Multinational Company Acquisition - Kraft/Cadbury Case Study

Author - Blake Downward

Kraft Foods INC. (U.S.A.) acquisition of Cadbury P.L.C. (U.K.)

The Kraft acquisition of Cadbury is a shining example of a Multinational Company (MNC) growing their international business through purchasing a foreign company. Both companies were already well-established MNC's with a worldwide presence. Kraft recognised that their future growth would need to come from emerging and developing markets. Acquiring Cadbury would allow them to reach these markets and implement their strategy in the shortest possible time-frame.

In January 2010, Cadbury shareholders accepted an offer from Kraft to absorb the company. In this case study the author aims to highlight the main reasons for the takeover, the process of negotiations and finally, the outcome of the acquisition.

Kraft

Kraft Foods INC. is a United States corporation founded in 1923. Prior to the acquisition of Cadbury, Kraft was the second largest food company in the world and had a presence in over 150 countries. A large proportion of Kraft's worldwide revenues came from just 11, well-known, well-established brands – each brand drawing in over 1 billion US dollars in revenue each year. Most of these revenues came from developed markets in North America (USA and Canada) and from Europe. The problem with these developed markets, is that they are quite mature markets and that also means that their growth is very slow. Operating in such mature and competitive markets has slowly eaten away at Kraft's profit margins. This has forced Kraft to shift their strategy away from developed markets, towards emerging markets, in order to find new sources of sustainable growth. At that time (pre-acquisition), Kraft had only a very small presence in the worlds' strongest emerging markets (aside from China) – such as India, Mexico, Brazil and South Africa. Gaining access to these emerging markets, as well as moving towards the high growth snack foods market, were critical factors in our long-term strategy. As the author will demonstrate in this paper, acquiring Cadbury was the perfect move in implementing this strategy.

Cadbury

Cadbury is a U.K. company with almost 200 years of heritage (founded in 1824). Unlike Kraft, Cadbury has maintained a disciplined approach to their business and remained in the realm of their core market. This focus on their core product market (chocolate and confectionary), has enabled them to refine their business practices in order to produce a consistently high quality product, in a highly efficient and cost effective manner. As a result of these efficiencies, Cadbury is one of the best performers amongst their competitors, reporting gross margins of 45.6% (compare this with Kraft's gross margin of 35%). Since Cadbury focused on doing one thing well (chocolate and confectionary), this gave them the ability to penetrate emerging markets effectively (44% of Cadbury's revenue came from emerging markets).

So why the bid for Cadbury?

At Kraft, our strategy was to move into a high growth product market (chocolate and confectionary) and at the same time move our brand into high growth geographic markets (developing and emerging markets). The fastest and easiest way to achieve our goals (but maybe not the cheapest), was to acquire an already established company and their portfolio of brands. Along with Cadbury - Hershey's, Mars and Nestle were earmarked as potential targets. Mars and Nestle were quickly screened out of the process due to their sheer size. Both companies are large, diversified conglomerates. Purchasing these companies would require extremely large amounts of capital, and would also be likely to attract the attention of anti-trust law. This left just Cadbury and Hershey's as potential targets. Cadbury was selected over Hershey's largely due to their presence in emerging markets. In particular, the two countries belonging to the Commonwealth – India and South Africa. Prior to the acquisition, Kraft had no presence in the Indian market and only a small presence in South Africa. India makes up a large proportion of the world's population, and Cadbury was already well established there. Cadbury products were being sold by India's largest retail chain which gave them access to 92% of India's population. Acquiring Cadbury would mean a direct channel into India and other fast developing nations for Kraft products. A major factor in considering the takeover of a multinational target is the effect of exchange rates on cash-flows to the parent company. Aside from India and South Africa, Kraft and Cadbury have very similar exposure to foreign currencies, and both already engaged in hedging foreign currency positions. A combination of the two firms would lead to a reduction in the net cash flows in some foreign markets. Ultimately leading to a smaller foreign currency exposure and also less of a need to hedge the exposure in the forward or futures markets.

Given all of these factors a decision was made, and Kraft would prepare to buy Cadbury.

The Bids

The process of negotiation was a fairly long and drawn-out one. It took four months from the initial offer until the final offer was accepted by the Cadbury board. In these four months, Cadbury was able to squeeze a much higher premium out of Kraft. Cadbury was in an ideal position for negotiations because their business was not distressed in any way. They were maintaining high levels of growth and profit, so they had every right to demand a high premium as compensation for selling their business.

For simplicity, I will only detail the first and final offers to buy Cadbury. (see the table below for full details)

On the 7th of September 2009, Kraft formally placed a bid to buy Cadbury at a 28% premium above their current share price. This offer was rejected by Cadbury and signalled the beginning of the negotiations. The final bid that was accepted by Cadbury was made the following year on January 19, 2010. Kraft had increased their cash offer, pushing the final price to represent a 44% premium on top of Cadbury's September 2009 share price (£5.81).

(Table 1)

	Cash portion (GBP)	**Number of Kraft Shares**	**Kraft Price (USD)**	**Exchange Rate (USD/GBP)**	**Total Bid (GBP)**	**Cadbury Price (GBP)**	**Premium**
7/09/09	3.00	0.2589	28.1	0.611	7.44	5.81	28%
19/01/10	5.10	0.1874	29.58	0.6109	8.48	8.37	1%

The offers were made up of a cash portion and a share offer. This means Cadbury shareholders would receive some cash and some Kraft shares as payment for the Cadbury shares they held. The total value to Cadbury shareholders was dependent on how much cash was received (in GBP), the current value of Kraft shares and the current exchange rate (to convert the value of Kraft shares into GBP).

The cost for Kraft is quite different to the value Cadbury shareholders derive. The first major risk for Kraft depends on how much cash they must pay for each share. For example, if Cadbury shareholders were happy to receive only Kraft shares as payment, Kraft would not be exposed to any exchange rate fluctuations as they are only handing over shares. On the other hand, if Cadbury shareholders did not want any Kraft shares and wanted the full payment in cash, this would maximise Kraft's exposure to exchange rate fluctuations.

Over the course of negotiations, Kraft was forced to increase their cash offer. In other words, Cadbury demanded that Kraft take on more exchange rate risk because Kraft was the party making the bid.

At Kraft we knew that exchange rate fluctuations could have a large negative effect on the final price we pay for Cadbury. Prior to our first offer, we calculated the project's "value at risk" (VaR). Using ten years of monthly USD/GBP exchange rate prices we found the monthly standard deviation to be 2.21% (this is a fairly stable deviation for currencies, this is due to their high correlation - 0.6864). At a 95% confidence level, we determined the maximum one month loss to be as follows:

$$VaR = 0 - (1.65 * 2.21)$$

$$VaR = -3.6465\%$$

If we apply this to the cash portion (300 pence) of our initial bid, we find;

$$-3.6465\% * 300 = 10.94\, pence$$

Which would increase the cost (to Kraft) of the offer by 1.5%, in a month. If Kraft were to increase their cash offer, this VaR would also increase.

Close inspection of Table 1 shows that the exchange rate at the time of the first offer was almost exactly the same as it was for the final offer.

Working together

After the acquisition comes the real test as to whether it was a success or not. It is still early days, but the initial results have been very pleasing to us at Kraft and we have since been able to continue moving forward with our long-term strategic goals. We have successfully been able to move into high growth emerging markets and at the same time we have been able to promote Cadbury sales from within our established distribution networks. Over one third of the global Kraft Executive Management team is from Cadbury and they have been critical in our attempts to move into new markets. Please see Table 2 for the most outstanding improvements in our business since the takeover. Great increases in both share price and revenues, whilst at the same time reducing our long-term debt obligations by almost 50%.

Overall, this has been a very successful takeover. Our expectation is that the 2013/2014 financial year will be an even greater improvement as this acquisition begins to mature within our company.

(Table 2)

	2010	2012	% change
Share Price	$29.58	$39.70	34.21%
Revenues	$31.5 billion	$35 billion	11%
Long-term Debt	$26.9 billion	$15.6 billion	-42%