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Price war for Warren Buffett

Food prices at the grocery store registered their 23rd consecutive year-over-year decline in February. It's the longest such deflationary skein in the 70-year history of the finished consumer-foods component of the Producer Price Index. Comparing deflation at the supermarket with inflation on Wall Street, you're likely to think of our friend Kraft Heinz Co. (KHC on the Nasdaq). [“Sell big food,”](#) said the issue of *Grant's* dated March 25, 2016. Sell it all over again, we here reiterate.

Every reader will find something of interest in the analysis to follow, even the many whose idea of a good risk/reward proposition isn't taking the other side of a Warren Buffett trade. This is the story of low interest rates, high price/earnings ratios, EZ credit and fast-paced deal-making—i.e., the story of our financialized world. “There are just way too many assets chasing the sales,” analyst Scott Mushkin tells colleague Evan Lorenz. There it is, in a nutshell.

Kraft Heinz is the conglomerate born of the July 2015 acquisition of Kraft Foods Group, Inc. by HJ Heinz Co. Among the brands thereby joined are the ones you might have grown up with: Oscar Mayer, Planters, Velveeta, Philadelphia, Maxwell House, Kool-Aid, Jell-O. America is the first among the 190 countries that contribute to annual sales on the order of \$26.5 billion. Berkshire Hathaway Inc. and 3G Capital share majority ownership (with interests of 26.8% and 23.9%, respectively). Say “3G” and some think of fat and fatter profit margins, others of small and smaller paychecks. Since the merger, Kraft Heinz has boosted

its adjusted EBITDA margin to 29.4% from 23.2%.

In the past 12 months, the KHC share price has vaulted by 20%, to \$91.90. The market has fixed on superficially good fourth-quarter results, in which headline sales fell by 3.7% from a year earlier (vs. guesstimates of a drop of 5.5%), while non-GAAP earnings per share weighed in at \$0.91, a 47% year-over-year leap and \$0.04 ahead of consensus. And despite the fourth-quarter's revenue contraction, organic sales in the United States showed a year-over-year gain of 1.7%. Then, too, management last month boosted its forecast for merger-related savings to \$1.7 billion from \$1.5 billion, of which, at year end, \$1.2 billion was already in the can.

So much for surface impressions. “Delving deeper into the fourth-quarter details, you might conclude that the 3G model is moving past its sell-by date,” Lorenz advises. “Yes, sales surprised to the upside, but for reasons that reflect no glory on the front office—retailers bought too much in mid-2015 and retrenched in the fourth quarter of that year; they stepped up their buying in the first and fourth quarters of 2016, which volumes helped to serve up the rise in organic sales growth. The earnings beat was driven by a lower than expected tax rate (\$0.04 benefit) and a lower interest rate (\$0.01 benefit) to offset a decline in expected margins.”

“Trade spend optimization”—i.e., paying less for shelf space in the supermarket—is one of the keys to 3G's storied success in cost containment. Or, at least, it has been. News of a \$300

million boost in promotional spending sent the Kraft Heinz share price tumbling by 4.2%. It roared right back again on news, announced the very next day, Feb. 17, of Kraft's bid for Unilever plc, about which more below.

KHC's fancy valuation—26.8 times trailing adjusted earnings, 24.4 times the 2017 estimate—rests on the bulls' conviction that management can continue to crack the whip on costs, efficiency being imperative in the absence of earnings growth. Post-merger, growth in Kraft's adjusted EBITDA—\$1.2 billion—happens exactly to match the “integration synergies” that Kraft's management claimed through 2016.

Not that the vaunted 3G management style is exclusively about the ax. The cheapskate Brazilians are better at sourcing and buying things than the legacy Kraft Foods team was. Savings from that source, substantial to start with, quickly trailed off; in the first, second and third quarters of 2016, they came in at \$72.5 million, \$50 million and \$11 million, respectively. (No word on the fourth quarter, and management says it won't reveal such data in the future.)

It's easy to show that, in round numbers since Kraft bought Heinz, underlying profitability of the merged entity has actually declined. Thus, from \$7.8 billion in 2016 adjusted EBITDA, subtract the aforementioned savings from better sourcing (at least \$133.5 million) and full-year integration savings (\$1.2 billion). Revealed: a 2.5% decline in underlying adjusted EBITDA.

Kraft's problems are set to deepen as the grocery business becomes more competitive. “Amazon is really attack-

ing the \$1 trillion consumables marketplace,” says Mushkin, the retailing analyst at Wolfe Research. “The company built out 24 fulfillment centers last year. Our expectation is at least another 30 fulfillment centers will be built in the U.S. averaging one million square feet—maybe even 35. Look at their AmazonFresh program [a grocery sales platform], which recently rolled into Miami, Dallas, Chicago, Boston and Orange County. There is Subscribe & Save [a feature offering consumers steep discounts on periodic orders], which they’ve been very aggressive with—the pricing is incredible.” Or look at the newish Amazon private-label line of baby food called Mama Bear. Bearish—for the incumbents—indeed.

“If you look at Amazon and then you look at what Wal-Mart is doing,” Mushkin goes on, “in one sense, Wal-Mart is copying Amazon. Wal-Mart now owns Jet [an online competitor to Amazon]. Jet soft-launched its Jet Fresh, [which] is now available almost everywhere east of the Mississippi, and they’re offering 25%-off coupons. On top of that, regular Jet is offering 15% off your first three orders. Jet is basically a consumables company delivered to your house.”

Or you may drive to Wal-Mart, which is likewise investing in lower prices. So far, so good on the top line: In the fiscal fourth quarter of 2017 (ended Jan. 31), Wal-Mart’s same-store sales showed a year-over-year gain of 1.8% vs. a 0.6% rise in the year-earlier period. No such success in earnings leverage, though: The modest rise in fourth-quarter sales notwithstanding, operating income fell by 6.6%.

According to a Feb. 27 Reuters report, Wal-Mart is testing even steeper price reductions in 1,200 stores in the Midwest and Southeast. How to finance this stratagem? Summoned to Bentonville, Ark., Wal-Mart’s suppliers have reportedly heard an ultimatum to slash their prices by 15%. In 2016, Wal-Mart accounted for 22% of Kraft Heinz’s sales.

Lorenz beguiled a recent weekend with transcripts of the latest earnings calls by the top grocery vendors. “Target Corp. told analysts at the end of February (in the context of a 1.5% decline in fourth-quarter same-store sales) that it would sacrifice \$1 billion in operating margins in 2017 to invest

in stores and lower prices,” he reports. Target Corp. chairman and CEO Brian C. Cornell told dialers-in, “We’ve not seen this number of distressed retailers since 2009 in the Great Recession. This contraction will create opportunities for Target to pick up market share over the long term, but aggressive promotional activity will create pressure on our business in the near term. At the same time, there are others who are thriving in this new environment. So the changes we’re making are aimed squarely at moving Target into the retail winner circle.”

“On March 2,” Lorenz proceeds, “Kroger Co. announced its first quarterly same-store sales decline (down 0.7%, excluding fuel) in 13 years, and it, too, pledged to cut prices. SuperValu, Inc., registering a 5.7% drop in same-store sales in the three months ended Dec. 3, vowed to ‘react’ to the low-price environment. Whole Foods Market, Inc., also feeling the deflationary chill with a 2.4% same-store sales decline in the Jan. 15 quarter, issued its own defiant price-slashing edict.”

What will the Trump administration tweet when it discovers that Aldi, the closely held deep-discounter from Mülheim, Germany, is thriving right here in America? Aldi’s no-frills approach to retailing features low, low prices and lots of store brands, including—a shot across the Heinz bow—SimplyNature ketchup. Aldi is on record with plans to spend \$3 billion on building 650 new American stores as well as to invest \$1.6 billion in remodeling and expanding most of its existing 1,633 American locations. Another German deep discounter, Lidl Stiftung & Co. KG, says it plans to open its first American outlet this summer. In the United Kingdom, where the Germans command a greater share of retail traffic than they do in the 50 states, the margins of the indigenous grocers, including Tesco plc, have come under pressure.

How to account for the strikingly high incidence of distressed American retailers? Jeff Bezos and the worldwide web have something to do with it, naturally. So, too, do ultra-low interest rates, high price/earnings ratios and credit markets fitted out with red carpets. Consider, for instance, the New York/New Jersey grocer Fairway Group Holdings Corp., which made no net profit in the three-plus years that separated its IPO from its 2016 bank-

ruptcy filing. And having emerged from bankruptcy infused with loans from a consortium led by a unit of the Blackstone Group—this was last summer—the company has closed only one of its 15 stores. In January, it opened a new store in Brooklyn.

Or reflect on single-B-plus-rated SuperValu, whose net income has been sawed almost in half in the past year; except for the hospitality of the junk-bond market, it might be closing stores. Triple-B-minus-rated Whole Foods, which is furiously opening stores, paid an average of 5.7% on borrowings in the quarter ended Jan. 15. If the organic-foods retailer were to refinance today, it would pay far less: The Whole Foods senior unsecured 5.2s of December 2025 change hands at 105.77, a price to yield 4.4%.

Then there’s B1-rated Albertsons Companies, Inc., the Cerberus Capital Management-run grocery roll-up (Safeway, Jewel-Osco, Albertsons), whose pro forma operating income of \$468 million failed to cover interest expense of \$681 million in the nine months through Dec. 3, 2016. No harm, no foul: Management is preparing to issue public equity and, according to Bloomberg, is in talks to buy Sprouts Farmers Market, Inc. ([Grant’s, Nov. 15, 2013](#)).

It’s hard to say what Aldi is paying for capital, but it likely isn’t much. Lidl, the other closely held German grocer, bore an interest cost of 2.2% in the 12 months ended February 2016. Triple-B-minus-rated Kraft Heinz pays 2.9%.

In buying HJ Heinz almost four years ago, 3G and Berkshire touched off a managerial revolution in the packaged-foods business. Zero-based budgeting and zero (or at least heavily reduced) trade-promotion costs became standard operating procedure. It hasn’t mattered that kale-eating consumers have bought fewer hot dogs and less American cheese; at Kraft Heinz and its imitators, cost-crunching has so far carried the day. Thus, its droopy sales notwithstanding, Campbell Soup Co. lifted its adjusted EBITDA margin to 22.9% at last report from 18.9% in 2014.

“Maybe Kraft Heinz bid for the Anglo-Dutch Unilever because American packaged-foods companies have already adopted 3G’s methods,” Lorenz speculates. “There’s not much fat

to cut. As far as Unilever goes, North America and Europe contributed only 42.3% of revenue in 2016. Asia and Latin America chipped in the rest, and they continue to enjoy positive organic growth. In 2016, Unilever's EBITDA margin was a mere 18.4%, resembling Campbell's before the soup company got religion."

As we went to press, the *Financial Times* unveiled online an interactive table to allow its readers to speculate on KHC's next strategic gambit. "Build your own Kraft Heinz takeover," the headline beckons. What size premium will the acquirer pay to snatch its prey? How much debt will it employ? How much will Buffett and 3G contribute? What share of the merged company will they own? And—from *Grant's Interest Rate Observer*—another question: Could this be the end of the world's love affair with Kraft Heinz?

And still another, which we address to the packaged-foods bulls: What if the retailers, like their suppliers, see the economic light? "With companies

[like Kraft Heinz] pulling back promotions," observes John J. Baumgartner, a Wells Fargo Securities analyst who appraises KHC "market perform," "if you are the retailer, you are like: Wait a minute, the volumes are still down. Your product is not bringing people to our stores. It is not a traffic driver. And we are no longer being paid rent for the product. Why are we going to keep it on the shelf? We'll scale back three or four [shelf] facings, put private label in there instead and we will do a natural or organic brand. There are more and more options now."

What is Kraft Heinz worth? "The consumer-staples component of the S&P 500 trades at 22.4 times trailing GAAP net income today," Lorenz replies. "It traded at an average of 17.4 times net income in the decade ended June 2013, at which terminal point 3G and Berkshire did their deal with Heinz. Compare and contrast the 26.8 multiple of adjusted earnings that Kraft Heinz commands today. What should you pay for that business in the

context of sliding revenues and margins that are no longer fattening? Less, we continue to believe."

P.S. The grocery price war could put additional pressure on American restaurants ([Grant's, Dec. 23, 2016](#)). "Way too many assets chasing the sales"—the insightful comment quoted above—also describes the dining-out branch of the food business. The price difference between eating at home and eating at a restaurant was historically high last year. With restaurants raising prices to cover rent and wages and with grocers cutting food prices to drive traffic, the affordability gulf may widen. In February, compared to a year ago, the food-at-home component of the CPI fell by 1.7% while the food-away-from-home component rose by 2.4%. According to Black Box Intelligence, same-store sales for restaurants in that month plunged by 3.7% from the 12 months before.

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