

# Takeover as a business strategy

**Ian Marcousé** examines whether takeovers are an effective way for UK firms to enter the Chinese market



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In February 2017 UK giant Reckitt Benckiser agreed an \$18 billion takeover of US baby milk manufacturer Mead Johnson. The all-cash bid forced Reckitt to borrow \$9 billion on a 3–5 year view, pushing its gearing up. The interest payments on all the debt should be covered by the new profits brought to the business from baby milk sales.

Reckitt Benckiser owns a number of major consumer brands such as Nurofen, Dettol, Airwick and Vanish. Now it wants to break into the \$50 billion global market for baby milk. Mead Johnson has a 10% share,

but usefully focused on just three markets: the USA, South America and China. This means avoiding a head-on clash in Europe with the world’s two biggest suppliers: Nestlé (Switzerland) and Danone (France).

## Good move?

The strategy behind the takeover is as much geographic as product-related. It gives Reckitt a \$1 billion-plus presence in China. Chinese consumers are fanatical about buying baby milk products from the West. Reckitt, like other UK firms, has been slow to see the opportunities in China. Now it can buy its way in via a US company.

The desirability of Mead Johnson’s baby milk brands is borne out by the fact that Danone had already held talks to try and buy their US rival. But there were concerns about competition authorities intervening. With Reckitt there will be no such problems.

Unfortunately it’s also hard to see where the synergies lie when Reckitt has no baby milk business to merge with Mead Johnson. Despite this, Reckitt told its shareholders that \$200 million per year of savings could be expected within 3 years.

**Table 1 Reckitt Benckiser group income statement**

	2016 (£m)	2015 (£m)
Revenue	9,891	8,874
Cost of sales	(3,865)	(3,628)
Gross profit	6,026	5,246
Operating expenses (overheads)	(3,616)	(3,005)
Operating profit	2,410	2,241
Net financing cost	(16)	(33)
Pre-tax profit	2,394	2,208

But what of all the evidence that most takeovers prove a disappointment to the bidder? Reckitt chief executive Rakesh Kapoor seems untroubled. Partly, perhaps, because he knows that baby milk powders, like painkillers and antiseptics, have huge gross margins. Therefore slight underperformance by staff is rarely a problem. Others have noted that he stands to receive a multi-million-pound bonus if the takeover goes to plan, so his views may be coloured by this.

**Table 2 Reckitt Benckiser group balance sheet (31 December 2016)**

	2016 (£m)	2015 (£m)
Fixed (non-current) assets	14,569	12,386
Stock (inventories)	770	681
Debtors (receivables)	1,623	1,331
Cash	1,057	870
Trade payables	(3,495)	(2,948)
Other current liabilities	(1,906)	(2,091)
Long-term (non-current) liabilities	(4,192)	(3,323)
Net assets	8,426	6,906
Share capital	317	317
Reserves	8,109	6,589
Total equity	8,426	6,906

## Practice exam questions

40 marks, 50 minutes

- 1 A key part of Reckitt's strategy is to buy Mead Johnson to get into China. Analyse the factors influencing the attractiveness of an international market such as China. (12 marks)
- 2 Reckitt is buying Mead Johnson for \$18 billion cash, partly financed by a \$9 billion 3–5 year bank loan. Analyse whether Reckitt might be overstretching itself financially. (12 marks)
- 3 Reckitt Benckiser has chosen to target China by a takeover. Evaluate whether this is the best way to enter an international market for a business such as this. (16 marks)

## Sample answers

1 There are economic and business factors to consider. The two primary economic factors are the absolute level of per capita GDP at PPP. This can vary from around \$1,000 a year in poor countries to \$50,000 a year in rich ones. China, at around \$15,000 a year, is comfortably in the middle, with a significant number of people with strong spending power. The other factor is GDP growth, with China's 6–7% outstripping almost every other major economy. This is important to give a sense of where GDP per capita might be in 3–5 years' time (a typical planning horizon for business strategy). China's combination of reasonable affluence and strong growth (plus 1.35 billion people) probably makes it the most attractive market in the world on purely economic grounds.

From a business point of view there are more things to consider. Is there a level playing field between state and private sector businesses? And between Chinese and foreign ones? These might be critical factors for a business thinking of launching into China for the first time, but given that Mead Johnson already has \$1.2 billion of sales in China, it has presumably overcome any market obstacles already. Similarly, even though it may have big competitors such as Nestlé, it already knows how to deal with them.

2 In 2016 Reckitt Benckiser (RB) had £4,192m of long-term liabilities, representing 33.2% of its £8,426m + £4,192m = £12,618m capital employed. If there is a 'perfect' gearing figure, that's probably it. But borrowing an extra \$9bn of 3–5-year debt meaning pushing non-current liabilities to £13,192bn and the capital employed to £21,618bn. So even if we ignore the other half of the \$18bn purchase price for Mead Johnson, gearing rises to £13.192bn / £21.618bn × 100 = 61%. This is beyond the 50% figure regarded as risk-acceptable — 61% represents a risky balance sheet. (For techies, this under-estimates the problem, because takeover bids inevitably include a goodwill 'overpayment' for the assets of the company being acquired. When this is written off against the reserves,



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shareholders' funds shrink, making the gearing level rise further.) The text talks blithely about the interest payments being covered by the Mead Johnson profits, but that ignores the possibility of a toughening in market conditions.

There's also a big question mark over the impact on RB's liquidity position. \$9bn borrowed leaves another \$9bn to be found. Shareholders hate being asked for more money, so a big share issue may be difficult. So the directors will probably try to squeeze as much as possible from current profits and from working capital. The business does make more than \$2bn profit in a year, so perhaps \$1bn of this could be diverted towards the bid. But the 2016 current ratio was  $\$770m + \$1,623m + \$1,057m = \$3,450m / \$3,495 + \$1,906m = \$5,401m = 0.64$ . This is well below the accountants' rule-of-thumb of 1.5, implying that no cash should be squeezed out of this source.

Unless RB holds a huge 'rights issue' to raise more share capital, it will indeed be overstretching itself financially. Fortunately the strength of its brands makes this less of a concern than it would be otherwise.

- 3** Bosses of big businesses love to make a takeover bid. It stands as clear proof of the boss's clarity of vision for the company's future and his or her decisiveness. It at least appears to justify the boss's multi-million salary and huge share options.

Takeovers pretty much guarantee that the leader will be remembered in future company histories, but not necessarily for the reasons the leader expects. Fred (no-longer-Sir) Goodwin staked his reputation at RBS

on buying ABN AMRO for £50bn. This bankrupted the company. Research has shown for many years that most takeover bids prove unsuccessful — the takeover winner becomes the loser.

In this case the strategic fit looks promising. There's no sales overlap between disinfectant and baby milk, but both are sold through similar sales channels, giving scope for cost synergies (merging sales and distribution — and making redundancies). The alternative of building a new baby milk brand from nothing might take 10 years to reach a 10% market share — but would more probably end in failure. Ansoff would probably regard such an enterprise as a new product in a new market and therefore (high-risk) diversification.

On the other hand, organic growth has its own specific strengths. Perhaps RB should focus on being better at producing the products it already sells. Directors should be quizzed on why they are having to play catch-up in China — did they not see this vast opportunity for their existing brands? Why not? Because they seem to have failed so far in China, they're taking an \$18bn gamble that without question stretches the balance sheet. Organic growth wouldn't do that.

In its current circumstances, the best way for RB to enter the Chinese market for baby food is to buy Mead Johnson, but is that the only option? If RB's objective is to enter China, surely the best way in would be to launch a number of true RB brands such as Nurofen and Dettol. This would be a form of organic growth rooted in RB's core competences, and far less risky in terms of the balance sheet.

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