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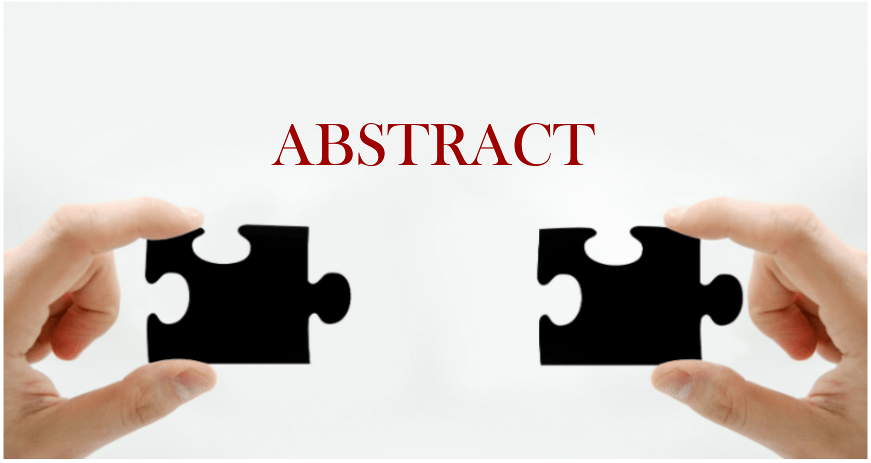

This article discusses the acquisition of Kraft Foods Group Inc. by H.J. Heinz Co. to form the Kraft Heinz Company. Given the recent disappointing results and dramatic drop of the share price, how could this have happened under the guidance of such experienced investors like Warren Buffet's Berkshire Hathaway Inc. and 3G Capital Inc.? And this also leads to the main question for this analysis, which centers on: "Did Heinz overpay for the Kraft acquisition?" To answer this question, a valuation of Kraft Foods Group Inc, as well as potential synergies was performed.

To give some answers about what went wrong and in order to determine if H.J. Heinz Co. overpaid when it acquired Kraft Foods Group Inc., a valuation of Kraft Foods Group Inc. is done using discounted cash flows, the residual income model, the dividend discount model, and EBITDA multiples. Also, the potential synergies of the newly combined company are valued. These valuations were done using relevant parameters in March 2015 at the time of the acquisition. A valuation range of $ 81.04 – 101.59 per share of Kraft Foods Group Inc. common stock was reasonable at that time, if potential synergies were fully realized. But synergies have only been partly realized in the past years. Also, short term and long term growth rates of net revenues appeared to be lower than expected. A valuation range of $ 63.64 - $65.63 is more appropriate.

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INTRODUCTION

On March 25, 2015 Kraft Foods Group Inc. and H.J. Heinz Co. announced their intention to merge Kraft Foods Group Inc. into H.J. Heinz Co. to form the Kraft Heinz Company. H.J. Heinz was owned by Warren Buffett's Berkshire Hathaway Inc. and 3G Capital Inc.; two companies with extensive experience in investing and restructuring companies to boost profit and equity value. But on February 21, 2019 the Kraft Heinz Company announced a loss over the 4th quarter of 2018 in the amount of $12.61 billion. This loss was mainly due to a $ 15.4 billion write down on intangible assets, related to the Kraft and Oskar Meyer brands. The Kraft Heinz Company further announced it would reduce its dividend by 36%. On top of all this, the company disclosed that the U.S. Securities and Exchange Commission (SEC) is investigating the accounting practices of the company.

In reaction to this string of negative information, the share price of the Kraft Heinz Company dropped dramatically by approximately 28% (from $48 to $35) in a single day on February 21, 2019. And, this drop in share price is even bigger compared to the $71.00 at which trading opened on July 6, 2015; the first day the shares of this newly formed company traded in financial markets. What went wrong?

In order to analyze the acquisition of Kraft Foods Group Inc. by H.J. Heinz Co., further insight is needed about the main companies involved. The following section provides a general overview of these companies and summarizes developments in recent years.

Kraft Foods Group Inc.

Kraft Foods Group Inc. (Kraft) is a large manufacturer of fast moving consumer goods with a focus on grocery items, based in Chicago (IL). The company has a long history of acquisitions and divestments. In 2009 Kraft acquired UK-based candy manufacturer Cadbury Plc.. Integration turned out to be difficult and a split of the company between its candy and grocery related activities was considered. In August 2011 the split was announced (Reuters, 2011); the more stable North-American grocery product lines would be spun off and continued as Kraft Food Group Inc. and the remaining fast growing international snack products division would be renamed to Mondelez International Inc. (Mondelez). The spin-off was formally completed in October 2012 (Kraft Heinz Company, 2012). After the spin-off, Kraft showed a low net sales growth.

H.J. Heinz Inc.

H.J. Heinz Inc. (Heinz) is an international food processing and packaging company mainly known for its ketchup. The company is based in Pittsburgh (PA). After the turn of the millennium the company came under increasing pressure from activist shareholders. In 2006 came under pressure from Nelson Pletz' Trian Group. After a proxy fight Peltz won two seats on the board (Hamill & Sorkin, 2006). While both Heinz and Peltz claimed victory, it became clear there was a battle ongoing regarding the long term strategy for Heinz. This battle for control and direction left Heinz vulnerable and made it a potential target for acquisition. On February 14, 2013, BHI and 3G announced the acquisition of Heinz (Reuters, 2013) for $ 72.50 per share in cash. The transaction was valued at approximately $ 28 billion; at that moment the largest acquisition in the food industry in history (Berkshire Hathaway, 2013). After the acquisition BHI and 3G implemented drastic cost reductions, leading to an increase of profit margins significantly above the industry average (Daneshkhu, Whipp, & Fontanella-Khan, 2017).

Berkshire Hathaway Inc.

Berkshire Hathaway Inc. (BHI) is a US-based multinational conglomerate holding company, headed by its well-known CEO and Chairman Warren Buffett. BHI wholly owns, or holds a significant minority stake in a large variety of companies ranging from insurance, flight services and media, to food & beverage, clothing and financial services. The strategy of BHI is to invest in, preferably undervalued, companies with strong financial fundamentals and equally strong brands, for the long term or even indefinitely. By streamlining expenditures as well as the financial structure of these companies, BHI aims to increase the free cash flows of these companies to ultimately increase dividend payments as well as equity value.

3G Capital Inc.

3G Capital Inc. (3G) is a Brazilian-American long term investment firm, with headquarters in both Rio de Janeiro and New York City. It is known for its rigorous cost efficiency improvement in acquired companies using a zero-based budgeting strategy (Daneshkhu, Whipp, & Fontanella-Khan, 2017). 3G has partnered with BHI in several deals in the past (Burger King, Tim Hortons) and recently with Heinz and Kraft. It also played a significant role in creating the largest global beer-brewer Anheuser-Busch InBev SA/NV. 3G used its subsidiary 3G Global p

MERGER DETAILS AND THE NEW KRAFT HEINZ COMPANY

On March 25 2015, Heinz announced a merger with Kraft (Kraft Heinz Company, 2015). The deal was actually an acquisition where Kraft merged into Heinz. Kraft shareholders received a "special cash dividend" of $ 16.50 per share as well as one share of common stock in the new combined Kraft Heinz Company (KHC) for every share of Kraft common stock, in total representing a 49% stake. Owners of Heinz common stock first saw their share converted into a 0.443332 share of Heinz common stock. After this conversion all remaining shares of Heinz common stock were exchanged for an equal amount of shares of KHC. Furthermore, BHI and 3G invested an additional $10 billion in KHC. As a result, the Heinz shareholders would collectively own 51% of the new KHC. The exchange rate was fixed and did not fluctuate with the Kraft share price after the announcement. If the merger was not completed, Kraft would have been obliged to pay Heinz a $1.2 billion termination fee.

The market reacted positively to the announced merger in the sense that trading of Kraft's shares ended on March 24 at $61.33 and opened at March 25 at $81.45; an increase of 32.81%. Also, the Board of Directors of Kraft advised positively in the merger proposal. On July 2, 2015 KHC announced the successful completion of the merger and that the new company would focus on integrating the two businesses and establishing a new organizational structure (Kraft Heinz Company, 2015). The trading of shares of Kraft common stock ended that day at $ 88.19 and trading of new KHC common stock started at $ 71.00 on July 6, 2015. This difference can be explained by the special dividend of $16.50; it basically went ex-dividend.

KRAFT HEINZ COMPANY

After the merger, KHC expected $2.0 billion integration costs, the result of workforce reductions, asset related costs as well as lease and contract terminations. This ultimately resulted in a decrease of its workforce by approximately 10,000 employees; 20% of its total workforce. Also several factories were closed. In 2016, the first full year after the merger, net sales jumped as a result of the merger from $18.3 to $26.5 billion. But, in the second year (2017), the first signs of trouble appear when net sales dropped from $26.5 to 26.2 (-1.13%) even though the U.S. economy grew by 2.3% that year. Because COGS and SG&A decreased even more, by $0.9 billion, but still considerably lower than expected $1.5 billion synergies by the end of 2017, the operating income increased. The net income showed an increase from $3.45 to $10.99 billion. Closer inspection shows that this increase is mainly the result of a one-time adjustment of provisions for income tax; on December 22, 2017, the Tax Cuts and Jobs Act was enacted by the U.S. federal government. This resulted in a considerable (positive) tax effect of approximately $ 6.98 billion.

This one-time income tax adjustment may have shifted the attention from the underlying problems. The 2017 Consolidated Statements of Income shows the first results from the implemented zero-based budgeting strategy; the focus on cutting cost to increase profits yielded results in the short term, but the underlying figures started to deteriorate. Net sales figures started to decrease despite the good state of the U.S. economy at that moment.

The newly combined company also seems increasingly dependent on a few large key customers. The 2016 annual report noted that Wal-Mart Inc., KHC's largest customer, represented 10% of net sales in 2014 before the merger, 20% after the merger in 2015 and 22% in 2016. No figures are released on other key customers, but it is assumed that just a few large grocery chains are responsible for the bulk of KHC's annual net sales. This gives these key customers significant buying power when negotiating with KHC.

As mentioned, revenue growth stagnated after the merger. In 2018 net sales growth was only 0.7%. On February 21, 2019 KHC announced a loss over the fourth quarter of $12.61 billion, mainly due to a $15.4 billion write down on intangible assets related to the Kraft and Oscar Meyer brands (Kraft Heinz Company, 2019). Analysts raised concerns whether focusing on reducing costs in the past years has had a negative impact on maintaining and developing the brands as well as responding to new consumer preferences to increase its market share. KHC further announced it would reduce its dividend by 36% and the company disclosed that the Securities and Exchange Commission (SEC) is investigating the accounting practices of the company. In reaction to this string of negative information, the share price of KHC dropped dramatically by approximately 28% (from $48.18 to $34.95) on February 21, 2019. This drop in the share price, the write down on assets together with the allegations regarding accounting malpractices, has even resulted in several class action complaints filed against KHC (Yahoo Finance, 2019), (Globalnewswire, 2019). On February 28, 2019, KHC filed a notification to the SEC that their 10-K will be submitted late (Kraft Heinz Company, 2019). Currently, KHC's annual report for 2018 is still not available.

INDUSTRY CONTEXT AND COMPETITION

The fast moving consumer goods / grocery manufacturing sector is a very competitive industry. Competition is a dynamic process in which the industry structure is constantly changing. Competitive advantages emerge or disappear as a result of either external or internal change (Grant, 2016). The industry life cycle is made up of five stages: start-up, growth, shakeout, maturity, decline. Performing an analysis to determine in which stage a company is, provides an opportunity to obtain information that can be used to prepare forward-looking estimates that are implemented into both the financial and operational forecasts and strategic modeling.

In order to gain some further understanding of the environment in which Kraft, Heinz and subsequent Kraft Heinz Company (KHC) were/are operating, some understanding is needed on trends regarding the main customers of these companies; the grocery retail industry. According to McKinsey (Kuijpers, Simmons, & Wamelen, 2018) the grocery industry is in trouble, even though it has grown 4.5% annually over the past decade. Three disrupting forces are mentioned; consumers' changing habits and preferences, intensifying competition, and new technologies. The traditional grocery stores also face increased labor costs and fierce competition from lower priced formats. As a result of these pressures, mergers and acquisitions (M&A) activity in the grocery retail industry, especially in the U.S. and Western Europe, is increasing. In the past decade the major players in this market acquired smaller chains in order to achieve economies of scale and remain competitive (Loria, 2017).

Both the fast moving consumer goods / grocery manufacturing sector and the grocery retail industry are matured industries with a high level of competition amongst the players in this market. KHC is in the matured/shakeout phase of the industry life-cycle, which is generally characterized by mass market replacement purchases, fights to defend or gain market share at the expense of competitors, price competition, and on the shakeout phase, failure of mergers and acquisition leads to excess capacity in the industry. Rivalry between existing competitors can become more alike as industry conventions emerge, technology diffuses and consumer tastes converge. This will also lead to a fall in operating margins and industry profitability, driving weaker competitors from the market (Porter, 2008). These effects are visible at KHC given its deteriorating profitability ratios.

Also, the increased consolidation in the grocery retail industry results in increased buying power for the large chains and puts pressure on operating margins of suppliers like KHC, as well as other (globally) competing companies like Nestlé, The Kellogg Company, General Mills, Unilever, Danone and Mondelez. The major brands of all these companies are under pressure from cheaper private label brands of major grocery chains. Therefore, consolidation in the fast moving consumer goods / grocery manufacturing sector seems a logical result in order to also achieve economies of scale and reduce costs, if these companies want to remain competitive as well (or stay in business at all).

It also becomes clear that in recent years the preferences of a large portion of consumers changed towards healthier foods, according to Grocery Dive (Dumont, 2019), which poses a challenge to Kraft Heinz. Consumers pay more attention to the food they buy, and consumers' attention are shifting to fresh home cooked food as an alternative, and perceived as healthier foods. Both Heinz and Kraft are traditionally strong in processed foods which are frequently perceived as unhealthy.

STRATEGY

The basic idea of strategy is the application of strengths against weaknesses, and the most coherent strategy is one that coordinates policies and action (Rumelt, 2017). A strategy is also an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage. A company has an effective strategy and competitive advantage over its rivals if it creates superior value for customers, competitors are unable to duplicate or find it too costly to imitate (Hitt, Ireland, & Hoskisson, 2017). Companies that have significant competitive advantages are able to earn superior profits within their industry. Both Kraft and Heinz have been leaders in the fast moving consumer goods and grocery manufacturing sector due to competitive advantage for many years. Recent events such as weakening financial performance suggests that KHC is losing these competitive advantages. Essentially, the basis of competitive advantage is either through cost leadership or differentiation, which emerges as a result of either external or internal change (Grant, 2016). KHC clearly needs to review its strategy if the company wants to remain competitive in the long run.

ORGANIZATIONAL CULTURE

Post-acquisition problems are probably the most difficult part of mergers and acquisitions; the new combined company may not be appropriately aligned both culturally and/or strategically. Also the management philosophies of both companies may differ. The underperformance of KHC may be a signal of such internal cultural and strategic misalignments or even mismanagement. Recently, KHC disclosed that the SEC is investigating the company due to allegations of financial accounting distortion and manipulation. The sudden change in KHC financial accounting methods is an indication of management dichotomy in financial reporting, which has created an additional problem for KHC.

The company is also struggling with its new shared corporate culture. Evidently, the zero-based budgeting strategy emphasizes cost cutting, instead of investing in new products or employees (Daneshkhu, 2018). This resulted in a very low KHC CEO approval rating of 29% on Glassdoor.com, a website that is used by potential job-applicants. This low approval rating of KHC CEO Bernardo Hees contrasts negatively to very high CEO approval ratings (close to 100%) at direct competing companies like Nestlé and General Mills, which makes it easier for these competitors to attract new talent or lure key employees from KHC (Raath, 2018).

Given the continuing consolidation in both the fast moving consumer goods / grocery manufacturing sector as well as the grocery retail industry, combined with the current problems within the company, KHC may become vulnerable. The company needs to deal with its strategic, cultural and accounting problems urgently and at the same time also needs to acquire (parts of) other companies, if it does not want to become a target itself. But as a result of its current problems KHC will probably find it much harder to acquire new companies in the (near) future; shareholders of target companies as well as lenders will probably question whether KHC is able to create value from the new combination and demand an all cash deal, higher price if stocks are involved in the purchase or higher interest rates.

ACQUISITION STRATEGY

The strategy used by BHI and 3G in the past, is mainly to buy undervalued companies with substantial free cash flows, strong balance sheets and limited debt. This type of company gives the opportunity to increase leverage. The proceeds from the increased leverage can be used to repurchase shares or make a substantial one-time dividend to the shareholders. By combining two or more companies, cost synergies are realized, which increases profitability and return on equity for investors.

In 2017 KHC tried to further increase the size of the company, as well as potential cost synergies by attempting to acquire the Dutch-British food and personal care conglomerate Unilever Plc. (Massoudi, Fontanella-Khan, & Elder, 2017). From KHC's point of view this acquisition did make sense because of potential cost synergies, especially if the plan was to split Unilever Plc. and spin off or sell the personal care division and integrate the food division into KHC. Also as mentioned earlier, given the consolidation in the sector, KHC probably needs to acquire (parts of) other companies if it does not want to become an acquisition target itself. Unilever reacted with a clear statement that the bid of $50 in cash and shares "fundamentally undervalues Unilever". The statement further made clear that "Unilever rejected the proposal as it sees no merit, either financial or strategic, for Unilever's shareholders. Unilever does not see the basis for any further discussions." (Unilever, 2017). The offer valued Unilever at $143 billion. One of the underlying reasons why Unilever rejected KHC's offer could have been that Unilever has a business culture trying to balance strong financial results and sustainability. This culture would certainly clash with KHC's current cost driven corporate culture. KHC surprisingly retracted its offer only a couple of days later.

VALUATION AND ASSUMPTIONS

In this section a stand-alone valuation of Kraft as well as the potential synergies is performed, to determine if Heinz (and BHI and 3G) overpaid when it acquired Kraft. This valuation uses parameters that seemed to be reasonable in March 2015 as at the time of the acquisition, but do not necessarily need to be appropriate after the 2015 creation of KHC. For the valuation of Kraft and the potential synergies, herein, four methods were used: 1) Discounted Cash Flow (DCF); 2) Residual Income Method (RIM); 3) Dividend Discount Model (DDM; two versions) as mentioned by Wahlen, Baginski & Bradshaw (2017); and 4) and EBITDA Multiple. In order to value Kraft, and the potential synergies, the weighted average cost of capital (WACC) or the expected return on equity is needed as a discount rate. The following formula is used for WACC:

$$WACC = (E/V * Re) + \big(D/V * Rd * (1 - tax\ rate)\big) * (P/V * Rp)$$

In the formula, Re, Rd and Rp are the costs of equity, debt and preferred stock respectively. Similar to this, E/V, D/V and P/V are the weights for these capital sources. Next, the expected return on equity is estimated using the capital asset pricing model (CAPM).

$$[E]Ri = Rf + \beta i([E]Rm - Rf)$$

Since the merger was announced on March 25, 2015, historical financial data from March 24 was used in order to exclude market fluctuations as a result from the announcement. For the risk-free rate, the 10 year treasury yield on March 24, 2015 is used: 2.08% (Macrotrends.net, 2019). For the market risk premium (MRP) in the first half of 2015, two sources are used.

$$MRP = [E]Rm - Rf$$

Table 1. Market Risk Premium

Market Risk Premium Q1/Q2 2015	
KPMG	6.30%
Damodaran, A. (Stern, NYU)	5.78%
Average	**6.04%**

Sources: (Damodaran, 2015); (KPMG, 2018).

For this case the average of these two sources, 6.04%, is used as the market risk premium. The Beta for Kraft is 0.897 (Stowell & Kawar, 2014). Using this information, the expected return on equity for Kraft is calculated: 7,50%. Using the outstanding long term debt of Kraft at the end of 2014, since no repayments are to be made until June 2015, the weighted average interest rate on long term debt can be calculated: 4.62%; this can be used as the cost of debt (Rd).

Table 2. Kraft Long Term Debt

Kraft (x $1 million)	**Dec. 27, 2014**	**Maturity Date**	**Interest Rate**	**Type**	**Payment Period**
Senior unsecured notes	$ 1,000.00	June 4, 2015	1.625%	Fixed	Semiannually
Senior unsecured notes	$ 400.00	June 15, 2015	7.550%	Fixed	Semiannually
Senior unsecured notes	$ 1,000.00	June 5, 2017	2.250%	Fixed	Semiannually
Senior unsecured notes	$ 1,035.00	August 23, 2018	6.125%	Fixed	Semiannually
Senior unsecured notes	$ 900.00	February 10, 2020	5.375%	Fixed	Semiannually
Senior unsecured notes	$ 2,000.00	June 6, 2022	3.500%	Fixed	Semiannually
Senior unsecured notes	$ 878.00	January 26, 2039	6.875%	Fixed	Semiannually
Senior unsecured notes	$ 787.00	February 9, 2040	6.500%	Fixed	Semiannually
Senior unsecured notes	$ 2,000.00	June 4, 2042	5.000%	Fixed	Semiannually
Total debt	***$ 10,000.00***				
Weighted average interest rate long term debt	***4.62%***				

Source: 10-K 2014 (Kraft Foods Group Inc., 2014)

Since the effective tax rate for Kraft in that year was 25.8% (Kraft Foods Group Inc., 2014), the after-tax cost of debt is Rd * (1 – tax rate) = 3.43%. Because Kraft did not issue preferred stock, P/V is zero. To calculate the market value of equity of Kraft, the share price of March 24 2015 is used as well as the number of outstanding shares at the end of 2014. Since no market value of debt of Kraft could be found, the book value is used instead to determine the weights. Using the previously calculated Re and Rd, this leads to a WACC of 6.61% for Kraft.

Table 3: Weighted Average Cost of Capital (WACC)

WACC Kraft		
Share price	$ 61.33	March 24 2015
Shares outstanding	587.33	x 1 million
E	$ 36,021	x 1 million
D	$ 10,000	x 1 million
V	$ 46,021	x 1 million
E/V	0.783	
Re	7.50%	
D/V	0.217	
Rd	4.62%	
Tc	25.80%	
WACC	6.61%	

Source share price: www.historicalstockprice.com

Also, a long term growth rate is needed for some valuation methods. It is assumed that in the long run the net sales growth will be more or less similar to the growth rate of the economy in general. In this case, the 2015 estimated long run GDP growth rate of the Federal Reserve is used: 2.0% (Board of Governors of the Federal Reserve System, 2015). Currently (2019) the estimated long run GDP growth rate is 1.9% (Board of Governors of the Federal Reserve System, 2019).

Discounted Cash Flow Model

Using DCF, the present value (PV) of future unlevered free cash flows (FCF) and the terminal value (TV) are calculated.

$$P_0 = \frac{FCF_1}{(1+r)^1} + \frac{FCF_2}{(1+r)^2} + \frac{FCF_3}{(1+r)^3} + \cdots \frac{FCF_n}{(1+r)^n} + \frac{TV_n}{(1+r)^n}$$

Where: $TV_n = FCF_n * (1+g)/(R_{e-g})$

In order to be able to use this model, the projected future unlevered free cash flows are needed. Using the 10-k filings of Kraft from 2012 (the first year after the split between Kraft and Mondelez) to 2014 (the last year of Kraft as a separate entity), a common size income statement is derived.

Table 4: Common Size Income Statement

Income Statement Kraft (x $ 1 million)	2014	2013	2012	2011	2010
Net revenues	$ 18,205	$ 18,218	$ 18,271	$ 18,576	$ 17,797
Cost of sales	$ 13,360	$ 11,395	$ 12,499	$ 12,813	$ 11,777
Gross profit	***$ 4,845***	***$ 6,823***	***$ 5,772***	***$ 5,763***	***$ 6,020***
Selling, general and administrative expenses	$ 2,956	$ 2,124	$ 2,961	$ 2,937	$ 3,063
Asset impairment and exit costs	$ -1	$ 108	$ 141	$ -2	$ -8
Operating income	***$ 1,890***	***$ 4,591***	***$ 2,670***	***$ 2,828***	***$ 2,965***
Interest and other expense, net	$ -484	$ -501	$ -258	$ -7	$ -6
Royalty income from Mondelēz International	$ -	$ -	$ 41	$ 55	$ 43
Earnings before income taxes	***$ 1,406***	***$ 4,090***	***$ 2,453***	***$ 2,876***	***$ 3,002***
Provision for income taxes	$ 363	$ 1,375	$ 811	$ 1,101	$ 1,112
Net earnings	***$ 1,043***	***$ 2,715***	***$ 1,642***	***$ 1,775***	***$ 1,890***

Source: 10-K filings 2012-2014 Kraft Foods Group Inc.

Common size income statement						Average
Net revenues	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Cost of sales	73.39%	62.55%	68.41%	68.98%	66.17%	68.33%
Gross profit	***26.61%***	***37.45%***	***31.59%***	***31.02%***	***33.83%***	31.67%
Selling, general and administrative expenses	16.24%	11.66%	16.21%	15.81%	17.21%	14.98%
Asset impairment and exit costs	-0.01%	0.59%	0.77%	-0.01%	-0.04%	0.34%
Operating income	***10.38%***	***25.20%***	***14.61%***	***15.22%***	***16.66%***	16.35%
Interest and other expense, net	-2.66%	-2.75%	-1.41%	-0.04%	-0.03%	-1.71%
Royalty income from Mondelēz International	0.00%	0.00%	0.22%	0.30%	0.24%	0.13%
Earnings before income taxes	***7.72%***	***22.45%***	***13.43%***	***15.48%***	***16.87%***	14.77%
Provision for income taxes	1.99%	7.55%	4.44%	5.93%	6.25%	4.98%
Net earnings	***5.73%***	***14.90%***	***8.99%***	***9.56%***	***10.62%***	9.79%

Assumptions	
Cost of sales / net revenues	68.33%
Selling, general and administrative expenses / net revenues	14.98%
Asset impairment and exit costs / net revenues	0.34%
Interest and other expense, net / net revenues	-1.71%
Royalty income from Mondelēz International / net revenues	0.13%
Depreciation and amortization / net revenues	2.11%
CAPEX / net revenues	-0.42%

In the 2012 10-k filing Kraft provided a separate backwards looking income statement related to Kraft activities for 2011 and 2010 as well. Using the common size income statement for 2010-2014, the averages for the separate categories are estimated. These estimates give an idea of the cost structure of Kraft and are assumed to be more or less constant in the future. Using these estimates, projections for the income statement for 2015-2018 are made. This same method was used to estimate depreciation & amortization and CAPEX for 2015-2018. In this step also EBITDA, EBIT, NOPAT and FCF are calculated. In order to calculate FCF, the change in net working capital (NWC) is needed. Initially the same method of projection for future years was used. This yielded irregular valuation results.

The reason for this is that Kraft includes the current portion of long term debt under current liabilities. In the past (2011-2013) this current part of long term debt used to be $4 - $8 million per year, but in 2014 this current part is $1405 million, which highly distorts the change in net working capital (NWC) in 2014 and "over-influences" any future unlevered free cash flow estimates. As an alternative the average of the long term debt repayments in the period 2015-2018 ($847 million per year) is used to estimate and smooth the change in NWC. Although the actual debt repayments are known and could be used to estimate the change in NWC, in this case this method was not used since a large debt repayment in 2018 highly (negatively) over-influences the terminal value and as a result thereof, the value per share. Therefore, it is assumed for the estimates that long term debt repayments are more or less constant over time in the long run.

Table 5: Change in NWC estimates

NWC estimates	2011	2012	2013	2014	2015	2016	2017	2018
NWC ex current portion LT debt	$ 708	$ 1,222	$ 1,502	$ 1,423	$ 1,444	$ 1,466	$ 1,488	$ 1,510
Current portion of LT debt	$ -8	$ -5	$ -4	$ -1,405	$ -847	$ -847	$ -847	$ -847
Total NWC	$ 700	$ 1,217	$ 1,498	$ 18	$ 597	$ 619	$ 641	$ 663
change in NWC		$ -517	$ -281	$ 1,480	$ -579	$ -22	$ -22	$ -22

The effective tax rate for 2014 is mentioned in the annual report and is assumed to remain constant at 25.8% in future years. Finally, an estimate for the annual growth rate of net revenues for 2015-2018 is needed. The growth rate of net revenues in 2010-2014 was low (< 1%). It is assumed that due to higher economic growth this growth increases to 1.5% in 2015-2018 (still lower than actual economic growth estimates) and will be equal to the long run economic growth estimate in the long term (2.0% for 2019 and further). This leads to an estimated value per share of $65.80 using DCF.

Table 6: Assumptions DCF

Annual growth rate of net revenues (2015-2018)	1.50%
Long term growth rate	2.00%
WACC	6.61%
Tax rate	25.80%
Debt	$18,582

Table 7: Outcome DCF

Projections Kraft (x $ 1 million)	**2014**	**2015 (E)**	**2016 (E)**	**2017 (E)**	**2018 (E)**
Net revenues	$ 18,205	$ 18,478	$ 18,755	$ 19,037	$ 19,322
Cost of sales	$ 13,360	$ 12,626	$ 12,815	$ 13,008	$ 13,203
Gross profit	***$ 4,845***	***$ 5,852***	***$ 5,940***	***$ 6,029***	***$ 6,119***
Selling, general and administrative expenses	$ 2,956	$ 2,768	$ 2,809	$ 2,851	$ 2,894
Asset impairment and exit costs	$ -1	$ 62	$ 63	$ 64	$ 65
Operating income	***$ 1,890***	***$ 3,022***	***$ 3,067***	***$ 3,113***	***$ 3,160***
Interest and other expense, net	$ -484	$ -317	$ -322	$ -326	$ -331
Royalty income from Mondelēz International	$ -	$ -	$ -	$ -	$ 1
Earnings before income taxes	***$ 1,406***	***$ 2,705***	***$ 2,746***	***$ 2,787***	***$ 2,830***
Provision for income taxes	$ 363	$ 698	$ 708	$ 719	$ 730
Net earnings	***$ 1,043***	***$ 2,007***	***$ 2,037***	***$ 2,068***	***$ 2,100***
Interest and other expense, net	$ 484	$ 317	$ 322	$ 326	$ 331
Provision for income taxes	$ 363	$ 698	$ 708	$ 719	$ 730
Depreciation and amortization	$ 385	$ 390	$ 396	$ 402	$ 408
EBITDA	***$ 2,275***	***$ 3,412***	***$ 3,464***	***$ 3,516***	***$ 3,569***
Depreciation and amortization	$ 385	$ 390	$ 396	$ 402	$ 408
EBIT	***$ 1,890***	***$ 3,022***	***$ 3,067***	***$ 3,113***	***$ 3,161***
Provision for income taxes	$ 363	$ 698	$ 708	$ 719	$ 730
NOPAT	***$ 1,527***	***$ 2,324***	***$ 2,359***	***$ 2,394***	***$ 2,431***
Depreciation and amortization	$ 385	$ 390	$ 396	$ 402	$ 408
Change in net working capital	$ 1,480	$ -579	$ -22	$ -22	$ -22
CAPEX	$ -77	$ -53	$ -54	$ -55	$ -56
FCF	***$ 3,315***	***$ 2,082***	***$ 2,679***	***$ 2,720***	***$ 2,761***
Period	0	1	2	3	4
Discount factor		0.938	0.880	0.825	0.774
Discounted FCF		$ 1,953	$ 2,357	$ 2,244	$ 2,137
Terminal Value					$ 61,039
Sum of PV of FCF 2015-2018	$ 8,691				
PV of Terminal Value	$ 47,244				
Enterprise Value	$ 55,935				
Less Debt	$ 18,582				
Plus Cash and Cash Equivalents	$ 1,293				
Equity Value	$ 38,646				
Outstanding Shares	587.33	* 1 million			
Value per Share	**$ 65.80**				

Residual Income Model

The main problem with the DCF model is that the outcome is highly influenced by, possibly biased, assumptions regarding future growth. The residual income model (RIM) counters this problem partly by incorporating the book value of equity into the valuation. The following formula is used for residual income model:

$$P_0 = BV_{equity} + \frac{RI_1}{(1+r)^1} + \frac{RI_2}{(1+r)^2} + \frac{RI_3}{(1+r)^3} + \cdots \frac{RI_n}{(1+r)^n} + \frac{TV_n}{(1+r)^n}$$

Where: $Residual\ Income = Net\ Income - Required\ Income$

In this case a dividend pay-out ratio of 60% is estimated; approximately the average dividend pay-out ratio in recent years for Kraft. Using this pay-out ratio, RIM yields an estimated value per share of $ 56.34.

Table 8: Assumptions RIM

Residual Income Model		
Cost of Equity	7.50%	
Long run Growth Rate	2.00%	
Shares Outstanding	587.33	* 1 million
Dividend year 0	$ 2.15	
Dividend total	$ 1,262.76	
Pay-out ratio	60.00%	

Table 9: Outcome RIM

Period	0	1	2	3	4
Year	**2014**	**2015**	**2016**	**2017**	**2018**
Net Earnings	$ 1,043	$ 2,007	$ 2,037	$ 2,068	$ 2,100
BV equity	$ 4,365	$ 4,455	$ 4,924	$ 5,370	$ 5,794
Required Return	$ 327	$ 334	$ 369	$ 403	$ 434
Residual Income	$ 716	$ 1,673	$ 1,668	$ 1,665	$ 1,665
Dividend	$ 626	$ 1,204	$ 1,222	$ 1,241	$ 1,260
Retained Earnings	$ 90	$ 469	$ 446	$ 425	$ 405
Terminal Value					$ 30,895
Discount factor		0.930	0.865	0.805	0.749
Present Value		$ 1,557	$ 1,444	$ 1,341	$ 24,383
Sum of Present Values	$ 28,724				
BV Equity	$ 4,365				
Total Value	**$ 33,089**				
Shares Outstanding	587.33				
Value per Share	**$ 56.34**				

Dividend Discount Model

Dividend discount model (DDM) values the shares of a company based on the dividends. In recent years Kraft declares the following dividends:

Kraft	2014	2013	2012
Dividends declared	$ 2.15	$ 2.05	$ 0.50

In this analysis two versions of the DDM are used. The first model uses constant growth rate of dividends.

$$P_0 = D_1/(R_e - g)$$

$$\text{Where: } D_1 = D_0 * (1 + g)$$

In the constant growth rate *g* expressed the dividend growth rate. In this analysis the future dividend growth rate is assumed to be equal to the growth in 2013-2014; 4.88%. The constant growth rate DDM, yields a per share value of $ 86.14.

Table 10: Dividend Discount Model (single-stage)

Dividend Discount Model	
Dividend	$ 2.15
Cost of Equity	7.50%
Dividend Growth Rate	4.88%
Long run Dividend Growth Rate	2.00%
Value of Stock	$ 86.14

Since the (constant) dividend growth rate of 4.88% is significantly higher than the growth rate of net revenues in recent years, as well as the estimated long term growth rate, this means that around the year 2030 Kraft would have a structural dividend payout ratio of more than 100%. Because this is not sustainable indefinitely, a second two-stage version of the DDM is used. This model uses two growth rates: g_1 is the dividend growth rate for a period of 10 years (2015-2024; 4.88%), and g_2 is the long run dividend growth rate used to calculate the TV of the dividends. g_2 is equal to the long run economic growth rate; 2.0%. The two-stage model yields a value per share of $45.25.

Table 11: Dividend Discount Model (two-stage)

Period	0	1	2	3	4	5
Year	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Dividend	$ 2.15	$ 2.25	$ 2.36	$ 2.48	$ 2.60	$ 2.73
Terminal Value						$ 50.62
Discount factor		0.930	0.865	0.805	0.749	0.697
Present Value		$ 2.10	$ 2.05	$ 2.00	$ 1.95	$ 37.16
Sum of Present Values	$ 45.25					

EBITDA Multiples

The following transactions from 2000-2015 are included in the EV/EBITDA comparable multiples calculation.

Table 12: Industry EV/EBITDA comparable transaction multiples 2000-2015

Announcement Date	Target	Acquirer	EV/ EBITDA
Oct. 2015	SABMiller	Anheuser-Busch Inbev	16.1x
May. 2014	The Hillshire Brands Company	Tyson Foods Inc.	16.9x
Feb. 2013	H.J Heinz Company	3G Capital and Berkshire Hathaway	13.0x
Dec. 2012	Morningstar Foods, LLC	Saputo Inc.	9.3x
Nov. 2012	Ralcorp Holdings, Inc.	ConAgra Foods, Inc.	12.1x
July 2012	Peet's Coffee & Tea, Inc.	Joh A. Benckiser GmbH	23.6x
Feb. 2012	Pringles Business of P&G	Kellogg Company	11.1x
Dec. 2011	National Beef Packing Co. LLC	Leucadia National Corp.	2.9x
Aug. 2011	Provimi SAS	Cargill, Inc.	8.1x
Nov. 2010	Del Monte Foods Co.	Funds affiliated with KKR & Co. and others	8.8x
June 2010	American Italian Pasta Co.	Ralcorp Holdings, Inc.	8.3x
Jan. 2010	N.A. Frozen Pizza Business of Kraft	Nestlé S.A.	12.5x
Nov. 2009	Birds Eye Foods, Inc.	Pinnacle Foods Group, Inc.	9.5x
Sept. 2009	Cadbury plc	Kraft Foods Inc.	13.3x
Sept. 2008	UST LLC	Altria Group, Inc.	11.8x
June 2008	The Folgers Coffee Company	The J.M. Smucker Company	8.8x
Apr. 2008	Wm. Wrigley Jr. Company	Mars, Incorporated	18.4x
Nov. 2007	Post Foods	Ralcorp Holdings, Inc.	11.3x
Feb. 2007	Pinnacle Foods Group, Inc.	The Blackstone Group, L.P.	8.9x
Aug. 2006	European Frozen Foods of Unilever	Permira Advisors Ltd.	9.9x
Aug. 2006	Chef America, Inc.	Nestlé S.A.	14.5x
Oct. 2001	The Pillsbury Company	General Mills, Inc.	10.3x
Dec. 2000	The Quaker Oats Company	PepsiCo, Inc.	15.1x
Oct. 2000	Keebler Foods Company	Kellogg Company	10.0x
June 2000	Nabisco Holdings Corp.	Philip Morris Companies Inc.	13.6x
June 2000	International Home Foods	ConAgra Foods, Inc.	8.5x

Sources: (Stowell & Kawar, 2014), (Ralph, 2015), (Raza, 2013), *Tyson Foods Inc. 2014 10-k*

The Fosters Group/SAB Miller transaction (2011) is left out since the highly negative transaction multiple of -122.9x over-influences the outcomes (outlier). Using the 2014 EBITDA for Kraft, the mean EV/EBITDA multiple of 11.8x yields a value per share of 16.26. Using the average EV/EBITDA multiple of the two most recent transactions (16.5x) yields a price of $34.48 per share. The EBITDA multiples yield a low valuation due to the low EBITDA of Kraft in 2014 in comparison with previous years.

Table 13: EV/EBITDA comparable transaction multiples

EV/EBITDA Transaction Multiples						
2014	***EV/EBITDA***	***EV***	***Debt***	***Cash***	***Equity Value***	***Value per Share***
75th percentile	13.9	$ 31,524	$ 18,582	$ 1,293	$ 14,235	$ 24.24
mean	11.8	$ 26,837	$ 18,582	$ 1,293	$ 9,548	$ 16.26
median	11.2	$ 25,480	$ 18,582	$ 1,293	$ 8,191	$ 13.95
25th percentile	8.9	$ 20,191	$ 18,582	$ 1,293	$ 2,902	$ 4.94

Synergies

Also the potential synergies of the merger have been valued. According to the press release issued on March 25 2015, "significant synergy potential include(s) an estimated $1.5 billion in annual cost savings implemented by the end of 2017". It is assumed these synergies will materialize gradually over time and reach the full $1.5 billion in 2018. Using the DCF method, the after-tax synergies are valued at $35.79 per share. This relatively high value probably shows the potential BHI and 3G saw in the merger.

Table 14: Synergies

Synergies Kraft Heinz (x $ 1 million)	**2014**	**2015 (E)**	**2016 (E)**	**2017 (E)**	**2018 (E)**
Period	0	1	2	3	4
Synergies	$ -	$ 250	$ 500	$ 1,000	$ 1,500
Tax provision	$ -	$ 65	$ 129	$ 258	$ 387
After-tax Synergies	$ -	$ 186	$ 371	$ 742	$ 1,113
Discount factor		0.938	0.880	0.825	0.774
Discounted Synergies		$ 174	$ 326	$ 612	$ 861
Terminal Value					$ 24,605
Sum of PV of Synergies 2015-2018	$ 1,974				
PV of Terminal Value	$ 19,045				
Synergies Value	$ 21,019				
Outstanding Shares	587.33	* 1 million			
Value per Share	**$ 35.79**				

Sensitivity Analysis

To determine how valuation is influenced by WACC/Cost of Equity and long term growth rate, a sensitivity analysis is performed for both DCF and RIM as well as on the synergies. From this analysis it becomes clear that both WACC/Cost of Equity and long term growth rate have a very significant impact. A relatively small decrease of WACC from 6.61% to 6.00%, which probably could be achieved by increasing the leverage, already increases the estimated stand-alone value per share using the DCF method, from \$ 65.50 to \$ 80.53. The sensitivity analysis of DCF is also an indication that if KHC (or BHI and 3G) manages to change to financial leverage in such a way that WACC is lowered, the value per share significantly increases even with a relatively small decrease of WACC. This analysis also shows the potential effects of lower (more or less equal to current) growth rates and partially explains the drop in the KHC share price from mid-2017.

Table 15: Sensitivity Analysis

Sensitivity Analysis; Kraft - DCF					
WACC	***\$ 65.80***	***5.00%***	***6.00%***	***6.61%***	***8.00%***
Growth Rate	***0.00%***	\$ 63.30	\$ 47.64	\$ 40.38	\$ 28.08
	1.00%	\$ 83.60	\$ 60.80	\$ 50.82	\$ 34.74
	1.50%	\$ 98.10	\$ 69.57	\$ 57.58	\$ 38.84
	2.00%	\$ 117.44	\$ 80.53	\$ 65.80	\$ 43.63
	3.00%	\$ 185.12	\$ 113.42	\$ 89.07	\$ 56.07

Sensitivity Analysis; Kraft - RIM					
Cost of Equity	\$ 56.34	5.00%	6.00%	7.50%	8.00%
Growth Rate	0.00%	\$ 68.28	\$ 56.70	\$ 45.26	\$ 42.42
	1.00%	\$ 81.42	\$ 64.97	\$ 49.95	\$ 46.39
	1.50%	\$ 90.82	\$ 70.49	\$ 52.88	\$ 48.83
	2.00%	\$ 103.34	\$ 77.38	\$ 56.34	\$ 51.67
	3.00%	\$ 147.16	\$ 98.06	\$ 65.57	\$ 59.08

Sensitivity Analysis; Synergies					
WACC	\$ 35.79	5.00%	6.00%	6.61%	8.00%
Growth Rate	0.00%	\$ 34.70	\$ 28.44	\$ 25.54	\$ 20.64
	1.00%	\$ 42.89	\$ 33.74	\$ 29.75	\$ 23.33
	1.50%	\$ 48.74	\$ 37.28	\$ 32.47	\$ 24.98
	2.00%	\$ 56.53	\$ 41.70	\$ 35.79	\$ 26.91
	3.00%	\$ 83.81	\$ 54.96	\$ 45.17	\$ 31.92

Combined Valuation

The following overview shows the stand-alone valuation of Kraft using various methods as well as the combined valuation with the potential synergies.

Table 16: Combined Valuation

Valuation Kraft 2015	Stand alone	With synergies
Discounted Cash Flow	$ 65.80	$ 101.59
Residual Income Model	$ 56.34	$ 92.12
Dividend Discount Model (fixed)	$ 86.14	$ 121.92
Dividend Discount Model (two phases)	$ 45.25	$ 81.04
EBITDA Multiple	$ 16.26	$ 52.04

Since the outcome for the fixed growth DDM is not sustainable in the long run, this outcome is discarded for the final valuation-range. The EBITDA multiple is also discarded because of the relatively low EBITDA in 2014. This yields a valuation range of $81.04 – 101.59 ("With Synergies") for Kraft around March 24, 2015 and if potential synergies are realized. But if the current results are considered, the average growth rate over the next years is adjusted to 0%, the long term growth rate to 1% and synergies are only 60% realized, the valuation range decreases to $63.64 - 65.63 ("Adjusted"). This is without taking into account the current write-down on some of the brands of KHC.

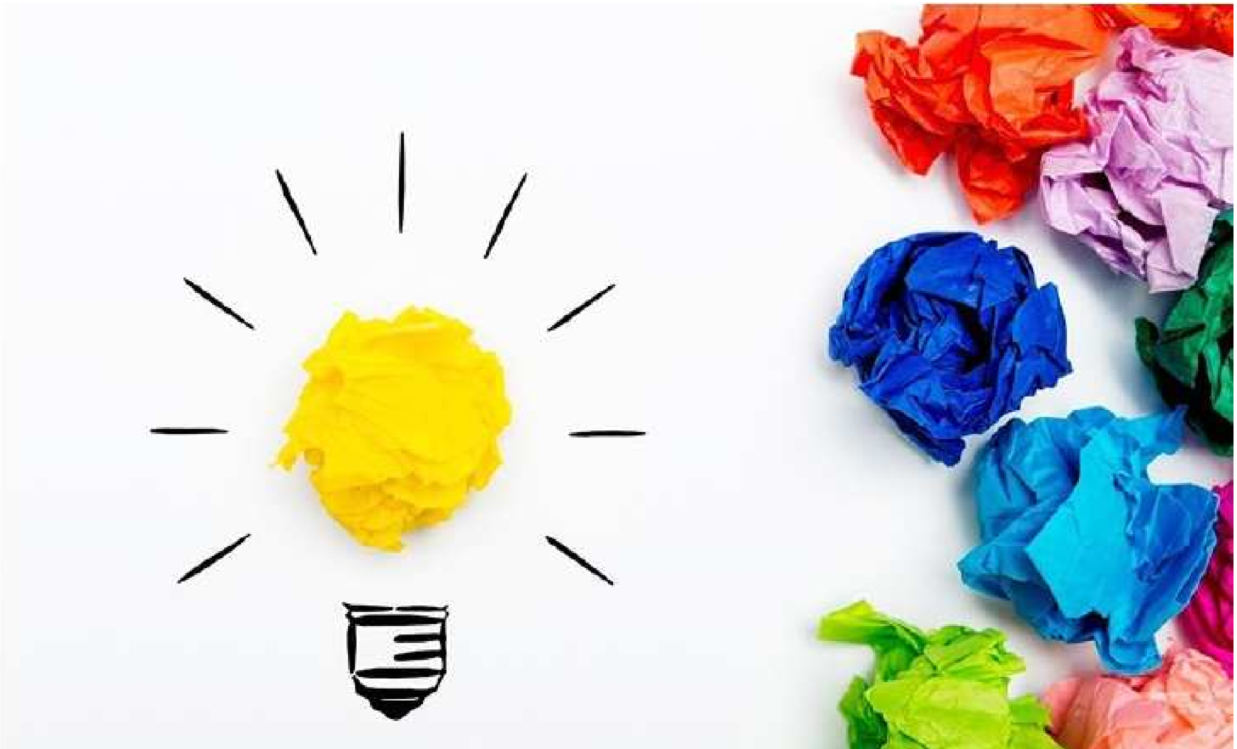
Table 17: Adjusted scenario

Annual growth rate of net revenues (2015-2018)	0.00%
Long term growth rate	1.00%
Tax rate	25.80%

Synergies Kraft Heinz (x $1 million)	**2014**	**2015 (E)**	**2016 (E)**	**2017 (E)**	**2018 (E)**
Period	0	1	2	3	4
Synergies	$ -	$ 200	$ 450	$ 900	$ 900
Tax provision	$ -	$ 52	$ 116	$ 232	$ 232
After-tax Synergies	$ -	$ 148	$ 334	$ 668	$ 668
Discount factor		0.938	0.880	0.825	0.774
Discounted Synergies		$ 139	$ 294	$ 551	$ 517
Terminal Value					$ 12,014
Sum of PV of Synergies 2015-2018	$ 1,501				
PV of Terminal Value	$ 9,299				
Synergies Value	$ 10,800				
Outstanding Shares	587.33	* 1 million			
Value per Share	**$ 18.39**				

Table 18: Adjusted combined Valuation

Valuation Kraft 2015 (adjusted)	Stand alone	With synergies
Discounted Cash Flow	$ 47.10	$ 65.49
Residual Income Model	$ 47.24	$ 65.63
Dividend Discount Model (fixed)	$ 86.14	$ 104.52
Dividend Discount Model (two phases)	$ 45.25	$ 63.64
EBITDA Multiple	$ 16.26	$ 34.65



CONCLUSION

Did Heinz (and BHI and 3G) overpay for Kraft? In 2015 a valuation range of $81.04 – $101.59 may have seemed reasonable. But considering the fact that the expected synergies did only partly materialize after the merger and because of the potential accounting malpractices in the past, Heinz definitely overpaid for Kraft. A lower valuation of $ 63.64 - 65.63 would have been more appropriate. This assumption was also acknowledged recently by BHI's CEO/Chairman Warren Buffett: "I was wrong in a couple of ways about Kraft Heinz. We overpaid for Kraft." (CNBC, 2019).

But this conclusion is only part of the story; the focus on rigorously achieving cost synergies and implementing zero-based budgeting may have caused a blind spot for a shift in consumer preferences. KHC's brands are increasingly "caught in the middle"; they are under pressure from competitive budget private label brands, price pressure from consolidated grocery chains and increased consumer preference for (higher margin) healthier products. This resulted in stagnating net sales figures, despite the current strong state of the U.S. economy.

It is also clear that KHC is struggling with its corporate culture and that employees have problems with the rigorous focus on cost efficiency. This results in very low approval rating of CEO of KHC, especially in comparison to competing companies. The current corporate culture may have been the main contributing factor for failed attempt in 2017 to acquire Unilever plc.

Given the continuing consolidation in both the fast moving consumer goods / grocery manufacturing sector and the grocery retail industry, combined with the problems within the company, KHC may become increasingly vulnerable. KHC needs to deal with these problems and needs to acquire (parts of) other companies if it does not want to become a target itself. In its current state, KHC will probably find it harder to acquire new companies in the (near) future; shareholders of target companies as well as lenders will probably question whether KHC is able to create value from the new combination and demand an all cash deal, higher price if stocks are involved in the purchase or higher interest rates.

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Sources financial statement and merger data:

- Financial statement data for 2012 – 2017 regarding Kraft and Kraft Heinz used in this term paper was retrieved from Form 10-K filings in EDGAR on the SEC website.
- Merger data used regarding Kraft, Heinz and Kraft Heinz was retrieved from Form S-4 filings on the SEC website.