Kraft Heinz

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Sum Zero – Top Stocks for 2020
Company – Kraft Heinz (NASDAQ:KHC)
Market Capitalization: $38.6B
Enterprise Value: $67B
Current Price: $31.60 (12/13/19 market close)
Target Price: $41.66
Expected Return: 37%
Disclosure: I have an ownership in shares of Kraft Heinz at the time of writing.

Business Background

Kraft Heinz is the third largest food and beverage manufacturer in the United States and the fifth largest in the world. This happened after Kraft and Heinz merged together in July 2015. Kraft Heinz currently has 38,000 employees with their headquarters located in Chicago, Illinois and Pittsburgh, Pennsylvania. They have a sales distribution network that spans all over the world including places such as Europe, Latin America, Russia, China and Australia. 30% of their sales come from outside of the United States and 70% come from within the United States.

Despite some setbacks lately, Kraft Heinz still holds some of the biggest brands in the world. They have 8 $1 billion+ brands with some of their bigger brands being Heinz Ketchup, Kraft Cheese, Kraft Maccaroni & Cheese, Velveeta, Lunchables, Capri Sun, A1 Steak Sauce, Philadelphia Cream Cheese, Quero, Planters and some others.

What Went Wrong and Why is the Market Giving Investors an Opportunity?

After the merger of Kraft and Heinz in July 2015, management went on a cost cutting plan which reduced their workforce and also cut spending on marketing and R&D which eventually led to a write down in the brand value of Kraft Heinz's natural cheese business, Oscar Meyer cold cuts business and Canada retail business. In total it was a $15.4B impairment charge that consisted of $7.1B of goodwill impairment in their US Refrigerated and Canada Retail unit and $8.3B related to Kraft and Oscar Mayer intangible assets.[1]

In addition, the internet has made it much easier for private label brands to market directly to consumers and there is also a shift in tastes from consumers to more organic and healthier options which resulted in a lot more competition for Kraft Heinz's brands. Kraft Heinz thought they had premium branded products and they thought they could pay a premium price for the assets and simply just increase the price of these products but that didn't work. As the prices of their products rose, grocery shoppers shifted to other brands signaling that cheese is a lot more of a commodity than Kraft Heinz initially thought.

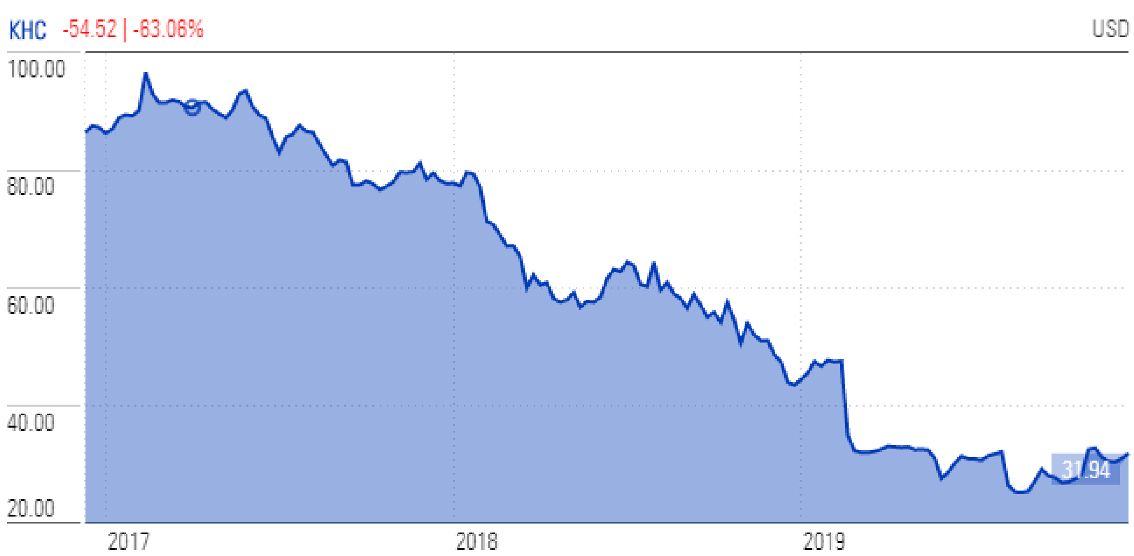
In addition to a lack of spending in marketing and R&D, reductions of their workforce, higher competition than anticipated, Kraft Heinz was also facing an SEC investigation into their procurement

[1] marketwatch.com/story/why-the-154-billion-kraft-heinz-brand-write-down-was-unusual-2019-02-22

accounting policies. Kraft Heinz had to restate their earnings for 2016 and 2017 due to employee misconduct. This then delayed financial statements for the following two quarters after this announcement.

Lastly, following the merger of Kraft and Heinz in July 2015, the company was saddled with a large debt load that was used to finance the deal. In response to higher cost of sales (input costs, transportation, packaging), less pricing power than previously thought for Kraft and Oscar Meyer brands, and increasing interest rates (rates have since went back down since December 2018) management cut the dividend by 33%.

Following all of the bad news, analysts cut their price targets and their recommendations and the stock went from the mid $90's per share down to as low as $24.86. Following a much better 3Q 2019 the stock has somewhat rebounded to $31.60 at the close of the market on December 13, 2019.



Source: Morningstar

<u>How Will Kraft Heinz's Problems Get Fixed?</u>

There has been so much talk about the negatives with Kraft Heinz but what investors are failing to see are the moves that they have made and continue to make in order to rectify the missteps they made following the merger. I believe that these steps in the right direction – which could happen within a year but also may take 2 or 3 years as well – will help increase shareholder value as the new management fixes the missteps that were taken following the merger.

<u>New management</u> - Miguel Patricio was appointed as the new CEO of Kraft Heinz in July 2019 and Paulo Basilio, whom was previously CFO before David Knopf, returned to the CFO position on September 1, 2019. This was a major change and I felt it was a long overdue decision from the Board of Directors since the previous CEO, Bernardo Hees, put too much emphasis on cost cutting and underinvested in Kraft Heinz's brands, meanwhile 29-year old David Knopf seemed too inexperienced in my opinion to handle such a demanding job of a multinational, billion dollar corporation. The new CFO has more experience including running Kraft's financial operations as CFO from July 2015 to October 2017 and Miguel Patricio has already dealt with a similar issue of increasing brand values for the Asian Beer operations at

Amheuser-Busch where he served as global chief marketing officer and president of the Asia-Pacific unit. He has been highly regarded when it comes to marketing and better marketing among some other things is what I believe to be one of the highest priorities on Kraft's list of things to improve on going forward.

He already has shown improvements as CEO and I think his decision to not give forward guidance has helped him and the company focus on a turnaround and the long-term of the business instead of getting distracted.

"While our third-quarter results remain below our potential, we showed sequential improvement versus the first half, and I believe we are beginning to operate the business better,"

- Kraft CEO Miguel Patricio

Asset sales – Kraft Heinz completed the sales of its Canadian natural cheese business for $1.23 in July 2019 and used the proceeds to refinance debt. Kraft Heinz also shopped some of their other brands in the middle of 2019 such as Maxwell House, Breakstone's sour cream and cottage cheese brands and their baby food brand Plasmon but have since pulled back. They likely pulled back on selling these brands due to Kraft not getting the prices they were looking for.

You can look at this as a negative since you can say that no one wants these brands because of the loss of their brand value which I can agree with but I do believe there is a positive here also since they are still being prudent in not selling their brands for a really low price out of emotion. There were a lot of negative headlines at that time about Kraft Heinz when the media reported that they were looking at asset sales which must have made it a lot harder to sell those brands. Overall, I think it was a better decision to hold on to them for now instead of selling them at an unreasonable price. Management can always revisit selling these brands later on. They can also review other options to raise capital possibly by spinning off some brands into a separate equity.

Restructure debt – Kraft Heinz's Debt-EBITDA ratio is currently 4.7 which is high but they are already reducing it. Management has emphasized their desire to decrease their debt load in order to maintain their investment grade status. They already sold their Canadian cheese brand to help alleviate some of the debt, they reduced debt by $2.4B since the merger, and they also just bought back $2.5B of outstanding debt in September. They have $3B of debt maturing next year but they also currently have $2.32B at the end of Q3 2019 in cash and as Kraft's CFO, Paulo Basilo, mentioned on the Q3 2019 earnings call, they have a $4B revolving credit facility that they haven't drawn down yet.

"Also in Q3, we undertook a successful leverage near to $3 billion refinance that further strengths our liquidity. We have a strong investor participation in our offering that we think reinforced investor confidence. And this refinance gives us significant flexibility through 2025, especially given the fact that we currently have no commercial paper outstanding and a $4 billion revolving credit facility that has never been drawn. Refinancing our debt as well as establishing our long-term strategy are critical steps to defining how we will continue to deleverage our company and maintain our investment-grade status."

- *Paulo Basilio, CFO, Q3 2019 Earnings Call*

If they needed to, they could use this to pay back debt. This would increase interest expense but would alleviate any issue of not having enough cash on hand to pay back the debt should it come down to this.

The following year, 2021, Kraft only has $990M in debt which is a very manageable amount of debt. In 2022 and 2023 the principal coming due starts to get bigger but I believe 2 years will give Kraft enough time to sort out the issues they are having with negative organic growth and lack of pricing power.

At December 29, 2018, aggregate principal maturities of our long-term debt excluding capital leases were (in millions):

2019	$	355
2020		2,992
2021		990
2022		3,508
2023		2,460
Thereafter		20,329

Source: Annual Report

And I don't see Kraft taking on any more excess debt to finance an acquisition anytime soon after Kraft's attempt to acquire Unilever failed. This is a good sign for Kraft since it will help them keep their investment grade rating which is important to give them the option of refinancing at a favorable interest rate.

Dividend – Kraft already cut the dividend before by 33% and it's possible they could do it again but this may not be such a bad thing for long-term shareholders. Kraft Heinz right now has 1.22 billion shares outstanding and currently pays out an annual dividend of $1.60 which comes out to $1.95B a year. TTM free cash flow is $2.87B so the company funded the annual dividend payment by $900M. During 2018, free cash flow was $1.74B which results in a deficit of $200M to fund the dividend.

Although the dividend was funded in excess of $900M over the last 12 months it isn't safe especially due to Kraft Heinz's large debt load and need for funds to spend on marketing in order to help their brands. If the dividend were to be cut, this could turn out well for long-term shareholders since this would give Kraft Heinz an extra $2B a year to spend on marketing and debt reduction. It would be short-term pain for a lot of shareholders for the benefit of long-term gain.

If the dividend isn't cut though, investors can realize an extra 5% return but I believe that cutting the dividend is the better option and although the market may take it negatively upon announcement, it could be an opportunity to buy shares at lower prices.

Better marketing and Reinvest in Brands – Kraft Heinz has begun to respond better to changing consumer demands. The Head of Marketing for Oscar Meyer, Greg Guidotti in a statement announced that they will be removing all added nitrates and artificial preservations from its hot dogs.[2] They are also looking to better adapt to the changing world through technology and become more consumer focused. Although other brands have already been doing this and Kraft is late, I view it as a positive that Kraft is understanding where they went wrong in the past and are marking strides to fix it. This will be important to turning around the brand to a much better and more modern image.

"Now we are changing that. We are getting more and more consumer focused, and we also want to embrace new technologies, because consumers are changing. We are hiring more technology people. Now we must create our own platform and talk directly to consumers."

[2] https://news.kraftheinzcompany.com/press-release/brand/oscar-mayer-gets-better-hot-dogs-hands-across-america-adding-two-new-vehicles-it

- Jorge Paulo Lemann[3]

“In marketing, we are defining the framework and optimal marketing spend, both by brand and by working/nonworking allocations. And so far, we identified the opportunity to reallocate a substantial amount of dollars to work in [indiscernible] 2020 as well as redirect dollars disproportionately towards support of our flagship brands. Based on this alone, we will see a significant percentage increase in media spend and an even greater increase for the brands that are the biggest drivers of our profitability. Around our innovation efforts, we are revamping our product development process so we can be faster and more consumer-centric with our new products. And we are evaluating shifting innovation support to fewer, bigger, better initiatives, launches that promise to be more incremental to our base.”

- Miguel Patricio, Q3 2019 Earnings Call

Drive Organic Sales Growth – Management is looking to drive up what has been very lackluster over the past couple years – organic sales growth. Kraft Heinz has some good brands that are still seeing organic growth in sales but there are also bad brands that are heavily weighing back overall organic sales growth. As you can see from the chart below though, management has already been able to deliver some improvement in organic net sales growth for the company as a whole and Miguel just took over as CEO starting in the 3rd quarter. I’m expecting more to come over the next year.

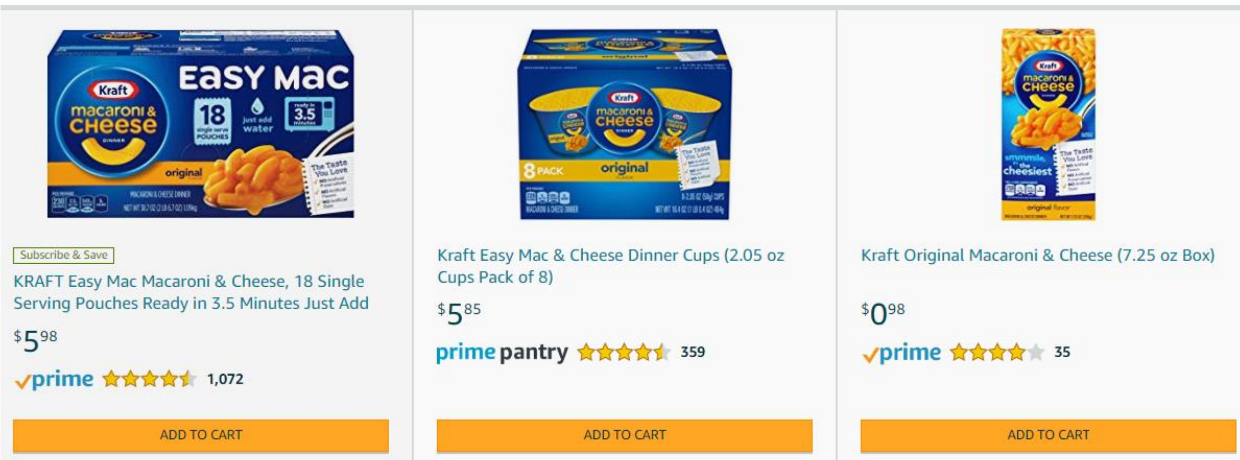
Source: Q3 Earnings Slides

The good brands I view are Heinz Ketchup, Philadelphia Cream Cheese and Quero. Although I am subject to sample bias on this, when I travel around New York City and walk by or go to restaurants, diners and other eating areas, I still see a lot of Heinz ketchup. Heinz ketchup still has a very respected brand name

[3] insiderfinancial.net/buffett-says-no-backup-deal-for-kraft-after-unilever-snub-cnbc.html

and has one of the largest market shares in the ketchup market which is a very high demand condiment in the United States.

Buried underneath a lot of some of the poor performing brands is what I believe a capital compounder of which Warren Buffett himself said that he didn't overpay for (Heinz) but he did say that he overpaid for Kraft. In 2013, Warren and 3G Capital bought Heinz for $23B and with a current market cap for Kraft Heinz of $38B, investors are paying $15B for all of the other brands which some will need a lot of work but there are some good ones in there as well. For example, when searching on Amazon for Kraft brands, you can see below that Kraft Macaroni and Cheese has been rated well with shoppers. It has at least 4 out of 5 stars in the 3 products shown below.[4]



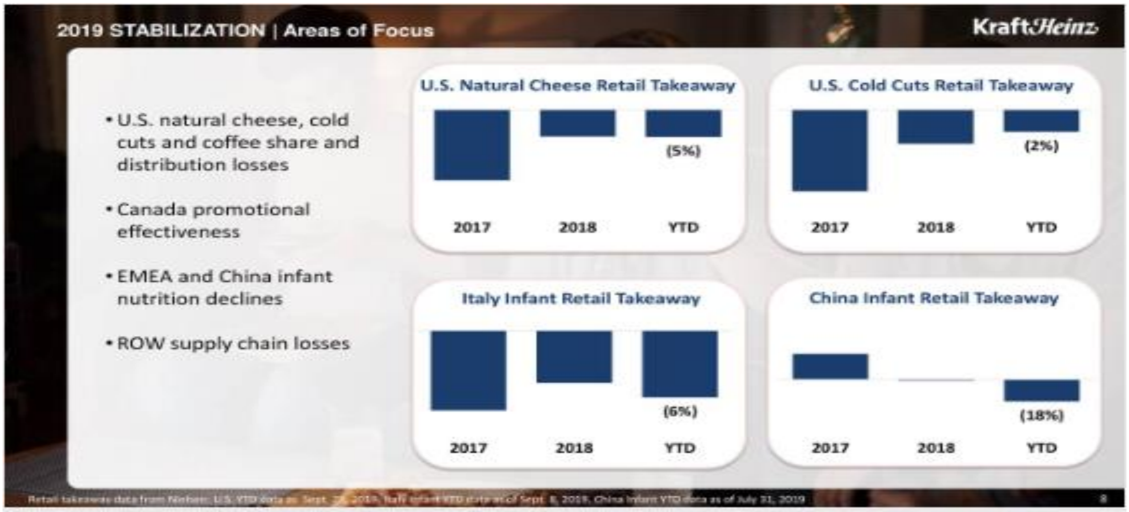
Source: Amazon

<u>The Good</u>

Source: Q3 2019 Earnings Slides

4 https://www.amazon.com/stores/node/2595015011?_encoding=UTF8&field-lbr_brands_browse-bin=Kraft&ref_=bl_dp_s_web_2595015011&productGridPageIndex=2

The Bad



Source: Q3 2019 Earnings Slides

Restatement of Financials and Internal Investigation into Procurement – There was a lot of negative news surrounding the SEC subpoena because it never sounds good when any company receives one. This also led to a lot of worry from investors since the company's quarterly filings were delayed as Kraft had to go back and revise 2-3 years of financial statements.

Although late with their filings, Kraft Heinz has since restated their financials and submitted the quarterly financials that they previous delayed. They also completed an investigation into their procurement processes which led to a revision of net income by an immaterial amount because of an undervaluation of cost of goods sold and almost $200M in misstatements.

The procurement process was most likely caused by the cost cutting and laying off of employees but after the internal review there will be better internal controls going forward. Kraft should now be in a better position to focus on the turnaround. I haven't seen any news about the SEC investigation being completed but Kraft has disclosed that they're fully cooperating.

Insider Buys

Although 3G Capital sold shares to reduce its stake by 19% in Kraft Heinz in September 2019 it still owns around 20% of Kraft Heinz. This is still a material stake in the business and their interests are still aligned due to the magnitude of the investment. Warren Buffett's stake in Kraft Heinz has remain unchanged since the merger back in July 2015 and it seems that it is unlikely to change anytime soon as Warren has said that he doesn't have intentions to sell. [5]

In addition, there has been insider activity recently which signals that although the performance of business operations have been a huge disappointment over the last 2 years, insiders appear to now

[5] https://www.cnbc.com/2019/02/25/buffett-says-berkshire-hathaway-overpaid-for-kraft-following-last-weeks-stock-plunge.html

believe that the valuation and price have gotten too low and the company will start to turn things around. They are betting with their own money.

As you can see from the image below, there were 2 big insider buys for a total of $107M just in the middle of September 2019 including a $100M investment from 3G Capital founder and chairman Jorge Paulo Lemann who acknowledged that they messed things up at Kraft Heinz but they will fix it. There has also been options issued to directors at $29.03 a share which isn't a major incentive but still some incentive to get the company going in the right direction again.

Transaction Initial Date[2]	Name	Title	Transaction Type	Shares	Market Value
Sep 18, 2019	Alexandre Van Damme	Independent Director	Buy at $28.45 per share.	250,000	7,112,500.00
Sep 16, 2019	Jorge Paulo Lemann	Independent Director	Buy at $28.60 per share.	3,496,503	99,999,985.80
Sep 12, 2019	Alexandre Behring	Chairman of the Board	Acquisition	4,306	125,003.18
Sep 12, 2019	Jeanne P. Jackson	Independent Director	Acquisition	4,306	125,003.18
Sep 12, 2019	John T. Cahill	Vice Chairman of the Board	Acquisition	4,306	125,003.18
Sep 12, 2019	John C. Pope	Independent Director	Acquisition	4,306	125,003.18
Sep 12, 2019	Joao Mauricio Giffoni De Castro Neves	Independent Director	Acquisition	5,247	152,320.41
Sep 12, 2019	Jorge Paulo Lemann	Independent Director	Acquisition	8,096	235,026.88
Sep 12, 2019	Alexandre Van Damme	Independent Director	Acquisition	8,096	235,026.88
Sep 12, 2019	Gregory Abel	Independent Director	Acquisition	8,096	235,026.88
Sep 12, 2019	Georges El-Zoghbi	Director	Acquisition	3,669	106,511.07
Sep 12, 2019	Tracy Britt Cool	Independent Director	Acquisition	7,148	207,506.44
Sep 12, 2019	Feroz Dewan	Independent Director	Acquisition	8,096	235,026.88

Source: Morningstar

Financial Ratios

Kraft Heinz makes for a compelling investment based on an evaluation of common financial ratios such as P/S, EV/EBIT, and P/FCF. If the impairment charges for goodwill and intangible assets aren't included then the P/E ratio would be very attractive as well but due to cumulative write downs over the last 4 quarters of $17.16B, net income over the last TTM is -10.82B. The good news is that these write downs area already reflected in the stock price and last quarter there was only a small amount of write offs for intangible assets that was around $10M so it looks like these irregular charges shouldn't have a material effect on earnings going forward unless new management isn't able to increase the earnings power of the struggling brands.

There has also been a lot of talk about their debt which I agree is on the high side but when you factor in what they are earning before interest and taxes, a multiple of 12 for EV/EBIT is attractive. With new management committed to bringing back organic growth and increasing brand value, I believe that net and operating earnings will grow which makes Kraft Heinz even more compelling if they can execute.

Price Per Share	$ 31.60
Shares	1,221.00
Market Cap	$ 38,583.60
Debt	$ 30,700.00
Cash	$ 2,320.00
Minority Interest	$ 130.00
Enterprise Value	$ 67,093.60
In millions except for per share data	

TTM Sales	25,340.00
TTM Net Income*	(10,820.00)
TTM Free Cash Flow	2,870.00
TTM Ebit	5,540.00
2019 Exp Net Income	3,431.00
*Includes impairment charges of $17.16B	

Forward P/E	12
Market Cap/FCF	13
EV/EBIT	12
Price/Sales	1.52
Price/Book	0.75

Intrinsic Valuation

Free cash flow over the last 12 months was $2.87B and if management is able to execute on their plan of reducing debt and reinvesting in their brands to drive sales growth then I can easily see Kraft growing their free cash flow by $700M to $3.5B. Applying a 2% terminal growth rate and a 10% required return and using a multiple of 17.5 results in a price per share of $41.66.

I view 17.5 as a reasonable multiple for a consumer goods company since consumer goods companies in good parts of the business cycle are usually valued in the mid and sometimes high 20's. I don't believe Kraft deserves a multiple this high at this point in their turnaround but if current management can get Kraft on the right path again even in the short-term then a multiple in the high teens is very reasonable in my opinion. Right now, the current multiple to free cash flow is 13.

Growth	4.0%
Required return	10.0%
Terminal Growth	2%

	0	1	2	3	4	5	Terminal Value
	TTM	2020	2021	2022	2023	2024	2025
Free Cash Flow	$ 2,870.00	$ 2,984.80	$ 3,104.19	$ 3,228.36	$ 3,357.49	$ 3,491.79	$ 3,561.63
Discount Rates		0.91	0.83	0.75	0.68	0.62	
Discounted FCF		$ 2,713.45	$ 2,565.45	$ 2,425.51	$ 2,293.21	$ 2,168.13	

Sum of Discounted FCF	$ 12,165.76
FCF in 2025	$ 3,561.63
Multiple	17.5
Terminal Value	$ 62,328.52
Discount Rate	0.62
Discounted Terminal Value	$ 38,701.11
Terminal Value Plus Total Disc cash flows	$ 50,866.87
Shares Outstanding	1,221.00
Value Per share	$ 41.66

*All data except per share and percentages are in millions

Scenario Analysis

	Bear Case	Bear Case	Base Case	Bull Case	Bull Case
5 yr growth rate	2%	3.0%	4.0%	4.0%	4.0%
Required Rate of Return	10%	10%	10%	10%	10.0%
Terminal Value growth rate	2%	2%	2%	3%	3%
Sum of Discounted FCFs	11,506.61	11,832.09	12,165.76	12,165.76	13,007.75
FCF in Terminal Value Year	3,232.09	3,393.66	3,561.63	3,596.55	3,596.55
P/FCF Multiple	10	12.5	17.5	20	22.5
Terminal Value	32,320.90	42,420.75	62,328.53	71,931.00	80,922.38
Discount rate at year 5	0.62	0.62	0.62	0.62	0.62
Discounted Terminal Value	20,038.96	26,300.87	38,643.69	44,597.22	50,171.87
Sum of discounted FCF plus Discounted Terminal Value	31,545.57	38,132.96	50,809.45	56,762.98	63,179.62
Shares outstanding	1,221.00	1,221.00	1,221.00	1,221.00	1,221.00
Value Per Share	$25.84	$31.23	$41.61	$46.49	$51.74
Price Per Share (Market Close 12/13)	$31.60	$31.60	$31.60	$31.60	$31.60
Potential Upside (Downside)	-18%	-1%	32%	47%	64%

*All data except per share and percentages are in millions

Conclusion

I liked Kraft Heinz a lot more in the mid to high 20's where I felt it offered much better protection on the downside but even in the low $30's and with the major changes that Kraft continues to make I believe there is still opportunity for a gain of 32% next year from capital appreciation in the stock price and 5% from the dividend if Kraft doesn't cut it. If Kraft is able to find ways to fund the dividend, reinvest in R&D for new innovative products, increase marketing spend, pay back debt, and develop a more efficient system which was hurt from all the employee layoffs then it would be better but it isn't all that bad for long-term focused shareholders if they cut the dividend since the extra capital will help speed up the recovery process.

There are some risks in Kraft which would mainly reside in the new management failing to execute on its plan to rejuvenate the brands and drive organic sales growth. This could lead to a domino effect which would make the debt harder to pay back and a continued loss of market share to competitors which would just make it harder to recover. Although a possibility, I don't think this will be the outcome since a food company is a lot easier to turn around then most other industries, the new CEO has some experience in brand marketing with other struggling brands in his previous role and there are already signs of an improvement. They had a good 3Q and 2 directors have invested a little bit over $100M of their own money showing their confidence that the new management can turn things around.