Case-2

PepsiCo's Acquisition of Quaker Oats

Overview

This freshly researched case focuses on the company's acquisition of Quaker Oats in 2001 and the portfolio restructuring initiated by CEO Roger Enrico between 1997 and 1999. In 2001, PepsiCo was the world's fifth largest food and beverage company with revenues of approximately $26 billion, but the company's revenues were $31 billion when Enrico became PepsiCo's CEO in 1996. At the time, PepsiCo was diversified into soft drinks, Frito-Lay snack foods, and such quick service restaurant businesses as KFC, Taco Bell, Pizza Hut, California Pizza Kitchens, Chevy's Mexican Restaurants, Hot n' Now, Eastside Mario's and D'Angelo sandwich shops. With a flat-lined share price, Enrico shed PepsiCo's weak performing, cash hungry restaurant businesses in 1997 and embarked on a dramatic portfolio restructuring strategy that entailed the spin-off of the company's soft drink bottling operations and the acquisitions of Cracker Jack and Tropicana. Enrico's predecessor, Wayne Calloway, believed the quick service restaurant business possessed marketing-related and managerial skills common to soft drinks and snack foods and that the corporation could achieve outstanding performance by exploiting opportunities for cost sharing, skills transfer, and brand sharing. Calloway's diversification strategy resulted in the price of PepsiCo's stock increasing at an average annual compound rate of 20.3% during his ten-year tenure as CEO. For years we, along with others, heralded PepsiCo's diversification strategy as a successful example of related diversification and our prior cases on PepsiCo pushed this theme. However, as the quick service restaurant industry became increasingly mature and saturated during the 1990s, it became evident that the inclusion of fast food restaurants in PepsiCo's portfolio would continue to suppress earnings growth and diminish shareholder value. In 2000 with restructuring well under way, PepsiCo competed almost exclusively in food and beverage categories that grew at twice the 2% soft drink industry growth rate and commanded a 2 to 1 market share lead over its nearest competitor in the convenience food and beverage industry.

The 2001 acquisition of the Quaker Oats grain-based snacks and its Gatorade isotonic beverage businesses gave PepsiCo a platform to not only continue to lead the food and beverage industry in revenue growth, but also lead the industry in operating profit and earnings growth. PepsiCo's

Chairman and CEO Steve Reinemund, who succeeded Roger Enrico in May 2001, commented that the acquisition of Quaker Oats would insert the leading sports drink into PepsiCo's portfolio and provide ample opportunities for revenue growth and cost sharing through synergies existing between PepsiCo's and Quaker's brands:

> Quaker brings to PepsiCo a very wide range of benefits that touch virtually every one of our businesses. With Gatorade, we'll add the leading isotonic brand to our beverage portfolio. Quaker's high-efficient broker-warehouse system will help Tropicana accelerate national distribution and growth of its shelf stable products. The Quaker brand and the company's line of wholesome snacks gives us an ideal way to expand beyond salty snacks. And bringing our companies together will create literally hundreds of millions of dollars in purchasing, manufacturing and distribution synergies.

PepsiCo's senior executives anticipated that by 2004 the assimilation of Quaker Oats' brands into PepsiCo's business and product portfolio would increase annual operating cash flow by $4 billion and improve return on invested capital by 100 basis points per year to reach 30% by 2005. As of late-2001, with the exception of volatility in the months following the Quaker acquisition announcement, the market had reacted favorably to PepsiCo's acquisition of Quaker Oats.

Suggestions for Using the Case

This case is ideal for opening the module on corporate diversification strategies. The case teaches well because students are familiar with the company's products. Class debate should center around whether and to what extent PepsiCo's restructured portfolio is well positioned to contribute to increased shareholder value. Even though restaurants were an attractive feature of PepsiCo's portfolio in earlier years, by the mid-1990s PepsiCo's restaurant businesses threatened the company's earnings potential and their "cash hog" character was creating cash flow problems for PepsiCo's other businesses. The issue here is whether the addition of all the Quaker brands will enhance PepsiCo's competitive strength, prove to have good strategic and resource fit, and help boost PepsiCo's overall performance.

The case contains ample data for students to prepare a 9-cell industry attractiveness/business strength matrix and to go through the steps of analyzing a diversified company's business portfolio that are described in Chapter 10. Students will also need to draw upon the material covered in Chapter 9 concerning related diversification, strategic fit, economies of scope, cost-

sharing and skills transfer across businesses, and the cash flow requirements of the various businesses included in the portfolio of a diversified corporation. Following their analysis of PepsiCo's newly restructured business portfolio, students will need to make recommendations regarding what actions PepsiCo management needs to take in digesting the Quaker Oats acquisition and in realizing the promised performance gains. Do all of the Quaker brands possess good strategic and resource fit? Does PepsiCo need to have all these brands as part of its portfolio? Do some of the Quaker brands need to be divested? Where does Gatorade fit in and what strategy changes are needed at Gatorade, if any?

There is a case preparation exercise for this case on the Case-TUTOR software package. It is designed to introduce students to use of the tools and concepts in Chapters 9 and 10. Students are called on to assess the attractiveness of PepsiCo's soft drink, bottled water, ready to drink teas and coffees, snack foods, chilled juices, isotonic beverages, grain based snacks, flavored grains, ready to eat and hot cereals, and other breakfast foods businesses and to evaluate the competitive strength of PepsiCo's various business units. The exercise involves constructing an attractiveness/strength matrix and exploring the strategic fits and resource fits among its businesses. These analytical steps, along with an assessment of PepsiCo's financial performance, put students in good position to develop solid recommendations on what PepsiCo's new top management team should do to make a success out of its new Quaker Oats acquisition and its restructuring strategy.

You'll find that this case works well for oral team presentations and for a written assignment outside of class. Our suggested assignment questions are

1. Steve Reinemund has employed you as a consultant to assess PepsiCo's diversified business portfolio in 2001 and to make recommendations as to what actions PepsiCo's new top management team should now take to make a success out of its new acquisitions and its restructuring strategy. Your report should contain a 3-4 page executive summary of your recommendations, which are fully supported by the use the concepts and analytical tools presented in Chapters 9 and 10. Supplement your executive summary with additional charts and tables as needed to support your analysis and recommendations. It is strongly suggested that you follow the analytical steps covered in Chapter 10 in developing your paper.

2. What is your evaluation of the Tropicana, Cracker Jack, and Quaker Oats acquisitions? Do they make good strategic sense for PepsiCo? Why or why not? What strategic and resource fits do you see? Do some of the Quaker brands need to be divested? Where does Gatorade fit in and what strategy changes are needed at Gatorade, if any? Please develop a 4-6 page report

to PepsiCo management detailing your analysis and action recommendations.

Assignment Questions

1. What is PepsiCo's "new" corporate strategy? Briefly identify the business strategies that PepsiCo is using in each of its consumer business segments—Pepsi-Cola soft drinks and beverages, Frito-Lay snack foods, Gatorade/Tropicana, and Quaker Foods North America.
2. What is your assessment of the long-term attractiveness of the industries represented in PepsiCo's business portfolio?
3. What is your assessment of the competitive strength of PepsiCo's different business units?
4. What does a 9-cell industry attractiveness/business strength matrix displaying PepsiCo's North American business units look like? Is the acquisition of Quaker Oats likely to result in more rapid growth in revenues and earnings for PepsiCo? Explain.
5. Does PepsiCo's portfolio exhibit good strategic fit? What value-chain match-ups do you see? What opportunities for skills transfer, cost sharing, or brand sharing do you see? How might Quaker Oats' portfolio of grain based snacks, breakfast items, side dishes, and Gatorade benefit from being a part of the PepsiCo business portfolio?
6. Does PepsiCo's portfolio exhibit good resource fit? What are the cash flow characteristics of each of PepsiCo's three segments? Which businesses are cash hogs and cash cows?
7. Did the spin off of PepsiCo's restaurants make good strategic sense? How attractive was the quick service industry between the late-1970s and 1997? What was the business strength of PepsiCo's three major quick service chains and 5 lesser-known chains? To what degree did the restaurant segment contribute to corporate revenues and operating profits between 1993 and 1996? Would you describe PepsiCo's restaurants as cash cows or cash hogs? What strategic fit opportunities did the restaurant segment offer?
8. Based on the preceding analysis, what is your overall evaluation of PepsiCo's business portfolio in 2001? Does the portfolio provide the company's shareholders with an opportunity for above-average market returns?
9. What strategic actions should Steve Reinemund take to capitalize on the portfolio restructuring engineered by Roger Enrico? Are any further modifications to the portfolio worthy of consideration?

Teaching Outline and Analysis

1. **What type of corporate diversification strategy is PepsiCo employing? What are the key elements of PepsiCo's "new" corporate strategy? Briefly identify the business strategies that PepsiCo is using in each of its consumer business segments—Pepsi-Cola soft drinks and beverages, Frito-Lay snack foods, Gator ade/Tropicana, and Quaker Foods North America.**

PepsiCo's current corporate strategy

- Basic approach: related diversification.
- The businesses are all concerned with consumer foods and beverages and share key emphasis on some of the same value chain activities and key success factors: branding, importance of advertising, new product development, operating efficiencies, and strong distribution.
- There have been clear efforts to transfer managerial and marketing skills and expertise from unit to unit.
- Cross-utilization of distribution channels to expand distribution of various products. For example, making Tropicana available in retail outlets that carry Gatorade.
- Capture cost-sharing benefits among the business units where possible—corporate-wide purchasing of packaging.
- Power of One strategy that encourages simultaneous purchases of the company's products.
- Grow all the businesses by expanding into foreign markets

Common aspects of business strategy among PepsiCo's divisions. All of PepsiCo's businesses compete on the basis of product differentiation and are attempting to build a differentiation-based competitive advantage. For the most part, the differentiation is keyed to product features, image and reputation, heavy advertising and promotion, and new product development.

2. **What is your assessment of the attractiveness of the industries that PepsiCo has diversified into?**

It is important to recognize that PepsiCo has diversified into convenience food and beverage industries rather than the broader processed foods industry. Convenience foods and beverages are growing at about twice the 2% overall food and beverage industry growth rate and the sizes of the food and beverage categories in which PepsiCo competes are very large—see case Exhibit 15 for a complete run down of the sizes of food and beverage categories where PepsiCo competes. In addition, some food and beverage categories that are represented in PepsiCo's portfolio have outstanding growth rates. Food and beverage categories that rate as highly attractive include almost all snack categories, soft drinks, bottled water, ready to drink tea, chilled juices, and isotonic beverages. Product categories that appear to be only moderately attractive include flavored grains, ready to drink coffees, hot cereals, and other breakfast products. Some students may rate flavored grains, other breakfast, and hot cereals as unattractive because of industry maturity, but these categories have some appealing characteristics—strategic fit with other PepsiCo/Quaker products, helping to enhance PepsiCo's clout in supermarkets (because of the wider product breadth), . Quaker's ready to eat breakfast cereals are the primary product category represented in PepsiCo's portfolio that have few attractive characteristics.

Table 1 presents our industry attractiveness ratings for each industry that PepsiCo has diversified into.

3. What is your assessment of the competitive strength of PepsiCo's business units?

Students will have little trouble determining that PepsiCo has done an exceptional job of building a portfolio of business with strong competitive positions in their respective industries. The company holds number one market shares in almost every convenience food and beverage category while Pepsi Cola trails only Coca-Cola in soft drink market share. During the mid-1990s, Pepsi was falling behind Coke by an increasing margin, but in 2001 Pepsi trailed Coke in market share by only two percentage points. To better grasp the competitive strength of PepsiCo's brands, you may wish to create a chart on the board where you can write the industry size and PepsiCo's market share for its major businesses as students call them out. The chart should include the following information:

	Industry Size (in millions)	PepsiCo's Market Share
Pepsi-Cola	$30,000	30.9%*
Frito-Lay	$20,600	58%

Tropicana	$6,850	35%
Aquafina	$2,170	9.4%
Lipton/SoBe RTD teas	$1,630	43%
Gatorade	$2,000	85%
Quaker snacks	$1,358	15.4%
Quaker rice cakes	$161	69.1%
Quaker hot cereals	$850	60.6%
Quaker RTE cereals	$7,500	9.2%
Quaker flavored grains	$1,005	33.2%
Quaker other breakfast	$310	22.6%

*Based on case volume

You may wish to point out that all businesses have built much of their strength on their product innovation skills and marketing and promotion expertise and that PepsiCo's marketing-related success has provided the company with worldwide name recognition for most of its businesses and products. PepsiCo has very good worldwide distribution capabilities in all of its businesses even though its newly acquired Quaker brands have yet to expand outside the U.S. and Canada to a meaningful degree. Table 2 presents our competitive strength calculations for PepsiCo's major business units.

4. What does the 9-cell industry attractiveness/business strength matrix reveal about PepsiCo's North American portfolio? Is the acquisition of Quaker Oats likely to result in more rapid growth in revenues and earnings for PepsiCo? Explain.

To draw a 9-cell industry attractiveness/business strength matrix for PepsiCo using rigorous methodology, students really need to do industry attractiveness ratings for each of the industries in which PepsiCo competes and do competitive strength ratings for each of PepsiCo's business units. These ratings should then be used to plot the location of the bubbles on the 9-cell grid. Otherwise, students end up locating the bubbles on the basis of "judgment," which may or may not match up well with a well-done set of ratings. To encourage students to practice applying the tools and con cepts in Chapter 10 when they prepare a case, we suggest spending class time here to go through the development of industry attractiveness ratings and business strength ratings and then using these ratings to draw the 9-cell matrix. However, if time is tight you can resort to the judgment approach. Table 1 of this note shows our industry attractiveness ratings and Table 2 presents our business strength ratings. Figure 1 shows a 9-cell attractiveness-strength matrix where the location

of the bub bles is based on the industry attractiveness and business strength ratings shown in Tables 1 and 2.

There's ample room for judgmental differences regarding selection of the factors, the weights, and the ratings used to draw a 9-cell attractiveness-strength matrix depicting PepsiCo's portfolio. So you should expect that student opinions will vary and the matrices they come up with will vary. In this instance, however, the variations should not be very great since it is clear that, with the exception of RTE cereal, the industries represented in PepsiCo's portfolio are relatively attractive. It is also clear from the case that all of PepsiCo's businesses have strong competitive positions. Hence, most bubbles on the 9-cell matrix representing PepsiCo's businesses cluster in the top left of the grid.

The 9-cell matrix analysis (Figure 1) indicates that PepsiCo's portfolio consists chiefly of "grow and build" businesses that should be given a high priority for investment. Students should conclude that RTD teas and coffees, flavored grains, and other breakfast products should be given a medium in vestment priority, while ready to eat cereals should receive only minimal investment or possibly considered for divestiture. Students ought to pick up on PepsiCo executives' comment that flavored grains, hot cereals, and other breakfast products generate free cash flows that can be utilized to support investment in other businesses—hence there should be no stampede to divest cash cow businesses.

5. **What strategic fits exist among PepsiCo's collection of businesses. What opportunities are there to share costs, skills, or brands between its business units? How might Quaker Oats' portfolio of grain based snacks, breakfast items, side dishes, and Gatorade benefit by their inclusion in the PepsiCo business portfolio?**

Substantial cost sharing and skills transfer opportunities exist between PepsiCo's beverage brands and between its various snack brands, but there appear to be less strategic fit opportunities across PepsiCo's major business divisions. The operating processes vary greatly between hot fill beverage bottling, soft drink concentrate production, grain-based food products production, and snack food production. Students may suggest that beyond PepsiCo's corporate-wide purchases for ingredients and packaging materials, it is unlikely that PepsiCo managers could find ways to share costs or transfer anything besides marketing skills between these businesses. It should be noted, however, that there are ample opportunities to share costs within broad product categories and that marketing innovation plays a major role in PepsiCo's competitive strategy in each of its lines of business. PepsiCo management relies

heavily on marketing innovations to position their brands in each market in which it competes. Consumers in each of these markets have much in common and it should be expected that PepsiCo managers can share marketing skills and consumer behavior information in crafting and implementing the strategies of each of the main business groups. Some students may point to the company's Power of One strategy that allows its products to be cross-marketed in retail locations as an example of marketing-related strategic fit. While this is true and certainly indicative of potent strategic fit, students should recognize that capture of important joint distribution opportunities existing between Gatorade and Pepsi soft drinks have been prohibited by the FTC for a 10-year period—thus impeding/ delaying the realization of potentially large strategic fits benefits (one of the major attractions of the Quaker acquisition).

Figure 1 | Sample Industry Attractiveness/Competitive Strength Matrix of PepsiCo's Domestic Businesses

The operations, sales and marketing, and advertising/promotion of Quaker's hot and RTE cereals, flavored grains, and other breakfast products have little in common with value chain activities of PepsiCo's convenience foods and beverages, but do offer cost sharing and skills transfer opportunities among themselves. Figure 4 provides a list of cost sharing, skills transfer, and brand sharing opportunities along the value chains of PepsiCo's business units with the value chain of its core beverage business.

Figure 2 | Assessment of Strategic Fit Potentials Between PepsiCo's Business Units

6. Does PepsiCo's portfolio exhibit good resource fit? What are the cash flow characteristics for each of the three segments? Which businesses are cash hogs and cash cows? Does the portfolio provide the company's shareholders with a good return on investment?

Students who have completed the Case-TUTOR exercise should recognize that the portfolio has very good resource fit, with most of the company's businesses offering ample cash flows to fund internal investments. Clearly, Frito-Lay North America and PepsiCo North America are tremendous cash cows capable of funding further expansion in those businesses, plus providing excess cash flows to fund the expansion of beverage and snack food sales outside of the United States. Tropicana's cash flows are less impressive, but students' cash flow analyses should disclose the rather substantial investments in that business since its acquisition by PepsiCo in 1998. PepsiCo's investments in Tropicana have proven successful so far, with outstanding growth in revenues, operating profits, and operating profit margins. In addition, students should approve of the profit margins of the company's North American snack food and beverage businesses. PepsiCo's efforts to build market share in international snack food and beverage markets have not only created businesses with less impressive cash flows (both businesses were cash hogs in 1999), but also businesses with rather narrow operating profit margins.

Tables 3 and 4 present estimated cash flows and operating profit margins for PepsiCo's business units between 1998 and 2000.

The cash flow characteristics and operating profit margins of Quaker's U.S. and Canadian food and beverage businesses are rather impressive Like Frito-Lay North America and Pepsi-Cola North America, Quaker's North American businesses are cash cows capable of funding investments across the company. Quaker's businesses outside the U.S. and Canada have less impressive cash flows and in some years could be described as cash hogs. The operating profit margins of Quaker Oat's businesses outside of the U.S. and Canada fall substantially behind North American business units, but are in the same ranges as PepsiCo's international businesses. However, the operating margins of Quaker's U.S. and Canadian food and beverage business units pale in comparison to Frito-Lay North America's and Pepsi-Cola North America's impressive operating profit margins.

A case can be made that the company's efforts to gain synergistic benefits between Quaker, Pepsi, and Frito-Lay operations must move forward at an aggressive pace to improve the

margins of Quaker's brands. However, there are comments in the case suggesting that hot fill operations such as the production of orange juices, isotonics, fruit juices, and RTD teas offer smaller margins than what could be expected from the production and sale of soft drink concentrates.

Tables 5 and 6 present our cash flow and operating profit margin calculations for Quaker Oats' business units between 1998 and 2000.

Table 3 | Estimated Cash Flow for PepisCo's Business Units, 1998-2000

2000	**Frito-Lay North America**	**Frito-Lay International**	**Pepsi-Cola North America**	**Pepsi-Cola International**	**Tropicana**
Operating profit	$1,851	$493	$833	$148	$225
+ Depreciation/other amortization	366	172	94	91	83
+ Amortization of intangible assets	7	46	2	14	69
+ Other non-cash expenses	0	0	0	0	0
– Interest expense[1]	61	31	23	13	17
– Income taxes[2]	430	217	165	93	122
– Capital expenditures	502	264	59	72	134
– Dividend payments[3]	336	169	129	72	95
= Estimated cash flow	$ 895	$ 30	$552	$ 3	$ 9

Revenue Contribution[4]	
Frito-Lay North America	41.9%
Frito-Lay International	21.1%
Pepsi-Cola North America	16.1%
Pepsi-Cola International	9.0%
Tropicana	11.9%

1999	**Frito-Lay North America**	**Frito-Lay International**	**Pepsi-Cola North America**	**Pepsi-Cola International**	**Tropicana**
Operating profit	$1,580	$406	$751	$108	$170
+ Depreciation/other amortization	338	149	72	85	81
+ Amortization of intangible assets	8	46	2	13	70
+ Other non-cash expenses	37	0	0	0	0
– Interest expense[1]	95	45	31	21	27
– Income taxes[2]	620	296	205	140	178
– Capital expenditures	472	282	22	82	123
– Dividend payments[3]	302	144	100	68	87
= Estimated cash flow	$ 474	($166)	$466	($105)	($93)

Revenue Contribution[4]	
Frito-Lay North America	38.6%
Frito-Lay International	18.4%
Pepsi-Cola North America	12.8%

Pepsi-Cola International	8.7%
Tropicana	11.1%

1998	**Frito-Lay North America**	**Frito-Lay International**	**Pepsi-Cola North America**	**Pepsi-Cola International**	**Tropicana**
Operating profit	$1,424	$367	$732	$99	$40
+ Depreciation/other amortization	326	142	30	64	27
+ Amortization of intangible assets	7	43	3	8	22
+ Other non-cash expenses	54	0	0	6	0
– Interest expense[1]	107	50	20	23	10
– Income taxes[2]	90	42	17	19	9
– Capital expenditures	402	314	21	46	50
– Dividend payments[3]	254	119	47	54	25
= Estimated cash flow	$ 957	$ 26	$660	$34	($ 5)

Revenue Contribution[4]	
Frito-Lay North America	33.4%
Frito-Lay International	15.7%
Pepsi-Cola North America	6.2%
Pepsi-Cola International	7.2%
Tropicana	3.2%

[1] Interest expense estimated by multiplying total interest expense listed in case Exhibit 7 by revenue contribution for business segment.

[2] Income tax expense estimated by multiplying total income tax expense listed in case Exhibit 7 by revenue contribution for business segment.

[3] Dividend expense estimated by first determining the total number of shares by dividing total cash dividends by EPS listed in case Exhibit 1. The resulting total number of shares was multiplied by cash dividends per share. The total cash dividend figure was then multiplied by revenue contribution for business segment.

[4] Revenue contribution calculated by dividing business segment revenues by total revenues.

Table 4 | Operating Profit Margins by PepsiCo Business Segment, 1998-2000

Year	Frito-Lay North America	Frito-Lay International	Pepsi-Cola North America	Pepsi-Cola International	Tropicana
2000	21.6%	11.4%	25.3%	8.0%	9.3%
1999	20.1%	10.8%	28.8%	6.1%	7.5%
1998	19.1%	10.5%	52.7%	6.2%	5.5%

7. **Did the spin off of PepsiCo's restaurants make good strategic sense? How attractive was the quick service industry between the late-1970s and 1997? What was the business strength of PepsiCo's three major quick service chains and 5 lesser-known chains? To what degree did the restaurant segment contribute to corporate revenues and operating profits between 1993 and 1996? What strategic fit opportunities did the restaurant segment offer? Would you describe PepsiCo's restaurants cash cows or cash hogs?**

The following information was taken from case Exhibits 1 and 5 and represents PepsiCo's domestic situation in 1996.

	Pepsi-Cola	Restaurants	Frito-Lay
Operating profits	$1,428	$ 370	$1,286
Less interest (prorated)*	(147)	(172)	(126)
Less taxes (prorated)*	(220)	(258)	(188)
Less dividends (prorated)*	(173)	(203)	(148)
Plus depreciation (prorated)*	323	435	237
Less cap. expenditures (prorated)*	(476)	(523)	(666)
= Estimated cash flow	$ 735	$(351)	$ 395

*Note: Prorated by allocating corporate-wide figures to each segment based on the segments' % of total sales: Beverages (33.3%), restaurants (36.1%), and snack foods (30.6%). Then, for

each segment, allocate segment item between domestic/foreign operations based on its % of total segment sales, e.g., beverage domestic sales = 73.4% of total beverage sales in 1996; snack food domestic sales = 68.4% of total snack food sales in 1996; restaurant domestic sales = 79.6% of total restaurant sales in 1996. Depreciation and capital expenditures for KFC, Pizza Hut, and Taco Bell are shown in case Exhibit 5.

Estimated cash flows for PepsiCo's international operations can be approximated as follows, using data from case Exhibit 5.

	Beverages	**Restaurants**	**Snack Foods**
Operating profits	$ (846)	$153	$346
Less interest	(53)	(44)	(58)
Less taxes	(80)	(66)	(87)
Less dividends	(63)	(52)	(68)
Plus depreciation	117	111	109
Less cap. expenditures	(172)	(134)	(307)
= Estimated cash flow	$(1,097)	$(32)	$(65)

Table 5 | Operating Profit Margins by PepsiCo Business Segment, 1998-2000

2000	U.S. and Canadian Foods	Latin American Foods	Other Foods	U.S. and Canadian Beverages	Latin American Beverages	Other Beverages
Operating income	$458.5	$26.8	$25.2	$273.7	$30.9	($6.8)
+ Depreciation and amortization	67.0	6.0	4.3	45.0	6.3	4.4
– Interest expense (net)[1]	21.3	3.1	1.9	15.4	2.4	0.9
– Income tax expense[2]	90.0	13.1	7.9	65.3	10.4	3.8
– Dividend payments[3]	2.0	0.3	0.2	1.4	0.2	0.1
– Capital expenditures	117.6	10.3	3.9	140.2	11.5	2.1
= Estimated Cash Flow	$294.7	$ 6.1	$15.6	$ 96.3	$12.7	($9.3)

Revenue Contribution[4]	
U.S. and Canadian Foods	47.2%
Latin American Foods	6.9%
Other Foods	4.2%
U.S. and Canadian Beverages	34.3%
Latin American Beverages	5.4%
Other Beverages	2.0%

1999	U.S. and Canadian Foods	Latin American Foods	Other Foods	U.S. and Canadian Beverages	Latin American Beverages	Other Beverages
Operating income	$399.8	$26.2	$21.1	$253.9	$16.5	($ 7.3)
+ Depreciation and amortization	66.9	5.9	3.5	36.2	5.0	5.4
– Interest expense (net)[1]	25.1	3.3	2.3	16.0	2.4	1.1
– Income tax expense[2]	81.5	10.7	7.4	51.9	7.9	3.6
– Dividend payments[3]	2.2	0.3	0.2	1.4	0.2	0.1
– Capital expenditures	70.6	9.6	3.7	106.0	25.4	7.1
= Estimated Cash Flow	$287.3	$ 8.3	$11.0	$114.8	($14.5)	($13.8)

Revenue Contribution[4]	
U.S. and Canadian Foods	49.9%
Latin American Foods	6.5%

Other Foods	4.6%
U.S. and Canadian Beverages	31.8%
Latin American Beverages	4.8%
Other Beverages	2.2%

1998	U.S. and Canadian Foods	Latin American Foods	Other Foods	U.S. and Canadian Beverages	Latin American Beverages	Other Beverages
Operating income	$369.8	$28.2	($1.2)	$214.9	$25.6	($7.4)
+ Depreciation and amortization	65.2	6.7	6.3	31.5	5.8	4.7
– Interest expense (net)[1]	27.7	4.5	2.5	16.3	3.3	1.3
– Income tax expense[2]	52.6	8.6	4.7	31.0	6.2	2.4
– Dividend payments[3]	2.1	0.3	0.2	1.2	0.2	0.1
– Capital expenditures	102.7	13.2	5.7	57.6	12.1	5.5
= Estimated Cash Flow	$249.9	$ 8.2	($8.0)	$140.3	$ 9.6	($11.9)

Revenue Contribution[4]	
U.S. and Canadian Foods	47.0%
Latin American Foods	7.7%
Other Foods	4.2%
U.S. and Canadian Beverages	27.6%
Latin American Beverages	5.5%
Other Beverages	2.1%

[1]Interest expense estimated by multiplying total interest expense listed in case Exhibit 9 by revenue contribution for business segment.

[2]Income tax expense estimated by multiplying total income tax expense listed in case Exhibit 9 by revenue contribution for business segment.

[3]Dividend payments estimated multiplying total cash dividends listed in Exhibit 2 by revenue contribution for business segment.

[4]Revenue contribution calculated by dividing segment revenues by total revenues.

Table 6 | Operating Profit Margins by Quaker Oats Business Segment, 1998-2000

Year	U.S. and Canadian Foods	Latin American Foods	Other Foods	U.S. and Canadian Beverages	Latin American Beverages	Other Beverages
2000	19.3%	7.7%	12.0%	15.8%	11.3%	-6.7%
1999	16.9%	8.5%	9.8%	16.9%	7.2%	-7.0%
1998	16.3%	7.6%	-0.6%	14.3%	9.6%	-7.2%

Careful analysis of PepsiCo's 1993-1996 financial statements should lead students to conclude that the spin-off of the company's restaurants as Tricon Global Restaurants was beneficial from a cash flow perspective. The restaurant business required capital investments far beyond its internal cash flow capabilities. Students that have calculated ratios similar to what is shown in Table 7 will also recognize that the operating profit margins of PepsiCo's domestic restaurants trailed the operating margins of Frito-Lay and Pepsi-Cola by a substantial amount. The company's international restaurant division performed similarly to Pepsi-Cola's international operations in most years, but usually achieved operating margins that were about one-half of those recorded by Frito-Lay's international operations. The combination of poor profitability and cash hog status should help students understand why the company's stock performed so poorly during 1996. PepsiCo's stock price was further depressed by the poor performance of its North American soft drink business relative to Coca-Cola and by vast capital requirements of its international soft drink business that had attempted to fight Coca-Cola head-to-head in almost every international market. Even though Pepsi-Cola trailed Coca-Cola in the U.S., its domestic soft drink business was clearly a cash

cow, as was Frito-Lay's North American operations.

A very good argument can be made that the spin-off made good strategic sense since the unit lacked good resource fit and culture fit with PepsiCo's snack foods and beverage businesses. In addition, the industry became increasingly unattractive as maturity and saturation contributed to aggressive price competition during the 1990s. Students can rightfully argue all three businesses relied heavily on common or shared marketing expertise (in previous versions of this case and teaching note, we believed that there was adequate marketing fit to include quick service restaurants in the PepsiCo portfolio.), but Enrico states clearly that as the industry matured, PepsiCo's knowledge base developed in convenience snacks and beverages was of little use to its restaurants. However, we do not concur with Enrico's claim that casual dining (Chevy's, California Pizza Kitchen) collapsed as PepsiCo entered those categories, since from our observations casual dining has exploded across the U.S. during the late-1990s.

Table 7 | Key Financial Performance Ratios For PepsiCo's Consumer Segments, 1993-1996

Domestic:		Beverages	Restaurants	Snack Foods
Operating profit margins	1996	18.5%	4.1%	19.4%
(Operating profit as a	1995	16.9%	7.9%	19.6%
% of revenues)	1994	17.0%	7.3%	19.5%
	1993	13.6%	8.5%	19.3%
International:				
Operating profit margins	1996	-30.2%	6.6%	11.3%
	1995	3.9%	5.3%	11.2%
	1994	5.4%	4.7%	12.2%
	1993	4.5%	8.2%	12.1%
Overall:				
Operating profit margins	1996	5.5%	4.6%	16.9%
	1995	13.2%	7.4%	17.0%
	1994	13.8%	6.9%	16.9%
	1993	11.2%	8.5%	16.9%
Operating profits as a	1996	5.9%	8.1%	26.0%
% of assets	1995	13.6%	12.4%	26.6%
	1994	13.1%	10.0%	27.7%
	1993	9.9%	12.4%	23.7%

8. **Based on the preceding analysis, what is your overall evaluation of PepsiCo's business portfolio in 2001? Does the portfolio provide the company's shareholders with an opportunity for above-average market returns?**

   Students will likely commend Roger Enrico for his efforts as CEO to build shareholder value. Enrico's spin-off of the company's restaurants, the IPO of its bottling operations, and the acquisitions of Tropicana, Cracker Jack, and Quaker Oats have contributed to a 50% increase in the company's share price between 1997 and late-2001. The company's businesses all hold

impressive positions in their respective industries and some have outstanding potential for growth. It is unlikely that the domestic sales of soft drinks or snack foods will grow much more quickly than current annual growth rates, but Gatorade, Aquafina, and SoBe offer considerable growth opportunities in North America. It's unlikely that Aquafina or SoBe will soon become global brands, but PepsiCo does have the potential to grow Gatorade's sales outside of the U.S. In addition, Frito-Lay can continue its growth outside of the U.S. and that the company's new approach to international expansion in soft drinks is much more likely to succeed than its prior approach to attacking Coca-Cola in its strongest international markets.

There is some question concerning the ability to gain synergistic benefits between some of Quaker's food businesses and PepsiCo's convenience food and beverage businesses, but the cash flow analysis and operating profit margins presented in Table 6 suggest that these businesses do have the ability to contribute to increased shareholder value through their impressive cash flows and respectable profit margins. The company's ready to eat cereal business competes in a fierce competitive environment and its flavored grains and other breakfast products lack the sparkle of Gatorade, but appear to be solid businesses capable of delivering above-average profits and free cash flows.

9. **What strategic actions should Steve Reinemund undertake to capitalize on the portfolio restructuring engineered by Roger Enrico? Are any further modifications to the portfolio worthy of consideration?**

Students may struggle with what moves are needed next at PepsiCo. However, the company has only marginally approached its task of integrating Quaker's brands into PepsiCo's current organizational structure and it is possible that some arrangements must be made concerning the disposition of Quaker cereals, flavored grains, and other breakfast products. Students should not be too forceful in arguing for a rapid liquidation of these business since analysis of Quaker's financials suggest these businesses have handsome profits and free cash flows. The cash flow in excess of what is needed to fund internal expansion could be used to fund necessary investments at Gatorade and Tropicana. Strategic recommendations made by students may include some of the following:

- Utilize excess cash flow for Quaker's non-convenience food and beverage businesses to fund expansion in other businesses
- Possible divestiture of Quaker's non-convenience food and beverage businesses if the businesses are capable of commanding a premium price—we do not see these businesses

as having much strategic attraction to PepsiCo.

- Push Gatorade into markets outside the U.S.
- Expand North American distribution of SoBe RTD teas
- Integrate distribution of North American Tropicana, Lipton, Aquafina, SoBe, FruitWorks, and other non-carbonated beverages
- Capitalize on strategic fits among Gatorade/Tropicana/RTD teas and other hot fill production and value chain synergies as permitted by the FTC (full capture of distribution fits will have to occur on down the road)
- Distribute non-carbonated beverages outside North America where taste preference opportunities exist
- Further integrate North American distribution of Quaker snacks, Cracker Jack, and Frito-Lay snacks
- Expand international sales of Quaker snacks and Cracker Jack to markets with suitable taste preferences
- Pursue opportunities to combine production of Quaker and Frito-Lay snacks or Quaker and Cracker Jack snacks if production similarities exist
- Expand PepsiCo's Power of One strategy to additional international markets
- Utilize Power of One to market convenience foods and beverages beyond soft drinks and salty snacks

Steve Reinemund and other senior executives at PepsiCo should probably articulate the planned corporate strategy changes to the investment community. Roger Enrico admitted his decision to let his turnaround strategy become disclosed to investors over a lengthy period contributed to the company's poor share price growth between 1997 and 2000.

Epilogue

There was nothing new to report on PepsiCo at the time this TN went to press. However, you can check our periodically updated case epilogues at the password-protected Instructor Center (www.mhhe.com/thompson) for the latest information. The online epilogues are updated whenever we become aware of pertinent breaking news about the company and/or developments relating to the specific issues contained in the case.