The Big Read Kraft Heinz Co

Kraft Heinz: hungry for growth after austerity diet

With revenues flat and shares falling, the food group is cooking up fresh plans

Alistair Gray and James Fontanella-Khan 2 HOURS AGO

Pornography is an unconventional subject for a family food company. But during commercial breaks from the Super Bowl earlier this month, Kraft Heinz used the idea of "food porn" to promote frozen meals to American football fans.

Without ever mentioning the P word during the primetime broadcast, the ads for its 'Devour' brand played on the theme of a young man becoming hooked after ogling online images of "steamy" mac and cheese.

"This addiction can happen to anyone," his girlfriend warns. The company went a lot further online: it even took out ads on an actual porn website.

The Devour campaign is the latest sign from Kraft Heinz and its Brazilian investment backers, 3G Capital, that they are prepared to take risks to win back shoppers who have ditched the mass-produced foods that were household staples for generations. In the process, the company is trying to change the view of what has been one of the most influential and controversial business models of recent decades.

3G, whose brands range from Budweiser to Burger King, is known less for its marketing prowess and more for an intense focus on costs that has served as a model for corporate America in how to make money in mature markets.

A tie-in advert with the superhero character Deadpool for the hit movie sequel promoted the Devour brand

Yet almost four years since 3G engineered the $63bn megamerger of Kraft and Heinz, the company's financial performance has stuttered with the shares down around one-third since the 2015 tie-up. Wall Street has been left wondering if the lean-and-mean approach it once applauded has gone too far and starved the brands of much-needed investment.

"They were focused on cutting costs to the exclusion of other aspects of the business," says Steven Davidoff Solomon, a former corporate lawyer at Shearman & Sterling who is now a professor at the University of California, Berkeley School of Law. "Companies today are run pretty efficiently, as compared to the 1980s. You can't cost-cut your way to a new product."

Now, in a series of interviews with the Financial Times, Kraft Heinz executives describe how they are trying to reposition the brands for the future, harnessing product innovation, ecommerce and data-driven marketing.

“This concept that ‘they cut too much’: I’m actually growing where I believe there is value and decreasing where I believe there is not,” says Bernardo Hees, chief executive of Kraft Heinz, at the company’s Chicago headquarters. “We started accelerating our growth agenda,” he says. “We decided to invest more.”

Warren Buffett once described 3G’s co-founder Jorge Paulo Lemann, a former professional tennis player, as among the world’s most effective businessmen.

In a series of debt-fuelled deals orchestrated with his partners Marcel Telles and Carlos “Beto” Sicupira, the billionaire took control of some of the world’s biggest consumer brands and squeezed higher profits out of them. At the heart of its philosophy is a capacity to nurture companies for decades, much longer than typical private equity firms.

Hedge fund manager Bill Ackman and grand slam champion Roger Federer, as well as Berkshire Hathaway’s Mr Buffett, were among a host of wealthy luminaries attracted by the handsome returns 3G’s strategy produced at its portfolio of companies.

But when Mr Lemann said last year that a rapidly changing market for consumer goods made him feel like a “dinosaur”, investors feared he may be right.

“I’ve been living in this cozy world of old brands, big volumes and nothing changing very much. You could just focus on being very efficient and you can do OK,” Mr Lemann said. “All of a sudden we are being disrupted.”

The combination of Kraft, whose portfolio includes Philadelphia Cream Cheese, Oscar Mayer hot dogs and Kool-Aid, with Heinz, another consumer staples stalwart that the Brazilians had bought two years earlier, promised to transform the food industry. 3G, whose partners had previously rolled up some of the world’s biggest breweries into AB InBev, planned to do with baked beans, jelly and ketchup what had already been done with beer.

The new owners quickly implemented their “zero-based budgeting” regime, which forces managers to justify every item of spending, no matter how small, every year. As part of the integration they closed six factories and cut 4,900 jobs.

Rivals from Kellogg to General Mills sought to emulate 3G’s frugality, which according to Chris Growe, managing director at the brokerage Stifel, pushed Kraft Heinz’s already-low overheads from 11.5 per cent of sales in 2015 to just 8 per cent in 2017. The ratio at other large US food companies averaged 14 per cent.

“We’ve never really seen a company do that before, especially one as big as Kraft Heinz,” says John Baumgartner, analyst at Wells Fargo, of its margin improvement. But he adds: “They’ve been so focused on cutting costs they really hadn’t put a lot into top line.”

Results due on Thursday are forecast to show the group generated sales of $26.3bn in 2018, little changed from the year before and about 4 per cent lower than 2015.

More consumers are shunning packaged foods in favour of fresh, natural and local alternatives. Avocado, kale and quinoa are in; processed cheese is out. Disrupters include Halo Top Creamery, which has upended the ice-cream business with its low-sugar and low-fat products, and Chicago’s RXBar, a protein bar company which Kellogg bought for $600m just five years after it was founded.

Kraft Heinz executives say there has always been more to 3G’s philosophy than cost-cutting. While the budget-trimming comes after the takeover, they say, there is an overlooked second phase that focuses more on investment and expansion.

Kraft Heinz's share price has dropped by more than a third since the merger

$ per share

Source: Refinitiv
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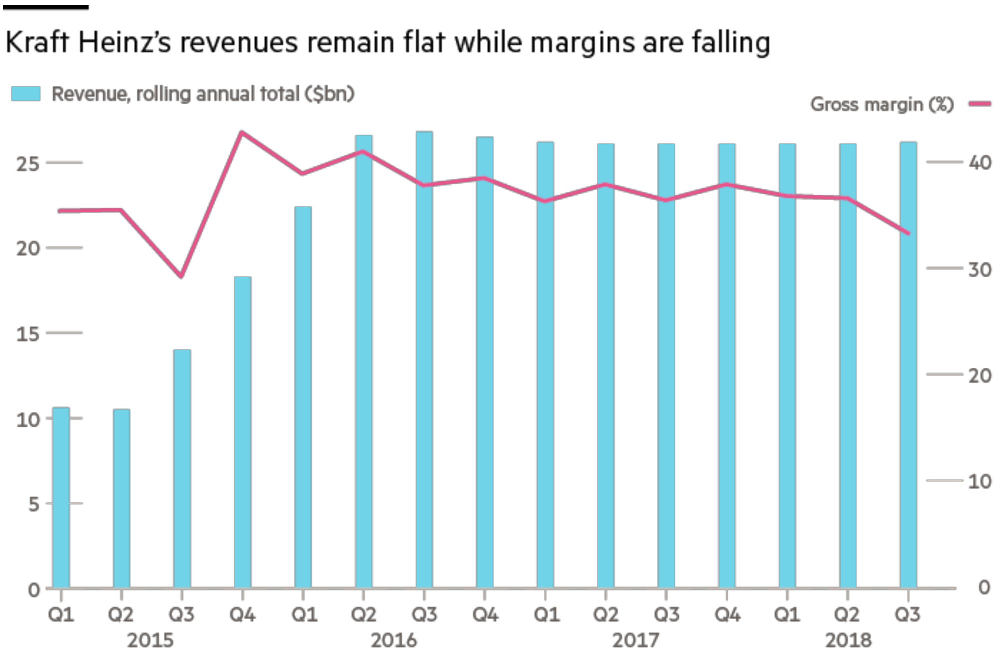
Supporters say evidence that they are prepared to invest is apparent at Restaurant Brands International, the vehicle 3G set up to bring under one roof the fast-food chains Burger King and Popeye's and Canadian coffee shop chain Tim Hortons.

"There is absolutely nothing in the model that prevents anything from growing or not growing," says Mr Hees, who was chief executive of Burger King before he took charge of Heinz when 3G and Berkshire acquired it in 2013 for $23bn. "If you think you need to travel more because you're going to have better results, then that's easy; go travel."

Despite its reputation for austerity, the enlarged company has shown willingness to spend big. Within months of the tie-up, the enlarged Kraft Heinz group relocated from suburban Chicago to a glistening high rise downtown that overlooks Lake Michigan. Ad slots at the Super Bowl, during which the group also promoted Planters snacks, cost an estimated $10m.

Echoing other consumer goods companies that are struggling for growth in mature markets, Kraft Heinz last year set out plans to invest $300m in the business. While 3G executives argue the shift in favour of investment has always been part of the plan, some on Wall Street sense a clear change in its approach. "The model has really done a complete 180," says Mr Baumgartner.

Kraft Heinz is deploying some of the funds to come up with new products. Recent additions to supermarket shelves include Just Crack an Egg, a microwaveable cup of diced ingredients to which consumers do as the title instructs; O, That's Good!, frozen pizzas launched last year with Oprah Winfrey; and MAX, an attempt to drag the 127-year-old coffee brand Maxwell House into the 21st century. The iced coffee is promoted in advertising by a young woman playing the drums.



Source: S&P Capital IQ
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Conscious of rising demand for healthier foods, Kraft has also been "reformulating" hundreds of products. The updated recipes reduce fat and remove preservatives. It spent $10m doing so for its Oscar Mayer hot dogs.

Yet there are clear limits to the health kick. The group is showing no sign of abandoning the kind of high margin products that served it so well for so long. Instead, it is trying to make them more relevant to today's consumers.

Internally, Kraft Heinz views "healthy" cuisine as just one of several consumer "need states". Others include "craft", or foods that give an impression of locality, or "ethnic", given western consumers' rising appetite for exotic cuisine. They include Ssäm, a Korean-style sauce rolled out in partnership with David Chang, founder of innovative Asian restaurant chain Momofuku.

"The best way to think about it is about the occasions that people consume food," says Eduardo Luz, Kraft Heinz's global brand officer.

Kraft Heinz has come up with new products, including O, That's Good frozen pizzas launched last year with Oprah Winfrey © Getty

He points to Devour, which was developed by Springboard, Kraft Heinz's "incubator" unit, to identify disruptive brands. “We saw the needs of young males that want to eat — at some times of the week — a completely indulgent and rich meal without concern about calories,” he says. “They just want something delicious to eat while watching a football game.”

More broadly, Mr Hees questions the notion that his product roster does not appeal to younger customers. He believes millennials will still eat processed and frozen foods along with healthier options.

Devour’s “food porn” ads are also an example of how Kraft Heinz is prepared to do unconventional things to attract attention. “We prefer this risk to the indifference of people just skipping your ads,” Mr Luz says. Last summer the company’s Country Time Lemonade division said it was willing to pay fines for children who were running into trouble with the law for operating soft drinks stands without a licence.

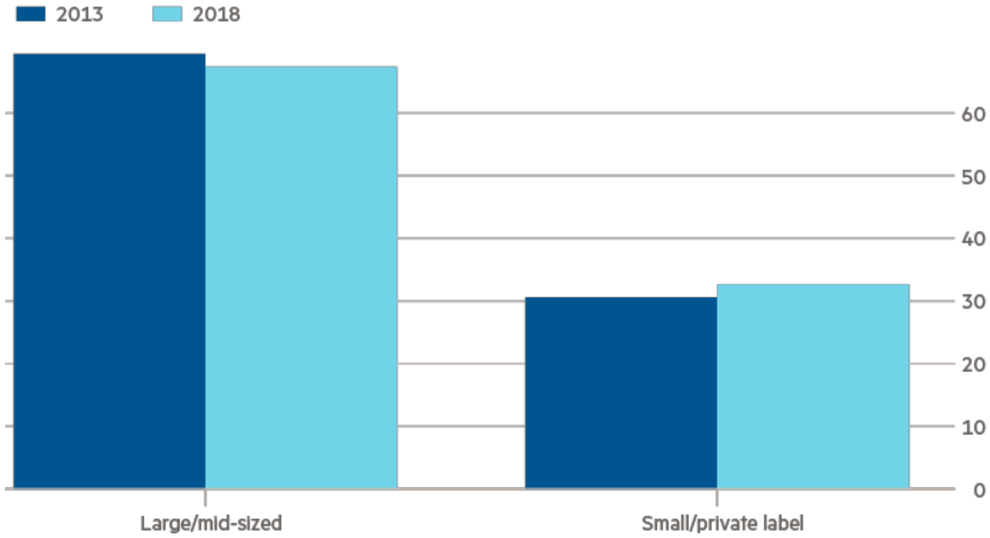
Ecommerce is another focus. Nina Barton, head of digital growth, says Kraft Heinz is “making massive investments” in technology to reposition for a digital future.

While ecommerce has yet to transform groceries the way it has other industries, at least in the US, Amazon has launched an assault on the sector and executives believe it is only a matter of time before supermarket suppliers are disrupted.

“This is going to be one of the biggest shifts in the industry,” Ms Barton says. “Our supply chain, fundamentally, was built for the Walmarts and the Krogers of the world. Amazon has a very different business model. We’re working in concert with them to figure out how to deliver on that.”

Smaller manufacturers grab a larger share of the market

Proportion of $ sales, based on scans of customer packaged goods (%)



Source: IRI
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Kraft Heinz is not alone in feeling the need to reinvest to improve revenues and reposition its businesses for the digital age. While not commenting on Kraft Heinz or 3G, Hugh Johnston, chief financial officer at PepsiCo, says: “There were some companies that chose what I would characterise as deep cost-cutting techniques.” He adds. “We think a balance between margin improvement and top-line growth is a more sustainable way to deliver value to shareholders.”

“Investors recognise, generally, that higher revenue growth is generally a better way to deliver EPS [earnings] performance than simply through cost- cutting.”

Some investors remain unconvinced, however. With the group’s investment plans putting downward pressure on margins, Kraft Heinz's market value has dropped $30bn since the 2015 tie-up. In the same timeframe, the MSCI World Consumer Staples index has rallied 11 per cent.

Bernardo Hees, chief executive officer of Kraft Heinz says the company is growing where it sees value © Bloomberg

For all Kraft Heinz's efforts to boost its top-line growth, many on Wall Street suspect it is only a matter of time before the Brazilians turn to their old playbook: dealmaking.

Kraft Heinz executives do little to douse the speculation. "The food industry has not consolidated as much as many other industries — there will be more consolidation in the future and we do want to be a force behind that," says Mr Hees.

Since its $143bn swoop for Unilever collapsed almost two years ago, Kraft Heinz has stayed clear of large deals. Instead it has focused on far smaller bolt-ons such as the $200m purchase of Primal Kitchen, a purveyor of health-conscious dressings.

Given the leverage of its balance sheet, Wells Fargo's Mr Baumgartner says it is difficult to see how Kraft Heinz could "make the numbers work" in a transformative transaction. Net debt stood at about $31bn as of the end of September, equivalent to 4.1 times earnings before interest, tax, depreciation and amortisation, according to S&P Capital IQ — relatively high compared to industry peers.

"When the businesses were growing effectively and the environment wasn't as difficult, the view was 'we very much want them to continue' [doing deals]," says Andrew Lazar, an analyst at Barclays. "Now, investors are a bit less sanguine about buying another slow-growth packaged food company."

Not for everybody: hard-driving ethos values brutal transparency

At Kraft Heinz's headquarters, the performance of senior executives is displayed openly on a chart on the wall — in common with every other salaried employee. Many would balk at the brutal transparency, but Melissa Werneck, head of human resources at the group, says the company is "unapologetic" about its approach.

"This is not [a place] for everybody," Ms Werneck says. "We don't pretend to be [something] that we are not."

Asked to describe morale, she says: "We went through a huge cultural transformation. We cannot deny that. We had an acquisition [Heinz] six years ago and went through a merger four years ago."

Referring to some negative reviews and ratings on Glassdoor, the website where current and former staff leave anonymous reviews about employers, she says: "It's expected when you see this — a company that went through this transformation — that we would have dropped on this score."

Those who have done well say the culture rewards results and hard work.

Young talent is promoted quickly, says Alex Behring, managing partner at 3G, Kraft Heinz's biggest shareholder. He was handpicked in his twenties to run the investment firm's railway business in Brazil in the late 1990s. "I joined because I was immediately given a chance to build something very early on in my career," he says.

The 3G formula is simple, says Bernardo Hees, chief executive of Kraft Heinz, right. "We work like crazy. We are completely obsessed with data. We have fun, and we like to enjoy building big things."

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