pennlive.com

The Patriot-News

Can Hershey pull off deal for Cadbury?

As the Derry Twp.-based candymaker ponders its future, analysts debate whether the company can afford the risk international growth presents.

Sunday, December 13, 2009

BY JOHN LUCIEW jluciew@patriot-news.com

Would The Hershey Co. and its stock be weighed down by an estimated $10 billion in debt from a potential bid to buy British chocolate maker Cadbury?

Or would the acquisition provide the Derry Twp.-based candy company with long-term international sales growth, enabling the charitable trust that controls Hershey to fulfill its mission of funding the Milton Hershey School "in perpetuity?"

Those appear to be the competing questions as the Hershey Co. and the Hershey Trust Co. debate whether to make an offer for Cadbury that would best Kraft Foods' $16.4 billion formal bid for the confectioner.

Citing anonymous sources familiar with the matter, The Wall Street Journal last week reported that Hershey management and the trust's board were nearing a final decision and "tilting toward" making a bid for Cadbury.

No final decision had been made, however, and tensions over debt from the deal and its impact on the Hershey Co.'s credit rating remained key issues for management, the report said.

"We're waiting for the Hershey Trust to make a move," Christopher Growe, an analyst at Stifel Nicolaus, said in a telephone interview Thursday.

Both the company and the trust declined comment.

If Hershey, the smallest of the companies involved, makes an offer for Cadbury, it will mark an evolution for both the company and the trust.

When Kraft unveiled its unsolicited offer for Cadbury in early September, many analysts considered, then dismissed, Hershey as a rival suitor.

Hershey was too small, its debt capacity too limited, and its control structure, dominated by the trust, was too restrictive and conservative to compete with Kraft, went the thinking of many analysts.

Later, reports surfaced that Hershey was in talks with Italian chocolate maker Ferrero SPA and, more recently, with Swiss food giant Nestle SA over a potential joint bid for Cadbury.

Analysts viewed these possibilities more seriously, with many seeing a corporate partnership, as complicated as they are to forge, as Hershey's only realistic path to topping Kraft in the bidding for Cadbury.

Now, however, it appears those talks between Hershey and other candy companies have cooled, according to published reports.

"Perhaps it's proven too difficult to split up the company and decide who gets what piece," a New York investment banker said of the task of dividing up Cadbury between Hershey and a partner.

"You can't split up distribution. Distribution stays with one or with the other," he said.

That appears to leave Hershey to go it alone in pursuing Cadbury by taking on an estimated $10 billion in debt to mount an estimated $17 billion bid for the British candy company.

Not everyone is convinced the company can pull it off.

"Hershey is an uncompetitive bidder without a partner," Growe told Bloomberg News. The St. Louis-based analyst who tracks the food sector recently recommended selling Hershey shares and holding Kraft.

Spurring Hershey and the trust to shake off their insular, conservative images are two driving forces -- the competitive challenge presented by last year's merger of the Mars and Wrigley companies and the enduring mandate of the late chocolate magnate Milton Hershey to manage the bequeathed candy fortune to benefit underprivileged children through the school that bears his name "in perpetuity."

Hershey appears to be doing well amid a challenging financial year. It has a leading market position in the U.S. chocolate and confectionery market and strong cash-generating ability, according to analyst ratings.

Hershey's core chocolate business provides fairly stable earnings and strong profitability. And the company is benefiting from cash-strapped consumers inclined to trade down from premium chocolate to Hershey's brands.

But a closer look reveals flaws, which have the potential to magnify over time.

While Hershey is strong in chocolate and other candy lines, it lacks chewing gum. And as well positioned as it is in the U.S. market, the company and its marketing reach is dwarfed by bigger rivals oversees, particularly in fast-growing, emerging markets like China and India.

Acquiring Cadbury would remedy those global concerns and improve long-term growth trends. But it would come at a high short-term cost in the form of debt. Hershey's stock, its profits and even its dividend could all take hits as the company pays down the Cadbury tab, analysts have said.

That's apparently the rub between the trust, which is intent on keeping control of the Hershey Co. and views itself as the ultimate long-term investor, and company management, which must keep a close eye on yearly profits, quarterly earnings, and daily stock prices.

"The possible results are [Hershey] could have a lower bond rating, resulting in higher interest costs to the company," Robert J. Chalfin, a lecturer in management at the University of Pennsylvania's Wharton School and a principal in a New Jersey-based investment firm, said of the impact of debt.

"To the extent that they have a down year or don't meet their projections, it could place increased strains on cash flow," he said.

According to The Wall Street Journal, debt leftover from a potential Cadbury deal and its impact on the company is a key concern of the Hershey Co.'s management.

But the controlling trust appears far more preoccupied with Hershey's long-term fortunes and the pressing need for strong international sales to help finance another century of philanthropy through the Milton Hershey School.

"At the end of the day, I assume it's the trust that will make the decision," said the investment banker who has been tracking Hershey's courtship of Cadbury. "They have more power than the company."

What's clear is Hershey will have ample opportunity to enter the bidding for Cadbury, given the timetables embedded in British takeover laws and Kraft's seeming reluctance to budge from it initial offer.

Cadbury, maker of Dairy Milk chocolate and Dentyne gum, already has rebuffed Kraft's offer as too low and views the pairing with a slower-growth food conglomerate as unattractive.

Cadbury is expected to further defend itself against Kraft's advances at a presentation this week in London for analysts and investors that will tout Cadbury's sales growth, profit margins and share prices.

Analysts expect Kraft to eventually raise its stock and cash offer, the per-share value of which is lower than Cadbury's current stock price.

But with no rival bidder for Cadbury, Kraft appears in no rush to do so and could wait until just before the deal's late-January deadline under British takeover law, analysts said. Any competing bid for Cadbury would automatically extend the timetable for completing a deal.

"Oh, Kraft is going to have to raise its bid. It's a nonstarter," the investment banker said.

The question remains how high will Kraft go, and would Hershey have the desire to top it?

Kraft, with a $39.4 billion market cap that is about five times Hershey's, remains the front-runner, according to analyst Andrew Wood at Sanford Bernstein quoted on the TheDeal.com. According the business Web site, Kraft could go as high as $18.3 billion by the end of the period Cadbury shareholders have to consider the offer.