An accident with the ketchup

Kraft Heinz and its investors taste the food industry’s woes

3G Capital’s problem with its famous brands

This was supposed to be the quarter that Kraft Heinz showed America’s huge, struggling food companies a new model for success. A merger in 2015 had joined two of the world’s most iconic food makers. Backed by 3g Capital, a private-equity firm, the new group slashed costs at a pace that made rivals shudder and investors swoon. After a failed bid in 2017 for Unilever, an Anglo-Dutch giant, Kraft Heinz set out to prove it could not just cut fat but boost sales on its own. Bernardo Hees, the company’s boss, pointed cheerfully to new products, including Heinz Mayochup and something called Just Crack

an Egg. The company was on the path to “sustainable, profitable growth”, he declared in November. Unfortunately, it wasn’t.

On February 21st Kraft Heinz announced a staggering $15bn impairment, a dividend cut of more than 30% and an inquiry into its procurement by the Securities and Exchange Commission (sec). Earnings calls are often sleepy affairs. This one was a nightmare. Some of 3g’s long-time critics are now clucking with satisfaction. Others fear 3g is tarnishing American treasures such as Kraft Macaroni and Cheese and Warren Buffett, who partnered with 3g to combine Heinz and Kraft and last year lost nearly $3bn on the deal. Yet dramatic as Kraft Heinz’s decline may seem, 3g’s impact and the food industry’s problems extend far beyond it.

While its founders are Brazilian, 3g’s buyout business is based in Manhattan. (Its most famous founder, Jorge Paulo Lemann, lives in Switzerland.) Unlike many big private-equity firms, 3g’s main investors are not pension funds but family offices and individuals, including its partners. It does not have a wide portfolio, but backs just two companies: Kraft Heinz and Restaurant Brands International (rbi). Blackstone, a private-equity firm based a few blocks away, has nearly 2,500 staff. 3g’s New York office has fewer than two dozen. Yet 3g’s leaders have rocked the consumer industry like few investors in history.

All buyout firms are thirsty for deals, but 3g is uniquely parched. Before starting 3g, the firm’s founders went on a beer-buying spree that culminated in 2016 with Anheuser-Busch InBev’s purchase of sab Miller for more than $100bn. ab InBev, in which 3g’s partners have a large stake, now brews more than one in four of the world’s beers. Kraft Heinz counts Kraft cheese, Heinz Ketchup, Jell-O, Philadelphia

Cream Cheese and Oscar Mayer among its holdings. rbi includes Burger King, Popeyes, a fried-chicken restaurant, and Tim Hortons, a popular Canadian chain.

The way 3g runs companies is as notable as its appetite for buying them. In a practice called zero-based budgeting, managers must justify their expenses anew each year. The idea is to expand margins continuously. Overseeing this are managers chosen for their talent and work ethic, rather than mere experience. Daniel Schwartz, a 3g partner, became the chief executive of Burger King at 32. Mr Hees, a 3g partner who spent more than a decade working for a Latin American railroad, became Kraft Heinz's boss at 45. David Knopf, its chief financial officer, assumed his position in 2017 at 29.

To 3g's detractors, this all seems a bit mad. The company's strategy can be caricatured as follows: buy a big business, cut costs, repeat. This is not entirely fair. rbi has invested in marketing Burger King, winning prizes for its ads. ab InBev is working to boost its sales, for instance by pushing higher-priced beers and deploying best practices across its vast geography.

But buying big companies and slashing costs remain 3g's speciality. The risks of that strategy have become clear. rbi struggled to integrate franchisees at Tim Hortons. ab InBev last year said it would slash its dividend by half.

Nowhere has 3g's approach played out more tumultuously than at Kraft Heinz. America's food industry seemed the perfect target, with flabby companies and powerful brands. Rare is the American who has not slurped Kool-Aid or downed an Oscar Mayer hot dog smothered in

Heinz Ketchup. 3g reckoned the brands were strong enough to withstand large cuts. As it turns out, they were not.

This was not the same for ab InBev, which despite abysmal results in America, has little beer competition from in-store brands, is rarely sold online and faces ample growth abroad. Kraft Heinz's business, by comparison, is concentrated in America, where the food industry is being turned on its head. It brands may be familiar, but that does not make them popular. Small firms are offering healthier options, taking advantage of cheap digital marketing and nimble contract manufacturers. The smallest 20,000 packaged goods players account for about half the industry's growth, according to Nielsen, a research firm.

Meanwhile, the rise of e-commerce and European discount grocers has put pressure on food retailers, which are in turn squeezing food companies. Stores led by Walmart are using extensive data to launch their own, increasingly sophisticated, low-cost private label goods, all the while pushing companies to lower their prices.

Things started well for Kraft Heinz. Its operating profit margin surged from 15% in 2014 to 24% in 2017. The first big setback came that year when Paul Polman, then Unilever's boss, rebuffed the company's $143bn courtship. (Unilever, wisely, has devoted growing attention not to food but to beauty and household products.) Without his megadeal, Mr Hees turned to the basic work of lifting sales by pouring more money into advertising, product innovation and Kraft Heinz's sales force, but that ate into profits.

Equally striking is the company's new $15bn impairment, a recognition that the value of giant brands has shrivelled. Mr Buffett says that he misjudged the worth of Kraft's stable of products (see article). "The management team entered into this merger with the assumption they could cut the spending needed to maintain brands, let alone help them grow," says Robert Moskow of Credit Suisse, a bank. "The world changed on them—retailers changed and consumers changed."

Flawed though 3g's approach may seem, few food companies offer a successful alternative. Companies have tried to evolve by buying smaller firms, often at lofty prices and with mixed results. For instance Campbell Soup bought Bolthouse Farms, a maker of fruity drinks, in 2012, but is now trying to sell it. Last year it bought Snyder's-Lance, a pretzel and popcorn company, to boost its snacks business. Its debt level has risen accordingly. Indeed, shopping sprees at Campbell, ConAgra and General Mills have made those companies more levered than Kraft Heinz, according to Sanford C Bernstein, a research firm.

Kraft Heinz now wants to shrink to grow: it plans divestments over the next 18 months to improve its balance sheet so it can make other, big deals. But the sec's subpoena suggests that some internal processes might be unravelling as managers struggle to meet bold goals. The notion that big deals will save American food firms looks increasingly dubious. In 2014, before Heinz bought Kraft, the combined gross operating profits of the companies were about $6.5bn. Now, due in part to some problems beyond its control, Kraft Heinz expects its 2019 profits to be about the same.

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