Business update
OCTOBER 2018
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Coca-Cola buys Costa

WHITBREAD PLC

Bought for £19 million, sold for £3.9 billion — seems like a good deal. But is Whitbread really right to be selling Costa Coffee?
Ian Marcousé investigates

Back in 1995, Whitbread bought the 39-store Costa Coffee chain from the Costa family and began a process of strategic change. Five years later it sold off its own 200-year heritage in brewing beer and running pubs, choosing to focus on Costa and Premier Inn. This allowed the company to build Costa into the UK's number one coffee bar chain (far larger than Starbucks) plus a strong number two position in the fast-growing Chinese market. Costa now has 2,400 coffee shops in the UK and 1,400 in 31 other countries.

Good for Coke

It's easy to see why Coke wants Costa. Figure 1 (next page) shows part of the reason: Costa has grown dramatically and is outrageously profitable. A 46% return on capital (ROC — the best measure of profitability) is rare for such a large business.

There are also obvious strategic reasons. Coca-Cola is still dependent on fizzy drinks for 75% of its sales, but these are under pressure from health lobbies throughout the developed world. Whereas global sales of fizzy drinks are flat, coffee sales are growing by 5% a year. Costa is already number 1 in the UK and number 2 in China, but the might of Coca-Cola (market valuation: $191 billion) could easily propel Costa into much stronger positions in the other 30 countries in which it operates, especially across Europe. Furthermore, owning Costa may allow Coke to introduce the brand to America and take on Starbucks in its enormous home market (Table 1).

Table 1 Top five coffee retailers

By European outlets		By American outlets	
Costa	2,755	Starbucks	13,532
Starbucks	2,406	Dunkin' Donuts	8,828
McCafé	1,253	Tim Hortons	683
Caffè Nero	755	Barnes & Noble	580
Greggs	498	Caribou	490

Bad for Whitbread?

But is it the right move for Whitbread's stakeholders? The company's shareholders certainly think so, as shares leapt in price by more than 15% overnight. Shareholders anticipate huge one-off dividends, as Whitbread boss Alison Brittain has hinted that the company will pay out most of the £3.9 billion.

Are the shareholders being grotesquely short-termist? Costa's strategy in China (460 stores today,

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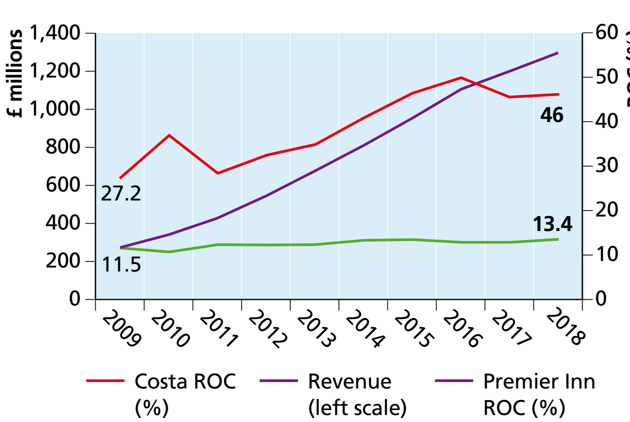
planned to rise to 1,000 by 2022) looks sound, providing growth for the business for years to come. Yet the shareholders would prefer to take the cash now. Fortunately the Coke takeover may also be good for Costa staff, as huge extra funding spurs faster growth and therefore more career opportunities worldwide. But for the UK economy it seems a huge shame that future Costa profits will flow to the USA rather than to this country. Costa has been rare in driving a middle-market UK brand into China — now it's to be another American brand.

Whitbread's boss says the sale will help the company fund Premier Inn's drive into the German hotel market. But the company's pre-bid gearing (borrowing) level was only 30% of its long-term capital, suggesting there can't have been much of a constraint on its ability to finance growth. It's a bit of a sell-out.

Practice exam questions

40 marks, 50 minutes

1. Use Figure 1 to assess whether Whitbread plc is right to sell Costa Coffee to Coca-Cola. (10 marks)
2. Use Ansoff's matrix to assess Coca-Cola's purchase of Costa. (10 marks)
3. Evaluate Whitbread plc's apparent corporate objectives based on the evidence provided and your wider business understanding. (20 marks)



Source: Whitbread plc accounts

Figure 1 Costa growth and profitability

Answers

1 Figure 1 shows revenue growth at Costa from £300 million in 2009 to about £1,300 million in 2018 — an increase of 333%. Over this time inflation may have been 20–25%, so the real-terms increase in sales has been massive. At the same time the profitability of those sales rose significantly from an ROC of 27.2% in 2009 to 46% in 2018. Although profitability has not risen steadily (it seemed to overreach itself in 2016) the upward trend has been clear. Furthermore the growth in profitability at Premier Inn is far less impressive, largely because it is no more than 13.4% in 2018. ROC figures are directly comparable: Whitbread can only generate £13.40 for every £100 invested in Premier Inn, whereas Costa generates £46 profit per £100. Figure 1 raises serious questions about the wisdom of Whitbread's decision to sell Costa.

Knowledge: 2, application: 2, analysis: 3, evaluation: 3

2 Ansoff warned of the risks of straying too far from the corporate comfort zone of existing products in existing markets. But that does not mean he was warning against bold strategic moves. He would understand that boxing Coca-Cola into the static market for fizzy drinks would be unwise. Two questions remain: how great are the operational risks posed by a move into coffee? And how great are the financial risks from this move?

The latter can be dealt with quickly. For a company valued at $191 billion, spending £3.9 billion

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(approximately \$5 billion) is unlikely to be damaging, so the effective financial risks are close to zero for Coca-Cola. Even the operational risks seem low, as Coca-Cola knows the UK and Chinese markets well, so this is product development not diversification in Ansoff's terms. By taking over Costa staff as well as assets Coke will be buying the coffee market expertise it needs.

Using Ansoff's matrix confirms that Coca-Cola's purchase of Costa looks sound.

Knowledge: 2, application: 2, analysis: 3, evaluation: 3

3 The evidence seems clear that Whitbread plc is pursuing 'shareholder value'. This usually means pursuing the long-term financial interests of shareholders, but the text makes Whitbread's approach seem more short-termist than that. Whitbread is giving its shareholders what they think they want (loads of money, and soon) rather than acting in their best long-term interests. Selling Costa risks selling Whitbread's better half, and also leaves the rump of the business less diversified. It'll be a pure hotel business — vulnerable, for example, if German hotel chains bite back, pushing Premier Inn into a loss-making position in Germany.

This seems ironic for a business with such a great history as a master of business strategy. Its clever moves in 1995 and 2000 are perhaps being thrown away in 2018. But the shareholders are happy. This may point to a further issue in relation to corporate objectives. Perhaps Whitbread's boss is prioritising her own job security over the best interests of the company's stakeholders. There is no doubt that this move will secure her position for years. Shareholders love bosses who generate big chunks of dividend cash. Corporate objectives can get muddled with the interests of those who control the business (the directors). If that's the case one can reasonably be scathing. Personal interests should never sway decisions by a well-paid plc boss. But Alison Brittain may simply reply that she's doing what shareholders want, and reject the other issues.

Overall, the objectives seem narrowly focused on generating short-term cash to make shareholders happy. Perhaps by chance Whitbread's staff may also benefit from the sale to Coca-Cola, but it's hard to see this as the pursuit of stakeholders' wider interests. It's a much narrower decision than that.

Knowledge: 4, application: 4, analysis: 6, evaluation: 6

Taken from 'Topical Cases' at **www.a-zbusinesstraining.com**, *Ian Marcousé's site for CPD, topical cases and business worksheets.*