

The Cutting Edge™ April 2005

Business Briefing

What's Happening in the Secondary Wood Products Industry?

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This month, Business Briefing expands its usual sector situation report to headline status. Our purpose is to recap recent history and forecast the near future for the important secondary wood products sectors that comprise your largest customer base.

Hardwood Sawmills

Sawmilling is truly a business where supply and demand set prices. In 2004 mills produced 11.35 billion board feet of lumber, about 1 billion more than in 2003. Prices by year end were, voila, off their highs set earlier in the year. Driven by the continuing housing boom, mill customers in the cabinet and flooring sectors increased lumber purchases.

Hardwood Consumption

Industry Sector	Hardwood Usage (Billion Board Feet)		% Increase
	2003	2004	
Kitchen Cabinets	0.64	0.78	22
Dimension/Millwork	0.67	0.70	5
Flooring	0.85	0.89	5
Furniture	1.56	1.40	-10

Buoyant markets for low-grade lumber from the center of the log are critical to mill profitability:

Pallets - Cutting over 3 billion board feet, the pallet industry is the biggest hardwood user. The industry is operating at 90% of capacity. With the economy continuing to grow, pallet mills are set to grow at a near 4% rate in 2005.

Furniture Frames - Upholstery frames built from U.S. hardwoods are in decline. The transition to plywood frames and the impact of imports are the primary culprits.

Railroad Ties - At 880 million board feet, 2004 saw the highest hardwood consumption since 1998. With railroads adding and upgrading track, tie demand will remain strong this year.

Specie winners included Hard Maple, which reached record price levels, as well as Cherry. The

big loser was Red Oak as demand from flooring mills and cabinet plants dropped severely. Oak, our most prevalent hardwood, is no longer the consumers' favorite.

Exports were up 10% with the focus on Asia rather than Europe. The fastest growing market was Vietnam, and China retained second place in the destinations ranking. The Asian markets will continue strong in 2005. Lower demand will come from Germany, the UK, France, and the Benelux countries as Eastern European lumber enters these markets.

Hardwood imports rose by nearly 16% last year with Canada the largest supplier. In total 86 countries shipped hardwood lumber to the U.S. With abundant supplies available from U.S. mills, import penetration may flatten in 2005.

In the end, experts are predicting a solid 2005 for hardwoods with growth of about 3%.

Kitchen Cabinets

With continued strong demand from new home starts and remodeling, cabinet sales in the U.S. reached nearly \$14 billion in 2004. Last year's growth of 16.8% extends the trend of double-digit sales increases to three years. In fact, since 2000 cabinet volume has expanded by an amazing 61%.

With this performance the cabinet industry has replaced wood furniture as a major consumer of lumber, panelboard, coatings, and machinery. Cabinetmakers purchased about 780 million board feet of North American hardwood lumber directly. Another 600 million board feet was purchased in the form of components like doors, drawer fronts, and mouldings.

This sector's preference for light-colored woods like Hard Maple and Cherry has pushed prices of those species to record highs. Red Oak, long a staple of the cabinet industry, has fallen out of favor with cabinet buyers.

Other noteworthy cabinet statistics include:

- About 91 million kitchen cabinets plus nearly 9 million bathroom vanities will be installed in 2005.
- Remodeling accounts for 75% of all kitchen installation - Rapid appreciation of home values has turned residential real estate into the investment of choice for most of America.
- Spending on kitchen remodeling has increased by nearly 100% in the past five years.

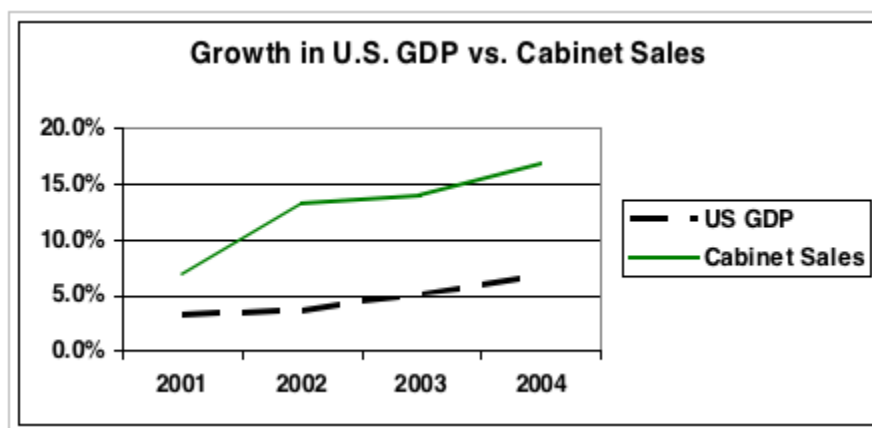
To date cabinetmakers have avoided the import tidal wave that continues to hammer the U.S. furniture industry. Imported cabinets accounted for less than 5% of domestic consumption. Of that amount Canadian producers supplied about 75%. Many major cabinet companies have, however, extended their sourcing programs for materials and components like drawer sides and doors to China and elsewhere. Imports of wood furniture parts, the statistical category that includes cabinet components, have expanded by nearly 19% since 2002.

Managing that lengthy supply chain has proved challenging. Some cabinetmakers are retreating to domestic suppliers as quality and delivery issues prove difficult to overcome.

Experts are predicting another banner year in 2005 with cabinet volume up by 12-15%. Cabinet sales rose 12.8% in February vs. the same month in 2004 according to the KCMA's Trend

of Business Survey. For the first two months of 2005 sales were also up 12.8%.

With the U.S. economy averaging 4.5% growth since 2000, can the industry sustain their recent double-digit advances? Many players in our industry have a vested interest in their success. Stay tuned.



Down at the company level...

Masco reported a 12% increase in cabinet sales in their 4Q2004. Operating profit was 18.2%, up from 16.6% in the same period last year. Installation services also showed strong growth with an 11.8% rise in sales.

KraftMaid, one of the **Masco** cabinet companies, is planning a \$106 million, 700,000 ft² plant in West Jordan, Utah, near Salt Lake City. At full capacity the plant will employ 1,300 workers and produce 6,000 cabinets per day.

Yorktowne Cabinetry, an Elkay Company, is expanding its operations through a \$19 million, 356,000 ft² assembly and finishing plant in Danville, VA.

American Woodmark reported disappointing 3Q2005 earnings in spite of a 12.4% increase in sales. Gross margin fell to 18.8% from 20.8% in the same quarter last year due to manufacturing inefficiencies. The company is developing a new assembly plant in Allegany County, Maryland.

Home Furniture

Our readers are all too aware of the cataclysm that has befallen the wood home furniture industry in the U.S. American consumers continue to buy furniture. Last year retail furniture spending rose 8%. But the sources of these products are foreign, not domestic.

As a result, 2004 saw 60 more furniture plants close or suffer mass layoffs. More than 14,000 workers were laid off. The list of companies affected included **Thomasville**, **Pennsylvania House** (a La-Z-Boy company), **Ethan Allen**, **Bassett**, and **Hooker**.

On the bright side, the remaining plants produced 4.2% more wood furniture in the first three

quarters. If that pace continued through year-end, 2004 would be the first positive year of domestic production since 2000.

As shown in the Hardwood Consumption table above, a declining furniture industry also adversely impacts its supply chain. The usage of hardwoods as well as panelboard, veneer, coatings, and corrugated containers also fell. The Hardwood Review forecasts hardwood usage by furniture makers to fall another 2.9% in 2005.

With the tariff issue behind us, some experts are predicting a new wave of closures as plants that were saved by the prospect of a high tariff are finally shuttered. Recent shutdowns and layoffs include:

Broyhill Furniture is closing its Conover, NC, assembly and finishing plant that employed 106 people.

Bernhardt is shifting all wood casegoods production offshore with the closure of its 350,000 ft² Plant 2 in Lenoir, NC. The plant will be converted into a warehouse. About 200 employees will lose their jobs.

Lexington Furniture is eliminating dimension production at its Plant 4 with a loss of 25 jobs and a downsizing at its Plant 5 affecting 70 workers.

Canadian producer **Shermag** announced the closing of its bedroom plant in Cotsdown, Quebec, with 84 jobs.

Other companies, particularly in upholstery, are fighting the closure trend. **Mitchell Gold** has purchased the former Bassett Furniture plant in Hiddenite, NC, to support continued sales growth. The company sells to specialist retailers like Pottery Barn, Crate & Barrel, and Storehouse. **BenchCraft** has expanded its production capacity by relocating warehousing operations to a leased 105,000 ft² facility in Ripley, MS.

Private investors acquired **WoodMarc**, a subsidiary of Berkshire Hathaway's Nebraska Furniture Mart. The 260,000 ft² plant, located in Winterset, IA, augments its domestic production with imported products to provide a broad range of entertainment and bedroom furniture.

Financial results at the company level...

Bassett Furniture reported a 5% increase in 1Q2005 sales fueled by a 22% gain in shipments to their BFD retail stores. Management stated that BFD growth is now outpacing attrition in sales to other, independent distribution channels. The BFD operation now includes 120 stores with another 20-25 planned for 2005.

La-Z-Boy announced a 5.3% increase in 3Q2005 sales with revenues through nine months growing by 4.4%. Increases in raw material costs caused operating profits to fall to 3.9% from 5.3% a year earlier.

Analysts report sales at **Furniture Brands International** "spotty" for its 1Q2005 citing weak demand across its middle- and upper-priced product lines. Like Bassett

the company is focusing its distribution on single-branded stores that exclusively feature FBI products. FBI has gone from 137 such stores in 2000 to a planned 407 by year end.

Casegoods producer **Stanley Furniture** reported 4Q2004 sales of \$83.3 million, up 12.4% over the same period last year. Gross margin also rose to 24.9% resulting in an operating margin of 11.3%.

Chromcraft announced a 27.7% jump in profits in its 4Q2004. Full-year results showed a sales decline of 6.4% with a 15.5% gain in operating income.

Office Furniture

BIFMA reported that January orders increased by 8% year over year marking the sixth month in a row of year-over-year growth. Shipments grew too, up 17%, the second consecutive month of double-digit increases.

This report is good news for an industry sector that suffered a breathtaking decline in sales three years ago following the boom times of the 1990's. From a rate of over \$13 billion in late 2001, shipments fell to nearly \$8.5 billion in mid-2003. Shipments are just now exceeding the rate first achieved in early 1995. Since 1999 the big three office furniture makers - Steelcase, Haworth, and Herman Miller - have shuttered 16 plants. Industry-wide layoffs totaled 13,000 workers.

Analysts are cautiously projecting the industry's return to more normal times when shipments grew in step with U.S. gross domestic product.

Company results are, however, mixed...

Steelcase announced a major restructuring plan to remove excess production capacity. Headcount is being reduced by 600, and 2.6 million ft² of manufacturing space is being eliminated.

Herman Miller's 3Q2005 revenues advanced 16% to \$382 million fueled by strong international sales. Gross margin rose to 32.1% despite higher material costs. SG&A expenses decreased to 24.5% leaving a solid 7.6% operating margin.

Overall, BIFMA, the industry trade association, is predicting 9.2% growth in 2005.

Wood Flooring

January 2005 shipments of strip flooring declined 4% over the same month in 2004.

This performance followed significant weakness in pricing and a leveling in sales over the last seven months of 2004. And while experts believe total U.S. hardwood flooring sales grew in 2004, much of that growth was in domestically produced engineered products as well as imported flooring.

Indeed *Hardwood Review* calls the significant growth of flooring imports the biggest hardwood industry story in 2004. Government data show that imports of solid strip and engineered flooring rose by 37% last year. But misclassification of trade data may under represent that number. Suffice it to say that imports of wood flooring are quickly gaining speed, and foreign producers are pushing for U.S. market share.

Strong consumer demand will not absorb the volume of flooring made available by importers and domestic producers who expanded their own capacities. Larger supply often means lower prices. Falling Red Oak prices, down 75% over the last 14 months, have enabled domestic producers to improve margins. However, experts predict lower prices will not bring increased sales of domestic Oak flooring. More exotic offerings like Brazilian Cherry and Mahogany are catching the consumers' eye. The import tidal wave of flooring, like that in wood furniture, will continue...

Moulding & Millwork

Cabinets were not the only wood product benefiting from record-setting home construction in 2004. Moulding and millwork producers, especially those selling into high-end residential markets, experienced good business.

While housing starts were up 7.5% and remodeling expenditures grew by 7.8%, non-residential construction lagged with only 0.6% growth in 2004.

Inevitably, as with most other wood products, imports have taken market share. For example, from 2000 to 2004 hardwood moulding imports rose 30.3%. About two-thirds came from Southeast Asia with China shipping about 43.5% of all moulding imports. Chile is now the second largest source of hardwood mouldings.

As a result, hardwood usage by domestic producers in this sector has declined about 19% since 2000. Like the cabinet industry, Maple has taken share from the Oaks in moulding and millwork products. In addition MDF and finger-jointed mouldings for paint grade and veneer-wrapped MDF have increased in acceptance and popularity.

Experts are predicting stronger non-residential construction in 2005. While homebuilding may decline slightly, demand for this sector's products should improve. In the end the story here will be the same - competition from every country that has a tree will put pressure on prices. To survive domestic producers must find niche markets, offer more customized products, and mind their costs.

Economic Factoid

Newsflash!! The U.S. household savings rate is growing, not falling. For years many economists have read disaster in a savings rate barely above zero. The savings statistic, it seems, simply subtracts consumption from disposable personal income and calls the difference 'savings'. By this logic 'savings' in 2004 were 1.1% of disposable personal income. What about appreciation in assets like stocks and real estate? And what about spending on purchases with long lives like education that is really a capital investment? Neither appreciation nor capital investment is counted as a positive. In fact the current measuring logic turns a reduction in education spending into an increase in savings! If appreciation in homes and equities was counted in 2004, the true savings rate jumps to 46% of disposable income. Those pessimists calling for the consumer to run out of cash might have a long wait.