BUSINESS

Kraft Heinz's Interest in Unilever Comes Right Out of 3G Capital's Playbook

Brazilian private-equity firm is known to boost profitability at its businesses through cost cuts, acquisitions

At Heinz, which 3G Capital bought in 2013 along with Warren Buffett, 3G managed to strip out $1 billion in annual costs before acquiring Kraft two years later. *PHOTO: ASSOCIATED PRESS*

By **ANNIE GASPARRO**

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Behind Kraft Heinz Co.'s short-lived bid for rival packaged-food giant Unilever PLC is a basic conundrum: The company is running out of ways to improve profitability through its own cost cuts.

Kraft Heinz's operating-profit margins jumped last year, driven by the aggressive cost-cutting methods of Brazilian private-equity firm 3G Capital, which helped orchestrate Heinz's 2015 purchase of Kraft and is the company's biggest shareholder.

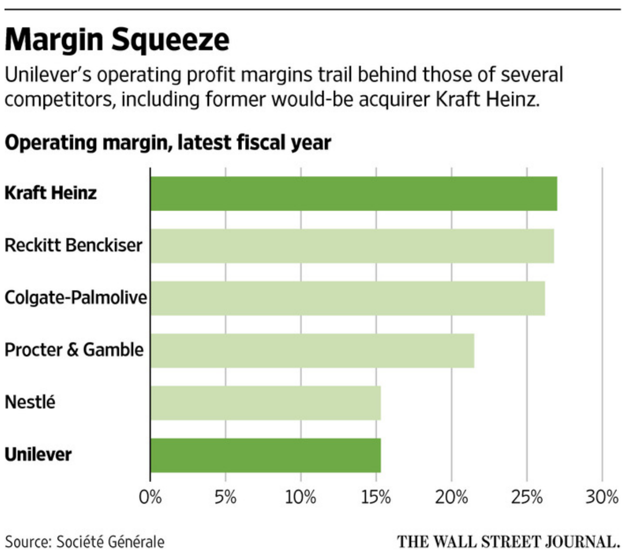
But executives told investors last week that the potential for additional savings was limited. Quarterly earnings beat Wall Street expectations but cost cuts weren't as dramatic as some investors anticipated, pressuring the company's shares and leaving some hungry for another deal.

Kraft Heinz shares soared 11% in New York on Friday when it made its $143 billion bid for Unilever public, but it withdrew its offer two days later, sending Unilever's shares down 6.6% in London on Monday. An acquisition of the Anglo-Dutch consumer-goods giant could have ultimately generated upward of $5 billion in savings from the combined company's annual budget, according to people familiar with the situation.

Kraft Heinz said buying rivals isn't the only way for it to produce strong returns. Chief Financial Officer Paulo Basilio, also a partner at 3G, said Wednesday that the company has decided to make additional investments in marketing, improving food quality and developing new products to boost sales.

Kraft Heinz has come out with new products like Heinz barbecue sauce and a new line of frozen meals focused on natural ingredients. “We don’t need another acquisition to drive value,” Mr. Basilio said.

But investors in companies led by 3G, including Anheuser-Busch InBev NV and Burger King operator Restaurant Brands International Inc., have come to expect rapid returns. When savings max out a few years after a merger, 3G has a habit of making another sizable deal, beginning the process over again.



Even though discussions with Unilever are off the table, the offer “serves as a reminder of Kraft Heinz’s interest, capacity and commitment to pursuing large-scale M&A in a potentially near-term time horizon,” said Barclays analyst Andrew Lazar.

3G is known for wringing costs out of businesses.

At Heinz, which they bought in 2013 along with Warren Buffett, 3G managed to strip out $1 billion in annual costs before acquiring Kraft two years later. Last year, Kraft Heinz’s operating-profit margin expanded 5 percentage points to 23% of sales.

3G has helped bring similar profitability enhancements to Burger King, which bought Tim Horton’s in 2014 to create Restaurant Brands International. RBI recently reported that its key profitability metric rose 16% last year.

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AB InBev, which was built by 3G’s founders, has acquired major brewers since 2008, including Mexico’s Grupo Modelo, Korea’s Oriental Brewing and, most recently, SABMiller PLC. It moved to cut several of those deals as growth in revenue and profitability slowed.

For example, its pursuit of SABMiller came as it struggled to revive Budweiser in the U.S., its biggest market, and faced an economic downturn in Brazil, its second-biggest market. Acquiring SABMiller gave it not only a new business with costs to cut but also new geographies like Africa and parts of South America that reduced its dependence on the U.S. and Brazil.

When 3G partners invest in a company, they first apply zero-base budgeting—a stringent method of managing costs that requires each department to justify all expenses again every year, instead of working off the previous year's budget.

That results in more virtual meetings rather than traveling, fewer free snacks around the office, executives jettisoning first-class flights, and permission required for employees to make color photocopies. 3G also typically saves money by eliminating hundreds of management jobs, negotiating better pricing on ingredient costs and downsizing underused factory lines.

The need for cost cuts is exacerbated by changing consumer tastes and priorities that are shaking up the food industry. Kraft Heinz, which logged $26.5 billion in sales last year, in 2015 said the deal would allow the combined conglomerate to revive the center aisles of supermarkets. But its comparable sales inched up 0.3% last year after falling 1.6% in 2015.

David Garfield, head of consumer-products consulting at AlixPartners, said food makers are partly driven to consolidate to increase their scale, which gives them more purchasing power and greater efficiency in manufacturing. "It's not just about being bigger for the sake of size."

—Tripp Mickle contributed to this article.

Write to Annie Gasparro at annie.gasparro@wsj.com

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