

H.B. Fuller (NYSE: FUL)

Short Thesis

4/5/25

H.B. Fuller we gotta problem my dawg....

While not mired in scandal, H.B. Fuller has a checkered ESG and governance track record—ranging from historic NGO controversies in Latin America to underwhelming climate disclosure practices. Additionally, past concerns over aggressive accounting practices in the 1990s—including inventory treatment and cost capitalization—highlight a historical willingness to stretch financial presentation. While not thesis-defining, these issues reinforce broader concerns around transparency, cost pass-through, and strategic oversight.

Overview

H.B. Fuller manufactures adhesives, sealants, and other specialty chemical products. FUL's business is fundamentally tied to volatile oil and gas based raw materials. It operates in a high-fixed-cost environment with lagged pricing, weak free cash flow, and deteriorating margin structure.

This report presents a high-conviction short thesis using first-principles logic, hard financial evidence, and valuation reality.

Core Short Thesis: Three Defensible Syllogisms

1. Raw Material Sensitivity and Pass-Through Lag

Premise 1: 75% of H.B. Fuller's cost of sales is raw materials (FY2024 10-K).

Premise 2: Many inputs are petroleum- and natural gas-derived, directly tied to energy markets

Premise 3: In Q1'25, raw material costs rose 50 bps of revenue, while pricing only rose 0.2%—yet gross margin fell 70 bps and net income dropped 57%.

Conclusion: FUL struggles to pass through cost inflation in real time, creating structural margin vulnerability as input prices rise.

2. Structural Input Cost Pressure and Lagged Pass-Through

Premise 1: In Q1'25, raw material costs rose 50 bps as a % of revenue — even though WTI crude prices declined.

Premise 2: Pricing only rose 0.2%, and gross margin declined 70 bps.

Premise 3: This confirms a lag between cost inflation and customer price realization, independent of energy market volatility.

Conclusion: Fuller has structural raw material cost exposure that is not fully hedgeable with oil — and its pass-through lag means even non-oil-specific inflation will crush margins quarter to quarter.

3. Free Cash Flow and Leverage Are Breaking the Narrative

Premise 1: Q1'25 free cash flow was -\$85.9M vs. +\$4.1M YoY, despite flat revenue.

Premise 2: SG&A rose 4.8% YoY, interest expense hit \$32M, and gross margin still declined.

Premise 3: Net debt stands at ~\$2.07B with a 55.1% debt/cap ratio

Conclusion: The “compounder” narrative is dead; negative operating leverage and capital strain are now defining factors.

Potential Inventory Issue

H.B. Fuller uses FIFO (First-In, First-Out) accounting, which expenses older (and potentially higher-cost) raw materials first. While Q1'25 reported a 1.7% increase in sales volume, the company still held ~79 days of inventory on hand at quarter-end. Additionally, raw material inventories remained flat at ~\$214M between Nov 30, 2024, and Mar 1, 2025—suggesting that not all higher-cost inventory was consumed in Q1. As a result, elevated-cost materials purchased in late 2024 are likely still flowing through cost of goods sold. Therefore, Q1 margins reflect lagged cost inflation, and this drag is likely to persist into Q2—even if spot input costs moderate.

Modeled Intrinsic Value

- Sales growth (2025–2034): 2% CAGR and Net income terminal growth (2035–2235): 1% CAGR
- Static cost structure, 8% discount rate → NPV of Net Income: \$2,027M
- Shares outstanding: ~54M → Implied intrinsic value: \$37/share
- Current share price: ~\$54

Conclusion: Even under conservative assumptions, FUL is ~30% overvalued. This model excludes management's already-lowered 2025 guidance, suggesting actual downside may be worse.

Logical Setup for Q2'25 Miss

Q1'25 Snapshot

- Revenue: Flat + Raw Material Costs: +50 bps + Pricing: +0.2% + Gross Margin: -70 bps
- Net Income: -57.4% + FCF: -\$85.9M

Looking Forward: Q2'25 Risk

- Tariff uncertainty has increased since Q1'25 disclosure
- Fuller's pass-through lag is proven in Q1 data → customer price increases are unlikely to be in place by Q2.
- In Q1'25, pricing rose just 0.2% while raw material inflation drove a 70-bps gross margin decline—clear evidence of FUL's structural lag in passing through input costs.

Conclusion: Q2'25 is likely to show continued gross margin compression, lower YoY net income, and worsening cash flow. This serves as the most immediate catalyst.