

Kraft Heinz debacle proves not even Buffett immune to mistakes

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INVESTING

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While Berkshire Hathaway CEO Warren Buffett has achieved well-deserved mythical stature among investors, even the “Oracle of Omaha” makes huge mistakes. Exhibit A is the recent debacle involving his investment in Kraft Heinz.

I recently highlighted Buffett’s call in his 2018 annual letter to shareholders of Berkshire Hathaway for investors to focus on Berkshire’s “forest,” which consists of five “groves” of major importance. The third grove consists of four companies in which Berkshire shares control with other parties, including Kraft Heinz, now a diseased “tree.”

In 2013, Berkshire teamed with Brazilian private equity (i.e. buyout) giant 3G Capital to purchase H.J. Heinz. Buffett became friends with 3G head Jorge Paulo Lemann when both served on the board of Gillette. Berkshire was the “financing partner,” purchasing \$8 billion of Heinz preferred stock while Berkshire and 3G each purchased half of the Heinz common stock for \$4.25 billion. Lemann’s 3G associates Bernardo Hess and Alex Behring would run Heinz as CEO and Chairman, respectively.

In his 2013 letter, Buffett lauded the partnership structure used with Heinz as a template for future large acquisitions. He also stated his belief Heinz “fits us well and will be prospering a century from now.” He also noted while the Heinz acquisition had similarities to a “private equity” transaction, Berkshire never intended to sell a single share.

The private equity playbook calls for the new owner to take all or most of the following steps: 1) slash expenses, 2) sell-off assets; 3) load-up on debt; 4) pay itself a fat dividend and 5) sell the company.

In his 2015 letter, he discussed how the Heinz partnership with 3G had more than doubled in size by merging Heinz with Kraft Foods, creating Kraft Heinz (27% owned by Berkshire). He invited shareholders to bring their kids to see Kraft’s Oscar Mayer Wienermobile at Berkshire’s annual meeting. He also noted Berkshire’s and 3G’s shared “passion to buy, build and *hold* large businesses that satisfy basic needs and desires,” but also their very different paths in pursuing their goal.

Berkshire’s *modus operandi* was to buy well-managed businesses that were humming along and create an environment where managers could maximize both their effectiveness and “pleasure they derive from their jobs.” This is a very “hands off” strategy.

By contrast, 3G looked for companies with bloated expense structures that offered opportunities for **rapidly** eliminating costs. 3G was known for using a machete vs. a scalpel, mass layoffs and counting paper clips. It implemented “zero-base budgeting” whereby every dollar spent had to be justified each year (i.e. vs. starting with the prior year’s amount). Their style is the epitome of “hands on” and you won’t find “pleasure” anywhere in their handbook.

Buffett lauded the productivity gains derived from 3G’s strategy, but the proverbial chickens came home to roost on February 21 when Kraft Heinz announced 1) disappointing earnings for 2018 and guidance for 2019, 2) a large dividend cut, 3) a \$15.4 billion write down of its assets, acknowledging the brands it had acquired less than four years prior were worth much less now and 4) an SEC investigation into its accounting practices. The stock promptly plunged a whopping 27%, erasing about \$16 billion of value and contributing to a \$2.7 billion loss Berkshire posted for 2018.

Buffett subsequently acknowledged Berkshire/3G overpaid when they arranged for Heinz to buy Kraft to form Kraft Heinz in 2015, noting “the business does not earn more because you pay more for it.” He said he’d neither pull the plug on the stock nor buy more after the drop because “it’s not worth as much.” Perpetually slashing costs is apparently not a “magic bullet” or sure path to prosperity, particularly when you need to continually invest in your brands in a time of rapidly changing consumer tastes.

Berkshire and 3G were always an odd couple, but as Berkshire grew bigger and stock prices rose, it became increasingly difficult to make a meaningful, traditional acquisition. Enter 3G. In his 2018 letter, Buffett said Berkshire was possibly

the only Fortune 500 company that does not prepare monthly financial statements, nor have a company-wide budget. This meant there was *never* a quarterly earnings number to hit, because “shunning the use of this bogey sends an important message to our many managers, reinforcing the culture we prize.”

As Mark Twain said, “it ain’t what you don’t know that gets you in trouble. It’s what you know for sure that just ain’t so.”

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