A Railway over the Wall: Grupo Mexico Acquires Florida East Coast Railway for $2.1bn

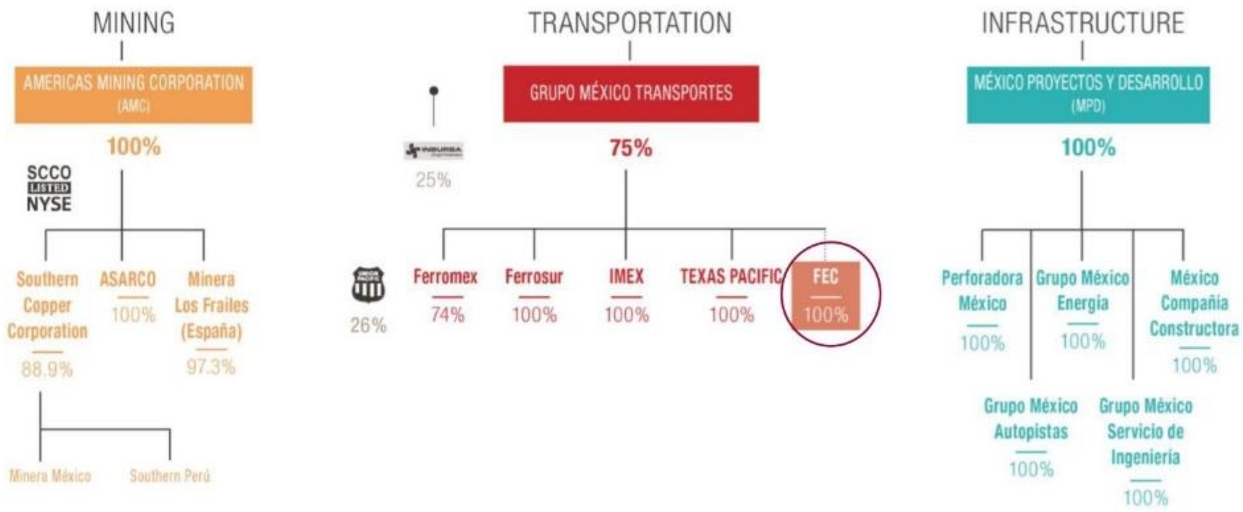
Grupo Mexico S.A.B. de C.V. (BMV: GMEXICOB) — market cap as of 07/04/2017: MXN438.12bn ($23.47bn)

Introduction

On March 28, 2017, Mexican mining and railroad conglomerate Grupo Mexico SAB has agreed to buy Florida East Coast Railway Holdings Corp. (FEC) in a $2.1bn deal. By means of this purchase, Grupo México Transportes (Grupo Mexico's transport subsidiary) expands its operations in the U.S. with the incorporation of 351 miles of railway and expects to create a $930m pro-forma EBITDA entity.

About Grupo Mexico S.A.B. de C.V.

Based in Mexico City, Grupo Mexico is a $3.36bn EBITDA conglomerate that encompasses mining, infrastructure and transport.



Through its transport unit - Grupo Mexico Transportes (GMXT), it holds controlling stakes in Ferromex, Ferrosur, IMEX and Texas Pacífic. Together, they operate more than 10,000km of Mexican railroad tracks covering the country's main industrial and commercial areas, moving more than 1.4 million freight cars loaded per year and employing over 500 people. With the two other major players, Kansas City Southern and Ferrovalle, Grupo Mexico controls more than 72% of the Mexican rail freight market.

GMXT's strategy of expanding its exposure to the U.S. freight market, combined with steady growth and expansion of routes to seize new opportunities, has delivered good results. In FY2016, Grupo Mexico's transport unit reported $1.76bn in revenues and $775m EBITDA, implying a 43.8% EBITDA margin (up from 36.8% in 2015).

About Florida East Coast Railway Corp.

Florida East Coast Railway Corp. (FEC) is a Class II railroad (i.e. operating revenues larger than $37.4m but smaller than $433.2m) founded in 1895 and, since 2007, owned by funds affiliated with Fortress Investment Group (itself recently target of a takeover: see here).

Headquartered in Jacksonville, Florida East Coast Railway offers rail services along the east coast of Florida and is the exclusive service provider to the state's southern ports, namely Port Miami, Port Everglades and the Port of

Palm Beach. The company has higher revenue per track mile than any major railroad in North America, highlighting strong efficiency and high quality infrastructure.

Florida East Coast Railway counts c. 1,200 employees and its fleet includes 73 locomotives, 502 trucks, 4,294 railcars and 3,850 trailers. Serving a diverse mix of customers, including auto, chemicals and metals, the railway handles 540,000 annual carloads. The company reported FY2016 sales of $404m and EBITDA of $154m, implying a 38.1% EBITDA margin.

Industry Overview

Today, the value of the U.S. freight rail industry is around $60 billion. The network consists of 140,000 rail miles operated by 7 Class I (carriers with Operating Revenues > $433.2m), 21 regional and 510 local railroads. Together, they provide the United States with 221,000 jobs.

The industry can be defined as very concentrated as there are only 7 carriers with operating revenues exceeding $433.2m (Class I), down from 14 in 1990. Moreover, the 4 major companies account for more than 90% of total volume: those are Union Pacific, Burlington Northern and Santa Fe Railway, CSX Transportation and Norfolk Southern Railway.

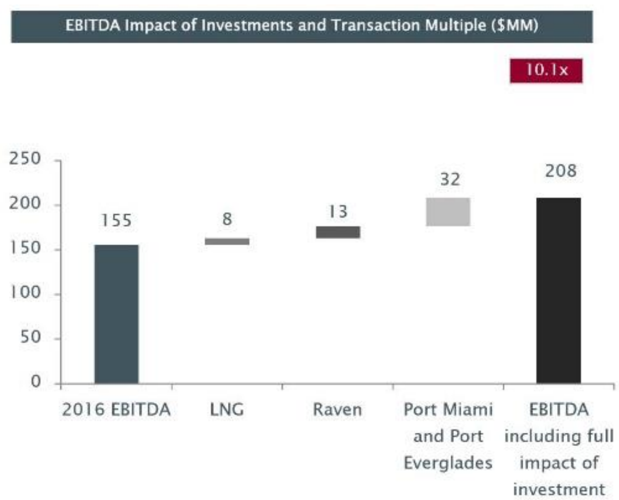
The U.S. freight rail carriers are private organizations that are responsible for their own maintenance and improvement projects. Compared to other industries, they invest one of the highest percentages of revenues in maintenance (c. 80% of CapEx, on average) and to add capacity to their systems (c. 20% of CapEx, on average). For instance, U.S. railroads generated c. $33bn in revenues in 2014, and $28bn were reinvested in the industry.

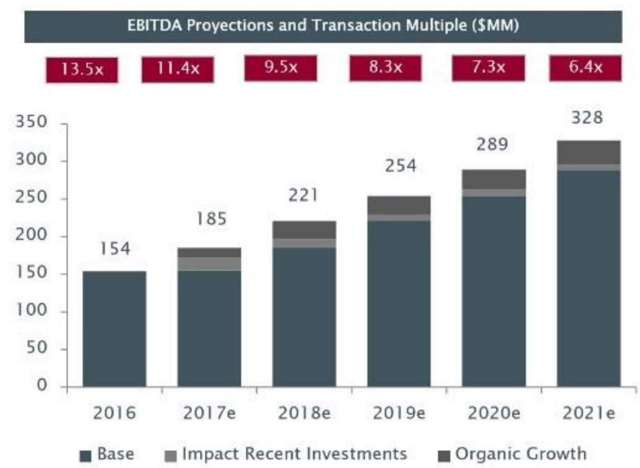
Of rail freight, 90% are bulk commodities (agriculture and energy products, construction materials, coal, chemicals, food, …) and 10% is intermodal traffic which generally consists of consumer goods.

In addition to being very sensitive to movements in trade and the economy, oil price changes also have a great impact on the industry, since c. 20% of a railroad's operating expenses are fuel costs. In addition to fuel, labour costs & equipment, and material costs represent each 1/3 of total expenditures.
Finally, the railroad industry in the United States is very dependent upon the U.S. population, with a growing population resulting in higher demand for goods and thus investments in transportation infrastructure.

Deal Structure

The total purchase price of $2.1bn, which is composed of $350m equity contribution from GMXT, $200m assumed debt from the target and $1.55bn debt facilities, implies an EV/EBITDA multiple of 13.5x. However, adjusting the EBITDA for the recent investments done by FEC, we get to a 10.1x transaction multiple.





Finally, projecting organic growth consistent with historical trends, we get to a forward multiple of 6.4x by 2021. Overall, the price paid seems pretty much in line with the average 10.2x EV/EBITDA paid in railroads transaction.

Despite the large amount of debt used in the deal, the combined entity will enjoy a solid financial position and disciplined leverage metrics. According to GMXT the 2016 post-transaction Net Debt/EBITDA ratio of 1.88x is expected to decrease to 1.5 in 2017 and to 0.29 by 2020. Pro-forma revenues and EBITDA amount to $2.1bn and $930m, respectively.

Deal Rationale

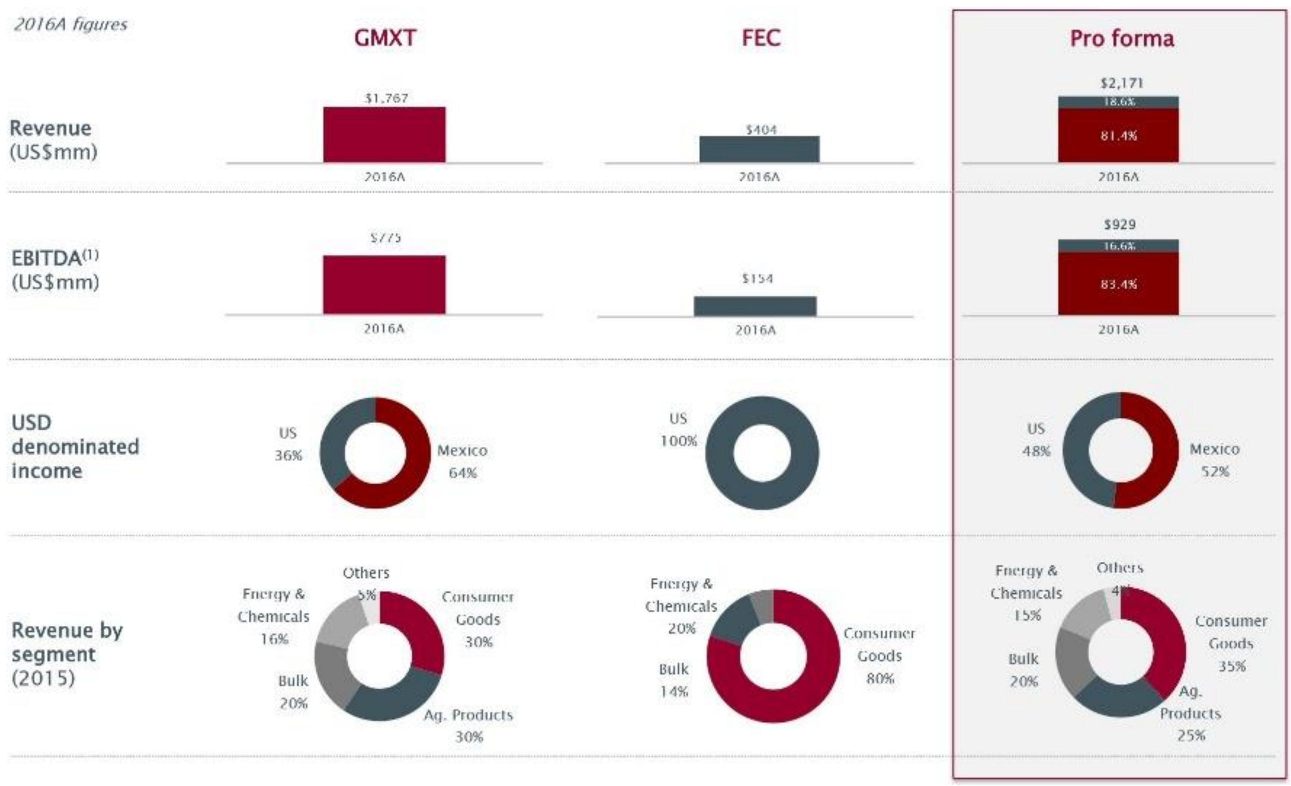
"The acquisition of FEC is an important strategic addition to our North American transportation service offering," said Alfredo Casar, president and chief executive of GMXT.

With the acquisition, Group Mexico will get hold of the largest regional railroad in the whole North America and get access to an unparalleled location. Indeed, Florida is the 3rd largest state in the U.S. in terms of population and the 4th in terms of GDP. Moreover, it is the 16th largest economy in the world.

Diversification and economies of scale are the two key benefits deriving from the transaction. In fact, GMXT will be able to expand and consolidate its presence in the U.S., complementing its Texas Pacific operations. Moreover, the company will increase its exposure to dollarized markets, and this will lead to more diversification in terms of customers, products and geography.

Looking at post-deal revenues, consumer goods will account for 35%, closely followed by agricultural products at 25%, bulk at 20% and energy and chemicals at 15%. Moreover, the mix between GMXT and FEC operations, will lead to a very balanced entity, with 48% of sales coming from the U.S. and 52% from Mexico.

The resulting synergies could make Grupo Mexico, which is already the cheapest railway operator in Mexico, even more competitive. Finally, the target's 2009 – 2016 EBITDA CAGR of 11.7% and the strategic investments already underway, which are mainly focused on transformational developments, make for a compelling growth potential.



Market Reaction

On March 28, 2017, Grupo Mexico's share price fell by 3.28% to MXN56.65 and has been trading on such levels since. Florida East Coast Railway is not publicly traded.

Advisors

BBVA Bancomer and Credit Suisse served as financial advisors to GMXT. Florida East Coast Railway was advised by Barclays and Morgan Stanley.