Report to the Commonwealth of Massachusetts, Securities Division on Fairness Opinions and Value of Gillette-P&G Merger

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March 14, 2005

You have asked me to review the Gillette fairness opinions in the P&G-Gillette merger provided by Goldman, Sachs and UBS. I have reviewed the financial projections provided by Gillette. I assume that these are the projections used by Goldman, Sachs and UBS to generate their valuation analyses of the transaction. I have also reviewed the presentation to the Board of Directors on January 27, 2005. I assume that this is the transaction analysis provided by Goldman, Sachs and UBS to the Board of Directors. Having reviewed these materials, the fairness opinions by Goldman, Sachs and UBS seem reasonable and valid in that they rely on internal Gillette and Procter & Gamble projections. However, there appear to be substantial discrepancies in the estimates of how valuable the merger is between what was publicly reported and the internal reports provided by Gillette and Procter & Gamble. The public statements of officers of Gillette and P&G seem to understate the value of the merger. In addition, there seem to be errors in the way the value of the merger synergies was calculated. These errors underestimate the value of the merger. These issues would benefit P&G shareholders at the expense of Gillette shareholders.

To begin, there are discrepancies between the public statements made by Gillette and P&G officers about the value of the merger and their internal company projections. Specifically, the Press Release accompanying the announcement of merger (see Exhibit 99.1 attached to Form 8-K filed by Gillette on January 27, 2005) states "P&G expects to achieve revenue and cost synergies at a present value of about $14 to $16 billion." Similar statements can be found in several of the Forms 425 (SEC file no. 1-00922) filed by Gillette on January 28, 2005 (see either the Fact Sheet or the slides accompanying the Procter & Gamble and Gillette webcast). A detailed statement about these synergies can be found in the discussion by Mr. Clayton Daley, Chief Financial Officer, Procter and Gamble, in the Form 425 filing of February 2, 2005.

In the internal company documents, the estimates of the revenue and cost synergies are higher. On page GIL00453 of the documents provided, Gillette (codenamed Bonefish) estimates the total value of the synergies at $22.09 billion in the second column on the left and $28.08 billion in the column on the right. The $22.1 billion figure (rounded) is repeated on page GIL 00454. These figures are significantly higher than those provided in public statements.

In the discussion materials dated November 17, 2004, pages GIL00455-464, a detailed breakdown is given of cost savings totaling $1.160 billion per year, which appear to be pre-tax cost savings. There do not appear to be data here on revenue synergies. In the board of directors meeting on January 27, 2005, after-tax synergies are estimated to be $1.05 billion per year (see page GIL00483). These are presumably total synergies—both cost and revenue. Working through the data provided, the after-tax synergies of $1.05 billion seem to come from taking the annual synergies of $1.501 billion from page GIL00454 (column on the right) and applying a 30% tax rate to them: $1.05 billion = (100%-30%) X $1.501 billion. I estimated a range of values for the synergies using the assumptions provided on page GIL00483 about the phase-in of the synergies (30%, 75%, 100% over three years) and the cash cost to achieve the synergies ($0.9 billion over two years). I also incorporated the assumptions on page GIL00485 about the discount rate and the FCF (free cash flow) perpetuity growth rate. These calculations are reported in the bottom part of Table 1. As can be seen, the range of values is between $14.89 billion and $22.67 billion. Since there are approximately one billion Gillette shares outstanding, this amounts to synergies of between $14.89 and $22.67 per share of Gillette. Of this amount, Gillette shareholders receive around $9.00 (the difference between the pre-announcement Gillette stock price of $45.00 and the implied value of Gillette shares based on the 0.975 exchange ratio of P&G for Gillette).

Going a step further, errors in how the synergies were calculated seem to understate how large the synergies are. For example, the $1.501 billion in pre-tax synergies from page GIL00454 includes a reduction in the synergies of $375 million due to amortization step-up. This should not have been included in the calculation of the synergies. For confirmation of this point, see page GIL00453 where it says in the comments associated with "Amortization Step Up" that "Bonefish has errantly included this non-cash item . . ." In the rebuttal comments, it says "point accepted." Table 2 shows what the overall value of the synergies would look like if this reduction in synergies had not been included. Here the range of values is between $18.82 billion and $28.55 billion. Again, since there are about one billion Gillette shares outstanding, the synergies per share are between $18.82 and $28.55.

On the basis of the data provided by Gillette, it appears that the public announcements understated the value of the synergies. Further, the internal calculations from Gillette seem to have erroneously underestimated the value of the synergies. Underestimating the value of the synergies would benefit the P&G shareholders at the expense of the Gillette shareholders. For example, using the synergies range of $18.82 billion to $28.55 billion, Gillette shareholders receive about $9 billion of the synergy value and the P&G shareholders receive about $10 billion to $19.5 billion of the synergy value. In public statements, Gillette and P&G officers claimed that the value of the synergies to P&G shareholders was between $5.5 billion and $7.5 billion (see, for example, Mr. Clayton Daley, Chief Financial Officer, Procter and Gamble in the Form 425 filing of February 2, 2005).

Given that Mr. James Kilts, CEO of The Gillette Company, has a large number of options on Gillette stock, it may seem unlikely that he would negotiate a merger transaction that was unfavorable to Gillette shareholders. Yet, in my earlier report, I noted that Mr. Kilts was receiving from Procter & Gamble an unusual additional payment of $11.316 million in addition to his contractually agreed aggregate change in control payment of approximately $32.387 million from Gillette. These are sums Mr. Kilts would not have received in the absence of a merger agreement.

In conclusion, there are discrepancies between the public statements made by Gillette and P&G officers about the value of the merger and their internal company projections. The public statements seem to understate the value of the merger. In addition, there seem to be errors in the way the value of the merger synergies was calculated. These errors underestimate the value of the merger. Both of these issues would benefit P&G shareholders at the expense of Gillette shareholders.

Table 1
Synergies based on Presentation
to Board, January 27, 2005

(in billions)	Year 1	Year 2	Year 3	Synergies grow at growth rate in subsequent years
After tax synergies	0.315	0.7875	1.05	
Cost of synergies	-0.45	-0.45		
Net Gain	-0.135	0.3375	1.05	

Terminal value of synergies (in billions)

	FCF Perpetuity Growth Rate		
Discount Rate	3%	3.50%	4%
8%	$21.00	$23.33	$26.25
8.50%	$19.09	$21.00	$23.33
9.00%	$17.50	$19.09	$21.00

Overall value of synergies (in billions)

	FCF Perpetuity Growth Rate		
Discount Rate	3%	3.50%	4%
8%	$18.17	$20.17	$22.67
8.50%	$16.38	$18.00	$19.98
9.00%	$14.89	$16.23	$17.84

Table 2
Corrected Synergies

Pre-tax synergies	1.876	billion	(removes amortization step up)
After-tax synergies (30%)	1.313	billion	

(in billions)	Year 1	Year 2	Year 3	Synergies grow at growth rate in subsequent years
After tax synergies	0.39	0.98	1.31	
Cost of synergies	-0.45	-0.45		
Net Gain	-0.06	0.53	1.31	

Terminal value of synergies (in billions)

	FCF Perpetuity Growth Rate		
Discount Rate	3%	3.50%	4%
8%	$26.26	$29.18	$32.83
8.50%	$23.88	$26.26	$29.18
9.00%	$21.89	$23.88	$26.26

Overall value of synergies (in billions)

	FCF Perpetuity Growth Rate		
Discount Rate	3%	3.50%	4%
8%	$22.92	$25.43	$28.55
8.50%	$20.68	$22.71	$25.19
9.00%	$18.82	$20.50	$22.50