

Cutting Edge Newsletter™ August 2006

Business Briefing

Energy and Environment

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While predicting short-term change is a fool's game, understanding the key longer range trends that may affect the global business landscape is a primary responsibility of senior executives. Companies that astutely plan for the future and adapt their operations accordingly have the best odds of dealing with uncertainty and risk.

In listing the top ten global trends that will shape the business world in the coming years, consultants McKinsey & Company included the **demand for natural resources and the resulting strain on the environment**. Indeed, global warming, the depletion of tropical forests, plus the ensuing regulations over the use of scarce materials and treatment of the atmosphere are grabbing ever larger headlines and the increasing attention of politicians. Our challenge is to create innovative technology and laws that balance economic growth and environmental sustainability.

The environment is nothing new for the wood products industry. Foresters clearly understand the need for sustainability. For years, forest products companies both large and small have patiently invested in their resource base often with 50+ year horizons. Much capital has been invested in maximizing the transformation of wood fiber previously considered waste into useful products. More billions have been spent to clean up the effluent streams of their manufacturing processes. Undeniably, our forests are our only renewable natural resource, and without it, the wood products industry will disappear. Our industry knows that well.

Recent wood industry headlines generate interesting questions and highlight potentially profitable opportunities to those in our business...

Energy Prices Impact Sawmillers

Prices of many wood products often do not reflect the costs of production inputs like labor and energy. When costs of these inputs rise, profit margins fall. According to *Timber Processing*, sawmill energy costs have increased by more than 40 percent in the last year.

Energy issues affect virtually every element of lumber production:

1. **Transport** - Sawmillers are paying 15 percent more for freight of logs and finished products than in 2005.
2. **Mill Fuel** - Mills that fire kilns and boilers with natural gas are suffering. The economics of wood waste-fired boilers and cogeneration have improved thus creating opportunities for companies supplying technology in waste-to-energy conversion.
3. **Power** - Electricity costs per thousand board feet have increased by more than 10 percent. Solutions like soft starters on large motors, computerized maintenance management programs, and energy measurement systems are finding increased application.

Mills are ripe markets for those companies that offer energy saving technology.

Demand for Green Furniture Grows

A survey by trade magazine InFurniture has found an increasing preference for eco-friendly furniture among U.S. consumers...

- 74 percent of consumers are interested in protecting the environment (58 percent somewhat interested, more than 16 percent very interested).
- 54 percent are more likely to purchase furniture from wood certified as originating in sustainably managed forests.

Unfortunately, only 36 percent indicate a willingness to pay a higher price for furniture built from certified wood. In Europe, timber certification is essentially mandated and thus part of the consumer culture. In the U.S., demand for such products is presently a niche market.

Through the efforts of enlightened retailers like Crate & Barrel, awareness of 'green' furniture is growing among consumers. In the contract sector, architects and developers who follow the voluntary environmental standard, Leadership in Energy and Environmental Design (LEED), are sourcing eco-friendly furniture and other wood building products. Furniture and millwork manufacturers are increasing supplies of these items.

Interested residential furniture makers have formed the Sustainable Furniture Council to promote the benefits of 'green' furniture. The group is promoting responsible material sourcing and certification through the Rainforest Alliance's Smartwood program.

The 'green' movement in the U.S. may finally be gaining traction.

Forest Ownership Changes

Large and small forest products companies have invested in timberland since Frederick Weyerhaeuser purchased 900,000 acres in Washington State in 1900. With wood and paper demand remaining relatively strong across the decades, these timber investments were a good hedge against rising fiber costs.

Recently, these tree-owing companies have sold their forests. The buyers are Timberland Investment Management Organizations (TIMOs) and Real Estate Investment Trusts (REITs). In April, two TIMOs purchased International Paper's 5.1 million acres of U.S. timberland for \$6.1 billion. One REIT, Plum Creek, owns more than 8 million acres of forest land. Weyerhaeuser (with 6.5 million acres) and Temple-Inland (with 2 million acres) are the only two large publicly traded companies with significant holdings of trees on the stump.

How will these new owners manage their forest holdings? Will quick profits from residential/resort development or the slower cash flow from sustainable management of these resources for wood fiber hold sway?

California Proposes Tougher Emission Regs

The California Air Resources Board (CARB) is seeking tighter restrictions on formaldehyde emissions from plywood, particleboard and medium-density fiberboard. Formaldehyde, a recognized human carcinogen, is used in the adhesives or binders employed in the manufacture of these products. These standards will apply to panelboard and products using panelboard made and sold in California.

Drafts of the Phase I regulations call for a maximum of 0.3 parts per million (ppm) in particleboard, 0.9 ppm in plywood, and 0.19 ppm in MDF by July 2008. Phase II limits formaldehyde emission to 0.05 ppm in plywood and 0.03 ppm in plywood after July 2010. MDF producers are allowed an additional

two years to achieve 0.05 ppm for Phase II.

The key elements of this debate are:

- This draft regulation reduces formaldehyde emissions to levels below what is found in nature. Companies like composite panel Sierra Pine who support the broad goal of the regulation wonder if the Phase II amounts can be measured accurately. How then will the new limits be enforced?
- Some industry experts report that adhesives with ultra low formaldehyde levels suffer from poor physical properties and much higher cost. CARB claims that readily available, alternative resins are cost competitive and are "technologically suitable". Columbia Forest Products is now offering cost-neutral, formaldehyde-free hardwood plywood. Their adhesive provides superior water resistance and equal shear strength plus an end product that is compliant with LEED standards. Formaldehyde-free MDF, however, costs more and has lower water resistance and strength properties.
- The new regulations will require board manufacturers to certify their products and downstream users to provide chain of custody documentation. The enforcement mechanics for compliance with these regulations is unspecified. How will CARB police certification and chain of custody in foreign-made products? Will these rules lead to additional plant closures and job loss in the U.S.?

Ironically, composite panels like particleboard, MDF and plywood are environmentally friendly. Their manufacture employs millions of tons of wood fiber that have no other use except as fuel. The use of this fiber enables the recovery of more than 95% of harvested trees into valuable products. The use of panelboards as substrates for valuable veneers reduces the harvest of less abundant species.

CARB has presently scheduled a vote on these regulations no later than January 2007.

Bottom Line: Without question, environmental consciousness is growing, and this awareness will eventually bring change to your business. Don't despair. Rather, get informed and act proactively. Change brings opportunity for profit to those who are prepared.

Sector Report

Kitchen Cabinets

Cabinet sales rose 8.9% in June versus the same month in 2005, according to the KCMA's Trend of Business Survey. For the year to date, sales were up 11.8%. April saw custom sales fall by 3.9% while semi-custom rose by 13% and stock by 7.2%.

Cabinet sales continue to show strong growth in spite of declining housing starts.

At the producers...

- **Masco** reported cabinet sales of \$863 million in its 2Q2006, up 3 percent from the same period last year. Operating margin fell to 14.3 percent, down 8.2 percent from last year. Sales of assembled cabinets reportedly grew by double digits, but total revenues were negatively impacted by weakness in ready-to-assemble cabinets. The latter products suffered from higher transport and material costs. Higher interest rates also reduced sales of these cabinets to lower-end consumers.
- **American Woodmark** 4Q2006 sales rose 4.5 percent to \$216.4 million. Operating profit increased to 10 percent, a 76.6 jump from the same period last year. Analysts attributed much of this improvement to higher labor productivity and the exit from lower-margin cabinets.

Closets

A survey by trade magazine Closets confirmed the emergence of the home organization industry as an important secondary wood products sector. The products of this sector include closet, garage, and other storage systems. Experts indicate that the total ex-factory value of this sector exceeds \$2 billion and grew 30% in 2005. Firms in this sector are small with mean sales of \$1.6 million and an average of 17 employees. Solid wood and veneer doors/drawer fronts now account for 20 percent of sales. Drawers are the most popular upgrade. Melamine panels are the material of choice for the casework.

One industry participant forecasts a trend to larger, more sophisticated producers and resellers as the product category evolves.

Home Furniture

News among U.S. furniture producers remains mixed as more plants are shuttered and imports grow...

- **Furniture Brands International** reported 2Q2006 sales of \$601 million, up 1.3 percent from the same period the year earlier. Gross margin was essentially flat, while operating margin rose from 2.8 percent to 5 percent. Inventories grew by 11 percent to \$489 million as purchases of imported products outpaced shipments to its resellers. Imports account for about 44 percent of FBI's sales. With the resignation of the Broyhill division's CEO, FBI now has three divisions without permanent senior leadership. Broyhill also announced the closure of its 522,000 square foot Pacemaker casegoods plant in Lenoir, NC, that employed 692 workers.
- **La-Z-Boy** continued to under perform with 4Q2006 sales declining 10.1 percent to \$508 million. Upholstery sales fell by 12.5 percent, while casegoods dropped by 8.2 percent. Gross margin rose to 25.1 percent from 24.1 percent last year. Operating margin declined to 4.3 percent from 5.3 percent in the same quarter last year. The company also announced the sale of its American of Martinsville contract furniture division to Hancock Park Associates, a private equity firm. The division's annual sales are about \$96 million.
- **Bassett** reported a 5.5 percent rise in 2Q2006 sales and tripling of net income. For the first six months of FY2006, sales grew by 6.3 percent to \$174.1 million. The company now distributes through 136 Bassett Furniture Direct stores, which accounted for about two-thirds of total wholesale shipments.
- **Hooker** reported net sales of \$90.7 million in its 2Q2006, a 2.3% increase over the same period last year. The higher volume contributed to a 20% growth in net income. For the first six months of FY2006, sales totaled \$176 million, up 4 percent from last year. For the year sales, of imported products rose by 25 percent while shipments of domestically-produced goods fell by 36.2 percent. As a result, management announced the closure of its 265,000 square foot Roanoke, VA, plant that employed 275 workers. Its production will be shifted to the company's remaining plant in Martinsville, VA.
- **Ethan Allen** reported a 12.3% increase in its 4Q2006 revenues with sales totaling \$272 million. Gross margin rose to 51.4 percent while operating margin improved to 13.6 percent. For FY2006, total sales topped \$1 billion for the first time in company history.
- **Stanley Furniture** announced 2Q2006 revenues of \$77.5 million, a decline of 7.7% year on year. Decreased production levels and higher raw materials costs contributed to an 8 percent decline in gross margin. Operating margin fell to 8.1 percent from 11.2 percent last year.

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

- RTA furniture maker O'Sullivan Industries, which recently emerged from Chapter 11 bankruptcy, is closing its South Boston, VA, plant and idling 200 employees. The company now operates a single plant - its 1.1 million square foot facility in Lamar, MO.
- Upholstery maker Berkline/Benchcraft is closing its Baldwyn, MS, factory putting 400 workers out of work.
- Upholstery maker Stanton International is shuttering its Phoenix, AZ, plant and consolidating production to its Stockton, CA, operation. The closure will affect 40 workers.

Office Furniture

BIFMA reported that June orders grew by 2 percent, the lowest year-on-year increase since July 2004. Orders have grown by double digits in nine of the preceding 12 months. Shipments rose by 8 percent and have grown by 9 percent or better in nine of the previous 11 months. On a trailing twelve-month basis, orders grew 10.5 percent. Likewise, shipments rose by 9.7 percent reaching \$10.49 billion. That level had not been reached since January 2002.

In spite of weak April and June performances, industry analysts indicate that the drivers of demand - corporate profits, service employment, and non-residential construction - remain strong.

NeoCon, the primary industry trade show held annually in June, was deemed a tremendous success by industry observers and participants.

At the company level...

- **Herman Miller** announced 4Q2006 sales of \$444 million, up 9 percent. Operating margin declined to \$37.7 million, a decrease of 16.6%.
- **Steelcase** reported 1Q2007 sales of \$727.3 million, a 7.6 percent increase year-on-year. Operating margin improved to 4.4 percent from 3.8 percent. The company has experienced difficulties in consolidating its wood product operations from three plants to one. This consolidation is part of a strategy aimed at reducing overall square footage from 14 million to 5 million.
- **Knoll, Inc.** reported a 25 percent gain in its 2Q2006 sales to \$247.5 million. Its gross margin, historically among the highest in the office furniture sector, was 31.9 percent, down from 34.5 percent for the same period last year. Cost of sales was impacted by higher material and energy costs. Operating margin fell to 11.8 percent from 12.2 percent.
- **HNI**, headquartered in Muscatine, IA, saw its 2Q2006 office furniture sales rise by 13 percent to \$514.3 million. This product segment accounted for 77 percent of total company sales. Operating profit was \$38.3 million, a decline of 17.5 percent over last year.

Wood Flooring

June 2006 shipments of strip flooring totaled 42.856 million square feet, down 5 percent compared with the same month in 2005. Year to date the industry has shipped 260.302 million square feet, only 2 percent more flooring than in the first six months of 2005.

Non-Residential Construction

Lodging construction increased at a 95 percent annual pace through April. This building boom is being driven by a 9 percent annual growth in room sales, triple the long-term expansion rate. At this point, building new hotel rooms is cheaper than buying existing rooms.

Factory construction jumped by 8 percent in April from the previous month, a 28 percent gain over the same period last year. Most of this gain is attributed to durable goods producers who are expanding to meet orders from both domestic and foreign buyers.

Warehouse construction is about 10.6 percent above last year. Thus far, demand for warehouse space has not matched growth in the overall economy. Experts attribute this situation to improved import product flow and direct container deliveries to final destinations.