

Phillip morris–kraft case study

Business



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1. Background: Begin by writing a short history of the acquiring firm and the target firm. The narrative should concentrate on how the companies have done so far and what strategies they used in accomplishing their goal thus far.

Delineate any particular strategy used. (E. g. Growth by acquisition. In the case study, the acquiring firm is Philip Morris, which was founded in 1847 by Philip Morris.

The company, now one of the world's largest tobacco multinationals, started as a single shop on London's Bond Street. In 1881 the company went public and in 1885 the company was established as Philip Morris & C., Ltd. In 1894, the Morris family sold the company to William Curtis Thompson and by 1902 the company had already been incorporated in New York. In 1919, Philip Morris Company in the United States was purchased by a firm owned by American stockholders.

In 1924 the company launched the Marlboro brand, which since then has been Philip Morris's trademark cigarette brand. In the 1950s, the company launched Philip Morris International; this was done in order to market the company's products all over the world. Following an internationalization strategy, Philip Morris introduces its brands in Europe (through a production plant that the company acquired in Switzerland in 1963), Australia, and other parts of the world. By 1972, the company's strategy pays off; Marlboro becomes the bestselling cigarette in the world. Around this time the company starts seeking to continue growing through diversification; in 1970

the company acquired Miller Brewing Company and Seven-Up Company was acquired in 1978. In 1985 the company purchased General Foods for 5.

6 million USD; in 1988 the company intended to establish itself as the second largest company in the food market through the acquisition of Kraft, Inc. The target firm in the case study is Kraft, Inc. The company was founded by James L. Kraft in 1903 by James L. Kraft; the company started as a wholesale cheese business, but by 1914 a plant had been opened in Chicago and it started producing its own cheese under the Kraft brand.

By this time, the company, which had been incorporated in New York as J. L. Kraft and Bros. Company, already handled a wholesale operation in which more than thirty different kinds of cheese were being distributed throughout the United States. Pasteurized cheese was invented by Kraft in 1915 and in 1924 the company changed its name to Kraft Cheese Company. During the 1920s (and extending throughout the first half of the twentieth century), the company set into motion an expansion plan that was founded on internationalization strategy (which was complemented by a growth by acquisition strategy in the United States).

In the 1980s, more specifically at the time that Philip Morris bid to buy the company outright, the company was refocusing on an all-food strategy (after implementing a diversification strategy that included a merger with Dart Industries in 1980 and the acquisition of Hobart Corporation in 1981). 2.

Financial Analysis: Look at their financial statements for the past 3 to 5 years and very briefly analyze the companies past performance. Concentrate on the any particular strengths and weaknesses of each firm. First, in

considering Philip Morris, the first thing that must be mentioned is that between 1983 and 1987 the company consistently registered revenue increases; in 1987, for example, revenue was equivalent to twice the revenue that had been recorded in 1983.

Net income also doubled during this period. Also, sales registered continued growth in its tobacco, food, and beer product divisions; its stock price index and its ROE also grew consistently. Based on this, it can be said that Philip Morris was strong in all of its divisions, although it needed revitalization in its food division given that after monumental growth in sales between 1985 and 1986, the growth had lost momentum and had slipped slightly in 1987.

Second, in considering Kraft Inc., it is important to annotate that between 1983 and 1987 the company had managed to sustainably increase its revenues. Furthermore, net income followed an increasing trend consistent with the increases in revenue during the period.

Following the company's division into three separate market segments (U. S. Consumer Food; U. S. Commercial Food; International Food) all three segments experienced sales increases between 1983 and 1987; operating profit increased while at the same time depreciation decreased. Based on this, it becomes clear that as the company chose to focus exclusively on its food products, the company was financially solid and in no immediate need to seek bailout (be it by looking for a buyer or turning for a bank to borrow money).

3. Why is the acquiring firm interested in the target firm? This type of information is readily available if you look at the articles announcing and/or

evaluating this acquisition. Also the companies themselves will put out such information. Philip Morris was pursuing a strategy of diversification at the time; the company's sales and profits came mostly from its tobacco sales (as Marlboro, Benson & Hedges, and Virginia Slims brands led the market). In consolidating its diversification strategy, the company started buying companies in other markets as early as 1970. Come the 1980s, however, its results at diversifying had been moderately successful at best; most ventures outside the tobacco market had been sold off and one of the companies it held on to outside the tobacco market, General Foods, was gradually declining.

This, coupled with the declining consumption of cigarettes in the United States (which went from peaking at 640 billion cigarettes in 1981 to an estimated 563 billion in 1988), made Philip Morris take an interest in Kraft. Not only was Kraft a financially strong company at the time, but it was also a leader in its market and its management could help revitalize General Foods. In short, “ the acquisition of Kraft would have made Philip Morris the world's largest food company, and it would have been a major step in the firm's strategy of reducing its dependence on tobacco and moving into the food business” (HarvardBusiness School, 1989). 4 Financial Package: This is the most important information and it is given in the announcement. What is the acquiring firm offering? What deal is being considered? Is it all cash or cash and stock or a stock swap, or some combination? Describe this package.

Philip Morris announced its offer to buy all of Kraft's common stock on October 18, 1988. In a surprising move, the company offered a buying price of 90 USD per share in cash. The total offer stood at 11 billion USD and the <https://assignbuster.com/phillip-morriskraft-case-study/>

offered buying price per share represented a 50% premium over Kraft shares' October 18 closing price. At the time that the announcement was made, and if it were to finally materialize, the buyout would be the second highest in history (only surpassed by the 13.3 billion USD that Chevron Corporation paid in 1984 for Gulf Oil Corporation). Finally, in terms of how the payment would be made, " Philip Morris proposed to finance the acquisition with \$1.

5 billion in excess cash and its available bank credit lines of up to \$12 billion" (Harvard Business School, 1989). 5. Analysis -Pre-merger and Post-merger: Value the companies individually pre-merger i. e. if they did not go through with activity this, what will be their value.

In the post-merger valuation, assume that the merger has taken place and evaluate the effect on the acquiring firm. This will involve analyzing synergies resulting from the acquisition/merger. Synergies could be cost savings, increase in profitability, or just expansion into new markets. Include synergies that resulted from the acquisition. This will be reflected in your pro forma statements.

First, in considering the pre-merger scenario, it is worth noting that both companies were financially strong and the financial forecasts for 1989 were strongly positive. On the one side, Philip Morris garnered 14.6 million USD in tobacco sales; this marked a 15% increase from 1986 tobacco sales.

Furthermore, by that year its market share in the United States increased from 37% in 1986 to 38% and its operating profits reached 3.3 billion. Even though there was a relative decrease in cigarette sales in the United States,

the company managed to compensate by its 15% growth in cigarette exports (as they were expected to reach 115 billion cigarettes in 1988).

As well, before the merger the company had spent the last 18 years attempting to diversify its operations; this strategy had been only moderately successful and at the time of the merger the company looked for a strong company to buy. Second, in considering Kraft, Inc., it must be said that before the merger net sales “ were \$9. 9 billion in 1987, an increase of 27% over 1986. Net income from continuing operations rose 11 %, to \$435 million” (Harvard Business School, 1989). Beginning in 1980 the company had also attempted to diversify its operations, but just before the merger proposal a restructuring process that intended to focus exclusively on its food products was being pursued.

In 1987, Kraft was organized into three business segments: US. Consumer Food, US. Commercial Food and International Food. In 1987, US. Consumer Food had sales of \$4. 5 billion and an operating profit of \$593 million.

US. Commercial Food, Which included Kraft Foodservice, the second-largest U. S. food service distributor, had sales of \$3 billion and an operating profit of \$86. 4 million.

International Food had sales of \$2. 3 billion and an operating profit of \$229. 8 million (Harvard Business School, 1989). Now, considering that the merger had actually taken place, it is important to point out that this would have proven positive for Philip Morris as it would have managed to diversify operations, consolidate itself as the second largest food company in the world, and aside from increasing its hold over the world market, the merger <https://assignbuster.com/phillip-morriskraft-case-study/>

would have resulted in varied synergies (mostly related with cost saving and increases in profitability given the scale of the ensuing company and its increased market share). 6.

Find the value of the new firm. Was value added from this transaction? What affect did it have on the market value of the company? No value was generated in the market because the transaction never took place. On October 23, just five days after having received Philip Morris's offer, Kraft's board of directors rejected it. The board's arguments for rejecting the offer were as follows: " first, after careful analysis, our investment banker, Goldman, Sachs & Co., has advised us that the bid is inadequate; and second, our stock has been trading above the \$90 offer, a clear signal that investors see the bid as low" (Harvard Business School, 1989). Instead of accepting the offer, the company decided to follow a restructuring plan in which " for each share of common stock, shareholders would receive a cash dividend of \$84 and a high-yield debt valued at \$14, and they would retain their now highly leveraged equity interest" (Harvard Business School, 1989).

In order to secure financing, the company sold business interests; dividend payments for shareholders would be guaranteed via bank borrowings.

Initially, this news generated speculation in the stock market; Kraft's stock price grew by 10 USD (reaching 102 USD) following the announcement of the restructuring plan. However, uncertainty inevitably ensued and in the following days, the price of the stock went down, settling at 96. 50 USD on October 28. 7. Financing: After completion of the valuation examine how this activity will be financed and its impact on the firm.

Will the firm is able to handle the financing obligations undertaken -be it debt or equity. If they have to raise funds from the market, should they go debt or equity to finance this investment? If they go with debt, will they be able to service it? Generally in this type of analysis, financial statements are projected for at least 5, 7 and up to 10 years. Like it was said previously, the transaction did not take place in the end. The 11 billion USD offer that Philip Morris made to buy all of Kraft's common stock (at a price of 90 USD per share in cash) was rejected by Kraft's board of directors. Instead, the company decided on a restructuring plan that would require a total of 10.

2 billion USD for the company to make dividend payments to all stockholders and be able to materialize its restructuring plan (one which raised the total value of each share to 110 USD). The company would sell off assets (valued at 2.1 billion); it would also cut down on operating expenses (largely due to the sale of some of its operating assets). Furthermore, in procuring the 10.2 billion that it required, management intended to get “ 6.

8 billion in bank borrowings at a 12%'annual interest rate and the \$3 billion in debt with rates ranging from 12.5% to 14.75%. The \$2.1 billion from .

asset sales would be used to pay down the bank debt” (Harvard Business School, 1989). Adding on to all of this, the remainder of the company's financial scenario following the restructuring plan was as follows: The company planned to retain \$904 million of existing debt at an average annual interest rate of 8.65%. The debt received by shareholders would accrue interest at a 15.25% annual rate (paid semiannually), with no cash payments in the first 5 years.

Interest would be paid in cash at the 15.25% semiannual rate after the fifth year. Exhibit 11 presents pre-bid sales and profit forecasts for Kraft through 1989 (Harvard Business School, 1989). Finally, in assessing the company's financial situation, it can be said that despite it requiring a herculean effort, the company was financially solid and would be able to service its debt. However, it is important to point out that this would require extremely efficient production (which required in turn the full commitment of all stakeholders, especially employees as cost minimization became a must).

Also, the company was heavily counting on the strength of its major brands, all of which were protected by the plan that had been developed. 8.

Qualitative Analysis: Comment on subjective factors that affect the merger, positively or negatively. Use PRICTO or SWAT. In rendering a qualitative analysis of the factors that might have affected the merger, the first thing to mention is the perceived value that both companies had of what Kraft, Inc.

was actually worth. Philip Morris, for example, was convinced that valuing Kraft's shares at a unit price of 90 USD was more than a fair valuation for the company considering its overall financial situation. On the other hand, and as Kraft's board of directors made it clear, the company felt that making a proposition that was in tune with the company's average stock price at the time was insufficient to motivate the company to agree to the merger. In fact, the board of directors was so convinced that Kraft was worth more than it invited other possible bidders (that might have been interested in purchasing the company) to make an offer in excess of 100 USD per share. This factor surely doomed Philip Morris's proposal.

However, it is important to point out that there were other factors that might have exerted a positive influence on the merger. Specifically, on Philip Morris's side there was the desire to expand its operations through a strategy of diversification. Becoming the world's second largest food company was a major incentive for Philip Morris, as was the possibility of getting a managerial team that could revitalize General Foods. On Kraft's side, the merger might have allowed it to become stronger financially; the company would have also gained given that it would have been allowed to keep its entire managerial team (and it would be allowed to function independently). These factors surely appealed to Kraft, Inc., but in the end the offer was rejected given that the paying price was considered to be too low (and Philip Morris thought it was a generous offer, reason why it did not make a new, higher bid).

9. Summary & Conclusions: Offer your opinion: Who won and who lost? Give an overall view of the merger. Given that the merger never took place, it is impossible to speak of winners or losers from the merger. At the same time, I do consider that based on the way that the whole situation ended, both companies turned out to be losers. On the one side, Philip Morris lost an opportunity to diversify its operations and consolidate itself as the world's second largest company in the food market. Furthermore, it lost because it was unable to secure the experienced and skilled management team that it necessitated in order to revitalize its only major foods company (General Foods).

On the other hand, Kraft, Inc. also lost because in order to compensate shareholders for refusing Philip Morris' offer, a restructuring plan that

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involved acquiring a total debt in excess of 12 billion USD heavily constrained the company's financial resources. Furthermore, the company was forced to sell various non-essential business interests in order to mitigate a portion of the debt payments. As well, it is important to point out that even though the stock market's price for Kraft stock rose to 102 USD upon news of the restructuring plan, it quickly decreased and settled at 96.50 USD only five days after its restructuring announcement.

True, the market value of Kraft's stock increased (from 92 USD to 96.50 USD in a matter of ten days), but that mild increase came at a great cost (a multibillion dollar debt). 10. Public Policy: Comment on the effect of this merger on general public, if any. Will it adversely affect society or will it be better for it. The merger ended up not taking place.

However, if it would have taken place I believe that it would have had a positive effect on society. First, the company resulting from the merger would have been financially stronger and more dynamic. Research and development efforts would have pushed innovation forward; it is likely that new products would have been developed at a faster pace. It is also probable that stock prices would have increased as a result of the merger; this would have been beneficial for stockholders in the whole (as no debt would have had to be garnered, as was the case finally with Kraft, Inc.).

In terms of prices, it is unlikely that the ensuing company would have driven prices up given that despite increased market share the market still remained highly competitive (as competitors abounded and substitute food products were available in high quantities).