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What does M&A activity tell us about management quality?

Kraft and Unilever recently served up an industrial sized helping of insight into the relative quality of its respective managements. Both shed unflattering lights on each company but for different reasons.

Strategic incoherence and unrealised value

Unilever has been under increasing scrutiny even though it has provided investors with reasonable returns over a prolonged period. Its margins lag key comparators and are a weakness that Kraft sought to exploit.

The FT recently suggested that Unilever has five options at its disposal to respond to an approach such as KraftHeinz's: *"It can announce a bold cost-cutting plan; pay a bigger dividend; do a share buy-back; split itself up; buy another company, or some combination of these."*

The FT argued that Unilever should ignore each one. Our view is that the FT is right as far as it goes but it misses the most sustainable option for long-term value. As an OMINDEX 'BBB' rated company, Unilever has only realised little over half of its potential *Total Stakeholder Value* and there is plenty to be done outside of these conventional responses to investor pressure.

Unilever's latent value can only be realised by reconciling its purpose with a coherent set of operating plans that integrate the value potential of every single person connected to the business (including its suppliers). Simply put, such action would equate to a 5-10% operating margin opportunity within 2-3 years for its current business. How can we be so bold in this view? Well, Unilever has already admitted that its focus has not been good enough and needs to be improved and that Kraft has been exactly what the business needed to kick-start an improvement in generating better returns.

This is an astonishing admission of management weakness. The very best, most mature, companies are those constantly at the leading edge of optimal operating efficiency by ensuring that everyone turns up every day with a passion to improve it. No external stimulus is necessary because it is already hardwired into the business culture. It is no surprise that higher rated companies on OMINDEX tend to have superior margins: these arise from a combination of obsessive knowledge sharing to create value and never ending improvement from all: it is a potent and powerful mix. For Unilever investors, if CEO Paul Polman can begin to understand how to apply this to its global operations (our OMINDEX methodology is free to see and is a critical starting point for a complete diagnostic), then a new competitive differentiation and sustainable advantage can currently be built where none currently exists.

Management is not a quality that matters at Kraft

Our OMINDEX methodology specifically measures a company's ability to manage *Value*, defined as an interrelated and aggregated set of four variables – Output, Cost, Revenue and Quality (OCRQ). The very best firms understand both the need to manage this definition of value, and importantly, how all its human capital connects to OCRQ value creation for long-term advantage.

Kraft Heinz (or its major investor 3G) has a well-documented strategy best summarised by Fortune Magazine as "Buy. Squeeze. Repeat". It does not rely on developing management quality to drive value via growing organic revenue, output or quality but simply drives out cost to create an impression of 'improved margins'. It is then destined to seek further acquisitions to fuel growth. This strategy is not about value creation but the systematic driving of short-term financial returns at the expense of long term value and sustainability. Little wonder that Unilever rebuffed this approach and that other firms have already sought to outline a pre-emptive defence strategy.

It is evident that there are plenty of investors who admire 3G and argue that 3G's strategy is critical to ensure efficient resource allocation in its market. An alternative view is that 3G has little societal legitimacy and is purely exploiting opportunities for the benefit of its investors. Viewed from the prism of organisational maturity, we can conclude two things. Firstly, the volatility of Kraft Heinz stock itself suggests both high risk and instability, reflecting issues around the sustainability of its business model: something that is not present in highly mature firms who can drive high margins without the need for complex and risky acquisitions. Secondly, the relative immaturity of its peer group allows Kraft Heinz to both exist and potentially thrive. Fixing both would generate greater value for all stakeholders.

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