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Business Briefing

China Update, by Art Raymond, araymond@raymondnet.com

China is losing its luster as location for low-cost production. In a survey by the American Chamber of Commerce of 66 manufacturing companies in Shanghai, one out of five will be moving their operations to other countries. Top destinations are India, Vietnam, Thailand, Malaysia, and Brazil. The primary reasons are rising costs and an appreciating Chinese currency.

Costs for credit, materials, energy, environmental compliance, and health care are rising. The consumer price index rose 8.7 percent in February, year-on-year. That's the biggest increase in 12 years. Inflation of that magnitude puts pressure on wages. One factory owner reported that wages in his plant have risen 30 to 40 percent for skilled workers and 50 percent for unskilled since mid-2004.

As a result of rising living costs, many workers in Guangdong province, the center for many export businesses like furniture manufacturing, did not return from the Chinese New Year break. Officials estimated that 11 percent failed to return. Other estimates were as high as 30 percent.

Add the reduction in China's export subsidies on low value-added products like furniture and flooring plus lower demand from the U.S., and manufacturing profitability has taken a hit. In fact, reports indicate that 10-20 percent of the 70,000 factories in Guangdong province have closed. One-third of the members of the Federation of Hong Kong Industries, a southern China trade group, indicated plans to cut investment with two-thirds uncertain whether to spend more capital there.

The renminbi has risen 15 percent against the U.S. dollar since the peg was removed in July 2005 with 7 percent of that rise coming in the last 12 months.

The Chinese companies harmed the most are those producing labor-intensive export products. These firms were attracted to China by its low cost labor and generous government incentives. Indeed many of the pioneers in export furniture production moved their plants from Taiwan and Hong Kong to capture these benefits. Having left Taiwan due to rising costs there in the early 1990's, these owners are the first to consider relocation.

As an alternative to leaving China, other companies are considering moving further inland to escape higher costs. But evidence exists that the hinterlands do not offer much lower costs.

Reports from recent furniture markets indicate that prices will rise 4 to 20 percent as a result of these cost pressures. To take cost as well as time out of the supply chain, more Chinese furniture makers will sell direct to U.S. retailers. Those U.S. furniture companies who have shifted from producing to importing will be increasingly disintermediated. Chinese furniture producers are being lured by the strong Euro and increasing their sales efforts in Europe.

In spite of the changing economic picture, China remains a good place to operate. First and foremost, Chinese labor is productive. Never forget that wage cost is only half of the equation that determines labor cost in a financial statement. Productivity must also be considered when comparing the location-related attributes. Not every country has a high work ethic.

The second benefit of a Chinese base of operations is the enormous domestic market there. When selling to the local market, the strength of the currency is less troublesome.

Infrastructure is also well-developed. Construction of highways continue, the port facilities are among the best in the world, and ocean transport to/from China is reliable, fast, and frequent.

At the end of the day don't expect China to disappear as a source of low-cost products built for the U.S. market. But, for producers of cheap export goods, the bloom is off the rose. The window of a country's competitiveness remains open for fewer years now as globalization's benefits are seen in the under-developed world.

Economic Quote

"If a tax cut increases government revenues, you haven't cut taxes sufficiently enough."

- Milton Friedman

Sector Report

Kitchen Cabinets

According to the KCMA's Trend of Business Survey, February cabinet sales fell by 3.7 percent versus the same month last year. For the year to date, cabinet sales dropped 7.4 percent vs. 2007. As sales in February 2007 fell 15.1 percent, the February 2007 performance shows cabinet sales continuing to soften.

In its annual Kitchen/Bath Industry Outlook, the National Kitchen & Bath Association cites two reasons for optimism in 2008:

1. Declining home values typically spur owners to improve their houses either to attract a buyer or to enhance staying put.
2. The trailing edge of the Baby Boom generation is in the prime remodeling age.

Still the association sees a down year in 2008. Their forecast: kitchen and bath spending on both new construction and remodeling will decline 11.5 to 14.2 percent depending on the extent of the economic downturn. This drop is on top of the 12.3 percent decline reported by the KCMA for the full year 2007.

Cabinetmakers are combating this sales decline by extending their product offerings with cabinetry for other rooms. For the past ten years cabinet companies have focused on upgrading the kitchen with extras such as crown moulding, decorative turned posts, and useful accessories. Now, as houses have grown in size, cabinets are finding their way into mudrooms, libraries, home theatres, home offices, recreation areas. Factors driving that trend are (a) the evolution of furniture-like finishes in lieu of a simple stain/topcoat and (b) the ability to finance these additions with mortgage money.

These efforts show that U.S. cabinetmakers are continuing to defend their home markets against foreign competition.

At the company level…

Masco reported a 10.7 percent drop in its 4Q2007 cabinet sales to $665 million. Operating profit came in at 10.7 percent, level with the prior year.

American Woodmark, the second largest cabinetmaker, announced an 18 percent decline in its 3Q2008 sales to $132.8 million. Gross margin dropped from 18 percent to 14.3 percent. Operating margin turned negative at (2.6 percent) vs. 2.9 percent in the prior year.

Home Furniture

Worse Than You Thought
Seems that U.S. furniture production fell further than originally reported in the period 2002-06. The Department of Commerce has revised 2006 numbers with total production coming in at $21.2 billion or 19.2 percent less than the $27.7 billion previously reported.

Upholstery makers saw a sharp adjustment with their output dropping to $9.9 billion from the original $12.3 billion.

Wood furniture producers, earlier credited with $13.5 billion in 2006, actually turned out only $8.6 billion. Yet this adjustment may not reflect reality for U.S. wood furniture companies. From 1999, the year domestic wood furniture production peaked at $11.94 billion, the DoC believes U.S. furniture makers shipped only 28 percent less product. During that period 280 wood furniture plants closed in the U.S. The use of hardwood lumber by the furniture sector dropped a whopping 59 percent. More adjustments seem necessary to portray the true status of U.S. wood furniture production.

One difficulty in measuring the actual value of domestic manufacturing is the re-shipment of imported products through the warehouses of U.S. furniture producers. Sale of foreign-made wood furniture through these U.S. companies has been a primary distribution channel for this product category. Little, if any, value is added by U.S. workers in these warehouses.

Furniture Store Sales Continue To Fall
Regardless of where furniture is produced, this product is not retailing. Sales of furniture stores dropped 4.3 percent in the year since January 2007.

This important distribution channel has been hit with numerous bankruptcies, and fewer furniture stores remain in operation in the U.S. Consumer spending on furniture continues stuck at 0.9 percent of average annual expenditures.

At the company level…..

Sun Capital, with a 9.4 percent stake in Furniture Brands, announced its interest in acquiring the U.S.'s no. 1 furniture importer/manufacturer. Sun's offer is the second for FBI following Hong Kong-based Samson Holding's proposal last July. Samson owns 14.9 percent of FBI. FBI is the maker of the Broyhill, Thomasville, and Lane brands. Stock analysts are skeptical of any deal given FBI's declining fortunes. The company is closing its retail stores, consolidating distribution operations, and heavily discounting its products in mass merchants like Big Lots. In addition, Sun's investments in furniture retailing have proven ill-timed given the state of the consumer economy.

La-Z-Boy reported a 7.8 percent decline in its 3Q2008 sales. In spite of this drop, net income rose to $9.5 million from a loss of $7.8 million. The quarter's results included income from the company's participation in the anti-dumping action against Chinese producers. In early April, the company also announced the consolidation of cut and sew operations from its U.S. plants to one plant in Mexico. The Mexican plant will fulfill custom orders for its remaining U.S. upholstery operations. The company also announced the closure of its Tremonton, UT, upholstery operation. Following that closure La-Z-Boy will have six North American facilities (five in the U.S. and one in Mexico) totaling 5.5 million ft2. These changes will reduce their work force by 1,280.

Bassett Furniture Industries has retained two advisory firms to evaluate its future. Over the past ten years Bassett has closed all of its fully integrated wood furniture plants in the U.S and focused on developing its Bassett Furniture Direct retail chain.

Hooker Furniture said its 2008 sales dropped by 9.5 percent but that net income jumped 39 percent to a record $19.7 million. Gross margin improved by 1.8 percentage points due to the company's exit from domestic wood furniture production last year. Initiatives to improve its inventory leverage also resulted in a 26 percent drop in inventories since last January.

Chromcraft Revington posted a 27.2 percent decline in its 4Q2007 sales and an operating loss of $8.3 million. For the full year, sales were down by 23.1 percent, a performance that resulted in a net loss of $14.9 million. The company also announced the closure of its Delphi, IN, plant and conversion of this facility to warehousing. The shutdown will idle about 150 workers. The plant's products will be sourced from offshore. The company's remaining facilities are located in Senatobia, MS, and Lincolnton, NC.

Berkline/BenchCraft is disbanding upholstery operations at its Blue Mountain, MS, plant and eliminating 400 jobs there. Cut and sew operations employing 135 workers will remain at that location. Upholstery operations from Blue Mountain will be transferred to its 1,000,000 ft2 plant in Morristown, TN, creating 200 jobs there. Also closed will be the company's metal stamping plant in Lenoir City, TN, with a loss of 40 jobs.

Rowe Furniture is shuttering its Clayton Marcus brand plant in Hickory, NC, and shifting production to its Elliston, VA, plant. Rowe purchased Clayton Marcus from La-Z-Boy last October.

Sauder Woodworking, a major player in the RTA furniture market, is trimming its product line by one-third and will downsize its staff by 70 or 80 positions to enable improvement of operating efficiency. The surviving products account for about 90 percent of sales. The company currently employs about 2,500 in total. Management is forecasting decreased production in the second half of 2008.

Vaughan Furniture is closing its last U.S. manufacturing plant in Galax, VA and eliminating 275 jobs. The company, who was a major player in the fight against low-cost Chinese-made bedroom furniture, has closed five plants and cut over 1,200 jobs since February 2003.

Case goods producer Woodmarc Enterprises has closed its plant in Winterset, IA, and is exiting the furniture business.

Canadian furniture maker Durham Furniture is exploring the sale of its Chesley, Ontario, plant and is consolidating all production to its Durham, Ontario, factory as it struggles to rebalance capacity and demand.

Shermag, another Canadian producer, reported the closure of its Lennoxville, Quebec, plant. This announcement comes just weeks after its closure of four plants in Quebec and New Brunswick affecting 320 workers. Management is evaluating the prospect of going private.

Universal Furniture, owned by Chinese-based Lacquer Craft, is merging its imported upholstery line into its sister company, Craftmaster Furniture, of Taylorsville, NC.

Promotional wood bedroom maker Higdon Furniture of Quincy, FL, filed for Chapter 11 bankruptcy protection.

Office Furniture

BIFMA, the sector trade association, reported a 2 percent drop in February orders compared with the 1 percent increase in January. Shipments rose by 3 percent, a slight acceleration over the 2 percent rise in the prior month.

Analysts now indicate that shipment and order comparisons will turn negative later this year. Supporting that opinion are the recent drop in the AIA Architecture Billings Index (see story below on non-residential construction) and the cautious reports from Steelcase and Herman Miller.

The industry is shipping at an $11.46 billion rate vs. $13.35 billion at the historic top in late 2000.

At the company level…

Steelcase, the world's largest manufacturer of office systems and business furniture, announced a 15.8 percent increase in its 4Q2008 sales y-o-y. North American sales improved 9.4 percent; international sales, a whopping 32.6 percent. Operating income was up from $2.8 million in the same quarter last year to $46.8 million. Management is projecting 1Q2008 revenues will range from minus 2 percent to plus 2 percent.

Herman Miller reported a 2.2 percent increase in its 3Q2008 sales to $469.3 million. International revenues jumped 6.2 percent. Operating profit rose 25.7 percent to $61.7 million. Operating margin was 12.5 percent. Management note that orders fell by 0.8 percent year-over-year.

HNI Corporation has acquired Hickory Business Furniture from Furniture Brands International for $75 million. HBF produces mid- to upper-end upholstered seating, wood tables, and case goods for the office furniture market.

Wood Flooring

NOFMA, the primary flooring industry association, has ceased reporting monthly strip flooring production data. When an alternative source for this information is identified, Business Briefing will resume reporting this indicator of flooring industry health.

Armstrong World Industries reported wood flooring sales of $188.8 million in its 4Q2007, a decline of 2 percent from the prior year.

Mohawk Industries, in its 4Q2007 report, announced that sales of its Unilin flooring products were up 20 percent y-o-y due primarily to the strength of its European laminate market.

Tarkett Wood has sold the assets of its hardwood plants in Johnson City, TN, and an additional plant in Indiana to New Stream Capital, a private equity firm based in Ridgefield, CT. With this move the company has exited the hardwood flooring business in the U.S.

Non-Residential Construction

The non-residential sector is showing signs of drastic turn in its fortunes. Architects' billings are a leading indicator of the strength of this area of construction. Last December the American

Institute of Architects' Architecture Billings Index was 55.4. Any score over 50 indicates an increase in billings and a positive forecast for construction activity nine to 12 months in the future.

In February the Index plunged to 41.8, the lowest level since late 2001.

Millwork

Pella Corporation is closing its Story City, IA, plant and laying off 244 workers. The company blamed the housing decline and the resulting need to reduce capacity. The plant will be converted to a warehouse.