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Business Briefing

The Good Ride Will End

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It is going to happen. Maybe not this year, but at some point in the future, the housing boom will end. With it will go the engine of growth for the U.S. economy. Nearly 40% of all jobs created in the last two years are attributable to housing. Higher home prices have supported strong consumer spending through cash-out refinancing. Over the past four years, this combination of consumer spending and residential construction has accounted for 90% of GDP growth.

What has driven this so-called housing bubble?

- Low interest rates and loose mortgage underwriting standards have enabled more buyers to qualify for mortgages.
- High price appreciation and beneficial treatment of profit from the sale of a home have shifted investment demand from stocks and bonds.
- Deductibility of mortgage interest has lowered the total cost of ownership.

Home ownership is part of the American dream. A home is the largest asset most of us own, and that asset has been remarkably free of price declines. The average price of a house in the US has not fallen since the Great Depression.

But beware these danger signs:

- 25% of all home buyers in 2004 made no down payment.
- 23% of all houses were bought in 2004 for investment with another 13% purchased as second homes – these investors are more likely to sell than owner-occupiers.
- Sales of new and existing homes have set records for four straight years.
- Prices have appreciated since 2000 at three times the annual average over the prior 32 years.
- The ratio of home prices to rents is 35% above the 1975-2000 average. Rental yields therefore have fallen below current mortgage rates making it difficult for landlords to make money.
- Home prices are rising much faster than other prices. Wages and salaries simply are not keeping up.

Like dot.com stocks in the last equity market boom, real estate values must revert to their mean rate of growth. Tightening liquidity from higher interest rates, or an economic bump from higher oil prices, or the impact of bad weather, could disqualify first-time home buyers. Investors whose rental incomes do not cover costs will lose patience and sell. To achieve market equilibrium, falling demand will necessitate falling supply.

The remodeling boom will also subside. As reported earlier in *Business Briefing*, spending on projects to up fit existing homes has reached record levels in recent years. Many wood products are used in these projects. Among the top ten list, new kitchens, siding replacement, decks, window replacement, and attic bedrooms all need wood resources. The average kitchen remodel costs $15,273 with a large percentage going for new cabinets.

Bottom Line: It is not a question of ***if*** the housing boom ends, it is ***when***. If your company has prospered from the recent housing boom, it is time to think about what happens when fewer cabinets, wood floors, windows, and doors are needed. Like a good Boy Scout, a manager should always plan for future possibilities, like it or not.

Where Goes China?

While you are contemplating your future, do not forget China. As everyone in the wood industry knows – as China goes, so goes our world.

According to the *Financial Times* China's future and its' place in the world economy will unfold in one of four scenarios:

- **Global Economic Partner** – In this scenario, China builds a thriving middle class with huge demands for consumer goods, high tech gear, entertainment, and the like. If so, China not only continues as an exporter, but also becomes a sizable market for U.S. made goods and services – Dell computers, GM cars, Kraft foods, and Proctor & Gamble personal products. Many see recent history in China as confirming this scenario.

- **Global Economic Predator** – What if China becomes a protected market continuing to export but buying little in the way of value-added imports? This model was the driver for success in South Korea during the 90's. Labor costs and exchange rates were controlled while domestic demand was satisfied by domestic production. Experts see this scenario being tempered by inevitable labor unrest as workers demand better incomes and currency devaluations in China's markets causing their exports to become too expensive.

But with China's size, its predator approach over 10 to 20 years would disrupt the economies of the U.S. and other developed countries. Markets for Western goods would not evolve. Chinese producers would move up-market and expand competition in Western markets. Huge domestic markets would enable scale efficiencies and drive costs even lower. China would probably ignore intellectual property rights, trade secrets, and patents. Masses of well-trained engineers and scientists would provide home-grown innovation.

If confronted by this scenario, U.S. companies must (a) share only the intellectual property that it can protect or afford to lose, (b) realize Chinese demand for their products are reduced, (c) consider what U.S. industries can be saved and invest appropriately, and (d) understand that Chinese opportunities are based on management expertise.

- **Slow-Growing Global Participant** – This outcome occurs if bringing their huge population into the world marketplace is more complex that Chinese officials anticipate. This scenario results if access to critical resources and raw materials is limited, an infectious disease pandemic breaks out, or a combination of corruption and environmental decline occurs. In short, this result requires the loss of control by the Chinese government.

- **Frustrated, Unstable Outsider** – This outcome develops if the integration of the Chinese population into the world economy moves slower than expected. In this case, the Chinese government may enforce desperate measures to maintain control ala North Korea albeit much bigger. Such developments in the world's most populous country must be taken seriously. Usually such unrest brings adventures abroad, in this case perhaps a move to annex Taiwan. Recent proclamations that China will employ nuclear weapons if the U.S. interferes with its interest in Taiwan are worrying.

Experts claim that China can avoid such unrest by dumping some of its massive holding of U.S. dollars. That move would, of course, disrupt our economy via a substantial decline in the dollar.

If events in China affect your company, you should prepare. First, list the happenings outlined above that impact your business. Then, consider the risk or probability that such events will occur. Finally, prepare a plan for the higher risk events.

What do you think will happen in China?

Katrina's Impact On The Forest

On September 20th, the U.S. Forest Service estimated that Katrina damaged 19 billion board feet of timber in Mississippi and Alabama. Forty percent of that total is hardwoods. Slightly damaged trees take years to die. A study of past storm damage in South Carolina show that nearly one third of the forest was injured. Based on that information, the Forest Service estimate may understate the loss by 50%.

Salvage operations will recover some of the damaged footage. However, the recovery rate of hardwoods in the South Carolina study was only 18% of the blown-down trees. Softwood timber recovery ran 70% in South Carolina. Remember that sizable softwood stocks are on actively-managed timberland versus the smaller private holdings where hardwoods are found.

Note, too, that fallen softwood loses value faster than hardwoods. For that reason, salvage operations will focus first on recovering valuable Yellow Pine logs. This timing may result in shortages of hardwood logs at sawmills. Since much of the Southern forests are Red Oak, this situation may bring higher prices to that depressed species.

Stay tuned as this situation evolves.

Economic Factoid

The net worth of U.S. households rose for the eleventh consecutive quarter in 2Q2005. The total net worth is $49.8 trillion, up 9.4% from a year earlier. Soaring home prices account for the majority of this gain and offset a 9.9% rise in household debt in 2Q. Within that debt figure, mortgage debt rose by an 11.5% annual rate.

Economists note that the rising wealth will cushion the economy from the negative impact of higher oil costs and offset the zero savings rate. But will the use of wealth for current consumption mean a weaker economic future in the U.S.?

Sector Report

Kitchen Cabinets

Cabinet sales rose 11.1% in August vs. the same month in 2004 according to the KCMA's Trend of Business Survey. For the first eight months of 2005, sales were up 14.0%.

- Medallion Cabinetry announced the development of a new plant in Culver, IN. The 275,000 square feet plant is expected to employ 330 people and utilize state-of-the-industry technology for manufacture of semi-custom cabinets.

Home Furniture

Furniture Markets

The long-awaited Las Vegas Furniture Market opened its doors for its inaugural show in early August. The event reportedly drew 62,000 visitors which compares to about 70,000 at the rival High Point Market. Las Vegas operates in 2.8 million square feet versus 12 million square feet in High Point. Vegas officials project construction of additional space to match High Point's total.

Interestingly, attendance at High Point's September Pre-Market fell significantly. Buyers attending this informal event preview and comment on new product introductions set for the regular October Market. Some cited market fatigue given the timing of pre-market, the new Las Vegas Market, and the Tupelo, MS, show. Many exhibitors, who now import much of their product, no longer have time to tweak their designs in time for the formal market. As a result, large furniture makers such as Lexington Home, Flexsteel, and Klaussner plan to discontinue High Point pre-market. Many others remain non-committal.

With the Las Vegas Market and its many attractions now in the mix, a shake-out in the furniture market calendar and sites is no doubt in the offing. At the end of the day, the buyers will drive this rationalization.

Costs Higher For Foreign Producers

Chinese factories are reporting concern about the higher cost of petroleum products and some raw materials. Managers are bemoaning rises in utilities, finishing materials, metal, and transport. In addition, the costs of Asian woods such as rubberwood have risen by 45% over the last year. This situation bodes well for U.S. hardwood suppliers whose prices have remained relatively stable during that period. One major producer indicated that their use of U.S. lumber would increase by 50%.

Higher utility costs will most likely be accompanied by more frequent brownouts that force factories to cease production. With delivery reliability an increasingly important factor to U.S. buyers, production disruptions will translate into higher inventories.

Higher oil means higher shipping costs. On October 1, an emergency bunker adjustment factor will add $45-50 to the cost of a 40-foot container. This addition comes on the top of the $150 surcharge that occurred in July. Fuel surcharges for inland container transport have also risen by $40-140.

At the company level, results remain mixed…

- Canadian producer **Dorel Industries** will close its Ameriwood ready-to-assemble plant in Wright City, MO. About 300 workers will be idled. Management acknowledged that its recent growth was attributable to Dorel

Asia, its import division. This closure also confirms the maturation of the RTA industry, which was one of the few bright spots in domestic furniture manufacturing over the last 15 years.

- Casegoods producer **Hooker Furniture** is closing its Pleasant Garden, NC, plant. The 300,000 square foot plant employs 280 people, 16% of the company's workforce. Products will be shifted to their Martinsville and Roanoke, VA, operations.

- **Ethan Allen** reported positive sales trends in its 1Q2006 with incoming orders outpacing last year. Analysts noted that this report is not indicative of residential furniture demand across the industry.

The company also announced the conversion of its Dublin, VA, plant to a regional distribution center. The 570,000 square foott manufacturing plant, which was acquired from Pulaski Furniture in 2000, will house distribution operations currently located at its Old Fort, NC, plant. About 250 of the plant's 325 jobs will be lost. Ethan Allen now has eleven plants, five making casegoods, five making upholstery, and one assembling accessories. Combined these operations use about 3.5 million square feet.

- **Furniture Brands International** announced the consolidation of two upholstery plants in High Point, NC. These plants were operated by the HDM division that includes Henredon, Drexel Heritage, and Maitland Smith.

- **Bassett Furniture** reported a 5.3% gain in its 3Q2005 sales with operating profits jumping 67.2%. Leading the improved performance was a 12% rise in shipments to its' Bassett Furniture Direct retail stores. Through its first three quarters sales rose 4.7%, and gross margin increased to 28%. Bassett now operates 127 BFD stores which account for over two-thirds of its total shipments.

The company also announced the closure of its 540,000 square foot Mt. Airy, NC, casegoods plant. About 300 employees will be affected. BFI's plant in Bassett, VA, will assume manufacture of the Mt. Airy products. Management estimates that the closure will save $4-5 million annually in labor and overhead costs.

- **Lexington Home Brands** of Lexington, NC, is closing its Plant 2. This shutdown will leave the company with only two plants and will idle 360 workers.

- **La-Z-Boy** announced the closing of its only Canadian upholstery plant, a 400,000 square foot facility in Waterloo, Ontario. The shutdown will result in the loss of 413 jobs. Products will be shifted to plants in Neosho, MO, and Dayton, TN.

A tornado spawned by Hurricane Rita damaged the company's Newton, MS, plant. This operation employs 200 workers and produces wood parts for upholstered furniture. No injuries were reported. Management is assessing the damage and possible repair plans.

Office Furniture

BIFMA reported that August orders increased by 16% and shipments grew 7% versus the same month in 2004. Analysts indicate that this performance shows the industry remains in the recovery mode. On a trailing twelve-month basis, orders grew 9.4% to about $9.7 billion. Likewise, shipments jumped by just over 10%. At $9.66 billion, annual shipments are now about 14% higher than the market bottom of $8.47 billion in November 2003. As orders have outpaced shipments, industry backlog has grown. Analysts commented that the industry's prospects are underpinned by solid commercial construction activity (see below), improving employment, and declining office vacancy rates.

Producer level reports are also positive…

- **Steelcase** reported an 8% increase in its 2Q2006 sales year over year. Gross margin, benefiting from the higher volume, expanded to 31.6%, up from 30.2% last year. Operating profit rose to 5%. Analysts are predicting continued strong sales growth in the 3Q.

- **Herman Miller** announced that 1Q2006 sales grew by 20.6% year over year. Orders increased by 28.9%. Gross margin rose to 32.9%. Accompanied by a decline in SG&A expenses, operation profit jumped 9.1%.

Wood Flooring

July 2005 shipments of strip flooring fell 4.8% from June but rose by 5.5% over July 2004. For the first seven months of 2005, shipments are down 1%.

Non-Residential Construction

The pace of activity in this important sector is looking up. Spending for office construction, flat over the last 16 months, is projected to rise by 30% over the period through 2006. Construction of manufacturing plants jumped 25% in the last half of 2004 and has remained at that level through the first half of 2005. With factory capacity utilization now over 80%, experts project spending on new plants to increase another 20% by the end of 2006. Three industries have accounted for most of this spending: electronics, transportation equipment, and food/beverage.