

COMPANIES & FINANCE EUROPE: A chance too sweet for Nestlé to pass up

By William Hall, Financial Times
Published: Sep 03, 2002

Can Nestlé, the world's biggest consumer food company, afford not to buy Hershey Foods, the biggest US chocolate manufacturer?

Hershey up for auction represents a once-in-a-lifetime opportunity for Nestlé to conquer the world's biggest chocolate confectionery market and, of all Hershey's would-be suitors, Nestlé is the most natural fit. It is weak in the US, where Hershey is strong, and it can easily afford the acquisition.

But Nestlé could be tempted to overpay for Hershey, and it would be doubling up its presence in a market growing well below its 4 per cent growth target.

Peter Brabeck, Nestlé chief executive, took the unusual step last week of breaking the Swiss company's traditional vow of silence about potential takeover targets - noting that a \$12bn price tag for Hershey did not make sense and any bid would face serious antitrust obstacles.

"Clearly Peter Brabeck wants to try to manage the information flow and put pressure on the other side to get them thinking about a lower price," says Simon Marshall-Lockyer, of Cheuvreux in Zurich.

"It is nonsense to say that Nestlé does not want Hershey. Of course they do and they will have to sell parts to get it through the regulators," says Bank Vontobel's **James Amoroso**.

Nestlé, globally number one in chocolate confectionery, has struggled in vain to eat away at the 70 per cent combined market share of the top two players - Hershey and Mars - in the US, where it remains a weak number three.

This puts it at a serious disadvantage in a slow-growing US market where access to supermarket shelf space is critical and market leadership offers big advantages in terms of pricing power and manufacturing efficiencies. Margins tend to be much higher than in Europe because the US is a real single market where economies of scale are readily achievable.

On a long-term view, gobbling up Hershey also makes strategic sense - there is nothing else on the horizon for years to come. "If they let this one go they have to give up the idea of being number one or two," says Mr **Amoroso**.

The US chocolate market may be slow growing, but its population is growing faster than in Europe.

Establishing a leadership position would allow Nestlé to substantially improve its profitability and use the strong cash flow from its mature chocolate products to finance expansion into faster growing markets outside the US.

Mr Brabeck's attempt to talk down the price of any Hershey deal is understandable. While the long-term strategic fit makes sense, it will be hard to justify in terms of short-term shareholder value, says Mr Marshall-Lockyer.

He estimates that an \$11.5bn bid would dilute Nestlé's own earnings by 4 per cent.

Hence the speculation that Nestlé might join forces with Cadbury Schweppes of the UK. Both groups would like to regain US marketing rights for flagship brands, such as Nestlé's KitKat and Cadbury's Almond Joy, licensed out to Hershey.

A Nestlé-led deal involving the partial break-up of Hershey's product portfolio could resolve US antitrust issues and also price concerns.

Even if Nestlé only kept half of Hershey's current US market share it would still be number one with 30 per cent.

Nestlé may have to sacrifice its coveted Triple A credit rating to finance the deal, but Mr Brabeck has made it clear that the company is not run by financial ratios.

It would still have paid \$10.3bn for pet food producer Ralston Purina, bought last year, even if it had meant losing the rating. The same would almost certainly be true in the case of Hershey.

© Copyright The Financial Times Ltd 2002. "FT" and "Financial Times" are trademarks of The Financial Times Ltd.