

# Strategic Report for The Kraft Corporation

## **Pandora Group** **Out of the Box Consulting**

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## Executive Summary

Throughout its history, the Kraft Corporation has established its product portfolio through internal innovation and acquisition. Today, Kraft is the largest producer of consumer food products. Kraft's portfolio contains a host of well established brands—Oreo, Nabisco, Kool-Aid, Maxwell House, Oscar Mayer, Velveeta, and numerous others. The industry to which Kraft belongs is defined as large producers of food and beverage products. Companies in this industry generally operate domestically as well as internationally, in both developed and undeveloped markets. The industry is characterized by intense competition on both price and quality, with advertising and marketing playing a huge role in building consumer demand and generating brand loyalty.

Phillip Morris (now Altria) purchased the Kraft Corporation in 1988 for \$12.5 billion as Altria sought to diversify itself against anticipated declines in per capita consumption of tobacco products. After purchasing Kraft, Altria took Kraft public through an Initial Public Offering in 2001. Trading under the ticker KFT, the company boasts a market capitalization in excess of \$50 billion. In 2003, Altria announced that a spin off of Kraft would occur, though a timeline was not set as Altria wished to settle its pending tobacco litigation prior to releasing Kraft from its control. Altria currently owns 85% of the common equity and nearly 98% of the voting rights of Kraft stock.

Several factors combine to affect the performance of Kraft as well as the industry as a whole. These include rising input and commodity costs, increasing market share of private label products domestically and abroad, declining at-home consumption of food

products, and changing dietary trends toward healthier foods. As a result of these factors, Kraft's margins have suffered in recent years, and its stock price has failed to significantly outperform the S&P 500. In order to counter these trends, Kraft has instituted two restructuring programs aimed at divesting non-core products, realigning their product portfolio, increasing efficiencies, and cutting costs. The restructuring programs will result in the closure of nearly 20 factories and a reduction in workforce by nearly 6,000. Kraft hopes to receive \$800 million per year in cost savings from these programs. These programs were already under way at the time of this report.

In this report, Pandora Group focuses its attention on two main strategic issues. The first issue is Kraft's decreasing use of hedging techniques to control for rising input costs. Although Kraft does make use of financial derivatives such as futures to hedge against rising commodity costs, they are not doing this enough, and their margins have contracted as a result. Pandora Group recommends that Kraft undertake an aggressive risk management strategy specifically targeted at hedging spiraling commodity costs.

The second strategic issue Pandora Group will call attention to is the negative impact that Altria's ownership is having on Kraft's stock price and debt ratings. Kraft's debt ratings were downgraded as a result of a \$10.1 billion settlement in Altria's tobacco litigation. With no apparent strategic reason for Altria to own Kraft, Pandora Group recommends an immediate separation of Kraft from Altria. This separation should result in an upgrade of Kraft's debt ratings and will allow Kraft better access to the capital markets. As a result, Kraft will be able to increase its leverage to peer levels, which are nearly double the amount of leverage Kraft currently holds. The proceeds of

these debt issuances should be returned to shareholders through share repurchases. Furthermore, Kraft's separation from Altria will increase the "tradable" volume of Kraft's stock, result in Kraft's inclusion in several key indices, and produce an immediate increase in Kraft's share price. Spinning off Kraft should also be beneficial to Altria. In the past, the stock prices of conglomerates have received premiums because of the perceived notion of less risk through diversification.<sup>1</sup> Today, however, conglomerates often trade at discounts because they are viewed as inefficient and reduce investors' ability to diversify risk themselves. Therefore, there is limited downside to Altria shares for the spinning off of Kraft.

## Company Background

The Kraft Company began in 1903 when James L. Kraft started a wholesale cheese business in Chicago. Eleven years later, after being joined by his four brothers, the company expanded and was selling cheese across the United States. By 1916 the company received its first patent on the process of processing cheese, and by 1924, the company was publicly traded and began international operations first in London and then in Hamburg. The growth and success of Kraft can be attributed to internal product development as well as to the addition of new products through acquisition. In 1933, Kraft introduced their Miracle Whip salad dressings and just three years later in 1937 introduced Macaroni and Cheese, one of their most recognized products. In 1950, Kraft began selling the first commercially packaged cheese slices, and introduced Cracker Barrel natural cheese in 1954. Kraft also made additions to their product portfolio through acquisitions. In 1928, Kraft acquired the Phenix Cheese Corporation, adding Philadelphia cream cheese to their list of expanding products. In that same year Kraft developed Velveeta cheese spread. In 1980, in order to diversify their product mix,

Kraft merged with Dart Industries, the company that made Duracell batteries, but kept separate operations. The two companies were split up just six years later in 1986.

While the Kraft name has been preserved since its founding, Kraft's history is dependent on the histories of several other companies. The Kraft Corporation as we know it today is the result of a substantial consolidation in the food products industry. This consolidation combined some of the largest food product companies of the 19<sup>th</sup> and 20<sup>th</sup> centuries and some of the industry's most recognizable entrepreneurs—individuals such as Charles Post, Oscar Mayer, Joel Cheek (Maxwell House), Adolphus Green (Nabisco), Phillip Suchard (Milka), and Theodor Tobler (Toblerone). These entrepreneurs, acting in the same fashion as James Kraft, founded several independent food companies: Oscar Mayer turned around a failing meat market in 1883, Maxwell House Coffee was invented in a hotel in Nashville in 1892, Jacobs Kaffee was founded in Germany in 1895, Postum introduced cereals in 1897, the National Biscuit Company (later Nabisco) began after the consolidation of a handful of regional bakers in 1898, the Phillip Suchard Company was established in Switzerland in 1901, and the Tobler brand of chocolates were introduced in 1908. While the Kraft name has stuck with the company, Kraft's product portfolio owes as much credit to these companies as it does to its own product development.

In 1929, Postum and Maxwell House merged, along with Baker's chocolate and Jell-O, to form General Foods Corporation. General Foods Corporation conducted a number of acquisitions to grow the company, acquiring Jacobs Kaffee in 1979, Oscar Mayer in 1981, and Suchard Tobler in 1982 (from merger of Phillip Suchard Company and Tobler

in 1970). General Foods Corporation was later acquired in 1985 by tobacco giant Phillip Morris, now known as Altria Group, Inc. In 1988, Phillip Morris purchased Kraft for \$12.9 billion.

General Foods and Kraft, now both under the control of Phillip Morris, combined to become Kraft General Foods, creating the largest food maker in the United States. Despite the combination, the two companies operated independently of one another with separate management until 1995 when they were integrated to achieve management synergies and greater efficiency. After the combination of Kraft and General Foods, many of Kraft's lower margin businesses were divested. The divested businesses included their North American table spreads business and its bakery unit. Specific products divested included Lender's bagels in 1996 and Log Cabin syrup in 1997. After the integration, Kraft added Del Monte pudding and Taco Bell's grocery line to their new, more focused product portfolio. Influenced by the new social trend to fight spiraling obesity in the United States, Kraft purchased Boca Burger and Balance Bar in 2000 for a combined price tag of \$779 million. In 2000, Phillip Morris added to Kraft's already immense product portfolio by acquiring Nabisco Holdings for \$18.9 billion, which had earlier merged with A.J. Reynolds (1985). Nabisco was integrated into the Kraft Foods business, and 7,500 jobs were cut in 2002 as a result of the acquisition. In 2001, Phillip Morris created a holding group for all of their food products though they retained the Kraft name, calling the company Kraft Foods Inc. In that same year the company performed an Initial Public Offering, trading under the ticker KFT. The company continued with acquisitions and divestitures in 2002, adding Stollwerck AG and selling Fleischmann yeast products and Farley's & Sathers Candy Company. Over

the decades, Kraft Foods Inc. has expanded its product portfolio to include such household names as Oreo, Philadelphia cream cheese, Knudsen, Jell-O, Miracle Whip, Ritz, Triscuit, Mac n' Cheese, Easy Mac, Minute rice, Kool-Aid, Cool Whip, StoveTop, Planters, Del Monte, and numerous others.

In 2003, Roger Deromedi was named as Kraft's sole CEO. Deromedi had originally been appointed co-CEO from his earlier position as CEO of Kraft Foods International. In that same year, Phillip Morris, now Altria, announced its plans to spin off Kraft Foods into its own company. Despite the announcement, the spin off has yet to occur due to Altria's pending tobacco litigation. Altria will wait to execute the spin off until it is certain that plaintiffs cannot go after Kraft's assets when it becomes an independent company.

In 2004, after realizing downward pressure on margins, rising input prices, and a huge product portfolio, Kraft initiated a corporate restructuring. Kraft announced this plan in 2004 hoping to return the company to its core businesses of cheese, coffee, and cookies. During the restructuring, which is set to last for three years, up to 20 plants will be closed, approximately 6,000 positions will be eliminated, and non-core products will be divested.

## Competitive Analysis

Kraft Foods Inc. operates in a vast industry generally defined as either Diversified Food and Beverages or Branded Foods and Beverages (SIC codes fall between 2011-2099 and 5141-5149). This broad industry definition serves as an umbrella under which a variety of firms operate. Firms falling into this industry include Kraft, Kellogg, Nestle,

Campbell Soup Co., General Mills, Unilever, Danone, Archer Daniels, ConAgra, Heinz, Cadbury Schweppes, Frito-Lay, Hershey, Sara Lee, Wrigley, Hormel, Starbucks, Coca-Cola, Pepsi Co., Anheuser-Busch, and a host of others. For the purpose of analyzing the competitive landscape of the industry, we will restrict this broad group to large and diversified firms in the Branded Foods and Beverages industry. These firms are Cadbury Schweppes, ConAgra Foods, Group Danone, Nestle, Sara Lee, Unilever, General Mills, and Kellogg, all of which have market capitalizations in excess of \$10 billion. Firms in the industry are involved in the processing, packaging, marketing, and distribution of primarily food products. A geographic market definition is of lesser importance because of the mere size of the firms in the industry. These firms are so large with such a variety of products that all operate both in the U.S. and internationally. In both geographic markets, the Branded Foods and Beverages Industry must compete with generally less expensive, private label products. Competition with this category of products will be further discussed in the substitutes and complements section of this analysis.

### Internal Rivalry

The Branded Foods and Beverages Industry is characterized by intense competition and a constant quest for preserving and increasing market share. The main vehicle by which firms in the industry preserve market share is through brand loyalty and diversification. In general, the products of these firms are highly elastic with consumers weighing the trade off between price and quality between companies and products. Consumers in the industry have minimal switching costs and there is never the guarantee of brand loyalty. Therefore, the way these firms maintain market share is by providing brand quality at an affordable price. Firms in the industry can further

maintain and even increase their market share by offering new and innovative products. These products can be developed through internal innovation or through merger and acquisition activity. Since market share is of such importance, and since consumers ultimately determine market share through their purchasing decisions, advertising and marketing of brands are of the utmost importance. Advertising and marketing is essential to promote brand awareness as well as to facilitate the acceptance of price increases among consumers. Thus, there is some cooperation among firms against the erosion of market share to private label products. With all firms promoting brand quality, there are signals passed onto the consumer that brand name products are superior to private label products in quality and elegance.

The current landscape in the industry is one defined by a constant jockeying for market share amidst fierce, industry-wide competitive pressure from both internal and external factors. Firms in this industry are struggling to be profitable. There have been restructurings and realignments at Kraft and at other companies in the industry in order to increase volume and profitability despite increasing input costs, sluggish top line growth, margin contraction, and rising pension costs. Under the current conditions, firms are trying to run themselves as “lean” as possible by eliminating unprofitable brands, divesting unprofitable assets, and restoring product portfolios to core products. Kraft specifically has undergone a restructuring aimed to reduce operating costs by \$800 million per year. Kraft reduced its number of SKU’s (Stock Keeping Units) by 20% between 2003-2005, divested its sugar confectionary business, closed 20 physical plants, and reduced the labor force by 8%.<sup>ii</sup> Similar changes have been seen across the industry. There has also been a drastic increase in marketing and advertising expenses. Kraft

increased marketing expenditures by 20.7% in 2005. The increases in marketing expenses are driven by the company's need to facilitate acceptance of price increases among consumers as higher input costs are passed along.

There is room in the industry for firms to increase their market share, though because of the maturity of the industry, this will ultimately come at the expense of the market shares of other firms. The main method by which firms can increase market share is by increasing volume. This is ultimately related to the effectiveness and execution of marketing campaigns and consumers' acceptance of new products. Firms will need to create new products that adapt to the changing lifestyles and preferences of consumers, which have shifted in the last decade toward a focus on health and wellness. There is also the potential for growth through mergers and acquisitions, though this is limited by the degree of consolidation present at the large firm level. While the industry is still very fragmented at the local level, at the national level there are a few large companies that have strong brand recognition. In the first half of 2005 there were 224 merger and acquisition transactions in the industry as companies realigned their portfolios and sought growth.<sup>iii</sup> According to industry reports, there are still some "niche" companies that could be acquired by the larger players even though many of the more desirable acquisitions have already been made. There is also the possibility for international expansion, specifically in emerging markets, where food consumption beyond mere sustenance is increasing. This appears to be the best opportunity for growth because foreign markets may be less competitive for branded products. One constraint to the Branded Foods and Beverage industry in terms of international expansion, however, is the prominence of private label products abroad. In Europe and other global regions,

the price differential between brand name products and private label products is much larger, which would force companies to compete more on price amidst the same cost pressures.

## Entry

The Branded Foods and Beverage industry is a mature market and has already experienced significant consolidation at the large company level. Because of this, the threat of entry by a new competitor is slim. The existing companies in the industry have already spent significant amounts of money on branding, and the quality associated with brands by consumers is difficult to overcome, though necessary for entrants to entice switching among consumers. A new entrant would have to offer the same quality as existing products and would have to beat existing companies on price to steal market share. Further, this is a relatively capital intensive industry with significant start-up costs. The fixed costs necessary for entry, including the costs of production and packaging facilities and distribution networks, are daunting. These fixed costs serve as the largest barrier to entry. An entrant would also have to spend a disproportionate amount of money on marketing and advertising to induce switching among consumers. Even if a company were able to enter, it is doubtful they could acquire significant market share. The companies in the industry are large and established and have the advantage of significant economies of scale and scope in production, marketing, and distribution which enhances an entrant's inability to compete on price, quality, or promotion. Potential entrants must also realize the threat of predatory pricing. These are large firms who could easily reduce prices and take short run losses to deter entry. Lastly, if a firm was able to enter the industry, it is likely the entrant would be acquired

by one of the larger companies before reaching the scale and scope of a Kraft or Kellogg. Therefore, the threat of entry of a major player in the industry is low.

### Substitutes and Complements

The threat of substitutes is significant for the Branded Foods and Beverages Industry. As mentioned earlier, private label products, also referred to as “generic” products, pose a serious threat to industry and firm profits. In Kraft’s 10Q, the Company writes that a potential risk is “a growing presence of hard discount retailers, primarily in Europe, with an emphasis on own-label products.” According to the Private Label Manufacturers Association (PLMA), 16.1% of sales in U.S. supermarkets in 2004 were private label products.<sup>iv</sup> This number is only expected to increase as the quality of private label products converges with the quality of brand products and as consumers’ acceptance of these products increases. Private label goods not only pose a problem for the industry because they are direct substitutes, but also because they deter companies within the industry from raising prices. Consumers evaluate the trade off between quality and price for both brand name products and private label products. Since these goods are elastic, any increases in the price differential adversely affects volume. These substitutes create a huge strain on Kraft’s profits because they prevent the company from passing on higher input prices to consumers. For international operations, this effect is amplified since private label products are more widely accepted than in the U.S. and because the price differential abroad is already larger than it is domestically. In order to differentiate products and prevent the substitution of private label products for brand name products, Kraft and other companies in the industry have increased their advertising and marketing expenses to facilitate the acceptance of an increase in the

price differential and to differentiate their products from private labels in the eyes of the consumer.

The second main substitute that presents a threat to profitability rests in the changing preferences of consumers. In recent years, there has been a push toward food and beverage products that are geared towards health, nutrition, and general wellness. As stated in the 10Q, a risk to company profits is “changing consumer preferences, including diet trends.” The newfound success of products associated with the Atkins Diet, the South Beach Diet, and other diets have resulted in the substitution of some of Kraft’s less healthy products with more nutritionally sound products. Most industry analysts believe that the trend toward health food is here to stay as we now have much better information about the effects of certain foods on health. This has led Kraft to increase the nutritional value of their own products and to make their nutritional contents more available to consumers. Kraft has also taken steps to change their portfolio mix to incorporate this new trend. In 2000, the company purchased health food lines Balance Bar and Boca Burger for a combined \$779 million. Kraft also struck a deal with the creator of the South Beach Diet to allow Kraft to put the diet’s “seal” on nearly 200 products. Kraft’s diversification has also been beneficial in this transition as Kraft has seen increases in sales of snack and granola bars. While the importance of health and nutrition is gaining momentum, industry reports show that taste is still a key factor in determining sales.<sup>v</sup> The stigma that nutritional value equates to less desirable taste should buy the industry some time and afford firms the opportunity to realign product portfolios before this stigma is removed.

The trend away from at-home consumption of food and beverage products is another threat facing Kraft. According to the U.S. Department of Agriculture, in 2004 consumers spent only 54% of food related income on meals eaten at home, a 22% decline since 1970.<sup>vi</sup> One of the main drivers of this reduction is the increase of women's participation in the labor force, which has increased 14% since 1970.<sup>vii</sup> The decline in at-home coffee consumption is also adversely affecting Kraft. This is a direct result of the accessibility and scale of Starbuck's. Kraft is a leading producer of household coffee through its Maxwell House brand. In the second quarter of 2005 the cost of coffee as an input increased 59% year over year, yet Kraft was forced to reduce prices for Maxwell House Coffee by 5% in August 2005 to better compete with Starbucks. With these trends appearing lasting, Kraft is taking steps to reduce losses from the decline in at-home consumption by increasing sales to restaurants, schools, and other institutions as consumers substitute away from at-home food products.<sup>viii</sup>

The demand for Kraft's products relies less on the demand for complementary goods and more on general economic conditions. Because of this, it is relatively difficult to think of goods that are complementary to Kraft's products. The industry sells consumer food products, so demand tends to rise and fall with disposable income rather than with complementary goods.

### Supplier Power

Companies that package and market products in the industry generally have more value added through packaging and distribution than companies involved in the lower margin business of processing agribusiness commodities. Therefore, Kraft and its competitors should be able to maintain relatively consistent margins year after year

under normal conditions. Prices of inputs for the industry are generally competitive and market determined, so suppliers of these inputs should never be able to hold a company in the industry hostage to extract profits. Hedging and the use of financial derivatives can also be employed to guarantee margin consistency. While such tools can be used to hedge against commodity prices, the current environment of rising input costs is a major problem facing the industry. On average, agricultural commodities represent 19% of a company's costs and packaging represents 8% of operating costs. The industry as a whole is suffering from volatile commodity prices, specifically oil prices and petroleum based packaging products. Prices for pulp, aluminum, nuts, and sugar have also increased in recent quarters. With yields on sugar beet crops already projected to be low, and with political changes in the European Union's sugar policies, sugar prices have increased from \$0.21 per pound to \$0.30 per pound. For most companies, sugar represents 5-10% of raw material costs. Kraft has a particularly high exposure to sugar prices of firms within the industry. Cheese, coffee, cocoa, and sugar are Kraft's most valuable input commodities and Kraft projects that these commodity costs will be \$800 million more than 2004 levels. Despite the rising commodity costs, most firms are reluctant to change their product recipes to save money on rising input costs for the fear of losing volume and brand quality. While most companies use hedging to minimize their exposure to rising commodity costs, ultimately these costs are market determined. Due to hedging, the effect of rising input costs on a company's financial health is lagged as derivatives expire and new derivatives are purchased at higher futures prices. Therefore, even though suppliers do not have significant power in setting prices and extracting profits, the current environment of rising commodity prices is of significant concern for the industry.

## Buyer Power

In the current environment, there is significant opportunity for buyers to extract industry and Firm profits. Although Kraft raised prices by 3.1% for their top 25 products in 2004 as a result of the increase in input prices, competition in the industry makes it difficult to raise prices. The main factor contributing to the loss of profits is Wal-Mart. Wal-Mart has significant power to control the prices of the goods it purchases and has made clear the commitment to do so. If firms are unwilling to negotiate with Wal-Mart on price, then Wal-Mart can threaten to or pull products and reduce a company's volume sales. As Wal-Mart grows, the option of not selling to Wal-Mart for the sake of preserving price is becoming less and less of an option for companies in the industry who wish to maintain market share. The Wal-Mart effect places significant pressure on margins and sales. According to Kraft's 10Q, "a trend toward increasing consolidation in the retail trade and consequent pricing pressure and inventory reductions" is a huge threat to Kraft's success and profitability. While no specific companies are listed in the 10Q, this appears to be a reference to Wal-Mart more than other retailers. According to Wal-Mart, sales of grocery, candy, and tobacco in Wal-Mart stores have increased by 10.1% in 2004 and 10.9% in 2003. These increases are likely to apply further pressure to industry margins. The threat of Wal-Mart's buyer power and the resulting margin pressure may eliminate strategic buyers, such as private equity firms, from considering firms or product lines in the industry as buyout opportunities.

Buyer power may also be created as Kraft reacts to the decline in at-home consumption of food products and coffee. As discussed earlier, in order to compensate for lost at-

home consumption, Kraft has begun to sell more volume to restaurants, schools, and other institutions. In terms of coffee, Kraft has been forced to reduce prices to compete with Starbucks. If buyers are able to sense these weaknesses then they should have more power to negotiate on price.

## SWOT Analysis

### Strengths

- Large and diversified (snacks, beverages, cheese, dairy, grocery)
- Strong product portfolio (Oreo, Nabisco, Mac N' Cheese, etc.)
- Established distribution channels (supermarkets, wholesalers, etc.)
- Strong brand recognition and brand loyalty
- Restructuring to realign core business, cut unprofitable segments
- Threat of entry by new firms very low
- More value added through packaging and distribution than processing of agribusiness commodities
- Exposure to developing markets in Middle East, Latin America, Asia where diets are moving beyond sustenance

### Weaknesses

- Low growth opportunities
- Must make strategic acquisitions for growth
- Low switching costs for consumers to change brands
- Must compete on price and quality of product
- Must spend an increasing amount on advertising and marketing
- Subject to changing consumer preferences

- Limited ability to raise price
- Inability to hedge effectively has created increasing margin pressure

### Opportunities

- Room for international growth in developing and emerging markets
- Spin off from Altria can create a new shareholder base, result in Kraft's inclusion in major indices
- Capacity to increase leverage
- Add health and nutritional products to adapt to changing preferences
- Potentially attractive to strategic buyers
- "Niche" companies in the industry possibly available for acquisition

### Threats

- Decreasing at-home consumption of food products
- Starbucks reducing at-home coffee consumption
- Declining fraction of income is spent on food
- Growth of private label products
- Rising commodity, packaging, and other input costs (coffee, nuts, energy)
- Buyer power for Wal-Mart and other retailers
- Reduction in inventories by retailers
- Increase in women's labor participation reduces meals at home
- Lifestyle changes toward health and nutrition
- Rising costs of sugar from increased demand in Asia and political changes in EU

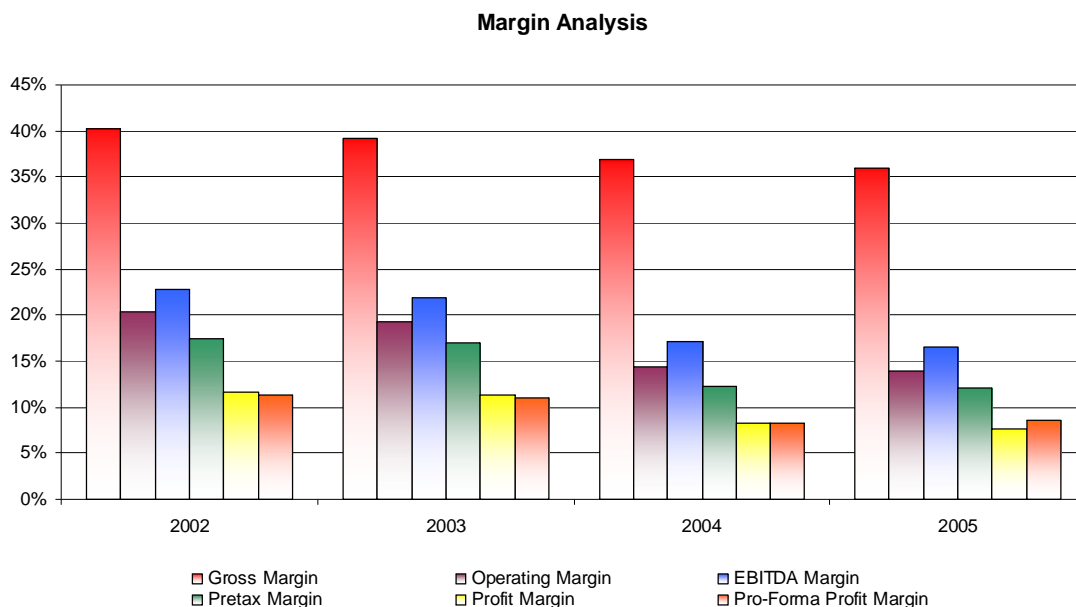
- Rising pension costs
- Altria's tobacco litigation
- Potential obesity litigation
- Credit ratings negatively affected by Altria

## Financial Analysis

Kraft's financial struggles begin at the top line and flow through the rest of the financial statements. One of the overriding problems facing Kraft is the company's inability to increase revenues. Recently, Kraft has increased prices on several products as input costs have risen. In an already saturated industry defined by competition, these price increases ultimately affect volume sales. Over the past three years, top line growth has begun to taper-off. Financial analysts project about 2-3% revenue growth over the next year as volumes increase slightly. Growth is expected to slow because of price increases and the loss of volume from divested products. Stagnant growth in the United States is also a result of declining at-home consumption of food products, the rise of private label products, and changing consumer preferences regarding health. If we break down revenue by segment, then we see that low total revenue growth is being driven by U.S. segments. Developing and emerging markets, where diets are beginning to move beyond mere sustenance, appear to be one of the most promising areas of growth. Kraft might also seek to increase revenues through acquisition. Realigning their product portfolio to include faster growing products such as those relating to health and nutrition may allow Kraft to boost top line growth. EPS growth is another concern for many analysts and investors. Many recognize that while EPS is growing, it is due primarily to the reduction in the number of shares outstanding rather than the quality

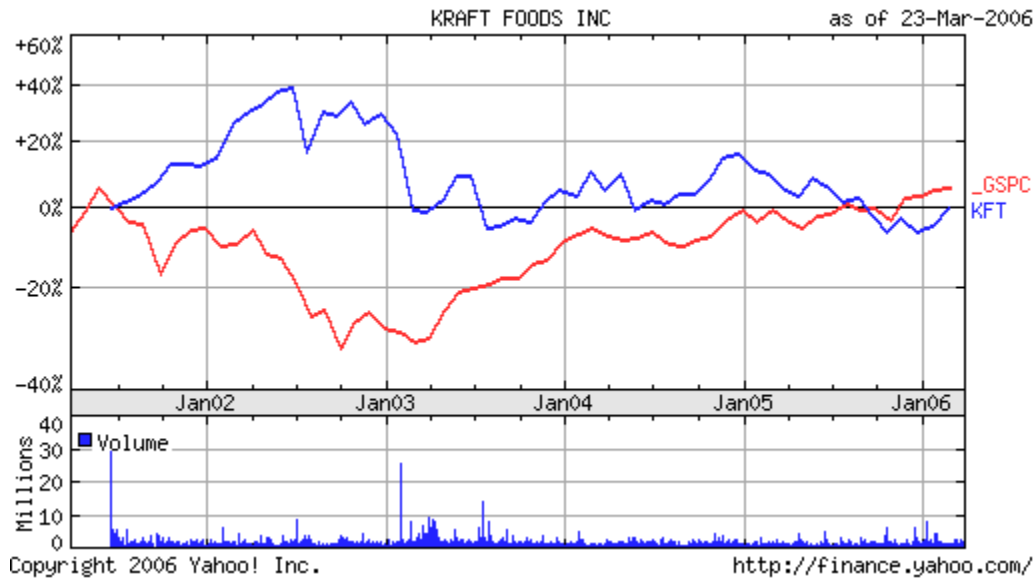
of Kraft's earnings or increased profit. The reduction in number of shares outstanding is primarily the result of share repurchase programs at Kraft.

The effect on profitability from sluggish top line growth is being compounded by increased pressure on Kraft's margins. Kraft is realizing significant cost savings from their restructuring programs (nearly \$800 million per year), yet their margins are still under siege. Margin pressure is being felt from a variety of factors. One of these factors is the inability to increase product prices because of intense competition. Competition is fierce with other companies in the industry and has grown with the increase in private label products. Margins are further being pressured by increasing input costs, such as energy, packaging, cocoa, and sugar. On top of this, Kraft is facing increased buyer power from Wal-Mart and a significant increase in marketing and advertising expenditures. All of these factors have combined to create steady declines in margins across the board over the past four years. This is evident in the following graph:

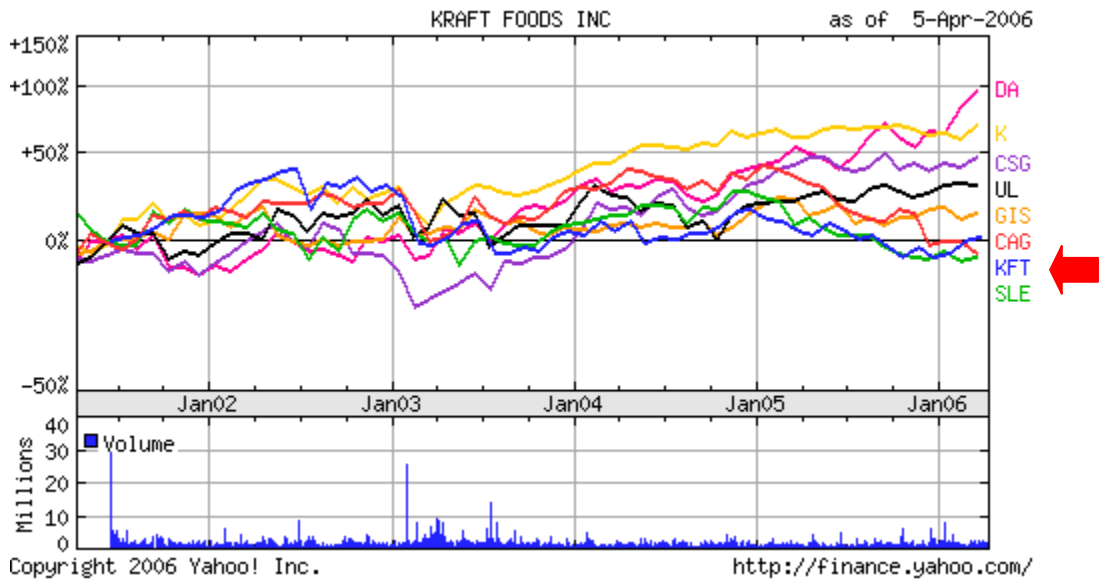


From the top of the income statement to the bottom, Kraft's contracting margins may be the greatest financial problem currently facing the company. The use of financial derivatives, such as forward contracts and futures, can be used to alleviate some of this margin pressure. Although this information is not explicitly laid out in the information available, companies within this industry are relying less and less on hedging tactics to control commodity and input prices. This a result of the drag hedging has placed on company performance in recent years. While Kraft says that they use these financial instruments to control input prices, their business model supports buying inputs for spot prices. This appears to be extremely problematic for Kraft and the industry as a whole, especially with the current environment of rising commodity prices. These inputs are highly inelastic, and as input prices rise and are less and less hedged, lost profits will be harder to recover across the industry.<sup>ix</sup>

Looking at Kraft's stock performance over the past several periods, we find that Kraft's stock has not significantly outperformed the market (S&P 500) since about April 2003. In 2002, there was a brief period where Kraft's stock outperformed the S&P 500. This outperformance stemmed from Kraft's restructuring programs and speculation regarding a spin off from Altria. As questions arose as to when Altria would actually spin off Kraft, and about the security of Kraft's assets from tobacco litigation, the stock price has yielded modest returns. Kraft's stock price relative to the S&P 500 can be seen in the graph below:



Most recently, Kraft's stock has been performing relatively poor despite the company's 3% dividend yield. When we analyze Kraft's peer group, we find that Kraft's performance is not solely the affect of industry-wide problems.



DA: Group Danone, K: Kellogg, CSG: Cadbury Schweppes, UL: Unilever, GIS: General Mills,

As we see from the stock chart above, Kraft's stock has performed at the low end of its peer group over the last few years. Comparing trading multiples of the peer group of large food producers, we find that Kraft is trading at a slight discount to its competitors, despite the strength of Kraft's product portfolio and the fact the Kraft is the #1 producer of food products.

Multiple	Kraft	General				Cadbury		Group
		ConAgra	Sara Lee	Unilever	Mills	Kellogg	Schweppes	Danone
P/E	19.96x	13.51x	26.03x	15.15x	15.01x	19.24x	15.81x	27.10x
EV/EBITDA	10.14x	9.07x	7.98x	8.70x	9.15x	10.30x	12.24x	11.26x
EV/Revenue	1.81x	0.98x	0.92x	1.63x	2.05x	2.26x	2.43x	2.00x
Price/Book	1.76x	2.09x	5.40x	6.52x	3.30x	8.06x	3.97x	1.25x

In this table, those competitors realizing higher multiples than Kraft are highlighted in blue for each multiple. One reason which may describe the stock's poor performance is Altria's ownership of Kraft. Many investors question the security of Kraft's assets from tobacco litigation as well as the timeline for a potential spin off from Altria. These concerns, along with slow growth and margin contraction, appear to be the main reasons why Kraft is trading at a slight discount to its peers. A spin off from Altria or improvements in margins from restructuring programs or hedging practices may result in multiple expansion for Kraft.

The value of Kraft's stock, and any stock for that matter, is ultimately determined by the discounted present value of the free cash flows. Looking at Kraft's free cash flows we find:

Free Cash Flow	2002	2003	2004	2005
Cash Flow from Operations	3720	4119	4008	3464
Capital Expenditures	(1184)	(1085)	(1006)	(1171)
Free Cash Flow	2536	3034	3002	2293
Growth Rate of Free Cash Flow		20%	-1%	-24%

Over the past few fiscal years, Kraft's free cash flows have been declining significantly, primarily as a result of declines in cash flows from operations. Using a variation of the Gordon Growth Model, we find the valuation implied growth rate of Kraft's free cash flows.<sup>x</sup> The valuation implied growth rate indicates the market's prediction of how fast Kraft's cash flows will grow in perpetuity. Using a required rate of return of 5.78% (using WACC), we find:

Gordon Growth Model	
Market Cap	\$52720.02
Plus Debt	11200
Minus Cash and Equivalents	316
Total Enterprise Value	63604.02
Normalized FCF FY2005	2293
Required Rate of Return	5.78%
Price Per Share (Mar. 23)	\$31.14
Valuation Implied Growth Rate of FCF	2.17%

This analysis suggests that the market believes that Kraft's cash flows will only grow on average by a dismal 2.17% per year. This is a reflection of investor speculation regarding Altria, increased margin pressure, and the struggle for top line growth.

Using DuPont Analysis, we can analyze Kraft's Returns on Equity relative to its competitors. In 2005, Kraft's return on equity was significantly less than its peer group. The following table disaggregates ROE for Kraft and its competitors:

	Kraft	ConAgra	Sara Lee	Unilever	General Mills	Kellogg	Cadbury Schweppes	Group Danone
Profit Margin	8%	4%	4%	2%	11%	10%	7%	4%
Financial Leverage	1.98	2.64	4.95	6.27	3.34	4.66	3.53	3.35
Asset Turnover	0.58	1.10	1.31	1.13	0.62	0.96	0.68	0.81
ROE	9%	13%	24%	12%	23%	43%	17%	10%

In terms of profit margin, Kraft is performing at or above the median of its peer group. However, Kraft's ROE is the lowest of the peer group. The contribution to ROE from asset turnover is low compared to the peer group, yet this component is not the most striking. This analysis suggests that Kraft's low ROE is primarily the result of financial leverage. The financial leverage ratio is a proxy for how much of the company is financed with debt. For Kraft, this metric is contributing significantly less to ROE than its competitors. For the rest of the peer group, the financial leverage component of ROE is providing the largest boost to ROE. This begs the question: Why is Kraft's ROE so low and why is Kraft receiving such a small boost from financial leverage when everyone else in the industry is realizing the reverse? Looking at the ratios of debt to value (debt plus equity) for each of the competitors, we find that Kraft is only financed with 28% debt, while the rest of the industry, on average, is financed with 63% debt (no other peer (ConAgra) is financed with less than 46% debt). These companies are all large producers of food products and have large, steady, and predictable cash flows. The predictability of cash flows would indicate that these companies can handle high levels of debt to finance operations, growth, and share repurchases. Despite this capacity, Kraft remains financed with only 28% debt.

Kraft may be maintaining low levels of debt because of the speculation surrounding Altria's tobacco litigation. On March 21, 2003, Altria lost a \$10.1 billion dollar judgment in its tobacco litigation case. As a result, several debt rating agencies took measures to reduce Kraft's debt ratings even though the company explicitly states in the 10-K that "the Company is neither a party to, nor has exposure to, this litigation." Kraft's current debt ratings can be summarized in the following table:

Rating Agency	Short Term Debt	Long Term Debt
Moody's	P-2	A3
Standard and Poor's	A-2	BBB+
Fitch Rating Services	F-2	BBB+

The downgrades of Kraft's debt ratings have, and will continue to increase Kraft's borrowing costs. Pandora Group believes that if a spin off from Altria were to occur, these debt ratings would be upgraded since there was no material change at Kraft when they were downgraded; rather, it was solely determined by Kraft's link to Altria. A split from Altria should result in Kraft being able to assume more leverage, obtain a lower cost of capital, and reduce investors' required rate of return for Kraft stock. All of these factors should benefit Kraft's stock price. The available debt capacity and the reduction in the cost of debt might make Kraft attractive to a strategic buyer if the company was separated from Altria.

## Strategic Issues and Recommendations

There are two main strategic issues facing Kraft. The first strategic issue is the reduced use of financial derivatives to control for rising commodity and input costs. Financial derivatives, because they must be purchased prior to precise knowledge of a future payout, are an expense with no guaranteed benefit. In recent periods, financial derivatives have adversely affected the performance of many companies in the industry. These companies, basing current decisions on past trends, are using financial instruments less and less to control for rising input costs with the fear that they will only create a drag on the bottom line. This is a major problem in the current environment of rising input costs. Rising input and commodity costs are creating the most pressure on Kraft's margins, as discussed in the financial analysis section of this report. If Kraft continues its moderate use of futures and forwards to hedge against commodity prices, then the Company's profits are vulnerable to spiraling input costs. To solve this problem, Pandora Group urges Kraft to reassess their risk management strategy, and more specifically, to use financial derivatives more aggressively to control commodity costs and preserve margins.

The second strategic issue facing Kraft is the negative effect on Kraft's debt ratings and stock performance as a result of the Company's link with parent company Altria (Phillip Morris). Kraft's debt ratings and stock price have been more negatively affected by speculation and concerns over pending tobacco litigation facing Altria than by any material changes in Kraft's operations. The solution to this problem, therefore, is to separate Kraft from parent Altria and make Kraft an entirely separate entity. The spin off of Kraft will result in a more favorable valuation, an increase in the Company's debt

ratings, and will provide Kraft the opportunity to capitalize on current trends in the capital markets.

With Altria's tobacco litigation now past its peak, this is the most viable time in recent years for a spin off of Kraft to occur.<sup>xi</sup> Recently, an Illinois Supreme Court overturned the \$10.1 billion settlement that was originally granted for the fraudulent marketing of "light" cigarettes by Phillip Morris. Further, juries are having a more and more difficult time holding Phillip Morris accountable for the consumer's choice to smoke their products and the resulting health effects of this choice. Hence, this is the most opportune time of recent periods to separate Kraft from its parent.<sup>xii</sup>

In the past, conglomerates such as Phillip Morris were given favorable valuations for the perceived reduction in risk from diversification. In current years, conglomerates have been viewed as inefficient and as reducing investors' ability to diversify risk themselves.<sup>xiii</sup> Kraft was originally purchased by Altria for the sake of diversification due to a growing fear and anticipation of a decline in consumption of tobacco products. With a reduction in the premium given to conglomerates, and in light of significant differences in operations between Kraft and Altria, there is no lingering reason as to why these companies should be linked. The combination of the two companies is only hurting Kraft, since the constant fear of a large litigation settlement is always looming. Pandora Group therefore recommends that Altria sell their 85% ownership of Kraft as soon as possible.

The spin off of Kraft from Altria should result in several benefits for Kraft and its valuation. Kraft's debt ratings, which were downgraded as a result of the pending tobacco litigation, should be restored since the downgrades had nothing to do with Kraft's operations or its ability to pay debt holders. This change will provide Kraft with a lower cost of capital, greater ability to access the capital markets, and some multiple expansion. Kraft is currently financed with only 28% debt, which is significantly less than its peers who have double this level. As seen in the financial analysis, this low debt level is creating a drag on Kraft's ROE relative to its peers. Separating from Altria, and an ensuing upgrade of Kraft's debt ratings, will allow Kraft to lever the company to the level of its peers. Current trends in the debt markets—low corporate spreads and a flat yield curve—have made it very easy to issue large amounts of corporate debt at a cheap price.<sup>xiv</sup> Kraft should take advantage of these trends as long as they can. The proceeds from a debt issuance can be used to return money to shareholders through share repurchases. If Kraft does not choose to increase the leverage of the company after the separation from Altria, then it is likely that a strategic buyer, seeing this opportunity to cheaply issue debt, will likely take over the company and increase its leverage. Increasing the leverage of Kraft, however, seems the logical result after a spin off from Altria.

There is a secondary, less fundamental benefit to Kraft's valuation if separated from Altria. A spin off of Kraft will gain a significant amount of attention for Kraft stock from investors and investment funds. Currently, non-Altria owned shares of Kraft represent about \$7 billion of Kraft's \$50 billion market capitalization. Because the "tradable" portion of Kraft's shares is reduced by Altria's ownership, Kraft is absent from several

key indices, such as the S&P 500 and the Dow Jones Industrial Average. Spinning off Kraft will change the shareholder base of Kraft, and while this may increase volatility, it should result in approximately a 10% increase in Kraft's valuation as index funds and other institutions that follow such indices buy Kraft shares.<sup>xv</sup> Kraft's inclusion in the S&P 500 could occur as quickly as three months after a spin off from Altria. Inclusion in such indices will also result in increased analyst coverage of Kraft which can foster better communication between management and investors.<sup>xvi</sup> Further, there is limited downside to Altria shares for removing Kraft from its control. As mentioned earlier, conglomerates no longer receive premiums for the notion of perceived diversification; rather, they receive discounts. Hence, spinning off Kraft should only benefit Altria's stock price. Since the estimated benefits of spinning off Kraft significantly outweigh any lost benefit to Altria, Pandora Group advises that Kraft be separated from Altria as soon as feasibly possible.

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<sup>i</sup> Periscope Research Report

<sup>ii</sup> S&P 500 Analyst Report

<sup>iii</sup> S&P500 Analyst Report

<sup>iv</sup> S&P 500 Industry Report

<sup>v</sup> S&P 500 Report

<sup>vi</sup> S&P 500 Report

<sup>vii</sup> S&P 500 Report

<sup>viii</sup> S&P 500 Report

<sup>ix</sup> Insight into declining use of hedging provided by Alan Boyce

<sup>x</sup> In this version, Total Enterprise Value replaces price, and Free Cash Flow replaces Dividends.

<sup>xi</sup> Periscope Research Report

<sup>xii</sup> Periscope Research Report

<sup>xiii</sup> Periscope Research Report

<sup>xiv</sup> Guidance from Alan Boyce

<sup>xv</sup> 10% increase based on guidance from Alan Boyce

<sup>xvi</sup> Guidance from Alan Boyce