

Cutting Edge Newsletter™ October 2007

Business Briefing

Take a Deep Breath

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The Fed's September 18th rate cuts validate what we in the wood products industry have known for months: the economy is anemic. It's no secret – the slumping U.S. housing market killed a lengthy run of great business for those firms dependent on homebuilding and the economy is suffering from the effects.

Let's take a look at the winners and losers as of mid-2007:

Kitchen Cabinets - The August Trend of Business Report from the Kitchen Cabinet Manufacturers Association showed cabinet sales down 12.8 percent year to date. Sales at stock cabinet producers who primarily supply homebuilders have fallen by 20.4 percent. Continued strength in remodeling has softened the revenue declines at custom and semi-custom cabinetmakers, whose categories fell 4.3 and 5.2 percent respectively.

Masco, the largest cabinetmaker in the U.S. and second-ranked **American Woodmark** saw their sales drop 14.6 and 25 percent in their most recent quarters.

Cabinet imports dropped by 6.4 percent in the first six months of this year. Shipments from Canada, once the source for 90 percent of U.S. cabinet imports, fell over 29 percent. Chinese cabinet exports captured market share by rising nearly 45 percent. Cabinet imports remain below 5 percent of U.S. demand and thus far show no signs of following the upward trajectory of wood furniture imports.

On the remodeling front, a recent *Wall Street Journal* article indicated that Americans are losing their appetite for expensive kitchen makeovers. Spending on renovations costing more than \$20,000 dropped 40 percent in the year ending in August versus the prior twelve-month period. While high-ticket kitchen remodeling has declined, the total number of kitchen updates climbed by 200,000 thus far in 2007 to 7.6 million.

Hardwood Flooring - Industry experts estimate that sales of domestic flooring mills are down about 10 percent year-on-year. Select & Better plain sawn oak flooring now averages about \$1.75 per square foot versus \$2.22 in September 2005. During the same period, the price of green No. 2 Common red oak lumber has moved from \$460 to \$510 per thousand board feet. Seeing their material costs rising while selling prices fall is leaving most wood flooring producers less than optimistic.

As domestic demand has fallen, imports also have slumped. Foreign-made hardwood flooring shipments to the U.S. have declined nearly 62 percent, led by a 71 percent decline in shipments from China. Our market quite simply is not as attractive as it was in 2005.

Experts predict continued structural change in the industry. Flooring giant **Mohawk Industries** recently acquired four plants from Columbia Forest Products. Full-line flooring producer **Shaw Industries** has acquired the privately-owned Anderson Family of Companies, which includes Anderson Hardwood Floors. Anderson had previously supplied flooring for sale under the Shaw brand. **Armstrong World Industries** reportedly has their Bruce, Hartco and Robbins flooring operations on the block.

Residential Furniture – Through mid year at least 25 furniture plants have closed in 2007. Total shipments of U.S. furniture companies were down 7 percent year to date through July with June's shipments down a staggering 20 percent vs. the same month last year.

The culprit is weak consumer demand. Furniture retailers are struggling to attract customers and, like producers, are seeing double-digit declines in sales. One example is **Havertys**, a top 100 furniture retailer with 122 stores, whose September sales fell 14.3 percent and are now down 10 percent for the full year.

Feeble demand has also hit wood furniture imports. Year to date total imports grew only 3.6 percent versus 11 percent in 2006. China, with 10 percent export growth, continues to capture market share from other top 10 source countries.

More troubling is the growing shift of upholstery production to China. Most experts have viewed upholstery as somewhat immune to import penetration especially at high price points. But 9 U.S. upholstery plants have been shuttered this year. Anecdotal evidence points to growth in imports of higher-priced, customized sofas and chairs.

Befitting an industry in turmoil, change continues in this sector:

- Chinese furniture maker **Samson Holding** has purchased a 14.9 percent stake in **Furniture Brands International**, the largest furniture company in the U.S. Samson is one of FBI's largest suppliers. Earlier Samson's **Universal Furniture** subsidiary announced the acquisition of the **Pennsylvania House** trade name from **La-Z-Boy**. Pennsylvania House, once a major U.S. producer of upper-medium priced casegoods, now imports 100 percent of its offering.
- **Furniture Brands International** reported an 11 percent decline in 2Q2007 sales and a 67 percent drop in operating profit. Management is now forecasting an operating loss in Q3 with a 12 percent fall in sales. The company announced two more plant closings. Its Thomasville Furniture division is closing its Creative Interiors plant at Carysbrook, VA, which makes RTA products. The plant employs about 170 workers and its products will be shifted to the company's Appomattox, VA, plant. The Henredon division will close its Morganton, NC,

plant at year end and idle 520 workers. Its products will be shifted to offshore suppliers.

- **La-Z-Boy** reported 1Q2008 sales down 12.6 percent from the same quarter last year.
- Upholsterer **Rowe Fine Furniture** has agreed to acquire Hickory, NC, upholstery maker **Clayton Marcus** from **La-Z-Boy**.
- Producer and importer **Chromcraft Revington** announced a loss in its 2Q2008 as sales declined by 19 percent from one year earlier.
- In spite of an 11.5 percent decline in its 2Q2007 sales, **Hooker Furniture** increased its gross margin to 31.3 percent of sales from 28.3 percent a year earlier. The company now imports all of its product offerings, with the exception of upholstery produced by its Bradington-Young and Sam Moore subsidiaries.
- The recent trend of upholstery plant closures continues. Mid-priced upholsterer **Brookwood Furniture** has announced the closing of its Pontotoc, MS, plant and the idling of 100 workers. In August, **England Furniture**, a La-Z-Boy division, closed its 100,000 ft² Stockton, CA, plant and laid off 54 employees.
- Casegoods producer **Moosehead Mfg.** will reopen under new ownership. Acquisition of its 80,000 ft² Monson, ME, plant was completed in late September, and 40 workers will be hired. The 60 year-old company had closed in February. Its Foxcroft, ME, plant remains shuttered.

Moulding & Millwork

The combined effects of import competition and weak home construction have weakened demand at domestic moulding and millwork companies. The slow market, according to the Wood Moulding & Millwork Producers Association, has caused 5 large moulding/millwork plants to shutter since January.

Market researcher The Freedonia Group is predicting a 1.7 percent annual growth in demand for moulding and trim products through 2009. Most of this gain will be concentrated in non-residential construction given the weak homebuilding sector.

Thankfully, non-residential construction continues its upward trend. In August, the annual rate of this construction category rose by 15.2 percent versus the same month last year. This strength combined with higher corporate profits and solid white collar employment is benefiting on wood using sector...

Office Furniture

The August industry report from the Business and Institutional Furniture Manufacturers Association showed continued strength. Orders increased by 3 percent and shipments by 7 percent over the same month last year. Both numbers declined versus July when orders climbed by 9 percent and shipments by 12 percent.

Reports from producers indicate strong international sales combined with a positive, yet more challenging environment in the North American market:

- **Steelcase** reported a 4.5 percent jump in its 2Q2008 sales. Gross margin rose to 33.66 percent, up 13.7 percent from 30.94 percent last year. Operating margin also recovered to nearly 6 percent from 5.37 percent in the same period last year. Analysts report that the company continues to benefit from international growth, as well as solid performances in its mid-market office and healthcare lines.
- **Herman Miller** announced a 9.3 percent increase in its 1Q2008 revenues. Gross margin improved moderately to 34.1 percent from 33.9 in the same period last year. Management acknowledged that large North American project business had softened.

Industry analysts are predicting annual growth for this sector at 3 to 4 percent in line with the GDP.

Bottom Line: Tough times demand brave leadership. Business as usual will not cut it. It's time for wood products firms to invest in process improvements and new market development that will power their performance when the economy recovers. *And it will.* The miracle that is the U.S. economy is merely taking a breather.

Economic Factoid

Present and planned construction of new MDF mills will lift world capacity by 12.3 percent in 2007 and 7.8 percent in 2008. At least 83 new mills are on order or under construction. Their combined capacity is about 13 million m³. As shown in the table below, 4 million m³ of this addition will be in Europe and North America. China will account for 3.7 million m³ with 42 new lines in 2007 and 11 in 2008. South America will double capacity. These investments represent the largest surge in construction in decades and perhaps in the history of the industry.

**Total World MDF Capacity
(000 m³)**

| Region | 2005 | 2006 | 2007 | 2008 |
|------------------------|---------------|---------------|---------------|---------------|
| North America | 5,650 | 5,743 | 6,213 | 6,795 |
| Australia/New Zealand | 1,900 | 1,867 | 1,517 | 1,527 |
| China | 14,220 | 14,375 | 16,675 | 18,075 |
| Southeast Asia | 3,260 | 3,453 | 4,310 | 4,347 |
| Northeast Asia | 2,369 | 2,372 | 2,387 | 2,387 |
| South America | 3,230 | 3,470 | 3,920 | 4,767 |
| Europe | 14,160 | 14,932 | 16,392 | 17,352 |
| Rest of the World | 621 | 760 | 1,372 | 1,687 |
| Total | 45,410 | 46,972 | 52,786 | 56,937 |
| % Annual Growth | - | 3.4 | 12.3 | 7.8 |

| | | |
|--------------|--|------|
| Total Growth | | 25.4 |
|--------------|--|------|

Source: *Wood Based Panels International*, Issue 4/2007