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Investment Banking

Kraft Heinz's Struggles Highlight the Need for Balance in CPG Strategies

In This Report

Investors seek companies that balance cost-cutting and innovation

CPGs look internally and externally for product development

Divestiture activity surges as CPGs favor depth over breadth

Food for Thought

Kraft Heinz's Struggles Highlight the Need for Balance in CPG Strategies

3G's aggressive cost-cutting at Kraft Heinz appears to have backfired, showing the need for CPGs to focus on balancing efficiency and innovation—as well as acquisitions and divestitures—as they look to adapt to shifting consumer tastes.

In the food and beverage industry, 2019's biggest headline has been Kraft Heinz's $15.4 billion write-down of its beleaguered Kraft and Oscar Mayer brands in February. Since private equity firm 3G Capital merged the two consumer packaged goods (CPG) giants in 2015, 3G's aggressive cost-cutting stunted innovation and delayed the development of new products to meet consumers' changing tastes. Kraft Heinz reduced its research and development budget from $120 million in 2016 to $93 million in 2017, according to public filings.

As evidenced by the more than 30% drop in Kraft Heinz's stock price since the write-down, investors believe that now is the wrong time for CPG companies to deemphasize innovation. Consumers' preferences are shifting rapidly to newer, on-trend options—such as better-for-you foods, healthy and protein-rich snacking, and plant-based foods—and turning away from more established brands in favor of emerging health-focused brands and more value-oriented private label options.

While Kraft Heinz's struggles have reverberated throughout the food and beverage industry, it is more of a wake-up call than a death knell for cost-cutting and merger activity among CPGs. Legacy players still have significant advantages in terms of resources and opportunities to leverage their immense scale. If they take the right approach, large CPGs can prosper in this changing food and beverage landscape.

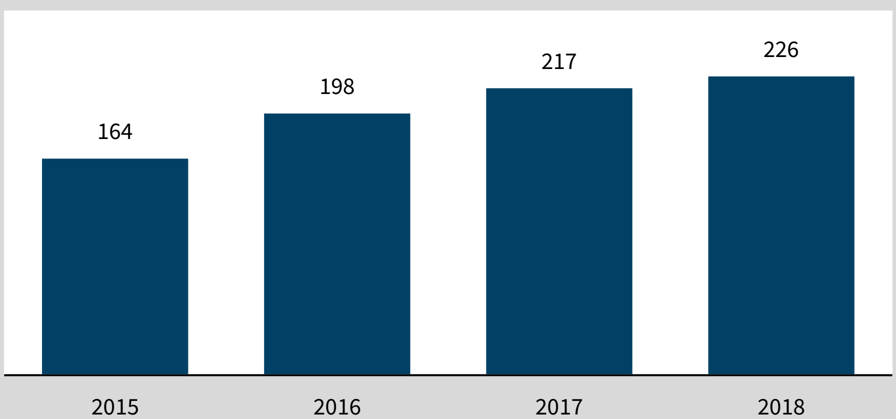
But they must strike a successful balance between cost-cutting and innovation—and at the same time streamline their portfolios to focus on core competencies while continuing to make acquisitions in on-trend categories. In this issue of Food For Thought, we examine what the food and beverage industry can learn from the struggles of Kraft Heinz and how these lessons are affecting M&A activity.

Balancing Innovation and Cost-Cutting

One of the biggest lessons to come from Kraft Heinz's $15.4 billion write-down is that focusing too aggressively on cost-cutting can have dire consequences for large CPGs. At a time when consumer preferences are shifting rapidly, failing to invest in new product development undercuts the prospects of growing sales in on-trend categories—as was the case after 3G implemented zero-based budgeting and other cost-cutting measures at Kraft Heinz. In today's landscape, sustainable value creation

Divestitures Surge in the Food and Beverage Industry

The number of divestitures in the food and beverage industry increased nearly 40% from 2015 to 2018. Facing a growing threat from private label and emerging brands, large CPG companies are looking to streamline their portfolios and focus on areas where they have a competitive advantage amid shifting consumer tastes.



Source: Capital IQ and public filings as of Feb 11, 2019; includes only North American and European companies for large CPGs will come from a balance of cost-cutting and investing in top-line growth.

From an M&A standpoint, companies must take a more measured approach when factoring potential synergies into valuations they are willing to pay for a target. While acquisitions will still provide ample opportunities for CPGs to implement cost-saving measures, investors are suspicious of mergers based solely on synergies. Investors increasingly want to see CPGs use mergers to both cut costs and acquire innovative, high-growth brands.

Looking Internally and Externally for Product Development

Over the last decade, CPGs have outsourced much of their innovation efforts by acquiring smaller, emerging brands that consumers have come to trust and identify as authentic in on-trend categories, such as healthy and protein-rich snacking and natural, organic, functional, and plant-based foods. But CPG companies have realized that innovation in these areas cannot just come through acquisitions. Instead, they need to invest in developing products in these areas internally—and they have the resources and muscle to do so.

Plant-based foods and beverages is one of the most attractive growth categories in the broader better-for-you trend. The plant-based segment has become more than a niche and increasingly appeals to not just vegetarians or vegans. Vegan meat producer Beyond Meat exemplifies the tremendous tailwinds in the plant-based segment. William Blair served as an underwriter of Beyond Meat's IPO, which priced on May 1.

In addition, the perimeter of the grocery store continues to experience stronger traffic and sales growth as consumers seek fresh, minimally processed, convenient meals and snacks. In November 2018, William Blair advised Universal Pure, a leading provider of outsourced high-pressure processing, cold storage, and other technologies that help fresh foods last longer, on its sale to Tilia Holdings. The transaction exemplifies how food technology is evolving to address consumers' desire for fresher and clean label products.

Certain segments of the frozen food section are also seeing robust growth. After several years of middling demand, sales of frozen foods have accelerated as select packaged foods companies have had success steering shoppers back to this section. There has been significant innovation in this area as emerging brands, especially those focused on natural, plant-based and vegetable-based foods, have generated considerable consumer interest. This topic is further explored in the February 2019 *Brand Matters* report published by William Blair equity research analyst Jon Andersen.

If legacy CPGs fail to innovate in these high-growth areas, private label is increasingly a threat to fill the void. Today, private label is no longer merely a fast follower; retailers are using their store brands as laboratories for innovation. As demand for better-for-you and clean-label products grows, store brands are well positioned to attract new consumers and gain market share thanks to improved quality, lower price points, and greater alignment with consumers' personal values.

Divestiture Activity Surges as CPGs Favor Depth Over Breadth

Facing significant headwinds, including emerging brands that are gaining shelf space, legacy CPGs realize that they need to identify their core competencies and go deeper in these areas. This has led to a steady increase in divestiture activity in the food and beverage industry over the last four years.

On the heels of its recent write-down, Kraft Heinz is considering divesting the iconic coffee brand Maxwell House, according to CNBC. In February, organic and natural products company The Hain Celestial Group initiated the divestiture of Hain Pure Protein. In April, Kellogg Company announced that it was selling Keebler Cookies, Famous Amos, and other cookie and fruit snacks brands to Ferrero Group, the makers of Nutella. Narrowing their portfolios allows CPGs to focus on internal innovation and acquire complementary targets in areas where they have a strategic advantage.

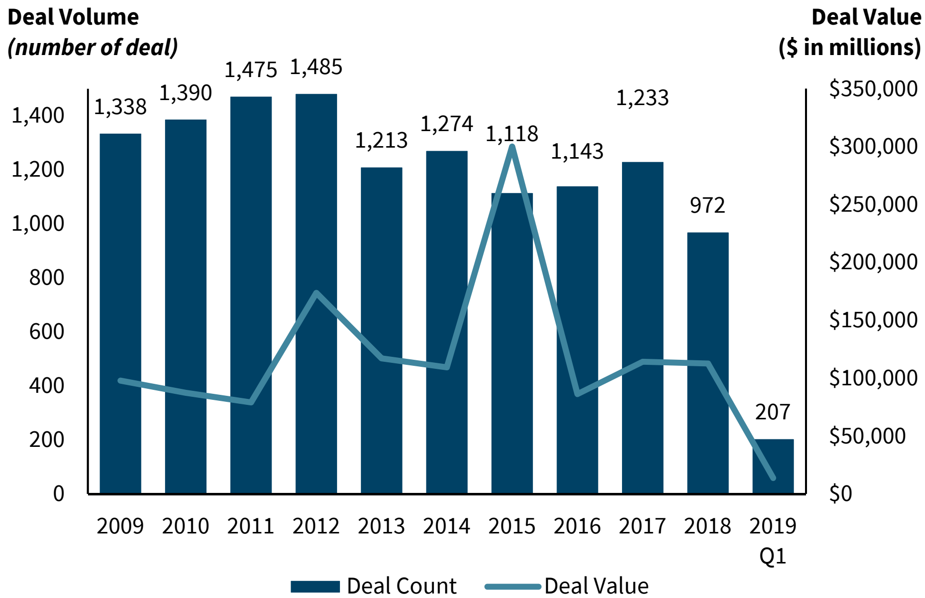
To learn more about these and other trends that are shaping dealmaking activity in the food and beverage industry, please do not hesitate to contact us.

Market Analysis

We look behind the numbers to examine the market dynamics that are driving trends in the deal-making and capital-raising landscape in the food and beverage industry.

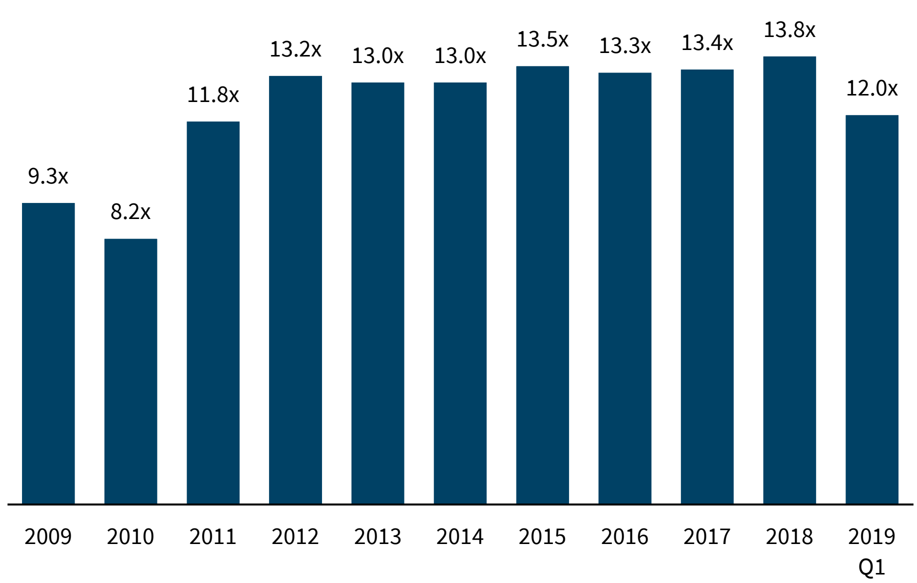
Food and Beverage M&A

M&A activity in the food and beverage industry is off to a slow start in 2019. In 2018, valuations reached their highest level in more than a decade. This, as well as concerns about slowing economic growth and increased skepticism about mega-mergers driven mainly by synergy opportunities, is serving as a headwind to dealmaking. But acquisition interest remains robust for innovative companies in better-for-you, plant-based, snacking, and other on-trend categories.



Sources: Dealogic

Average EV/EBITDA Multiple



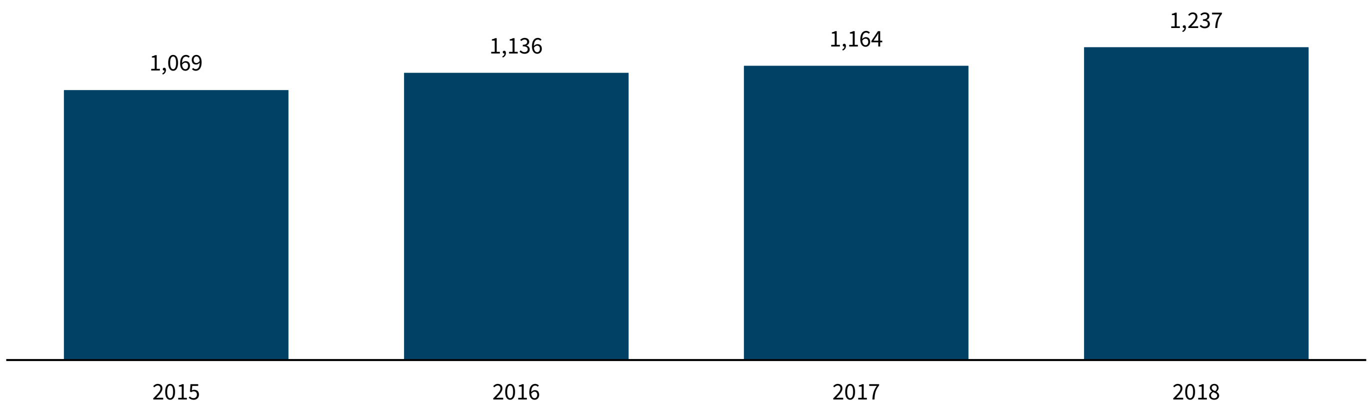
Source: Dealogic

Divestiture Trends

Across industries, companies have increased their focus on repositioning their portfolios. Much of the divestiture activity in consumer and retail is coming from food and beverage companies looking to streamline and focus on core competencies. Kellogg's divestiture of its cookie and fruit snacks brands in April is the most recent example of large CPGs' efforts to reposition their portfolios amid shifting consumer tastes.

Number of Divestitures – Consumer and Retail

Millennials, who will soon overtake baby boomers as the generation with the most discretionary spending power in the United States, are less brand-loyal and more focused on value than older generations.



Source: Capital IQ and public filings as of Feb 11, 2019; includes only North American and European companies

Companies Planning a Divestiture in the Next Two Years – All Industries

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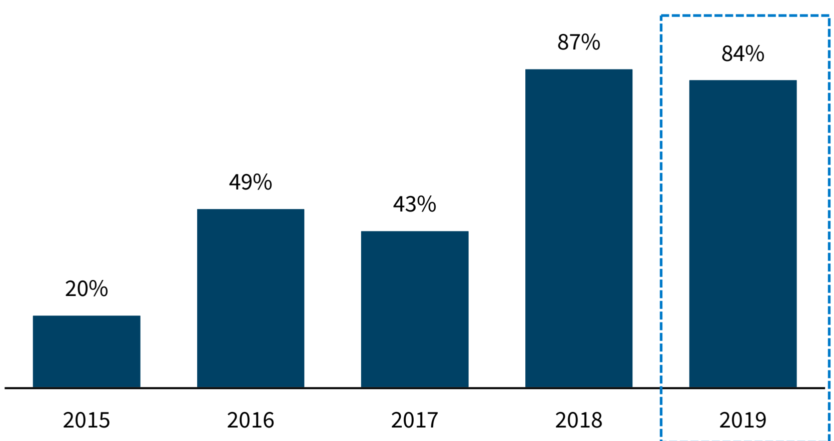

Key Trends in Divestiture Activity Among Consumer and Retail Companies

82%

Expect to divest a business in the next two years

68%

Are reviewing their portfolios every six months or more frequently

60%

Expect to divest a business in the next 12 months

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Drawing on our deep sector expertise and the strength of our relationships, William Blair has built a leading food and beverage investment banking franchise. Business owners turn to us for outstanding execution for their M&A and capital-raising objectives.

Select William Blair Food & Beverage Recent Transactions include:

$276,718,750 BEYOND MEAT Initial Public Offering May 2019	Not Disclosed Universal Pure has been acquired by tilia November 2018	Not Disclosed The Mountain Valley Spring Water has been acquired by Cott October 2018
$74,752,300 PRIMO WATER Follow-on Offering May 2018	PLN 780,579,707 Hortex has been acquired by MIDEUROPA PARTNERS January 2018	$1,200,000,000 Ferrara candy company has been acquired by FERRERO December 2017
Not Disclosed ATLANTIC AQUA FARMS PREMIUM SHELLFISH has been acquired by ONTARIO TEACHERS' PENSION PLAN November 2017	Not Disclosed LYONS has been acquired by PAINE SCHWARTZ PARTNERS November 2017	Not Disclosed GRUPA DELICPOL has been acquired by Continental Bakeries October 2017

William Blair
By the Numbers

350+

bankers globally with local cultural knowledge

1,070+

completed transactions

$315 billion+

in advisory and financing transactions

In the past five years as of March 31, 2019

Selected Upcoming Industry Events

June 2019

02-04	International Dairy Deli Bakery Association Annual Convention "Dairy-Deli-Bake", Indianapolis, IN
02-06	NGA Leadership Development Program (Cornell), Ithaca, NY
05-07	Insight NACS Future of Convenience, London, UK
10-11	NOSH Live, New York, NY
10-12	United Fresh 2019, Chicago, IL
11-14	The Consumer Goods Forum, Global Summit 2019, Vancouver, Canada
23-25	NASFT – Summer International Fancy Food & Confection Show, New York, NY
26-27	TRA Marketplace (formerly Southwest Foodservice Expo), Houston, TX

July 2019

14-15	TRA Marketplace (formerly Southwest Foodservice Expo), Houston, TX
15-18	NBJ Summit, Rancho Palos, CA
22-24	Center Store Grocery, Snack & Beverage Planning, Rosemont, IL

August 2019

24-26	NACDS Total Store Expo, Boston, MA
25-29	Candy Annual Planning, New Orleans, LA

September 2019

12-14	Natural Products Expo East, Baltimore, MD
12-14	All Things Organic - BioFach America, Baltimore, MD
15-18	FMI Annual Business Conference, Chicago, IL
16-18	Food Evolution Summit, Indian Wells, CA
23-24	IFE Americas Food & Beverage Show, Miami Beach, FL

Access to Industry Leaders
William Blair is committed to providing the consumer and retail community with access to leading industry investors and corporations around the globe. To learn more about attending our upcoming conferences, please contact James Bertram at *jbertram@williamblair.com*.

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William Blair's investment banking group enables corporations, financial sponsors, and owner/entrepreneurs around the world to achieve their growth, liquidity, and financing objectives.

Drawing on the collective intellectual capital and deep sector expertise of a global team that reaches 20 cities on four continents, the investment banking group brings a rigorous and innovative approach to corporate board advisory projects, mergers and acquisitions, and equity and debt financing. From 2014 to 2018, the team advised on more than $300 billion in completed transaction volume.