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New Recommendation: BUY **CSS Industries (CSS)** **July 31, 2014**

Recent P/E: 8.50[1] (ftm consensus) **Recent Price: $25.00** **Target: 35.00**

Summary:

CSS Industries is a relatively small public company that operates in business segments that receive almost no financial coverage. Its business is comprised of three groups, which could be broadly described as: decorative ribbon, boxed greeting cards and paper party goods.

All of the products sold by CSS are consumer discretionary items. Financially, it reports in a single business segment, although it operates its groups independently.

Although there is no glamor in any of the business groups that make up CSS, it is a solid company, with some growth potential and some potential for lowering operating costs. Importantly, CSS has a very strong capital structure with no long-term debt. The value of its cash and short term investments on-hand totals almost half of the total enterprise value of the company. It pays a 2.3% dividend.

As a business, CSS has what we consider to be a small economic moat. They have good market share in businesses that do not attract competitors. The competitors they do have tend to be small and do not have sophisticated distribution infrastructure. Further, a substantial portion of its sales goes to Walmart (27%) and Target (12%). A concentration of sales to two customers can be a negative, but these customers are very demanding. Both Walmart and Target require suppliers to have capable distribution capabilities to support their respective low inventory, rapid turn business models. Such distribution capabilities are expensive to establish and, in and of themselves, do create a business moat. There are just a few companies that sell products like the ones CSS supplies and the cost and difficulties of establishing a capable distribution system does serve to keep potential competitors out of contention for business from CSS's big accounts. Economic moat notwithstanding, Walmart and Target are not easy customers to deal with in

[1] We calculate the P/E ratio net of cash and short term investments. The P/E ratio calculated without that modification is 12.7.

terms of both pricing and delivery. It would be hard for a CSS competitor to crack these two accounts without the back-up of an expensive distribution system. Further, it would be very difficult to build an expensive distribution system unless you have two big customers to serve with it.

Management at CSS is very circumspect about its growth and its cost structure going forward. The total comment on the subject in its most recent financial reports is "The Company believes that its all occasion stationery, stickers and memory product lines have higher inherent growth potential due to higher market growth rates. The Company continues to pursue sales growth in these and other areas."

Our conclusions are first: that the ribbon business is solid and will fluctuate up and down with the basic domestic economy. Our second conclusion is that while there is considerable upheaval in the greeting card business, on-balance, the greeting card business is not dying and will not be simply replaced by the internet. There is some indication that CSS is doing a reasonable job of reacting to and forecasting industry trends in this business and that if it can continue to do so, it can see some growth therein. Our third conclusion on the party goods group is that this is not being replaced by the internet and will also fluctuate basically in line with the entire economy. Our fourth conclusion is that the management of CSS is competent and does see the array of opportunities and is capable of operating their business to take advantage of those opportunities.

Our conclusions translate into a bit of earnings growth for the company as summarized in the attached income statement projections. The earnings growth projections, coupled with the very strong balance sheet translate into a "BUY" recommendation for CSS.

The Ribbon Business is Solid

CSS is a major supplier of decorative ribbon in the US. Ribbon is an accessory that accompanies holiday presents and floral arrangements. Ribbon is not particularly expensive to make. It requires little engineering or R&D, but there are thousands and thousands of variations in color, style and size. Customers expect basically immediate delivery, so for a ribbon supplier, distribution and inventory management constitute a challenge.

Ribbon is not being displaced by the internet. Nobody adds color, style and flair to a floral arrangement or to a Christmas present by googling it or putting it in an Amazon shipping box.

Our research indicates that overall floral sales in the US are dependent on the overall economic conditions, but floral sales do show some reasonable growth going forward, basically mirroring the overall continuation of the economic recovery. Sales were down in 2008 and 2009, following the recession, but were up marginally in 2010 and 2011. In 2012, industry sales were up 7% followed by a 5% increase in 2013. The distribution pattern of flowers in this country is changing, with declining numbers of local florists, more flowers being purchased through big chains, such as Costco as well as through the internet. Changing distribution patterns aside, the demand for ribbon as a floral accessory does not really depend on the distribution pattern for the flowers themselves. Some flowers delivered by Costco are going to have ribbons as an accessory and some are not. The same is true for flowers ordered over the internet as well as flowers bought from the local florist – some are going to wind up with ribbons and some are not.

The comments on flowers pretty much carry over to the demand for ribbon for Christmas and birthday presents. Some presents are going to be wrapped with ribbon and some are not, whether those goods come through the internet, from Amazon, from Target or from a local specialty shop. Statistics on birthday presents are not readily available, but statistics on total Christmas shopping show that they are tied to the overall economy and that the distribution patterns are changing from local stores to internet sourcing. The changing distribution patterns are disrupting the retail industry, but not changing the demand for ribbon so much. CSS supplies the ribbon.

At the same time, the ribbon business is not growing much, nor is it seeing a whole lot of low-price ribbon competition. CSS uses ribbon manufacturers worldwide and has a good cost structure in its supply chain. All-in-all, the decorative ribbon business is an established, cash-cow business.

The Greeting Card Industry Is Not Dying

Most of the industry known as greeting cards is composed of individual cards, typically supplied by Hallmark or American Greetings. Historically, many of these cards were sold, primarily to women and frequently through specialty card shops. Mirroring the entire retail business, the internet, along with changing fashion trends, are disrupting the traditional market for greeting cards, rankling the Hallmark and American Greetings establishments. The internet is taking market share from the mass marketed cards, but fashion trends are adding to the high end card demand. (Hallmark and American Greetings are scrambling because both serve, and have considerable investment in, the general mass market, but neither do a very good job with the high end card market.)

It is easy to think that every internet greeting replaces one greeting card, but there is no “law” about one-to-one interchange. A husband may send his wife a dozen email notes a day, but does that replace her birthday card? No it does not - ask any wife that is used to getting a card for her birthday. The fashion trend to high end cards, frequently printed on very specialized paper stock, is disrupting the mass marketed card market as much as the internet, but overall card demand is still OK.

The comments above are descriptive of the overall market for cards and simply reinforce the idea that while the greeting card industry is facing considerable disruption, it is not dead, nor is the industry as a whole, dying. That said, CSS does not supply individual greetings and does not really compete with Hallmark and American Greetings. The cards from CSS are “boxed” cards. Boxed cards are not individually targeted cards, and are considered a separate part of the greeting card industry.

In spite of the upheaval in the greeting card industry distribution patterns, the overall industry has seen growth rates since 2009 similar to that of the overall floral industry. The industry is moving to artistic cards, frequently printed on very high end, or very specialized paper. Stores that supply this type of card are actually doing quite well, while the mainstream Hallmark card store is languishing.

The overall mood at the recent National Stationery Show in New York this year was very up-beat. Those industry folks on top of the trends were very pleased, although the mood was somewhat offset by those folks missing the trends and committed to the established practices of the past decades.

There are no solid statistics on various strata of the card business, but the take away from our research and our conversations with industry participants is that there are good opportunities in the industry. Retailers also complained that they did not see good boxed card sets. Good industry opportunities and the need for boxed cards more closely matched to what people want do represent opportunities for the CR Gibson group of CSS. CSS is not heavily invested in retail card shops, so the industry infrastructure upheaval is not particularly impactful on CSS and they can turn their attention to the creative art of matching the style of goods supplied to the desires of the end customers.

Paper & Party Goods

Paper goods and stickers is the third part of CSS Industries. Good data on this segment of the industry is hard to find and there is no question that eBay and the internet are changing the distribution patterns for how consumers get their paper and party goods. However, if you are a parent of a four year old, you are going to need something tangible for the birthday party. You can't hold the party on the internet. We have seen no evidence to suggest that the overall demand for party goods does not follow the pattern of the general economy. CSS supplies the actual party goods and the goods themselves are independent from the distribution channel. Because party goods are a consumer discretionary item, their sales will slow more than the overall economy in a down turn, but they will grow more highly on the upside. At the moment, the US economic trend is on the upside.

Competent Management

Management at CSS has cut costs, disposed of businesses, bought synergistic businesses and it has streamlined operations. In the past three years, the net effect has been a decrease in sales of 17%, with a reported increase in net income of 21%. Very few companies can successfully restructure and show increased profits at the same time. If CSS can continue to rebuild its business into an overall revenue growth, we believe that the growth will disproportionately fall to the bottom line.

Last year, CSS bought Carson & Gebel (C&G), a major supplier of decorative ribbon in the US, greatly increasing their overall market share. CSS paid less than $6 million for the Carson & Gebel business. We do not have any statistics on the sales or profits of the CSS ribbon group before or after the purchase of C&G. However, given the low overall price paid for C&G and the potential to fold C&G into their own Berwick Offray Ribbon infrastructure, we have to believe that the overall financial impact of the C&G purchase was overwhelmingly positive. Our conversations with industry personnel indicate that while there is some grumbling about the C&G purchase from C&G's customers, everyone agrees that it was a very good business move for CSS.

Possible Buy-out Candidate

CSS operates in a small, niche market, but given the overall strength of their balance sheet and their cash and short term investment position, it is very possible that an outsider could purchase this company at a very attractive price. In particular, it would make economic sense for a large company that had good distribution in place serving both Walmart and Target to purchase CSS and fold the CSS products into an existing distribution system. A considerable amount of operating costs could be eliminated in such a scenario. We have no information that such a take-over is imminent or is even on the horizon, but, given the financial position of CSS, such a buyout would be very possible. Generally, buyouts of healthy companies are attractive opportunities for the current shareholders.

Possible Growth in Emerging Markets

CSS operates in emerging markets, using them principally for supply of products. As with the above thesis on a possible buy-out, we have no information that suggests that CSS is starting to enter emerging markets to sell their products. However, given the overall improving economic conditions that exist in many emerging markets and the fact that CSS is already over there, it is quite likely that establishing sales channels in emerging markets is on the radar screen at CSS. It would be a positive development for overall revenue and profits.

The Financial Model

Getting from the above, qualitative, analysis of CSS and its various businesses to a quantitative financial model is a bit of a stretch. That said, all of the items sold by CSS are consumer discretionary. Consumer discretionary items as a general rule increase sales in an economic recovery at a rate that outpaces the overall recovery. Floral industry sales increases of 7%in 2012 and 5% in 2013 follow this trend. The overall greeting card market shows a similar trend.

We expect the US GDP to show a growth this year of about 2.5%, and increasing in the second half of 2014. Increased rate of GDP growth will lead to a probable increase in discretionary consumer expenditures by 4 to 6%. CSS should add some further growth in sales due to the C&G acquisition. The above overall growth rates for 2014 and the C&G acquisition lead us to conclude that a 1% annual growth in revenue and a 1% reduction in cost of goods sold, with a level expense for SG&A are all conservative estimates for the business as it is currently structured. Given competent management, it is very possible that some businesses may be purchased and some sold, but we believe that any such transaction will be positive for net income and add to the above estimates.

With the reasonable assumptions noted above, net income grows from $18.7 million in FY 2014 (which ended 3/31/2014) to $23.6 million in F/Y 2016. Per share income grows from $2.00 to $2.44.

The above per share numbers are based on the current shares outstanding of 9.4 million and a modest buy-back program of 70,000 shares per year. Since 2005, CSS has reduced the number of shares outstanding from 10.5 million to the current 9.5 million – a reduction of 10%. They currently have authorization from the Board of Directors to purchase an additional 500,000 shares of their stock. Clearly, they have the financial resources to do so. Any such purchases over 70,000 per year would add to the per share estimates cited above.

Our target of $35 is based on a P/E of 11x FY 2016 earnings plus $8 in cash and short term investments.

Conclusion

Overlooked, markets are not dying as is generally assumed. CSS has strong cash and a good dividend of 2.3%. For a value oriented portfolio we believe CSS is a solid investment. Buy the stock.

CSS Industries Financial Projections
July 31, 2014

Price Target				
	P/E	**FY15E**	**FY16E**	**FY17E**
	12.7	$ 27.60	$ 31.01	$ 34.52
	8.5	$ 18.47	$ 20.75	$ 23.11

Projected Income Statement (in mil. $)	**FY10A**	**FY11A**	**FY12A**	**FY13A**	**FY14A**	**FY15E**	**FY16E**	**FY17E**
Revenue	448.5	384.0	384.7	364.2	320.5	323.7	326.9	330.2
Cost Of Goods Sold	(337.9)	(269.1)	(273.2)	(253.8)	(217.3)	(216.2)	(215.1)	(214.0)
Gross Profit	**110.6**	**114.9**	**111.5**	**110.4**	**103.2**	**107.4**	**111.8**	**116.2**
Selling General & Admin Exp.	(95.7)	(86.9)	(85.0)	(80.6)	(75.2)	(76.0)	(76.7)	(77.5)
Operating Income	**14.9**	**28.0**	**26.5**	**29.7**	**28.0**	**31.5**	**35.1**	**38.7**
Interest Expense & Other Unusual Items	(1.4)	(1.2)	(1.2)	0.1	(0.3)	(0.3)	(0.3)	(0.3)
EBT Excl. Unusual Items	**13.5**	**26.8**	**25.3**	**29.9**	**27.6**	**31.2**	**34.7**	**38.4**
Unusual Items	(44.5)	(0.5)	0.1	(7.3)	0.0	0.0	0.0	0.0
EBT Incl. Unusual Items	**(30.9)**	**26.3**	**25.4**	**22.6**	**27.7**	**31.2**	**34.7**	**38.4**
Income Tax Expense	7.2	(9.4)	(9.0)	(7.0)	(9.1)	(10.9)	(12.2)	(13.4)
Earnings from Cont. Ops.	**(23.7)**	**16.9**	**16.3**	**15.5**	**18.5**	**20.3**	**22.6**	**25.0**
Earnings of Discontinued Ops.	0.0	(11.2)	(0.5)	(0.3)	0.2	0.0	0.0	0.0
Net Income	**(23.7)**	**5.7**	**15.8**	**15.2**	**18.7**	**20.3**	**22.6**	**25.0**
EPS	**(2.45)**	**0.59**	**1.62**	**1.59**	**2.00**	**2.17**	**2.44**	**2.72**
Weighted Avg. Shares Ost. (in mil.)	9.67	9.73	9.73	9.56	9.39	9.32	9.25	9.18