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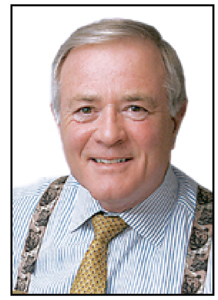

William Rutherford

Playing ketchup

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Brazilian private equity firm 3G Capital burst into the United States when it bought well-established food companies Burger King in 2010 and H.J. Heinz in 2013. Its method of operation included cutting costs and executing mass layoffs. 3G attracted the attention of other hedge funds and Warren Buffett's Berkshire Hathaway. Together, 3G and Buffett bought U.S. ketchup maker Heinz.

In 2015, with Buffett's help, Heinz acquired and merged with Kraft Foods to create the world's fifth-largest food company. It was a classic Buffett buy: an easy-to-understand company with iconic American brands, not unlike other long-term Buffett holdings, such as Coca-Cola and Dairy Queen. 3G and Kraft Heinz next attempted to buy Unilever for $143 billion, but that deal collapsed amid concerns about a cultural clash of the two entities.

On Feb. 22, Kraft Heinz disclosed that the U.S. Securities and Exchange Commission was investigating the company's "accounting policies, procedures and internal controls in procurement." Kraft Heinz's share price plunged 27 percent that day; the firm wrote down $15 billion in the value of its Kraft food lines, including Kraft macaroni and cheese, Oscar Mayer hot dogs and other waning brands. The firm also slashed its dividend. The write-down called into question 3G's management style.

3G had underinvested in its brands to maximize current earnings at the expense of growth. Consumers have demonstrated a declining interest in its legacy food brands such as Velveeta cheese, Kool-Aid and Jell-O and a growing interest in natural and organic ingredients and products. Furthermore, consumers' buying habits have changed, with private labels such as Costco's trusted Kirkland Signature putting additional pressure on national brands to maintain position on grocery shelves.

3G's slash-and-burn approach turned off potential acquisition targets, limiting external growth opportunities and suppressing internal innovation.

"I've been living in this cozy world of old brands (and) big volumes," 3G co-founder Jorge Paulo Lemann said at the Milken Institute Global Conference in April 2018. "You could just focus on being very efficient and you are OK. All of a sudden we were being disrupted in all ways. We just bought brands and thought they would last forever. … We have to adjust to new demands from clients.

"We focused on such things as zero-based budgeting, free tickets and single-sided printing," Lemann added. "We focused on financial management to the exclusion of marketing, research and development."

This is an old song that has been repeated, unsuccessfully, many times and may well be added to similar Harvard case studies, but once again, the lesson was not learned. As one budgeting consultant who worked on the 3G investment said, "We were able to challenge the entrenched methodologies that were burdening these companies, but we were not thinking about what would come next."

The same day as Kraft Heinz's precipitous stock decline in February, stocks of other companies in the branded food product space, such as Campbell Soup, General Mills and Kellogg, dropped too, even though they were not implicated in the SEC probe. But the pain did not stop there.

Buffett, who partnered with 3G to take over ketchup giant H.J. Heinz Co. and two years later merge it with Kraft, said at that time, "This is my kind of transaction, uniting two world-class organizations and delivering shareholder value." Berkshire Hathaway owns about 27 percent of Kraft Heinz, generating a multibillion-dollar write-down on the year. Berkshire Hathaway's 2018 per-share earnings were slashed in half.

Buffett now has been quoted as saying he paid too much for Kraft Heinz. In his recent shareholder letter, he said, "it's very hard to offer a significant premium for a packaged goods company and have it make financial success."

Further fallout of the February 2019 price decline in Kraft Heinz has been the effect on index funds. Kraft Heinz is in the S&P 500, so every index fund has to own it and share in the decline. Since it is in the major indices, many exchange-traded funds own it and also lost value. Those funds run the gamut of traditional, plain vanilla funds to dividend ETFs to smart beta and multi-factor strategies to value plays. The three-year return for Kraft Heinz is a minus 51 percent. The much heralded passive and robo investing in ETFs and index funds demonstrates that often what one doesn't own is as important as what one does own.

The latest tally of analyst opinions from the major brokerage houses shows that among the components of the S&P 500 index, Kraft Heinz is now the No. 82 analyst pick, a move up by 16 spots. This rank is formed by averaging the analyst opinions for each component from each broker, and then ranking the 500 components by those average opinion values. The lesson: beware of Wall Street analysis.

There are many other lessons to be learned here both for management of companies and investors:

1. Don't overpay. If you overpay, it is very hard to recover. Buffett now says he overpaid for Heinz. In retrospect it may be easy to see, but not so easy in the thrill of the moment.
2. You can't cut your way to prosperity.
3. Listen to your consumer. Kraft Heinz completely missed the changing tastes of its market.
4. Keep your product line fresh.
5. Passive investing has its flaws. No one investment philosophy lasts forever; it must be constantly re-examined and retested.
6. Even a brilliant stock picker like Warren Buffett can be wrong. Perhaps he was trapped by his own personal tastes and investment philosophy (his holding period is forever, so he says). Buffett also owns Dairy Queen and dines daily on hamburgers and cherry Coke, so could he have underestimated how consumers are moving away from such a diet?
7. If something is going wrong, fix it. Now!

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