km from ports. In 2008 its sales, operational results and profits were US$ 1.97 billion, US$ 347 million and US$ 293 million, respectively. 63% of its profits were due to the iron business, compared to a historical 36% ratio.

Considering global competition, CAP has comparative advantages in its iron mines and not in its steel operations. Moreover, it dangerously rests on keeping foreign steel at bay, distributing the market with Brazilian giant Gerdau AZA, under an implicit agreement that has been for a long time in the competition authorities' radar. The real economic change in the value of the company would come from increasing its mining business to over 25 million tons of iron per year. This is where the present controlling agreement is foundering.

For a long time now, CAP has been growing based on its own cash flows, postponing mining developments to this restriction. A publicly traded company, it was not to increase its capital unless all of its controlling partners had the ability to pay for it under their agreement. Because this was apparently not the case, it ended up having a slower development based not on a possible lack of access to capital, but on a weak controlling agreement that could not make an efficient use of the former.

As of now and under public disagreements among major CAP investors, there is an opportunity to create value for all shareholders. The old "divide and reign" is a feasible possibility. CAP could be divided into two companies, an iron producer and a steel producer. Shares could be then exchanged between relevant shareholders so as to get effective controlling stakes in each one of the new companies. The next step, at least in the case of the iron producer, would be to publicly raise capital. It would no longer be a captive unit mainly dependent on non economic factors.

In approximate figures, using present market values and a 50/50 economic value distribution, the iron producer could be structured with US$ 1.500 million iron mining assets and the steel producer with the other half of the economic assets. Net financial debt could be equally distributed between both. The mining company could then raise US$ 500 million to credibly detonate its growth to a 25 million ton iron production.

The opportunity for an "Iron Chancellor" to enter into the scene is obvious. The next years the world will return to growth and so will the need for commodities, being iron one of them. Having comparatively low iron production costs at ports is and will be the best guarantee of a fruitful venture in the long term; naively trusting a domestic steel distribution agreement is not and will not. The most possible scenario for the domestic steel market is one of increased competition. What it does not make sense for CAP is to continue working as it has done in the past.

If shareholders want more value, they should bet where their wealth is (i.e., iron ore resources), not where controlling restrictions have led to. These last ones have been dragging the potential aggregate value. Furthermore, even in the absence of restrictions, it makes sense to divest the steel business and to concentrate on the iron one.

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