

Cutting Edge Newsletter™ December 2008

Business Briefing

Save GM? by Art Raymond, araymond@raymondnet.com

In the good old days of the 50s and 60s, many believed what was good for General Motors was good for America. GM and its Big Three motor car brethren were a huge part of the U.S. economy, an efficient nationwide machine that used mass production to win a world war and bring rise to a prosperous middle class of Americans. In those halcyon days of yesteryear, big businesses across a wide spectrum of products partnered with powerful unions to set generous wage and benefit packages in exchange for a reliable supply of workers. Economic growth and prosperity, it was thought, could be guaranteed by adherence to Keynesian economics and New Deal legislation. Or so the Big Three, the United Auto Workers, and left-leaning politicians of the time believed.



But that experiment in a Scandinavian-style welfare state proved short lived. The American economy is made up of hustlers who like their independent, pioneering ancestors prefer to get ahead through hard work rather than handouts. Making more with less, being the low cost producer, is the ideal that all well-managed companies strive for. Today, the successes of Wal-Mart, Apple Computer, and others testify to the importance of competitiveness. Survival of the fittest is more than a cliché in the U.S.

Beginning in the late 50s workers across the country turned their backs on unions. Companies in right-to-work states built non-union plants that employed workers at lower wages. And global competition in the form of cheaper, better built Toyotas, Nissans, and Hondas hit American roads and highways. When the Japanese motor car companies built non-union plants in the U.S., the jig was up. Detroit simply could no longer compete.

The legacy of high wages and benefits proudly negotiated by the Big Three and the UAW have inexorably consumed our home-grown motor car industry. History contains similar stories in the steel and airline industries.

Sadly those workers who believed the dream of a secure, overpaid job for life are the most injured. Thankfully, the real U.S. economy, that rough and tumble miracle, will inevitably provide for those who are flexible and unafraid of work. The fittest will survive.

Since I wrote the above words in the fall of 2005, little has structurally changed at GM, Ford, and Chrysler. But the recent, sudden drop in auto sales has made their situation critical. With U.S. auto sales running at an annual rate of only 10.5 million, even the Japanese car companies cannot make a profit and are idling capacity. Detroit's automakers are burning cash at an astronomical rate to keep their heads above water.

Why shouldn't GM file for Chapter 11 bankruptcy protection? After all, that alternative was created precisely to give a company time to restructure its business. GM and Ford have solid long-term prospects in Europe and emerging markets. For GM 65 percent of sales now come from outside of America. Total car sales in the BRIC countries - Brazil, Russia, India, and China - now exceed those in the U.S. The smaller, fuel efficient cars that American automakers produce in these markets are profitable.

The problem, of course, is their North American operations. While the Big Three has shuttered two

million units of annual capacity and made significant productivity gains, labor costs remain stubbornly high. A deal made in 2007 with the UAW will strip about \$1,000 in legacy costs from every car made beginning in 2010. But the average hourly labor cost for the Big Three is \$29 higher than for non-Detroit car makers. Plus the current contract forces the carmakers to pay laid-off workers about \$70 per hour in wages and benefits. This "Jobs Bank" costs the Big Three close to \$500 million over the past year. Honda just built a sparkling new, non-union plant in Indiana for \$550 million.

In addition, GM alone provides health benefits for a million people only a fraction of who are current employees. The old joke is really true: GM is no longer a car company that provides health benefits but a health-care company that happens to build cars.

Washington's complicity in the Big Three's woes is often overlooked. A huge factor in the UAW's power over Detroit is Congress's fuel efficiency standards aka the CAFE rules. This regulation dictates the average miles per gallon that a carmaker must achieve for the vehicles it sells. For passenger cars the standard is 27.5 mpg; for light trucks, 22.5 mpg. Imported vehicles do not count in the CAFE calculation. The Big Three cannot simply move production of smaller, fuel efficient cars to Spain where the UAW is not an issue. It's clearly their U.S. labor costs, not the salaries of their CEOs and the expense of their private jets.

In the hearings on an auto industry bailout, Congress asked the Big Three for a business plan. Holman Jenkins in a recent Wall Street Journal op-ed offered two reasonable strategies they might incorporate in such a plan:

1. Cancel the CAFE rule and free the Big Three to negotiate with the UAW—The threat of moving production offshore, an alternative that most other industries have, would drive a more competitive labor contract.
2. Use the bailout cash now being considered to buy out the union—The carmakers could then staff their plants with workers earning a pay package comparable to that paid in foreign-owned U.S. car factories.

Without resolving the labor cost issue, any bailout will just prolong the misery and add to the cost the taxpayer will ultimately bear.

Of course, politics will compromise a true, sensible solution to Detroit's problem. Everyone knows the main issue, but recent history has shown Congress' propensity to postpone tough decisions that ruffle their constituencies.

Chapter 11 for the Big Three is the best solution but not without its problems. Industry suppliers must be paid, and the risk that consumers will not buy a car from a bankrupt company must be overcome. Government-supplied debtor-in-possession financing to ensure the viability of the supply chain combined with sales incentives and news that the filing is only temporary can avert this stigma. Detroit is indeed a special case, and its handling has long-term consequences for U.S. business. Our choices are clear. Either cede control to Congress by virtually nationalizing the Big Three in a fit of populist rage. Or rationally use a tried and true method that gives control to an experienced bankruptcy judge.

In the end, the Big Three must put itself on a competitive footing with the rest of the auto industry. The bottom line remains as it was three years ago in my original article...

Bottom Line: So in the end, what is good for GM is good for America. Competition makes us all better. Like a dinosaur the GM of old will disappear. Let the economic lessons learned from its history never be forgotten.

Russians Delay Log Export Tax

The Russian government has announced a delay in the implementation of an export tax of 80 percent on softwood logs and 50 percent on hardwood logs. The tax, originally scheduled to take effect on January 1, will be postponed for nine to 12 months. The current log tax of 25 percent with a minimum of €15 per m3 installed on April 1, 2008, will remain in effect.

The tax is designed to push development of the Russian log processing industry and is creating havoc in the country's main export markets, China, Japan, and Finland. The delay will enable these buyers to identify alternative sources for logs and lumber. Japan has reduced log purchases from Russia by 50 percent this year; China, by nearly 25 percent. China has increased its purchases from Canadian suppliers by 58 percent this year.

Eroded confidence in Russia's future log/lumber supply credibility and heightened investment risk

are significant side effects of this delay. The shifts in sourcing to other countries confirm the opinion that Russian saw mills cannot supply the volumes of wood demanded by China and other users. This situation should benefit Canada and New Zealand softwood suppliers.

Lacey Act Enforcement Delayed

The U.S. Department of Agriculture has postponed the enforcement date for the new Lacey Act import declarations for wood furniture and components. The Act, originally promulgated to prohibit illegal trafficking in wildlife, was amended this year to combat illegal logging.

Under the new law importers are required to declare the origin and species of wood products. As illegally harvested logs often sell for lower prices, foreign producers using these logs to manufacture exports for the U.S. market reportedly have a material cost advantage as high as 50 percent. Forcing these producers to pay market price will improve competitive conditions for both U.S. log exporters and U.S. value-added wood products firms.

Economic Fact

Eventually the education of a country's citizens determines the state of its economy. Thus the findings of the recent United Nations study of education systems around the globe are troubling. Out of 24 countries, the U.S. ranks 18th in tests used to determine the reading, math, and science abilities of 14 and 15-year old students. South Korea and Japan rank at the top while Germany surprisingly falls in at 19th.

Sector Report

Kitchen Cabinets

According to the KCMA's Trend of Business Survey, October cabinet sales fell by 22.3 percent versus the same month last year. Year to date cabinet sales have dropped 17.8 percent vs. 2007. Stock cabinet sales were down 18.5 percent, custom sales down 18.8 percent, and semi-custom sales off 16.9 percent showing weakness across all price points.

At the company level...

- **Masco** reported that its cabinet sales fell by 15.9 percent in its 3Q2008. Operating margin declined to 5 percent, down from 14.7 percent last year.
- **American Woodmark** announced a 16 percent decline in its 2Q2009 sales. The company continues to grow market share in a very weak environment. Gross profit fell to \$19.5 million, down nearly 30 percent. As a result, the company lost \$1.1 million.
- **MasterBrand Cabinets** announced the closure of its Richmond, IN, semi-custom kitchen plant. About 275 employees will be idled.

Home Furniture

2008 Furniture Shipments to Fall

Industry analyst Jerry Epperson is now forecasting a 7.2 percent decline in U.S. furniture and bedding shipments in 2008 and a mild 1.7 percent rebound in 2009. His predictions also show that industry shipments will not regain its 2006 peak until 2011.

Retail sales of home furniture are down an annualized 23 percent over the past four months.

Value of Furniture Industry Plummet

In 2002 the stock of the major publicly-traded U.S. furniture companies (Bassett, Chromcraft, Ethan Allen, Flexsteel, Furniture Brands, Hooker, La-Z-Boy, Stanley, and Havertys) was valued at over \$6 billion. As of mid-November you could buy those companies for less than \$1.5 billion.

North Carolina Training for Upholstery Workers

No surprise. Apparently the closure of so many U.S. furniture plants is resulting in a shortage of young workers wanting to enter the industry. As a consequence four North Carolina companies—Baker, Brayton, KI, and High Point Furniture—have initiated a program to train prospective upholsterers. The program, called CRAFT, is funded by a \$165,000 federal grant to Guilford Technical Community College.

At the company level...

- **Furniture Brands International**, the second largest U.S. furniture maker/importer, reported a 17.6 percent decline in 3Q2008 sales. Gross profit dropped by 14.8 percent to 21.7 percent. As a result the firm lost \$13.7 million in the quarter vs. a profit of \$5.3 million in the same quarter last year.
- Producer/retailer **Ethan Allen** announced that its 1Q2009 sales were down 17.2 percent to \$206 million. Operating margin declined to only 12.2 percent from 27.8 percent in the previous year.
- Producer/retailer **La-Z-Boy** reported a net loss of \$53.7 million for its 2Q2009. Sales continued to drop across all product lines with upholstery falling 8.1 percent; case goods, 17.1 percent; and in their retail stores, 14.5 percent. As a result, the company will lay off about 10 percent of its work force, about 850 workers. Parts of this move include the closure of 15 to 20 under performing stores and the reduction of FY2009 capital expenditures from \$27 million to \$18-20 million. Early next year the company will close its 280,000 sq. ft. Bauhaus USA upholstery plant in Sherman, MS, and eliminate 150 jobs. Production will be shifted to its Saltillo, MS, plant.
- **Bassett Furniture** posted a \$2.7 million loss in its 3Q2008 on a sales decline of less than 1 percent. For the nine months sales rose by 3.3 percent.
- **Stanley Furniture** said its 3Q2008 sales fell 25.6 percent to \$54.5 million. Due to a restructuring charge the company lost \$3.5 million. For the nine months sales dropped by 18.4 percent. To rejuvenate its domestic production the company is now offering 14 finish options on its Coastal Living product line, a level of customization more associated with the cabinet industry. Lead time on this line is less than 30 days thus making the product available to U.S. retailers much faster than imported goods. The company currently makes about 70 percent of its line in the U.S. and is now one of the largest domestic case goods producers.
- In a sign that furniture regardless of origin is not selling at retail, **ArtCraft Furniture** has ceased operations in the U.S. The company was owned by Ningbo Art Furniture, a Chinese furniture producer, and was established to sell directly to U.S. retailers.
- **Chromcraft Revington** reported a 3Q2008 loss of \$10.2 million as sales fell by nearly 19 percent.
- Upholstery producer **Flexsteel** said its 1Q2009 residential furniture sales were off 1 percent.
- Furniture maker **Jasper Cabinet** has been acquired by the Theater Xtreme Entertainment Group, a publicly-traded company that operates a chain of home theatre design centers.
- **Riverside Furniture** has idled 250 workers at its Ft. Smith, AR, plants and will consolidate its Plants 2 and 6 into a single operation in January.
- **Vaughan-Bassett Furniture** announced plans to close its Elkin, NC, plant and idle 400 workers. The company has operated the 700,000 sq. ft. plant for nearly 40 years and plans to reopen the facility when business recovers. As a result, its Galax, VA, plant will resume a full work schedule.
- **Baker Furniture** laid off 117 workers at its Hildebran, NC, plant. Last year the company closed two plants in Mocksville, NC, and consolidated that production to Hildebran.
- **Bradington-Young**, the leather upholstery division of Hooker Furniture, is cutting its work force by 54 at its Cherryville and Hickory, NC, plants.
- Furniture frame maker **Frank Chervan** is closing several of its operating units in its Bedford, VA, plant. About 90 employees will be affected. The company produces hardwood furniture frames for wood and upholstered seating. Its Roanoke, VA, plant will continue in operation.

Office Furniture

BIFMA, the sector trade association, reported a 6 percent decline in October orders and a 2 percent rise in shipments. Year to date, orders and shipments are essentially flat vs. 2007. Analysts are now cautious about this sector's prospects given weakening in demand drivers such as white-collar employment, new office construction, and corporate profits.

At the company level...

- **Steelcase**, the world's largest manufacturer of office systems and business furniture, has warned that its 3Q2009 revenues will fall to \$805 million from its previous guidance of \$840 to 875 million.
- **HNI Corporation** announced that its 3Q2008 office furniture sales were flat vs. the same period last year.
- **Knoll Inc.** reported an 11.6 percent rise in its 3Q2008 sales to \$283.5 million.

Wood Flooring

A study released by the U.S. International Trade Commission reported that the U.S. wood flooring industry experienced a major increase in offshore competition over the past five years. Imports rose from \$1.2 billion in 2002 to \$2.7 billion in 2006 before falling back with the decline in home building to \$2.4 billion in 2007. Like in wood furniture, the primary culprit is China, which is now the world's largest wood flooring producer.

While the volume of solid wood flooring produced in the U.S. rose through 2006, the value of domestic shipments peaked at \$1.5 billion in 2004. During that time the market share of imports grew from about 16 percent to nearly 31 percent in 2006. The import share fell back to 27 percent in 2007.

Residential housing accounts for about 80 percent of wood flooring sales. Consumer tastes are trending away from domestic species like oak and traditional appearance in favor of more exotic species, wider plank flooring, and rustic looks like hand scraping. Plank flooring now has about 35 percent of the U.S. market. Also a significant share of all wood flooring is now factory finished.

The study found that U.S. producers' costs were competitive with foreign flooring plants with the exception of labor.

At the company level...

- **Armstrong Hardwood Flooring** announced 3Q2008 sales of wood flooring down 11 percent to \$171 million.
- **Lumber Liquidators** posted 3Q2008 sales of \$123.1 million, up nearly 21 percent. Same store sales rose 2 percent.
- **Mohawk Industries** reported a 9 percent decline in 3Q2008 sales. Business deteriorated for its Unilin laminate flooring line with sales down 5.5 percent.

Non-Residential Construction

The American Institute of Architects' Architecture Billings Index dropped to an all-time low of 36.2 in October, down from 41.4 in September. Inquiries for new projects hit 39.9, also an all-time low.

The AIA's chief economist noted that government and non-profit projects are suffering from an inability to finance through the bond market. This institutional sector had been providing some strength in non-residential construction.