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Pass the ketchup

Evan Lorenz writes:

One point seven billion dollars: Those are the cost savings that 3G Capital has wrung from the July 2, 2015 merger of Kraft Foods Group, Inc. and H.J. Heinz Holding Corp. Unfortunately, there is nothing more to squeeze out, Kraft Heinz Co. (KHC on the Nasdaq) warned the Street last week, and sales are declining. What comes next for the food conglomerate? Nothing good, we surmise.

You are by now, no doubt, familiar with the plight of packaged-foods companies. Consumer tastes have shifted toward the fresher/better-for-you/organic products found in the periphery of grocery stores and away from the canned soup, boxed macaroni and cheese and processed meats stacked in the center aisles (*Grant's*, March 25, 2016). Aldi and Lidl Stiftung & Co. KG, the German deep-discount retailers that favor store brands over their national counterparts, are rapidly expanding in the United States. Then, too, Jeff Bezos is making a major push into the grocery business (*Grant's*, March 24, 2017).

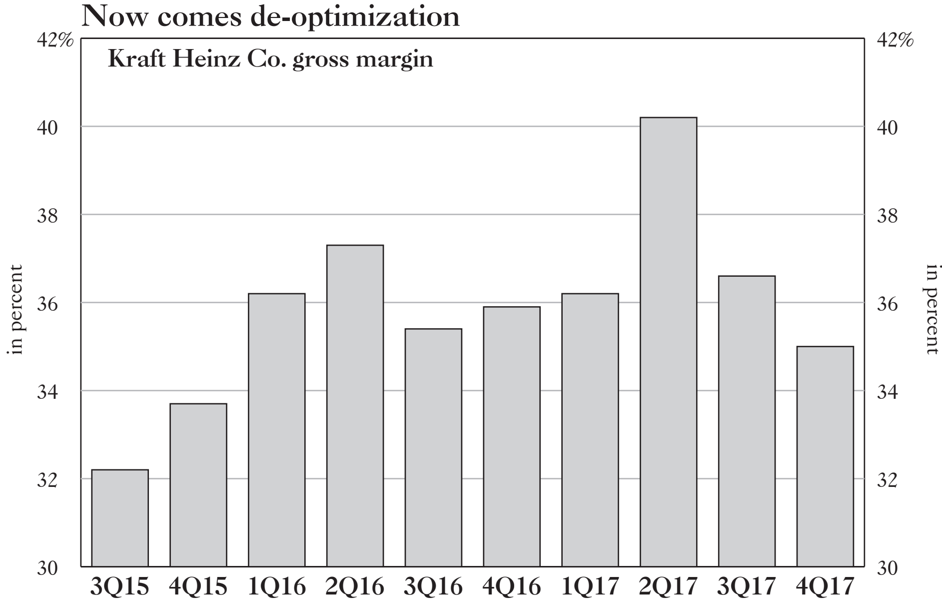
The food-makers have confirmed the bear case. Last Friday, Kraft Heinz and Campbell Soup Co. (CPB on the Big Board), two *Grant's* picks-not-to-click, reported earnings misses driven by sluggish sales and contracting gross margins. Since our 2016 report, these stocks have dropped by 10% and 27%, respectively, in the context of a 33% levitation in the S&P 500.

Kraft Heinz telegraphed its rocky fourth-quarter results by holding a one-and-a-half-hour conference call and issuing a 77-page slideshow last Thursday about its progress since the merger. Why, analysts whispered, did management need to give a business update less than 24 hours before the earnings conference call if not to soften the coming blow?

The brilliant Brazilians introduced the packaged-foods industry to a host of cost-cutting, efficiency-seeking management jargon: zero-based budgeting (ZBB), management by objective (MBO), trade spend optimization, etc. While the Thursday call had the obligatory sprinkling of 3G argot, much of the discussion covered basic blocking and tackling issues that would be familiar to any retail analyst a decade ago. For example, Mike Donohoe, a marketing VP at the Kraft Cheese division, spent several minutes talking about planograms, i.e., how food-makers work with grocers to ensure products are properly stacked on shelves. Donohoe was pleased to announce that a certain unnamed grocer had given various KHC-branded mustards more prominent positioning.

What was left unsaid was the price Kraft Heinz paid for that shelf space. Retailers typically demand trade "spend," i.e., dollars that grocers can use to lower retail prices or fatten margins, for desirable in-store real estate. Cutting these quid pro quo arrangements under the guise of trade spend optimization was one of the major sources of the aforementioned $1.7 billion in savings from the merger with Heinz. It sounds like Kraft Heinz may be de-optimizing its trade spend in 2018. On the Feb. 16

Now comes de-optimization



source: The Bloomberg

earnings call, management said that it will be "investing" $250 million to $300 million in an effort to boost revenue growth through a variety of initiatives.

Acquisitions are one way KHC could change course. "This period of change compels our company, our competitors and our staples peers to be more efficient—and may drive pressure for further consolidation of our industry," CFO David Knopf said on Kraft Heinz's Feb. 15 call. "We think these pressures could generate further opportunities for us to expand our portfolio of leading brands and leverage our highly scalable operating model."

Then why did management sound so ambivalent when analysts dwelled on M&A during the call? After all, KHC has historically commanded a premium multiple; investors see the ketchup-maker as a platform company for reaping profits by rolling up lesser packaged-foods businesses.

Here, Kraft Heinz has created its own problem: Heinz's acquisition of Kraft was a shot across the industry's bow. CEOs at competitors like Campbell quickly adopted 3G jargon (e.g. ZBB) and M.O., lest the corporate vessels they command fall victim to Brazilian assault. As a result, there isn't a lot of fat left for KHC to cut from potential American acquisitions. Anyway, as a group, such companies face declining revenues.

This is why Kraft Heinz made an unsuccessful bid last year for Unilever plc. The Anglo-Dutch manufacturer of food- and home-care products was less efficient than its American peers and gets the majority of its sales from faster-growing emerging markets. And this is why Kraft Heinz spent so much time last week discussing how the company would attempt to increase sales organically.

So, how should we assess Kraft Heinz's ability to manage an operating business, apart from slashing its costs. "[T]he Heinz brand in the United States is now 17% bigger than it was in 2015," CEO Bernardo Vieira Hees noted of a key success on the Feb. 16 call, "which is a good example of the process we are going through with each category." The growth in the Heinz brand is part of KHC's focus on big bets—on concentrating ad and innovation dollars on a few brands and product categories that management believes hold the most promise.

To put Heinz's growth in context, overall organic sales in the United States fell by 0.3% in 2016 and by 1.5% in 2017. This implies that non-Heinz-branded sales contracted substantially over the past two years. Kraft Heinz owns 33 brands that reap $100 million or more in revenues. By focusing on a few designated winners rather than the overall portfolio, the company runs the risk of eroding the equity of its smaller brands. Neglected, the step-children may disappoint.

Kraft Heinz trades at 19.1 times trailing earnings today, which constitutes a kind of progress; it was quoted at 34.9 times when we had our first say almost two years ago. Still, virtually 19 times net income is a fancy multiple for a company facing revenue and margin pressure in a hyper-competitive grocery market.

Mr. Market appears unfazed. Short interest is a minimal 2.9% of the KHC float. Of the 25 analysts who rate the stock, 18 say buy and not one says sell. Over the past 12 months, insiders have sold no shares (nor have they bought). Give them credit for loyalty, anyway.

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