2009 in the Office Products Market – How tough will it be?

The year ahead doesn't look good, unless of course you have lots of cash and are keen to invest.
Economic forecasters tell us unemployment will rise, consumer confidence is shattered, businesses will collapse, we may have a recession and then – to add insult to injury there will be price rises due to the lagged affect of the big fall in the $A. Wow! Frankly, it's a dismal outlook – and a huge turnaround from the buoyant conditions of a year ago.

Negative market growth

By the time you are reading this the 'back to business' period will be providing some signals as to how subdued market growth will be for 2009. If your figures for January are up on last year, then consider yourself to be doing well. We expect total market growth in 2009 to be negative – in the low single digit range (-2 to -4%). It could be better than this if consumer/business confidence improves (in response to lower petrol prices, much lower interest rates, stabilisation in financial markets and Government stimulus initiatives). On the other hand it could also be worse with the main risk being a meaningful slowdown in China serving to deflate demand and prices for our commodities, which will further dampen our domestic economy.

Lower profits

The real story of 2009 however will not be stalling sales, but plunging profits. In an environment of weak demand, suppliers and dealers are restricted in being able to pass on the full amount of currency induced cost increases, for fear of losing sales. At the same time lower sales volumes are being spread across the same fixed cost base, impacting profits in a double whammy effect. Just look at Harvey Norman's results towards the end of 2008. With flat sales their year to date profit is more than 30% lower than the year before. This is due to much lower margins, as weak consumer demand and competitive pressures prevent them passing on the full cost of rising import prices. The Harvey Norman example is quite moderate – we expect profit across the OP market to be vastly lower in 2009.

An approach to take

Consider it a given; 2009 will be a year of market contraction, lower profits and more intense competition. In these conditions you can choose to accept it as inevitable your business will suffer. Or you can view it as an opportunity to be better than your competitors, raise your standards, work harder/smarter and provide superior value. With this approach your results may still be down on last year, but you can bet you will do better than most, plus you will be significantly better positioned when conditions improve again. In this sense 2009 is an opportunity for smart operators to capitalise and move ahead of competitors. It is not a time to stop all development initiatives. Rather they should be reviewed objectively with the realisation that conditions *will* return to normal – although perhaps not for a few years.

Consumer segments

Households and micro businesses who have been the growth drivers in the market for several years will unfortunately be the most negatively affected – at least in the early part of 2009. This will affect retailers' sales (such as newsagents, Big W and Officeworks) and will be driven by cutbacks on discretionary items. However we expect these two segments to be the first to bounce back. By around mid 2009 the effect of lower interest rates, petrol prices and Government spending initiatives, should see expenditure stabilising and perhaps begin to turn up.

By contrast growth amongst the SME business segments will hold up somewhat in the early part of 2009 before starting to weaken more significantly in the mid and latter part of the year (as unemployment and reactions to profit deterioration take hold). This more delayed impact will affect the commercial and contract dealers such as Corporate Express, OfficeMax, COS, Lyreco as well as the dealer groups; Office National, Office Choice, ASA and APG.

Most businesses will be scrutinising their office product budgets in 2009, seeking to cut them back and impose more restrictions on what may be purchased.

Products

With consumers' cost cutting there will be a move to more 'value' products. These tend to be basic versions of products (often of low quality), frequently using a little known brand or 'private label.' Non-OEM printer cartridges (compatibles and refills) will also become more popular.

Products will polarise into one of two zones. On the one hand will be the stable-low growth categories able to maintain positive growth. These include everyday staple products that offices need to function, for example printer cartridges, paper and adhesive tapes. On the other hand there will be negative growth categories that include higher value capital items (eg printers), discretionary items such as computer accessories, new technology products and also premium products.

Market conditions will also drive large dealers to carry out more direct importing (bypassing local suppliers) in an effort to maintain a competitive edge and maintain margins.

Prices and margin erosion

Margins will come down during 2009 as importers and dealers, in an effort to stay competitive and avoid losing customers, avoid passing the full burden of higher costs caused by the lower $A to customers. We expect this phase of cost-absorption /margin erosion to begin easing in the second half of 2009 by which time falls in input costs (oil, freight, electricity etc) will have flowed through to an easing in product costs. The wildcard however is the $A. We expect that after the dramatic falls during the second half of 2008, it will remain relatively steady for 2009, in the range of $US0.65 – 0.70 = $A1.00.

Competition and operators

Unfortunately the tough conditions will be too much for some operators. We expect there will be several closures of dealers, wholesalers and suppliers in 2009 and beyond. The most vulnerable operators will be those that have not worked at modifying/adapting their businesses to the evolving market over the last few years.

We see the following types of operators being at more of a disadvantage in the prevailing conditions;

- Small narrowly-based import suppliers (ie with a limited range of products).
- Wholesalers and paper merchants, who are particularly vulnerable to even small margin changes and cash flow delays.
- Retailers with thin margins and high fixed cost overheads (especially those in premium locations).

Eyes wide open

There is no doubt 2009 will be a tough year for most in the industry. There will be closures, cash flow problems and rumours flying on who is in trouble. The nearest experience goes back to the recession of 1992, whose depths we hopefully will not reach.

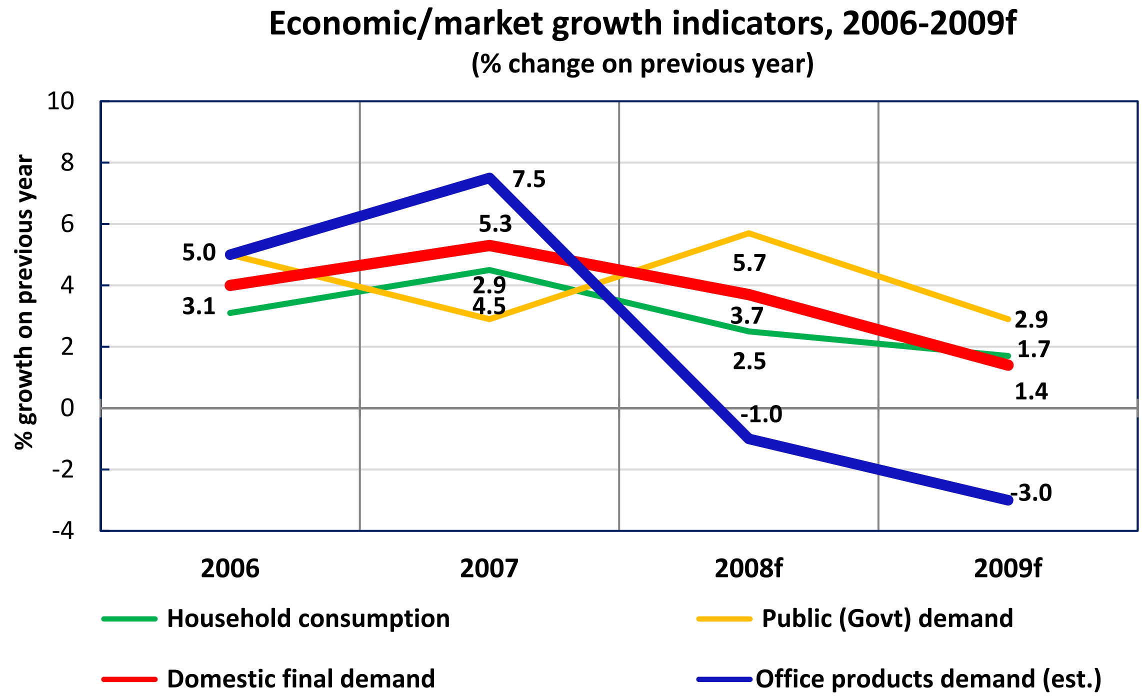
We believe the second half of 2009 will see conditions improve (especially from a profitability perspective). Once margin pressures abate, via a stabilisation of the $A and lower commodity prices, profits will start improving, making it easier to cope with the weak sales, which are likely to endure.

The best operators will weather 2009 by remaining focussed on providing value to customers (looking after them), remaining optimistic (we will come out of this) and positioning for the upturn (investing).

Economic Indicators, 2006-2010 (annual % change*)

Indicator	2006	2007	2008f	2009f	2010f
GDP	2.7	4.2	2.3	1.8	1.9
Household consumption	3.1	4.5	2.5	1.7	2.3
Business investment	8.7	13.0	8.1	-0.3	2.5
Public demand	5.0	2.9	5.7	2.9	2.1
Domestic final demand	4.0	5.3	3.7	1.4	2.9
Unemployment rate (%)	4.9	4.4	4.3	5.4	6.2
Inflation (underlying) (%)	3.5	3.1	4.3	3.3	2.7
Currency: A$/US$ (exchange rate)	0.75	0.88	0.77	0.68	0.67
90 day bank bills (%)	6.4	7.2	5.6	4.8	4.7

Source: ANZ Economic Outlook, December quarter 2008 & past reports.
*f = Forecast * Unless denoted otherwise*



Source: ANZ bank & Penfold Research estimates

Penfold Research
Penfold Research, based in Australia, provides operators in the office products industry with information to assist with planning, decision making and strategy development.

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