CASE SEVEN

AMERICAN CAN COMPANY —INTERNATIONAL BUSINESS GROUP

On August 19, 1976, Jim Berezin looked out over the lovely park surrounding American Can Company's headquarters in Connecticut's Hudson Valley. He knew that the two decisions facing him were important to his company and to his career. Success would depend on both an accurate analysis of ACC's foreign exchange exposure position and the persuasiveness of his presentation of his analysis and recommendations to the officers on the treasurer's staff.

For several months Jim had agreed with the bankers he consulted. They predicted that the Mexican peso would not devalue before December 1976, if it devalued at all. In the last week, however, several Mexican sources suggested to him that peso devaluation was imminent. ACC's Mexican subsidiary, Nueva Modelo, S.A., had a net exposed asset position in pesos. A peso devaluation would result in reported losses when Nueva Modelo, S.A. was consolidated into ACC's financial statements.

Although Jim had to confront the immediate possibility of peso devaluation he knew that ACC's management also expected him to develop a program to deal with the persistent threat of loss due to changes in exchange rates. He knew he would need to compare the risk of exchange rate loss to the costs of the various alternatives available for eliminating the risk.

THE COMPANY AND ITS FOREIGN OPERATIONS

Founded by George Moore in 1901, American Can had grown into the second largest producer of consumer containers in the United States. ACC's consolidated financial statements are shown in Exhibits 1 and 2. Its packaging business groups produced cans, cartons, wraps and plastic for food and beverage processors, and meat packagers. While packaging constituted the largest part of ACC's operations the company had diversified into the production of such consumer products as Dixie paper cups and plates, popular brands of tissue paper, toweling and napkins, as well as Butterick and Vogue home sewing patterns. Smaller ACC business groups produced chemicals, plastics and pharmaceuticals, and were engaged in publishing, printing, and solid waste recycling.

The American Can International Business Group supervised operations in Canada, Venezuela, the Dominican Republic, France, Germany, Japan, and Mexico. In 1975, international operations accounted for 15% of corporate sales and 25% of pretax earnings. The responsibility for planning and the control of the foreign subsidiaries was vested in the Corporate Planning and Control groups, while the treasurer's office developed financial strategies for foreign operations. Jim was responsible for international cash management and corporate-wide banking relationships.

MANAGEMENT OF FOREIGN EXCHANGE EXPOSURE

Exposure reports were submitted quarterly by the financial staffs of ACC's foreign subsidiaries. The personnel of the subsidiaries were binational, and local personnel were frequently unacquainted with U.S. accounting conventions. To assure himself of accurate information, Jim had visited the financial directors of each subsidiary to explain the procedures for completing the report.

Each month Jim calculated the subsidiaries' exposure. He also gathered information on cash transactions between ACC and its foreign subsidiaries, such as dividend payments, which were scheduled for the near future. When he felt that exposure should be reduced he recommended action to the officers at ACC.

The company had a policy of avoiding speculation. "As a general principle we seek to finance our overseas operations in such a way as to minimize our exposure to loss from currency fluctuations and hence forego speculative opportunities for windfall gains." One method of reducing such exposure is to match the currency denomination of assets and liabilities. Since most subsidiaries' assets were denominated in local currency, ACC could follow the strategy of denominating all debt in local currency. However, interest costs for borrowing foreign currency were often significantly higher than dollar interest rates. ACC evaluated this trade-off for each subsidiary. "With our foreign affiliates characteristically having substantial short-term assets in local currency, the amount of corresponding financing to be locally funded is a matter for management evaluation at both affiliate and corporate levels." While forward contracts could also be used to eliminate exposure, ACC had a policy for entering into such contracts only in protection of specific exposed cash flows such as projected dividend payments.

In Mexico, ACC's major debt was denominated in dollars. Since Mexican interest rates had been about 5–6% higher than U.S. rates for many years, this strategy had meant substantially reduced interest costs for ACC. Since the exchange rate had remained at MP 12.50 per U.S. dollar since 1954, ACC had accumulated these interest savings over many years. While the value of any debt denominated in pesos would decline with a peso devaluation, the accumulated interest gains from borrowing dollars had more than compensated ACC for this forgone opportunity. This strategy had proven successful over the many years of exchange rate stability, but Jim knew that it left Mexican assets exposed to exchange rate changes. In view of the increasing probability that the peso would devalue, the risk/cost trade-off which had existed for years was obsolete. It was time to re-evaluate ACC's peso position.

NUEVA MODELO, S.A.

American Can bought into Nueva Modelo in 1957. After a long history of operating losses, ACC revitalized the operation with an injection of management talent in the late sixties. The operations were turned around and began to show a profit in 1974. The company produced general purpose cans and food and beverage containers for the extremely competitive Mexican market. All products were sold in Mexico since it was uneconomical to transport such items as containers which are bulky and have low value per unit. Nueva Modelo's financial statements for 1974 and 1975 are shown in Exhibits 3 and 4.

Competition was very lively. In addition to the Mexican subsidiary of another major U.S. container company, a Mexican-owned company competed aggressively for Nueva Modelo's customers.

Nueva Modelo's customers were segregated into two groups. About half of NMSA's containers were sold to large, food processing subsidiaries of U.S.-based corporations. One large, local food company and several smaller, local firms constituted the remaining half of their customer base. All of the trade credit extended by NMSA was denominated in pesos.

Tin plate was the major raw material used in container production. At the beginning of each year, NMSA's purchasing department presented its annual tin plate requirements to Altos Hornos de Mexico, a government-owned tin plate producer. Altos Hornos then scheduled a monthly quota of tin plate for NMSA. NMSA ordered additional tin plate from U.S.-based steel corporations to fill its needs.

THE HISTORY OF THE PESO

In April, 1954, the Mexican peso was devalued from MP 8.65 to MP 12.50 per U.S. dollar and had remained fixed at that level since then. Throughout the 1960's, the stability of the peso, the availability of confidential bank accounts, and the stability of the Mexican political situation lured increasing numbers of foreign investors. In the face of the currency crises of the early 1970's the peso maintained its parity with the dollar. In fact, several times the International Monetary Fund used the peso, which was considered a very stable currency, to support other major currencies.

After economic slowdowns in 1971 and 1972, the Mexican government began expansionary efforts to improve economic growth. In 1973, the Foreign Investment Law was passed. This law reduced the freedom previously accorded to foreigners investing in Mexico. A slowdown in the rate of foreign investment and economic expansion followed. Prices continued to rise. From 1970 to the end of 1975, consumer prices rose 76% (see Exhibit 5 for price index history). Mexican inflation exceeded U.S. inflation by 28%. While the government attempted to pursue anti-inflationary policies, demands for wage increases generated substantial political unrest.

Inflationary pressure, political unrest, and the decline in foreign investment greatly reduced investor confidence in the peso. A pattern of "spring jitters" developed. Each spring rumors of devaluation prompted capital flight from Mexico. Government assurances that parity would be maintained had reversed these periodic capital flights and reduced pressure on the peso. In the spring of 1976 there had been talk of a peso devaluation and the government had again promised to maintain parity. Most analysts felt that because of the relatively rapid inflation rate in Mexico, the peso would eventually be devalued; however, it was expected that the government would avoid devaluation until after the Presidential elections which were scheduled for the fall.

The Financial Director of Nueva Modelo had just phoned to report that he thought the government would not wait until the fall but would devalue the peso much sooner. He felt a devaluation might be announced within the next several weeks. This reminded Jim of the warning that he had received while attending a meeting in Chicago in the spring. At that time, a Mexican banker had forecast that the devaluation would take place during the summer. In addition, Jim trusted the judgment of NMSA's Financial Director. In his words, "When Dave Wann doesn't sleep well, I don't sleep well."

THE DECISION

Jim knew that ACC's management would be concerned about the effect of a devaluation on the "bottom line." Under the FASB-8 accounting rules exchange losses would directly affect ACC's profit. As he headed back to his office Jim pulled NMSA's most recent financial statements (shown as Exhibits 6 and 7) from his files. He also gathered together information on peso forward rates and interest rates (see Exhibit 8). He planned to estimate the company's exposure and the loss ACC could expect if the peso devalued. He would also consider various hedging strategies and their costs. He could then recommend appropriate action to the Treasurer.

Exhibit 1
American Can Company—International Business Group
American Can Company and Consolidated Subsidiaries
Balance Sheets, 1974-75 ($000)

	December 31, 1975	December 31, 1974
ASSETS		
Cash & Marketable Securities	142,951	83,967
Accounts and Notes Receivable	333,644	350,329
Inventories	431,931	522,937
Other Current Assets	24,853	26,970
TOTAL CURRENT ASSETS	933,379	984,203
Plant & Equipment	1,723,103	1,656,634
Less: Accumulated Depreciation	874,200	829,010
Net Plant & Equipment	848,903	827,624
Other Assets	72,998	91,903
TOTAL ASSETS	1,855,280	1,903,730
LIABILITIES		
Accounts Payable	140,952	166,264
Income Taxes Payable	42,104	61,280
Short-Term Debt	70,080	87,363
Accrued Expenses	163,340	181,464
Current Portion		
Long-Term Debt	15,559	12,403
Dividends Payable	10,548	14,039
Other Current Liabilities	24,934	23,118
TOTAL CURRENT LIABILITIES	467,517	545,931
Long-Term Debt	359,194	370,632
Special Reserves	136,924	141,050
Other Liabilities	101,387	91,062
CAPITAL		
Share capital	282,388	282,351
Retained Earnings	507,870	472,704
TOTAL LIABILITIES AND CAPITAL	1,855,280	1,903,730

Exhibit 2
American Can Company—International Business Group
American Can Company and Consolidated Subsidiaries
Income Statements for Years Ending
December 31, 1974 and 1975 ($000)

	1975	1974
Net Sales	2,870,156	2,897,741
Cost of Goods Sold	2,382,628	2,391,824
Gross Profit	487,528	505,917
Selling and Administrative Expenses	303,818	285,217
	183,710	220,700
Other Income and Expense	(8,509)	620
	175,201	221,320
Interest Expense	34,657	32,520
Income before tax	140,544	188,800
Taxes	63,247	88,791
Income After Tax	77,297	100,009
Extraordinary Charge[1]	—	5,073
Net Income After Tax and Extraordinary Charge	77,297	94,936
Preferred Dividends	2,908	2,908
Common Dividends	39,223	42,597
Net Income Reinvested	35,166	49,431

[1]Costs relating to plant closing program

Exhibit 3
American Can Company - International Business Group
Nueva Modelo, S.A.
Balance Sheets, 1974–1975 ($000)

	Sept. 30, 1975			Sept. 30, 1974		
	Local Currency	Exchange Rate	U.S. Dollar	Local Currency	Exchange Rate	U.S. Dollar
ASSETS						
Cash & Marketable Securities	18,848	12.5	1,508	1,487	12.5	119
Accounts and Notes Receivable	34,646	12.5	2,772	46,437	12.5	3,715
Inventories	217,450	12.5	17,396	101,082	12.5	8,087
Other Current Assets	950	12.5	76	94	12.5	8
TOTAL CURRENT ASSETS	271,894		21,752	149,100		11,929
Gross Buildings and Equipment	113,914	12.0	9,459	108,564	12.0	9,030
Accumulated Depreciation	63,221	11.7	5,408	57,623	11.6	4,961
Net Building and Equipment	50,693		4,051	50,941		4,069
Land and Construction in Progress	13,563	12.5	1,085	13,811	12.5	1,105
NET FIXED ASSETS[1]	64,256		5,136	64,752		5,174
Other Assets	128	12.5	10	889	12.5	71
TOTAL ASSETS	336,278		26,898	214,741		17,174
LIABILITIES AND CAPITAL						
Accounts Payable	153,810	12.5	12,305	54,263	12.5	4,338
Income Taxes Payable	6,191	12.5	495	2,997	12.5	240
Current Portion Long-Term Debt[2]	547	12.5	44	547	12.5	44
TOTAL CURRENT LIABILITIES	160,548		12,844	57,807		4,622
Long-Term Debt[2]	113,172	12.5	9,054	113,720	12.5	9,098
Special Reserves	1,819		145	—		—
TOTAL LIABILITIES	275,538		22,043	171,527		13,720
Share Capital[3]	68,479	12.4	5,520	68,479	12.4	5,520
Retained Earnings	(7,740)		(665)	(25,265)		(2,066)
TOTAL CAPITAL	60,739		4,855	43,214		3,454
TOTAL LIABILITIES AND CAPITAL	336,277		26,898	214,741		17,174

1. Fixed assets acquired at rates different from the prevailing rate of MP 12.5/$ have been fully depreciated.

2. Long term debt includes the following obligations:

		1975	1974
- Notes payable in U.S. dollars to ACC at 6% per annum. Due Dec. 31, 1975, but to be renewed an additional year.		$9,010,000	$9,010,000
- Debt to Banco Internacional Immobiliaria due in pesos.	MP	1,094,079	1,641,117
Short-term portion	MP	547,040	547,040
Remaining long-term portion	MP	547,039	1,094,077

3. Share capital is translated at the exchange rates prevailing when capital was paid in.

These schedules reflect modifications of actual financial statements but are illustrative of Nueva Modelo's exposure position.

Exhibit 4
American Can Company—International Business Group
Nueva Modelo, S.A.
Income Statement for Year Ended Sept. 30, 1975 (000)

	Mexican Peso	Exchange Rate	U.S. Dollars
NET SALES	285,486	12.5	22,839
Cost of Goods Sold	236,411	12.5	18,913
GROSS PROFIT	49,075		3,926
Selling and Administrative Expenses	11,886	12.5	951
GROSS OPERATING INCOME	37,189		2,975
Interest Expense	11,444	12.5	916
Other Income and Expense	3,562	12.5	285
Tax Expense	4,658	12.5	373
NET INCOME	17,525		1,401

These schedules reflect modifications of actual financial statements but are illustrative of Nueva Modelo's exposure position.

Exhibit 5
American Can Company—International Business Group
Price Index Behavior

	Relative Prices Mexican/U.S.		Mexican Prices (1970 = 100)	
	WPI	CPI	WPI	CPI
1958	.87	.95	74.5	70.7
1959	.88	.97	75.3	72.6
1960	.92	1.00	79.0	76.1
1961	.93	1.00	79.7	77.4
1962	.96	1.00	81.2	78.2
1963	.95	1.00	81.6	78.7
1964	.99	1.01	85.1	80.6
1965	.99	1.03	86.7	83.5
1966	.97	1.04	87.8	87.0
1967	1.00	1.04	90.3	89.6
1968	.99	1.02	92.0	91.6
1969	.98	1.01	94.4	95.1
1970	1.00	1.00	100.0	100.0
1971	1.00	1.01	103.7	105.7
1972	.99	1.03	106.7	111.0
1973	1.01	1.08	123.4	123.6
1974	1.04	1.19	151.2	151.3
1975	1.05	1.28	167.1	176.8

Exhibit 6
American Can Company—International Business Group
Nueva Modelo, S.A.
Balance Sheet, July 1976 (000)

	Local Currency	Exchange Rate	U.S. Dollar
ASSETS			
Cash & Marketable Securities[1]	5,551	12.5	444
Accounts and Notes Receivable[1]	60,889	12.5	4,871
Inventories[2]	121,956	12.5	9,756
Other Current Assets	1,794	12.5	145
TOTAL CURRENT ASSETS	190,190		15,216
Gross Buildings and Equipment	113,472	12.0	9,423
Accumulated Depreciation	66,179	11.7	5,644
Net Building and Equipment	47,293		3,779
Land and Construction in Progress	16,369	12.5	1,309
NET FIXED ASSETS	63,662		5,088
Other Assets	2,791	12.5	224
TOTAL ASSETS	256,643		20,528
LIABILITIES AND CAPITAL			
Accounts Payable	37,857	12.5	3,025
Mexican Income Taxes Payable	12,232	12.5	978
Short-Term Debt[3]	21,250	12.5	1,700
TOTAL CURRENT LIABILITIES	71,339		5,703
Long-Term Debt[4]	106,250		8,500
Special Reserves	3,752		301
TOTAL LIABILITIES	181,341		14,504
Share Capital	68,479	12.4	5,522
Retained Earnings	6,837		502
TOTAL CAPITAL	75,316		6,024
TOTAL LIABILITIES AND CAPITAL	256,657		20,528

[1]All cash and marketable securities, receivables and payables were documented in pesos.

[2]In July 1976, tin plate comprised 90% of inventories; work-in-progress and finished goods comprised 10%. Since much of Mexico's tin plate was imported, the market/replacement value (in pesos) of the raw materials portion of inventory would rise to exactly offset any devaluation. Within the inventory turnaround period, the market value of the finished goods inventories would not rise in response to a devaluation.

[3]Bank debt of $1,700,000 is due to First National Bank of Maryland on September 25, 1976.

[4]Long-term loan of $8,500,000 from the Bank of America. This loan is a refunding of part of the debt due ACC at the end of 1976. (See Note 2, Exhibit 3).

These schedules reflect modifications of actual financial statements but are illustrative of Nueva Modelo's exposure position.

Exhibit 7
American Can Company—International Business Group
Nueva Modelo, S.A.
Income Statement for Period Covering October 1, 1975 Through July 30, 1976 (000)

	Mexican Pesos	Exchange Rate	U.S. Dollars
SALES	317,645	12.5	25,412
Cost of Goods Sold	262,650	12.5	21,012
GROSS PROFIT	54,995		4,400
Selling and Administrative Expenses	14,005	12.5	1,120
GROSS OPERATING INCOME	40,990		3,280
Interest Expense	11,985	12.5	959
Other Income and Expense	2,210	12.5	177
Tax Expense	12,218	12.5	977
NET INCOME	14,577		1,167

These schedules reflect modifications of actual financial statements but are illustrative of Nueva Modelo's exposure position.

Exhibit 8
American Can Company—International Business Group

	Market Rates						
	Forward Rates[1]		Interest Rates				
	Discount Percent Per Annum		Prime Rate (percent per annum)		Guidance Rates to Subsidiaries[3,4,5] of U.S. Corporations (percent per annum)	Eurodollar Rates[6] (percent per annum)	
	30 days	12 months	U.S.[2]	Mexico[3,4]		30 days	12 mos
1976							
JAN 30	8.10%	8.69%	6.75%	11.5%	12-11 ½%	5.07	6.75
FEB 27	6.38	10.39	6.75	12.0	13-12	5.19	6.94
MARCH 26	12.98	13.15	6.75	13.0	16-13	5.07	7.07
APRIL 30	29.89	24.55	6.75	not available	no market	5.19	6.75
MAY 28	12.30	20.70	6.75	no market	no market	5.81	7.69
JUNE 25	13.51	12.74	7.25	no market	no market	5.69	7.44
JULY 30	8.00	15.00	7.25	14.0	16-14	5.44	6.88

[1]Rates to sell pesos forward.

[2]Rates to borrow dollars.

[3]Rates to borrow pesos.

[4]Credit was rationed by the central bank so that credit may not have been available at stated rates.

[5]Rates on 6-12 month notes for subsidiaries of U.S. corporations, for credit in pesos; net of taxes.

[6]Average of bid and asked rates for dollar-denominated deposits in London banks.