Why Kraft Still Looks Cheap Before It Recrafts Itself

On Monday Kraft (KFT) begins its new life as two new companies: Kraft Foods Group (KRFT) and Mondelez International (MDLZ). In fact, both stocks trade on a when issued basis already. The purpose of the split is to highlight the value in the company. The old Kraft consisted of a North American grocery business with low single digit revenue growth prospects and the possibility of modestly expanding operating margins, and a global snacks business with emerging markets exposure and higher growth potential. Kraft felt that operating both businesses under one corporate entity made the company less attractive than as two separate entities, since as two separate companies they could appeal to investors seeking stable income (who could invest in the grocery business) while investors seeking faster growing but more volatile earnings could choose the snack business. In effect they were suffering from the "conglomerate discount" such that investors looking for more specific exposure didn't find the company attractive. The upcoming split results in two separate companies that can appeal to two different types of investor.

Although KFT has been a great investment over the past couple of years and especially since the split was first announced, now that the two new components of Kraft can be examined it reveals the purpose of the split. For every 30 KFT shares held, KFT owners will receive 30 shares of MDLZ and ten shares of KRFT. Recently the two new companies' management teams made presentations and KFT responded poorly because the earnings guidance of the new bits of KFT added up to less than the prior guidance for the whole.

But when you look at each company, the figures aren't that bad. KRFT, the North American grocery business, will pay a $2 dividend and based on the when-issued price yields 4.4%.

Although that represents a heft 77% payout ratio, low single digit revenue growth with modest operating leverage should leave this dividend comfortably covered since they sell into less economically sensitive sectors. The 4.4% dividend yield compares favorably with its likely peers, such as General Mills (GIS) yielding 3.3% or Kellogg (K) yielding 3.4%.

Meanwhile MDLZ is more appropriately compared with global snack companies with decent emerging markets growth. MDLZ is guiding to $1.55 EPS which gives it a P/E of just over 17,and is no more expensive than, say Coke (KO) with a forward P/E of 17.3.

This illustrates the point of the split, because finding true comparables to the old KFT was difficult given its diversified business mix with very different margins and outlook.

Recently, the management teams for both new companies (KRFT and MDLZ) gave investor presentations. The reaction was cool, not least because together, the two companies' 2013 earnings guidance added up to the equivalent of $2.30-2.40 for the old KFT, whereas KFT itself had previously been guiding to $2.60-2.80. It was this disappointment, that the sum of the parts was less than the whole, that pushed the stock down.

But here there's probably a little gamesmanship going on. Neither management team of the new companies "owns" the prior guidance in the same way that old KFT's CEO Irene Rosenfeld did (she'll be running MDLZ). The leadership teams of the two new companies are most likely motivated to be cautious, both because of the transition to independence but also because stock options that will be part of executive compensation will be priced shortly after the two new companies' stocks start trading. But it's still the same set of businesses, with the same strong brands and growth prospects. So we think the two pieces of the old KFT remain reasonably attractive as an investment.

We think it’s also interesting to be long KFT hedged with a short position in the Consumer Staples ETF (XLP). When KFT splits into KRFT and MDLZ we think the two components of old KFT will appreciate relative to what the old KFT was worth, and against the basket of consumer staples stocks which is the most correlated hedge.

Disclosure: Author is Long KFT, Short XLP