

Business Briefing

Weakening U.S./Canadian Trade

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With geographic proximity and a common language, Canada and the U.S. are natural trading partners. Canada is our largest export customer for hardwood products like logs, lumber, flooring, moulding and furniture. Since 1997, the Canadian share of U.S. exports of these products has risen from 30 to 39 percent and now totals \$1.33 billion. The U.S. is Canada's number one customer for export wood furniture and their furniture makers use lots of U.S. grown lumber. Add a stronger Canadian dollar, which has strengthened by 26 percent against the U.S. dollar since hitting its low in January 2001, and you should have solid prospects for growing export sales across our northern border.



But, look at recent trade data. Exports of primary hardwood raw materials to Canada have dropped significantly since peaking in 2004. Logs exports to our northern neighbors are down nearly 19%, while lumber shipments have dropped by 6.5%.

What happened? Like other similar trade stories, the culprit is China. In 2004, the Canadian furniture industry began feeling the impact of well-priced Chinese imports. Chinese furniture shipments to Canada grew by 43% that year, and through 2006, the 3-year growth was 143%. Total 2006 shipments were US \$1.38 billion. Not bad for a country that only shipped US\$101 million of furniture products to Canada in 1997.

Over that period, Canadian producers have shuttered furniture plants. Shermag, one of Canada's largest furniture makers, has closed six plants in the last two years. In late 2005 their furniture trade association brought an action to the Canadian government requesting safeguard tariffs on imported furniture from China. That attempt to protect domestic furniture production was unsuccessful. We are seeing an instant replay of events that have occurred since 2000 in the U.S. furniture industry.

Canada's furniture industry is heavily dependent on exports to the U.S. Our market takes 95% of their furniture exports. Last year, those exports actually fell. Less furniture production means less lumber consumption. The decline of Canadian furniture production bodes badly for US hardwood exporters.

Keep your eye on this important trade story.

China Moving Up Value-Added Curve

The goal of any developing economy is to increase its manufacture of higher value-added products. Low-value, high labor content products are replaced with higher-value goods for both domestic and export markets. By doing so, workers' wages can rise, and their standard of living can grow.

In furniture, Taiwan is a good example of this economic evolution. From the mid 1970's until the early 1990's, that country was the leading source country of wood furniture imports by the U.S. As Taiwan's productive workforce attracted investment by electronics makers and other high value industries, wages rose. Soon the prevailing labor costs became an economic disadvantage for Taiwanese furniture producers. Drawn by cheaper wages, the Taiwanese relocated their plants to China. That move jump started the Chinese wood furniture industry.

China is no different. While much of their economic strength has been built on the backs of their low-cost workforce, officials there are focusing on changing their manufacturing mix toward higher value products. Changes in their tax policy are a sign that Beijing wants to produce more sophisticated goods. China charges a 17 percent value-added tax on all goods made there and then rebates part of that tax on export goods depending on the product and the industry. Rebates are being trimmed on furniture, flooring and other labor-intensive products and increased on technology products. Clearly, Chinese planners are seeking to steer the economy up the value-added curve.

Two examples of this strategic trend are Intel and GM:

- Intel has received approval from Chinese officials to build a \$2.5 billion plant to fabricate integrated circuits. This decision is certain to stimulate more production of sophisticated electronics components in China. Currently plants there assemble products of laptops, cell phones, and the like from imported parts. These plants will benefit from a shorter supply chain.
- GM is on track to sell 110,000 Chinese-made Buick LaCrosse in its second year of production. China is its fastest growing market, and the company recognizes Chinese design input is critical for its next LaCrosse due out in 2010. As a result, a Shanghai-based, Chinese staff will generate the car's interior design, influence the exterior and control much of the supply chain.

While China has lots of labor, the supply of skilled workers is short, especially in coastal regions where most manufacturing is located. Labor costs are rising just like occurred in Taiwan. Production of labor-intensive items like furniture in China may lose its luster.

More importantly, China is issuing a wake-up call to the U.S. - don't rest on the belief that innovation is a sustainable competitive advantage. Creativity can, in fact, be outsourced from smart people wherever they live.

U.S. Productivity Slows

One reason inflation is proving stubborn for the U.S. economy is the recent decline in labor productivity. Unit labor output and the growth of the workforce define just how fast an economy can expand without inflation.

In the late 90's, productivity enabled fast growth, low unemployment, low interest rates and low inflation. If the downturn in productivity proves more than temporary, our economy could be in for slower growth in living standards. And the Federal Reserve may be unable to lower interest rates in fear of higher inflation.

In 4Q2006, productivity growth fell to 1.4 percent from its high of 4 percent reached in 2004. Some economists suggest that this decline stems from the difficulty producers are having boosting output with recently-hired, less well-trained workers. Others blame weak investment by companies since 2001, while some experts point to a lessening effect of technology on output.

Have U.S. companies harvested all of the low hanging fruit? Do fewer cost-cutting opportunities exist to boost productivity? Stay tuned as Business Briefing follows this important story.

Economic Factoid

The gross domestic product of the U.S. is heading toward a mind-boggling \$13 trillion annually. Just how big is that number? If Texas was a country, its GDP would nearly equal that of Canada. Florida's is equivalent to South Korea. Russia's economy is about 80 percent the size of Ohio's. This comparison gives one a sense of just how mighty our economic machine really is. Let's keep our eye on the ball and this miracle alive.

Sector Report

Kitchen Cabinets

Cabinet sales continue weak following the end of a ten-year uptrend last November. According to the KCMA's Trend of Business Survey, February sales fell by 15.3 percent. YTD 2007 sales were down 13.4 percent. Drilling into the numbers, February custom cabinet sales fell by 6.2 percent; semi-custom cabinet sales, by 9.8 percent; and stock cabinet sales, by 21.1 percent. The latter category is favored by homebuilders while custom and semi-custom are traditionally more prevalent in remodeling.

- **Wellborn Cabinets** of Ashland, AL, has purchased the Atkins, VA, lumber processing/parts production facility from **Vaughan-Bassett Furniture**.

Home Furniture

As consumers struggle with rising mortgage payments and lower overall confidence, weakness continues in furniture retailing. **Haverly Furniture**, which operates 121 stores primarily in the South and Central U.S., reported that same-store sales fell 12.9 percent in February. That performance was its worst since April 2001, and management sees no catalysts to change the current downtrend.

U.S. retail weakness has also impacted furniture makers around the world. 2006 imports of wood furniture rose only 3.6 percent vs. double digit growth in the prior two years. As a result, the market share of wood imports has stabilized at just over 50 percent. Upholstery imports continue to rise along with purchases of cut-and-sewn covers by U.S. furniture makers. Foreign-made upholstery now accounts for about 21 percent of U.S. retail sales.

As this sector continues to restructure, the news at the company level remains mixed...

- **Furniture Brands** released a mid-quarter update projecting that a 15 percent drop in 1Q2007 sales. Prior to that announcement Sun Capital Partners, a private equity group, purchased a 5 percent stake in Furniture Brands. This purchase adds to Sun's furniture portfolio, which includes producer Lexington Home Brands, importer Powell Company, upholsterer Rowe, and retailer Wickes.
- Analysts have trimmed their 3Q2007 forecast for producer and retailer **Ethan Allen Interiors**. Noting that the company continues to be the best performer in residential furniture, sales are now expected to be flat vs. the same period last year.
- **La-Z-Boy** announced a major restructuring plan that includes two plant closures and approximately 500 job cuts. The shuttered plants produce upholstery, are located in Lincolnton, NC, and Iuka, MS, and employ 250 and 150 workers respectively. In addition the company is consolidating its North Wilkesboro, NC, rough mill operation into a Kincaid casegoods plant in Hudson, NC. That move will eliminate about 100 jobs. Lincolnton product is being shifted to the company's Dayton, TN, plant. The 1,800 workers there have petitioned the NLRB for a union election. The company also sold its Bedford, VA, Sam Moore division to Hooker Furniture.
- **Bassett Furniture** announced the closing of its 323,000 square foot casegoods plant in Bassett, VA. About 280 employees will lose their jobs as the company exits domestic casegoods production.
- Upholstery maker **Klaussner Furniture** announced the closing of its Bruce, MS, plant affecting 117 workers.
- Manufacturer and importer **Chromcraft Revington** reported a loss in its 4Q2006 on a 4.4 percent decline in sales. For the full year, sales were down 5.4 percent to \$160 million. As part of their restructuring efforts the company has consolidated its Chromcraft, Peters-Revington, Silver, Cochran, and Sumter residential products under the CR Home brand name.
- **Hooker Furniture** announced that its 4Q2006 sales were up 0.9 percent while net income fell 13.3 percent. For the full year, sales totaled \$350 million, up 2.4 percent from \$341.7 million in the prior year. FY2006 net income rose 12.8 percent. As reported above, Hooker has purchased upholsterer **Sam Moore** from La-Z-Boy.
- Sauder Woodworking, the large RTA furniture maker, has signed a deal with **Ikea**, the world's largest furniture retailer, to produce components for its kitchen cabinet line. Ikea is adding North American sources to supply its 39 stores in the U.S. and Canada. As reported in the December 2006 *Cutting Edge*, Ikea's Swedwood manufacturing subsidiary is building a furniture plant in Danville, VA.
- RTA producer **O'Sullivan Industries** announced that all salaries and wages are being cut by 6.6 percent in an effort to maintain liquidity. The company presently employs about 800 workers at its Lamar, MO, headquarters and plant. O'Sullivan closed its South Boston, VA, plant in 2006 and is currently rolling out a line of imported product.

Office Furniture

The Sector Outlook - To better understand this sector's future requires a brief history lesson. From January 1980 until office furniture peaked in early 2001, orders and shipments grew by 7.4 percent and 7.2 percent respectively. The growth curve during that 21-year period was only interrupted by a brief recession in the early 90's. Much of this performance was driven by the growth of middle management in the 80's and increasing adoption of desktop computers and information networking. With the explosion of the dot.com bubble, the sector suffered a 37 percent decline with industry sales dropping from \$13.35 billion to \$8.465 billion in just 33 months.

As the economy strengthened in 2003 and 2004, the sector gained momentum and showed double-digit growth in 2005. Order and shipment growth, however, weakened as 2006 progressed. In the last half of 2006 monthly year-on-year growth of shipments slowed to 6 percent from 9 percent in the first half while orders fell from 8 percent to 5 percent.

BIFMA's most recent monthly report shows a slight reacceleration in demand for office furniture. February orders grew by 14 percent year-on-year rebounding sharply from a flat January. This performance was the first month of double-digit growth since last July.

Imports grew by 16 percent in 2006 and continue to take market share. However many believe that U.S. producers will defend their turf with customization and fast delivery much like the cabinet sector.

No revolutionary products, like the now ubiquitous office cubicle, are on the horizon that will drive above average demand. For that reason, sector analysts now believe that industry growth will fall to a steady 3 to 6 percent in step with the U.S. GDP. Not the halcyon days of yesteryear but not bad.

At the company level...

- Steelcase, the world's largest producer of business furniture, reported a 5.4 percent increase in its 4Q2007 revenues over the same period a year ago. With North American business growing by only 0.8 percent, much of the revenue gain came from the 17 percent jump in international sales.
- Herman Miller reported 3Q2007 sales of \$484.8 million, up 14.3 percent from a year ago. Operating margin rose to 10.1 percent, up from 8.7

percent last year. The company has opened its first Chinese production facility which will focus on supplying the Asian market and facilitate sourcing low-cost components.

- Knoll reported 4Q2006 sales up by 23 percent to \$273 million. Gross margin fell to 32.6 percent due to increases in raw materials and transportation costs. Thanks to a decline in SG&A expenses, operating margin rose to 13.05 percent vs. 11.45 percent in FY2005.

Wood Flooring

January shipments of strip flooring declined to 36.766 million square feet, down 16 percent compared with the same month in 2006.

Non-Residential Construction

The national office vacancy rate fell to 15.3 percent in 4Q2006. Analysts now predict that vacancies will stabilize at that rate in spite of continued strength in office construction. Spending on office construction jumped 18 percent last December vs. the previous year. Reed Construction Data expects this pace of investment to continue through 2008. That's lots of millwork and office furniture.

Public Policy