

CHAPTER 17 – Multinational Cost of Capital

Owens-Illinois to Buy Mexican Glass Container Business for USD 2.15 Billion

The deal includes five plants in Mexico and one in Bolivia

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Owens-Illinois Inc. (U:OI) is counting heavily on Mexico for a dash of growth in the sluggish global market for glass bottles. The Perrysburg, Ohio-based company announced Wednesday an agreement to pay USD 2.15 billion for Vitro S.A.B. de C.V.'s food-and-beverage glass container business, the largest in Mexico. The agreement includes Vitro's (MX:VITROA) five glass-container plants in Mexico and one in Bolivia.

Owens-Illinois shares rose 9.2%, or USD 2.19, to USD 25.98 in 4 p.m. trading on the New York Stock Exchange. Chip Dillon, an analyst at Vertical Research Partners, said the planned acquisition could be "a game changer" in terms of investors' perception of potential growth at Owens-Illinois.

The company is the world's largest maker of bottles for beer, wine and liquor, but sales have declined in recent years amid weakness in Europe and Australia and a partial retreat from China, where Owens-Illinois found local price competition too stiff.

U.S. companies have been stepping up their purchases in Mexico, a bright spot recently in contrast to slumping Brazil. U.S. acquisitions in Mexico last year totaled about USD 7 billion, up from USD 5.3 billion in 2013, and so far this year they amount to USD 4.4 billion, including the Owens-Illinois deal, according to Dealogic.

The Owens-Illinois acquisition pleased one of the company's biggest shareholders, Atlantic Investment Management Inc., whose stake is nearly 8%. Just five months ago, Atlantic sent the Owens-Illinois board a blistering letter, calling for more aggressive stock buybacks and describing the company's management style as "reactive." On Wednesday, Alexander Roepers, president of Atlantic, said in an interview that the Mexico deal is "the spark that was needed" and will be more positive for earnings per share than stock repurchases.

The acquisition marks the second major investment in Mexico announced by Owens-Illinois in the past eight months. In October, it announced a joint venture with Constellation Brands Inc. to operate a plant in Nava, Mexico, that makes bottles for Corona Extra and related beers. Through that venture, Owens-Illinois plans to invest about USD 275 million to expand the Nava plant.

Global demand for glass beverage bottles has been growing at only about 1% to 2% annually in recent years, according to Euromonitor International. But Owens-Illinois said Mexico's market for food-and-beverage glass packaging is growing about 2.4% a year.

Mexico is the world's fourth-biggest producer of beer, after China, the U.S. and Brazil, Owens-Illinois said. Vitro's glass-packaging business, however, is mainly focused on wine, spirits, food and soft drinks. Mexico had been a major gap in Owens-Illinois's global network of bottle plants.

The purchase will increase Owens-Illinois's net debt to about USD 5.4 billion from USD 3.3 billion, said Mr. Dillon of Vertical Research. But Atlantic's Mr. Roepers said Owens-Illinois should be able to pay down that added debt quickly. The company said it has secured committed financing from Deutsche Bank, its financial adviser for the deal.

The business being acquired has annual revenue of about USD 945 million, compared with about USD 6.6 billion for Owens-Illinois. The acquisition should add 30 to 40 cents to earnings per share in the first year, and about 50 cents per share by the third year. OI expects annual saving of USD 30 million also by the third year. Owens-Illinois said it expected the acquisition to be completed within 12 months, subject to approval by regulators and Vitro shareholders.

Questions

1. Get online (visit Morningstar, Yahoo, etc.) OI's financial information. Then, assess the capital structure of OI and how the acquisition of Vitro affects it. Do you think OI's capital structure is close to the optimal?
2. According to Morningstar, in August 2015, Vitro's capital structure was composed of MXN 7,389 M of Equity and MXN 18,025 M of Debt. Vitro's beta is .62. During the past 25 years, the Mexican stock market has had an average return of 22%, with a volatility of 31%. The Mexican corporate tax rate is 30%. The government interest rate in Mexico is 3%. Vitro's spread over government debt is 2.75%. Calculate the cost-of-capital of the acquisition for OI.
3. Should the purchase of Vitro increase or decrease OI's cost of capital?
4. Suppose you do not trust the estimate for the Mexican market return, $(k_M - k_f)_{\text{Mex}}$. Using the U.S. information presented in class, calculate $(k_M - k_f)_{\text{Mex}}$ using the Country Risk Approach and the Relative Equity Market Approach. Assume the inflation rate in Mexico is twice the U.S. inflation rate.
5. Why are U.S. companies investing more in Mexico and less in Brazil?