Case Study :: Kellogg Company

Attempting to Unlock Shareholder Wealth in a Mature Business

August 2024

Timeline of key events

1906 - William Keith Kellogg founded the Battle Creek Toasted Corn Flake Company, later to become the Kellogg Company

1952 – Kellogg's initial public offering

1964 – Kellogg's gives the world the Pop Tart

2001 – Kellogg's acquired the Keebler Company

2012 – Kellogg's acquired the Pringles product line from Procter & Gamble

June 2022 – Kellogg's announces a proposed transaction by which it will separate into three separate businesses: a global snack food company, a North America cereal business, and a company focused on plant-based foods

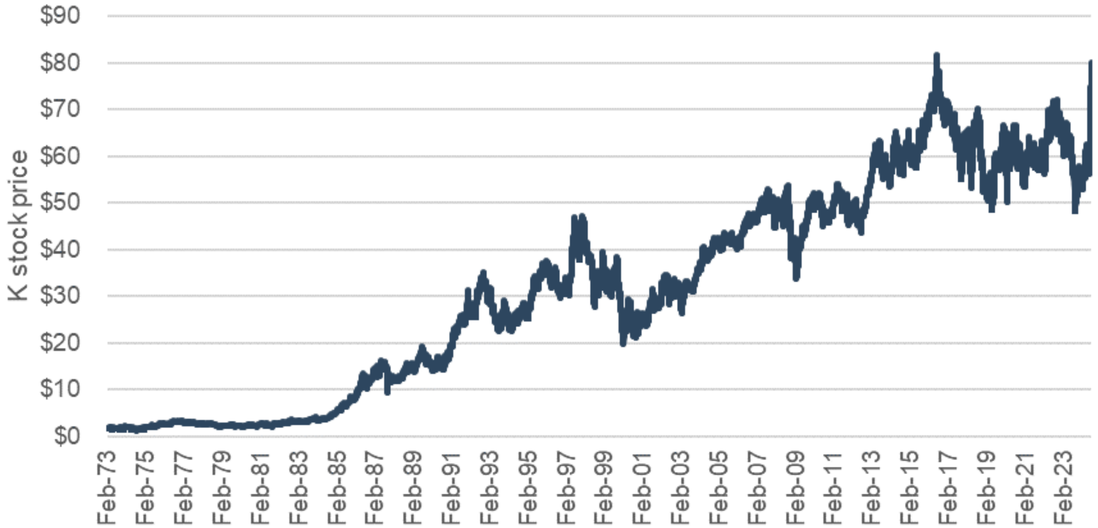
October 2023 – Through a tax-free dividend, Kellogg's shareholders receive one share of the newly-formed WK Kellogg company (ticker: KLG) for every four shares of Kellogg's owned. The remaining snack and plant-based food company is renamed Kellanova and continues to trade under the ticker "K"

August 4, 2023 – The Wall Street Journal reports that private candy company Mars was in advanced talks to acquire Kellanova for $30 billion

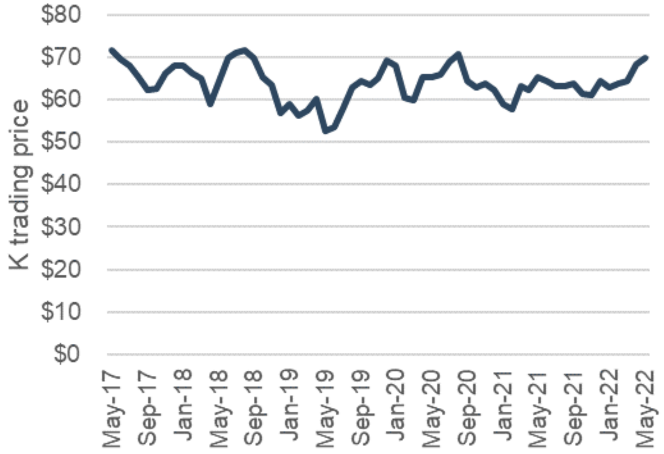
August 14, 2023 – Mars announces a $36 billion acquisition of Kellanova ($83.50 per share, 16.4x adjusted LTM EBITDA)

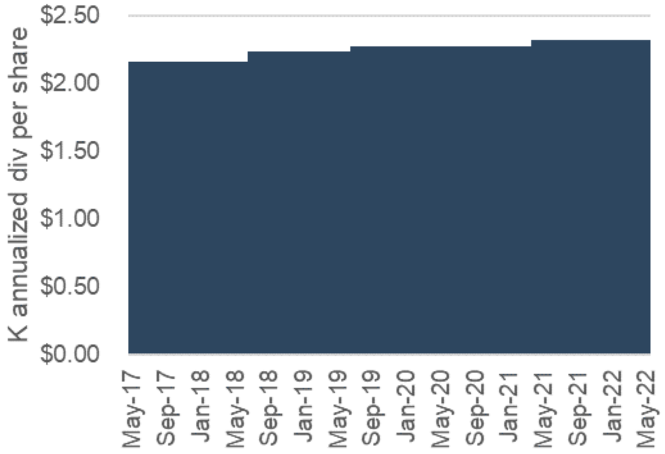
Takeaways for family business directors

- **Momentum is essential, even for mature companies**
- **Different assets appeal to different investors**
- **Strategy is always provisional**
- **Focus is appealing**
- **Cash flow, risk & growth are what ultimately matter**



Five years ending June 2022 :: Flat fundamentals and anemic shareholder returns





	FY2021	FY2020	FY2019	FY2018	FY2017	CAGR FY17-21
Net sales	$14,181	$13,770	$13,578	$13,547	$12,923	1.9%
less: Cost of goods sold	9,584	9,030	9,145	8,722	7,718	4.4%
Gross profit	$4,597	$4,740	$4,433	$4,825	$5,205	-2.5%
less: Selling, general & admin	2,575	2,885	2,747	2,936	2,774	-1.5%
Operating profit	$2,022	$1,855	$1,686	$1,889	$2,431	-3.6%
less: Interest expense	(223)	(281)	(284)	(287)	(256)	nm
plus/less: Other items, net	170	13	(104)	(77)	(494)	nm
Pre-tax income - Continuing ops	$1,969	$1,587	$1,298	$1,525	$1,681	3.2%
less: Income taxes	474	323	321	181	412	2.8%
plus: Earnings from unconsolidated entite	0	0	0	0	0	nm
Net income - Continuing ops	$1,495	$1,264	$977	$1,344	$1,269	3.3%
less: Net income attributable to NCI	(7)	(13)	(17)	(8)	0	nm
plus: Income from disc ops, net of tax	0	0	0	0	0	nm
Net income attributable to Kellogg Company	$1,488	$1,251	$960	$1,336	$1,269	3.2%
EBITDA	**$2,492**	**$2,320**	**$2,163**	**$2,601**	**$2,919**	**-3.1%**

Performance Measures :: May 2017 through May 2022

Ticker	Company	Annualized Shareholder Return	Annualized Dividend Growth
HSY	The Hershey Company	15.5%	7.8%
MKC	McCormick & Company, Inc.	14.0%	9.5%
TSN	Tyson Foods, Inc.	11.7%	15.4%
HRL	Hormel Foods Corporation	9.9%	8.9%
MDLZ	Mondelez International, Inc.	8.7%	13.0%
GIS	General Mills, Inc.	8.1%	1.2%
K	**Kellogg Company**	**3.1%**	**1.4%**
SJM	The J.M. Smucker Company	2.6%	5.7%
CAG	Conagra Brands, Inc.	-0.3%	9.3%
CPS	Campbell Soup Company	-0.5%	1.1%
KHC	The Kraft Heinz Company	-12.4%	-7.8%

- Following acquisition-aided sales growth of 4.8% in 2017, sales at Kellogg were essentially flat through 2021 with sagging EBITDA margins.
- Despite modest (1.4% annualized) growth in dividends per share over the period, Kellogg’s share price traded in a range of $50 to $70 per share with no sustained momentum.
- Dividend yield (~3%) was the sole source of shareholder return over the five years ending May 2022.

Source: S&P Capital IQ

June 2022 :: Breakup announcement

- On June 21, 2022, Kellogg announced a plan to break the company into three standalone entities:
    - Global Snacking Co.
    - North America Cereal Co.
    - Plant Co.

- Kellogg offered the following strategic rationales for the split:
    - Sharper management focus on distinct strategic priorities
    - Enhance operational agility
    - Prioritization of resources
    - Optimal capital allocation
    - Improved long-term outlook for profitable growth
    - Distinctive corporate cultures and career paths

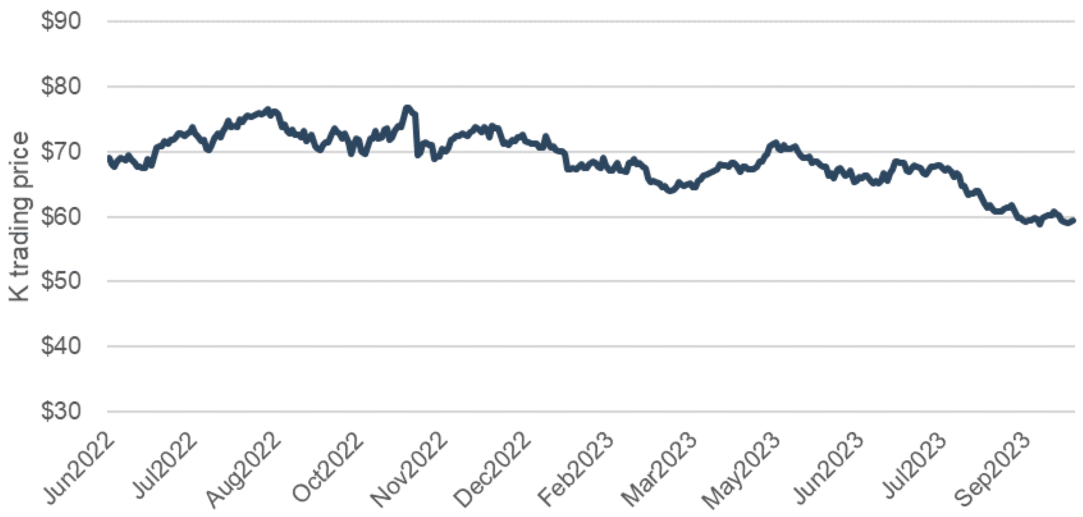
Global Snacking Co.
Higher-growth company
Net sales: ~$11.4 billion
EBITDA: ~$2.0 billion (~17.5% margin)

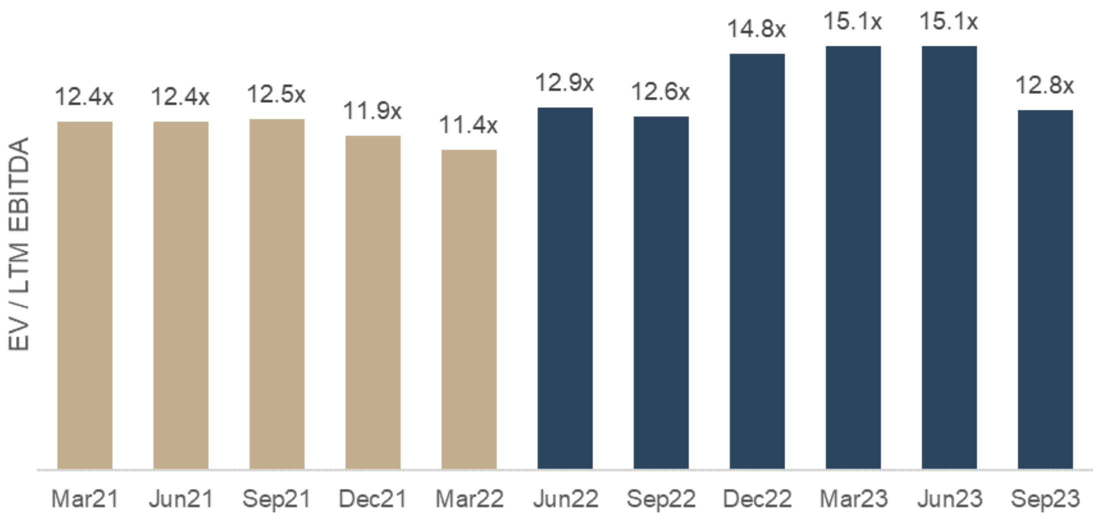
	Retail Sales Growth 2-Year CAGR, 2019-2021
Pringles	+13%
Cheez-It	+9%
Pop-Tarts	+4%
Rice Krispies Treats	+9%
Eggo	+6%

North America Cereal Co.
Improve profit margins
Net sales: ~$2.4 billion
EBITDA: ~$250 million (~10.4% margin)

Plant Co.
Accelerate growth
Net sales: ~$340 million
EBITDA: ~$50 million (~14.7% margin)

June 2022 to September 2023 :: Market views on value



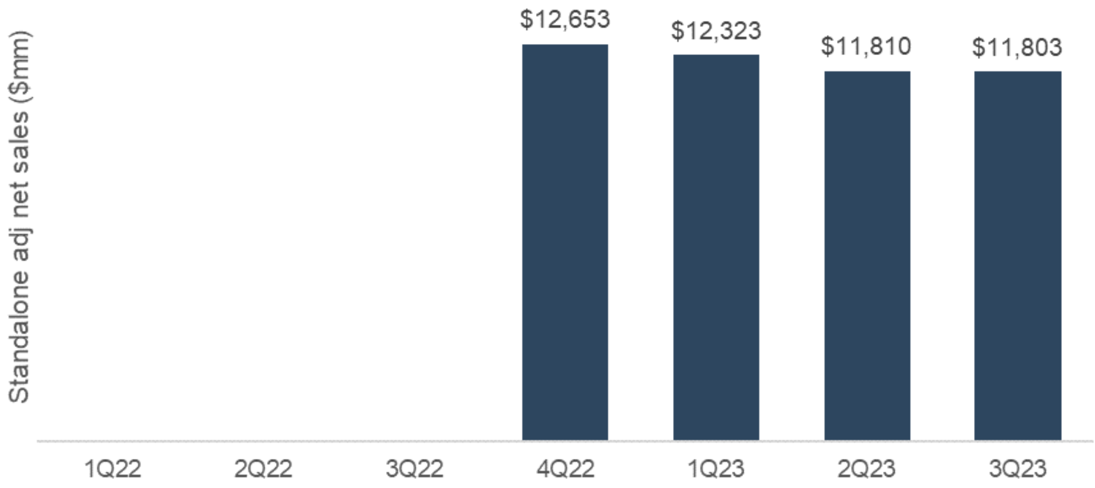


Pre-Announcement (Mar 31, 2022)		Post-Announcement (Jun 30, 2022)	
EBITDA	$2,552	EBITDA	$2,461
less: D&A	(474)	less: D&A	(473)
EBIT	$2,078	EBIT	$1,988
less: Pro forma taxes	24%	less: Pro forma taxes	24%
After-tax cash flow	$1,579	After-tax cash flow	$1,511
Stock price	$64.49	Stock price	$71.34
Enterprise value	$29,214	Enterprise value	$31,636
EV / EBITDA	11.4x	EV / EBITDA	12.9x
Capitalization rate	5.4%	Capitalization rate	4.8%
Expected growth	**1.5%**	**Expected growth**	**3.2%**
Implied WACC	6.9%	Implied WACC	8.0%

- Investors were generally receptive to the breakup plan, with Kellogg posting a 10.6% increase in share price during 2Q22, compared to median change of -2.2% for the companies in the peer group.
- EBITDA multiples are a function of capital intensity (the relationship between depreciation and EBITDA), the cost of capital, and expected growth in cash flow. At March 31, 2022, Kellogg traded at an EBITDA multiple of 11.4x, consistent with anticipated cash flow growth of 1.5% annually and an implied WACC of 6.9%.
- At June 30, 2022, Kellogg's EBITDA multiple had expanded to 12.9x. Against a backdrop of Fed tightening during the quarter, the cost of capital likely increased 100-125 bps. The increase in Kellogg's EBITDA multiple is consistent with a favorable assessment from investors that the announced breakup would help unlock faster cash flow growth.
- As revenue and EBITDA slumped in 2Q23 and 3Q23, investor enthusiasm waned, pulling the share price to ~$60 (12.8x), below the pre-announcement level.

June 2022 to September 2023 :: Performance of pro forma companies

Kellanova (Global snacking + Plant-based)

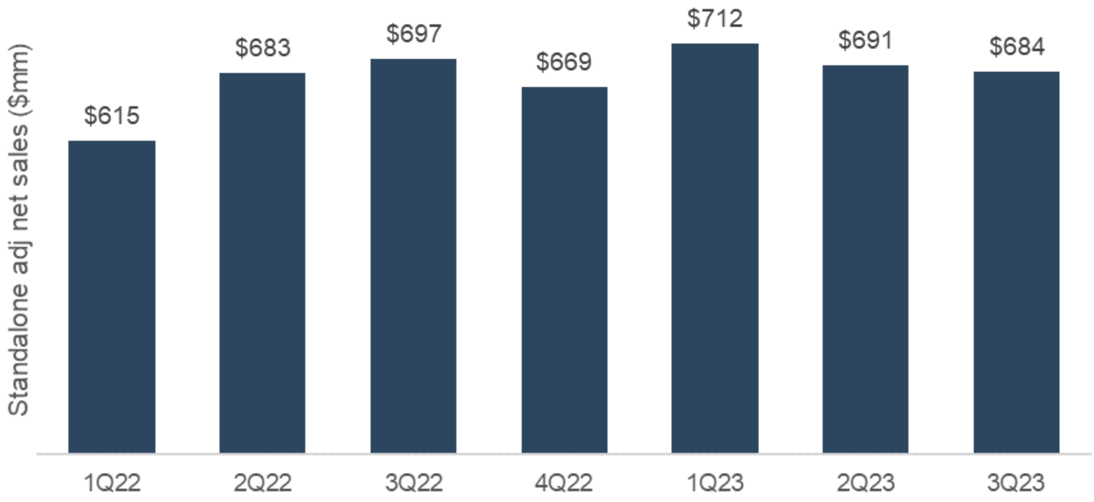


Restated standalone results (FY23)

Net sales: $13,122

EBITDA: $2,037

WK Kellogg Co (North America Cereal)



Management financial guidance (FY23)

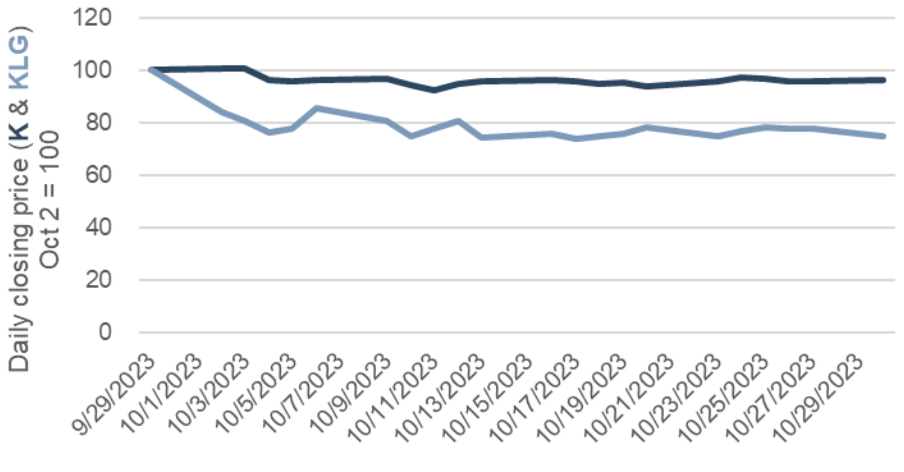
Net sales: $2,720-$2,740

EBITDA: $248-$252

- On a pro forma stand-alone basis, performance of both companies was flat to down in the quarters leading up to the October 2023 spinoff dividend distribution.
- The proposed “Plant Co.” described in the June 2022 breakup announcement ultimately remained in Kellanova.
- Full year 2023 revenue and EBITDA for the two companies was broadly consistent with figures from June 2022 investor presentation.

October 2023 :: Distribution day & relative valuation

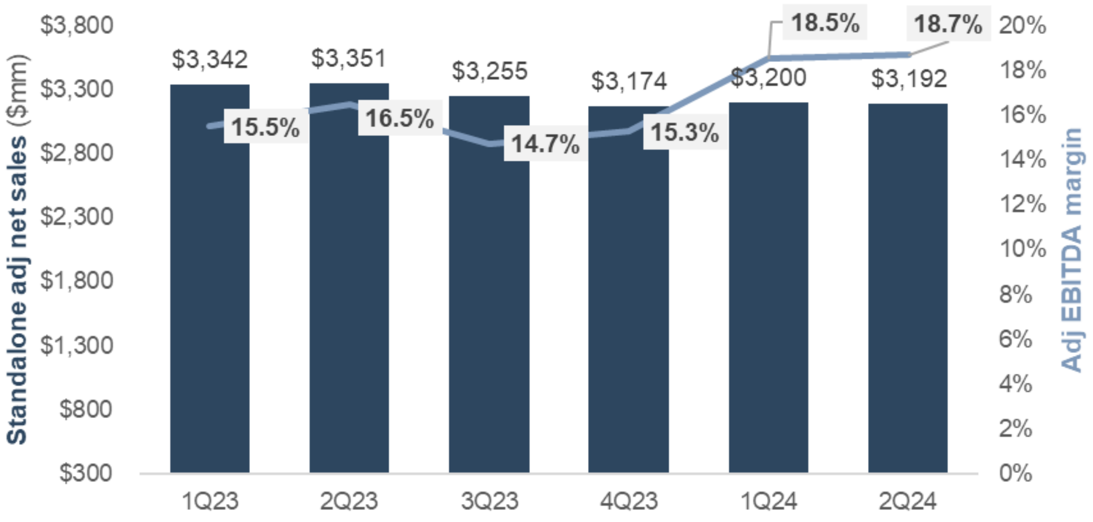
- On October 2, 2023, each Kellogg shareholder received (on a tax-free basis) one share of newly-formed WK Kellogg (ticker: KLG) for every four shares of Kellogg owned. Kellogg shares subsequently began trading under the name "Kellanova" (ticker: K).
- From the post-dividend trading price of $52.50 per share on October 2, 2023, shares of K trended down, closing the month of October at $50.47.
- After closing at $13.35 per share on the first day of trading, shares of slipped to $10.02 by the end of October.
- On October 31, the trading prices imply EBITDA multiples of 11.3x for K and 5.6x for KLG.

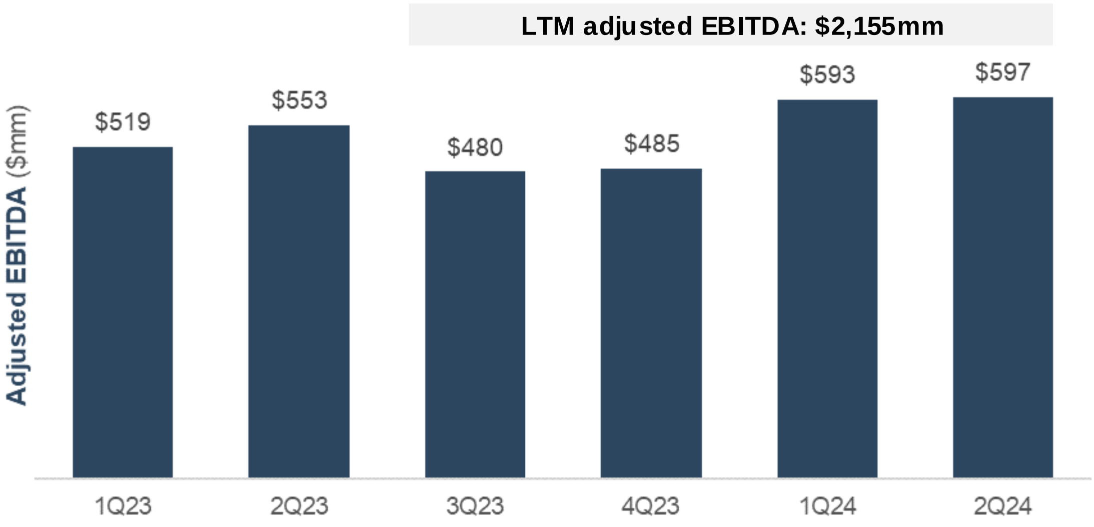


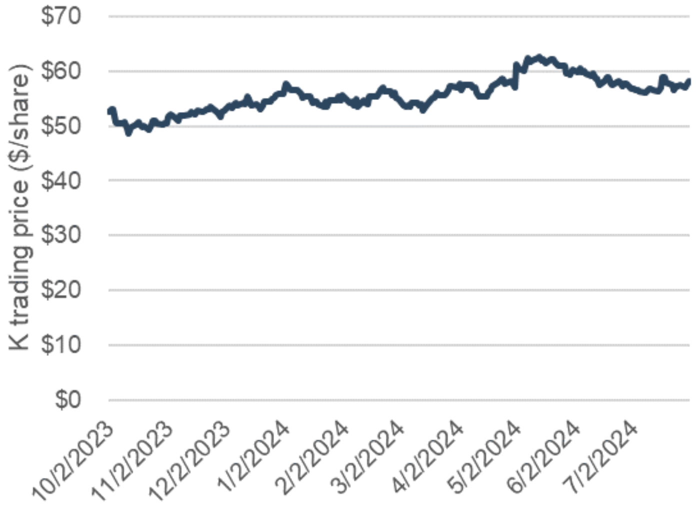
	October 31, 2023		
	K Kellanova	KLG WK Kellogg	Comments
Stock price	$50.47	$10.02	
times: Shares outstanding	343.0	85.6	
Market capitalization	$17,311	$858	
plus: Interest-bearing debt	5,873	659	*Post-split balance sheet figures from*
plus: Noncontrolling interest	194	0	*12/31/23 balance sheet (K) and investor*
less: Cash & equivalents	(274)	(108)	*slide deck (KLG)*
Enterprise value	**$23,104**	**$1,409**	
Pro forma FY23 EBITDA	$2,037	$250	*Pro forma EBITDA figures from K and KLG*
less: D&A	(419)	(66)	*investor slide decks*
EBIT	$1,618	$184	
less: Pro forma taxes	24%	24%	
After-tax cash flow	$1,230	$140	
EV / EBITDA	**11.3x**	**5.6x**	*Reflect perceived risk & growth differentials*
Capitalization rate	5.3%	9.9%	*Implied cap rate components based on*
Expected growth	**2.7%**	**0.0%**	*prior estimate of WACC for K and assumed*
Implied WACC	**8.0%**	**9.9%**	*0% growth profile for KLG*

- Post-split relative pricing measures suggest that investors were assigning much lower growth expectations to KLG relative to K.
- Post-split, KLG is much smaller (revenue, earnings & market cap) than K. Relative size is often a proxy for risk. EBITDA multiples suggest that investors were assigning a higher expected return to KLG than to K following the split.

October 2023 and beyond :: Post-split performance for Kellanova (K)



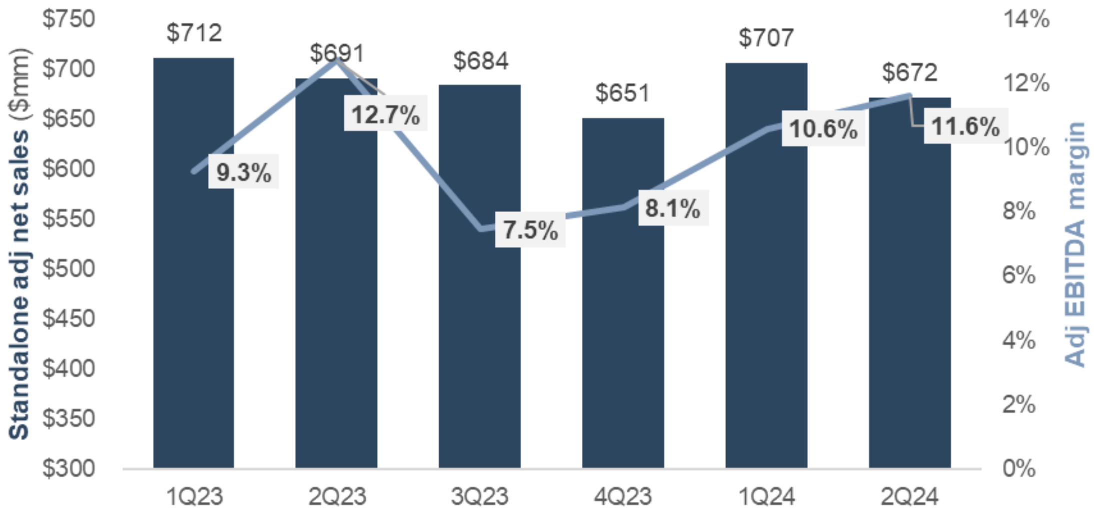


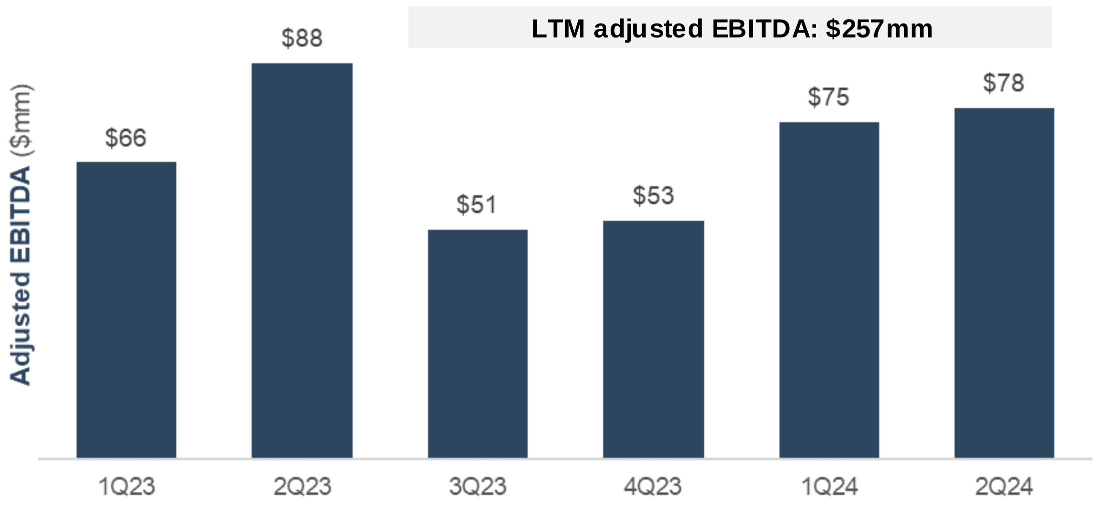


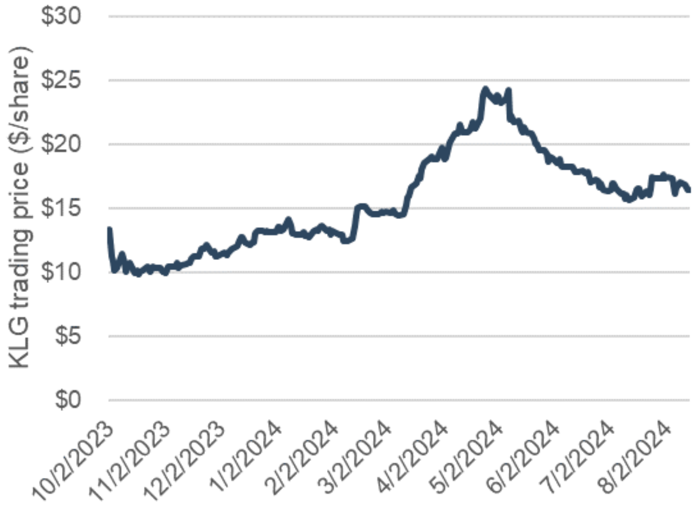
	10/31/2023	7/31/2024
EBITDA	$2,037	$2,195
less: D&A	(419)	(374)
EBIT	$1,618	$1,821
less: Pro forma taxes	24%	24%
After-tax cash flow	$1,230	$1,384
Enterprise value	$23,104	$25,656
EV / EBITDA	**11.3x**	**11.7x**
Capitalization rate	5.3%	5.4%
Expected growth	**2.7%**	**2.6%**
Implied WACC	**8.0%**	**8.0%**

- While revenue growth has yet to materialize for Kellanova, the company has delivered higher earnings on improved EBITDA margin (18.7% in 2Q24, compared to 16.5% in 2Q23).
- Following the initial tepid response to the spin-off from investors, the K share price increased from $50.47 at October 31, 2023 to $58.15 at July 31, 2024 (a 15% advance).
- The increasing share price for K is generally in line with improved earnings from margin enhancement, suggesting that investor expectations regarding growth and risk did not change materially.

October 2023 and beyond :: Post-split performance for WK Kellogg (KLG)





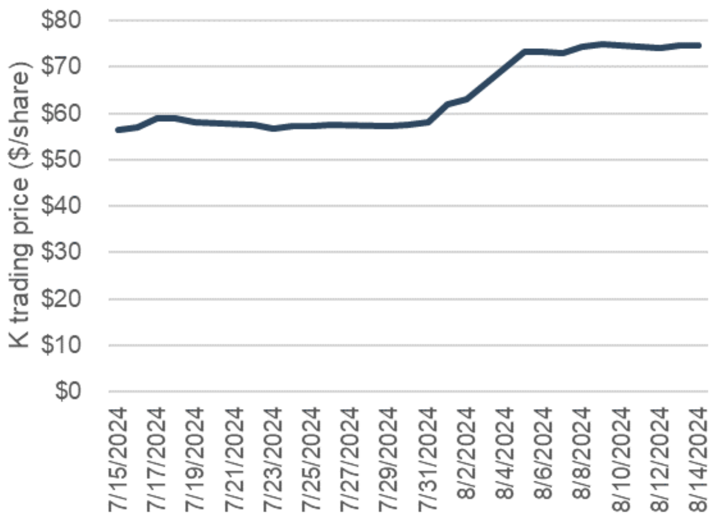


	10/31/2023	4/25/2024	8/12/2024
EBITDA	$250	$267	$257
less: D&A	(66)	(76)	(78)
EBIT	$184	$191	$179
less: Pro forma taxes	24%	24%	24%
After-tax cash flow	$140	$145	$136
Enterprise value	$1,409	$2,508	$1,886
EV / EBITDA	**5.6x**	**9.4x**	**7.3x**
Capitalization rate	9.9%	5.8%	7.2%
Expected growth	**0.0%**	**3.2%**	**1.8%**
Implied WACC	**9.9%**	**9.0%**	**9.0%**

- Revenue growth for KLG continues to prove elusive, with net sales in 2Q24 coming in 1.8% lower than 2Q23.
- EBITDA margin was also under pressure on a y/y basis (11.6% for 2Q24 compared to 12.7% for 2Q23).
- After a sluggish introduction to the market, investors began to warm to KLG shares in the first half of 2024, with the share price peaking north of $24 in April (9.4x LTM EBITDA) before retreating to ~$16 in mid-August.
- The increasing share price for KLG likely reflects some combination of reduced investor sensitivity to the risks facing the company and enhanced conviction regarding the likelihood of sustained growth in earnings.
- KLG continues to trade at a discounted valuation relative to K.

August 2024 :: Strategic acquirer steps up for Kellanova

- In early August 2024, reports began to emerge that privately-held Mars, Inc. was in advanced talks to acquire Kellanova at an enterprise value of ~$30 billion (~14x trailing EBITDA).
- The deal was announced on August 14 for $36 billion ($83.50 per share, 16.4x EBITDA)
- Strategic acquirers pay premium prices for targets for one (or a combination of) three reasons:
  - Through cost-saving initiatives, they expect to improve profitability of the target (**cash flow**)
  - Through combination with existing businesses, they expect accelerated revenue **growth**
  - They perceive less **risk** and/or are willing to accept a lower return



Isolated contributors to acquisition premium

Enhanced cash flows

17.1% Trailing EBITDA margin → **22.8%** Pro forma EBITDA margin

Enhanced growth

2.6% Standalone expected cash flow growth → **4.2%** Pro forma expected cash flow growth

Reduced risk

8.0% Standalone implied WACC → **6.5%** Pro forma implied WACC

Hypothetical combination of contributing factors

	7/31/2024	Potential Deal
Revenue	$12,821	$12,821
times: Margin	17.1%	**19.1%**
EBITDA	$2,195	$2,449
less: D&A	(374)	(374)
EBIT	$1,821	$2,075
less: Pro forma taxes	24%	24%
After-tax cash flow	$1,384	$1,577
Enterprise value	$25,656	$36,000
EV / Trailing EBITDA	**11.7x**	**16.4x**
Capitalization rate	5.4%	4.4%
Expected growth	2.6%	**3.4%**
Implied WACC	8.0%	**7.8%**

Takeaways for family business directors

Momentum is essential, even for mature companies. As our colleague Chris Mercer is fond of saying, if you have momentum, you need to do everything you can to keep it, and if you don't have momentum, you need to do everything you can to get it. Even if yours is a decades-old family business operating in a mature industry, momentum is critical. In the early 2020's, Kellogg Company had no momentum, and investors lost interest in the stock. The breakup plan was Kellogg's strategy for regaining momentum.

Different assets appeal to different investors. Corporate divestitures, like the Kellogg breakup, are predicated on the belief that some assets are better owned by others. Each asset on your family's balance sheet presents a unique blend of return and risk attributes. Do your family shareholders own the assets that best "fit" their needs and preferences?

Strategy is always provisional. When the breakup was announced in June 2022, the snack business (Kellanova) was pitched as having growth potential, while the cereal business (WK Kellogg) was supposed to be a margin enhancement play. To date, however, the margin enhancement has occurred in the snack business.

Focus is appealing. There's no way to know if Mars would have sought to acquire the old Kellogg Company, but the breakup transaction demonstrated a commitment on the part of Kellanova to focus on one thing: the worldwide snack market. What is your family business's "one thing"?

Cash flow, risk & growth are what ultimately matter. If the Mars transaction ultimately closes, it will put a nice bow on the story for Kellanova investors. However, there's a case to be made that the breakup didn't really create value. WK Kellogg commanded a lower multiple in the market than the Kellogg Company did, and Kellanova didn't get a premium valuation (until Mars came along). Sustainable value generally doesn't come from financial engineering. Instead, shareholder returns are strong when cash flows grow and risk decreases.

Additional reading / sources:

- READ — Microsoft PowerPoint - Kellogg Portfolio Transition Announcement Webcast Slides.pptx
- READ — Microsoft PowerPoint - Q2 2024 Webcast Slides
- READ — WK-Kellogg-Co-Q2-2024 Earnings-Final.pdf
- READ — Exclusive | Mars Near $30 Billion Deal for Cheez-It and Eggo Maker Kellanova
- READ — Mars in Advanced Talks to Buy Cheez-It, Eggo Maker Kellanova
- READ — Big Food Would Benefit From Private Ownership
- READ — Mars to Acquire Kellanova | Mars Global

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We help family ownership groups, directors, and management teams align their perspectives on the financial realities, needs, and opportunities of the business.

We have had the privilege of working with successful family and closely held businesses for over 40 years. Given our experience, we are convinced that an effective board of directors and an engaged shareholder base are essential for the long-term health and success of a family business. Yet, equipping family business directors and cultivating an engaged shareholder base are often difficult. We can help.

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- Customized Board Advisory Services
- Confidential Shareholder Surveys
- Management Consulting
- Benchmarking / Business Intelligence
- Independent Valuation Opinions
- Shareholder Engagement
- Transaction Advisory Services
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