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BTN Thursday Thoughts

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A Plethora of Packaged Goods: Are Consumer Goods Companies Stuffing the Customer Channel?

When it comes to Procter & Gamble (PG), Clorox (CLX), Colgate Palmolive (CL), as well even paper companies like Kimberly Clark (KMB), the investment theme always remains the same: "Who isn't going to wash their hair or brush their teeth every day?" Wall Street and investors consider these to be the ultimate defensive stocks as they pay dividends, are not very sensitive to interest rates like REITs or utilities, and what they sell is used daily and must be replaced. They generally pay up for these companies too, which is why we noted a few weeks ago, there are probably better bargains and growth potential in the stocks of chemical companies who make the plastic for the bottles, toothbrushes, and razors that the consumer products companies produce.

Every few years, these companies come under pressure for something that starts to go wrong in their business models. Private-label products sold on the same shelf with a similar looking package for 50%-70% of the price was the first pressure. That made it difficult to boost prices regularly to grow. Then it was FX hits from overseas sales as well as overseas companies having a currency edge to sell in the US. We think something that is starting to get notice may become **the next problem – channel stuffing at the consumer level.**

This is essentially conditioning the end-user to buy in bulk and drive up current sales. This can come from making the size of each unit larger – offer a box of 600 cotton swabs instead of 300 or a 64oz bottle of laundry detergent instead of a 48oz bottle. This is often seen as buy two shampoos or laundry detergent bottles and get a third bottle free. Either way, there is more inventory in American homes. People are not suddenly washing their hair 4x per day now. The only way to get customers to buy again is wait until they run out of 3 bottles or offer another sale.

These companies saw this happening after the stock market crash of 2008 and the start of the recession:

PG – late January 2009 conference call – "Organic volume was 3% below a year ago primarily to reductions in retailer, distribution, and in-home inventories in both developed and developing markets.

CL 3Q 2008 given in November 2008 conference call – "Volume in North America grew slightly. We have witnessed some pantry destocking on the part of the consumer."

The number of large-box retailers that pitch value and low prices is also pushing this type of channel stuffing at the consumer level. It's cheaper to sell a larger quantity per unit this way – the difference between delivering a box of 30 trash bags vs. a box of 50 trash bags is negligible. These chains are becoming a larger part of the customer base for the consumer products companies. Here is the growth over several years in store count:

	2001	2008	2018
Wal-Mart Supercenters	1,066	2,612	3,561
Wal-Mart Sam's Clubs	500	602	597
Target	977	1,591	1,834
Costco	345	512	746

We first saw this type of channel stuffing with batteries and razors at Gillette, Duracell, and Energizer. In one year, they would offer a package of four for $5. The next year, they would claim they didn't cut prices, but now they were selling a package of eight for $5, then 12 and 16. Use per person was not rising, people simply had more inventory being stored at home. Batteries had an extra bump from hurricanes and winter storms that would drive people to stock up – and then they didn't need more batteries for months. **This became an inherent problem and these companies both broke with the group and traded at much lower valuations.**

When we look at the recent trends in volume vs. pricing for US operations for some of these companies, we think the stocking up by the consumer has been encouraged for the last couple of years. The companies are showing volumes increasing more than pricing (in fact often the pricing trend is negative). We broke these down to be as US-centered as possible. Clorox lists its cleaning and household units as being US-only. Colgate-Palmolive breaks out sales into North America, which includes the US, Canada, and Puerto Rico and the US is about 92% of the total. Procter & Gamble does not break out volume trends by geography. However, North America is about 45% of its sales and it makes comments about developed and developing economies for volume trends.

Clorox gets 26% of its sales from Wal-Mart. It had the following comment in most recent conference call about club stores being a big part of sales:

> *"Second quarter sales grew 1% on top of 5% in the year ago quarter, which includes about 1 point of volume growth and about 0.5 point of pricing, partially offset by over 1 point of unfavorable mix, reflecting strong club channel shipments."*

CLX Cleaning	2013	2014	2015	2016	2017	6mths '18
Volume	3%	-1%	2%	6%	10%	4%
Pricing	2%	1%	1%	-1%	-5%	-1%

CLX Household	2013	2014	2015	2016	2017	6mths 18
Volume	-3%	1%	2%	3%	8%	3%
Pricing	4%	0%	3%	1%	-3%	-2%

*CLX has a 6/30 fiscal year thus 12/31 on the calendar is its 2Q

In the years for 2013 and 2015, Clorox noted that selling more of its professional products helped the pricing in cleaning. We think the trend shows that volume has been rising much faster than sales overall (as well as the economy). We do not know of many retailers that are eager to stock more inventory all the time, so we believe those higher volumes went through discounters into consumer closets. We think the results also show that sales are being driven with lower prices, which can be tough to reverse.

Colgate-Palmolive has more foreign sales but still gets 11% of its sales from Wal-Mart. Its North American sales are showing the same trend as Clorox:

CL North Am.	2013	2014	2015	2016	2017
Volume	3.5%	3.5%	2.0%	2.5%	0.0%
Price	0.0%	-1.0%	0.0%	-1.0%	-2.0%

CEO Ian Cook, in the *WSJ* in January 2017, talked about too much inventory in consumer homes being an issue:

"They don't go away from the behavior of brushing their teeth. They will exhaust pantry inventory, which is to say, if people have more than one tube of toothpaste at home they may try and stretch that tube before they reload their own pantry."

The 4Q17 call showed the same pricing pressure remains for CL:

"Now moving to the divisions. We'll start off with North America. In Q4, we saw a sequential improvement versus the third quarter in volume, net sales and organic sales growth in North America. Net sales were up 1% in the quarter with organic sales up 1% driven volume growth of 4.5% and pricing of minus 3.5%, while foreign exchange was even with the year ago period. We continue to see significant pricing pressure in the liquid hand soap and hand dish categories."

Procter & Gamble gets 16% of its sales from Wal-Mart and notes that its top-10 customers are 35% of sales. We cannot break out metrics by geography from their filings, but on the surface, PG is also showing volume growth exceeding sales growth:

PG total	2013	2014	2015	2016	2017	6mths 18
Volume	4%	3%	-1% *	-1%	2%	2%
Sales	1%	1%	3%	2%	0%	0%

- PG notes in 2013-15 that developed countries posted low-single-digit volume growth
- PG also has a 6/30 fiscal year

Kimberly Clark gets 14% of its sales from Wal-Mart. We looked at the personal care (diapers and tampons) and consumer tissue (toilet paper, paper towels) for North America, volume here has been exceeding pricing power too:

Personal Care	2013	2014	2015	2016	2017
Volume	1%	- %	4%	4%	- %
Price	-1%	- %	-2%	-2%	- %

Tissue	2013	2014	2015	2016	2017
Volume	- %	2%	6%	1%	-2%
Price	2%	-1%	-2%	-1%	-1%

We think investors must look at several things from these trends. The companies are still facing pricing pressure from private label goods and selling through discounters. The move toward private label seems to be accelerating too according to [Stores.org] as it gives the retailers more control over products. The article points out that people no longer switch to private label when times are tight and then back to branded products. It also asserts that Millennials are very comfortable with private label products. Trader Joe's pitches private label and has tripled its store base since 2001. This, along with selling through discounters, seems to be conditioning people to buy heavily when retail prices are low. What if commodity costs increase at this point? What if consumers try to simply wait out price increases by living off their stockpiles and buy less? It may hurt sales and margins for these companies.

All these higher volumes that were pushed are out in the countryside. **The improving economy arguably helped drive the volumes even higher and allows the companies to offset weaker pricing.** Channel stuffing eventually ends, often when customers cannot be induced to pre-buy even more. Normally, sales weaken as high inventories are worked down.

We don't want to go crazy here. We doubt these companies will end up cutting dividends over this issue. The original investment theme is also still here – people do brush their teeth every day. That makes channel stuffing here likely less problematic than when it happens at Dell Computer or Harley Davidson – people can hold out on buying a new motorcycle much longer than more shampoo.

However, it is important to realize that these problems are coming during a rising economy, not a recession. **One has to ask, "How do these companies ever overcome the issue of selling high volume at low prices through discounters without losing market share and earnings?"** Does the investment world eventually admit these companies have an inherent difficulty matching previous growth and assign Energizer multiples to them?

In 2013, before Energizer did a sizeable spin-off restructuring, it's stock was essentially $100 per share. Sales growth was negative at -1.1% and the P/E ratio was 14.4x. With the help of annual restructurings, EPS growth was 7% and another 5% growth came from buying back stock to cut the share count. So, the PE/G (P/E ratio divided by Growth) was about 1.2-2.1x.

Look at some of current situations for the other consumer products companies:

	P/E	Sales Growth	EPS Growth	PE/G	Yield
CLX *	21.2	2.4%	3.0%	7.1	2.9%
CL	24.4	1.7%	2.1%	11.6	2.3%
PG	19.1	2.0%	6.2%	3.1	3.4%
KMB	18.1	0.3%	3.3%	5.5	3.6%

* CLX has a big impact from the tax law – we used $6.27 forecasted EPS

We should add that PG has gained 2/3 of its EPS growth from repurchasing stock. These companies can all support their dividends at this time and we do not think the risk is coming in that area. The risk is if the market sees some of these problems as incurable and decides the P/E ratio for this group should really be 16-17 and the PE/G ratio closer to 4x.

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