

Cutting Edge Newsletter™ June 2007

Business Briefing

Hannover Highlights

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Many exhibitors at the recent Ligna Hannover Fair in Germany reported booming business. Buoyed by a stronger European economy, shipments of woodworking machinery by German machine makers are set to rise by ten percent in 2007.

The exhibits of the large high tech machine makers like Homag, Biesse and IMA were jammed with visitors. Many of the small meeting rooms were continually taken by buyers in the midst of negotiating purchases.

Lightweight panels were the buzz of the show. European furniture makers are rapidly substituting these materials for solid MDF and particleboard components. New technology in the lay-up and pressing of these honeycomb core panels has eliminated much of the labor in the production process. Machine makers now offer a range of equipment enabling woodworkers to match their investment to volume demand.



Hardware producers like Häfele offer special connectors that allow creative assembly of these hollow core panels.

Furniture giant Ikea has long incorporated lightweight panels in their product offering to reduce weight, energy input and wood fiber consumption. Europe limits the weight of RTA furniture cartons to 55 pounds per package. About forty to fifty percent of all furniture in Europe is flat packed (ready to assemble). The lightweight panels also allow designers to utilize thicker panels (1-1/2" to 2") in place of 1/2" and 3/4" solid core components.

This construction is nothing new. Architectural door producers have used honeycomb as the core material for interior doors for years.

Big questions remain to be answered about this technology:

1. Will the consumer accept lightweight panels? Certainly those who shop at Ikea do, by the millions.
2. What are the cost trade-offs? These panels cost more than MDF and particleboard for thinner components.

Swedwood, Ikea's manufacturing subsidiary, is installing a highly mechanized line for production of lightweight panels. Ikea is known for intelligently integrating their product and process design to achieve low costs. Keep your eyes on this technology.

California Gets Tough On Formaldehyde

The California Air Resources Board (CARB) has enacted tighter restrictions on formaldehyde gas leaching out of composite wood panels. To meet the law's standards, panel producers must modify their adhesives and binders to eliminate most, if not all, of the formaldehyde contents.

Set to take effect on January 1, 2009, the Phase One standards will have little impact on materials cost. However, Phase Two will raise the cost of MDF, particleboard, and plywood – key raw materials for furniture, cabinetry and millwork manufacturers, as well as homebuilders. CARB estimates that Phase 2 will raise the material cost of cabinets, countertops, shelves, and mouldings in a 2,000 sq. ft. home by \$400.

By January 2011, plywood makers must lower their product's formaldehyde emissions to no more than 0.08 parts per million. Particleboard must emit no more than 0.18 ppm, while MDF's limit is 0.21 ppm. Phase 2 pushes these limits to 0.05, 0.09 and 0.11 ppm respectively.

Formaldehyde is deemed to increase the risk of cancer. Woodworking companies and industry trade groups contended that CARB's rules are based on unsubstantiated health consequences and ignored newer scientific data.

CARB will require that domestic and foreign users of these panelboards must provide third party certification that their materials meet the emission limits. Industry experts wonder how CARB will monitor record keeping at foreign labs engaged by Chinese and other manufacturers.

Another stake in the heart of the U.S. furniture industry will hurt our cabinetmakers and other woodworking sectors that have managed to stave off the import tidal wave.

Economic Factoid

The U.S. is continuously slammed for its extravagant energy consumption. Yes, the U.S uses more energy per capita than any other country in the world. But what about per unit of gross domestic product, the broad measure of an economy's size?

Oil Consumption per Unit of GDP
(tons of oil per \$million)

| Country | 1985 | 1995 | 2005 |
|---------|-------|-------|------|
| China | 1,750 | 1,200 | 800 |
| India | 760 | 750 | 600 |
| Europe | 270 | 240 | 240 |
| Japan | 100 | 100 | 100 |
| U.S.A. | 300 | 270 | 250 |

Seems the U.S. is not so profligate after all...

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*, April sales fell by 11.2 percent, an improvement over March sales which dropped 17.1 percent versus the same month last year. YTD 2007 sales were down 13.9 percent.

At the company level...

- **Masco Corporation** with their Merillat, Mills Pride, and KraftMaid cabinet brands reported 1Q2007 cabinet sales of \$691 million, down 18.9 percent from a year ago. Operating margin fell from 14.2 percent to 11.9 percent. In spite of the revenue shortfall, management claims to be maintaining market share.
- **American Woodmark** reported 4Q2007 sales of \$166 million, a 23 percent decline year on year. Gross profit followed suit with a 23.9 percent drop. Operating profit fell to \$9.1 million, down 58 percent. Management is forecasting FY2008 sales down 7 to 11 percent as the weak housing market continues.
 1. Importer **Sunny Wood Products** announced its relocation to a new Cerritos, CA, distribution/assembly facility. At lower price points cabinets "assembled in the US" from imported cabinets are found in the big box DIY stores like Lowe's. Keep your eye on this challenge to domestic domination of the cabinet sector. Historically imports account for less than 5 percent of total cabinet sales in the U.S.

Home Furniture

The weakness in furniture retailing reported in April's *Business Briefing* continues...

- **Havertys Furniture**, who operates 122 retail stores in 17 southern and central states and sells in the mid- to upper mid-price points, reported an 8.6 percent drop in 1Q2007 sales. Earnings fell a whopping 84 percent. In April, the first month of their 2Q, the downturn continued as sales declined 17.1 percent versus a year ago. The company has responded with an aggressive financing offer – no interest until January 2010.
- Attendance at March's High Point Furniture Market was down 20 to 25 percent. Along with the new Las Vegas Market, High Point is the place where retailers view and order new products for their stores.

Poor business has even affected importers. Casegoods importer **Mirador** announced its closing and blamed slow business in the past 6 to 8 months. Mirador imported its products from 11 Far Eastern factories and was noted for its innovative designs.

Furniture giant **Ikea** however continues to swim against the tide as the company opened a 310,000 sq. ft. store in Draper, UT, to serve the Salt Lake City market. The Utah store is its 30th in the U.S. and 255th worldwide. Its new Danville, VA, plant is scheduled to begin production in early 2008.

Chinese manufacturer, **Coe Ltd.**, has established a U.S. marketing subsidiary, Amelia Home. Coe has 5,000 employees, 50 factories totaling 3 million square feet, and its own timberlands and saw mills. Well-financed Chinese producers continue to go direct to U.S. retailers in a move to optimize the supply chain.

Competition in the U.S. furniture business has never been tougher. As noted below, even upholstery producers, who many believed to be immune from foreign competition, are feeling the pain.

More at the company level...

- **Furniture Brands** announced 1Q2007 sales of \$574 million, down 13.3 percent year-on-year. The company earned only \$2.9 million, off a whopping 90 percent. Management predicted a difficult 2Q2007 with sales down 15 percent. In response, the company is closing three Thomasville Furniture facilities: two upholstery plants in Troutman, NC, and a 325,000 sq. ft. casegoods plant in Thomasville. Additional staffing cuts were announced in the executive and administrative ranks bringing the total of affected workers to 330.
- Producer and retailer **Ethan Allen Interiors** reported 3Q2007 revenues of \$247 million, down 7.7 percent from the prior year. In spite of weaker sales, gross margin rose 3.3 percent to 52.1 percent. At the end of the quarter, the company's retail network consisted of 310 stores with 154 company-owned.
- **Bassett Furniture** announced a 15.1 percent drop in its 1Q2007 sales to \$73.4 million. This decline resulted in a net operating loss of \$4.2 million.
- **Stanley Furniture** reported sales of \$75.1 million for its 1Q2007, down 10 percent. Gross margin followed lower at 18 percent of sales, off 24 percent from the prior year. Operating profit fell to \$3.1 million, down 64 percent year-on-year. Management is predicting sales to be off \$4.5 to 8.5 million in 2Q.
- Manufacturer and importer **Chromcraft Revington** reported a 1Q2007 loss of \$1.2 on 26.3 percent decline in sales.
- **Hooker Furniture** announced that its 1Q2007 sales were down 15 percent to \$77.3 million. Net income was down 26.5 percent to \$4.3 million. The company, which closed its last U.S. plant earlier this year, imports all of its wood products while producing upholstery domestically at its Bradington-Young and Sam Moore divisions.
- **Sauder Woodworking**, the largest RTA furniture maker in the U.S., has acquired the brand name, select designs, patents and a licensing agreement from O'Sullivan Industries. O'Sullivan halted production in early April after emerging from bankruptcy in April 2006. The acquisition does not include O'Sullivan's 1.1 million square foot plant in Lamar, MO. The deal enables Sauder to expand its distribution to key retailers like Lowe's, Staples, Big Lots and Wal-Mart.
- **Bush Industries**, another RTA producer, announced the closing of its Little Valley, NY, facility. The transfer of production to one of its Jamestown, NY, plants will idle about 50 workers. This closure is the third such consolidation in recent months, following the shuttering of two Erie, PA, plants and one in Tijuana, Mexico.
- **Richardson Brothers**, longtime casegoods producer, announced its exit from the furniture industry. The company closed its Sheboygan Falls, WI, plant in 2003 where it manufactured furniture for 120 years and became an importer of Chinese and Bolivian-made products.

- Upholstery maker **Berkline** announced the lay-off of 250 workers at its Livingston, TN, recliner plant.
- **Moosehead Manufacturing**, an old line Maine furniture maker, announced the closure of its casegoods operations. The 60-year old company was unable to compete with lower-priced imports.
- Canadian producer **Dorel** reported the closing of its **Ameriwood** subsidiary's Dowagiac, MI, RTA plant. The closure will affect 170 workers. Management is attempting to balance its capacity with demand. The shutdown leaves Ameriwood with plants in Cornwall, Ontario, and Tiffin, Ohio.
- Upholsterer **Ashley Manor** is closing its High Point, NC, plant in July. The company employs 30 workers who produce high-end sofas, loveseat and chairs. Management blamed the soft retail environment and strong import competition.
- **Smith Furniture Manufacturing**, the Waco, TX, upholsterer, announced the closing of its operations in early May. The company had been in business since 1939.
- On the bright side, furniture and cabinet maker **University Loft** is opening a \$22 million warehouse and manufacturing facility in Mount Comfort, IN. The 508,000 sq. ft. operation will produce casegoods and inventory accessories to support its vanity and kitchen cabinet business. The company also operates a 600,000 sq. ft. plant in Morristown, TN.

Office Furniture

BIFMA, the sector trade association, reported April orders for office furniture up 5 percent. Shipments increased by only 2 percent, down from 8 percent in March. Analysts believe that sector growth is moderating toward a GDP-like 3 to 6 percent growth rate. The association's economic advisor lowered their growth expectations to 6.8 percent in 2007 and 5.6 percent for 2008.

At the company level...

- **Knoll** reported a 13.7 percent jump in sales for its 1Q2007. Gross margin rose to 34 percent, up from 32 percent last year. In spite of higher SG&A expenses, operating margin rose to 12.4 percent.
- **HNI Corporation** reported its 1Q2007 sales of its office products up only 2.1 percent. Management is expecting little improvement over the remainder of 2007. Operating profit in the office sector was down 8 percent.

Wood Flooring

At the company level...

- **Armstrong World** announced that its 1Q2007 wood flooring sales declined 3 percent to \$199 million.
- **Mohawk Industries** reported 1Q2007 sales of its Unilin laminate flooring at \$352 million, up from \$303 million last year or 16.3 percent. Operating margin on flooring was 17.2 percent, up from 13.2 percent last year.