

The Cutting Edge™ February 2005

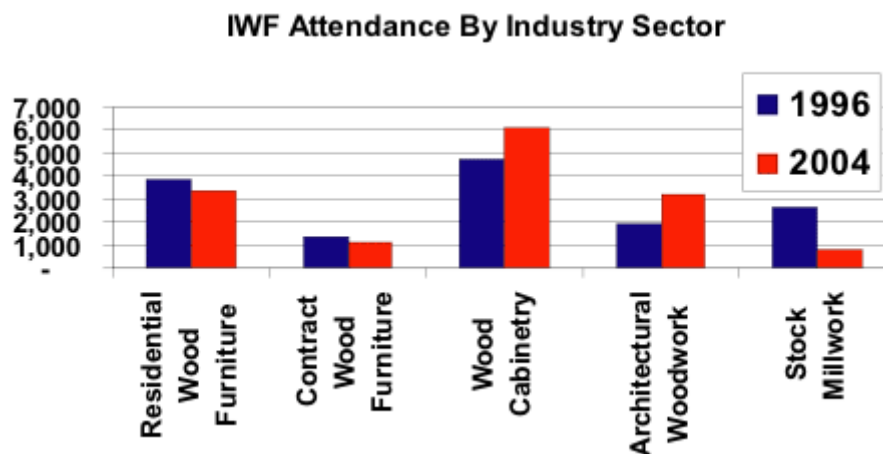
Business Briefing

Changing Woodworking Industry Demographics

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A glimpse at attendance data from the 2004 IWF provides anecdotal evidence of changing woodworking industry demographics.

The adjacent chart compares 1996 and 2004 IWF attendance by major industry sector.



As expected, residential wood furniture, impacted by numerous plant closings, sent 12% fewer people to the Fair. Over 13% fewer members of the contract wood furniture sector attended as that industry continues the severe hangover from the 2000-01 economic downturn. Attendance rose by 28% and 67% respectively in the cabinet and architectural woodwork sectors. Both continue to defend their markets from foreign competition. Recent investments in mass customization and speed to market have profited both cabinetmakers and architectural woodworkers. Cabinet companies have also benefited from healthy home building and remodeling demand (see story below).

Apparently more, smaller firms now populate the woodworking industry. Companies with less than 20 employees sent 48% of all attendees vs. 43% in 1996. Firms with sales revenues less than \$5 million accounted for 60% of total attendance last year vs. 57% in 1996.

The market for woodworking machinery follows these demographics. To grow your machinery sales, you must develop equipment that is affordable by smaller companies and designed to manufacture customized products efficiently.

Remodeling Set To Maintain Growth

Remodeling expenditures by home and rental property owners totaled \$233 billion in 2003, accounting for 40% of all residential construction spending and more than 2% of the U.S. economy. Last year's performance continued a decade-long boom in such spending. Along with

new home construction, remodeling has supported much of the activity in the U.S. secondary wood products industry. Indeed, with the steep decline in capital spending and raw materials purchases by the furniture industry, one can make a case that remodeling has prevented a total collapse in the wood products industry.

What does the future hold for this important driver of wood products demand? A recent study released by Harvard's Joint Center for Housing Studies provides insight into this sector's past and future.

The inventory of homes in the U.S. totals nearly 120 million. We add about 1.4 million new houses each year. The average age of these homes is 32 years. The need for repair and maintenance plus the incentive of rising home prices have motivated owners to invest in their homes' value. Over the past decade owners of over 30 million homes have made improvements worth over 10% of their homes' value.

About 20% of this spending goes for repairs and maintenance. Of the remaining dollars, about 45% were spent on interior space changes like kitchen remodels and 28% for exterior and interior replacement of floors, walls, and the like. Of the \$138 million spent on remodels and additions in 2003, about \$24 million were kitchens and baths. Kitchen and bath remodeling projects over \$5,000 in value grew from 750,000 in 1995 to 1.3 million in 2003. That's a lot of cabinets and vanities.

The drivers of future growth in this sector are numerous. Beyond the aging housing stock, the keys are:

1. The shrinkage of developable land - Less land for new housing will push owners to stay put and remodel their older homes.
2. Increasing household formation - Experts predict the number of households to grow by 12 million through 2015. That's a 10% faster growth rate than during the 90's.
3. Higher spending by Gen X'ers - The post Boomers are spending at a higher rate than their predecessors.

Threats to future growth are obvious:

- Higher interest rates - Tighter money will mean less credit for remodeling projects.
- Slower gains in home values - Consumers used cash-out mortgage refinancing based on highly appreciated house prices to finance many remodel projects.

Despite these potential obstacles Harvard is predicting continued 3% annual growth in remodeling over the next decade. This strength will be increasingly important as new home starts soften in 2005.

You can retrieve the full Harvard study at www.jchs.harvard.edu

2005 CFO Outlook

Bank of America's seventh annual survey of chief financial officers at U.S. manufacturing companies revealed some key predictions for 2005:

- 77% of CFO's believe the national economy will expand in 2005.
- 81% predict revenue growth at their companies.
- 41% expect to increase capital expenditures, up from 32% in 2004 - Only 19% are planning to spend less.
- The cost of materials, supplies, and equipment is their no. 1 concern followed by rising energy costs.
- 53% expect higher labor costs.
- 62% predict a rising cost of capital.

Economic Factoid

The newspapers and airwaves are full of bad news about the U.S. budget deficit. Yes, the shortfall is \$300 billion, serious money in anyone's book. But taken as percentage of the \$12 trillion U.S. gross domestic product, the deficit is small. Last year, the deficit percentage was about 3.8%. Since the mid-60's, this measure has been higher in ten years. In 1983 the deficit measure was 6% and remained near 5% in 1984-86. During that period, President Reagan cut taxes while waging the war against communism. The percentage fell to the 4-5% range during the early 90's. Once the economy started its eight-year run-up in the later 90's, the measure fell dramatically. A booming GDP caused this fall, not lower government spending. That same scenario - a rising economy resulting in higher tax revenues - is predicted for the remainder of this decade. The bottom line - big deficits in the past have not proved a hindrance to a healthy economy. Keep the faith.

Sector Situation Report

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

- Office Furniture - BIFMA reported that December 2004 orders increased by 17% year over year marking the second month in a row of double-digit order growth. Twelve-month industry orders totaled \$9.1 billion, the first time that measure has been above \$9 billion since July 2002. Shipments grew by 11%, the eleventh consecutive month of increases. The association's latest forecast calls for shipment growth of 8.1% for 2005.

Steelcase reported 3Q2005 sales up by 9.7% year-on-year with growth from North America up 9.6%. Margins continue to be hurt by higher raw material costs and costs incurred by plant consolidations.

Herman Miller's 2Q2005 revenues advanced 11.5% to \$368 million with much of the growth coming from international shipments. Gross margin rose to 32.6% despite raw material cost inflation. SG&A expenses increased to 25.7% leaving a 6.8% operating margin.

- Kitchen Cabinets - Cabinet sales rose 16% in December vs. the same month in 2003 according to the KCMA's Trend of Business Survey. For the full year cabinet sales were up 16.8% vs. 13.9% in 2003 and 13.2% in 2002. Quite a solid three-year run.

Predictions of fewer housing starts in 2005 bode badly for the cabinet sector. Companies have expanded capacity as if the boom of the early 2000's would continue forever. Certainly the inability to fill that new capacity will mean slower machinery sales to this important

sector. Pressure too is coming from foreign competitors. The industry is already using significant volumes of imported components such as finished doors and drawer fronts.

Continue watching the numbers for the cabinet industry. Look for softer cabinet demand in the last half of 2005.

- Home Furniture - The Furniture Civil War over dumping of Chinese wood bedroom products has ended. Final tariffs levied by the Department of Commerce range from just above zero to 198% with most falling at less than 6%. At the end of the day, the tariffs will not save a single U.S. furniture manufacturing job. The big winners in this unfortunate event were the attorneys who earned about \$4 million in fees from each side. Consumers will not suffer from higher prices as importers absorb the tariff cost. Encouraged by the low trade barriers, entrepreneurs in low cost labor countries like Vietnam are also planning large investments in furniture manufacturing capacity. These increases will add to the overcapacity that exists in this industry.

One example is a new plant announcement by Yihua Timber Industries, a Chinese company whose marketing partner is casegoods importer New Classic Home Furnishings of Rancho Cucamonga, CA. The Guangdong, China plant, to be completed in early 2007, totals 3.6 million ft² and will employ 20,000 workers! Valuing that capacity at \$80 per ft², that plant should produce nearly \$300 million of furniture annually.

Overcapacity, of course, shows up in lower prices. In 2003 the industry sold 8.2% more furniture units than in 2000. However, those extra units only generated 2.8% more dollars. This deflationary spiral will end only when capacity is in balance with demand.

Shipments of Chinese bedroom furniture to the U.S. did slow last year. In the first ten months of 2004 imports of wood bedroom rose by only 10.7%, substantially slower than the 148% growth from 2001 through 2003. Don't look for this decline to become a trend.

Vietnam has moved into the top ten of source countries for U.S. furniture imports. Shipments for the first half of 2004 totaled \$130 million, up 93% from the same period of 2003.

A recent Wall Street Journal article highlighted the "customize-me movement" among furniture consumers. Many small furniture producers are adopting customization, long a strategy of cabinetmakers, to stave off foreign competition. Hickory Chair, a 93-year old producer, has seen sales increase by 25% since offering custom finishes. Effective ways to compete with imports do exist for those willing to change and take a risk.

Those U.S. furniture companies that market imported furniture continue to grow while more domestic operations are shuttered.

- Hooker Furniture reported FY2004 sales of \$346 million, up 12%. Net income of \$18.2 million was up 24%. A 24.7% growth in its import division drove this revenue gain. Sales of domestically produced furniture declined by 11.3% and now accounts for only 30% of company revenues.
 - Furniture Brands International reported 4Q2004 sales fell by 5.4%. Operating margin

- rose slightly to 6.8% largely due to an improved gross margin of 26.1%. Management indicated that weak demand would continue into 1Q2005.
- Producer/retailer Ethan Allen reported 2Q2005 sales of \$245 million, up 1.7%. Gross margin rose to 48.7% in spite of higher raw material costs. Operating margin fell to 15% due to increased advertising spending.
 - Bassett Furniture said FY2004 sales were \$316 million, down 3% from the prior year. Their BFD retail store program now totals 116 stores with expectations to open 20 to 25 in 2005. BFD sales grew by \$20 million to offset lower shipments to JC Penney and small independent stores. Net income rose to \$8.2 million vs. a loss of \$0.5 million last year. Operating income was impacted by the closure of the Macon, GA, plant. Management believes that domestic capacity is now aligned with demand.
 - Ready-to-assemble producer O'Sullivan Industries reported a sales increase of 1.5% to \$66.2 million in its 2Q2005. The quarter, however, resulted in a \$3.2 million operating loss. Management continues to attribute its poor performance to higher particleboard prices and unabsorbed manufacturing overhead.
 - Furniture maker Keller, who had closed the last of its three U.S. plants in 2004 to become an import-only operation, has now sold its remaining furniture assets. Included in this sale were its customer list, inventory, web site, product designs, and High Point showroom. Management plans to "move into a new line of work" outside the furniture industry.
 - Contract furniture maker Kimball International has discontinued operations of its Kimball Home residential furniture unit. Management cited the challenges of the retail furnishings market and long-term profitability issues as reasons for the exit. The bankruptcy of its major customer, Breuners, also was a contributing factor.
 - Upholstery producer Dunmore Furniture of Hickory, NC, has also ceased operations. The major factor was the bankruptcy of retailer Heilig-Meyers, an event that left Dunmore with substantial debt. The closure came in spite of recent sales growth and resulted in the shuttering of 375,000 ft² of plants and lay-off of 150 workers. In general upholstery has not suffered from foreign competition to the same extent as wood furniture. However the overhang of the upheavals in the retail end of the business in the last five years has affected the soft goods sector.
- Wood Flooring - December 2004 shipments of strip flooring increased 5% over the same month in 2003. For the full year, shipments were up 6% over 2003. NOFMA reports that flooring prices declined during most of 2004. Anecdotal evidence from the market shows slower demand and rising inventories. Mills are refusing receipt of dry lumber. Capacity and supply have increased faster than demand as imports flood the U.S. market and consumers substitute engineered flooring for solid strip flooring. The volume of solid wood flooring imports rose by 75% in the first ten months of 2004.
 - Hardwood Lumber - Hardwood Review has predicted a modest increase in hardwood lumber demand in 2005. Unfortunately imports from Eastern Europe and Russia will take up much of the increase. The result - production at U.S. mills will be flat with 2004 at about 11.35 billion board feet.