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Doubts Linger Over Kraft Offer to Buy Cadbury

By Michael Carolan, NOVEMBER 5, 2009

LONDON — Kraft Foods Inc.'s lackluster third-quarter earnings demonstrate why it needs to buy a growth business like Cadbury PLC, but questions remain over the U.S. food giant's willingness to pay a knockout price.

Kraft, which has until Monday to make a formal bid for Cadbury or walk away for six months, disappointed investors this week when it lowered its outlook for organic revenue growth this year to about 2% from roughly 3%. Organic revenue growth strips out acquisitions, divestments and currency fluctuations.

In contrast, Cadbury expects organic revenue growth of about 5% this year, after a 7% rise in the third quarter.

"It looks as if Kraft's top line is stagnating completely," said a person close to the bidding process. "You can see why they're trying to buy growth elsewhere, seeing as they can't generate it themselves."

Cadbury shares closed down 1.4% at 766 pence ($12.57) in London on Wednesday after Kraft's results prompted some investors to trim their expectations of what it might pay for the U.K. confectioner.

Kraft's organic sales growth in the third quarter was 0.5%. This was the fourth consecutive quarter that Kraft's sales have disappointed investors, said Panmure Gordon analyst Graham Jones. Cadbury's sales have regularly grown above 6% over the past few years.

Cadbury Chairman Roger Carr called Kraft a "low-growth conglomerate" when rejecting the initial approach in September.

The disappointing sales growth will "make it more difficult for Kraft Chief Executive Irene Rosenfeld to reiterate the investment case in Kraft," said Cazenove analyst Polly Barclay.

Ms. Rosenfeld said Tuesday that Kraft remained interested "but will maintain a disciplined approach."

Kraft is struggling to grow, particularly in Europe, Mr. Jones said. "The reason they want Cadbury is that it will give them growth."

Industry consultant James Amoroso agreed. "The fundamental reality is that [the deal] makes strategic sense for Kraft but not for Cadbury," he said. "It is a one-way street, which is why Kraft has to pay up or shut up."

Kraft's earnings were closely watched since the initial £10.2 billion ($16.74 billion) proposal to buy Cadbury is partly in stock.

The offer was valued at 732 pence a share at Tuesday's closing price and any additional declines in Kraft's shares will decrease the offer's value further.

Ms. Barclay sees a fair value at between 788 pence and 873 pence. "We continue to believe speculation well above the top end of this range is very optimistic in the absence of any counterbid," she said.

J.P. Morgan analyst Pablo Zuanic said he doubts Kraft would pay more than 780 pence a share, given the lack of competing bids and the danger that Cadbury's shares would decline sharply should Kraft walk away.

But Kraft needs to be careful not to alienate Cadbury's shareholders with an excessively low opening offer, said Mr. Jones, of Panmure, though he conceded there was no point in "bidding against itself" at this stage.

Kraft, whose products include Kraft cheese, Oscar Mayer lunch meats and Planters nuts, posted profit of $824 million, or 55 cents a share, down 40% from $1.36 billion, or 91 cents a share, a year earlier.

Revenue declined 5.7% to $9.8 billion, hit by currency effects.

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