

## **The Cutting Edge™ August 2004**

### **Business Briefing**

**Capacity Utilization, Capital Investment, and Productivity** By Art Raymond, A.G. Raymond & Co., Inc. [araymond@raymondnet.com](mailto:araymond@raymondnet.com)

Contrary to negative reports on the six o'clock news and in your local newspapers, U.S. manufacturing has managed a stealthy recovery in orders, shipments, and capital investment over the last three quarters. And pricing power has returned in certain sectors. Is this run sufficient enough to embolden managers to invest in their businesses?

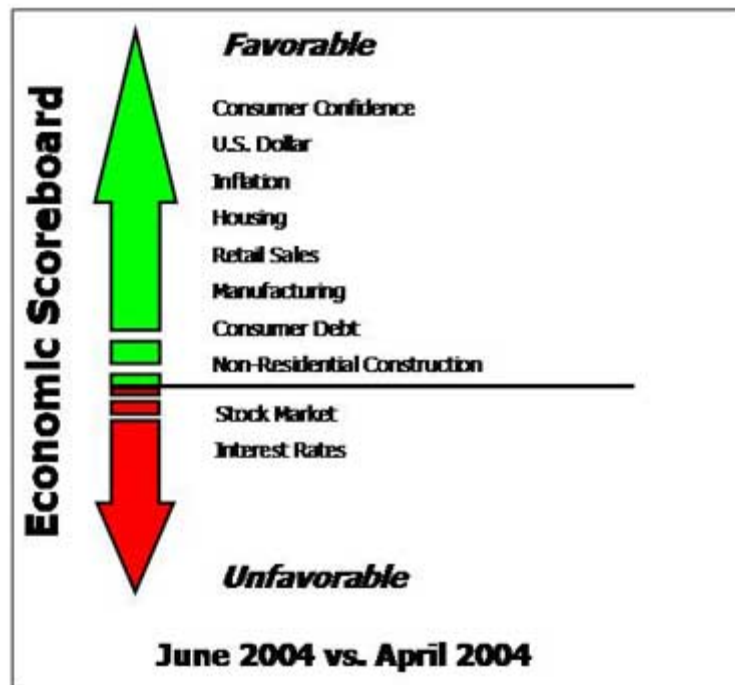
One economic measure that should help answer that question is **capacity utilization**. With this percentage rate, the Federal Reserve Bank estimates how much of the economy's production capacity is in use. Policy makers use this statistic, along with others, to determine the risk of inflation in the economy. If substantial excess capacity exists, the risk of inflation is theoretically low, and vice versa. Many believe that the tipping point for inflation is a capacity utilization rate of around 82% as reported by the Federal Reserve. Recently, the Fed's rate has lingered in the mid-to-high 70's vs. the 82.2% averaged during the 1990's.

In the face of the Fed's evidence of weak capacity utilization, inflation has recently swung upwards. And, as noted above, manufacturers have increased their capital spending. If the Fed's measure is correct, why would smart executives supposedly with excess capacity be adding plant and equipment?

Some economists believe the Fed is overestimating the installed capacity of our economy. U.S. Census data show that about 14,000 manufacturing plants have closed between 1998 and 2001. For 2002-2003, employment data show that about 20,000 more plants were shuttered. Experts also suggest that some of our capacity may not be useful in today's high speed, mass customization economy. These points argue that the denominator in the utilization rate calculation should be reduced.

Through a semi-annual survey of manufacturing companies, the Institute of Supply Management (ISM) reports its own utilization statistic. In April, the ISM's measure was 85.6% vs. 79% a year earlier and above 85% for the first time since mid-2000. Confirming the ISM, the Manufacturers Alliance (MA) reports that plants operating above 85% of their capacity jumped 42.3% from March to June 2004.

The ISM and MA numbers bode well for capital investment in plant and equipment. In particular, the ISM forecasted above-average capital spending in the wood products sector. Anecdotal evidence from that sector's producers and equipment suppliers also suggest a bright future for capital investment as manufacturers retool and expand to meet today's demands for delivery and customization.



Will that investment mean new jobs in manufacturing? The past two growth cycles in 1980-89 and 1991-2001 didn't result in higher manufacturing employment. The reason is higher productivity. Companies are getting more with fewer workers. And that's a good thing.

Productivity is a primary driver of higher living standards. As reported in previous Business Briefing columns, the U.S. economy has historically created new jobs to replace those lost to foreign competition and other reasons. No one wants to get less with more.

Trust the economy. Better yet, read the column found at [www.raymondnet.com/productivityboom.htm](http://www.raymondnet.com/productivityboom.htm) from the May 12 Investors Business Daily by two economists from the Federal Reserve Bank of Dallas. No one tells the productivity story better.

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**Economic Factoid** - In government economic statistics, the Wood Products Industry consists of plant that produce lumber, veneer, panelboard, millwork, and flooring. This sector is operating at 78% of capacity vs. an 80.2% average from 1972-2003. The Furniture Industry, including residential furniture office furniture, and kitchen cabinets, is operating at 69.6% of capacity vs. a 78.9% average from 1972-2003.

### Sector Situation Report

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

**Office Furniture** - Positive growth in May orders and shipments continued signs of a recovery in the contract furniture sector. Orders grew by 11% year-over-year, the second consecutive month of double-digit gains. Backlogs of unfilled orders grew by 14%

although the April-May comparison typically shows a seasonal decline. Shipments increased by 7%, the fourth positive month in a row. According to analysts, growing corporate profitability and industry employment also indicate that this sector has turned the corner after three years during which shipments fell by 37% from \$13.4 billion to \$8.5 billion. In 2002 capacity utilization of wood office furniture plants fell to an astounding 42% from 81% in 1998.

The news from U. S. office furniture makers includes...

- **Steelcase** reported total sales grew by 7.6% in its 1Q2005 supported by a 10.8% gain in the North American market. Gross margin, showing signs of increased operating utilization, increased to 29.3% from 28.1% in the same quarter of its FY2004.
- **Herman Miller** announced a 9.9% gain in its 4Q2004 sales. Gross margin declined to 31.8% from 33.3% largely attributable to higher steel costs.
- **HNI Corporation**, formerly HON, reported a 26.5% increase in its office furniture sales in its 2Q2004. Furniture represents about 75% of HNI's revenues. The majority of its core furniture products are metal. Like Herman Miller, HNI indicated cost pressures from higher steel prices.

**Kitchen Cabinets** - Cabinet sales in June were up a scorching 23.5% vs. the same month in 2003 according to the KCMA's Trend of Business Survey. Year-to-date 2004 cabinet sales were up 18.9%.

- **Masco**, with its well-known cabinet brand names Merillat, Mills Pride, and KraftMaid, raised earnings per share guidance for its 2Q2004 from \$0.50-0.53 to \$0.58-0.60. Management indicated strong business in cabinets as well as builder services.

**Home Furniture** - An important chapter in The Furniture Civil War concluded on June 18 when the U.S. Department of Commerce (DOC) announced preliminary anti-dumping duties on Chinese wood bedroom furniture. The table below shows the range of duties imposed:

#### **Preliminary Duties on Chinese Wood Bedroom Furniture**

<i>Group</i>	<b>No. of Companies</b>	<b>Duties</b>
Mandatory Respondents	7	4.9 to 24.34%
Section A Respondents	82	10.92%
All-China Rate	All others	198.08%

The DOC conducted detailed investigations into the cost structures of the seven mandatory respondents. This group represents about 40% of last year's \$1.16 billion of wood bedroom shipments from China to the U.S.

Section A respondents provided detailed answers to a DOC questionnaire. Members of this group were assessed a duty equal to the weighted average of the mandatory

respondents' rate, if judged not to operate under the control of the Chinese government. This group also represents about 40% of Chinese wood bedroom shipments to the U.S.

The last group, primarily of smaller producers, failed to respond to the DOC's questionnaire. These manufacturers most likely will shift from bedroom production to other furniture categories not carrying the anti-dumping duty.

Note that these duties are preliminary until final determination by the DOC on December 20. Some analysts believe the final rates will be higher. Some U.S. producers indicated that a duty of 30% is required to "level the playing field".

The law of unintended consequences will arise if the lowest rate remains below that 30% level and the large spread remains between the lowest and highest duties. By default, the larger bedroom producers paying lower rates will receive a competitive advantage over the smaller companies penalized with the 198% duty. Plus those larger producers will retain their competitive edge over U.S. manufacturers. The bedroom business will consolidate to the stronger Chinese producers, more of whom will reach the critical mass to sell direct to the U.S. market. Most probably, such a consequence is not what the petitioning U.S. furniture makers had in mind.

At the end of the day, the furniture supply chain will remain in turmoil as the impact of these tariffs is sorted out, business is shifted to other furniture producing countries like Vietnam and Brazil, and the U.S. producers are further dis-intermediated by more retailers buying direct from foreign sources. Until the industry creates demand by becoming customer centric, business will continue to underachieve.

### **In other furniture news...**

Aktrin Research projected that furniture industry employment will continue to decline through 2005. The trend that began in 2000 will see total furniture industry employment fall from 440,300 to 374,000, a decline of 15%.

June retail furniture sales grew by 4.7% year-over-year following a weak month in May and continuing anecdotal news of weak sales from U.S. furniture makers.

In early July Breuners Home Furnishings, a major retailer with 47 stores, filed for Chapter 11 bankruptcy protection. Management attributed its failure to soft business conditions and a high debt burden. This bankruptcy will negatively impact Furniture Brands International, the largest U.S. furniture maker who sold about \$42 million to Breuners in 2003.

### **The news from U.S. furniture makers includes...**

- **Furniture Brands International** reported a 0.7% sales decline in its 2Q2004 with operating profit increasing by 0.6% as the company begins to adjust to the Breuners bankruptcy noted above. Management is projecting flat year-over-year sales for the 3Q.
- An important supplier to **Ethan Allen**, who purchases about 30% of its production

overseas, is on the list of those Chinese producers subject to the 198% tariff. The company is also experiencing some supply disruptions due to the closing of two plants reported in the June Business Briefing as well as softness in demand at retail.

- Casegoods producer **Vaughan-Bassett**, whose CEO John Bassett was the ringleader in the anti-dumping campaign, announced the closing of its Sumter, SC, bedroom plant. This facility employs about 350 workers or 21% of the company's total work force and will cease production in late summer. Sumter's product lines will be shifted to its Galax, VA, and Elkin, NC, plants.
- **Hooker Furniture** announced 2Q2004 sales up 14.2%, the company's 10th consecutive quarter of increased revenues. Operating income rose to \$9.3 million, up 49% year-over-year. The 14th largest U.S. furniture maker generates over half of its sales from imported products carrying the Hooker brand name. Shipments of its domestically produced goods declined by 6% in the quarter. Management is not expecting the duties on Chinese wood bedroom to affect sales or profitability.
- Integrated producer/retailer **Bassett Furniture** reported 2Q2004 sales of \$80 million, up 4.5%, with net income rising 58% over the same period last year. Shipments to its Bassett Furniture Direct (BFD) stores rose by 11% year to date. The BFD network now includes 104 stores with 14 more expected to open in the last half of 2004. Sales to these retailers accounted for 57% of total revenues through the first half of FY2004. Bassett joined the petition requesting duties on Chinese wood bedroom furniture but also imports from producers there.

**Hardwood Lumber** - Industry analysts report a strong market for hardwoods in line with the stronger U.S. economy. In spite of firm prices the mills are keeping the supply of green lumber in balance with demand. Mills should see healthy business for lumber for flooring, kitchen cabinets, moulding/ millwork, pallets, and railroad ties. Export markets are also ahead of 2003 - up 10% in dollar value - with China continuing as a prime customer. Anecdotal evidence from the wood components sector reveals strengthening in its order files.

**Wood Flooring** - June shipments of strip flooring were up 5% over the same month in 2003. For the first six months of 2004 shipments increased by 9%.

**Non-Residential Construction** - News from this important user of wood products is mixed. Manufacturing employment, up by 44,000 jobs this year, has yet to translate into increased construction or renovation of manufacturing facilities. However, experts are forecasting higher demand for renovation of both operating and mothballed plants during the last half of 2004. The 25% growth in restaurants and 13% in general merchandise stores has bolstered commercial construction. Building material retailing is the fastest growing retail sector with a 16% gain year-over-year in June alone. Lowe's and Home Depot have aggressive expansion plans. Spending on education construction has fallen by 8% since mid 2003 in spite of rising enrollment. The majority of this decline comes from lower public K-12 spending. Construction at private schools and colleges, with their higher content of wood products for laboratories and libraries, remains steady. One bright spot is the revival in lodging construction, which has recovered to a two-year high. Hotel occupancy and room rates are up 3-4%. Experts are forecasting a 25-30% jump in lodging construction by the end of 2005.