THUNDERBIRD
SCHOOL OF GLOBAL MANAGEMENT

TB0343

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Hola-Kola—The Capital Budgeting Decision

The consumption of sugar-sweetened beverages has been linked to risks for obesity, diabetes, and heart disease; therefore, a compelling case can be made for the need for reduced consumption of these beverages.

Health Policy Report, *The New England Journal of Medicine*, October 15, 2009.

Mexico leads world in soda consumption, World Health Organization planning to fight it.

Carolyn Crist, Obesity Initiative, October 25, 2012.

In December 2012, Antonio Ortega, the owner of Bebida Sol, had just finished reading a report done by his general manager, Pedro Cortez, about the possible investment in a new product line, Hola-Kola. The idea of Hola-Kola came about three months earlier when Antonio attended a seminar on youth obesity organized by a local high school that his two children attended. Even though he had often heard of the rising obesity problem in Mexico, Antonio was still very disturbed by the statistics indicating how the obesity rate in Mexico had tripled since 1980, and that 69.5% of the people 15 years and older were either obese or overweight.

Even more shocking to Antonio, based on this statistic, Mexico now had the highest overweight rate in the world, surpassing the United States.[1]

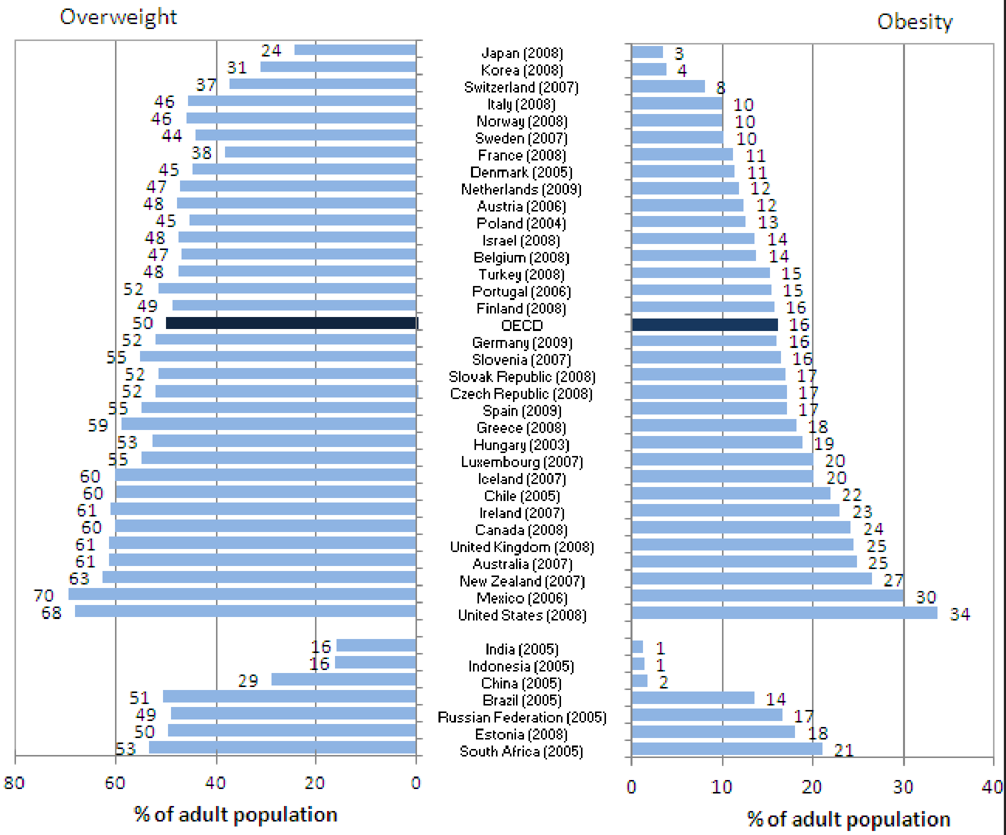
After the seminar, Antonio discussed the idea of Hola-Kola, a low-price, zero-calorie carbonated soft drink, with Pedro Cortez. Pedro was excited about the idea, and liked the opportunity to launch something new, especially given that the company had not introduced a new product in the last five years. However, Pedro thought a market study should be done to gauge the potential demand before the firm undertook the investment.

Company Background

Bebida Sol is a small, privately owned carbonated soft drink company based in Puebla, Mexico. A retired executive from a popular fast-food restaurant chain, Roberto Ortega, founded it in 1998. During his career as a restaurant executive, Roberto learned that Mexicans, regardless of social status, loved their soda pop. Many would drink soda to quench their thirst on a regular basis, due to the lack of hygienic, drinkable water. With the influx of international brands of soda pop, Mexico now had the highest consumption of carbonated soft drinks per capita in the world.[2] The average per capita consumption was 40% higher than the United States, at 163 liters (43 gallons) per year, while the United States consumed 118 liters (31 gallons), according to statistics presented by the international organization Oxfam and the Mexican NGO Consumer's Power. Due to the high obesity problem, health and consumer groups in Mexico had demanded that the government impose a 20% tax on soft drinks, claiming that it would not only reduce consumption, but the tax revenue could also be used to fight health problems that soft drinks generated.[3]

[1] "The World is Fat" by Catherine Rampell, 9/23/2010. http://economix.blogs.nytimes.com/2010/09/23/the-world-is-fat/.
[2] http://gain.fas.usda.gov/Recent%20GAIN%20Publications/The%20Mexican%20Market%20for%20Soft% 20Drinks_Mexico%20ATO_Mexico_8-20-2009.pdf; Global Agriculture Information Network (GAIN) report MX9326.
3 "Mexico, Leader in Soft Drink Consumption", July 10, 2012 http://www.mexicanbusinessweb.mx/eng/2012/mexico-leader-in-soft-drink-consumption/.

Exhibit 1. Rates of Overweight and Obesity Persons by Country (2010)



Source: "World Obesity Stats—2010 and Beyond," Douglas Robb, Sept. 27, 2010, *Health News*.

The market leaders for carbonated soft drinks in Mexico were Coca-Cola, Pepsi-Cola, Dr. Pepper Snapple, and Grupo Penafiel. Together, they accounted for a combined market share of more than 90%, with Coca Cola being the major player. The Mexican soft drink market (products include bottled water, carbonates, RTD tea/coffee, functional drinks, fruit/vegetable juices, and other soft drinks) had total revenues of $39.2bn in 2011, representing a compound annual growth rate (CAGR) of 6.3% between 2007 and 2011. Market consumption volumes increased with a CAGR of 4.5% between 2007 and 2011, reaching a total of 49.3 billion liters in 2011.[4]

Roberto thought these popular international brands commanded prices that might be out of reach for the poorer segment of the population. To capture this market, he started the company to offer private-labeled carbonated soft drinks with similar tastes, but at about half the price. His products consisted of regular cola carbonates and non-cola carbonates, such as lemon/lime or orange carbonates.

Bebida Sol's products were sold only in small, independent grocery stores and convenience stores in Mexico.[5] The firm avoided the supermarkets and hypermarkets because it could not sustain the desired margin in these large stores. Moreover, most of the consumers, especially the middle-to-low income ones, shopped at small, independent grocery stores. To create awareness, the owners of these independent stores were given incentives to personally promote the products. Sales increased dramatically, from 80 million pesos in 1998 to about 900 million pesos in 2011.

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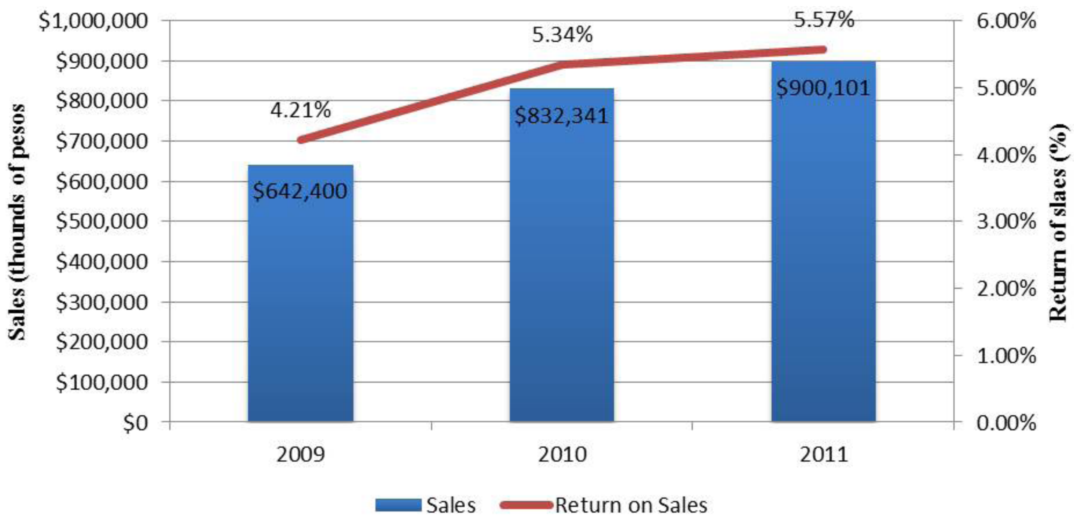
[4] "Soft Drinks in Mexico," Market Research Report, March 29, 2013. http://www.marketresearch.com/MarketLine-v3883/Soft-Drinks-Mexico-7679076/.

[5] There were about half a million small, independent grocery stores, and more than 8,000 convenience stores throughout Mexico.

In 2007, Antonio Ortega, Roberto's only son, took over the business when Roberto unexpectedly passed away. Antonio started working on the sales side of the business two years before his father's death. He had gathered a few valuable tips on how to run the business from his father, which had made him a rather conservative businessman. A year after Antonio took over the business, the global financial crisis hit. The economic downturn in Mexico actually benefitted the low-price soda business. Demand increased dramatically as many consumers became price conscious and switched from international brands to private labels. Bebida Sol's sales increased by 60% from 2008 to 2009, and continued to increase without the firm changing any of its business strategy or practices. The company's return on sales (net profit margin) also had been increasing in the last few years.

Exhibit 2. Bebida Sol's Sales and Return on Sales



The Proposal

Reading once again the executive summary of the report, Antonio recalled what his father told him several times during the two years he was working with him: "Don't grow the company for the sake of growing. Invest only when you are confident there is sufficient demand for a new product, and also when you have the financial resources." As far as financial resources, Antonio felt the timing could not be better. Due to strong sales and profitability in the last few years, Bebida Sol had accumulated a sizable amount of cash. With solid financial performance and steady cash flows, his banker had agreed to extend him a five-year, 16% annual interest term loan to launch Hola-Kola. In the proposal, Pedro Cortez estimated that with 20% of the needed capital borrowed, the 20/80 debt-equity structure would result in an 18.2% weighted average cost of capital for this project.

The bigger question lingering in Antonio's mind was whether there would be sufficient demand for this new, zero-calorie product line. Even though the demand for low-calorie sodas had increased in Mexico, they seemed to be consumed mainly by the middle-to-upper income segment of the population. The majority of the lower-income people still consumed only the regular, high-sugared carbonated soft drinks. It wasn't clear whether this was because the low-income group lacked the awareness of the obesity problem, or because there were not too many low-priced, low-calorie soda options available.[6] If it were the former, the outlook for low-price, low-calorie carbonated soft drinks might not be too promising at this time. If it were the latter, it might be the perfect timing for Bebida Sol to introduce Hola-Kola.

Pedro hired a consultant to do a market study right after Antonio discussed the idea of Hola-Kola with him. The consultant estimated that the company could sell a total of 600,000 liters of these zero-calorie carbonates a month, at a projected price of five pesos a liter. This volume of sales was expected for a period of five years at

[6] In an effort to fight the obesity problem, the Mexican government had been launching media campaigns to encourage the public to participate in weight loss programs in recent years. Drastic measures were also taken to ban high-fat, high-sugar food and drinks in schools, and to add more physical education in the school curriculum.

the same price. The market study took about two months to complete and cost the company five million pesos, which Pedro had paid shortly after its completion.

Since the existing bottling plant was running at 100% capacity producing regular sodas, the proposal called for a fleet of new, semi-automated bottling and kegging machines designed for long, high-quality runs. The total cost of these machines, including installation, was estimated to be 50 million pesos. This amount could be fully depreciated on a straight-line basis over a period of five years. Pedro believed that the purchase of these machines would enable Bebida Sol to reduce its cost of labor and therefore the price to the customers, putting the firm in a more competitive position. With proper maintenance, these machines could produce at least 600,000 liters of carbonated drinks per month. Pedro also estimated that these machines would have a resale value of four million pesos in five years' time, if the company were to either shut down the production of Hola-Kola, or replace these machines with fully automated ones at that time.

The new machines would be housed in an unoccupied annex by the main production facility of Bebida Sol. The annex was also large enough to store the finished products before they were shipped out to grocery stores. Antonio's father built the annex years ago when he planned to venture into the mineral water business. He died before he could execute his plan. The annex had been vacant ever since, even though Antonio recently received an offer to lease out the space for 60,000 pesos a year.

Pedro determined that additional working capital was needed to ensure smooth production and sales of this new product line. He proposed keeping raw materials inventory at a level equal to one month of production. To encourage the independent grocery stores to carry the new product line, he proposed offering a longer collection period, letting the grocers pay in 45 days, instead of the normal 30 days. As far as accounts payable, he would follow the company's normal policy, and settle the accounts in 36 days.

The proposal also outlined the various estimates of production and overhead costs, and selling expenses. Raw materials needed to produce the sodas were estimated to be 1.8 pesos per liter, while labor costs and energy costs per month were estimated to be 180,000 pesos and 50,000 pesos, respectively. The incremental general administrative and selling expenses were quite modest, estimated to be 300,000 a year, as the new product could be sold by Bebida Sol's current sales force and via existing distribution channels. The accounting department typically charged 1% of sales as overhead costs for any new projects.

Glancing back at his notes, Antonio started pondering. The market study seemed to indicate sufficient demand for the new product line. What he really feared was that the new zero-calorie carbonates might erode the sales of his existing products—the regular sodas. The market study suggested that potential erosion could cost the firm as much as 800,000 pesos of after-tax cash flows per year. At the new tax rate of 30% for both income and capital gains, could he add value to the firm by taking on this project?

Appendix 1. Bebida Sol—Income Statements for the Year Ending December 31 (thousands of pesos)

Income Item	2009		2010		2011	
Sales	642,400	100.0%	832,341	100.0%	900,101	100.0%
COGS	349,884	54.5%	456,409	54.8%	487,020	54.1%
Gross margin	292,516	45.5%	375,932	45.2%	413,081	45.9%
Marketing & Selling Expenses	120,359	18.7%	150,322	18.1%	168,330	18.7%
General Administrative Expenses	65,340	10.2%	88,622	10.6%	97,791	10.9%
EBITDA	106,817	16.6%	136,988	16.5%	146,960	16.3%
Depreciation	45,046	7.0%	59,444	7.1%	65,985	7.3%
EBIT	61,771	9.6%	77,544	9.3%	80,975	9.0%
Interest	23,120	3.6%	14,088	1.7%	9,340	1.0%
EBT	38,651	6.0%	63,456	7.6%	71,635	8.0%
Taxes @ 30%	11,595	1.8%	19,037	2.3%	21,491	2.4%
Net Income	27,056	4.2%	44,419	5.3%	50,145	5.6%
Dividends	20,000		20,000		20,000	
Retained Earnings	7,056		24,419		30,145	

Appendix 2. Bebida Sol—Balance Sheet as of December 31 (thousands of pesos)

Assets	2009		2010		2011	
Cash	12,023	3.1%	36,090	8.9%	53,020	14.0%
Accounts Receivable	61,600	15.7%	75,253	18.6%	78,913	20.8%
Inventory	32,592	8.3%	45,016	11.1%	60,044	15.8%
Prepaid Expenses	11,792	3.0%	20,660	5.1%	15,117	4.0%
Current Assets	118,007	30.1%	177,019	43.8%	207,093	54.5%
Gross fixed assets	439,230	112.0%	452,020	111.7%	463,122	122.0%
Accum depreciation	165,046	42.1%	224,490	55.5%	290,475	76.5%
Net fixed assets	274,184	69.9%	227,530	56.2%	172,647	45.5%
Total Assets	392,191	100.0%	404,549	100.0%	379,740	100.0%
Liabilities & Net Worth	**2009**		**2010**		**2011**	
Accounts Payable	34,509	8.8%	43,765	10.8%	48,035	12.6%
Accrued expenses	15,083	3.8%	19,087	4.7%	20,493	5.4%
Short-term debt	70,520	18.0%	63,429	15.7%	22,900	6.0%
Current Liabilities	120,112	30.6%	126,281	31.2%	91,428	24.1%
Long-term debt	45,023	11.5%	26,793	6.6%	6,693	1.8%
Equity	227,056	57.9%	251,475	62.2%	281,619	74.2%
Liabilities & Net Worth	392,191	100.0%	404,549	100.0%	379,740	100.0%