The Henry Fund
Henry B. Tippie School of Management
Zach Geerdes [zachary-geerdes@uiowa.edu]

HF RESEARCH HenryFund.Org

Home & Office Products

April 15th, 2019

Consumer Discretionary Sector

Industry Rating: Underweight

Investment Thesis

We recommend being *Underweight* in the Home & Office Products industry over the next year. The shift towards more technology based work spaces, combined with a lack of savings in the baby-boomers and an unfavorable e-commerce retail environment lead us to believe that this industry will see significant headwinds in the near future.

Drivers of Thesis

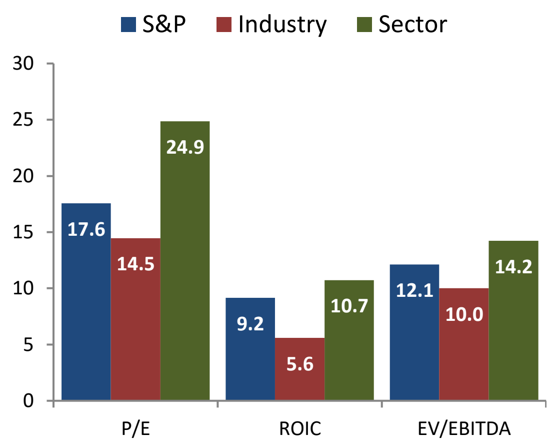
- The office product segment's declining revenues due technology takeover will continue to push down the performance of the office products segment.
- Inadequate retirement savings in the baby-boomer generation could cause lower sales and lower margins as premium products face tight budgets.
- The rise of E-Commerce causing a massive shift in the way people shop is dragging down industry manufacturers profits and lowering retail foot traffic.

Risks to Thesis

- Strong growth in disposable income and consumer spending will help companies sell their higher margin goods.
- Office product manufacturers shifting to technology-based office products and away from traditional pen and paper products would allow them to hedge some of their technology risk.
- Government policies, specifically involving the trade war with China, could harm sales as foreign exports may fall slightly due to tariffs on goods.

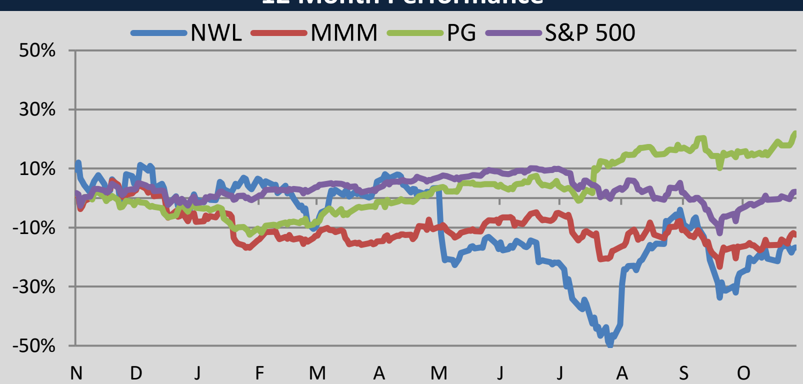
Key Industry Statistics

Market Cap	(In $ Billions)
Procter & Gamble (PG)	$234.14
3M (MMM)	$114.07
Stanley Black & Decker (SWK)	$18.21
Newell Brands (NWL)	$9.95
Societe BIC (BB – FR)	$4.46
Tupperware Brands (TUP)	$1.83
ACCO Brands (ACCO)	$0.91
Industry Ratios	
Price/Earnings	14.47x
EV/Sales	2.25x
EV/EBITDA	10.01x
ROIC	5.6%
ROE	16.9%
Net Margin	8.0%



Source: FactSet & Company 10-K's

12 Month Performance



Source: Yahoo Finance

Industry Description

The Home & Office Products industry is comprised of companies who manufacture and distribute home & office products for consumers. This industry consists of a wide range of products, from pencils to crock pots, and because of this the industry consists of a wide range of companies. The industry is primarily filled with Consumer Discretionary companies but also has a few Consumer Staples companies as well.

Important disclosures appear on the last page of this report.

EXECUTIVE SUMMARY

The Home and Office product industry can be broken down into two segments. The home product segment and the office product segment.

The home product segment consists of companies such as: Procter & Gamble, Stanley Black & Decker, Tupperware Brands, and Newell Brands. These companies specialize in selling products that are used in and around the home.

The office product segment consists of companies like: 3M, Societe BIC, Acco Brands, and Newell Brands. These companies specialize in products that are used in an office or other work setting.

We believe that an Underweight position in this industry is essential for the following three reasons: The rise of E-commerce will limit retail foot traffic resulting in lower sales, the technology take over will cause office products to continuing facing decreased revenues, and the baby boomers lack of savings will prove to limit the amount of premium products being purchased.

INDUSTRY ANALYSIS

The Home & Office Supplies Industry consists of companies from both the Consumer Discretionary and Consumer Staples sector. The products within this industry have a wide range from: pens, pencils and Sharpie's to blenders, crock pots and baby accessories.

We believe the industry as a whole is highly correlated to the health of the retail and ecommerce industry because almost every product in this industry is sold via retail channels. We believe the industry is also very sensitive to the health of the global economy due to the fact that many companies in the industry are consumer cyclical companies. If the economy starts to trend downward, we expect to see this industry struggle.

The ability to grow in this industry is highly dependent the release of new and innovative products that peak consumer interest. Establishing innovative products allows for sales increases, but also margin improvements. In an industry with an average net margin of 8.00%, small margin improvements go a long way.

Home Supplies

This segment of the industry consists of products such as: small kitchen appliances, food preparation & storage, security, baby products and home cleaning & fragrance. With such a large product range, this segment of the industry is unique in the sense that companies within the industry may compete with one another on as little as one product line. To increase sales in this segment manufacturers spend lots of money attempting to market and develop new innovative products. The ability to differentiate products and create demand can be a huge factor in determining success in this segment.

In addition this industry relies on product placement, placing products in places that the target audience will see the product. If consumers do not see the product then sales will drop. The fear with the growth of e-commerce is that it will hurt companies product placement.

This industry benefits from higher disposable incomes because when consumers have more income they are more likely to purchase the premium products rather than the lowest price options. However, this segment also defensive because it performs well in low economic growth periods due to he in-elastic demand of products.

The graph below is showing housing starts between 2009 and 2018.

Source: FRED

Housing starts appear to have an increasing trend, however the increase seems to be slowing and potentially even plateauing slightly. We believe this segment benefits as consumers move into new houses because consumers will spend a significant amount of money on consumer products. Thus: home remodels, new home construction, and new home sales are beneficial for sales in this segment of the industry. On the flip side, as home buying conditions become less favorable we expect sales in this segment to weaken.

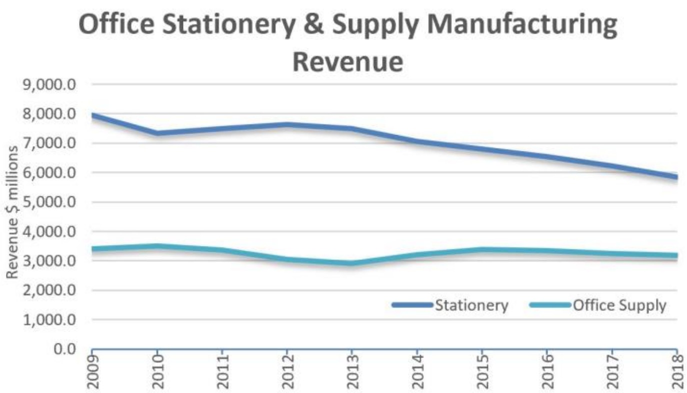
Office Products

The Office Supplies segment consists of products such as: pencils, pens, folders, note books, adhesives, and more. The office products segment is a mature-declining market.

The segment relies heavily on both retail sales and direct to consumer sales, with a heavier concentration on retail sales. This segment is quite fragmented with 59% of the market coming from small-mid size companies.

Source: IBISworld

We believe the growth in technology usage has significantly harmed this segments growth. In addition to the growth in technology usage, we believe the push for more eco-friendly work spaces has compounded the declining growth rate in this industry segment.



Source: IBISWorld

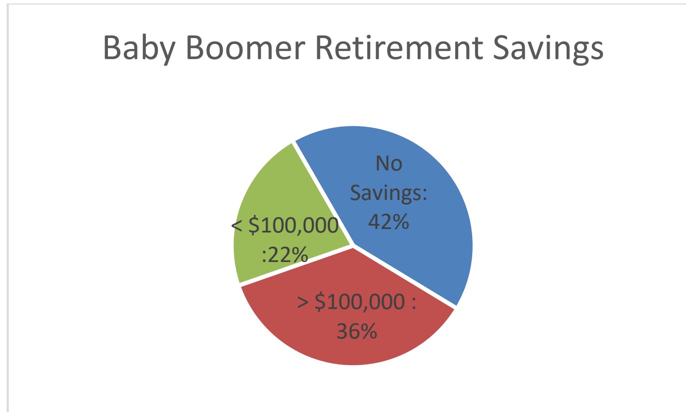
Over the past ten years the office supply manufacturing industry has experienced a CAGR of -0.65% decline in revenues. The stationery manufacturing industry has experienced a 10 year CAGR of -3.00% decline in growth[3]. It is interesting that the stationery manufacturing decline rate has been significantly faster than the office supply manufacturing growth rate, because these two industries have so many complimentary goods. This could suggest that the office supply manufacturing industry has even more downside.

The decline in office supply manufacturing revenue and the rapid deceleration of revenue in its industry counterpart, stationery manufacturing, demonstrates the impact of technology growth across home, office, and school spaces.

RECENT DEVELOPMENTS

A Retirement Crisis

The eye opening truth is that baby boomers haven't adequately saved money for retirement, and they are beginning to retire.



Source: Insured Retirement Institute

It can be seen in the above graph that nearly 2/3rd's of baby-boomers (people born between 1946 – 1964) have $100,000 or less saved up for retirement. What is even more troubling is that 42% of baby boomers have no savings. This entire generation will be at or above retirement age within the next 10 years and 42% of them have not started saving[9]. We recognize that they will still be able to fall back on social-security. If 42% of the baby-boomers are relying on social security as there main source of retirement income we believe that consumption will suffer, and premium products will be neglected by this demographic.

The Baby-Boomers may not necessarily be in the target audience of the Office Products segment, however they are most certainly in the target audience of the Home Products segment. We believe this trend will also hurt consumption of home products.

So what could this mean? We believe this means the average retirement age will go up, as the baby boomers realize they will need to work longer in order to sustain a lifestyle they desire. We also believe this will result in consumption of home and office goods, mainly home goods, going down since a large chunk of the population will have little disposable income.

Co – Living

A recently noted trend has been a growth in “co-living” startups. Co – living refers to a living system where people live in tiny areas with roommates and share common spaces much like a dorm. There are currently a lot of start-ups who are attempting to expand on this model while adding a hospitality aspect by providing hotel like amenities and services(4). This housing model is designed for tenants to live simple, social, and inexpensive lives. This development is potentially harmful for the industry in two ways. First, if people are living in tiny areas it means they have less room for extra goods. It also points toward more cost-conscious consumer tendencies, sacrificing the “bigger is better” mentality for the sake of saving money. Secondly, shared common areas mean that small kitchen appliances and various other products will be shared, potentially harming demand for various products in the industry.

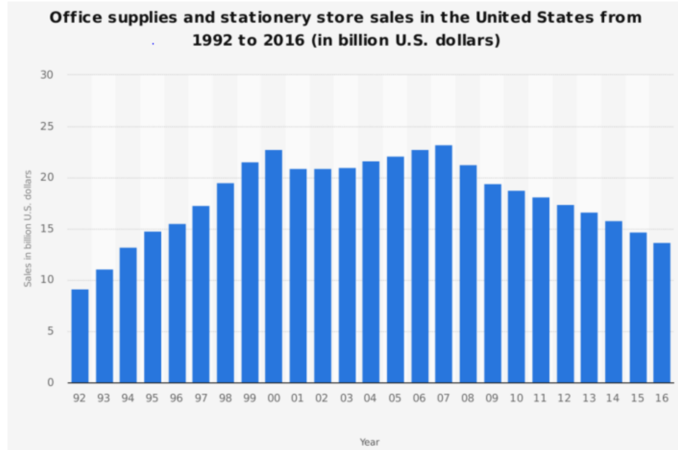
It is hard to quantify the impact of this movement, and we imagine it is rather small right now. However, if this trend continues and people become more comfortable sharing smaller living spaces we believe it will be an extremely unfavorable trend for the home products segment.

INDUSTRY TRENDS

From Paper to Computer

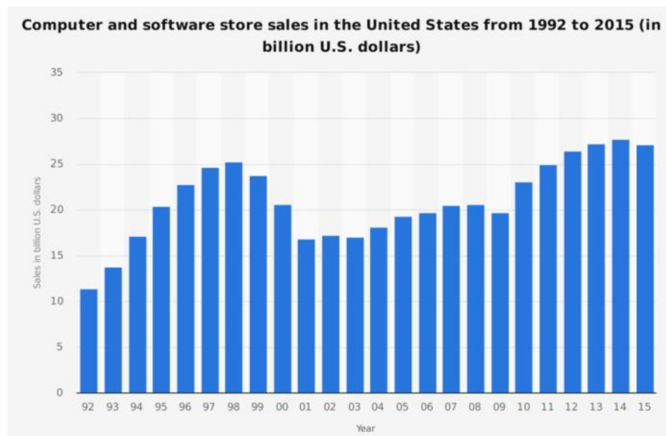
The biggest threat to the office supply industry is the threat of consumers switching to technology based equipment, and it has been happening. For example, schools giving their students laptops to complete daily tasks rather than requiring pen and paper. This is due to the efficiency of technology, but also the eco-friendly nature of going “paperless.” It is important to realize that a shift to a “paperless” society also means that the complimentary goods such as paper & pens will have much lower demand as well thus lowering sales in the office product segment.

The following graph shows the declining trend of office supply and stationery store sales.



Source: Statista

To prove these sales declines are from a switch to technology and not from the death of brick and mortar sales, here is a graph of the computer and software sales from the same time period.

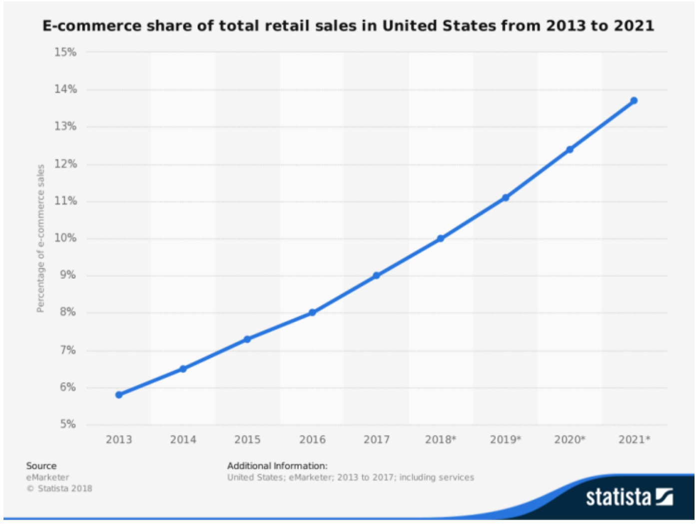


Source: Statista

From 2001 to 2015 software and computer sales have had an increasing trend. Notice during the same time period the office supply and stationery sales graph shows sales plateauing and slightly increasing, before sharply declining.

The Rise of E-Commerce

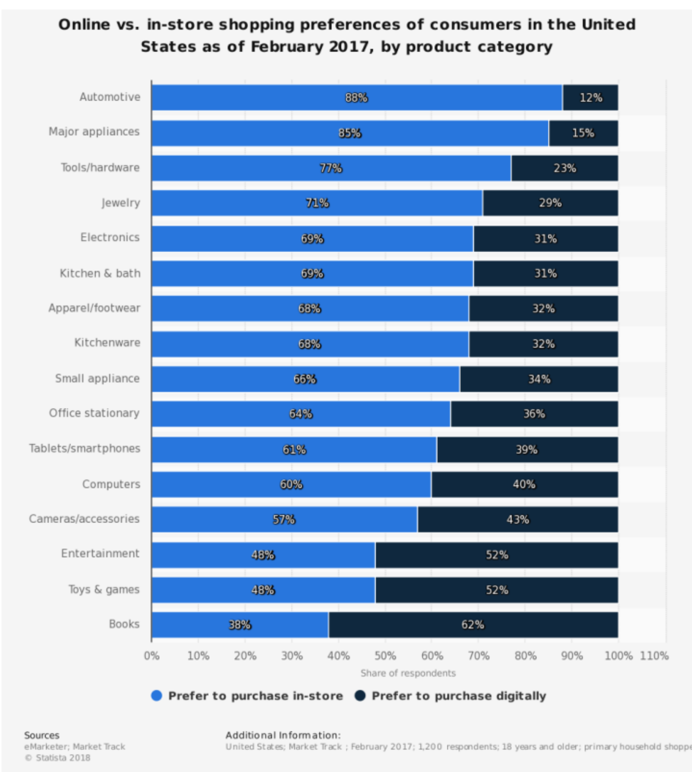
In the retail industry there is a shift towards buying products online rather than in a traditional retail outlet. Below is a graph depicting the percent of U.S. retail that comes from e-commerce transactions.



Source: Statista

E-commerce has been rapidly gaining market share of the retail segment, reaching 10% of all sales in 2018. As online retailing becomes more and more prevalent this will only continue to hurt traditional brick and mortar stores, we believe it is very possible that E-commerce will reach 30% of all retail sales in the net 10 years.

Below is a chart that shows the breakdown of consumers preferred channel of buying various product categories:



Source: Statista

One can see that when consumers purchase more expensive products, with the exception of computers and phones, they are more inclined to buy in-store. However, as items become less expensive consumers quickly prefer to buy digitally. Unfortunately for the Home & Office product industry most of their products are towards the bottom of the chart.

We believe this shift is bad for the industry because it will result in lower margins, and potentially lower sales. The lower margins will be a result of people being able to sort by price. Many of the items in this industry have very lower difference in perceived quality, so we believe people will elect to order the lower cost version of the item. In a store a person would be able to use their senses and see or feel the quality of an item, e-commerce takes that away.

This is detrimental to the industry because this industry depends on developing new goods to expand margins and sales, if these new goods are not expanding margins and sales and expenses to develop these goods are staying constant or rising, then the industry as a whole will become much less profitable.

Consolidating Industry

With the Office Supply segment declining, we expect to see increased consolidation efforts occurring. The largest player in the office supply segment is Crayola, whom is private and has about 16% of the market. With 59% of the market being mid-small sized companies there is a lot of space for acquisitions to occur. Consolidation has been very slow, but we believe that it is inevitable.

Eco-Friendly

The industry as a whole has seen a push towards eco-friendly supplies. This is particularly attractive for the home products segment of the industry because it means they have a point of differentiation. This trend has allowed producers to charge higher prices on products. This trend is expected to continue as long as disposable income and consumer spending on durable goods stays strong(12).

COMPETITIVE ENVIRONMENT

Threat of Substitutes

The threat of substitutes is high. Due to the wide variety of products that are in the industry, almost every product has a readily available substitute. Think about how many different writing utensils you see at an office retail store. Or think about how many different types of shampoos, body washes, and deodorants are in a personal care aisle. Technology has added another level of substitutes as consumers have moved away from office supplies and gradually moved towards using computers instead. Substitutes are abundant in the industry which makes cost leadership or product differentiation that much more important.

Threat of New Entrants

Threat of new entrants is moderate-low. The number of mid-small sized companies within the industry shows that it is possible to enter the market. However, the new entrants still have to be able to design, test and produce their own products which can be capital intensive. In addition, the Office Supply segment has been seeing declining revenues which makes entering the market much less attractive.

Bargaining Power of Suppliers

Supplier power within the industry is low. The suppliers are the companies that produce the raw materials to make the home and office products. The raw materials such as plastic, paper, and ink have a plethora of producers and there is little to no differentiation among the materials. This results in suppliers attempting to keep costs low to win business from customers who are usually wholesalers or manufacturers. All of this put together creates very low switching costs for companies in the home and office products industry.

Bargaining Power of Consumers

Consumer power within the industry is high. As stated earlier this industry relies heavily on retail sales, this results in retailers being able to make significant demands from companies within the home and office product industry. If companies figured out how to increase direct to consumer sales, they could lower the power of retail consumers.

Competitive Rivalry

Rivalry within the industry is high. Because of this high rivalry, developing and differentiating products within the industry is essential for new growth opportunities. As segments of the industry continue to experience declining revenues this will weaken the competitive rivalry.

Peer Comparison

We believe to encapsulate the full industry we needed to cast a wide net. For this reason we compared the following companies: Newell Brands (NWL), Stanley Black & Decker (SWK), Tupperware Brands (TUP), Procter and Gamble (PG), Columbia (COLM), 3M (MMM), ACCO Brands (ACCO), Societe BIC (BB-FR).

Margins

We first decided to look at margins across the board, it should be noted that with recent tax law changes some company's may have abnormal Net Margins.

Ticker	Gross Margin	EBIT Margin	Net Margin
NWL	34.4%	10.0%	-52.6%
SWK	35.0%	13.5%	4.3%
TUP	66.3%	15.0%	7.5%
PG	49.2%	21.6%	16.1%
COLM	47.6%	12.1%	9.6%
MMM	49.4%	23.7%	16.3%
ACCO	30.1%	10.5%	5.5%
BB-FR	52.4%	19.2%	12.0%

Source: Factset

From analyzing margins we believe that PG or MMM are the best positioned when looking at margins. They have solid gross margins, but more importantly they have he highest EBIT & Net Margins. We believe this means they have the best ability to control their costs. If you compare these two industry leaders to a company like TUP, one will see that TUP does a terrible job of controlling operating expenses (signified by the huge drop form Gross to EBIT margin).

Relevant Metrics

Ticker	FY1 P/E	EV/EBITDA	Debt/EBITDA
NWL	14.5	11.5	3.5
SWK	15.53	10.32	1.76
TUP	7.36	5.97	3.30
PG	22.13	15.3	1.95
COLM	23.50	15.97	0
MMM	19.49	14.13	1.59
ACCO	8.08	6.60	3.30
BB-FR	15.49	7.78	0.41

Analyzing the FY1 P/E and the EV/EBITDA ratios leads us to believe that TUP may be slightly undervalued. TUP is a company that we believe may benefit from a switch to E-Commerce because we believe they have strong brand awareness in their main product, food containers.

Overall - PG

This industry is very competitive, has lots of substitutes and consumers hold a good amount of power. This leads us to believe the company that can come up with truly differentiated, innovative products while holding expenses constant or cutting their expenses can increase their profit margins and gain greater market share in the industry. While TUP may be slightly undervalued right now and MMM also has strong margins, we believe that PG is best positioned.

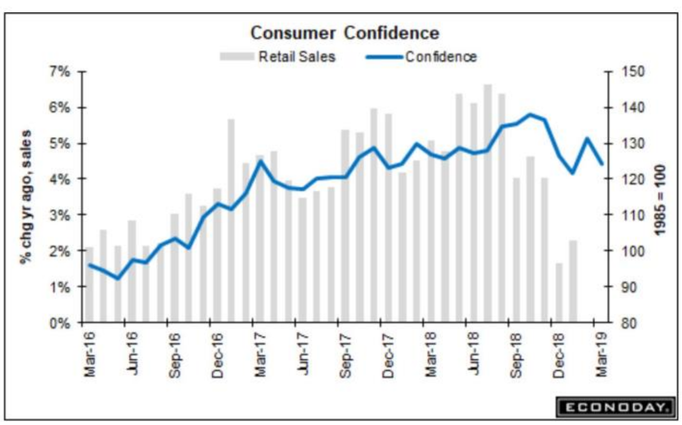
PG mainly specializes in the Home Products segment, and we believe this segment of the industry is much more promising then the Office Product segment which is why we like PG more than MMM.

We also believe that PG's profitability is much more valuable then investing in a company that is potentially slightly undervalued. We believe that moving forward PG is best positioned to continue to dominate their industry.

ECONOMIC OUTLOOK

Consumer Confidence

The below graph is showing an overlay of consumer confidence on retail sales. Both of these metrics are thought to be leading economic indicators.



Source: Econoday

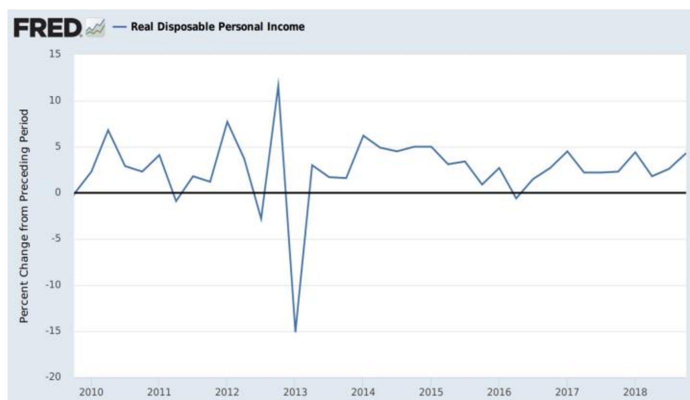
Consumer confidence had a strong bounce back in February after having consecutive month declines fueled by trade tensions and the United States government shutdown. These two economic issues have been showing promising progress resulting in consumers gaining more confidence in the economy. However, in March consumer confidence lost most of the Feb gains.

Despite the recent stumble in consumer confidence, the levels remain very high. If trade tensions and the government shut down resurface, combined with an inverted yield curve and slowing home starts, we believe that consumer confidence could plummet as low as 110 over the next six months.

The low retail sales numbers were expected as consumer confidence went down people were not spending as much money on discretionary purchases. We expect the next release of retail sales to have a significant increase as consumer confidence has gone back up. However, if retail sales continue to stay low not only is this bad for the Home & Office Products industry it also is bad for the economy as it shows a decrease in spending.

Disposable Income

The following graph shows the percent change in disposable income from the prior period:



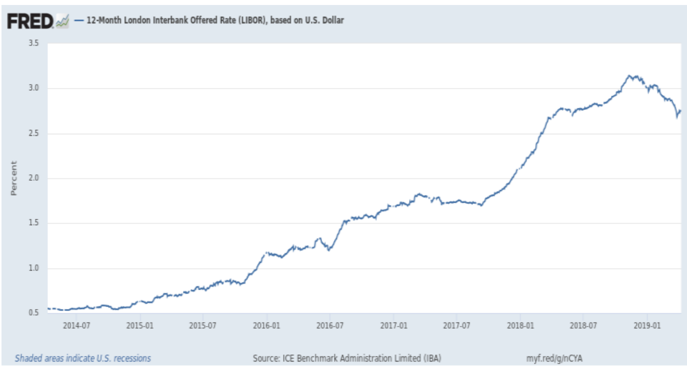
Source: Bureau of Economic Analysis

As one can see, the percentage change in disposable income has been rather strong since the dip in 2013, with the most recent years showing around a 5% increase from the prior period.

As we stated earlier in the report, strong disposable income growth is good for the Home & Office Product industry. Strong disposable income means that people will not only buy more products, but they will be more inclined to buy premium products.

LIBOR

The London Inter Bank Offering Rate (LIBOR) is relevant for this industry because many of the major players in this industry use LIBOR as a base for their borrowing rates in their revolving credit facilities. This means that Increases in LIBOR will make borrowing more expensive for the industry, and decreases in LIBOR will result in more favorable borrowing conditions. Below is a graph that shows the 12 – Month LIBOR rate:



As one can see, the 12-Month LIBOR peaked in early 2019 after a consistent incline over the past five years. It appears that the rate slightly fallen back, which helps company's in the industry achieve lower borrowing costs.

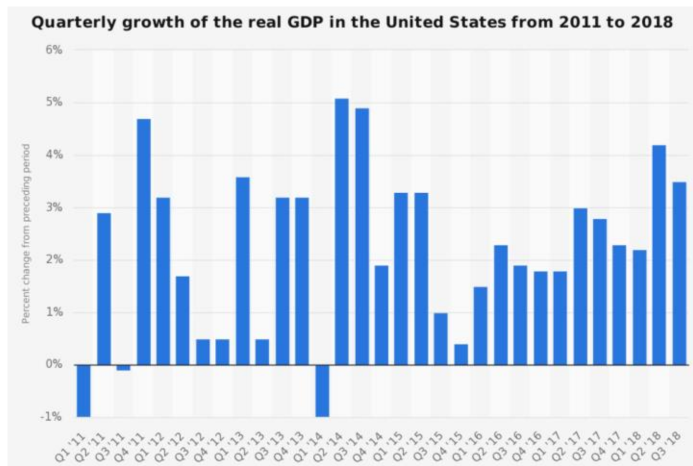
Treasury Yields

The following graph shows the spread of the 10 year treasury yield and the 2 year treasury yield. This metric is important for the industry because it shows future expectations.

The tightening spread, shown by the downward trend, is less favorable for the industry. We believe that as the spread tightens and potentially inverts, lenders will become a lot stricter with their lending. As we sated earlier, the industry benefits when consumers build new houses or move into new houses. If lenders are unable to achieve funding for these long-term loans we believe consumer consumption could suffer.

GDP

GDP growth in the most recent quarter,2018 Q3, was 3.5%. The 2017 Q3 growth was 2.8%[11]. GDP growth has been consistent and strong over the past two years. This is very favorable for the Home & Office product industry because it means that consumers are spending money.



Source: Statista

In the above graph one will notice that prior to Q1 of 2016, quarterly growth rates were extremely volatile. After Q1 2016, the GDP growth rates have been much less volatile. Consistent GDP growth has meant consistent consumer spending.

INDUSTRY POSITIVES

- The home products segment is a defensive segment meaning many companies have products with in-elastic demand. This would be beneficial if one is skeptical about the economic future. It should be noted that premium products within the segment would still be subject to discretionary pressure.

- The office products segment is in a declining revenue state, consolidation is inevitable. The companies that survive the consolidation will experience less rivalry.

- If disposable income continues to increase high end home products will see more sales, meaning higher profits for companies in the industry.

INDUSTRY NEGATIVES

- Continued growth of technology usage in the home, office, and school spaces will harm the Office Products segment of this industry.

- A downturn in new housing starts or home sales would harm the growth in the Home Products segment of the industry.

- A rising E-Commerce environment shifting consumers away from premium brands and harming the margins of manufacturers.

- An aging population with little to no retirement savings combined with a growing millennial trend towards co-living could result in Americans consuming less home products.

KEYS TO MONITOR

Technology Takeover – Will technology continue to diminish the need for office supplies? How will office supply manufacturers adapt?

Growth of E-Commerce – How quickly E-Commerce expands. Will it become the main outlet for purchasing home & office products?

Disposable Income/ Consumer Spending – Is disposable income continuing to grow? And are consumers spending?

Housing Starts – Will housing starts continue to grow? Or is the growing apartment population going to grow? Do people in apartments consume less?

Co-Living – Is co-living a fad, or is it a lasting trend? Can it impact the demand for household products?

REFERENCES

1. 10-K NWL,MMM,PG,SWK
2. FactSet
3. IBISWorld http://clients1.ibisworld.ca/reports/us/industry/default.aspx?entid=897
4. Wall Street Journal https://www.wsj.com/articles/for-rent-98-square-foot-br-in-co-living-apt-community-included-1538053200?mod=hp_lista_pos1
5. Construction Permits https://www.census.gov/construction/bps/uspermits.html
6. FRED
7. Federal Reserve FOMC Statement
8. Macro Policy https://www.economicshelp.org/macroeconomics/monetary-policy/effect-raising-interest-rates/
9. IRI-Data https://www.irionline.org/resources/resources-detail-view/boomer-expectations-for-retirement
10. Consumer Confidence https://us.econoday.com/byshoweventfull.asp?fid=498852&cust=us&year=2019&lid=0&prev=/byweek.asp#top
11. Bureau of Economic Analysis
12. Statista
13. Yahoo Finance

IMPORTANT DISCLAIMER