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Should Unilever get Krafty on its margins?

First it was Marmite-Gate then the wider valleys in Toblerone. The scenario we have highlighted for the last two years is finally playing out. Growth rates for staples companies are falling to low single digits and margin expansion is proving hard to come by in the light of raw material headwinds and rising labour costs. We have seen the valuation of these companies de-rated.

At its 2016 results presentation, Unilever indicated margin expansion of 40-80 basis points (bps) p.a. over the next few years with the caveat that in the near term, its achievements will be towards the bottom end of the range. Enter stage left Kraft Heinz, which is owned by Warren Buffet (26.8%) and 3G Capital (23.9%). The latter is renowned for its ZBB (zero based budgeting) approach, which aims at cutting costs to the bare minimum. In fact, looking at the following table, it is clear Kraft Heinz has achieved tremendous results when comparing its expense ratio (SG&A as % of sales) to other staples companies.

Company	Sector	Market Cap ($bn)	Gross Margin	Operating Margin	SG&A as % of sales	Organic growth 3yr CAGR
Estee Lauder	HPC	19	80.6%	15.5%	65.2%	7.3%
L'Oreal	HPC	103	71.2%	17.4%	53.8%	4.0%
Beiersdorf	HPC	22	58.3%	14.4%	44.0%	5.0%
Mead Johnson	Food	15	64.2%	24.8%	39.4%	3.6%
Pepsi	Beverages	151	55.0%	15.8%	39.2%	4.3%
Coca-Cola	Beverages	181	60.7%	23.4%	37.4%	3.5%
BAT	Tobacco	115	75.5%	38.1%	37.4%	4.5%
Danone	Food	42	50.0%	12.9%	37.1%	4.0%
Carlsberg	Beverages	11	50.2%	13.2%	37.0%	1.9%
Nestle	Food	227	51.0%	15.3%	35.7%	4.0%
Pernod-Ricard	Beverages	31	61.9%	26.2%	35.6%	2.4%
Brown Forman	Beverages	10	69.9%	34.8%	35.1%	6.0%
Colgate	HPC	59	60.3%	26.2%	34.1%	4.7%
Reckitt Benckiser	HPC	62	59.1%	26.8%	32.3%	4.3%
Henkel	HPC	22	48.3%	16.2%	32.2%	3.2%
Diageo	Beverages	70	59.5%	28.7%	30.8%	1.0%
ABI	Beverages	178	60.7%	31.6%	29.1%	4.8%
P&G	HPC	225	50.6%	21.5%	29.0%	1.7%
Imperial Brands	Tobacco	45	72.3%	44.4%	27.9%	0.0%
Unilever	Food/HPC	64	42.6%	15.3%	27.3%	3.6%
Hershey	Food	16	45.6%	20.4%	25.3%	1.7%
Heineken	Beverages	45	41.4%	16.5%	24.9%	3.8%
Church & Dwight	HPC	12	45.7%	20.9%	24.8%	3.4%
PMI	Tobacco	158	65.0%	40.2%	24.8%	4.1%
Mondelez	Food	68	39.8%	15.3%	24.5%	2.5%
CCEP	Beverages	17	35.8%	13.6%	22.3%	-0.5%
Kellogg	Food	26	34.6%	14.3%	20.3%	0.6%
Molson Coors	Beverages	18	39.4%	19.8%	19.5%	-0.6%
General Mills	Food	36	35.2%	16.8%	18.4%	0.0%
Kimberley Clark	HPC	44	36.6%	18.4%	18.2%	3.7%
Constellation Brands	Beverages	26	44.9%	28.5%	16.4%	5.2%
SCA	HPC	20	26.9%	11.9%	15.0%	3.3%
Kraft Heinz	Food	118	36.2%	23.2%	13.0%	0.1%
Kraft Heinz*	Food	118	36.2%	27%*	9.2%	0.1%

* adjusted for restructuring and integration costs

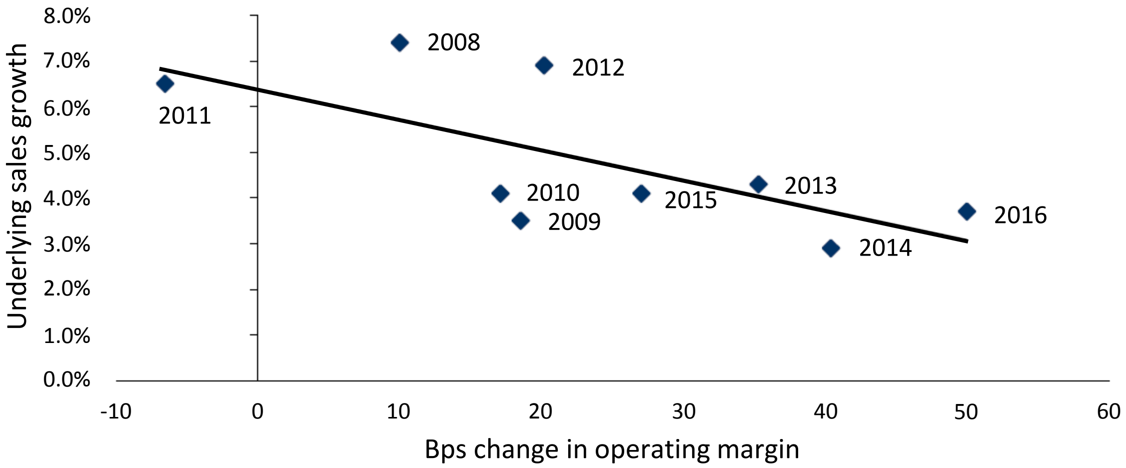
Source: Societe Generale, FactSet

Gross margins for Kraft Heinz are actually towards the lower end of its peer group at 36.2%. Looking at operating margins, however, Kraft Heinz is in the first quartile and is the best food company in the group. The driver behind this is the low SG&A (selling, general and administrative) expenses for Kraft Heinz, which come in at a staggeringly low 9.2% (adjusted for restructuring and integration costs). SCA has the next lowest SG&A expense ratio at 15%, which is still half of the universe's average of 30.4%.

What's behind this low SG&A expense and would we, as investors, really want Unilever to try to achieve a similar level? SG&A expenses comprise a range of items from labour costs through to advertising & promotions, distribution costs, rent, research & development. 3G managed to cut these expenses dramatically within Heinz, before and after, the merger. Interestingly, it hasn't quite achieved similar results at ABI after the acquisition of InBev.

In the case of Kraft Heinz, most of the cost savings relate to a rationalisation of manufacturing (and, therefore, cutting of labour costs) but also cuts to advertising & promotions, distribution and innovation. We believe the deep cuts in the last three segments are too far-reaching. In fact, managements of other European staples companies have agreed that using ZBB in all areas of a company is cutting investment too far and could have potential negative consequences.

There appears to be a clear relationship between SG&A spending and volume growth and pricing. In the case of Kraft Heinz, we think this cost cutting is depressing sales. Looking at the last column in the table above, it struck us that Kraft Heinz had almost zero organic growth in the last three years versus a sector average of 3.1%, while margins expanded by 960bps over the same time. In the case of Unilever there has been a negative trade-off between margins and growth over the last 10 years as can be seen in the chart below.



Source: Unilever, Kepler Cheuvreux

At its FY2016 results, Kraft Heinz announced a step up in marketing in 2017 in order to support organic growth. Although Kraft Heinz may talk about an opportunity to invest, we think it's the other way around and the investments are a necessity to recover lost ground. This will prove tricky, especially in the current environment where top line growth across the sector is slowing and margins are under pressure.

Where does this leave Kraft Heinz and Unilever? In our opinion Kraft Heinz's margins have now reached a peak and we expect SG&A as a percentage of sales to rise again towards the mid-teens.

This would imply an operating margin closer to high-teens, whilst playing catch up in terms of organic growth.

Would we as investors want Unilever to follow 3G's footsteps in implementing a blanket ZBB approach across the entire business and push its margin expansion over the next 2-3 years in order to satisfy transitory demand? The short answer is no. We invest in companies for the long-term and want to see a sustainable business model. We would not appreciate an overaggressive cut in costs simply to reach 80bps margin improvement in the next two years instead of previously guided 40bps. The risk would be that the top line suffers and with it the brand image, which is the most important asset to a staples company.

We appreciate that Unilever is feeling under pressure to show its shareholder the hidden value in its business. There is no doubt there are saving opportunities, especially within Unilever's Homecare division. Management had already implemented some aspects of ZBB in its cost-cutting plan before the approach of Kraft Heinz which would have resulted in a gradual increase in margins over the next 3-5 years. We fully supported this approach. We think a move to ZBB across the board, however, would be unsuitable for the steadfast investor. In the long term, the risks of cutting too deep are too high.

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