

The Cutting Edge™ December 2004

Business Briefing

How Are Our Hardwood Forests Doing?

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The North American wood products industry is the largest in the world. The industry manufactures over one-third of global production while servicing domestic markets that consume over one-half of all non-fuel wood products. Hardwood inventories on the stump are rising in spite of increases in harvests. Consumers around the world demand products made from U.S. hardwoods like maple, oak, and cherry.

However, challenging times lie ahead. According to Dr. Jim Bowyer of the University of Minnesota in a presentation to the National Hardwood Lumber Association, five major trends are changing the competitive environment for the forestry sector:

Increased Globalization - Many low-labor cost countries are rapidly growing their wood products industries especially for high labor content products. For example, China's burgeoning furniture industry has displaced much of the wood furniture production in the U.S. The result has been a 16 percent decline in hardwood lumber consumption here. Other products like mouldings and flooring are suffering similar fates. The end of this trend is nowhere in sight.

The U.S. Trade Deficit with China - This new dynamic is also resulting in large exports of U.S. logs and lumber to China. China is now the second largest destination for U.S. hardwood exports. This flow is benefiting from the low cost backhaul of containers that first crossed the Pacific full of Chinese-built TV's, furniture, toys, and other consumer goods.

Growth of Third World Forest Industries - While China has few native forest resources, other developing countries are now leveraging their timber assets. Russia, for example, holds more than 50 percent of world softwood resources and a hardwood forest slightly larger than that in the U.S. Investment for new mills is flowing into Russia particularly along the Sino-Russian border. Brazil and Chile continue development of their forests and wood products industries.

Development of Tree Plantations - In 2000 plantations covered an estimated 462 million acres around the globe, an area equivalent to the forestland in the U.S. These tree farms produce about 35 percent of the roundwood harvested in the world while accounting for only 5 percent of the total forestland. The conversion of land for plantations as well as for urbanization, agriculture, and road building in the U.S. is decreasing the loss of hardwood forests here. Also investment in wood processing facilities follows the supply of low cost wood fiber found in plantations. This fact will lead to more industrial capacity in competing countries.

Use of Hardwoods in Composites and Paper - More small diameter hardwood trees are being harvested for paper and composite products like laminated veneer lumber

and MDF. This trend is leaving fewer trees in the woods to reach sawtimber size.

These trends are changing the economics of forest products firms founded on the U.S. hardwood resource. Only those companies who react intelligently and creatively in their plans for the future will survive.

These plans must include capital investment in new facilities designed to leverage the advantages that arise from (i) our hardwood resource and (ii) the proximity to the world's largest market. These investments must feature new technologies in plant, process equipment, and information systems. Like never before, the wood products industry is dependent upon innovation by its managers and its suppliers.

Jobs, Jobs, Jobs...

As reported in the last Business Briefing, the employment picture in the U.S. is rebounding strongly. The November jobs report showed 337,000 new jobs. Revisions to August and September data added another 113,000 jobs meaning the economy created about 2.1 million jobs in the past twelve months.

The strength of the job market is confirmed by the Monster Employment Index. The MEI rose to a new high in November. The Index is now at 117 vs. 114 in October. In the last twelve months the Index has moved from just 88.

What Happened to Capital Investment?

The tax incentive for business investment has generated little in the way of increased capital spending. Last year Congress gave companies a bonus 50 percent first-year depreciation allowance on equipment purchased before the end of 2004. However, through September orders for capital goods excluding airplanes was up 12.3 percent from last year. That performance is normal for today's level of economic activity.

Economic Factoid

How good were the 'good old days' in the U.S.? At the turn of the 20th century, the average wage was 22¢F per hour. Few could afford what we now call essentials. Only 8% of the nation's homes had electricity. That measure is now 99.8%. Less than 10% had telephones. Only 200 miles of paved roads existed for 8,000 cars. Less than 8% of Americans had finished high school; only 2% had attended college. Life expectancy was 47 years for men. It's now 74 and rising. Paying homage to the past is reasonable. Longing for the past is indeed crazy.

Sector Situation Report

Latest news from the wood products industry by sector...

Office Furniture - BIFMA reported that September 2004 orders increased by 3% year over year marking the second month in a row of order growth. Shipments also grew by 6%, the seventh

month of increases. The association's latest forecast shows 2004 shipments up 4.8% followed by an 8.1% rise in 2005.

Kitchen Cabinets - Cabinet sales rose 10.1% in October vs. the same month in 2003 according to the KCMA's Trend of Business Survey. For the first ten months of 2004 cabinet sales were up 18%.

Strong sales of semi-custom cabinets, a category that is difficult to produce overseas and requires flexible manufacturing processes, is driving industry growth.

- **Masco**, the largest U.S. cabinetmaker, reported a 12.5% increase in 3Q2004 cabinet sales at their Merillat, KraftMaid, and Mills Pride brands. Operating margin in the cabinet segment was 17.5%.
- **American Woodmark**, the second largest U.S. cabinetmaker, reported sales growth of 18% for their 2Q2005 with gross margin increasing to 21.4% from 20.4% in the same quarter 2004. Operating margin strengthened to 9.4% from 8.1% last year. In spite of this performance, analysts noted that a slowdown in growth might be on the horizon.

A recent forecast by the Freedonia Group projects that cabinet demand will rise by 6 percent annually through 2008. Drivers of this growth are (i) strong repair and improvement expenditures and (ii) a trend toward more cabinets per residence in kitchens, baths, and other living areas, and (iii) more cabinet use in non-residential construction.

Keep your eyes on the numbers for the cabinet industry. This sector is more critical than ever to machinery builders.

Home Furniture - On November 9 the Department of Commerce reduced six of the nine antidumping tariff rates announced in June. The proposed rate for 115 Chinese bedroom manufacturers, who account for about 65% of bedroom imports from China, dropped from 12.91% to 8.64%. A group of Chinese furniture makers who produce about 5% of bedroom imports were assessed a tariff of 198%. The latter group was found to operate under Chinese government control. Effectively driven out of the bedroom segment, these most-penalized manufacturers are moving to other product categories like home office furniture.

The seven large Chinese producers who were mandatory respondents to the U.S. investigation received rates ranging from zero to 16.7%. Markor, the largest Chinese furniture maker, had its rate lowered to zero while the second largest, Lacquer Craft, saw its rate rise to 6.95%.

The International Trade Commission will have the final say-so on the DOC's tariffs on December 23. Given the low average rate, the ITC may determine that no material injury has occurred to U.S. producers and decide to suspend the case.

As noted in the last Business Briefing, any tariff less than 30% will not level the playing field for U.S. furniture makers. Thus the Furniture Civil War created between importers and U.S. producers by this tariff petition may end up a non-event.

Shipments of Chinese furniture to the U.S. continues. In the first half of 2004 imports of Chinese-made furniture rose by 45% over last year. In fact, with \$4.5 billion of shipments, China

accounted for nearly half of the \$9.2 billion in furniture imports. This year has also seen the emergence of Vietnam as a Top 10 source country.

The result of Chinese competition, however, is evident in the state of the U.S. industry. In its October 29 issue, *Hardwood Review* reported that 225 plant closures and mass layoff events have occurred in the U.S. furniture industry since January 2000. Job losses totaled about 61,000. North Carolina experienced the most closures (71) followed by Mississippi with 24 and California with 23. In our opinion, the shakeout of excess capacity is not over.

Recent closures and sales include:

- Furniture maker **Keller** has sold its 203,000 ft² New Salisbury, IN, plant to Child Craft, a juvenile furniture producer. **Child Craft** is transferring operations to that plant from its 650,000 ft² plant in Salem, IN, which was closed due to flood damage.
- California-based **Michels & Company** announced the closure of its Nichols, SC, plant. That 391,000 ft² plant was purchased from **La-Z-Boy** in 2001. 133 employees are being idled.
- Howard Miller, the largest clockmaker in the Western Hemisphere, has purchased the Ridgeway, VA, plant of furniture maker **Pulaski Furniture** along with the seller's Ridgeway Clock brand. Following the sale Pulaski has two remaining domestic plants.
- La-Z-Boy declined the \$21 million offer for the purchase of its **Pennsylvania House** division. The offer was made by an investment group with the support of the State of Pennsylvania attempting to salvage the company's plants, which will close by year-end, and the jobs of 425 workers. Pennsylvania House is shifting all casegoods to foreign suppliers and other La-Z-Boy plants.

With domestic production on the wane, the American Furniture Manufacturers Association has opened its membership to furniture importers. The new association will go by the name American Home Furnishings Alliance.

Meanwhile results at U.S. producers are mixed...

- **Furniture Brands International** reported 3Q2004 sales flat at \$557.8 million. Operating margin was also the same as last year at 6.2%. Management indicated positive order trends at their higher end Thomasville, Drexel-Heritage, and Henredon divisions. Demand at Broyhill and Lane, medium-price product lines, remains weak.
- **La-Z-Boy** said that net sales rose 4.4% to \$534 million in its 2Q2005. For six months sales totaled \$1 billion, an increase of 3.9% over the same period last year. Operating margins were weaker in both periods due to increased raw material costs and expenses incurred in closing the Pennsylvania House plants. Margins were also strained by the company's transition from a domestic manufacturer to an importer of casegoods.
- **Ethan Allen** reported 1Q2005 sales of \$230 million, up 3.4%. Gross margin declined to 47.9% due to higher raw material and energy costs as well as costs associated with recent plant closures.
- **Bassett Furniture** said 3Q2004 sales were \$78.6 million, down 1% from the prior year. Declining business with JC Penney and independent stores offset sales growth to its 109-store Bassett Furniture Direct retail chain.
- **Hooker Furniture** reported 3Q2004 sales of \$84.3 million, up 12.8%. Net income, hit by

the closing of the Maiden, NC, plant, fell 9.2% to \$3.2 million. For the nine months, sales were \$254 million, up 10.8% with profits up 14.8%. The sales increase was driven by a 24.5% growth in its import division.

- RTA furniture maker **Bush** has emerged from Chapter 11 bankruptcy protection with new financing and a restructured balance sheet. All vendors and unsecured creditors are being paid in full. The Jamestown, NY, company employs 2,600 people in facilities in New York, Pennsylvania, North Carolina, and Florida as well as China, Germany, and Mexico.
- Casegoods maker **Stanley Furniture** reported 3Q2004 sales of \$77.2 million, up 18.3%, and operating income of \$8.8 million, up 36% from the prior year. This quarter was the tenth consecutive quarter of year-over-year sales growth.
- **Chromcraft Revington** reported a 7.3% decline in 3Q2004 sales. For the first nine months of 2004, sales fell by 5.6% with net income declining by 13.9%. As with earlier reports management continued to attribute this weakness to increased foreign competition.
- Ready-to-assemble producer **O'Sullivan Industries** reported a sales decline of 12.3% to \$62.7 million in its 1Q2005. Operating income was 0.4% of sales, down from 5.4% in the prior year. Management attributed this performance to higher particleboard prices and unabsorbed manufacturing overhead.

Wood Flooring - October shipments of strip flooring decreased 8% over the same month in 2003. This performance followed September's 5% decline. For the first ten months of 2004, shipments were up 7% over last year. Beware of a new, downward trend in flooring demand.

Wood Components- Sales of furniture parts drove a 9% growth in U.S. furniture exports in the first half of 2004. The primary markets are Mexico and Canada. The latter has benefited recently from a stronger Canadian dollar.