

## Business Briefing

### Pop Goes the Bubble

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Look at August housing performance:

- New home sales were up 4.1 percent versus the prior month but down 17.4 percent from a year ago. The August increase was largely due to downward revisions in sales for the prior three months.
- The median price of an existing home fell by 1.7 percent to \$225,000, down 10.5 percent since April 2006.
- Sales of existing homes have fallen by 12.6 percent versus August 2005.
- Total housing inventory rose 1.5 percent to 3.92 million, a 7.5 month supply at current rate of sales, the highest level since April 1993.



The Federal Reserve Board provided further worry with their data on the average amount of owner's equity in real estate. This year, homeowners' average equity is running at 56 percent of the value of his/her home. This metric has fallen drastically from 81 percent in 1951 to 69 percent in 1981 and 58 percent in 2001. On the bright side, the high level of cash-out mortgage refinancing that was reported over the last five years apparently eroded homeowners' equity less than expected.

The importance of the housing market to the wood products industry goes without saying. Cabinet and flooring sales have fallen steeply in the last three months. Furniture at retail is flat at best. Keep your eye on just how far the housing market drops.

### The 'Plight' of the Middle?

In spite of the struggling housing market, middle class America is doing well. Compared to 25 years ago, 13 percent more families are earning over \$100,000 annually and the number of households making less than \$75,000 has fallen by 14 percent. Both numbers are adjusted for inflation. In 1960, the average family spent a full one-quarter of their income on food versus only one-eighth today (and half of that amount is spent on dining out). Median net worth has risen to \$90,000 in 2004 from \$70,000 in 1989.

### A Steel Glut

Inventories of steel are piling up in warehouses around the U.S. putting downward pressure on prices.

Steel service centers, who account for about 30 percent of steel sold in the U.S., say that inventories are at their highest level since early 2005. Imports are up 40 percent from a year ago and on pace to pass the 1998 record. Add to that supply the 9.4 percent rise in domestic steel production

Automakers Ford, Chrysler and others are cutting domestic production. With the housing market cooling, appliance producers may add to that manufacturing decline.

Good news for machinery makers and industrial builders may be bad news for U.S. industry overall.

### The Importance of Knowledge Creation

Intuitively, research and development is an important contributor to the wellness of the U.S. economy. Now, statisticians can measure that contribution and see its relative importance.

Heretofore, R&D has been considered an intermediate expense like labor rather than a capital investment. Using the new method, knowledge creation contributed 7 percent of the growth experienced between 1995 and 2002.

Also treating R&D as an investment makes the U.S. economy about 3 percent larger and, importantly, the national savings rate about 2 percentage points higher.

China apparently has long recognized the importance of R&D. Spending on knowledge creation has been growing at 17 percent over the past 12 years versus 4-5 percent in the U.S., Europe, and Japan. As a result China's share of global R&D is projected at 14.8 percent in 2007 versus 12.7 percent in 2005. America's share will slip to 31.9 percent from 32.7 percent last year.

Roughly 60 percent of U.S. R&D spending comes from the private sector. Of the world's top five R&D spenders, four are American – Pfizer, Ford, Microsoft and General Motors.

As management guru Peter Drucker said, "Production is not the application of tools to materials but logic to work." Developing and honing that logic for commercial purposes is what industrial R&D is all about. The continuing health of our manufacturing sector depends on it.

#### Economic Factoid

The health of the global economy is inexorably linked to the economies of China and the U.S. Half of all global economic growth in the last five years has occurred in these two countries. As they go, so goes Europe, South America, and the rest of Asia.

### Sector Report

### Kitchen Cabinets

Cabinet sales rose 8.3 percent in August versus the same month in 2005 according to the KCMA's Trend of Business Survey. For the year to date, sales were up 10.4 percent. While remaining positive, the Survey is revealing an inexorable slowing of cabinet sales since early 2006, when monthly growth year-on-year was in double digits. Anecdotal evidence of a slowdown is also piling up. Shorter work weeks, postponed expansion projects, and slashed capital budgets are reported by numerous industry participants. Plus, market researcher Freedonia is now forecasting a 3.2 percent industry growth rate through 2010 versus their 2005 prediction of 6.5 percent through 2008.

At the cabinetmakers...

- **Masco** released lower 2006 earnings guidance as a result of weaker expectations for housing starts. The company, that had previously forecasted an 8 percent decline in housing starts for the full year 2006, is now predicting a 20 percent drop for the remaining four months with the full year 2006 falling by 12 percent. Management also indicated that 2007 starts will likely fall a further 12 percent with the sharpest drop in 1Q2007.
- **American Woodmark** 1Q2007 sales rose 3.3 percent to \$222.4 million. The company's earlier decision to exit production of lower-priced cabinetry combined with delays in price increases for raw materials resulted in an improved gross margin. Gross margin jumped to 22 percent from 17.1 percent a year ago. Operating profit also increased from 5.6 percent to 9.5 percent from the same period last year. Analysts are concerned about the company's reliance on new home construction given the recent downturn in housing.

### Home Furniture

Domestic producers are experiencing a very weak retail demand for their products...

- **Ethan Allen** is forecasting that its 1Q2007 sales will fall below the same period last year. The company is closing its 280,000 square foot Spruce Pine, NC, casegoods plant and 159,000 square foot Atoka, OK, upholstery facility. Atoka will be converted into a regional distribution center. About 465 jobs will be eliminated. Following the closures Ethan Allen will have nine remaining domestic plants – four producing casegoods, four upholstery, and one accessory – employing 2,300 people.
- **Stanley Furniture** lowered revenue guidance for its 3Q2006. Sales are expected to decline between 8 and 10 percent versus the same period last year. As a result, its full year 2006 sales are now forecasted to drop by 4 to 7 percent.
- **Bassett** reported a 6.3 percent drop in its 3Q2006 sales and an operating loss of \$893,000. For the first nine months, sales remain positive at 2.1 percent above the same period last year. The company now ships 72 percent of its products to its Bassett Furniture Direct retail stores.
- **Hooker** reported flat 3Q2006 sales due to the challenging retail environment. Nine-month revenues rose by 2.9 percent versus last year.
- **The Rowe Companies**, a leading upholstery maker, has filed for Chapter 11 bankruptcy protection and plans to sell or liquidate its Storehouse retail division. Total sales of the company in its FY2005 were nearly \$300 million. As a result the company will close its Poplar Bluff, MO, plant that employs about 400 workers.

Meanwhile more plant closures and restructurings were announced by other U.S. producers...

- **Broyhill Furniture** has sold its Lenoir, NC, particleboard plant to North State Property Holdings, who will continue to operate the facility.
- Ready-to-assemble specialist **Bush Industries** is ceasing production at its 220,000 square foot Tijuana, Mexico, plant.
- Unfinished furniture maker **Whittier Wood Products** has purchased a 150,000 square foot plant in Vietnam and shift production of its alder line from its Oregon plant in early 2007. The shift will idle about 100 workers.
- **Masco** announced the closure of its D-Scan plant located in South Boston, VA. The plant, purchased in 2001, employed 110 workers and will be converted to a distribution center for imported products sold through the Tvilium-Scanbark division, a supplier to retail giant Ikea.
- **Hekman Furniture** is ceasing production at its Grand Rapids, MI, plant and will lay off 60 workers.
- **Chromcraft-Revington** is closing its Sumter Cabinet casegoods plant in Sumter, SC. About 200 jobs will be lost. The Sumter brand products will be purchased from Asian factories.
- **SLF (Samuel Lawrence Furniture)** and **Pulaski Furniture** merged to form a new company, Home Meridian International. The combined sales will total around \$270 million in casegoods, occasional, home office and entertainment furniture. Pulaski operates two plants in Virginia. SLF closed its Phoenix, AZ, plant in March 2004 and now imports all of its products.

### Office Furniture

BIFMA reported that August orders grew by 3 percent and shipments by 12 percent. This relatively weak showing versus late 2005/early 2006 has analysts concerned that growth in this sector may be moderating or, at worst, stalling.

In spite of this inconsistent recent performance, analysts are encouraged by the strength of the primary drivers of demand – corporate profits, service employment, and non-residential construction.

At the company level...

- **Herman Miller** announced 1Q2007 sales of \$450 million, up 4.4 percent year-on-year. Gross margin improved to 33.9percent from 32.9percent in the same period last year. In spite of higher SG&A expenses, operating margin also increased from 9.1percent to 10.2percent. Management is forecasting a 7.5percent increase in 2Q revenues.
- **Steelcase** reported 2Q2007 sales of \$790 million, a 12.3 percent increase year-on-year. North American sales rose to \$463 million, a 15.5percent increase. Gross margin came in at 31.5percent, even with that measure a year ago. Operating margin also improved versus a year ago to 5.9percent. Management issued 3Q guidance on revenue growth at five to nine percent. Analysts are concerned about the company's ability to earn its cost of capital but noted reduced losses in the company's wood products division.

### Wood Flooring

August 2006 shipments of strip flooring declined to 41.6 million square feet, down 11 percent compared with the same month in 2005. Year to date the industry has shipped 340.8 million square feet, a 1 percent decrease for the first seven months of 2006.

#### **Hardwood Sawmilling**

With domestic sales of hardwood lumber steady at best, export markets have become a key to profitability for U.S. hardwood mills. Thankfully, according to *Hardwood Review* hardwood exports are on track to a record year of 1.36 billion board feet. Primary markets include China, Southeast Asia, Europe, Saudi Arabia, and Canada.

#### **Softwood Sawmilling**

Following the downturn in home building, softwood lumber prices have fallen to their lowest level in five years. The price of framing lumber is now \$274 per thousand board feet versus \$401 a year ago. In response, many of the larger producers have ceased production at some mills. **Weyerhaeuser** has indefinitely suspended production at two mills in Saskatchewan, Canada, and is forecasting an 8 percent decline in lumber sales. **Louisiana-Pacific** has shut down a mill in Quebec.