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Demography

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How to Strip Big Food Down to Its Essentials

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MARKET WATCH: What's Happening? *Big Food is struggling with near-zero growth and low margins brought on by declining demand from consumers who want fresh, natural food. Big Food is therefore becoming an attractive market for private equity firm 3G, which specializes in transforming has-been brand giants into profitable producers of generic food.*

Our Take: *As Big Food firms come to a fork in the road, they must make a choice: Invest in healthier upscale products, drastically slash expenses to preserve the bottom line (either on their own or under new ownership), or expand sales abroad. For many firms, number two is probably the only available option.*

When Brazilian private equity firm 3G Capital Partners makes a move—or even considers one—markets take notice.

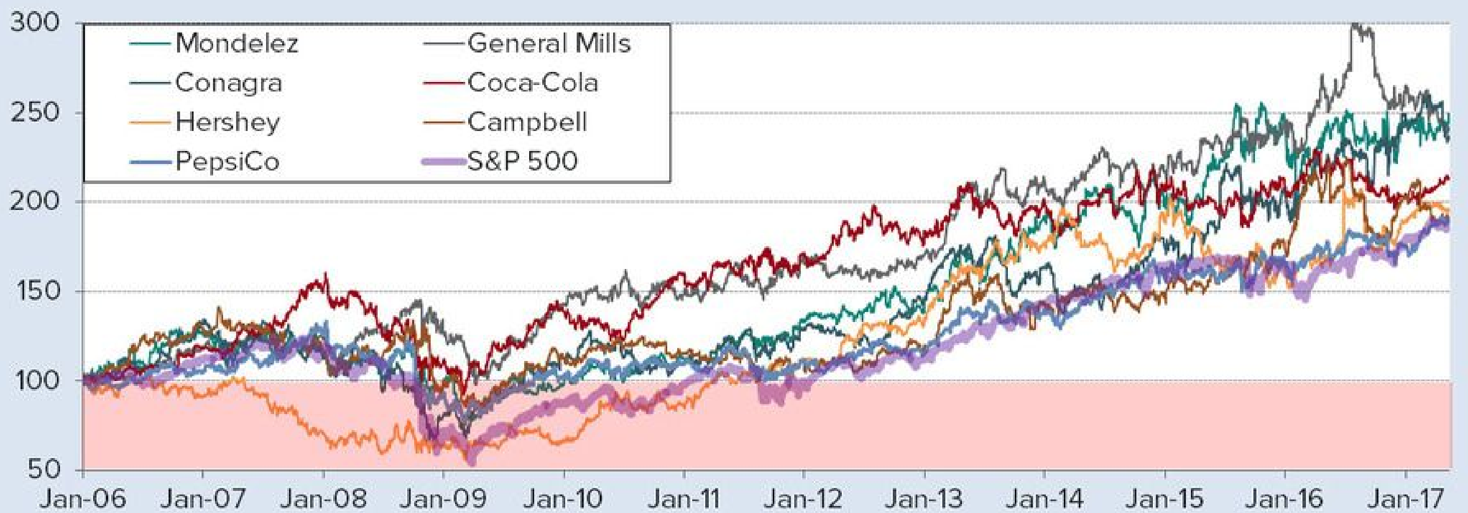
This appears to be happening in Big Food. Kraft Heinz (KHC), which is majority-owned by 3G, has been doing relatively well since it was formed via merger in late 2015. With a few blips along the way, Kraft Heinz stock has risen nearly 20% in the less than two years that 3G has been at the helm. The company saw its stock spike in February when news broke that the company had tendered a multibillion-dollar offer to acquire CPG giant Unilever (UL)—and although the merger quickly fell through, Kraft Heinz remains pricey.

Seemingly baked into this price is investor expectation that Kraft Heinz will acquire someone in the near future. According to consultancy EVA Dimensions, the economic value of Kraft Heinz should generate a stock price of $59. Instead, the company costs around $90 a share. Similarly, investment research firm New Constructs gives Kraft Heinz a lofty price-to-EBV ratio of 2.8. Thus, not only do investors place a premium on the companies that Kraft Heinz may acquire, but also on Kraft Heinz itself—due to the expectation that its future acquisitions will drive high returns.

Analysts are speculating that this “someone” will be another Big Food entity. Bloomberg columnist Tara Lachapelle recently wrote that Kraft Heinz could soon snatch up a company such as General Mills (GIS) or PepsiCo (PEP).

This prediction makes sense. Overall, yes, Big Food has performed very well since the Great Recession. Until the #TrumpTrade, it easily outpaced the S&P 500, mostly for style reasons. Investors craved consumer staples for their low perceived earnings vol (nothing is more recession proof than processed food) and for these firms’ steady dividends, which made them bond substitutes at a time when bonds were king. But as we’ll explain later, this favorable performance was driven by multiple expansion rather than by any commensurate earnings growth.

So now that the market has experienced “sector rotation” and the slow plodders are falling out of style in favor of racier beta, the air is hissing out of Big Food.



The market is now coming to terms with an industry that has in fact demonstrated declining trend growth for twenty years and may be in real trouble going forward. And this is where 3G steps in.

HOW 3G WORKS

To understand why another 3G deal is almost inevitable, we need to look at how 3G does business.

Founded in 2004, 3G specializes in mass consolidation, bare-bones efficiency, and low prices. The Brazilian private equity firm regularly partners with Berkshire Hathaway (BRK.A) to finance bids for large public companies.

Look at its track record: By merging Kraft and Heinz, 3G created the fifth-largest food and beverage company worldwide. In the world of Big Beer, 3G's principal investors went on a decades-long buying spree that left the company in control of AB InBev (BUD)—which now brews *nearly one-third of the world's beer*. 3G is also making headway in fast food. Following its highly profitable purchase of Burger King in 2010, the firm acquired Canada-based Tim Hortons in 2014, joining them under parent company Restaurant Brands International (QSR). In February, RBI announced plans to buy Popeye's for $1.8 billion.

3G'S ROBUST PORTFOLIO OF BRANDS

Restaurant Brands International

KraftHeinz

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Source: Company Materials (2017)

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3G's business method is simple: Achieve profitability by cutting all but the most vital expenses. The company's core philosophy hinges on "zero-based budgeting," by which budgets are built from scratch each year. These newly constructed budgets inevitably call for drastic overhead reductions and massive job cuts: Since the Kraft-Heinz merger, the company has closed six factories and eliminated 5,150 jobs, including 11 of the top 12 leadership posts.

Quite simply, 3G realizes better than the Big Food companies themselves that the brand premium which once justified lofty marketing budgets and endless product proliferation has largely disappeared—in an era when consumers are perfectly willing to buy a private-label brand for a few pennies less.

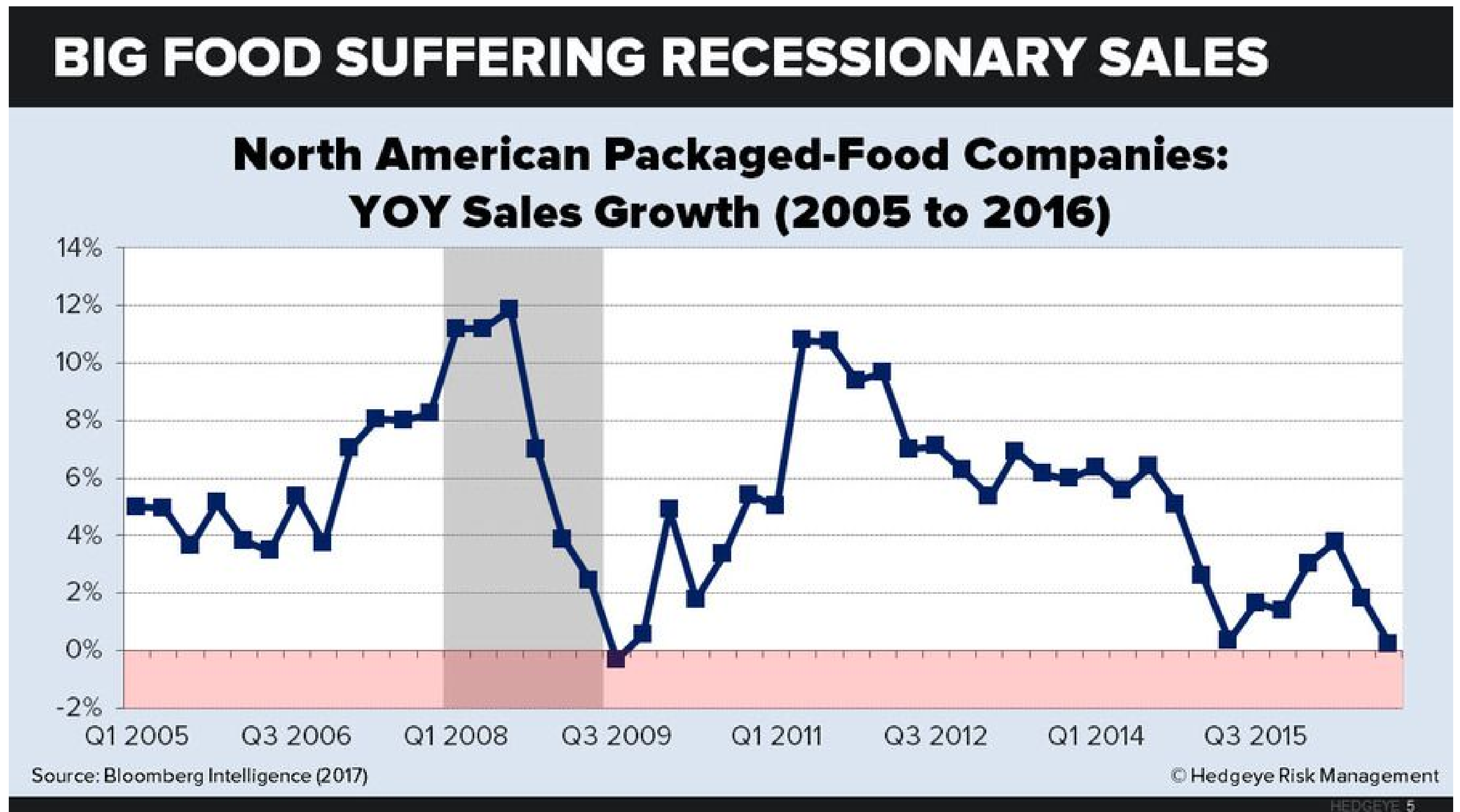
There's no room for sentimentality in 3G's playbook. Among the shuttered Kraft-Heinz factories was a legacy Madison, Wisconsin plant that once employed more than 4,000 workers. Other cost-cutting measures involve trimming the fat on everyday expenses—including removing free food from company offices, forcing employees to bunk together on road trips, and even printing double-sided to save paper.

These moves have paid off. Even with near-zero revenue growth, Kraft Heinz increased its cash flow by $2.1 billion YOY as of Q3 2016. Likewise, in the fast food business, Restaurant Brands International earns a profit of 45 cents on every $1 on the menu at its outlets—double the industry average.

WHY BIG FOOD?

If any market is ripe for 3G's extreme measures, it's Big Food.

North American packaged-food companies experienced just 0.2% YOY sales growth in Q4 2016, the lowest mark since 2009. PepsiCo's Frito-Lay snack division saw its North American volume drop in Q4 2016 for the first time in five years. Nestlé (VX: NESN) registered just 3.2% organic YOY growth in 2016, the slowest rate in two decades.



Taken together, the past two years have marked Big Food's worst consecutive years in terms of sales growth in *at least three decades*.

Because of these tough conditions, firms are looking to sell off the unprofitable arms of their businesses. Unilever wants to divest its margarine and spreads division worth as much as $8.5 billion. Conagra (CAG), which owns brands such as Slim Jim and Chef Boyardee, sold its frozen potato business last year and is considering further cuts.

More than just a temporary blip, Big Food's troubles have been simmering for decades.

The industry's very origin—and its early heyday of stellar growth—can be traced to the period between the Great Depression and the end of the postwar American High. During these years, Boomers were raised by G.I. and Silent Generation parents who viewed processed food as the modern, healthy option.

But ever since they came of age, Boomers have been pushing back against the prepackaged middle aisles of the grocery store. With their New Age mentality, Boomers have been skeptical of products that don't look and taste like their natural counterparts. In fact, they were the generation

to popularize the term “processed food” in the 1960s—only they meant it as a form of criticism, not praise. (See: “**What’s Eating Big Food?**”)

This mindset has worked its way down the generational spectrum. When it comes to food, Generation X is by and large following in Boomers’ footsteps, particularly when it comes to finding healthy food for their kids to eat. (See: “**Nothing’s Too Good for My Baby**.”) Millennials, meanwhile, are heeding the warnings of elders who have spoken out against the sugar-laden, additive-filled products that Big Food manufacturers have long counted on.

In response to this generational shift, many grocery stores are even paring back shelf space devoted to Big Food in favor of more space given to deli counters and other natural offerings.

WHAT’S LEFT FOR BIG FOOD?

Big Food is suffering from a prolonged “death in the middle,” whereby cost-conscious consumers are buying discount products and health-conscious consumers are buying high-end options. In order to survive, firms in this industry must move either up or down.

Go all-in on healthier items. Moving up means acquiring healthy brands that can support a premium—and gradually selling off the remainder.

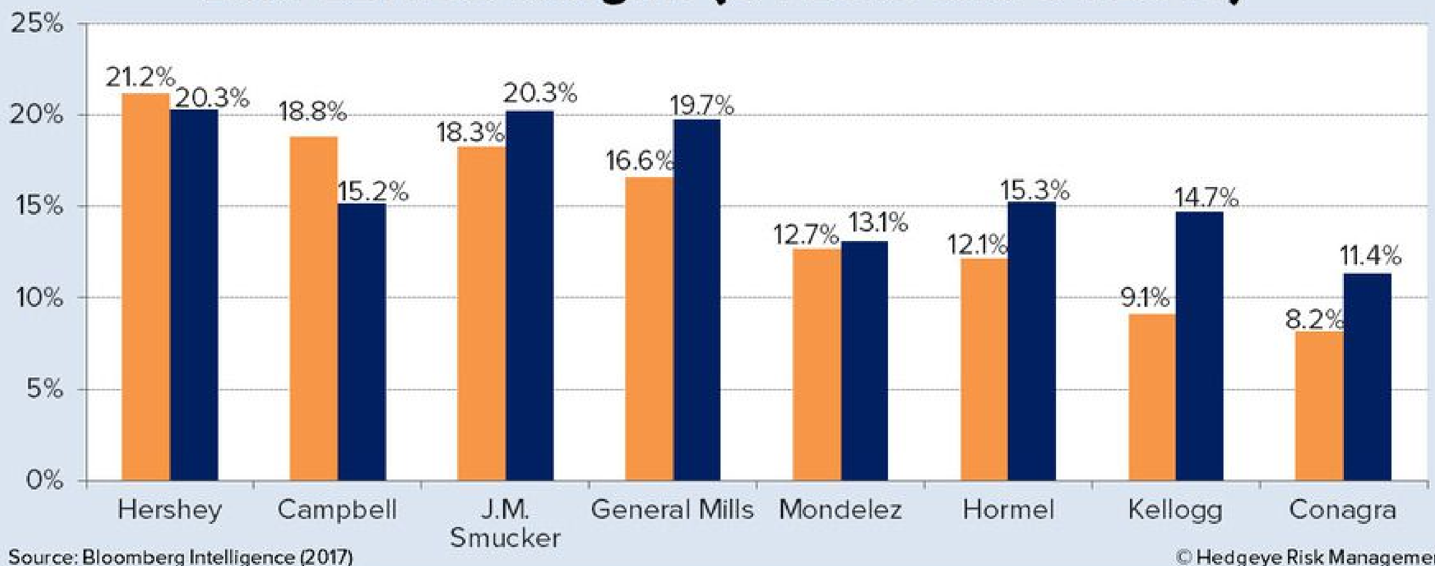
A few firms are utilizing this strategy. On a recent earnings call, PepsiCo executives said that the company’s growing “guilt-free” product lineup (such as bottled water) accounted for more than 45% of its Q1 2017 revenue. Hormel has spent billions since 2011 to acquire natural brands such as Wholly Guacamole and Applegate Farms—and now sells items such as a pea-based protein shake.

John Bryant, Kellogg chief executive, said earlier this year: “There’s probably more change today than at any time in my history of the industry.” In response to this change, Kellogg recently rolled out snacks containing teff, a gluten-free, high-fiber Ethiopian grain.

Cut, cut, cut. Moving down, on the other hand, means abandoning brand premium along with the associated costs, and instead becoming a low-margin commodity producer.

Since 3G’s Heinz acquisition, every major U.S. foodmaker has announced an initiative to significantly reduce its overhead. One of the first to do so was Mondelēz, which itself adopted zero-based budgeting. The company is also adding efficiencies to the production process and getting rid of underperforming products. General Mills hopes that its own “holistic margin management” will save a cumulative $4 billion by 2020. As part of its cost-cutting push, the company recently announced that it would be closing five plants and eliminating 1,400 jobs.

Is this push working? Somewhat: Most Big Food companies have improved their margins since Q1 2015, if only modestly. This self-remedying is undoubtedly one reason why Sanford C. Bernstein analysts recently wrote that “the number of attractive U.S. [Big Food] targets is getting smaller.”



Look for a new place to push products. Whatever types of products they sell, Big Food firms have always counted on the U.S. grocery store as their primary distribution channel. But that appears to be changing. PricewaterhouseCoopers estimates that by 2025, just 37% of all consumer packaged goods sales will take place in a grocery store—down from nearly half today.

One alternative for these firms would be to beef up their presence in discount retail establishments (Sam's Club, Costco) and convenience stores (7-Eleven), where shoppers are motivated by cost rather than quality. Another would be to pursue faster-growing global sales. Nestlé is well positioned in this regard, earning more than 40% of its revenue from emerging markets.

THE ULTIMATE FUTURE OF BIG FOOD

While Warren Buffett may bristle at the word "LBO" to describe what he and 3G did to Heinz, 3G itself is unquestionably a private equity firm that needs to keep the deals coming to make money. Its "lather, rinse, repeat" business model of acquiring a company, cutting costs, and moving on only works with a steady stream of acquisitions. (One director of an unnamed foodmaker calls 3G "the shark that can't stop swimming.") There's only so much trimming that 3G can do before it has squeezed out all available profitability.

A look at Kraft Heinz's margins reveals why investors believe that 3G will soon make another acquisition. As recently as Q3 2016, 3G was able to grow Kraft Heinz's margins by 14.6% quarter over quarter. However, the latest Q1 2017 margins came in virtually unchanged Q/Q.

A few Big Food companies likely have done enough to fend off the shark—including Hershey (HSY), J.M. Smucker (SJM), and General Mills, all of which boast EBITDA margins of around 20%. (Additionally, Smucker's family-run leadership branch may not even consider an offer.)

But the rest remain in the danger zone. One obvious candidate is Mondelēz. The company's LTM margins of 13% leave much room for improvement, and the acquisition would increase the global share of Kraft Heinz's sales from 30% to 48%. Plus, a Mondelēz merger would *more than double* Kraft Heinz's emerging market sales.

The bottom line: Big Food firms must move either up or down the price spectrum. If they successfully move up, they may perhaps regain their identity as a company with some significant year-to-year sales growth. If they move down, on the other hand, the best they can hope for is to become an efficient producer of generic food—thereby fending off acquirers and becoming a stable, low-growth, low-P/E company. A third option, available to some firms, is to get out of grocery stores and (especially) expand faster into emerging markets.

The extent to which companies have successfully moved in one of these directions may explain part of the industry's recent multiple expansion. For example, Smucker has been adding value by moving up, General Mills by cutting costs and moving down, and Nestlé (as ever) by marketing hard in sub-Saharan Africa.

Going forward, if firms don't go in one of these directions—up or down or abroad—they will waste away. Or they will be bought up by 3G, the shark that truly knows how to spot a struggling fish and will not hesitate to make the choice (going down) for them.

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