Thursday, 20 January 2022

Unilever + GSK Consumer: A post mortem

1. Why publish a post mortem?

In life we hold a post mortem medical examination to establish the cause of death where there is concern or uncertainty about its cause.

Project post mortems are often a good practice in business. The goal is to look at the project to determine what went right and what can be improved so that we can do things differently and better in future.

It is in that spirit that we are publishing this note, albeit that it is about a near death experience as it now appears that Unilever's attempt to purchase the GSK Consumer business is now thankfully dead rather than the value of our investment in Unilever. We wanted to share what we and hopefully Unilever's board and management might learn from the episode.

2. Fundsmith's position

Fundsmith invested in Unilever at the former's inception in 2010.

So how has our Unilever investment fared?

Value as at 19 January 2022	
£100 invested on 1 November 2010	
Fundsmith Equity Fund	£609
Procter & Gamble	£419
Nestlé	£392
MSCI World Index	£369
Unilever	£299

Source: Bloomberg, performance data to 19 January 2022

Unilever's performance has been poor. It is the worst performer by a considerable margin amongst the multinational FMCG companies we have owned and not just in terms of share price but also in terms of sales growth.

The company would have us ignore this long term underwhelming performance and talks about sales growth for the nine months ended September 2021 being their fastest for eight years. The irony is that food and refreshment, the business they planned to sell if they were to buy GSK Consumer, outperformed the rest of the business, the one they wanted to materially expand, 2 to 1.

Apart from observing that one swallow doesn't make a summer and a few quarters of growth do not amount to a satisfactory track record, we would also suggest that Unilever shouldn't seek long term shareholders if it doesn't want them to judge its long term performance.

3. Communications

Against the background of this miserable performance the company did not even attempt to contact us for the first eight years we were shareholders. We have always assumed that one job of the investor relations team was to keep in touch with the largest shareholders and especially one with the characteristics of Fundsmith – a long term investor who has never sold a share. It wasn't as if the investor relations team didn't know about us. They managed to make contact easily enough when they were struggling with the attempted move to Holland. It is never a good start if the first time you hear from someone it's because they need a favour.

We are now Unilever's 13th (unlucky?) largest shareholder according to Bloomberg or 7th if you exclude the index funds and Leverhulme Trust, so we are the 7th largest active fund management shareholder.

Maybe it's now more difficult to ignore us but to be fair communications have improved markedly post the Polman regime and we were consulted on the GSK approach.

4. The Kraft Heinz bid approach

However, we still get the sense that whilst Unilever wishes to have long term shareholders, it is not keen to be judged by events over the long term or to look back at past actions and learn from them.

Five years ago Kraft Heinz bid $50 (£36.50) per share for Unilever. Whilst we have never been Kraft Heinz shareholders and are not fans of their business model, Unilever surely needs to address the fact that five years later the share price is only at the level of that bid. The annualised return on the MSCI World Index over the same period is 12.5%. Why then should we trust this management and board with preserving value for shareholders? This seems to have been largely forgotten and when it is raised we are told that we would have fared worse with Kraft Heinz. We will never know but what is a fact is that we did not get the chance to choose.

The Kraft Heinz bid raised legitimate questions about the operational capability at Unilever which were never addressed publicly because Paul Polman's crusade saw off the bid without any discussion of the fundamentals or any analysis. Why bother asking the shareholders what they want?

There was much talk of 20% operating margins and other targets in response to the Kraft Heinz bid. We are not fans of such targets which are produced like a rabbit out of a hat in response to a bid – if you think you can achieve 20% operating margins why aren't you doing so anyway or at least disclosing that as an aim? Unilever's current operating margins? 16%. We did not ask for 20% operating margins nor do we require them but we dislike it when spurious targets are produced like a magician to thwart a bid and then conveniently forgotten.

5. The GSK Consumer bid

We saw no overt discussion of these two vital points in Unilever's announcement about GSK Consumer:

1. GSK Consumer made £2.2bn of EBIT in 2020. We have yet to see the 2021 results but assume about £2.5bn of EBIT. So Unilever's offer of £50 billion implies a ROCE of just 5% so they needed to improve the performance of the business significantly to make a return anywhere near Unilever's cost of capital without which this acquisition would have destroyed value.
2. Investors should soon be able to buy GSK Consumer in an IPO. For Unilever to buy it will involve paying a control premium to the expected IPO valuation. So we could either own GSK Consumer stand alone at the IPO valuation or through Unilever at a high valuation. What will Unilever do to the GSK business to raise its returns to make this premium justifiable?

Surely Unilever should have explicitly addressed those points before asking to be allowed to proceed with a bid. Instead we were faced with a statement that the bid worked based on financial metrics including the all-important return on capital. However, getting management to discuss what that number was, was like a dentist pulling a back tooth. This was all the more puzzling given that GSK is a listed company and the profits and cash flow of the Consumer division can be established from its segmental reporting. So investor communications may have become more frequent under the current executive team but there is still some way to go on openness in our view.

There were some other items which it would have been good to see addressed.

If Unilever was to improve the performance of the GSK business which it simply had to in order to justify the price to be paid this can presumably only have come from one or both of two sources: raising profit margins and/or accelerating revenue growth.

Reckitt Benckiser's OTC Health business which is similar to GSK's had margins of 21.8% in 3Q21 whereas GSK's are 25.9%. There does not appear to be much scope for improvement in the profitability of the GSK business.

As for growth, the consumer healthcare category has not produced good growth based on our experience of Reckitt Benckiser (RB) and Johnson & Johnson (J&J).

Here's the last three years' growth (prior to the pandemic) for these divisions of RB and J&J.

Like for like sales increase (%)	2017	2018	2019
RB Health ex-infant nutrition	0.0	2.0	-2.9
J&J Consumer	-0.5	3.2	1.4

Source: Fundsmith research, period ending 31 December

Barclays estimates that the global OTC market is growing at just 2-3% annually which would seem to accord with the RB and J&J numbers. Unilever would need to outperform this growth if it is to deliver satisfactory returns from the GSK acquisition.

Some other questions raised by Unilever's announcement:

- How much of Unilever's existing business is in health care? Why do they describe consumer healthcare as 'highly complementary'?
- Where Unilever does have some experience of recent acquisitions in adjacent areas the outcome is not encouraging. Dollar Shave Club was acquired allegedly for $1bn in 2016. Little has been heard since and not because it has gone embarrassingly well. Back to the point about being open in communications. Perhaps it would be useful for Unilever to let us have some insight into its own post mortem on this acquisition so that we can judge what should be learnt from it. At the moment far from there being a public post mortem it is buried in an unmarked grave.
- What do Unilever mean by 'beauty' in which they wish to expand? We have read several supermodels saying their daily 'beauty' routine is washing their face with soap and water, which means Dove could certainly claim to be a beauty brand, but it's not beauty in the way that L'Oréal or Chanel or Estée Lauder would understand it. Where are Unilever's aspirations within this spectrum? If the former, fine. If the latter, P&G started assembling a bunch of 'beauty' brands by acquisition, and eventually decided the beauty business wasn't for them and sold them off to Coty – whose experience incidentally also suggests it's tough to build a beauty business by acquisition. P&G might have discovered that running a business with 75% gross margins and "only" 18% operating margins and NOT seeing this as a good opportunity to increase operating margins was tough to fit into P&G's or any FMCG business' corporate ethos. This is the reason why the world's major true 'beauty' companies have one thing in common, namely they are all either actually or effectively family controlled, and a family which understands that if you try and even tinker with this margin structure, you'll destroy the whole thing.
- How radical were Unilever's plans? The release on GSK did not mention much about the food brands but we understand that some of the food brands, would be and maybe still are for sale as they are slower growing than healthcare. Certainly if Unilever was to return gearing to pre-GSK levels in the 'short to medium term' as per the release, they were going to have to make some major disposals. The fact that the release suggests this could happen 'in the short term' suggests that the GSK deal would have put them under self-imposed timescale pressure which is far from ideal when possibly selling some of your largest brands. Large friendly acquisitions rarely deliver value for shareholders. Unilever is hinting at not one but several – 'major acquisition**s**' [our emphasis].

6. Consumer bids in general

Bloomberg Intelligence noted that: since Kraft bought Heinz in July 2015, its shares are down 48%; since ABI bought SAB Miller in October 2016 its shares are down 49%; since Reckitts bought Mead Johnson in June 2017 its shares are down 21% ; and since Danone bought WhiteWave in April 2017, its shares are down 10%. Bloomberg refers to 'the curse of the consumer deal'.

We think that maybe any consumer companies trying to convince us that they should make a major acquisition should begin by telling us why "it's different this time" (acknowledgment to the late Sir John Templeton).

As an old saying goes, the race may not always be to the swift nor the battle to the strong, but it's the way to bet.

7. Repeating corporate gobbledegook is not a solution

Unilever's penchant for corporate gobbledegook as a substitute for effective action began before Kraft Heinz. In 2015 when then CEO Polman was discussing a new business unit – 'The new unit, baking, cooking and spreading, was set up and will inevitably provide much more focus... We will continue to strengthen the foundations of Unilever, building resilience and **agility** [our emphasis] ...'

When approached by Kraft Heinz, the Unilever CFO (Mr Pitkethly, the same one then and now), presenting at the Consumer Analysts Group of New York ("CAGNY") days later, commented on the presentation that he had had to rewrite it on the plane over to New York. So despite railing against how evil Kraft Heinz were, Unilever did NOT decide that its strategy and execution was the right way to go but rather that Kraft Heinz had a point and reacted to it. The result was a presentation and a press release that was shamelessly dressed up as merely accelerating what he was going to do anyway, and which has not happened.

In February 2017 at CAGNY, the CFO said 'And we also have the **agility** in our supply-chain and our distribution to respond rapidly to a changing environment, as was demonstrated just a few months ago in India… Over the last few years, we've taken a number of steps to make Unilever a stronger company, better able to deliver the growth model that we just described. The first thing we did was to restore growth and profitability. We did that by bringing a sharper focus on our consumers.' What eyewash.

Five years later, here we are again with the announcement along with the GSK bid that 'Later this month we will announce a major initiative to enhance our performance. After a comprehensive review of our organisation structure, we intend to move away from our existing matrix to an operating model that will drive **greater agility**, improve category focus, and strengthen accountability.'

In April 2019 Alan Jope said 'The third is geographically to make sure that we keep our emerging markets in momentum and take advantage of our strong footprint there. If we can do all of that and keep working on our **speed, agility** and nimbleness,' Mr Jope's contribution seems to be limited to adding nimbleness as a synonym for agility.

It seems to us that Unilever management's response to its poor performance has been to utter meaningless platitudes to which it has now attempted to add major M&A activity. What could possibly go wrong?

5. In conclusion

We are pleased that the Unilever management listened and has seemingly ended the attempt to acquire GSK Consumer by refusing to up its bid for a fourth time.

GSK Consumer will now face its own test when it is spun off into an IPO, its parent having dismissed the £50bn bid as under-valuing it. See our earlier reference to the Kraft Heinz bid for Unilever for details. It is a starting point from which its future performance should be judged.

The Unilever management seems to be playing what Warren Buffett lampoons as 'gin rummy' management - like a player in the eponymous card game, throwing away their least promising card(s) each round in the hope they will turn over better ones. They should maybe consider whether the problem may not be with the hand/business but with the player/management.

They have already sold the spreads and tea businesses. They have been pursuing a £50 billion acquisition and we could have expected further disposals and further major acquisitions if they had acquired GSK Consumer, taking them out of familiar businesses and into a new area where they have very limited expertise (beauty, oral care and OTC health).

We believe the Unilever management – or someone else if they don't want the job – should surely focus on getting the operating performance of the existing business to the level it should be before taking on any more challenges.

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