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Sell Big Food

In the physical world, some things are inherently safe, others inherently not. Daisies and dynamite, for example. There are fewer such clear distinctions to be drawn in the world of investing. Bonds are inherently senior to stock in a corporate capital structure, but "bonds," as an asset class, may or may not be riskier than "stocks," as an asset class. If risk is defined as the odds on the permanent impairment of capital, time and value decide.

Which brings us to Warren Buffett's favorite consumer packaged-foods company, to our former favorite canned-soup company and to "safety," as the Wall Street meme-makers define that elastic concept. In preview, *Grant's* is bearish on Kraft Heinz Co. (KHC on the Nasdaq), on Campbell Soup Co. (CPB on the New York Stock Exchange) and, yes, even on safety, as defined; mispriced investments are inherently risky, we are about to contend.

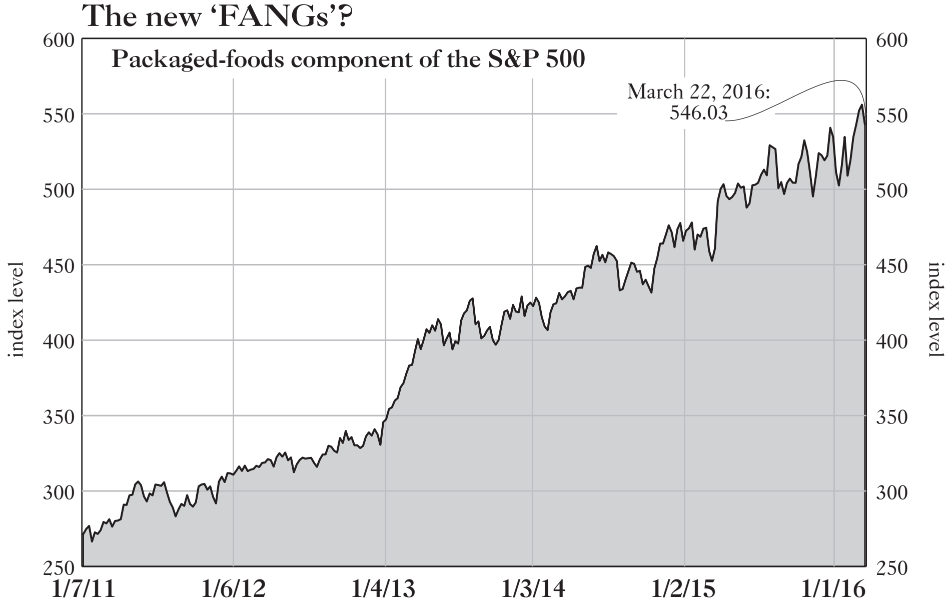
To judge by their assigned equity valuations, packaged-foods companies must be cycle-proof, even consumer-proof. Five years ago the dozen companies constituting the packaged-foods segment of the S&P 500 traded at an average of 15.6 times trailing net income. Today, they command an average of 24.8 times. There will always be Heinz ketchup, Campbell's soup and Kraft macaroni and cheese, the argument seems to run. The companies that make them may not deliver much topline growth, but, allegedly—Old Man River-fashion—they'll just keep rolling along.

You can be sure that the market isn't valuing the favored dozen on revenue growth. In the latest reported quarter, Hormel Foods Corp., producer of, inter alia, Spam and Skippy peanut butter, divulged a 4% drop in sales. Post Holdings, Inc. (Grape-Nuts, Honey Bunches of Oats) suffered a 4.2% decline in sales, excluding the benefits of acquisitions, and Kraft Heinz (Velveeta, Oscar Mayer) admitted to a 5% plunge in sales (pro forma the acquisition of Kraft Foods). "They are literally shrinking," Mathew T. Klody, managing partner of MCN Capital Management, Chicago, marvels to colleague Evan Lorenz, "and the market is paying 25 to 30 times earnings for them. If you look at these stocks, it looks like the FANG stocks [Facebook, Amazon, Netflix, Google] of six months ago. They've gone up parabolically."

Americans may be buying the stocks. They are not—as they have done in the past—buying the products. Health and wellness are today's on-trend watch words. They are not the first characteristics that spring to mind when contemplating the comfort foods of Kraft, Hormel, Heinz et al. Big Food still dominates the supermarket's center aisles. The trouble is that crowds are forming around the perimeter, where the kale is.

Newfangled foods—free-range, organic, gluten-free, farm-to-table, non-GMO and fresh, above all—are the drivers of sales growth today, John J. Baumgartner, the Wells Fargo Securities LLC analyst who covers packaged-foods companies, advises Lorenz. "I think the retailers are recognizing that the reason

The new 'FANGs'?



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that they lost traffic in the couple of years following the recession to places like Trader Joe's and Whole Foods is because they didn't merchandise as much natural and organic," Baumgartner explains. "As they recognized that and are ramping up their merchandising of natural and organic in a traditional grocery environment, it is putting traditional food in a bit more of a bind."

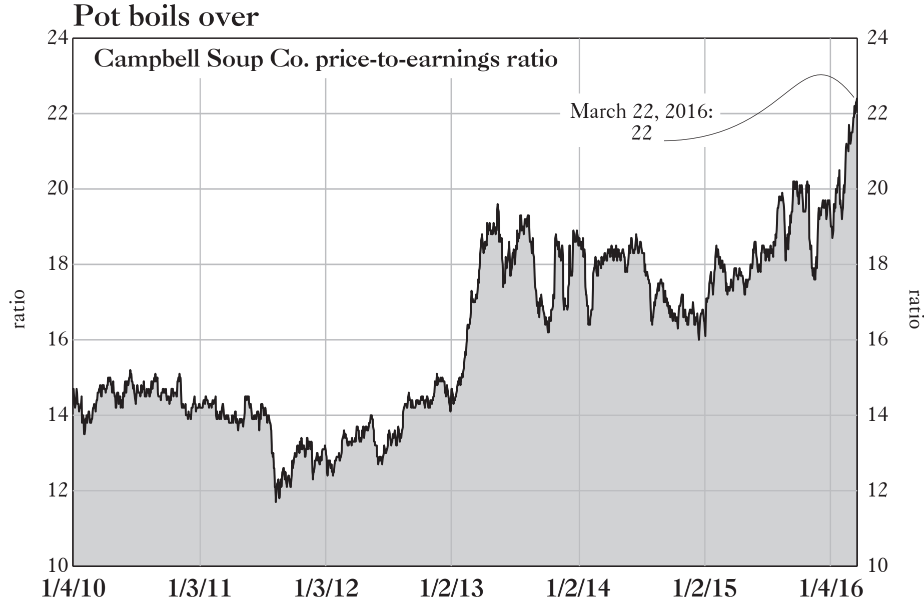
Untraditional is the millennial cohort's disdain for once revered brands. According to a recent survey by Mintel Group, almost half of Americans between the ages of 29 and 38 regard the Big Food companies with mistrust. Value is rather the young person's shopping mantra.

In 1986, *Grant's* published a profile of the independently thoughtful investor Bill Tehan. A one-time goldbug, Tehan had become a kind of food-bug. Disinflation was fattening the margins of the Hersheys and Heinzes and Kelloggs, and he was bullish on the group. How skinny were those margins, in comparison to today's, may bear a moment's reflection. In 1985, Campbell was earning 9.2% on sales, half of today's rate; Heinz was earning 12.1%, compared with 16.5% in 2015 and a projected 28.9% for 2017. (You can read the Tehan profile on the *Grant's* website.)

The low valuation of the food stocks in the wake of the Great Recession had little to do with business fundamentals. The affliction known in these pages as "2008-on-the-brain" was rather the source of knockdown P/E multiples. Anxious investors demanded government securities, not equities. The issue of *Grant's* dated Oct. 7, 2011 proposed a 10-year total-return contest between the common equity of Campbell Soup Co. and the then-current 10-year Treasury note. Our money was on CPB.

Here was a valuation story—ergo, by our definition, a safety story. Campbell traded at 12.9 times earnings and delivered a 3.6% dividend yield. The Treasury 2 1/8s of Aug. 15, 2021 traded at 102.66, a price to yield 1.83%. Suppose that Campbell's earnings and dividend stood still for the next 10 years, we proposed. At year 10, an investor would have earned a decade's worth of dividend payments, producing a 36% all-in return. Over the same period, a holder of the Treasury note would be just 18.3% to the good. It followed that,

Pot boils over



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in order to achieve a break-even return with the 10-year note, the Campbell share price would have to decline. It would have to decline by 17%, or 1.9% a year for 10 years, in fact, to reduce it to parity with the government security.

So far, so good for the soup maker. In the past five years, Campbell has generated a 110% return, including dividends; the 10-year note has delivered 9.7%. Campbell's earnings per share has grown by 13.6%, and its revenues by 3.6%, while the share count has fallen by 3.4%. The quarterly dividend has been lifted to \$0.312 from \$0.29. Net debt has pushed higher, to \$3.5 billion from \$2.6 billion, as the debt rating has drifted lower, to triple-B-plus from single-A.

But nothing that Campbell did contributed more to the trajectory of its share price than what Mr. Market did for it. From 12.9 times earnings in 2011, the multiple leapt to 22 times today. That sprouting P/E ratio has served up the bulk of the return.

Maybe the time has come for P/E contraction. In the quarter ended Jan. 31, total company volumes (including the likes of V8 and Pepperidge Farm) showed a year-over-year decline of 2%, while dollar-denominated revenues, also measured year-over-year, were flat. (Sales of soup actually fell by 4% year-over-year.) The way forward is cost-cutting, management and Wall Street now concur. The upshot is a consensus projection for operating income of \$1.5 billion in fiscal 2017 (ends July 31), up from \$1.2 billion in fiscal 2014. To hear the analysts tell it, operating margins will spurt to 18.5% of sales in fiscal 2017 from 14.4% in fiscal 2014. Who needs growth in sales or market share when you have forecasts?

For ourselves, we elect to cut short our 10-year bet, crowning ourselves and Campbell the winner and Treasurys the loser. We note that the Campbell insiders have sold a net 289,010 shares over the past year for proceeds of \$16.3 million. No soup for them; no soup for us.

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On, now, to Kraft Heinz, a grand specimen of the platform company, or roll-up, on which James H. Litinsky so profitably expounded at the *Grant's* fall conference (see the Oct. 30 issue). Certainly, 3G Capital, Inc. and Berkshire Hathaway, Inc. have been merrily rolling along. In 2013, they acquired HJ Heinz Co. for \$27.4 billion in cash. Two years later, their acquisition vehicle bought Kraft Food Group, Inc. for \$55.4 billion in cash and stock. Today, KHC is the largest American food manufacturer by market capitalization, at \$93 billion. Mondelez International, Inc. is a distant second, at \$63 billion.

For Litinsky, "platform" was a term of disparagement; not for KHC. "The Kraft Heinz Company," the investor-relations home page dilates, "a platform for performance. This historic transaction unites two powerful businesses and iconic brands, and provides a platform for leadership in the food industry, both domestically and internationally."

In the fiscal year ended Jan. 3, the combined entities of Kraft and Heinz produced $27.4 billion of sales to retailers worldwide. The United States and Canada contributed 79% of the total, Europe 9% and parts unknown 12%. You know the brands: Kraft, Oscar Mayer, Heinz, Planters, Velveeta, Philadelphia, Lunchables, Maxwell House, Capri Sun, Ore-Ida, Kool-Aid, Jell-O. Undisclosed is what each brand contributes to the corporate whole.

"Kraft Heinz's brands are ubiquitous," Lorenz observes. "On-trend, they are not. Yes, Oscar Mayer does produce a 'natural' line of lunch meats, but sugary drinks (Kool-Aid, Country Time), high-fat condiments (Cool Whip, Miracle Whip), sugary condiments (Heinz ketchup) and processed cheeses (Kraft, Velveeta) are the corporate workhorses. The price that you, the investor, pay for this conflation of chow is 34.9 times adjusted, pro forma 2015 earnings per share and 25.8 times the 2016 estimate. As for 2017, it's yours for just 20.2 times."

With revenues on the dwindle, management is promising $1.5 billion in cost reductions, or $1.23 for each of the company's 1.2 billion shares. According to Kraft Heinz, workforce reduction, overhead savings—3G's famous "zero-based budgeting"—and manufacturing and supply-chain efficiencies will deliver the savings by the end of 2017.

"As with Campbell Soup," Lorenz points out, "the Street has dutifully penciled in those projected savings and more into forward estimates. Operating income (of the pro forma kind) footed to $4.5 billion for the combined Kraft Heinz in 2015. Actual operating is expected to grow to $7.8 billion by 2017. This is despite an expected contraction in sales, to $27 billion from $27.4 billion over that span. Based on shrinking sales and expectations of growing profits, Street estimates imply that Kraft Heinz's operating margin will expand to 28.9% in 2017, from 16.5% (pro forma) in 2015."

"Of the dozen packaged-food companies in the S&P 500, only one, Mondelez, has an operating margin as high as the Street is betting that Kraft Heinz will achieve by 2017," Lorenz continues. "It's unlikely, though, that Kraft Heinz can follow Mondelez into the promised land of super-profitability. On Oct. 1, 2012, Mondelez (then Kraft Foods, Inc.) spun off its low-margin grocery businesses into a new company. This company, confusingly, bore the name Kraft Foods Group, Inc. In other words, Mondelez is a cherry-picked portfolio of higher growth and higher margin products. The operating margin for the other 11 packaged-goods companies in the S&P 500 averages 12.3% of trailing-12-month sales."

Bulls pin their hopes on something called "trade spend optimization" (when the busy financiers say "spend," what they mean is "spending"). This will take a little explaining. The revenues that the likes of Heinz Kraft report are net sales. Gross sales can be 20% higher than net. Undisclosed marketing expense accounts for the difference.

Trade promotions have their origin in the 1971 Nixon price controls. In an attempt to get one step ahead of the government, packaged-food companies padded their selling prices. It was insulation they could use when the federal price-control ax fell. When that threat receded, the cannier food companies retained the gross-to-net spread as a kind of piggy bank. Ever since, they've used it to secure desirable shelf space or better placement in weekly advertising circulars.

It's an expensive stratagem. Compare and contrast a 1% reduction in trade promotions with a 1% increase in sales volumes. The former is much more efficient than the latter. By cutting trade promotions, you effectively increase prices; a dollar thus saved contributes a dollar to operating income. In contrast, a 1% increase in volumes boosts operating profit only by the assumed operating margin, say 29%. Wishing that trade promotions would go away, Wall Street's optimists are prone to assume that they will.

You can't assume away the debt. The roll-up of Kraft into Heinz left the food behemoth with $28.9 billion of net borrowings. Based on management's estimate of pro forma, adjusted EBITDA for the full year 2015, net debt to EBITDA totaled 4.3 times; the Street projects a 2016 decline to 3.9 times. In the fourth quarter, which included a full three months of the combined Kraft and Heinz results, operating income covered interest expense by 4.8 times.

Even if Kraft Heinz refinances a big slug of its 9% preferred stock in June, the shoe of leverage will continue to pinch (the company's triple-B-minus debt rating is just this side of junk). The clamoring bulls demand that management materialize $3.1 billion in free cash flow in 2016. The stockholders demand that 3G and Berkshire honor their pre-merger commitment to maintain (and, if possible, boost) the 55-cent-per-quarter dividend. So far, so faithful—the dividend now stands at 57½ cents a share—but that payout is costing the company $2.8 billion a year, or 91% of this year's estimated free cash flow.

Hopes for the 3G/Berkshire giant run high. Standard & Poor's all but promises a future ratings upgrade, and Goldman Sachs last week actually delivered one. Now KHC is a "conviction" buy, Goldman said, as distinct, presumably, from a "half-hearted, going-through-the-motions-just-for-a-shot-at-the-investment-banking-business" buy. "Investors, in our opinion," Goldman opines, "are underestimating KHC's earnings power that stems from improved pricing discipline, cost cuts, commodities and international-revenue synergies. We see a positive estimate-revision cycle ahead with further potential M&A offering incremental upside."

Goldman isn't alone in harping on mergers and acquisitions. Some speculate that General Mills, Inc. may be next on the Kraft Heinz menu. In any case, an anonymity-seeking bull tells Lorenz: "The addressable market or the addressable targets for Kraft is immense. We've sized it up to something around $1 trillion, in terms of enterprise value of potential targets they can go after and acquire. This is both public and private companies globally. It is $1 trillion and relative to Kraft's enterprise value of $122 billion; there is 10-X. There is an endless amount of pipeline for deals."

Bulls cast Kraft Heinz as a kind of armed missionary. The heathens can either convert voluntarily to zero-based budgeting and reduced trade promotions (thereby lifting both their margins and share prices), or they can undergo forced conversion at the not-so-gentle hands of 3G and Berkshire. To judge by the prevalence of 3G management jargon on recent Big Food conference calls—Campbell and ConAgra Foods, for instance, both spoke the new patois—the gospel of efficiency is making inroads.

Whether the converts stay converted is another matter, for the packaged-foods business was, and remains, dog-eat-dog. Kraft Heinz did try to economize on promotional spending in the UK recently. It stopped spending as it had customarily spent to push its branded soup. What it did not do, at the same time, was freshen the product or otherwise call new attention to it. It didn't take long for the competition to notice. A supermarket land grab ensued, at the expense of Kraft Heinz. Presumably, the humbled bully will be back again to reclaim its lost territory and market share. The point to mark is that the presumed counteroffensive will not come for free. Which leads us to conjecture that some portion of that allegedly certain $1.5 billion in promotional cost savings may not be saved after all. Businesses need sustenance, too.

"As the new health-and-wellness brands gain more distribution," Lorenz points out, "they likewise gain economies of scale that allow them to cut prices, and this they do over time (think Chobani, Kind Snacks and Naked Juice, among others). So, while existing packaged-food brands are trying to increase profits by cutting trade promotional dollars, the price gap is narrowing between established processed foods and on-trend, newer brands."

"My perspective, at least, is that what one company is talking about is usually what most of the other companies talk about," Rob Dickerson, the vice president and head of global packaged foods at Consumer Edge Research, an independent research boutique, remarks. "It changes every year. Right now it is trade optimization. Why weren't they talking about trade optimization three years ago? Three years ago they were trying to increase marketing and trade spend to increase volumes. That didn't work.

"Eventually you say," Dickerson proceeds, "'How do you generate higher profit margins to grow your profits?' You are just going down the line; what lever can we pull now? If these companies were growing volumes, would we be seeing as much discussion around trade promotions as we are? My theory is most likely we would not."

Investors have a lever to pull. It's the one marked "sell."

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