

Compañía de Teléfonos de Chile

In April 1990, Claudio Garcia, the newly appointed senior executive vice president for finance and administration for Compañía de Teléfonos de Chile (CTC), found the telephone company in the middle of a challenging financial dilemma. CTC had embarked upon an aggressive expansion program that required substantial capital resources. The expansion program had been approved under Alan Bond, an Australian entrepreneur. The plan included reducing substantially the time needed to install telephone service and expanding capabilities to provide some of the latest high-tech capabilities that telecommunications had to offer.

However, because of significant personal financial difficulties, Mr. Bond sold his stake in the telephone company in April 1990. CTC was currently looking for new investors who could provide the necessary operating capital to continue its expansion. In seeking these investors, CTC had several options, but all had their drawbacks.

CTC could try to raise money from the local stock market. However, there were questions about whether there was sufficient capital in the market to finance fully CTC's needs. It could try to raise money from Chilean banks, but the small size of these banks and the legal restrictions they faced in being exposed to any one credit risk could prove problematic. Foreign commercial bankers had the necessary capital, but they shied away from making investments in Latin America—a region in which they faced massive loan write-offs from the debt crisis of the 1980s. Finally, CTC could also try to raise equity overseas through the listing of American Depository Receipts (ADRs), a step that likely would put its stock on the New York Stock Exchange. But this alternative also presented some substantial hurdles.

These, and many other questions, preoccupied Sr. Garcia as he considered how CTC's management might relax the financial constraints retarding CTC's growth.

Chile

The Country

In 1990, Chile was a country with a population of 12.9 million. Geographically, it was a long, thin country bounded by the Pacific Ocean on its west and the Andes Mountains along its east. These features made an extensive and reliable telephone network essential to the promotion of commerce within the country.

Since 1973, Chile had been ruled by Augusto Pinochet, a military general who had come to power in a coup over Salvador Allende, an elected Marxist leader who had ruled since 1970. In 1989, Pinochet put his continued leadership to a vote in a plebiscite—a vote that he lost. Though he promised an orderly transition of power, some observers questioned his sincerity. His long years in power, his vast control of the government through civil service appointments, and his complete dominance of the military forces made him a potent political force. Many wondered whether, once officially out of power, Pinochet might not continue to intervene in the governmental affairs of the country, or even stage another coup.

This case was prepared by Charles M. La Follette (MBA '92) under the supervision of Professors W. Carl Kester of Harvard Business School (Boston, MA, USA) and Enrique Ostale of Universidad Adolfo Ibañez (Santiago, Chile).

Copyright © 1992 by the President and Fellows of Harvard College. Harvard Business School case 293-015.

The Chilean Economy

The Chilean economy was largely based upon raw materials. The country was the world's largest exporter of copper and its third-largest producer (see Exhibit 1). Unlike its neighbors—Argentina, Bolivia, and Peru—Chile enjoyed a relatively stable economy. Inflation averaged 20.2% from 1984 to 1989.

Chile's history of debt payment was good. Unlike most of the Latin American region, Chile had never accumulated interest arrears on its \$18 billion debt. Nevertheless, its image suffered in the financial community from being associated with Latin American economies in general. Throughout the 1980s, the total debt of Latin America had increased 76.9%. Interest arrears of the region had boomed 22-fold since 1983 (see Exhibit 2).

During the early 1980s, the debt-to-export ratio of the continent steadily increased from approximately 2-to-1 to nearly 4-to-1 by 1986. To many in the world's financial centers, it seemed that the region would never be able to earn its way out of financial distress. Exchange rates and other economic data for Chile are provided in Exhibit 3. Economic data on selected other Latin American countries are provided in Exhibit 4.

Company Background

CTC's Privatization

By the late 1980s, Chile did not have a broad telecommunications network. In fact, the country ranked only 12th out of 24 Latin American and Caribbean nations in the extensiveness of its telephone network (see Exhibit 5). Though it was a state-owned enterprise, CTC suffered from a mediocre record in servicing customer needs. Hundreds of thousands of potential customers had been on the waiting list for service for several years (see Exhibit 6).

In 1987 the government decided to address the country's telecommunications problems by privatizing CTC. It put the firm up to bid on the stipulation that the winning bidder would expand, modernize, and improve the telecommunications network, as well as provide some initial financial security to employees who might be let go in a reorganization.

Several firms made bids for the telephone network, including BellSouth, Bond Company, Alcatel Althom N.V., Nippon Telegraph & Telephone Corp., Chase Manhattan, and Comunicaciones Chile. Several of the bidders offered distressed Chilean debt securities as payment, seeking to perform a debt-for-equity swap for the company. But in the end, Alan Bond's firm won the day. Though lower in total value, Bond Company's all-cash bid of \$114.8 million for 151 million shares (approximately 35% of total shares) of CTC was deemed more attractive than other, more creative financing bid structures. Bond Company subsequently acquired more shares that raised its ownership of CTC's stock to 49.5% by the end of 1988.

Bond Company immediately went to work on expanding the firm's operations. Soon after the acquisition, CTC embarked on an aggressive expansion mode to add 600,000 lines of service by the end of 1992. In addition, Bond Company's management began to implement a variety of other tactics that would further develop the company and make it one of the most modern telephone networks in South America. Among these goals were proposals to install a cellular service, implement new services such as paging and mobile radiocommunications, develop a high-speed data transmission network, advance towards full digitization of the network, improve the network maintenance and replacement program, introduce new value-added services, and operate a nationwide network of fiber optic and satellite transmission links.

Initial Setbacks

Unfortunately, the expansion and modernization program soon hit substantial difficulties. Many of these problems stemmed from the financial distress that began to afflict the Bond empire soon after its acquisition of CTC. Investors spanning the spectrum from American banks to local Chilean institutions began to shy away from CTC as an investment vehicle. By the late 1980s, the Bond Company found itself increasingly under pressure to sell substantial stakes in its holdings in order to meet debt obligations.

On April 11, 1990, Bond Company sold its stake of 365.5 million shares in CTC (along with an option to buy an additional 9.1 million shares) to Telefónica de España, S.A., the Spanish telephone company, for \$392 million. Nevertheless, even after Alan Bond had sold his stake in CTC, investors continued for a while to associate the company with Bond's difficult financial situation.

In addition, Claudio Garcia—who had joined the firm in September 1989—soon learned that the development program might not meet its targets. In hiring an international telephone operating company as an outside consultant in December 1989, CTC's administration acknowledged that substantial changes needed to be made in the management of the expansion plan.

Financial Concerns

In light of CTC's pressing financial and operating problems, Telefónica chose to cut its dividend. Both as a state-owned enterprise and under Bond's ownership, CTC had paid cash dividends in the amount of 100% of its net income. In 1990, CTC lowered its dividend to 80% of net income for the year. Within each fiscal year, CTC had historically maintained a policy that required it to pay out 60% of each quarter's earnings to the shareholders through a dividend. (When paying out 100% of its earnings, the fraction paid out each quarter was 75% of that quarter's earnings.) This meant that it had a particularly large final dividend payout to make at the end of each year. Relevant financial statements for CTC are provided in Exhibits 7 and 8. CTC's dividend history is provided in Exhibit 9.

The lowered dividend did not solve all of CTC's financial problems, however. The company still faced an uphill struggle in sourcing capital externally to meet its substantial capital expenditure budget. Following Telefónica's takeover, this budget increased as a consequence of the decision to extend CTC's line expansion target to 1.7 million by 1996 (see Exhibit 10 for capital expenditures projected through 1996). In particular, there were well-voiced concerns at CTC about whether the company would be able to raise substantial funds from its home country.

The Local Stock Market

The local Chilean stock market was thinly capitalized. At a market capitalization of \$11.6 billion as of March 31, 1990, the Chilean stock market was less than one third of 1% the size of the U.S. market, which had an estimated capitalization of \$2.9 trillion. Chile's market was not even big by developing country standards. Its market ranked only 11th among the world's 32 developing country stock markets in market capitalization (see Exhibit 11).

Chile's stock market was open only between 10:30 AM and 11:15 AM, and again between 11:45 AM and 12:30 PM each business day. Odd lots of stock were traded only once a week by auction. Average daily trading in the market was only about \$7–\$8 million. Analysts estimated that a large Chilean company could expect to raise only about 1% of the total market capitalization of the market in any new offering. Trading data for CTC's stock is provided in Exhibit 12.

Chilean Banks

Commercial banks might also be constrained from providing CTC with the necessary capital. Chile's banking community was not particularly large. Only 3 of the world's 1000 largest banks were based in Chile. Even by Latin American standards, Chile had a small banking community—ranking fifth out of the nine largest bank centers in Latin America in terms of total assets (see Exhibit 13).

Under Chilean law, commercial banks could lend up to 25% of their capital and reserves to a single company if the loans were adequately secured by tangible assets. However, because covenants on CTC's outstanding debentures prohibited it from pledging assets to secure new debt without the approval of a majority of the debenture holders, Chilean banks were constrained to lend no more than 5% of their total capital and reserves to CTC. It was possible that CTC's financial needs would quickly top this limit.

Chilean Pension Funds

One of the most rapidly growing domestic pools of capital in Chile was private pension funds. However, regulations constrained the types of investments these funds could make. Although CTC's equity would normally have been an eligible investment for Chilean pension funds, the funds were prevented from investing in any company in which a single investor (other than the Chilean government) owned 45% of the stock or more. Thus, in April 1990, CTC was not an eligible investment for private Chilean pension funds.

The Overseas Capital Markets

American depository receipts, or ADRs, represented a new potential option for raising additional capital. ADRs are receipts traded in the United States that represent the shares of foreign companies. They allow U.S. investors to invest in foreign markets through securities denominated in dollars and traded on American exchanges. Though the actual shares are deposited in a custodian bank located in the issuer's home country, the instruments have proven to be convenient and trustworthy.

ADRs grew in popularity throughout the 1980s as institutional investors sought to diversify their portfolio risk across international boundaries. Their ADR holdings increased substantially during this period. Since 1987, the annual ADR trading volume on U.S. exchanges increased by an average of 23.8%, while trading of U.S. stocks grew by only 4.2%. In 1989 foreign companies raised \$2.5 billion in new equity through ADRs. Exhibit 14 shows the growth of ADRs as a financial vehicle. Exhibit 15 shows the major institutional purchasers of ADRs.

Several different ADR programs were available. They differed primarily in the degree of financial reporting that a firm was willing to make to U.S. regulatory bodies. Level I ADRs provided the simplest method of accessing the U.S. capital markets. Level I ADRs were unlisted and traded by dealers in the over-the-counter market; the foreign company did not have to comply with U.S. generally accepted accounting principles (GAAP) or full Securities and Exchange Commission (SEC) disclosure requirements. In fact, Level I ADRs allowed non-U.S. companies to enjoy the benefits of a publicly traded U.S. security without having to alter their current reporting procedures at all.¹

To list securities on U.S. exchanges, foreign issuers had to use sponsored Level II or Level III ADRs. Each level required different degrees of SEC registration and reporting, and adherence to U.S. GAAP.² A brief summary of the different requirements by

¹Private Placement 144a ADRs was another method for entering the U.S. equity markets. In private placement ADRs, a private company could raise capital by placing ADRs with large institutional investors, again without registering with the SEC. However, this rule was not expected to become effective before June 1990.

²The Bank of New York, "American Depository Receipts and Privatizations," 1991, p. 5.

level is shown in Exhibit 16. Level III ADRs provided the most comprehensive (and expensive) means of entering the U.S. equity markets. Level III ADRs required full reporting of corporate data on a quarterly basis according to U.S. GAAP. In effect, in sponsoring a Level III ADR, foreign firms agreed to all of the reporting requirements with which listed domestic U.S. firms must comply.

Raising funds by issuing ADRs raised numerous problems for CTC. First, there was the potential problem that significant quantities of CTC's stock might flow back to the home market during market downturns—thereby causing disruptions, even suspensions, of trading in CTC stock on the Santiago Stock Exchange. Backflow could drive the price of the stock down and could lead to lower valuations in future stock offerings the company might pursue.

In addition, most ADRs came from companies domiciled in developed economies, not from companies in Latin America (see Exhibit 17). The appetite of U.S. investors for ADRs listed by a Latin American corporation had not been tested. Though there had recently been stock offerings for foreign telecommunication companies like Telefónica de España; Hongkong Telecommunications, Ltd.; Cable & Wireless Public Ltd., Co. (a U.K. company); and Telecom Corporation of New Zealand, Ltd., there might be perceptions of differences between the political risk of those countries and a country like Chile. In fact, there was no precedent to guide American institutional investors in evaluating a Chilean company, for there were no Chilean companies listed on the New York Stock Exchange.³ In addition, given the recent questions about CTC's development program raised by an independent—and American—telephone company, there were some concerns about whether CTC could withstand the scrutiny of skeptical analysts in road shows across the United States.

Finally, there were questions about whether CTC could satisfy the arduous reporting requirements of a Level III ADR. Would it be worth paying for the increased administrative cost of fulfilling those reporting requirements? Where would it obtain the necessary skills to satisfy these requirements?

There were no easy answers to any of these questions. Nevertheless, it was imperative that Sr. Garcia devise a strategy to finance CTC's ambitious program of investment and growth, analyze the financing alternatives, and submit a plan soon to CTC's board of directors.

EXHIBIT 1
Copper Production and Export (thousands of tons)

Source: *Economist Pocket World in Figures* (London: Hutchinson Business Books, 1990), p. 35.

	Top 5 Producers, 1988	Top 5 Exporters, 1988
U.S.	1,857	Chile 976
USSR	1,380	Zambia 424
Chile	1,013	Canada 262
Japan	955	Zaire 198
Canada	529	Peru 147

³Also, there was no tax treaty in force between Chile and the United States. Chilean tax law provided for a 35% withholding tax on dividends paid to foreign shareholders. The 10% corporate tax on income from which dividends were paid was available to shareholders as a credit against the withholding tax, but that credit increased the base on which the withholding tax was imposed (thus, on CP 100 of dividends, foreign shareholders would pay a net withholding tax of CP 27.78 = .35 × CP 111.11 - .10 × CP 111.11).

EXHIBIT 2
Total Latin American
Debt and Interest
Arrears (millions
of dollars)

Year	Total Debt	Interest Arrears
1980	\$242,535	\$ 8
1983	360,999	1,198
1984	377,531	3,108
1985	389,974	2,463
1986	409,708	3,285
1987	445,122	8,393
1988	427,597	8,944
1989	422,188	16,722

Source: "External Debt of Developing Countries," in *World Debt Tables, 1990-1991* (Washington, D.C.: The World Bank, 1991), p. 142.

EXHIBIT 3
Chilean Peso Exchange Rates and Economic Indicators

Source: Central Bank of Chile.

Chilean Peso/U.S. \$ Exchange Rate				
Year Ended December 31	Year-End Rate	Average Rate ^a	High Rate	Low Rate
1985	183.86	163.03	183.86	129.43
1986	204.73	194.15	204.73	185.70
1987	238.14	221.09	238.14	205.18
1988	247.20	245.48	248.24	240.90
1989	297.37	297.34	297.37	245.84
1990	296.98 ^b	na	na	na

Note: na = Not available.

^aThe average rate is calculated on the basis of month-end exchange rates.

^bEnd of March 1990.

Selected Macroeconomic Indicators

Item	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
GDP growth ^a (%)	8.3	7.8	5.5	-14.1	-0.7	6.3	2.4	5.7	5.7	7.4	10.0
Increase in Consumer Price Index (%)	38.9	31.2	9.5	20.7	23.1	23.0	26.4	17.4	21.5	12.7	21.40
Population (millions) ^b	10.9	11.1	11.3	11.3	11.7	11.9	12.1	12.3	12.5	12.7	12.90
Exports (\$ millions)	3,835	4,705	3,837	3,706	3,831	3,651	3,804	4,199	5,224	7,052	8,190.40
Imports (\$ millions)	4,191	5,469	6,513	3,643	2,845	3,288	2,956	3,099	3,994	4,833	
Current account surplus/deficit (\$ millions)	-1,189	-1,971	-4,733	-2,304	-1,117	-2,111	-1,329	-1,137	-808	-167	-740
Total external debt (\$ billions)	8.5	11.1	15.5	17.2	17.4	18.9	19.4	19.5	19.2	17.6	16.25
Debt service ratio to GDP ^c (%)	7.41	7.78	7.75	12.11	10.15	11.73	12.84	12.13	8.95	6.82	5.75
Exchange rate (pesos per \$) ^d	38.00	39.00	39.00	73.57	87.07	128.24	183.66	204.73	238.14	247.20	297.37
Unemployment rate (%)	13.6	10.4	11.3	19.6	14.8	13.9	12.0	8.8	7.9	8.3	5.30

^aAdjusted for inflation.

^bEstimated as of June of each year.

^cIncludes mandatory amortization and interest payments on medium- and long-term debt and interest on short-term debt.

^dObserved exchange rate as of December 31 of each year.

EXHIBIT 4 Comparison of Macroeconomic Indicators for Selected Latin American Countries

Source: *International Financial Statistics* (Washington D.C.: International Monetary Fund, April 1992).

	1985	1986	1987	1988	1989
<i>Increase in Consumer Price Index</i>					
Argentina	672.20%	90.00%	131.58%	342.73%	3,079.16%
Brazil	226.90	145.00	229.80	670.42	1,309.19
Colombia	24.00	18.90	23.30	26.10	25.65
Peru	163.40	78.00	85.96	666.16	3,398.50
Venezuela	11.40	11.50	28.16	29.46	84.27
<i>Exports (\$ millions)</i>					
Argentina	\$ 8,396.1	\$ 6,852.2	\$ 6,360.2	\$ 9,134.8	\$ 9,579.3
Brazil	25,639.0	22,349.0	26,224.0	33,789.0	34,383.0
Colombia	3,551.6	5,101.6	4,642.6	5,037.0	5,716.5
Peru	2,978.5	2,530.6	2,660.8	2,701.0	3,488.0
Venezuela	\$ 14,438.0	\$ 8,660.0	\$ 10,577.0	\$ 10,239.0	\$ 13,310.0
<i>Imports (\$ millions)</i>					
Argentina	\$ 3,814.2	\$ 4,724.1	\$ 5,817.8	\$ 5,321.6	\$ 4,203.2
Brazil	\$ 14,332.0	15,557.0	16,581.0	16,055.0	20,016.0
Colombia	4,140.9	3,861.6	4,321.9	5,001.8	5,004.1
Peru	1,835.0	2,908.8	3,562.3	3,348.0	2,749.2
Venezuela	\$ 8,106.0	\$ 8,504.0	\$ 9,659.0	\$ 12,726.0	\$ 7,803.0
<i>Current Account Surplus/Deficit (\$ millions)</i>					
Argentina	\$ (952)	\$ (2,859)	\$ (4,235)	\$ (1,572)	\$ (1,305)
Brazil	(273)	(5,304)	(1,450)	4,159	1,025
Colombia	(1,809)	383	336	(216)	(195)
Peru	135	(1,077)	(1,481)	(1,091)	324
Venezuela	\$ (3,334)	\$ (2,693)	\$ (2,709)	\$ (4,302)	na
<i>Total External Debt (\$ millions)</i>					
Argentina	\$ 49,148.7	\$ 51,422.0	\$ 58,324.0	\$ 58,803.0	\$ 63,314.0
Brazil	106,472.8	111,045.0	121,174.0	113,469.0	115,096.0
Colombia	14,237.4	14,987.0	15,663.0	16,434.0	16,013.0
Peru	14,136.9	14,477.0	15,373.0	16,493.0	16,827.0
Venezuela	\$ 34,692.8	\$ 33,839.0	\$ 34,833.0	\$ 34,684.0	\$ 33,194.0
<i>GNP Growth (%)</i>					
Argentina	-4.50%	5.60%	2.50%	-2.50%	-4.50%
Brazil	8.30	7.50	3.60	0.00	3.31
Colombia	3.10	5.80	5.40	4.10	3.40
Peru	2.40	9.17	8.26	-8.34	-11.65
Venezuela	1.30	6.34	4.51	6.11	-7.83
<i>Population (millions)</i>					
Argentina	30.33	30.74	31.14	31.53	31.93
Brazil	135.56	138.49	141.45	144.43	147.40
Colombia	28.62	29.19	29.73	30.24	32.53
Peru	19.70	20.21	20.73	21.26	21.79
Venezuela	17.32	17.79	18.27	18.76	19.25

Note: na = Not available.

EXHIBIT 5
Population per
Telephone Line
in 1986 for Latin
American and
Caribbean Nations
(persons per line)

Argentina.....	9.7
Bahamas.....	2.2
Barbados.....	3.3
Bolivia.....	41.4
Brazil.....	11.3
Chile.....	15.5
Colombia.....	13.0
Costa Rica.....	7.9
Cuba.....	18.9
Ecuador.....	27.4
El Salvador.....	38.1
Guatemala.....	62.0
Guyana.....	23.0
Honduras.....	86.6
Jamaica.....	205.0
Mexico.....	10.4
Neth. Antilles.....	4.0
Nicaragua.....	63.4
Panama.....	9.4
Paraguay.....	41.1
Peru.....	32.8
Trinidad and Tobago.....	11.0
Uruguay.....	7.6
Venezuela.....	11.3

Source: *Economist Pocket World in Statistics* (London: Hutchinson Business Books, 1990), p. 125.

EXHIBIT 6
CTC's Lines
in Service
and Waiting List

	December 31,				
	1986	1987	1988	1989	1990 ^a
Number of telephones.....	749,110	770,199	820,260	894,824	1,096,056
Telephones per 100 inhabitants...	6.6	6.7	7.0	7.4	8.9
Number of lines installed.....	584,829	614,884	634,327	799,917	1,018,568
Lines in service.....	527,789	548,359	591,565	645,863	811,811
Applications pending.....	219,265	230,452	236,349	283,919	307,843
Digitalization (%) ^b	36.8	36.0	37.9	51.1	64.0
Automation (%) ^c	96.1	98.0	98.5	99.3	99.6
Local calls (millions) ^{d, e}	1,095	1,146	1,231	1,341	1,524
Local calls per line in service ^{e, f}	2,667	2,686	2,778	2,610	2,587

^aEstimated.

^bPercentage of lines installed and connected to digital exchanges.

^cPercentage of lines installed and connected to automatic exchanges.

^dDoes not include calls made under CTC's "flat fee" charge system, or calls made from public telephones.

^eReflects information for the period ending the date indicated.

^fLines in service do not include lines that provide service on the "flat fee" charge system or that provide service from public telephones.

Totals were calculated for each year on the basis of the monthly average of the number of lines in service during each year.

Source: Corporate documents.

EXHIBIT 7
Consolidated Balance
Sheets (Adjusted for
general price-level
changes and expressed
in millions of constant
1990 Chilean pesos
[CP], except number
of shares)

Source: Corporate documents.

	1989	1988
Assets		
Current assets		
Cash and cash equivalents.....	CP 29,782	CP 27,770
Marketable securities.....	7,829	5,377
Accounts and notes receivable.....	31,094	16,722
Inventories.....	6,824	2,726
Other.....	743	1,587
Total current assets.....	76,272	54,182
Property, plant, equipment, net.....	295,440	216,796
Other assets.....	12,634	24,867
Total assets.....	CP 384,346	CP 295,845
Liabilities and shareholder's equity		
Current liabilities		
Bank borrowings.....	CP 11,232	CP 9,462
Current maturities of long-term debt.....	10,570	78
Accounts payable and accrued.....	46,012	28,029
Due to ENTEL.....	3,546	—
Other.....	3,481	159
Total current liabilities.....	74,841	37,728
Long-term liabilities		
Long-term debt.....	80,710	50,526
Accrued severance indem.....	4,971	5,142
Deferred income taxes.....	—	156
Total long-term liabilities.....	85,681	55,824
Shareholders' equity		
Common stock.....	200,560	195,694
Retained earnings.....	23,264	6,599
Total shareholders' equity.....	223,824	202,293
Total liabilities and shareholders' equity.....	CP 384,346	CP 295,845

EXHIBIT 8
Consolidated
Statements of Income
(adjusted for general
price-level changes
and expressed in
millions of constant
1990 Chilean pesos
[CP], except number
of shares)

Source: Corporate documents.

	1988	1989
Operating revenues		
Tariff regulated services.....	CP 68,498	CP 82,676
Other.....	13,342	20,859
Total operating revenues.....	81,840	103,535
Operating costs and expense		
Oper. salaries and related.....	16,770	18,101
Depreciation and amort.....	12,088	13,868
Cost of ENTEL services.....	199	975
Other operating costs.....	11,339	16,031
Admin. and selling costs.....	9,836	11,371
Total operating costs and expenses.....	50,232	60,346
Operating income.....	31,608	43,189
Other income (expenses)		
Interest income.....	1,651	4,967
Net interest expense ^a	(3,961)	(2,226)
Purchasing power gain ^b	5,517	7,098
Other.....	(7,013)	(10,042)
Total other income, net.....	(3,806)	(203)
Income before income tax.....	27,802	42,986
Income tax ^c		
Current.....	1,479	(298)
Deferred.....	1,317	(3,322)
Net income.....	CP 25,006	CP 46,606

^aCapitalized interest expense was CP 5,081 million in 1989 and CP 1,656 million in 1988, which gave rise to total (i.e., capitalized and noncapitalized) interest expense of CP 7,307 million and CP 5,617 million in 1989 and 1988, respectively.

^bPurchasing power gains are noncash sources of earnings that reflect the effect of Chilean inflation on the monetary liabilities owed by CTC during each year, net of the loss resulting from the effect of inflation on monetary assets held.

^cOn January 14, 1989, the Chilean income tax was substantially changed. Among other changes, corporations were not subject to income tax beginning on January 1, 1989. Income taxes were payable by the shareholders on dividends received. In light of this change, the net liability for deferred taxes shown on the balance sheet as of December 31, 1988, was credited to income in 1989.

Subsequent Chilean legislation passed in the first half of 1990 introduced a corporate tax rate of 10% on income earned after January 1, 1990, with an increase in the rate to 15% for 1991, 1992, and 1993, and a decrease to 10% for the years 1994 and beyond.

EXHIBIT 9
CTC's Cash Dividend
History^a (Chilean
pesos per share)

Source: Public documents.

	Interim	Final ^b	Total
1986.....	35.93	—	35.93
1987.....	17.14	25.56	42.70
1988.....	38.17	16.75	54.92
1989.....	46.02	9.06	55.08

^aChilean pesos are reflected at historical values, not at constant 1990 purchasing power values.

^bThe final dividend for each year is declared (and hence accrued) in April of each subsequent year.

EXHIBIT 10
CTC's Actual and
Projected Capital
Expenditures (millions
of Chilean pesos)

Source: Corporate documents.

	Actual			
	1988	1989	1990	1991-1996
For tariff-regulated services.....	CP 41,719	CP 79,325		
For services not currently subject to tariff regulation.....	4,377	11,520		
For new services requiring new concessions.....				6,422
Total.....	CP 46,096	CP 97,267		
	Projected			
	1990	1991	1992	1993-1996
For tariff-regulated services.....	CP 100,602	CP 95,042	CP 77,458	CP 243,735
For services not currently subject to tariff regulation.....	4,963	4,380	3,413	10,880
For new services requiring new concessions.....	15,187	15,441	8,468	14,658
Total.....	CP 120,752	CP 114,863	CP 89,339	CP 269,273

EXHIBIT 11
World Stock
Exchanges: Market
Capitalization of
Emerging Markets
(millions of dollars)

Source: *Economist Book of Vital World Statistics* (London: Random Century House, 1991), p. 146.

	1989
Argentina.....	\$ 4,225
Bangladesh.....	476
Brazil.....	44,368
Chile.....	9,587
Cote D'Ivoire.....	437
Colombia.....	1,136
Egypt.....	1,760
Greece.....	6,376
India.....	27,316
Indonesia.....	2,514
Jamaica.....	957
Jordan.....	2,162
Kenya.....	474
South Korea.....	140,946
Kuwait.....	9,932
Malaysia.....	39,842
Mexico.....	22,550
Morocco.....	621
Nigeria.....	1,005
Pakistan.....	2,457
Philippines.....	11,965
Portugal.....	10,618
Sri Lanka.....	471
Taiwan.....	237,012
Thailand.....	25,648
Trinidad and Tobago.....	411
Turkey.....	6,783
Uruguay.....	24
Venezuela.....	1,816
Zimbabwe.....	1,067

EXHIBIT 12
Trading Data
for CTC's Stock^a

Source: Public documents.

	Per Share (CP) ^b		Average Daily Number of Shares Traded (000s) ^c
	High	Low	
1989			
First quarter	188	149.5	135
Second quarter	207	172.5	342
Third quarter.....	206	173.75	202
Fourth quarter.....	200	169	383
1990			
First quarter	255	190	467

^aReported figures are for Series A shares only. CTC's capital is represented by no-par-value shares divided into two series (Series A and B). The rights of both series of shares are identical, except that the Series A shareholders as a class appoint six directors and the Series B shareholders as a class appoint one director. On December 31, 1989, there were 634,527,896 Series A shares issued and outstanding, and 67,552,376 Series B shares issued and outstanding.

^bChilean pesos are reflected at historical values; not at constant 1990 purchasing power values.

^cSeries A shares are traded principally on the Bolsa de Comercio de Santiago (the Santiago Stock Exchange). The shares are also listed on the Bolsa de Comercio de Valparaiso (the Valparaiso Stock Exchange) and are tradeable in a nascent electronic over-the-counter trading system. However, the Santiago Stock Exchange accounts for approximately 95% of the trading volume of CTC's shares in Chile.

EXHIBIT 13
Banking in Latin
AmericaSource: *Economist Book of Vital World Statistics* (London: Random Century House, 1991), p. 148.

	Number of Banks in Top 1,000	Total Capital (\$ millions)
Argentina	7	\$ 3,159
Brazil	17	10,914
Chile	3	878
Colombia	1	94
Mexico	5	2,226
Panama	1	89
Peru	1	170
Uruguay	1	822
Venezuela.....	5	934

EXHIBIT 14 Selected Data on ADR ProgramsSource: Philip Maher, "ADR Market Continued Growth in 1990, Riding Global Trend," *Investment Dealers' Digest*, February 1991, p. 12.

	1983	1984	1985	1986	1987	1988	1989
Total number of ADR programs.....	585	625	683	700	754	782	804
Number of ADR offerings	10	9	2	8	19	8	20
Total capital raised with ADRs (\$ millions)	617	608	28	696	4,586	1,275	2,614

EXHIBIT 15
Top Institutional
Holders of ADRs
(July 1989)Source: *Investment Dealers' Digest*, October 16, 1989.

	Amount (\$ millions)
CIGNA.....	\$980
Delaware Management	738
FMR.....	522
Manufacturers International.....	501
Capital Guardian	413
Wellington.....	386
California Public Management.....	369
INVESCO	239
Alliance Capital.....	232
IDS Financial.....	227
American Capital	206
Lazard Freres	198
J. P. Morgan	198
Scudder, Stevens	197
Dreman Value.....	182
Merrill Lynch Asset Management.....	181
Templeton.....	169
Pioneering Management	167
Newbold's Asset Management	143
Rosenberg Institute.....	143

EXHIBIT 16 Comparison of ADR Facilities

Sources: The Bank of New York, "American Depository Receipts and Privatizations," 1991; and J. P. Morgan, "American Depository Receipts for Chilean Companies: Benefiting from the U.S. Capital Markets," unpublished presentation materials.

Type of Program	Registration Requirements ^a	Disclosure Requirements	Type of U.S. Equity Offering ^b	Listing Possibilities	Typical Cost to Company
Un-sponsored ^c	Form F-6	None	Rule 144A private placement	OTC/pinks	None
.....	Rule 12g3-2(b)	None	placement	Bulletin board	None
Private placement	Rule 12g3-2(b)	Eurostyle	Rule 144A private placement	Various	\$100,000 to \$300,000
Sponsored					
Level I.....	Form F-6	None	Rule 144A private placement	OTC/pinks	\$5,000 to \$20,000
.....	Rule 12g3-2 (b)	None	placement	Bulletin board	
Level II.....	Form F-6	None	Rule 144A private placement	NYSE	\$200,000 to \$400,000
.....	20-F	Detailed	placement	AMEX	
.....				NASDAQ	
Level III.....	F-1	Rigorous	Public offering	NYSE	\$400,000 to \$800,000
.....	20-F	Detailed		AMEX	
.....				NASDAQ	

^aThe Securities Act of 1933 requires public securities to be registered with the Securities and Exchange Commission (SEC). Filing a Form F-6 registration statement complies with this requirement without substantial disclosure of information. Form F-1 requires financial information that is less than six months old and conforms to U.S. GAAP.

The Securities Exchange Act of 1934 requires companies listed on a major exchange to make regular filings of interim and annual reports to the SEC. A 20-F report requires detailed disclosure by foreign companies equivalent to a 10K report by domestic U.S. companies. Rule 12g3-2(b) of the 1934 Act permits exemption from such detailed disclosure by allowing foreign companies to file, on an ongoing basis, only that information that it is required to disclose in its country of domicile or that it distributes to any security holders outside the United States.

^bRule 144A permits restricted or nonpublic securities issued by foreign investors to be placed and traded privately among large, sophisticated institutional investors.

^cNo un-sponsored programs have been initiated since 1983.

EXHIBIT 17
ADR Programs
by Country of Origin
(July 1989)

Source: *Investment Dealers' Digest*, October 16, 1989.

Percentage of Total ADR Programs by Country

	Number	Percentage
United Kingdom.....	197	23.0%
Australia	179	20.9
Japan	144	16.8
South Africa.....	91	10.6
Hong Kong.....	30	3.5
France	24	2.8
Germany	24	2.8
Netherlands.....	21	2.5
Italy	20	2.3
Other	127	14.8
Total	857	100.0%

Percentage Sponsored ADR Programs by Country

	Number	Percentage
United Kingdom.....	148	38.3%
Australia	80	20.7
Japan	19	4.9
Netherlands.....	18	4.7
France	14	3.6
Sweden	13	3.4
Norway	12	3.1
Mexico	11	2.9
Spain	8	2.1
Other	63	16.3
Total	386	100.0%

Dividend Policy at FPL Group, Inc. (A)

In the late afternoon of Thursday, May 5, 1994, Kate Stark, the electric utilities analyst at First Equity Securities Corporation, received an investment alert on one of the companies she followed. According to the report, Merrill Lynch's utilities analyst was downgrading FPL Group, Inc., Florida's largest electric utility. The report began:

We are [lowering] the investment rating for FPL Group . . . due to our expectation that the Directors will choose not to raise the annual dividend from \$2.48 at [the annual meeting on] Monday, May 9, FPL's shareholders face the possibility that the dividend is not entirely secure, as we believe FPL may seriously review its dividend policy at this time. . . . Management has suggested that it feels that its dividend payout is inappropriately high (in excess of 90% in 1993) given the increasing risks facing the industry. . . . When asked specifically what might be done about the high dividend payout levels, management suggested that there are two ways to address high payout levels: 1) a company can grow out of a high payout; 2) a company can cut its dividend . . . we expect the company to keep the dividend at the \$2.48/share level through 1997.¹

Although this analyst was predicting the dividend would not change, this was the first time Stark had seen one of her peers suggest the possibility of a dividend cut. Only three weeks earlier, Stark herself had issued a report on FPL Group with a "hold" recommendation based on the assumption that FPL would keep its dividend at \$2.48 per share or increase it slightly. What concerned her, however, was the fact that FPL's stock price had fallen by more than 6% that day. While she could not be sure the drop was related to the report, she wondered what, if anything, she should say to her clients regarding FPL's stock and whether she should issue an updated report.

Electric Utility Industry

One can trace the history of the U.S. electric utility industry back to Thomas Edison's invention of the incandescent lamp in 1878. Electricity quickly became an important part of everyday life because of the ease with which it could be transported from one place to another and converted into other useful forms (mechanical power, light, etc.). Electricity—the flow of electrons—is created by forcing steam or water through a turbine lined with electromagnets, which induces electron movement. Once produced, electricity is transmitted through power lines and distributed to end users.

The concept of a public utility developed in the late nineteenth century to refer to a monopoly supplier of a "vital public service." The vital public service in this case was the generation, transmission, and distribution of electricity. In exchange for the monopoly right to supply electricity, power companies agreed to let government agencies regulate their prices and returns. By 1930, virtually every state had established a regulatory agency. In Florida, the Florida Public Service Commission not only regulated rates, returns, and capacity planning but also determined what nonutility businesses a utility could enter.

¹Sanford Cohen and Daniel Ford, "FPL Group: Dividend Policy Review; Lowered Opinion," Merrill Lynch & Co., May 5, 1994, pp. 1, 3.

This case was prepared by Research Associate Craig F. Schreiber under the supervision of Professor Benjamin C. Esty. This case was prepared solely on the basis of public information without the participation of FPL Group, Inc.

Copyright © 1995 by the President and Fellows of Harvard College. Harvard Business School case 295-059.