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Case Study Series

Will the Gillette Acquisition Ever Pay Off for Proctor and Gamble?

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Abstract

The case reviews P & G's acquisition of Gillette in 2005 for $57 billion. An article in a trade publication reviewed the acquisition after four years, and questioned the acquisition for not delivering on its promised benefits. This case focuses on the financial statements after four years and examines the article's negative conclusions. The case then goes on to use financial statements at the end of ten years of consolidation to evaluate the acquisition and it promised benefits.

Introduction

On January 28, 2005 Proctor and Gamble (P&G) announced that it had reached an agreement to acquire Gillette. P & G's chairman-CEO, A. G. Lafley, predicted that Gillette would add another full percentage point to the company's annual sales growth (5%-7%), and the operating margins of the combined firm would increase to 25% compared to existing margins in the high teens. Gillette Chairman-CEO, Jim Kilts, predicted the integration of what he called the two best companies in consumer products would become the stuff of Harvard Business School case studies as P&G reaped the benefits of "reverse synergies" from Gillette practices, while Gillette tapped P&G's beauty-care expertise.

Acquisition Creates Perfect Marriage

The acquisition cost $57 billion, and it created the world's largest consumer products company. P & G markets products largely to women, while Gillette sells high margin products, mainly razors, to men. One attraction for the acquisition was that the firms had few overlaps of customers or products sold. The product lines and customers complemented each other, and few anti-trust problems were expected with the US regulators.

The companies expected cost savings of $14-16 billion from combining back-room operations and new growth opportunities. This would make the merger profitable in the third year. Both companies would also benefit from adapting each other's technologies and joint research and development. For example, in the adoption of RFID (Radio Frequency ID), P & G and Gillette were early participants and much of their initial investment was likely to have been completed.

The CEOs of both firms elaborated on the many benefits of the merger of the two marketing giants. The more obvious benefits were:

1) the combined firm would be able to repulse the efforts of the world's largest retailer, Wal-Mart, to force cost concessions on its suppliers. Wal-Mart was the largest retailer, but it was not the only retailer to argue for cost concessions from manufacturers.

2) The initial estimate for job cuts was 6,000 positions, mainly to eliminate management overlaps and to speed the consolidation of business support functions. This was 4% of the combined workforce of 140,000.

3) P & G was already the largest advertiser in the US spending $5.5 billion, and Gillette was

spending over $600 million. The combined firm hoped to bring down the net cost of advertising through greater bargaining power.

4) With Gillette as part of its empire, P & G boosted its long-term growth rate by 1%, quoting a rate of 5% to 7% up from 4% to 6%. This would be accomplished through Gillett's higher growth rate and synergies forged by the combined operations. The dollar amount from this 1% boost was $500 million in added sales.

5) Both firms had strong management teams with P & G learning strong cost controls from Gillette and Gillette learning beauty care principles from P & G.

Wall Street Views

While the suddenness of the offer and the rich offering price surprised some Wall Street analysts, most were quick to praise the proposed acquisition. Oppenheimer & Co. analyst Linda Bolton Weiser called it a "brilliant move strategically. P & G would be entering one of the most attractive categories in personal care, wet shaving." Prudential Equity analyst Constance Maneaty stated, "Gillette should benefit from P & G's strong positions in Japan, China, and Mexico, while P & G will have a stronger position in the markets such as Brazil and India." Floyd Greenwood of Greenwood Research "Ultimately it is really positive."

Most analysts had positive comments, but some were reluctant to give a totally positive review. J. P. Morgan analyst John Faucher stated "We are skeptical that simply going from $55 billion to $65 billion in revenues really changes all that much. Also, Gillette's additional top-line growth will only modestly add to Proctor's." On the argument for expected synergies from the merger of two strong marketing firms, Bethany McLean of Fortune Magazine commented "Personally, I think synergies are a lot like UFOs. Lots of people claim to have seen them, but few can actually prove they exist." Both firms are strong, diversified companies, at the top of their game so one wonders what uncaptured synergies there could be.

Financial Details

On the day of the initial announcement, P & G offered 0.975 of its shares for all of Gillette's shares, a 17% premium to the stock price the day before the offer. P & G announced plans to buy back $18 to $22 billion of its stock during the next year to 18 months to reduce stockholder fears of stock dilution. That means the deal ultimately would be financed through 60% stock and 40% debt. Fitch Ratings said it expected to strip P & G of its double-A-minus rating, dropping it to single-A, claiming much of the cost savings will not occur for several years. P & G estimated the deal would reduce earnings by 25 cents to 35 cents a share in fiscal year 2006 and between 5 cents and 10 cents a share in fiscal 2007, making the deal profitable in fiscal 2008.[1]

Four Year Review

Five years after the deal was announced, with four years of financial data, an article in Advertising Age (Marketing- P&G's $57 Billion Bet on Gillette Five Years Later), questioned the wisdom of the acquisition at the four-year mark. The article went on to say "…things haven't exactly gone as planned. Most of the acquired Gillette businesses have been a drag on P & G's top line, not a boost. Most of Gillette's senior managers have left. P

[1] P&G Agrees to Buy Gillette in a $54 Billion Stock Deal, Wall Street Journal ONLINE, Jan.30, 2005.

& G's stock has lagged key competitors' stock, including Colgate-Palmolive and Unilever, which have beaten P & G 4 to 1 and 3 to 1, respectively in the stock market."

But the article quoted some P & G executives and former Gillette managers who claimed the deal was like an iceberg, with most of it under water and unobserved. They claimed benefits in Brazil and India, stronger operations throughout Europe, increasing investment and expertise in sports marketing, and faster internal decision making. P & G had a history of initial disappointments on acquisitions. P & G's 1985 acquisition of Richardson-Vicks with Olay and Pantene, did not pay off for at least 5 years with Pantene and nearly 15 years with Olay. The 1997 acquisition of Tampax foundered for more than 5 years until 2002. Ali Dibadj, a Sanford C. Bernstein analyst, gave the deal at this point a mixed review. He believed cost cutting was a clear standout but revenue growth a laggard, due to the lingering recession and the difficulty of getting men to trade up to the new Fusion razor and blades.

In 2010, Gillette was preparing the introduction of another new razor, Fusion-ProGlide, an improvement, over the Fusion introduced right after the acquisition had closed in 2005. Following the Gillette game plan, the new razor would price blades 10% to 15% over the prior Fusion blades. This was a pricing strategy that had worked for decades, but now it would be attempted in the middle of a painful recession.

The deal was still questioned in the framework of why P & G needed Gillette and why Gillette was willing to join with P & G. When the deal was announced both firms could see benefits of joining together, benefits not available as a sole competitor. P & G saw higher growth rates and higher razor margins, along with the ability to confront the Wal-Marts of the world with their attempts to force price decreases on the manufacturer. P & G also saw a strong management team at the head of Gillette and possibilities for growth in emerging markets. Gillette saw opportunities to cut product costs and back office costs, along with stronger growth possibilities in emerging markets.

Participants in the industry were aware that CEO Kilts had shopped Gillette to Colgate-Palmolive at least two years before the P & G deal. Colgate-Palmolive had turned down the opportunity to merge twice. The first refusal was due to a high valuation for Gillette. It is interesting to note that two years later the price P & G offered was almost twice the price that Colgate-Palmolive thought was excessive. The second refusal was due to different management cultures and the perceived problems in integrating the two firms. Also, Colgate-Palmolive was going through a reassessment of its strategies and the Gillette merger was a complication and distraction from the reassessment.[2]

Ten Year Review

At the four-year review, several analysts commented that P & G had a history of taking time to integrate a new acquisition and make it generate a respectable return on investment. It has been over ten years that Gillette has been part of P & G, and we can review if any of the promised metrics have been achieved over that extended time.

The four-year review was written in February 2010, which was before P & G's year-end report on June 30, 2010. That meant the authors of the article had 9 months for fiscal 2006, all of 2007, 2008, 2009, and part of 2010, possibly 4 years of data. We will use data until

[2] Neff, Jack, Why P&G's $57 Billion Bet on Gillette Hasn't Paid Off Big- Yet. Five Years and One Recession Later, Company Says Value Is There but Hidden, AdAge.Com, Feb. 15, 2010.

June 30, 2010, giving us four and three-quarters years of data. Then we will review data for the most recent five years of performance, 2012 to 2016.

Exhibit 1 Source: P & G's 10k reports to the SEC.

Proctor & Gamble (Year ends 6/30)
(000, 000) except for percentages

	2010	2009	2008	2007	2006	2005
Sales	78,938	76,694	79,257	72,441	64,416	53,210
Operating income	16,021	15,374	15,979	14,485	12,551	9,666
advertising expense	8,576	7,519	8,520	7,799	7,010	5,804
net income	12,736	13,436	12,075	10,340	8,684	6,923
profit margin	16.1%	17.5%	15.2%	14.3%	13.5%	13.0%
employees	127,000	132,000	135,000	135,000	140,000	

	2016	2015	2014	2013	2012
Sales	65,299	70,749	74,401	73,910	73,138
Operating income	13,441	11,049	13,910	13,051	12,495
advertising expense	7,243	7,180	7,867	8,188	7,839
net income	10,508	7,036	11,643	11,312	10,756
profit margin	16.1%	9.9%	15.6%	15.3%	14.7%
employees	105,000	110,000	118,000	121,000	126,000

Grooming Segment

	2016	2015	2014	2013	2012
Sales	6,815	7,441	8,038	8,009	7,441
Income Continuing Operations	1,548	1,787	1,837	1,954	1,787
Depreciation	451	540	603	576	540
Capital Expenditures	383	372	369	378	392
Total assets	22,819	23,090	23,767	23,971	24,518

Questions

a) Was the new P & G able to confront Walmart and hold the line on merchandise prices?
b) Did P & G deliver on its promise to cut staffing by 6,000 positions?
c) Did P & G reduce or hold the line on advertising expense for the combined company?
d) Did P & G deliver on the 5% sales growth?
e) Did P & G deliver on the higher operating margins after the acquisition?
f) Comment on the Grooming segment data- sales growth, net income trends, capital spending versus depreciation, and asset levels.
g) For the most recent five years of data (2012-2016): have P & G sales grown at 5%, operating margins reached 25%, or advertising expense decreased?
h) What can Gillette do to achieve the promised sales growth rate of 5% and operating margins approaching 25%?

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