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GENERAL MILLS' ACQUISITION OF PILLSBURY FROM DIAGEO PLC

On December 8, 2000, management of General Mills, Inc., recommended that its shareholders authorize the creation of more shares of common stock and approve a proposal for the company to acquire the worldwide businesses of Pillsbury from Diageo PLC. This transaction called for an exchange of shares of General Mills for the Pillsbury subsidiary that would leave Diageo as the largest shareholder in General Mills. Furthermore, it was agreed that, just before the transaction, Pillsbury would borrow about $5 billion and pay a special dividend to Diageo. Finally, General Mills would obtain a contingent commitment from Diageo that would pay General Mills up to $642 million on the first anniversary of the transaction, depending on General Mills' stock price. The proxy statement carried the opinions of General Mills' financial advisers that the transaction was fairly priced. Yet shareholders and securities analysts were puzzled by the contingent payment. What was it? Why was it warranted in this transaction? Would this deal create value for General Mills' shareholders? In light of answers to these questions, should General Mills' shareholders approve this transaction?

General Mills, Inc.

Headquartered in Minneapolis, Minnesota, General Mills was a major manufacturer and marketer of consumer foods, with revenues of about $7.5 billion in fiscal-year 2000. The firm's market capitalization was about $11 billion. It was the largest producer of yogurt and the second-largest producer of ready-to-eat breakfast cereals in the United States. The firm's segments included Big G cereals, Betty Crocker desserts, baking and dinner-mix products, snack products, and yogurt marketed under the Yoplait and Colombo brands. Each of these businesses in the United States was mature and offered relatively low organic growth. The firm pursued expansion opportunities overseas through company-owned businesses and through a cereal joint venture with Nestlé and a snack joint venture with PepsiCo. Through a program of aggressive share repurchases in the 1990s, the firm had increased its book value debt-to-equity ratio dramatically compared with its peers.

Diageo PLC

Diageo, headquartered in the United Kingdom, had been formed in 1997 through the merger of GrandMet and Guinness, making it one of the world's leading consumer-goods companies. Its product portfolio consisted of prominent alcoholic-beverage brands such as Smirnoff, Johnnie Walker, Guinness, J&B, Gordon's, and Tanqueray, as well as the Burger King fast-food chain and Pillsbury. Pillsbury had been acquired by GrandMet, acting as a "white-knight" acquirer to save Pillsbury from acquisition by Sir James Goldsmith, a well-known raider.

The Pillsbury Company

Pillsbury produced and marketed refrigerated dough and baked goods under the familiar Dough Boy character, canned and frozen vegetables under the familiar Green Giant brand, Old El Paso Mexican foods, Progresso soups, Totino's frozen pizzas, and other food products. Pillsbury had been headquartered in Minneapolis, Minnesota, as an independent company, and still had significant administrative operations there. Revenues for the company in fiscal-year 2000 were about $6.1 billion.

Origin of the Transaction

Seeking to build growth momentum, General Mills studied areas of potential growth and value creation in the spring of 1998. This had generated some smaller acquisitions and a general receptivity to acquisition proposals by the firm. In early 2000, the firm's financial advisers suggested that Diageo might be interested in selling Pillsbury, in an effort to focus Diageo on its beverage business, and that Pillsbury would complement General Mills' existing businesses. In March 2000, Diageo's chief operating officer contacted General Mills' chairman and CEO to explore a possible sale of Pillsbury. General Mills submitted its proposed deal terms to Diageo in June 2000—the total proposed payment was $10.0 billion. Diageo submitted an asking price of $10.5 billion. The two sides would budge no further, and it looked as if the negotiations would founder. General Mills did not want to issue more than one-third of its post-transaction shares to Diageo, and believed that its shares were undervalued in the stock market. Diageo believed it was necessary to value General Mills' shares at the current trading prices. In an effort to bridge the difference in positions, the two firms agreed upon including in the terms of the deal a contingent payment on the first anniversary of the transaction that would depend on General Mills' share price. James Lawrence, chief financial officer of General Mills, said, "We genuinely believe this is a way in which they could have their cake and we could eat it, too. There's no question in my mind that, absent this instrument, we wouldn't have been able to reach this deal." David Van Benschoten, General Mills' treasurer, added that the contingent payment was another example of the "development of the use of [options] in the past 20 years as finance has come to first understand, and work with, the constructs of optionality."[1]

[1] Steven Lipin, "First Roll out a Tool to Save Doughboy Deal," *Wall Street Journal*, July 21, 2000, C1.

On July 16, 2000, the boards of General Mills and Diageo approved the final terms. On July 17, the two firms issued press releases announcing the deal. In the week following the announcement, the shares of General Mills lost 8% of their value, net-of-market. But in late August, investors began to bid upward the General Mills share price, perhaps in response to the publication of the merger proxy statement and prospectus, and on news that the operating losses at Pillsbury had narrowed further than analysts had expected in fiscal-year 2000. That fall, General Mills was the subject of several “buy” recommendations. **Exhibit 1** gives the recent trading history of shares in General Mills.

Motives for the Transaction

In its proxy statement, General Mills declared that acquiring Pillsbury would create value for shareholders by providing opportunities for accelerated sales and earnings growth. These opportunities would be exploited through product innovation, channel expansion, international expansion, and productivity gains. The resulting product portfolio would be more balanced. The combined firm would rank fifth in size among competitors, based on global food sales.

In addition to growth, the deal would create opportunities to save costs. Management expected pretax savings of $25 million in fiscal 2001, $220 million in 2002, and $400 million by 2003. Supply-chain improvements (i.e., consolidation of activities and application of best practices in purchasing and logistics); efficiencies in selling, merchandising, and marketing; and, finally, the streamlining of administrative activities would generate these savings.

Terms of the Transaction

The transaction proposed that an acquisition subsidiary of General Mills would merge with the Pillsbury Company, with Pillsbury surviving as a wholly owned subsidiary of General Mills. The agreement outlined several features:

- *Payment of shares.* General Mills would issue 141 million shares of its common stock to Diageo shareholders. After the transaction, Diageo would own about 33% of General Mills’ outstanding shares. When the board of directors approved the merger in July, the company’s shares traded at around $34.00–$37.00. In the first week of December, the company’s shares traded at around $40.00–$42.00.
- *Assumption of Pillsbury debt.* General Mills agreed to assume the liabilities of Pillsbury at the closing, an amount expected to be $5.142 billion of debt. The Pillsbury debt would consist of about $142 million in existing debt and $5.0 billion in new borrowings, which Pillsbury would distribute to Diageo before closing. Terms of the new debt were conditional upon the consent of General Mills, for which a primary concern was that it should not lose its investment-grade bond rating.

- *Contingent payment by Diageo to General Mills*. At the closing, Diageo would establish an escrow fund of $642 million. Upon the first anniversary of the closing, Diageo was required to pay from this fund an amount to General Mills depending on General Mills' share price:
  - *$642 million*, if the average daily share price for 20 days were $42.55 or more.
  - *$0.45 million*, if the average daily share price were $38.00 or less. This price reflected the price at which General Mills was trading at the time the deal was negotiated.
  - *Variable amount,* if the average daily share price were between $38.00 and $42.55. Diageo would retain the amount by which $42.55 would exceed the average daily share price for 20 days, times the number of General Mills shares held by Diageo.

Some financial professionals called this a "claw-back" provision because it would reclaim some value for General Mills if its share price rose. Still other professionals referred to this as a "contingent value right" (CVR), a kind of collar that lived beyond the closing of the deal. CVRs were unusual corporate-finance devices that were used to give the seller confidence in the value of the buyer's shares.

Merrill Lynch estimated that the transaction costs for this deal would amount to $55 million.

Conclusion

In evaluating this proposal, analysts considered current capital-market conditions (see **Exhibit 2**). **Exhibit 3** presents a calculation of the historical share-price volatility of General Mills from the past year's weekly stock prices, ending December 8, 2000—this volatility was 0.248. Using the same method to estimate the *historical volatility* for the year ending July 17, 2000 (the date of announcement of the deal) yielded an estimate of 0.249. Analysts knew that it would be possible to estimate the *implied volatility* from traded options on General Mills' shares (prices on these options are given in **Exhibit 4**). **Exhibit 5** presents the volatilities and financial characteristics of General Mills' peer firms. Contingent payments of the sort used in this transaction were rare; **Exhibit 6** outlines some prominent transactions where they had been used previously, mainly in combinations of pharmaceutical firms.

Analysts wondered why the contingent payment was used in this deal, and why it would be attractive to either side. Most importantly, they puzzled over the implications of the contingent payment for the cost of the deal to General Mills' shareholders. Finally, they sought to determine whether the total deal was fairly priced from the standpoint of shareholders of General Mills. The financial advisers of General Mills presented valuation analyses of Pillsbury and General Mills as a foundation for an assessment of the deal terms (see **Exhibit 7** for a summary of the valuation analyses). Nevertheless, some securities analysts remained uncertain about the deal:

> The deal is dilutive … we are concerned with the company's expectations that the acquisition will be dilutive to earnings until fiscal 2004. GIS notes the deal will be accretive to EBITDA by fiscal 2002, suggesting the investment community focus on this metric. However, we prefer to monitor traditional earnings growth in order to track a company's progress.[2]

> The sizable jump in debt concerns us. After the merger is complete, GIS will have borrowings totaling more than $8.5 billion. To help manage the high leverage, the company will likely suspend any share repurchases, using the funds expected to be received [from asset sales] … to work down the large debt load.[3]

Ultimately, these analysts sought to make a recommendation about how General Mills' shareholders should vote on the proposed merger: for or against?

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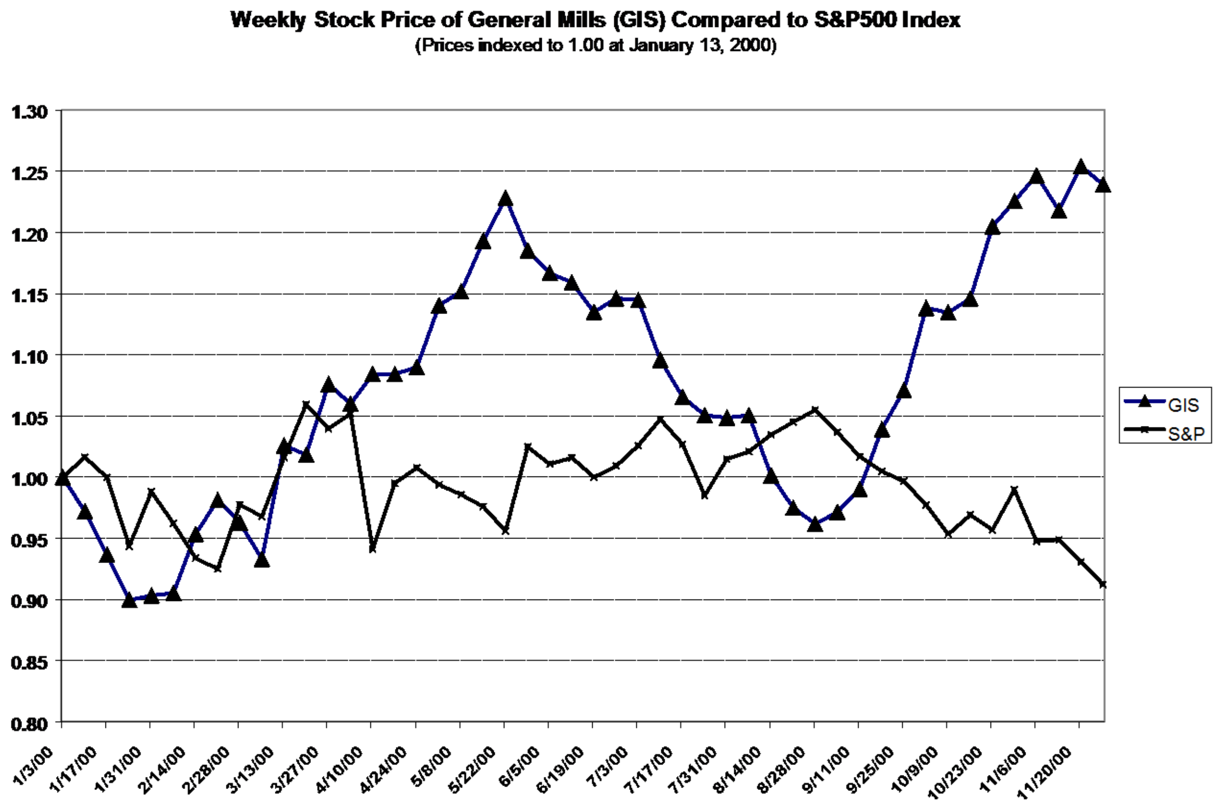
[2] *Value Line Investment Survey* (August 11, 2000): 1477.
[3] *Value Line Investment Survey* (November 10, 2000): 1476.

Exhibit 1

GENERAL MILLS' ACQUISITION OF PILLSBURY FROM DIAGEO PLC



Source of price data: Bloomberg Financial Services.

Exhibit 2

GENERAL MILLS' ACQUISITION OF PILLSBURY FROM DIAGEO PLC

Current Capital-Market Conditions at December 8, 2000

	December 8, 2000
Equity Market Indexes	
Dow Jones Industrial Average	10,373
S&P 500 Index	1,315
NASDAQ OTC Composite Index	2,645
Change in Equity Market Indexes over Last 12 Months	
Dow Jones Industrial Average	−5.6%
S&P 500 Index	−5.8%
NASDAQ OTC Composite Index	−21.1%
U.S. Treasury Yields	
Bills (90 days)	6.09%
Bonds	
1 year	5.22%
2 years	5.43%
5 years	5.32%
10 years	5.43%
20 years	5.74%
30 years	5.64%
Corporate Benchmark Rates	
Prime rate of lending	9.50%
LIBOR	6.45%

Sources of data: *Wall Street Journal* (December 8, 2000); *Value Line Investment Survey*.

Exhibit 3

GENERAL MILLS' ACQUISITION OF PILLSBURY FROM DIAGEO PLC

Estimation of General Mills Stock Price Volatility
across 53 Weeks, November 29, 1999 to November 27, 2000

Date	Weekly Closing Prices	Price Relative	Log of Price Relative	Squared Error of Price Relative
29-Nov-99	$36.56			
6-Dec-99	$33.55	0.918	-0.086	0.007731
13-Dec-99	$32.47	0.968	-0.033	0.001212
20-Dec-99	$32.65	1.006	0.006	0.000013
27-Dec-99	$34.45	1.055	0.054	0.002695
3-Jan-00	$32.67	0.948	-0.053	0.003028
10-Jan-00	$31.76	0.972	-0.028	0.000914
17-Jan-00	$30.61	0.964	-0.037	0.001518
24-Jan-00	$29.39	0.960	-0.040	0.001802
31-Jan-00	$29.51	1.004	0.004	0.000005
7-Feb-00	$29.58	1.002	0.002	0.000000
14-Feb-00	$31.15	1.053	0.052	0.002505
21-Feb-00	$32.07	1.029	0.029	0.000721
28-Feb-00	$31.46	0.981	-0.019	0.000444
6-Mar-00	$30.49	0.969	-0.031	0.001111
13-Mar-00	$33.52	1.100	0.095	0.008646
20-Mar-00	$33.28	0.993	-0.007	0.000085
27-Mar-00	$35.16	1.057	0.055	0.002816
3-Apr-00	$34.63	0.985	-0.015	0.000293
10-Apr-00	$35.43	1.023	0.023	0.000430
17-Apr-00	$35.43	1.000	0.000	0.000004
24-Apr-00	$35.61	1.005	0.005	0.000010
1-May-00	$37.27	1.046	0.045	0.001882
8-May-00	$37.63	1.010	0.010	0.000062
15-May-00	$38.98	1.036	0.035	0.001101
22-May-00	$40.14	1.030	0.029	0.000752
29-May-00	$38.73	0.965	-0.036	0.001418
5-Jun-00	$38.12	0.984	-0.016	0.000320
12-Jun-00	$37.88	0.994	-0.006	0.000071
19-Jun-00	$37.08	0.979	-0.021	0.000538
26-Jun-00	$37.45	1.010	0.010	0.000062
3-Jul-00	$37.41	0.999	-0.001	0.000009
10-Jul-00	$35.81	0.957	-0.044	0.002092
17-Jul-00	$34.82	0.972	-0.028	0.000893
24-Jul-00	$34.33	0.986	-0.014	0.000263
31-Jul-00	$34.27	0.998	-0.002	0.000014
7-Aug-00	$34.33	1.002	0.002	0.000000
14-Aug-00	$32.73	0.953	-0.048	0.002477
21-Aug-00	$31.86	0.974	-0.027	0.000823
28-Aug-00	$31.43	0.986	-0.014	0.000243
4-Sep-00	$31.74	1.010	0.010	0.000061
11-Sep-00	$32.36	1.019	0.019	0.000298
18-Sep-00	$33.96	1.050	0.048	0.002150
25-Sep-00	$35.01	1.031	0.030	0.000808
2-Oct-00	$37.20	1.063	0.061	0.003454
9-Oct-00	$37.07	0.997	-0.003	0.000028
16-Oct-00	$37.45	1.010	0.010	0.000065
23-Oct-00	$39.37	1.051	0.050	0.002320
30-Oct-00	$40.05	1.017	0.017	0.000232
6-Nov-00	$40.74	1.017	0.017	0.000223
13-Nov-00	$39.81	0.977	-0.023	0.000630
20-Nov-00	$40.99	1.030	0.029	0.000742
27-Nov-00	$40.49	0.988	-0.012	0.000200
Sum		52.132	0.102	0.060218
Average	35.0548	1.003	0.002	0.001158

Number of price relatives:	52
Number of stock prices:	53
Adjusted weekly variance:	0.001181
Annual variance:	0.061
Annual Standard Deviation or Sigma:	**0.248**

Source of data: Bloomberg Financial Services.

Comment: In this table, stock prices are converted into price relatives (which are simply the ratio of today's price to yesterday's price). Then the price relatives are transformed into logarithmic values (in order to normalize the distribution). In the right-most column, the squared deviations of the logarithmic values are computed from their mean value (0.002). The weekly variance is computed by dividing the sum of the right-most column (0.060218) by the number of price relatives (52) and then multiplying by a correction factor (52/51) to adjust for sampling bias. The annual variance is obtained by multiplying the weekly variance by 52. The standard deviation is the square root of annual variance. For a more detailed discussion of this estimation procedure, see J. Cox and M. Rubinstein, *Options Markets* (Englewood Cliffs, NJ: Prentice-Hall, 1985), 255–58.

Exhibit 4

GENERAL MILLS' ACQUISITION OF PILLSBURY FROM DIAGEO PLC

Prices of Call and Put Options on General Mills Shares

Option	Call	Put
July 19, 2000		
Stock Price = $35.00		
Expires July 22, 2000, Strike = $35	**$0.25**	**$0.375**
Expires October 21, 2000, Strike = $40	**$0.50**	**$5.375**
December 14, 2000		
Stock Price = $39.9375		
Expires January 20, 2001, Strike = $45	**$0.50**	**None traded**

Note: The 90-day T-bill yield at December 14 was 5.92%. In mid-July, the 90-day T-bill yield was 6.14%.

Source of data: *Wall Street Journal* (July 20, 2000, and December 15, 2000).

Exhibit 5

GENERAL MILLS' ACQUISITION OF PILLSBURY FROM DIAGEO PLC

Financial Data on Firms Comparable to General Mills

Company and Business	P/E	Previous Year's Food Sales ($bn)[1]	Previous Year's Sales ($bn)[1]	Beta	Exp. Sales Growth[2]	Exp. Earnings Growth[2]	Expected Dividend Yield (%)[2]	LT Debt-to-Equity Ratio	Total Debt-to-Equity Ratio	Sigma[3]
General Mills, Inc. Cereals, desserts, flour, baking mixes, dinner and side dishes, snacks, beverages, and yogurt products.	19.8	10.9	16.7	0.65	8.5%	11.5%	1.10	6.719	12.048	0.248
ConAgra Foods, Inc. Packaged foods (shelf-stable foods, frozen foods); Refrigerated foods; Agricultural products.	20.7	17.1	25.4	0.80	4.5%	12.5%	0.90	1.287	2.391	0.398
PepsiCo, Inc. Snack foods, beverages, and juice	30.6	7.9	20.4	0.85	5.5%	11.0%	0.56	0.383	0.399	0.287
Unilever Plc Foods, detergents, personal & home care products	N/A	7.2	43.6	0.75	1.5%	8.5%	0.76	0.160	0.326	0.425
Sara Lee Corporation Packaged meats, frozen-baked goods, coffee and tea, shoe care, body care, insecticides, air fresheners, intimates.	11.2	6.9	17.5	0.75	3.0%	8.5%	0.58	2.951	5.266	0.388

Exhibit 5 (continued)

H. J. Heinz Company Ketchup, condiments and sauces, frozen food, soups, beans and pasta meals, tuna and seafood products, infant food.	22.9	5.1	9.4	0.70	4.5%	9.0%	1.57	2.163	2.365	0.311
Campbell Soup Company Soup and sauces, biscuits and confectionery, and foodservice	19.7	4.8	6.3	0.80	3.0%	1.0%	0.90	9.050	23.850	0.375
Kellogg Company Cereals, cereal bars, toaster pastries, frozen waffles, bagels, and other products	18.8	4.4	7.0	0.70	5.5%	7.0%	1.10	0.699	2.164	0.365
Hershey Foods Corporation Chocolate and non-chocolate confectionery, pasta and grocery items	25.2	4.0	4.0	0.65	6.0%	9.0%	1.12	0.600	0.790	0.361
Quaker Oats Company Hot and cold cereals, pancake mixes and syrups, grain-based snacks, cornmeal, hominy grits, rice products, and pasta.	37.0	2.4	4.7	0.65	5.0%	11.5%	1.14	1.539	1.730	0.337

[1]Sales for fiscal year ending before July 17, 2000. PepsiCo's next earliest fiscal year ended in December 1999.
[2]Expected sales, earnings, and dividend yield for the five years from 2000 to 2005.
[3]Sigma (volatility) was estimated for the 54 weeks before and including July 17, 2000.

Source of data: *Value Line Investors Services* and case writer analysis.

Exhibit 6

GENERAL MILLS' ACQUISITION OF PILLSBURY FROM DIAGEO PLC

Terms of Other Contingent-Payment Schemes in M&A

Deal	**Eli Lilly and Company Buys 100% of Equity in Hybritech, Inc.**	**Rhône-Poulenc Acquires 68% of Equity in Rorer Group, Inc.**	**Dow Chemical Acquires 67% of Equity in Marion Laboratories**	**Roche Holding Ltd. Acquires 60% of Equity in Genentech**
Closing Date	February 1986	July 1990	July 1989	February 1990
Total Est. Payment (US$)	$412.8 million	$1,600 million	$5,700 million	$1,295 million
General Structure	One-stage exchange per each Hybritech share: (1) $22.00 cash or par value of 10-yr. conv. notes paying 6.75%. Conversion price $66.31 per share. (2) 1.4 warrants to buy Lilly common stock at $75.98 per share. (3) One contingent- payment unit (CPU) paying up to $22.00 in dividends over 10 years.	Three-stage transaction: (1) Cash tender offer for 50.1% of stock in Rorer. At $36.50 for 43.2 million shares, the initial cash outlay is $1,577 million. (2) RP transfers its worldwide HPB to Rorer. Rorer pays RP $20 million and assumes $265 million of RP debt. Rorer issues 48.4 million new common shares to RP. (3) RP issues 41.8 million CVRs (for terms of payment, see text of case).	Two-step transaction: (1) Dow acquires 38.9% of Marion through a cash tender offer at $38 per share. (2) Dow contributes its pharmaceutical subsidiary, Merrill- Dow, and 92 million CVRs in exchange for new Marion shares.	Two-step transaction: (1) Roche purchases a 20% interest in Genentech through the purchase of newly issued shares at $22 per share. (2) All non-Roche common shares are exchanged for $18 cash and 1/2 share of redeemable common stock. Following the transaction, public shareholders will own 40% of voting stock; Roche will own 60%.
Contingent Terms	Annual dividend of CPU equal to: [6% of sales + 20% of gross profits – ($11 million × (1.35^t))] divided by number of Hybritech shares. t = years since 1986. Sales and gross profits are for Hybritech.	CVR entitles holders to receive from RP the amount by which $98.26 a share exceeds either a $52.00 floor price or the average market value of Rorer's share price 60 days before the rights' maturity date of July 31, 1993. Maximum payout $46.26 per share. RP has the right to extend maturity of CVRs for an additional year to July 31, 1994. In that event, the ceiling rises from $98.26 to $106.12. Maximum payout increased to $54.12.	Similar to RP CVR: a put spread guarantees shareholder returns within a predetermined range of stock prices through 1992.	Redeemable common stock entitles Roche to redeem the shares at predetermined prices until June 1995. Thereafter, these shares will automatically convert into an equal number of regular common shares. Redemption price starts at $38.00 at closing and rises $1.25 per quarter to the maximum of $60 per share in April–June 1995.

Exhibit 7

GENERAL MILLS' ACQUISITION OF PILLSBURY FROM DIAGEO PLC

Valuation Estimates by General Mills' Financial Advisers

	Valuation Based on Comparable Firms	**Valuation Based on Comparable Transactions**	**Valuation Based on Discounted-Cash-Flow Analysis**
		Analysis of Pillsbury	
Analysis by Evercore Partners	LTM EBITDA: \$8.6–\$12.11 billion LTM EBIT: \$8.97–\$12.87 billion	LTM EBITDA: \$10.59 billion LTM EBIT: \$13.21 billion	Without synergies: \$8.4–\$10.5 billion With synergies: \$11.3–\$14.2 billion
Analysis by Merrill Lynch	\$8.598–\$10.78 billion based on LTM EBITDA and LTM EBIT	\$9.553–\$12.44 billion based on LTM EBITDA and LTM EBIT	Without synergies: \$9.184–\$11.204 billion With synergies: \$11.836–\$13.489 billion
		Analysis of General Mills	
Stock price at July 14, 2000		\$36.31/share	
Analysis by Evercore Partners	LTM EBITDA: \$34.60/share LTM EBIT: \$37.17/share LTM price/earnings: \$41.17/share	Comparable transactions are not an applicable basis for valuation of General Mills because the firm is not a target in this transaction.	\$34.69–\$42.15/share
Analysis by Merrill Lynch	\$31.75–\$42.25/share		\$38.50–\$46.75/share

Note: Evercore's analyses were expressed in terms of valuation multiples rather than dollar figures. To permit easier comparison with the Merrill Lynch figures and to simplify student analysis, the Evercore multiples were converted by the casewriter into dollar figures using several simplifying assumptions.

Source of information: General Mills Definitive Merger Proxy Statement and Prospectus, filed with the U.S. Securities and Exchange Commission (August 22, 2000).