

TEMPTING BUT NOT IRRESISTIBLE: SEEKING OPPORTUNITY IN THE KRAFT-CADBURY TAKEOVER

Introduction

Acrimonious takeovers or mergers naturally exhibit greater price volatility than friendly transactions, and the Kraft-Cadbury deal was no exception. In the course of pursuing Cadbury (CBY), Kraft (KFT) became entrapped in a transactional vise of its own design; bid too low for Cadbury and they would fail to acquire it, but bid much higher and the financial cost to Kraft would outweigh even the most optimistic projected benefits, as well as infuriate many already-vexed shareholders (Warren Buffett among them).

I wasn't drawn to joining the arbitrageurs in playing the spread, nor was I inclined to simply buy Cadbury shares as a wager on Kraft raising its bid. In either case, CBY shares had too far to fall if the deal broke (a reality reflected in the high cost of the CBY puts). What offered the more intriguing risk/reward was the less obvious possibility that Kraft shares might trade down in panicked response to a deal-related development. All of the elements necessary to that type of event certainly were present. Provided such downdraft was transient and transaction-related rather than a rational re-pricing based on long-term fundamentals, it might enable me to buy KFT at a significant margin of safety. There was of course no guarantee that such an episode would occur – it was entirely contingent on future events. But as the Roman philosopher Seneca said, luck is what happens when preparation meets opportunity. Taking into account the deal's history as well as all of the possible permutations, the odds were interesting enough to merit a closer analysis.

In the end, Kraft arguably overpaid, both in terms of what CBY received and the cost inherent in disposing of an arguably attractive asset to finance the bid. But management, to their credit or condemnation, walked the razor's edge and closed the deal. As the sell-off I had hoped to exploit never materialized, neither did the position.

Disclosure

This analysis was originally generated in December 2009 for internal distribution at a former employer. It has not been updated to reflect subsequent developments, with the exception of the retrospective comments contained in the "Introduction History" immediately below. Please see Disclaimer on the final page.

Overview and Rationale

On August 28th 2009 Kraft (KFT) launched an unsolicited \$16.7bn cash-and-shares bid for Cadbury (CBY/CBRY), the world's second largest confectionary company behind Mars. Kraft's offer, made public September 7th, was 300 pence cash and 0.2589 new Kraft shares for every Cadbury share (or approx. 745 pence the day the deal went public), so the equity comprised approx. 60% of the compensation. [Editorial Note: Both CBY and CBRY indicate Cadbury equity; CBY is the US ADR, and CBRY is the British equity the ADR based on.]

Event Timeline

11/9: Formal hostile offer announced
12/4: Offer document posted
1/12: Last day Cadbury can provide new information
1/19: Last day that Kraft can change the terms of its offer
2/2: Last day for a counter-offer, and last day by which KFT can win control of CBY

Kraft (KFT) equity shares are potentially attractive for 4 reasons:

1. KFT's attempted acquisition of CBY has driven the price down,
2. Many deal outcomes are neutral to mildly positive for KFT's stock price,
3. KFT pays a healthy 4.25% dividend that under selective circumstances *should* be reliable going forward, and
4. Developments during the pendency of the deal may result in a uniquely attractive mispricing of KFT.

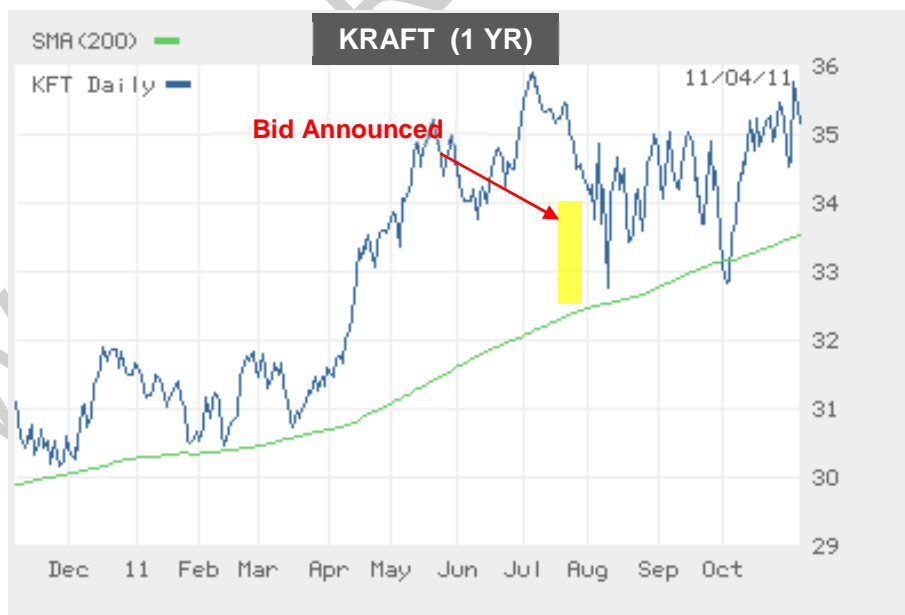
I generally believe that the last place one is likely to find an attractive mispricing is a well-known large-cap US equity. They typically have very expansive analyst coverage which, however conflicted or sloppy, inarguably decreases the odds that the investor will discover something important that the rest of the investment community has missed. Hence, most buying opportunities come in the form of either massive market corrections (which are rare) or company-specific events sufficiently misunderstood to present investment or trading opportunities. The latter are also rare and can be emotionally difficult to fully exploit; it can be hard to buy hand-over-fist when everyone else is fleeing, especially when one's initial purchases inevitably decline in value before rebounding.

Buying Kraft, as I contemplate herein, is in some respects counterintuitive. The typical arbitrageur would build a position in the CBY, the target, while shorting KFT. This is indeed what many are doing right now - buying CBY while shorting a portion of KFT's shares based on an assumed deal ratio. Provided the transaction closes, the arb pockets the difference.

However, the more I weighed the various scenarios vs. the current trading level of KFT, the more I wondered whether most outcomes, as well as the *most likely outcomes*, would be net positive for KFT's share price. It's important to note the two-fold nature of the analysis; the speculator must not only forecast the share-price impact of each scenario, but also the odds of each such scenario occurring. Significantly erring on either count almost invariably results in a negative shift in the risk/reward math.

Investment Argument

CBY is currently trading above the value of the KFT bid; this means that the arbs expect KFT to raise its bid. We know the arbs are involved based upon the turnover in the shares since the deal was announced. But even as the arbs pile into CBY and short KFT, **the smart play in this case may be to do the opposite and buy KFT.**



In assessing the outcome of the current situation, I make the following observations and assumptions:

- As the chart above indicates, the immediate reaction to the bid announcement was for KFT to trade down. This was likely a combination of the negative response to the anticipated impact on KFT and the influence of

arbitrageurs, who naturally were shorting KFT at the same time that they were buying CBY in order to lock in the spread. Whatever the degree those two factors respectively contributed to the decline, in the event that the deal is terminated it is reasonable to expect the shares to react in approximately the opposite fashion. The day the arbs are convinced the deal is dead they will rush to cover their KFT short, and that buying pressure can only force KFT shares higher.

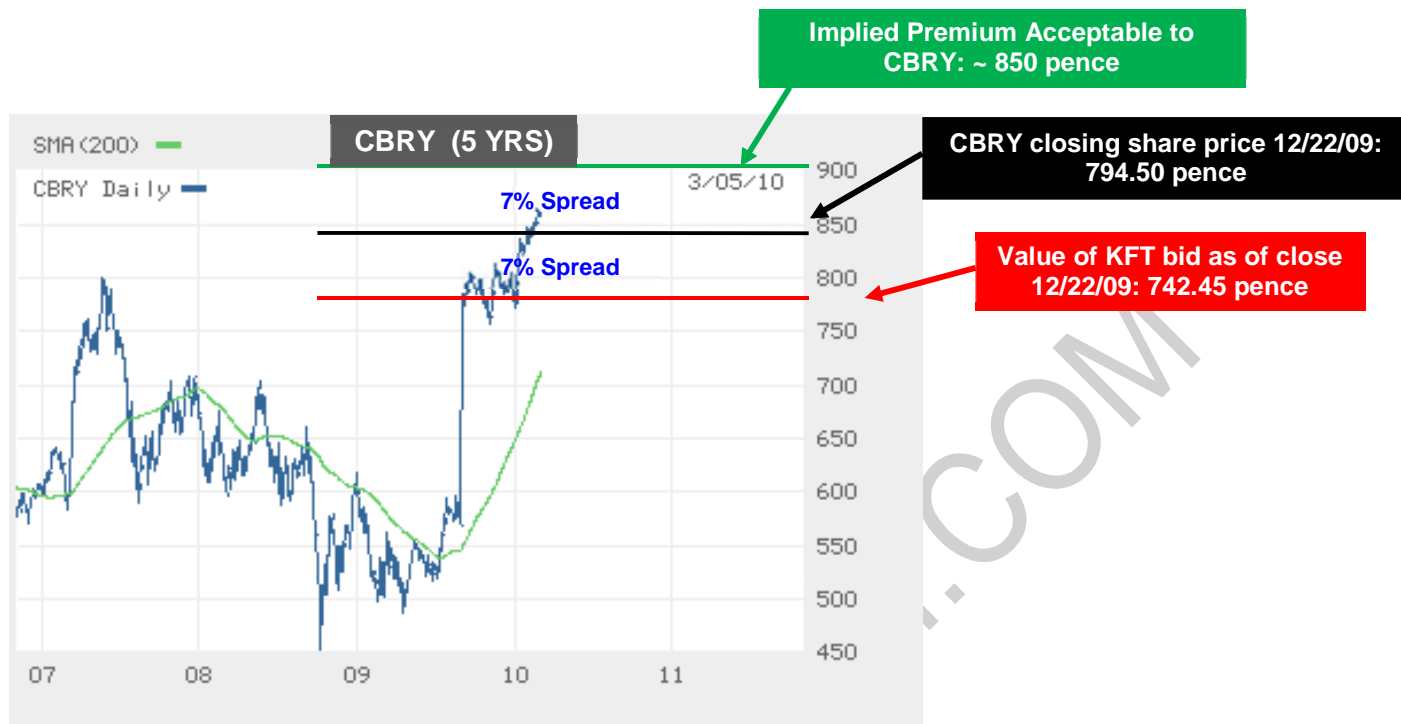
- With CBY having already strongly rejected KFT's first and only bid thus far, the odds of a deal getting done under the current terms are quite low. If KFT is going to win control of CBY, they will almost inevitably have to lift their bid significantly. At 12.3X LTM EBITDA, KFT's bid is far below the 17.8X LTM EBITDA that Mars paid for Wrigley in May 2008, the most recent and relevant valuation datapoint (to the arbs and investment community in general).

Although CBY has few of the typical defenses at its disposal – no noncore businesses to sell, no obvious acquisitions to make, or spare cash to return – the valuation disparity with the Mars/Wrigley bid arguably provides CBY management with more than sufficient justification to “just say no.” (The “Just Say No” defense of course doesn't literally apply here, nor would any others available via the Delaware Chancery Court, because CBY is not a US company.)

- While CBY CEO Todd Stitzer labeled the KFT bid "contemptuous" and "opportunistic," he also explicitly left the door open to a higher bid, more in the territory of 850 pence per share.
- However strategically attractive CBY is to KFT, if we can assume that KFT will not be able to acquire CBY without increasing its bid – *which I believe is a very safe assumption* – KFT will either have to dispose of assets, increase its debt, dilute its shareholders, or some combination thereof.
- KFT at present maintains an investment grade rating on its debt. Although KFT's current debt load of \$20.2 BN is manageable, the current bid would increase debt by \$6.7 BN (net of cash, assuming no KFT asset disposals but including CBY's debt) and lift its leverage ratio from 3.3X to 4.0X (leverage ratio = Debt / EBITDA).
- If KFT were to raise its bid to a Mars/Wrigley multiple of 17.8X, and the equity component remained unchanged, they would have to raise \$14 BN in debt, raising their leverage ratio to 5.0X, leaving KFT on the cusp of losing its investment grade rating (assuming no asset disposals).
- Whatever the pro-forma debt load, it is important to note that KFT generates free cash flow of \$3.73 BN. Of course, while this is reassuring, it would be little consolation in the event that they raise their bid by issuing additional debt, resulting in a punishing debt downgrade to high yield as a result.
- In lieu of debt, KFT could increase the equity component of the bid, but Warren Buffett (9.4%) and Nelson Peltz (0.44%), both of whom carry weight with management, oppose an equity dilution as well as a significantly sweetened bid. Buffett apparently has grave concerns regarding a higher bid.
- Most shareholders are similarly wary of the impact additional debt and the accompanying downgrade would have on KFT's financials.

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The chart below, which is based on the closing prices as of 12/22/09, illustrates the spectrum of expectations as reflected in the stock price.



It's impossible to miss what the arbs are betting on: That KFT will, whether with additional debt, shares, asset sales, or some combination of the three, raise its bid to *at least some premium* to the 5-year high for CBRY (approx. 800 pence). Naturally, the only reason for an arb to buy at these levels is the strong probability of receiving more. Looking to the chart, that expectation is quite high, because if the deal falls through CBRY could easily drop to 600 pence, which would constitute a 25% loss to an arb buying at 800.

Fundamental Valuation

Kraft isn't cheap, even if it's trading at about 13X trailing and forward earnings, which on its face seems a moderately attractive multiple. Despite the fact that revenue has been growing substantially over the preceding six years, book value per share has not. In fact, it has barely budged from the \$16.50 - \$17.50 range *despite* the fact that the shares outstanding steadily decreased during that period. In other words, had management not reduced the denominator of the equation by buying back shares, book value per share would have actually decreased.

Cash flow per share has been similarly stagnant. Given KFT's financial performance, the P/E multiple indicates a company that is more fairly valued than "cheap."

As the 3-year chart (below right) indicates, KFT has in the recent past traded above or near \$36, which would be a 33% gain from these levels. But it could also easily trade down to \$24, which would be a decline of approx. 10% from these levels (the consensus earnings estimate for 2010 is \$2, so \$24 would be 12X 2010 consensus EPS).

Cash Component (pence)	£	300.00
Equity Component		
Kraft Share Price	\$	27.29
KFT Shares per CBRY		0.2589
CBRY Equivalent (USD)	\$	7.07
GBP per USD (spot)		0.6262
CBRY Equivalent (GBP)	£	4.42
CBRY Equivalent (GBP, pence)	£	442.45
Kraft Total Bid, Current (pence)		
	£	742.45
Cadbury Current Share Price		
	£	794.50
CBRY Premium to KFT Bid (gr)		
	£	52.05
CBRY Premium to KFT Bid (%)		
		7.0%
Spread: CBRY vs. 850 p Level		
		7.0%

If KFT lobbed in a Mars/Wrigley-sized bid, it's plausible the shares could trade even lower. It would be a near certainty if they sweetened their bid with equity. If KFT increased their bid with debt, the shares might trade lower due to the

perception that management overpaid for KFT, but overpayment fueled by debt is logically much worse for the debt than the equity, given the stability of the underlying cash flow.

Worst Case Scenarios / Negative Outliers

- In terms of the share price, the worst plausible outcome is KFT raising its bid to a Mars/Wrigley multiple and getting saddled with massive debt. In that scenario, the shares immediately trade down to the low 20s, a victim of both shareholder disappointment at the massive premium and arbs piling in and aggressively shorting KFT to lock in the spread.
- That said, there's another possible negative: Discontinuation of the dividend. With 1,735,000,000 shares outstanding, the current dividend of \$1.16 costs KFT \$2,012,600,000. If KFT leverages up to offer a premium above its current bid, shareholders have no right to be surprised if the dividend is reduced.
- In considering the stability of the business, it should be noted that the current environment is, if anything, slightly deflationary. If those deflationary pressures strengthen, the pricing power that many of Kraft's branded products enjoy could diminish. Their cash flow would inevitably diminish with their margins, a phenomenon which could turn severe should the economy enter a stretch of stagflation, pushing up the cost of KFT's raw materials while pressuring the prices they charge at the store shelf. Operationally, this would be the worst of all possible worlds.



Best Case Scenarios / Positive Outliers

- The home-run outlier would be a takeover of KFT. No one seems to expect this from CBY, but a “Pac-Man Defense” where the target does an about-face and purchases the acquirer is not out of the question. It's just very unlikely.
- KFT could also be acquired by another confectioner/food company, such as Nestle. This again is somewhat unlikely.
- Although it would require some passage of time, it should be acknowledged that KFT might ultimately deliver on the cost savings and synergies it is trying to convince investors of. Management could simply succeed.

Summary

Kraft is neither cheap nor expensive, and already has significant leverage on its balance sheet. The decline in the value of the shares since the bid for CBY was announced represents a thin margin of safety. On the other hand, even the worst case – a massive premium financed by debt – arguably leaves room for eventual appreciation, provided KFT management executes on both the cost savings and opportunities for synergy (the former being much more persuasive than the latter). A principal attraction of the investment, the dividend yield, could come under significant pressure in the event that KFT uses debt to lift its bid to 850 pence. But KFT doesn't necessarily have to raise its bid to that level to prevail, which is why our Outcome Analysis places much higher odds on the bid being increased moderately rather than significantly. By choosing a middle ground, KFT just might snare CBY, avoid alienating its own shareholders, and continue to pay an attractive dividend.

Addendum 12-27-09

The text that follows expands upon the analysis above, particularly with regard to the investment rationale and tactics for possible implementation.

Risk / Reward, in Terms of the Capital Structure

As we already know, the capital structure of any company is a ladder comprised of senior and subordinated claims, with the equity being last in line, or having the most subordinated claim on assets. If we think of the cap structure in this sense, the equity is in effect “the last bond.” This last bond sometimes carries a coupon – the dividend – but the

equity's coupon is unlike a bond coupon in that unlike interest paid on debt, it is not contractual; it's discretionary. But equity also has the capacity to appreciate more than debt; the par value of equity is functionally irrelevant. The most conservative view of KFT is through the lens of this description, as a kind of *quasi-bond* that has much greater price volatility than your typical bond, and a much less reliable dividend, but much better appreciation potential than a bond or even preferred equity.

This bond, however, has no maturity and thus no pull to par which would bail us out in the event that we overpay. Hence our KFT quasi-bond could trade below our "functional par" price (i.e., \$27 per share = 100 cents on the dollar) for a period that could exceed our desired holding period.

Weighing Investment Rationale Against Event Outcomes and Their Financial Impact

Characterizing the equity as the last-in-line bond is helpful in understanding both the capital structure and the investment decision. Specifically,

KFT equity is only a long-term hold if we can rely on the shares at minimum exhibiting the positive traits of a subordinated bond (i.e., a decent yield and small likelihood of loss), with our return likely supplemented by but not dependent upon capital appreciation.

Owning the equity for its bond-like qualities means that we are *primarily concerned* about the equity trading *down*, not up; this is how we find ourselves considering KFT at all. Given sensible earnings assumptions based on recent history, it is easy to argue that KFT is reasonably valued. The question at hand is whether the Company will make a decision that causes the current price to suddenly become expensive by default.

If our overriding concern is the loss of the dividend or a decline in the share price sufficient to neutralize the dividend, it is important to recognize that for some outcomes – particularly those at the worst-case-scenario end of the event spectrum – certain risks probably occur in tandem. For example, if KFT were to pay what most Kraft shareholders would consider an excessive premium for Cadbury (CBY), that decision would not only drive KFT's share price down but the financial consequences thereof could entail a reduction in or total elimination of the dividend. This "tandem risk" scenario imposes a logical sequence on the investment decision.

The Investment Decision

The gating issue is binary: We do NOT want to invest if it is likely that KFT will raise its bid by a sizeable portion, because that would all but guarantee pressure on KFT's share price going forward AND its dividend might also be imperiled. Unless we are confident that KFT will not overpay, there's no point in even considering investing.

However, if we are largely confident that KFT will *not* overpay, the analysis shifts to gauging the odds and extent of the premium.

There is an unknown inflection point to the bidding. As KFT's bid approaches but doesn't exceed that tipping point, the share price will respond positively, reflecting the relief that KFT has not overpaid. However, once KFT's bid exceeds that inchoate threshold, its share price will fall under pressure, declining in loose parallel with the perceived degree of overpayment. We cannot know precisely where a reasonable premium becomes an intolerable one. Moreover, we cannot beforehand know the quantum of the bid increase, nor the composition of that premium (equity vs. cash/debt), nor what strategic decisions KFT management might offer to balance the negative fallout from a significant premium to their current bid (such as asset sales, etc.).

Provided KFT doesn't table a destructive premium for CBY, the question for investors is this: Will KFT's higher bid, however financed, still be modest enough that the equity isn't punished and the dividend isn't threatened?

In answering that question, the uncertainty we're willing to assume is a direct function of the price we're willing to pay. But for a premium that would devastate the equity, there's a share price that constitutes an attractive risk/reward under almost all other scenarios. If history and current circumstances indicate that near-term normalized EPS of approx. \$2 is reasonable, what is the lowest P/E multiple that the market would impose on KFT as a result of the highest "reasonable" bid?

The investment calculus is again polluted by questions regarding the composition of the premium, etc., but if it is logical to assume that KFT should not trade at a single digit P/E multiple (which would be half the S&P's current P/E and require fairly impressive incompetence on the part of management), KFT's share price should naturally bottom out

in the low 20's. A reasonable floor might be in the \$22 territory, but even \$23 would be a steep 15% drop from our implied purchase price of \$27; \$22 would comprise a 19% decline.

If we had confidence regarding the future earnings power of KFT as a standalone, or that the vaunted synergies/cost savings of the acquisition could be relied upon to offset the financial impact of a fat premium, we would be less wary. But we're not convinced in either case. The entire investment thesis is ultimately predicated upon the equity exhibiting the most favorable downside features of a bond, such that neither our principal nor our coupon are materially vulnerable. Equally important, we don't see much reason for optimism regarding KFT's share price; as mentioned elsewhere, it's on the cheap side, but in our estimation deserves to be. That's why what is attractive as a "quasi-bond" is much less appealing as an equity holding. Our entrypoint should reflect this.

Steven R. Grey (2009)

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Outcome Analysis

↑ = KFT equity rises
 ↓ = KFT equity declines
 ↔ = KFT equity trades sideways

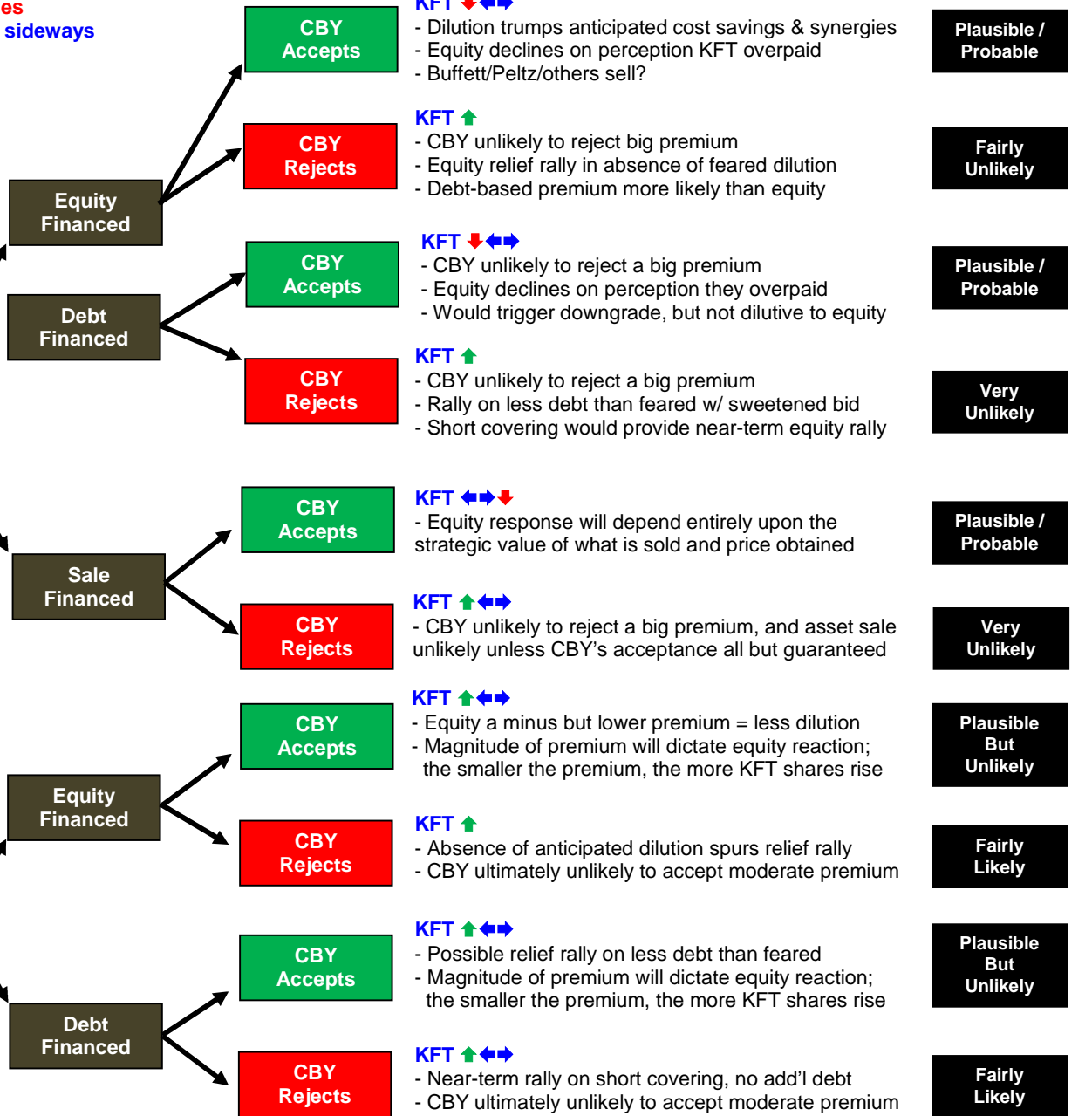
Competing Bids
 Hershey, Ferrero or Nestle could launch competing bids, which might impact whether KFT raises its bid and the degree to which it does so, but the consequences of KFT's actions remain the same.

Bid Raised

70% Chance

Significant Increase
 30% Chance

Moderate Increase
 70% Chance



Bid Maintained

30% Chance

CBY
Accepts

CBY
Rejects

Impact on Equity

Likelihood of
Indicated Outcome

KFT ↑

- Rally on less debt than feared w/ sweetened bid
- Big discount to Wrigley would also be a positive

Very
Unlikely

KFT ↑↔↔

- Near-term rally on short covering, no add'l debt
- No deal = no add'l debt, but slower growth

Probable

Important Note

This diagram is intended to serve only as a general framework for analysis. Certain factors are simplified in order to prevent it from becoming visually convoluted. Most prominently, deal financing will ultimately constitute some blend of equity, debt, etc., which are represented above, but infinite in combination.