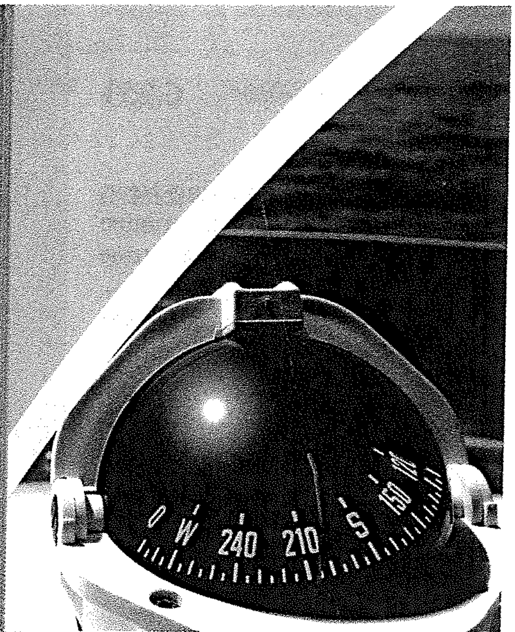

CASE 30

THE HEINZ AND KRAFT MERGER

On March 25, 2015, Heinz and Kraft announced a merger that would make the combined companies the third-largest food company in the United States, and the fifth-largest food company in the world. It would be called the Kraft Heinz Company. Kraft was the number-one producer of packaged macaroni and cheese (with an 80% share), and was among the top four companies that made mayonnaise, salad dressing, pickles, cottage cheese, sour cream, and lunch meat. Heinz was the number-one maker of ketchup (with a 60% share), and was among the top four companies that produce meat sauces, pasta sauces, and frozen appetizers. Together, the two companies accounted for \$22.2 billion in annual revenues.

According to the terms of the deal, a 51% stake in the new company would go to shareholders of Heinz and 49% would go to Kraft shareholders. Furthermore, Kraft shareholders would get a one-time cash dividend of \$16.50 per share (just over 25% of Kraft's stock price at the time of the announcement)—a total payout of \$10 billion that would be paid by 3G Capital and Berkshire Hathaway. Heinz's CEO, Bernardo Hees, would be the CEO of the new company, Heinz's chairman of the board, Alex Behring, would become the chairman of the new company, and Kraft's CEO, John Cahill, would become the vice chairman.

The announcement was met with responses that varied from enthusiasm to puzzlement. Both companies were already giant food companies with significant economies of scale and bargaining power over suppliers and buyers. Furthermore, there was very little overlap in their product lines, making it unclear whether and how product lines or activities might be consolidated. Was this merger going to make the combined companies more valuable than they were individually? If so, how? Would that additional value be worth more than the coordination costs and loss of flexibility that the merger caused?

Scott Olson/Staff

HEINZ

Heinz was founded by Henry John Heinz in Sharpsburg, Pennsylvania, in 1869. He had been peddling extra vegetables from his mother's garden from the time he was 8 years old. When the company was founded, it primarily produced horseradish, pickles, sauerkraut, and vinegar, all delivered via horse-drawn wagons to grocers in and around Pittsburgh. Ketchup, the product with which the Heinz Company would become so closely associated, was not added to the product line until 1876. In 1886, Heinz packed his bags with seven varieties of Heinz products and sailed with his family to England, marking the company's first global venture.

Heinz acquired a reputation as an advertising genius. His creative marketing ideas included New York City's first large, electric advertising sign: a 40-foot pickle. He was also known for the set of principles that became lynchpins of his company's culture:

- Every profit should be fairly earned (his motto was "Deal with the seller so justly that he will want to sell to you again").
- Despise any kind of waste (he inspired employees not to waste materials, time or opportunities).
- Respect all others, rich or poor, weak or powerful (his mother's favorite rule for life was "Always remember to place yourself in the other person's shoes").

As an outcome of this, his manufacturing facility became famous for its progressive benefits plans: free medical care, a swimming pool and gym, and classes for women in cooking and dressmaking.

After his death in 1919, his son (and later his grandson) expanded upon the company's traditional product lines. The company grew and became more diversified with each subsequent leader. By 2015, Heinz had $11.5 billion in revenues (see Figures 1 and 2), and its products were sold in 200 companies around the world. Roughly 47% of its sales came from ketchup and sauces, 37% came from meals and snacks, and the remaining 16% came from other products such as infant formula and baby food. Its iconic Heinz ketchup brand held the number-one or number-two position in 50 countries, and it was also well-known for brands such as Classico pasta sauces, Lea & Perrins Worcestershire sauce, Ore-Ida frozen potatoes, and frozen foods made under the Boston Market, T.G.I. Fridays and Weight Watchers brands. Its strongest 15 brands accounted for more than two-thirds of the company's sales.

Figure 1 Heinz's Income Statement, 2009–2013 ($US millions)

	Apr 13	Apr 12	Apr 11	Apr 10	Apr 09
Revenue	11,528.89	11,649.08	10,706.59	10,494.98	10,148.08
Cost of Goods Sold	7,333.42	7,649.55	6,754.05	6,700.68	6,564.45
Gross Profit	4,195.47	3,999.53	3,952.54	3,794.31	3,583.64
Gross Profit Margin	36.39%	34.33%	36.92%	36.15%	35.31%
SG&A Expense	2,533.82	2,548.36	2,304.35	2,235.08	2,089.98
Depreciation & Amortization	–	–	–	–	–
Operating Income	1,661.65	1,451.17	1,648.19	1,559.23	1,493.65
Operating Margin	14.41%	12.46%	15.39%	14.86%	14.72%
Nonoperating Income	–	–	–	–	–
Nonoperating Expenses	–	–	–	–	–
Income Before Taxes	1,343.64	1,183.44	1,374.17	1,290.45	1,296.20
Income Taxes	241.59	243.54	368.22	358.51	373.13
Net Income After Taxes	1,027.33	939.91	1,005.95	931.94	923.07
Net Profit Margin	8.91%	8.07%	9.40%	8.88%	9.10%

Figure 2 Heinz's Balance Sheet, 2009–2013 ($US millions)

Assets	Apr 13	Apr 12	Apr 11	Apr 10	Apr 09
Current Assets					
Cash	2,458.99	1,330.44	724.31	483.25	373.15
Net Receivables	1,344.18	993.51	1,265.03	1,045.34	1,171.80
Inventories	1,435.40	1,329.35	1,451.55	1,249.13	1,237.61
Other Current Assets	60.46	54.14	153.13	142.59	36.70
Total Current Assets	5,444.13	3,882.24	3,753.54	3,051.13	2,945.02
Net Fixed Assets	2,663.49	2,484.14	2,505.08	2,091.80	1,978.30
Other Noncurrent Assets	1,305.02	932.70	1,074.80	864.16	757.91
Total Assets	38,972.35	11,983.29	12,230.65	10,075.71	9,664.18
Liabilities	**Dec 13**	**Apr 12**	**Apr 11**	**Apr 10**	**Apr 09**
Current Liabilities					
Accounts Payable	1,192.07	1,202.40	1,337.62	1,007.52	1,113.31
Short Term Debt	251.45	246.71	1,534.93	59.02	65.64
Other Current Liabilities	202.19	101.54	98.33	30.59	73.90
Total Current Liabilities	2,924.86	2,647.96	4,161.46	2,175.36	2,062.85
Long Term Debt	14,617.65	4,779.98	3,078.13	4,559.15	5,076.19
Other Noncurrent Liabilities	725.80	812.84	786.74	727.62	900.30
Total Liabilities	22,674.93	9,224.70	9,121.68	8,184.37	8,444.25
Shareholder's Equity	**Dec 13**	**Apr 12**	**Apr 11**	**Apr 10**	**Apr 09**
Preferred Stock Equity	—	0.06	0.07	0.07	0.07
Common Stock Equity	16,140.00	107.77	107.77	107.77	107.77
Total Equity	16,297.42	2,758.59	3,108.96	1,891.35	1,219.94
Shares Outstanding (M)	0.10	320.23	321.28	317.69	314.86

Manufacturing and Distribution

In 2015, Heinz had 63 food-processing factories: 15 in North America, 17 in Europe, 24 in Asia/Pacific, and 7 in the rest of the world. It had developed and patented many of its own manufacturing processes and machines. Its products were sold through its own sales force and independent brokers, and were sold primarily to wholesalers, foodservice distributors, and directly to large retail accounts such as Wal-Mart. Wal-Mart, its largest customer, accounted for 10% of its sales.

KRAFT

Kraft Foods began in 1903, when James L. Kraft started buying and selling cheese out of a horse-drawn wagon in Chicago. Soon he was producing his own cheese and became primarily known for processed cheese sold in tins and loaves (the loaves are now known as Velveeta). The company grew and expanded its product line over the years, developing products such as Kraft Macaroni and Cheese Dinner, Miracle Whip, Philadelphia Cream Cheese, and more. Then, through a series of acquisitions and spinoffs orchestrated by Philip Morris (the cigarette company), several important product lines from General Foods, Oscar Mayer, and Nabisco were merged into Kraft's product portfolio. These included Jell-o and Maxwell House (from General Foods), Oscar Mayer Meats, Oreo cookies from Nabisco, and more.

By the end of 2014, it had revenues of $18.2 billion (see Figures 3 and 4), with 33% of revenues coming from cheese and dairy (brands like Philadelphia cream cheese, Kraft singles, and Velveeta), 15% from meats (e.g., Oscar Mayer hot

Figure 3 Kraft's Income Statement, 2010–2014 ($US millions)

	Dec 14	Dec 13	Dec 12	Dec 11	Dec 10
Revenue	18,205.00	18,218.00	18,339.00	18,655.00	17,797.00
Cost of Goods Sold	13,360.00	11,395.00	12,499.00	12,761.00	11,778.00
Gross Profit	4,845.00	6,823.00	5,840.00	5,894.00	6,019.00
Gross Profit Margin	26.61%	37.45%	31.84%	31.59%	33.82%
SG&A Expense	2,956.00	2,124.00	3,029.00	2,973.00	3,066.00
Depreciation & Amortization	—	—	—	—	—
Operating Income	1,890.00	4,591.00	2,670.00	2,923.00	2,961.00
Operating Margin	10.38%	25.20%	14.56%	15.67%	16.64%
Nonoperating Income	—	—	—	46.00	36.00
Nonoperating Expenses	—	—	—	46.00	36.00
Income Before Taxes	1,406.00	4,090.00	2,453.00	2,969.00	2,997.00
Income Taxes	363.00	1,375.00	811.00	1,130.00	1,110.00
Net Income After Taxes	1,043.00	2,715.00	1,642.00	1,839.00	1,887.00
Continuing Operations	1,043.00	2,715.00	1,642.00	1,839.00	1,887.00
Discontinued Operations	—	—	—	—	1,644.00
Total Operations	1,043.00	2,715.00	1,642.00	1,839.00	3,531.00
Total Net Income	1,043.00	2,715.00	1,642.00	1,839.00	3,531.00
Net Profit Margin	5.73%	14.90%	8.95%	9.86%	19.84%

Figure 4 Kraft's Balance Sheet, 2010–2014 ($US millions)

Assets	Dec 14	Dec 13	Dec 12	Dec 11	Dec 10
Current Assets					
Cash	1,293.00	1,686.00	1,255.00	–	2.00
Net Receivables	1,080.00	1,048.00	1,089.00	903.00	1,196.00
Inventories	1,775.00	1,616.00	1,928.00	1,943.00	1,773.00
Other Current Assets	259.00	198.00	131.00	194.00	165.00
Total Current Assets	4,791.00	4,908.00	4,823.00	3,272.00	3,307.00
Net Fixed Assets	4,192.00	4,115.00	4,204.00	4,278.00	4,283.00
Other Noncurrent Assets	326.00	391.00	325.00	29.00	23.00
Total Assets	22,947.00	23,148.00	23,329.00	21,539.00	21,598.00
Liabilities	**Dec 14**	**Dec 13**	**Dec 12**	**Dec 11**	**Dec 10**
Current Liabilities					
Accounts Payable	1,537.00	1,548.00	1,556.00	1,447.00	1,285.00
Short Term Debt	1,405.00	–	5.00	8.00	8.00
Other Current Liabilities	641.00	483.00	579.00	300.00	322.00
Total Current Liabilities	4,773.00	3,410.00	3,606.00	2,572.00	2,366.00
Long Term Debt	8,627.00	9,976.00	9,966.00	27.00	31.00
Other Noncurrent Liabilities	338.00	428.00	405.00	621.00	583.00
Total Liabilities	18,582.00	17,961.00	19,757.00	4,940.00	4,559.00
Shareholder's Equity	**Dec 14**	**Dec 13**	**Dec 12**	**Dec 11**	**Dec 10**
Preferred Stock Equity	–	–	–	–	–
Common Stock Equity	–	–	4,240.00	–	–
Total Equity	4,365.00	5,187.00	3,572.00	16,599.00	17,039.00
Shares Outstanding (M)	587.33	596.23	592.76	–	–

dogs and bacon, Lunchables), 11% from packaged meals (e.g., Macaroni and Cheese, Shake 'n Bake coatings), 10% from beverages (e.g., Maxwell House coffee, Kool-Aid, and CapriSun), and 9% from condiments (e.g., Miracle Whip, Mayonnaise, salad dressings, and A.1. sauces).

Manufacturing and Distribution

Kraft has 36 manufacturing and processing plants: 34 in the United States and three in Canada. Kraft sells its products primarily to wholesalers, distributors, convenience stores, and large retail chains. Its five largest customers accounted for 42% of its revenues, and Wal-Mart (Kraft's largest customer) accounted for 26% of its sales in 2014. In North America, the company used a combination of a direct sales force and third-parties sales agencies to promote its products to its customers; outside of North America, Kraft primarily used exporters and distributors to promote its products.

ARGUMENTS FOR AND AGAINST THE DEAL

The merger had been organized by 3G Capital (a Brazilian private investment group) and Warren Buffet's Berkshire Hathaway. Those supporting the deal argued that it would enable cost cuts of $1.5 billion through greater economies of scale in North America, and through using Kraft's better credit rating to refinance Heinz's debt. It was also argued that the combined company would have more market power over retailers, giving it greater access to shelf space and the ability to raise prices. Other argued, however, that the companies were already so big, and their brands already so powerful, there was likely little bargaining power left on the negotiating table.

Perhaps more convincingly, Bernardo Hees and Alex Behring had implemented dramatic cost-cutting practices at Heinz that included cutting jobs by 4%, closing several factories, and grounding corporate jets. It was thus reasonable to expect that the team would now impose these measures at Kraft, potentially yielding significant savings. Furthermore, many thought there was significant potential for Heinz to help Kraft sell more broadly in international markets. Whereas Heinz earned 40% of its sales outside of North America and had extensive manufacturing and distribution facilities abroad, Kraft earned only 2% of its sales outside of North America and had no manufacturing or distribution facilities outside of the continent. On the other hand, the potential to broaden Kraft's international presence was limited: In 2012, the company had struck a deal with former Kraft subsidiary, Mondelez International, that gave the latter company exclusive rights to sell many Kraft brands in international markets.

Both companies operated primarily in mature markets, and their revenues had been flat for years. Both companies were also seen as "old-school" brands that were facing serious challenges as customer tastes evolved to favor fresh, natural foods over those processed and packaged. "Both are stodgy, old brands that haven't kept up with the times in terms of shifting consumer appetites," according to Lou Biscotti, global practice leaders for WeiserMazars. Gary Stibel, CEO of New England Consulting, adds that the companies should have started reinventing their brands years ago, noting, "They've both played lip service to better-for-you (food trends) for over a decade." Would the merger help the companies better position themselves for the future?

Sources: L. Douglas, "Why You Should Pay Attention to the Heinz/Kraft Merger," Time.com, April 8, 2015; Anonymous, "Analysis of the Kraft-Heinz Merger," Forbes.com, March 30, 2015; B. Horovitz and J. Onyanga-Omara, "Heinz, Kraft to Create World's No. 5 Food Company," USAToday.com, March 25, 2015; S. Ovide, "The Long, Strange History of Kraft," *The Wall Street Journal,* August 4, 2011; Heinz 2014 10-K; Kraft 2015 10-K; Hoovers; www.heinz.com; www.kraft.com.