MORGAN-DEMPSEY
CAPITAL MANAGEMENT, LLC

Kraft Heinz Company (KHC) | Initiate 1.50% **September 2022**

Company Overview

The Kraft Heinz Company is the third-largest food and beverage company in North America and the fifth-largest food and beverage company in the world. In addition to Kraft and Heinz, the company's iconic brands include Oscar Mayer, Ore-Ida, Jell-O, Philadelphia (cream cheese) and Velveeta. The company generates more than 45% of sales from condiments and sauces, cheese and other dairy products. Kraft Heinz offers its products through retailers, ecommerce and foodservice distributors. The US accounted for over 71% of LTM revenues through March 31, 2022.

Transitional Strategy & Thesis

KHC has been in a period of significant change since CEO Miguel Patricio took over about three years ago. Management is amid a multiyear transformation program and has made changes that it believes has laid the groundwork for the company's return to solid and consistent growth.

- The company's strategic focus was changed from financially driven inorganic growth primarily consisting of acquisitions followed by cost cutting to organic growth driven by investments in marketing and innovation. This philosophical change driven by the new CEO has resulted in the creation of a new leadership team with significant experience in consumer goods that focuses on top line growth first, margin maintenance second. Small acquisitions are still part of KHC's growth strategy, particularly in emerging markets.
- KHC's decision to put the consumer first was an important driver of the reorganization of its business structure. The company moved from 55 categories of products to six platforms that are based on how consumers live their lives and how they eat. The objective of the change was/is to shift from focusing on discrete products to anticipating and meeting consumer needs. This approach has helped the company to move away from a more egalitarian approach to capital allocation to one based on the platforms and products with the best long-term potential. The six platforms are:
    - **Taste Elevation**: Enhancing the taste, flavor, and texture of food
        - Global platform
        - Includes Ketchup, Mayo/Mustard, Nut Spreads/Jams, and Hot Sauces
    - **Easy Meals Made Better**: Convenient foods that minimize tradeoffs at mealtime
        - Global platform
        - Includes Baked Beans, Mac & Cheese, Pizza/Pasta Sauces, Frozen Snacks/Apps
    - **Real Food Snacking**: Nutrition-rich, tasty, convenient, clean food experiences
        - US/Canada platform
        - Includes Nuts, Seeds, Trail Mix, Meal Combos, Snacking Cheese
    - **Fast Fresh Meals**: Help consumers make fresh, easy, prepared, or assembled meals
        - US/Canada platform
        - Includes Cream Cheese, Deli Meat, Bacon, Pickles
    - **Easy Indulgent Desserts**: Sweet and indulgent treats that bring simple joy to everyday life.
        - US/Canada platform)
        - Includes Pudding, Gelatin, Marshmallows, and Whipped Toppings

- **Flavorful Hydration**: Hydration across kids' beverage and beverage mixes
  - US/Canada platform
  - Includes Kids Ready to Drink Beverages, Powdered Beverages, and Liquid Concentrate.

- The company currently is in the midst of "reengineering" itself to make it less bureaucratic and more agile. The changes include:
  - Reducing management layers in the company.
  - Creating 25 "agile pods", each composed of 12 people, that work on 3 critical areas of the company
    - Consumer knowledge and innovation
    - Strengthening partnerships with customers (retailers) using data-driven insights to drive business
    - Improving the supply chain making it more resilient and agile
  - Greater investment in technology to improve logistics, marketing, and the effectiveness of promotions.
  - Increasing use of partnerships with suppliers (such as Simplot) and technology companies (such as Microsoft) to help add outside knowledge that can improve the company.
    - Two interesting aspects of the Microsoft relationship is the development of a "Supply Chain Control Tower" that will provide real-time visibility into plant operations while automating supply chain distribution across all product categories and the creation of "digital twins" for KHC's 34 owned North American manufacturing facilities that will help the company to test and perfect solutions and processes before applying them to the plant floor.

The shift to organic growth vs. inorganic growth has changed the company from a serial acquirer driven by financial engineering to a packaged food company driven by innovation, marketing, and operational improvement. This is the core of its transition. The reorganization of its product offerings into six consumer driven platforms has helped the company to reorient its approach to its businesses. Capital allocation decisions also will be helped by the company's identification of the platforms and product lines that have the greatest potential for growth. The less bureaucratic organizational structure and commitment to the collection and creative use of consumer data has the potential to help drive customer-centric innovation and marketing/promotional strategies that could catalyze further profitable growth. Finally, KHC's willingness to partner with organizations appears to be a smart strategic move, allowing management to focus on its areas of expertise while integrating the expertise of others. We believe that for these reasons the stock is a good candidate for the LCV portfolio.

<u>Positives</u>

- The company recently attained investment grade status for its bonds after reducing debt levels more quickly than expected. It will be easier and (relatively) less expensive for the company to access the fixed income markets.
- KHC has increased capital allocation to platforms that it believes has the potential to grow, particularly Taste Elevation. The company has become more judicious in the use of its resources.
- The company has been reshaping its product portfolio through divestures, partnerships, and small acquisitions. This ongoing process shows commitment to continually attempting to improve the growth profile of the company.
- The sale of its nut and specialty cheese operations has reduced the company's exposure to both commodities and private label. The company currently estimates that it has reduced its exposure to private label from 17% in 2019 to 11% today. This compares to an estimated total food and beverage industry average of 20%.
- The company has the potential for significant expansion into Non-North American Markets through both organic and inorganic means. The company has been successful growing in individual emerging market focusing on larger cities, using modern trade channels, and leading with ketchup. Approximately 23% of the company's

2022H1 revenues came from outside North America. There is significant international growth potential for the company.

- Food service is a strategic channel for the company and fertile area for growth as the channel continues to rebound from the pandemic. KHC focuses on condiment offerings and leverages food service channels to test new products which, if successful, are taken to retail.
- The company is using better data gathering and analytical techniques to improve its operations. One example is the development of a system that anticipates customer inventory needs, helping to reduce "out-of-stocks" that negatively impact sales.
- Created "The Kitchen", an internal marketing/media/advertising group designed to develop targeted consumer marketing programs more quickly and less expensively than through traditional agencies.

Negatives & Risks

- 3G, the private equity firm that helped create the company, has been selling significant blocks of stock, pressuring its price.
- Management has harvested the lowest hanging fruit. Now the company needs strong execution to successfully implement their program.
- Company's progress has been distorted by the general success of packaged foods during Covid. It will need to maintain/grow share in a radically different environment that includes higher inflation. Numerous price hikes have not yet significantly dented demand for its products.
- The company may be unable to improve margins in an inflationary environment. Price hikes will have limits.
- Supply chain issues are part of the next chapter of improvement and need to be successfully addressed.
- Acceleration in "trade down" to cheaper and/or generic products could reduce KHC's revenues and market share. There also is the potential for weaker margins if KHC increases promotions or limits price increases to protect market share.

Current & Historical Valuations

Valuation Matric	Current	5-Year High	5-Year Low	Average	Vs. Industry
Price to Earnings (PE)	29.4	155.1	3.8	33.6	1.8
Forward PE	13.2	21.6	8.8	14.0	0.8
Price to Expected Growth (PEG)	7.0	94.3	1.7	14.5	1.5
Price to Book Value	0.9	1.7	0.5	0.9	0.5
Price to Cash Flow	10.8	158.3	6.9	23.0	0.9
Price to Sales	1.7	3.9	1.0	2.0	1.0
Enterprise Value to EBITDA	12.1	16.4	9.6	11.4	0.9
Enterprise Value to Sales	2.5	5.2	2.3	3.0	1.1
Dividend Yield	4.4	9.3	2.9	4.9	1.3

Note:

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