The TONTO FILES

Peter Klein helped Jim Kilts turn around and sell Nabisco and then Gillette.
Those are just two of the highlights in his long career as a consumer products strategist

BY LISA GEWIRTZ-WARD

"I BEGAN MY CAREER," SAYS PETER KLEIN, "SELLING DRUGS ON THE CORNER of Haight and Ashbury in the 1960s." True enough: The drugs were over-the-counter medications like Vicks and Nyquil, and Klein was selling them to pharmacies (including one at that location) as a management trainee for Richardson-Merrell Inc. It was a good beginning for an ambitious young man with no flowers in his hair, though not for the reasons he thought.

For just as the Age of Aquarius was dawning, the sun was setting on the last great period of growth for the consumer products industry. Industry leaders would take time to react, but by the early 1980s, they were battling for market share—and Wall Street's approval—with countless turnaround plans, re-engineering schemes, adjacent expansion strategies and, above all, acquisitions. The wave of transactions, which continues to this day, involved many of the biggest and best-known companies in the world. Richardson-Merrell, for example, became Richardson-Vicks Inc. and then a part of Procter & Gamble Co., which won it in 1985 after Unilever put it in play with a hostile bid.

Klein had long since moved on by then, preferring to climb the ranks at Johnson & Johnson, Gillette Co. and Sterling Drug Inc. before becoming a consultant in the early 1980s. But throughout his long career—and especially in the past decade, when he held the top strategy and business development jobs at Nabisco and then Gillette—he has been involved in one way or another in much of the action as this huge, mature sector has tried to reconfigure itself in a changing world. Klein's role has never been a highly public one; that's for CEOs. Instead he has stayed in the background, in that vital spot where strategy meets execution. "So," he says, beginning an interview with typical humor, "this is Tonto, coming out of the tent."

If Klein is Tonto, the Lone Ranger would have to be Jim Kilts, the disciplined, analytical consumer products executive credited with turning around dozens of brands over the years, from Kool-Aid to Post Cereal. The relationship dates back to 1982, when Kilts was at General Foods Corp. and hired Klein as a consultant. Kilts went on to work at Kraft Inc., ultimately becoming executive vice president of worldwide food operations at Kraft's then-parent, Philip Morris Cos. But what he (and Klein) is best known for are two home runs: fixing Nabisco and selling it to Philip Morris for $14.9 billion in 2000 and fixing Gillette and selling it to P&G for $54 billion in 2005.

Gillette's sale to P&G was the largest-ever consumer products deal, making P&G the world's biggest consumer products company, with combined annual revenue of more than $63 billion. It's also a giant test case of the ability of an acquirer to combine seemingly complementary businesses, take advantage of diverse geographic strengths and make huge scale pay off.

The Nabisco sale was a coda to the overreaching $31 billion leveraged buyout of RJR Nabisco Inc. by Kohlberg Kravis Roberts & Co. in 1989. Because Nabisco was combined with Kraft Foods Inc., recently spun out of Altria Group Inc. (as Philip Morris is now known), it was also a big step in the unwinding of the 20-year strategic tie-up between food and tobacco.

At both Gillette and Nabisco, Kilts was hired as the CEO and brought in Klein as one of his key recruits. Klein's job was nearly identical at both companies: drawing up the strategic plan, which defined the company's goals and documented how to achieve them. Dealmaking for him has always been part of a bigger picture. Now a consultant again (his Rye, N.Y., firm is called PK Associates LLC), he regularly tells clients to be wary of the "zeal to deal." By that he means making key M&A decisions in the heat of the moment, instead of taking a longer-term approach and seeing deals as an extension of a plan.

Kilts *'Hi ho, Silver!'*

It's the kind of common sense that executives in an industry under pressure often manage to forget—and Klein's industry offers many a case in point. Take Kellogg Co.'s acquisition of Lender's Bagels for $455 million in November 1996. Three years later, the attempt to move into the broader breakfast market was deemed a failure. Kellogg sold Lender's to Aurora Foods Inc. for $275 million, 60% of its original price, and the company took a $170 million hit to its earnings.

The desperation to deal comes from the fact that the industry is not growing. For the past 25 years, consumer products companies have grown at less than 1%, simply tracking population growth in developed countries.

AS A CONSULTANT at Marketing Corp. of America in the early 1980s, Klein saw the transition unfold. Companies shifted attention from product development to grabbing market share, usually through advertising and acquisitions. Consolidation, Klein says, exacerbated this shift and created a vicious circle. Senior managers departed as companies were acquired, leaving fewer execs with experience in product development. Meanwhile, companies were having trouble recruiting young talent; many of the best and brightest went into financial services.

And the best-known brands in the supermarket weren't getting younger. Saltines date back to 1876, Coca-Cola to 1886, Juicy Fruit gum to 1893, Kellogg's Corn Flakes to 1906, Hellmann's mayonnaise to 1912, Land O'Lakes butter to 1921, Birds Eye frozen foods to 1930, Ragu pasta sauce to 1946, Häagen-Dazs ice cream to 1959 and Gatorade to 1965.

To be sure, consumer products companies in the 1980s were trying to innovate. In 1984 Klein was hired by Oscar Mayer Foods Corp., where Kilts had recently become a general manager, to evaluate one of its new products—stuffed frozen hamburgers. Klein suggested scrapping the frozen burger idea, since Oscar Mayer was spending money to learn things about the frozen-foods business that industry leaders had known for decades. Instead, he suggested extending Oscar Mayer's brands of deli meats and cheeses. The result was "Lunchables," packaged school lunches consisting of crackers, cheese, deli meats and desserts, which soon became a billion-dollar business.

But Lunchables was an exception—the more so, since most innovations come from outside big companies. "More than 80% of new products fail," says Klein, who studied marketing and finance at Syracuse University, earned an M.B.A. at Harvard Business School and has no doubt that stuffed frozen burgers would have failed too.

Klein continued his consulting career at the Cambridge Group Inc., which he joined in 1991. And he continued to work on buying and selling several supermarket aisles' worth of brands, divisions and companies, including Pine Sol, Gatorade, Tropicana and Mennen. Kilts was a big client, but not his only one.

That changed in 1998, when Kilts was hired as the CEO of Nabisco. It was almost 10 years after the "Barbarians at the Gate" buyout. KKR had exited in 1994, but the separation of Nabisco from RJR, one of the original objectives of the deal, was still hung up in tobacco litigation. Nabisco itself was struggling. A heavy debt load limited financial flexibility, its distribution system had been damaged by cost cuts, and it lacked an international division, which KKR had divested to pay off debt. "This put the company at a major disadvantage because it was operating in a global market," says Klein.

Kilts hired Klein as vice president of strategy, corporate planning, e-business and marketing services. Klein drew up a plan and got to work on item No. 1: turning around the biscuit division, whose profits were falling fast, despite popular brands like Ritz crackers, Wheat Thins, Fig Newtons and Oreo cookies.

Seeking to boost productivity, previous executives had restructured the biscuit division sales force. Originally, one sales person drove the trucks, stocked the shelves, set up displays and maintained relationships with store managers. Under the new system, a different person was assigned each function. The system was rolled out nationally before it was tested on a smaller scale. Many senior sales people responded by quitting. "They changed their distribution system and got it all wrong," he says. After studying the mess, Klein and Kilts revived the original structure and rehired some of the sales people who had quit.

The marketing plan also suffered from mismanagement and neglect. In the five years before Klein joined Nabisco, the

unit's ad budget had fallen to historical lows. Klein discovered that several viable brands, including Snackwells, Ritz and Fig Newtons, had been ignored. Nabisco decided to invest $50 million in marketing, increasing the advertising-to-sales ratio by 50%.

Shrewd acquisitions played a big role in the turnaround plan. Klein's team identified gaps in the product line, and in September 1999, Nabisco bought Favorite Brands International Inc. out of bankruptcy for $475 million—a deal that was within the company's limited means. Favorite Brands had been a hodgepodge of companies thrown together but never fully integrated. Its brands included Jet-Puffed marshmallows, Trolli Gummi candies and the Farley's & Sathers candies.

"We saw hidden value in Favorite Brands," says Klein, explaining that the brands, especially Trolli, complemented Nabisco's Life Savers unit. Previously undermarketed, the brands could be sold through the stronger Life Savers distribution system. The deal also made possible the introduction of Gummi Savers, now a significant product in the $700 million chewy-candy sector.

Nabisco was also eyeing United Biscuits, but it lacked the financial firepower to proceed alone. After initially competing against a team consisting of French food company Groupe Danone and financial partners Paribas Affaires Industrielles, or PAI (now PAI Partners), Cinven Ltd. and DB Capital Partners, it teamed up with them and bought United Biscuits jointly. Along with a stake in the JV, Nabisco was able to buy outright some of United Biscuits' holdings in China, Hong Kong and Taiwan. (Danone, meanwhile, bought its operations in Malaysia, Singapore, Scandinavia, Finland, Poland and Hungary.) The deal turned out to be a cost-effective way to restore some of Nabisco's international reach, since most of United Biscuits' operations were in Europe.

The turnaround was progressing, but Nabisco's stock remained depressed because of its relationship to parent RJ Reynolds (still its majority owner), which was facing billions of dollars in potential tobacco liabilities. Raider Carl Icahn had already made several attempts to buy Nabisco before Kilts and Klein joined the company. In 2000 he made another, offering a hefty 40% premium to the company's stock price. The board of directors put Nabisco on the auction block. Klein became immersed in the process, facilitating the development of the prospectus, working closely with the investment bankers on the deal and working on the management presentations to prospective buyers.

In June 2000, Nabisco was sold in a complex deal. Philip Morris bought Nabisco Holdings, the food unit, for $14.9 billion. Nabisco's parent company RJ Reynolds, meanwhile, assumed any tobacco liabilities associated with the deal along with $11.8 billion in cash that was on Nabisco's balance sheet.

Philip Morris wanted Nabisco to combine with its Kraft unit, which it had captured in a hostile deal in 1988 as a bulwark against its tobacco liabilities. For Kilts and Klein, this was familiar territory. As senior vice president of strategy and development at Kraft in the late 1980s, Kilts was in charge of defending Kraft from Philip Morris' original tender offer,

helping to get the price up from $90 a share to the $106 a share Kraft eventually fetched. After the deal was done, Kilts was in charge of integrating Kraft with Philip Morris' existing food business—his former company, General Foods, which Philip Morris had captured in 1985. Klein worked on that integration as well, helping to combine the two North American sales forces.

In 2000 the task would be to integrate Nabisco with Kraft. Klein stayed on to help, working with Irene Rosenfeld, then a rising star at Kraft and now chairman and chief executive officer of the company. Klein oversaw a Nabisco steering committee, which suggested ideas for integration, but Kraft was responsible for the ultimate plan. The hardest part for Klein was watching Life Savers, a unit he helped build, be dismantled. To get regulatory approval for the Nabisco deal, either Altoids or Life Savers' breath mints unit needed to be divested. Philip Morris decided to sell the Life Savers unit.

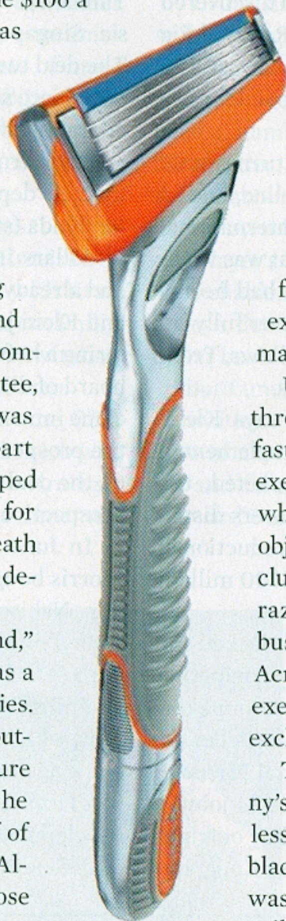
"It was a difficult decision, hard to comprehend," says Klein, who recalls being told that Altoids was a global brand with significant growth opportunities. Klein disagreed. Less than 10% of its sales were outside the U.S., he says. And while Klein was unsure whether Altoids had new products in its pipeline, he knew Life Savers did. Also by selling almost half of the Life Savers unit, which had been bigger than Altoids to begin with, it would become smaller and lose some of the benefits of scale.

After Nabisco, Klein planned to get back into consulting. But Kilts, who had been hired in 2001 as CEO of Gillette, once again knocked on his door.

Gillette, like Nabisco, was a major turnaround play. The company had missed analysts' forecasts for 14 straight quarters. The way Klein saw it, the biggest problem was that the company had become very insular and inefficient. It would pay bills in 15 days but take 120 days to collect debt. Sales meetings were held 10 to 15 days after the books closed each month, not daily. There were few staff meetings or quarterly reviews. Managers were not held accountable and didn't strive to meet performance objectives; few even knew what exactly was expected of them. The board of directors paid out only between 20% and 40% of its bonus pool each year.

As vice president of strategy and business development, Klein once again developed a three-year strategic plan for the entire company. Gillette hadn't created such a plan since 1992. "No one was planning for more than one year in advance," says Klein. The problem, he says, "was more or less self-inflicted."

KLEIN AND KILTS began by redefining the company's organizational structure, laying out clearly defined rules and responsibilities. They didn't replace most executives, though there were some musical chairs. Weekly staff meetings created a venue where managers could be held accountable to each other, not just to Kilts and Klein. Reorganizing made a big difference. By 2005 the board of directors doled out about 95% of the bonus pool to employees.



With the organization functioning, Kilts and Klein turned their attention to revamping the business. A major challenge was recovering from a badly bungled acquisition. Gillette had paid KKR close to $8 billion, including assumed debt, for battery maker Duracell International Inc. in September 1996. But according to Klein, key people from Duracell were lost after the acquisition, and Gillette focused on selling its high-end Ultra brand to the exclusion of some of its better-known, more mid-market brands, like CopperTop and Duracell Plus.

Under the new plan, Duracell would focus on all three brands and look to grow the business' margin faster than the battery business as a whole. To do this, executives were given quarterly and annual goals, which Klein and Kilts ensured were met. The other objectives outlined under Klein's three-year plan included: to expand the company's market share in the razor business, to grow Oral-B's manual toothbrush business and to improve its electric razor business. Across the board, Klein and Kilts found that Gillette executives had focused on high-end products to the exclusion of its bread and butter businesses.

The three-year plan helped improve the company's business and its stock performance. Nevertheless, Gillette was still overly dependent on razors and blades. And with about $10.5 billion in 2004 sales, it was dwarfed by consumer products giants such as Unilever and Procter & Gamble.

Klein believes that larger companies have many competitive advantages. They have more power when it comes to procurement and research and development. They also can invest in areas that are out of reach for smaller competitors. Frito-Lay Inc.'s extensive distribution system and Anheuser-Busch Cos.' advertising campaigns are examples. Larger companies can also exert more pressure on retailers, especially behemoths like Wal-Mart Stores Inc., for shelf space but can also work with them as a global partner.

In one of the many presentations Klein uses in his consulting work, he puts the advantages of scale this way: "It's the ability to invest in building capabilities, which are distinguishable from competitors, like: assessing and integrating acquisitions, managing investor relations and specific areas of technical expertise." Big firms can make investments, adds Klein, "while smaller firms go broke with one idea."

When Gillette decided to look for a big merger, Klein's role once again was to advise the board of directors and work with management and investment bankers. This was not the first time the company had considered a merger. Two years earlier, Kilts approached his counterpart at Colgate-Palmolive Co., Reuben Mark, to discuss a possible "merger of equals," but the sides couldn't agree on a valuation and who would run the combined company. In 2004, Gillette approached Colgate again, and the results were pretty much the same. But four months later, Gillette began talks with Procter & Gamble, which bought the company in February 2006 for $54 billion.

For Gillette, selling to P&G would reward shareholders and

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solve the size problem. For P&G, committed by chairman A.G. Lafley to look outside the company for growth, the deal was an attempt to build out its portfolio. One area that P&G was particularly interested in was Gillette's toothbrush business. P&G's toothpaste brand, Crest, has been trying to gain market share from the industry leader, Colgate, for years, and P&G hoped the deal would help it gain a competitive edge in the dental aisle. The idea is to pair Gillette's No. 1 toothbrush, Oral-B, with Crest, similar to the way shampoo and conditioner are packaged as an extension of a single product. According to a Wall Street Journal article at the end of April, the idea has yet to pay off. One hurdle: getting Oral-B staff to move from Boston to P&G headquarters in Cincinnati, where a Gillette manager decided the operation needed to be.

Another big driver for the deal was that the two companies could help each other expand internationally. Over the years, P&G has developed top-notch distribution systems in such fast-growing markets as China, Russia, Poland and the Philippines, and the chance to move Gillette's products through them was an important reason for the deal. Gillette has its own strengths in such countries as India and Brazil and could help P&G in those markets.

On the international fronts, things seem to be going well. P&G cited strong growth in developing markets when it announced in May that net income was up 14% (to $2.51 billion) in its fiscal third quarter. Overall, P&G's businesses and stock have performed well since the deal, though in a bond prospectus filed in May, it noted that the integration of Gillette continues.

While Klein believes that P&G's scale will help it compete in the years ahead, he sees three key challenges for all of the consumer products companies. The first is intensifying competition. Retailers are growing steadily more powerful, and their growing lineups of private-label products pose a serious threat to manufacturers.

The next challenge for consumer products companies will be getting more efficient. "A lot of the low-hanging fruit has already been picked off," he says, adding that companies would be well advised to rethink what their core businesses are and what functions, beyond the back office, can be outsourced.

The last challenge may be the toughest of all: It's the shortage of good people going into product development and marketing in this now-mature industry. Yes, Kilts has earned spectacular rewards for his work in the field: a total payout of $77 million after the sale of Nabisco and as much as $165 million from the sale of Gillette. Klein, too, has presumably done well in these deals, though he declines to say how well.

But those prizes were years in the making, and they won't be easily duplicated. These days, the young Peter Kleins of the world are much less likely to go into consumer products. As they make their way, though, they'll still do well to consider the lessons Klein and his colleagues have learned over the years. ■