3G Capital, a Private Equity Superstar

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For this first report on the M&A and Private Equity section, we will be following the story behind one of the most successful investment firms, 3G capital led by Brazilian deal-maker and former tennis player, Jorge Paulo Lemann. Founded in 2004, the firm is behind some of the biggest headline-grabbing M&A deals of the past fifteen years. Their investment strategy focusses on acquiring controlling positions in the retail and consumer sectors, increasing the profitability of the targets through consolidation (e.g. acquiring competitors) and finally applying, a zero-based budgeting strategy. It is also viewed by some as a brutal cost-cutting program, in which, each period's budget must entirely be justified in contrast to classical budgeting, in which only the budget increase is justified by management.

AB-InbeV Sab miller: A beer empire

After taking control of the two Brazilian breweries Brahma beer and Companhia Antarctica Paulista during the 90's, Lemann formed the largest South American beer company, which became known as AmBev. In 2003, Ambev had revenues of over USD$2.7 billion, controlling 65% of the Brazilian market and 80% of the Argentinian one.

In 2004, Ambev and European leader Interbrew, whose brands included Stella Artois and Leffe, concluded a USD$11.2 billion merger, successfully forming InBev, the world's largest brewer with 14% global market share and €9.5 billion sales. After pushing for more profitability through higher margins and geographical expansions, the next logical step was the controversial acquisition of the second largest global player, US-based rival Anheuser-Bush (maker of Budweiser), in an all-cash deal valued at USD$46 billion, giving birth to AB-Inbev.

The final step towards global consolidation of the beer sector took place at the end of 2015, when ABInbev concluded the largest acquisition in the UK corporate history by taking control of SAB-Miller for USD$108 billion and creating the largest consumer staples company with revenues of USD$55 billion and 28% global market share. This last deal gave ABInbev access to Grolsch and Peroni brands, and with it, increased its exposure to Latin America and Africa in an attempt to revive its growth.

Burger King´s LBO: the conquest of the food and beverage market

In 2010, 3G Capital concluded a historic LBO in the fast-food industry, when it acquired McDonald's trailing competitor for USD$4 billion or 9.4 times earnings before interests, taxes, depreciation and amortization.

As a quick reminder, an LBO is similar to the acquisition of a house: the buyer brings a small portion of capital and raises debt to complete the acquisition. In a successful scenario, the new owner adds values to the target by implementing a specific plan (expansion, restructuring, cost-cutting…), pays down the debt and finally sells back the entity at a higher valuation, pocketing both the return on capital and the return above the cost of the contracted debt. In a negative scenario, he isn't able to service the debt and loses ownership of the company to the creditors.

In the case of Burger King, which was now experiencing its third LBO in less than ten years, 3G Capital invested 30% of its own capital, effectively committing USD1.2 billion and contracted USD2.8 billion in debt to finance the remaining USD3.2 billion. With a target holding period of ten years, 3G Capital pressured Burger King to apply a new strategic plan, consisting of increasing its reliance on franchising, simplifying its menu to optimize costs and finally broadening its offering to breakfast menu to increase turnover. Furthermore, the plan included an international expansion in Latin America to strengthen its foothold in emerging markets. In 2014, four years after the implementation of the strategy, Burger King enhanced its operational efficiency and successfully implemented its cost-cutting strategy, effectively bringing its leverage down from 6 to 4.75 times earnings before interests, taxes, depreciation and amortization.

With these exceptional results, it was now time to acquire the struggling Canadian coffee and restaurant chain, Tim Hortons. The rationale behind this deal was two-fold, on one hand, 3G could once again apply its recipe for success, while benefitting from cost synergies and on the other hand, it gave the opportunity to move Burger King's headquarters to Canada and benefit from tax savings. Through this USD12.5 billion deal, 3G formed Restaurants Brands International, a fast-food giant with 18,000 restaurants worldwide and USD23 billion in sales. 3G owned 51% of the group and convinced Warren Buffet's Berkshire Hathaway, to acquire an additional 5% stake in the newly formed group.

Partnering with Buffet to take control of Heinz, Kraft and Unilever

The Tim Horton deal wasn't the first co-investment made with Buffet. In 2013, 3G and Berkshire performed the largest LBO ever in the food industry through the acquisition of the 150 years old consumer brand, Heinz. The USD2 billion deal, valued Heinz at 15 times earnings before interests, taxes, depreciation and amortization, more than twice the median multiple in the sector. Partnering with Buffet, who always expressed negative criticism towards the private equity industry, not only was the consecration for 3G and its reputation, but also was the beginning of a long-lasting partnership. 3G brings its operational expertise to the table, while Buffet brings the financial power, the experience and the reputation of a legendary long-term value-oriented investor.

Keeping in mind 3G's previous actions, the firm naturally partnered with Berkshire to merge Heinz with The Kraft Foods Group, forming the fifth largest food company worldwide in a deal valued at USD45 billion and expected to bring significant synergies driven by international growth and economies of scale of USD1.5 billion in 2017.

At the beginning of 2017, the team made a bid over Unilever for USD143 billion, in an attempt to create a consumer goods giant through the largest merger ever in the sector. According to Paul Hickman, analyst at Edison Investment Research, "Kraft Heinz's approach demonstrates the pressure on brand owners to consolidate in the face of international pressure on margins and constraints to organic growth opportunities". Thanks to this deal, the newly formed entity would've reached combined 2016 sales of USD85 billion, just behind Nestle, the largest the largest food and beverage company. The deal would've brought to Heinz Kraft, a diversification from food products, geographic complementarities, as well as, scale effects. However, the merger was not welcomed by Unilever's management and Buffet's strategy excludes hostile takeovers.

What's next?

3G Capital must now continue their consolidation plans in order to create value for themselves. Going forward with their build-up strategy in the beer, fast-food and consumer goods industries, 3G needs to find attractive companies in terms of valuation, growth prospects and potential synergies with their current portfolio companies. Their partnership with Berkshire Hathaway could be a perfect way to take positions in companies in which Buffet is already invested. For instance, building a stake in Procter and Gamble, in which Buffet has a 2 % stake, or in Coca-Cola, in which Buffet has a 9 % stake could make sense for 3G.

Finally, we should also question 3G's strategy, which mainly consists of cutting costs. Until what point can we pressure employees and cut investments without hindering long-term sustainable growth prospects?

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