

The Cutting Edge™ August 2005

Business Briefing

The Chinese Revalue

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On 1 January 1994 the Chinese devalued the yuan by 33% and pegged its currency to the U.S. dollar in a so-called "controlled floating rate system". Since then Chinese exports of furniture to the U.S. grew from \$500 million to \$8.6 billion annually, hundreds of U.S. furniture plants were shuttered, and over 60,000 workers were idled.

On 21 July 2005 China revalued the yuan by 2.1% against the dollar and announced that its value would float in a 0.3% band against a basket of currencies.

As the Chinese move toward a truly floating yuan, these changes could ripple through the world economy. While many experts predict higher interest rates in the U.S., the net effect on the U.S. economy remains to be seen.

Other Asian countries may now allow their currency to appreciate. Most Far Eastern central banks have kept their currencies weak to stimulate exports. Such actions may also contribute to upward pressure on U.S. interest rates.

Putting this first revaluation in perspective...

1. The revaluation was cosmetic - politically motivated rather than economically driven. Although how much the yuan can float in the new "controlled floating system" is a mystery, the effect on trade will be minimal.
2. The move is bearish for U.S. debt as currency manipulating intervention by the Peoples Bank of China will be reduced ie, fewer Treasuries will be purchased.
3. The change is modestly bullish for U.S. companies who export to China such as Caterpillar and bearish for those like Wal-Mart that import Chinese goods.
4. The stronger yuan is bullish for commodities like oil that are now 3% cheaper for Chinese buyers.

Two larger questions remain:

1. How and where will the yuan go from here? The recent move doesn't come close to the 40% increase in value that many so-called experts believe is warranted.
2. Has this small move appeased the protectionist Washington cabal bent on pressuring the Chinese to "level the playing field"?

Stay tuned to this important story.

Chinese Bid for UNOCAL - A Threat to America?

Like it or not, the Chinese government is a huge investor in our good ol' U.S.A. At last count, China owned about \$500 billion of U.S. Treasury debt that is helping finance the operations of the

U.S. government and make up for the measly savings rate here. So why has the bid by CNOOC, the Chinese state petroleum company, to buy Unocal, a U.S. owned oil company, unleashed a wave of Sinophobia?

Let's look at some facts and a few opinions...

1. CNOOC has bid \$18.5 billion in cash for Unocal - Unocal has agreed to a \$16.5 billion buyout by U.S. based Chevron in cash and stock.
2. Seventy percent of Unocal's proven oil and gas reserves are in Asia and the Caspian Sea region - In the event of war, how would the U.S. maintain access to these resources?
3. Unocal's oil and gas output in the U.S. represents less than 1% of total consumption - Are these resources really of strategic consequence?
4. If successful in the acquisition, CNOOC has promised to spin off some of Unocal's U.S. assets.
5. The Chinese government has never intervened in deals between CNOOC and Chevron - Chevron owns oil distribution and service stations in China. No one raises an eyebrow when Exxon buys drilling rights in Russia or U.S. airlines, who received cash handouts from the U.S. government after 9/11, buy planes from Airbus, owned by the British and French governments.
6. China is smartly shifting its cash from low-yielding U.S. Treasuries to physical assets whose returns are higher - This strategy is a direct result of low U.S. interest rates, an important component in the recent strength in our housing market and, indeed, our entire economy.
7. A stronger yuan will, most probably, encourage acquisitions of U.S. firms by Chinese companies - Those in the protectionist camp should always be careful what you wish for.
8. Similar fears of foreign ownership were raised during the Japanese tidal wave of the 1980's - Were the direct investments by Toyota and the like a bad thing for America?

In the end, we must realize that the free and open economy we espouse in the U.S. is a two-way street. More importantly, it is no one's right other than the shareholders of Unocal to decide who buys their company - their private property. What if a foreign firm bids to purchase your company? Shouldn't you be free to sell to the highest bidder?

Kudos, then, to Congressmen Baird, Dicks, Inslec, Larsen, McDermott, and Smith of Washington; Davis and Moran of Virginia; Blumenaur of Oregon; Kirk of Illinois; Lungren of California; Paul of Texas; Shays, Stark, and Thomas of Connecticut for voting against the legislation recently passed by the House of Representatives opposing CNOOC's take-over bid for Unocal and voting for our property rights.

The CNOOC bid was not the only takeover attempted by a Chinese company. Haier, a Chinese appliance manufacturer with plants in the U.S., recently bid \$16 a share to purchase Maytag. Their bid was higher than the initial offer by a private equity firm but less than the successful \$17 a share offer from Whirlpool. While Haier was unsuccessful, its participation in the bidding process resulted in a higher price for Maytag's owners. Allowing Chinese companies to purchase U.S. assets will increase returns to shareholders. That's a good thing.

Chinese firms are also rescuing distressed U.S. companies. Like many U.S. manufacturers, Huffy, the 113 year-old bicycle company, moved all of its production to independent suppliers in China.

Sales totaled nearly five million bikes a year. Three years ago the company made a strategic acquisition that turned sour and forced the firm to file for bankruptcy protection. When the company ran out of cash, its Chinese suppliers stepped in with a turnaround plan to save Huffy. While risky for the Chinese owners, it's a good thing for Huffy's employees.

Economic Factoid

Hispanics are the largest and fastest growing demographic in the U.S. By 2007 this group will have a projected buying power of \$1 trillion. Hispanics will buy three out of every five new homes sold in the U.S. More than half of this group will own homes within the next five years and spend more than \$4 billion on furniture in 2005. More importantly, one out of every six persons in the U.S. will be of Hispanic origin by 2009. The Hispanic market represents a huge source of revenues for many wood products.

Sector Report

Kitchen Cabinets

Cabinet sales rose 16.8% in June vs. the same month in 2004 according to the KCMA's Trend of Business Survey. For the first half of 2005 sales were up 14.9%.

Masco reported 2Q2005 sales of \$3.35 billion including \$900 million in revenues from cabinet brand names KraftMaid, Merillat, and Mills Pride. With their cabinet sales up 13% from the same period in 2004, operating margin rose 5.1% to \$144 million.

Home Furniture

While factory shipments grew by 5.5% in 2004, profit margins remained near 2003 levels. According to accounting firm BDO Seidman, industry gross margins rose from 21.47% from 20.9% in 2003. Operating profit declined slightly to 5.26% from 5.29% in the prior year.

Case good producers saw their gross margins climb from 21.19% in 2003 to 22.69% last year. Operating profits also climbed to 6.39%, up from 5.25%. As expected with higher imports of both components and finished products, material costs rose as a percent of sales while labor fell. Overhead as a percent of sales also declined as higher volume led to increased plant utilization.

Upholstery makers pushed their gross margins up slightly to 20.65% from 20.45% in 2003. Their operating profits fell from 5.39% to 4.56%.

BDO also noted an anecdotal finding that many companies believe profit margins have improved on imported products. In a recent interview, Senior Vice President Lynn Chipperfield of Furniture Brands International indicated that their profit margins on imports are about three to five % higher than equivalent domestic products. Yet FBI's earnings per share have fallen from \$2.11 in 2002 to \$1.66 in 2004. That these "improved margins" have not found their way to the P&L statement remains a mystery.

In the meantime, furniture imports jumped 15% in 2004, up from an 11% rise in 2003. China continued its 30%+ annual growth rate by rising 31% to \$8.7 billion. China's share of U.S. imports is now 47%.

Vietnam displaced the Philippines as the No. 10 source country with \$364 million of shipments.

Canada, long the no. 2 source country, is seeing its furniture trade balance slipping. Shipments to the U.S. declined by 3.7% in 2004 while imports from China jumped by 40%. Of the top ten Canadian producers, five saw their 2004 shipments flat with or behind the prior year.

In an interesting footnote, U.S. furniture makers Kincaid and Pennsylvania House, both part of La-Z-Boy, have opened galleries at a Shanghai, China, retailer. The showroom will feature products manufactured in China under the U.S. company's brands as well as some Kincaid upholstery.

At the company level, results remain mixed...

- **Shermag**, Canada's third largest furniture producer, posted a C\$13.7 million loss in its 4Q2005 vs. C\$4.3 million profit in the same period last year. The company also announced the closure of its Victoriaville, Quebec, plant with 95 workers losing their jobs and a workforce reduction at its St-Etienne, Quebec, plant affecting 83 workers. A Maine sawmill was also sold. These moves resulted in a one-time C\$5 million charge to earnings as the company continues to struggle with its balance of demand to capacity.
- **Hooker Furniture** reported a 3.1% decline in its 2Q2005 sales with shipments of domestically produced wood furniture falling 23%. Six months sales were virtually even with 2004. Net income for the quarter slipped by nearly 12% and for the first half, by 18%.
- **Ethan Allen** announced 4Q2005 sales declined from \$246.6 million last year to \$242.3 million. Gross margin improved to 49.9% vs. 47.5% last year. Due to higher national TV advertising, selling expenses rose to 20.5% from 18.6%. In an effort to reduce the build-up of finished goods inventory, working hours at two Vermont plants were cut to 32 hours a week.
- With 2Q2005 sales up only 0.1%, **Furniture Brands International** announced the closing of three casegoods plants and the conversion of an upholstery plant to a warehouse. This reduction will idle over 1,200 workers and over two million square feet of manufacturing space, a 15% drop. FBI is left with 31 plants, down from 59 when this initiative began. The affected plants include:
 - a) Thomasville Furniture's Plant A in Thomasville, NC, plus six support facilities with 620 jobs lost.
 - b) Broyhill's Harper Bedroom Plant and Occasional Plant 1 in Lenoir, NC, with some production shifted to the Pacemaker Plant - The net job loss totals 485.
 - c) Broyhill's Rutherfordton, NC, upholstery plant converted to a warehouse with production shifted to Plant 3 in Lenoir and Plant 5 in Taylorsville, NC - The net loss of jobs is 160.

Gross margin for the quarter was 24.7%, down from 26.2% last year owing to higher material and energy costs. SG&A costs jumped to 19.8% from 18.8% pushing operating profit down to 4.8%, down from 7%.

- Continuing its performance as one of the best managed U.S. furniture makers, casegoods

producer **Stanley Furniture** reported 2Q2005 sales of \$83.6 million, up 15.8% over the same period last year. Gross margin declined slightly to 24.7% resulting in an operating margin of 11.2%. Management attributed this decrease to higher material, energy, freight, and warehousing costs.

- **Bassett Furniture** reported a 3.4% gain in its 2Q2005 sales with net profits of \$1 million. Shipments to its Bassett Furniture Direct retail stores rose by 22%. As the company competes in the retail arena, sales to independent furniture retailers decline. The increase in 2Q shipments to the Bassett channel, however, outpaced this decline by \$3 million. For the first half sales were up 4.4%.
- **La-Z-Boy** posted earnings of \$20.8 million in its 4Q2005 and \$37.2 million for its FY2005. 4Q2005 sales were up 6.3% with full year sales improving by 4.9%. Casegoods sales rose by 10.2% in 4Q due primarily to shipments to the hospitality segment. Only 25% of casegoods were produced in the U.S. The company opened 17 new retail stores in FY2005 ending the year with 334. In addition 24 existing stores were converted to the New Generation format, which generates greater traffic and sales per square foot.
- Casegoods producer **Hart Furniture** of Collierville, TN, has shutdown all manufacturing operations. Management attributes the closure to a major customer's decision to replace Hart product with a Chinese-made bedroom suite. Hart specialized in promotionally-priced, laminated bedroom furniture. Low-priced solid wood products from China have eroded Hart's market share in this category.

Office Furniture

BIFMA reported that June orders increased by 13% and shipments grew 14% vs. 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 just under 8% to about \$9.5 billion. Likewise, shipments jumped by just over 10%. At \$9.56 billion, shipments are now about 13% higher than the market bottom of \$8.47 billion in November 2003. BIFMA is now forecasting a 12.4% gain in shipments for 2005 and 7% in 2006. Analysts are calling for the industry to resume growth at levels consistent with the overall economy (5.5 to 6%) in the last half of 2006.

Producer level reports are also positive...

- **HNI** announced 2Q2005 office furniture sales up 18.3% with operating profit at 10.2%.
- **Steelcase** reported a 13% increase in its 1Q2006 sales. Gross margin expanded to 30.8%, up from 28.6% last year. Operating profit rose to 3.8% from (0.5%).
- Sales at **Herman Miller** grew by 15.2% in its Q42005. Gross margin rose from 31.8% to 33.1% followed by a jump in operating profit to 11.1% from 5.5%.

Wood Flooring

June 2005 shipments of strip flooring fell by 4% over the same month in 2004. June 2004 was the strongest month of the strongest year for flooring shipments since the mid 1960's. For the first six months of 2005, shipments are down 2%. However over the last twelve months flooring shipments are about 0.6% above the previous twelve-month period.

Remodeling

Remodeling expenditures saw record growth in 2004 with a 12.3% jump over 2003. According to the National Association of Home Builders, Americans spend nearly \$200 billion on remodeling projects. The association is forecasting 6.3% growth in 2005.