

Cutting Edge Newsletter™ August 2008

Business Briefing

Is the Pendulum Swinging Back?

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Signs are building that the exodus of U.S. manufacturing just may be reversing:

- Home furnishings retailer Williams-Sonoma announced plans to locate an upholstered furniture manufacturing plant in Hickory, NC. In five years the new plant will employ up to 820 workers.
- Thomasville Furniture is adding 100 jobs at its case goods plant in Lenoir, NC.
- Furnishings giant Ikea just opened a massive RTA furniture plant in Danville, VA.
- Linwood Furniture, operating the once-shuttered Lexington Home Brands' Plant 2 in Lexington, NC, is expanding its product line and adding employees.



These events are occurring in the face of an abysmal U.S. retail market for furniture and the reported idling of furniture plants in southern China this year.

Bottom Line: Seems the economics of offshore production are tilting slightly toward locating production here in the U.S. Is a tipping point on the horizon? Stay tuned.

[Read more about the reasons for this emerging trend in FDM magazine's July edition.](#)

Homebuilding Recoveries: Looking Back to Look Ahead

In 2006 spending on residential construction fell 2.5 percent marking the end of a ten-year run of growing investment in housing. Since the end of 2006, the downturn has turned into a rout. Residential construction, including the new single-family, multi-family, and improvements categories, dropped a whopping 18.3 percent in 2007. New construction fell by nearly 25 percent.

New housing starts totaled 1.355 million in 2007. That performance was 480,000 starts below the average during the five-year run-up from 2001 through 2005. The pain, however, has continued into 2008, as housing starts in June were 27 percent below the same month in 2007. From the peak in January 2006, starts have plummeted nearly 60 percent.

You've heard most of the reasons. Oversupply is causing prices to fall. Falling prices lead to foreclosures as refinancing and selling are difficult. Banks have tightened underwriting policy making loans less available. We're in what economists call a classic negative feedback loop.

Most say that a bottom will not be made until housing prices stabilize. Experts normally use two measures to monitor the price level:

1. The ratio between house prices and annual household incomes – During the recent boom this ratio rose to 2.39 as speculative buying drove house prices to record levels. Currently the ratio has fallen to 1.88 – near its 17-year average.
2. The ratio of house prices to rents – A lower ratio means people are more likely to buy a home. In 2Q2008 this ratio dropped to 20.02 vs. a peak of 24.90 and an average of 14.44 from 1985 through 2002.

By these metrics a bottom looks near. But this housing cycle is not normal. Home prices have fallen 16 percent this time vs. only 2.8 percent in the last downturn (1990-91). And worse, banks are foreclosing on homes faster than they can sell those already taken over.

The Fed and the Treasury are powerless to stop this price decline short of blowing up a million unoccupied houses as one guru suggested.

Have we hit bottom? When will the homebuilding market recover? Let's look at past housing busts for some useful data.

As shown in **Chart 1** the U.S. has experienced four major homebuilding downturns since the peak in late 1963 when the annualized rate of housing starts bottomed below one million. Table 1 shows those bottoms and the previous highs.



Highs		Lows		% Decline	Months To 1,550,000
Month/Year	Annual Rate	Month/Year	Annual Rate		
October 1963	1,779,000	October 1966	843,000	52.6%	18
January 1972	2,494,000	February 1975	904,000	63.7%	18
November 1978	2,094,000	November 1981	837,000	60.0%	14
January 1986	1,972,000	January 1991	798,000	59.5%	38
January 2006	2,292,000	?	?	?	?
Average	2,126,200		845,500	59.0%	22

Source: U. S. Census Bureau

Assuming that the average decline in starts is about 59 percent, the bottom based on the January 2006 peak will be about 940,000 starts. That prediction is only marginally above the May 2008 rate of 937,000. With the market still weak, let's say the low occurs in July 2008.

How many months before housing recovers? Let's define recovery as reaching the average annual rate of starts since 1959: 1.55 million. That number is also very close to the average rate of starts – 1.59 million – since the last bottom in 1991. The shortest recovery period to 1.55 million starts was 14 months; the longest, 38 months; and the average, 22 months. Based on these data, our definition of recovery will be reached between 3Q2009 (July 2008 + 14 months) and 3Q2011 (July 2008 + 38 months). The faster recovery will track much like the quick bounce back from the 1981-82 recession. The slower recovery will look more like the mid- to late-1990s as we grew out of the 1990-91 recession.

Is this forecast statistically airtight? No. Simple and logical? Yes. Watch the Census Bureau housing numbers reportedly regularly by the business media for a bottom in starts, use our model to estimate recovery timing, and keep your fingers crossed.

Economic Tidbits

Many believe the mainstream media focuses wholly on the negative especially when reporting the economy. One example is its failure to trumpet the recent gains in the net worth of U.S. families. Yes, over the past six months net worth has fallen from \$58.5 trillion in 3Q2007 to \$55.97 trillion now. But the latter is still \$15 trillion above where it stood in the first year of the Bush administration. That growth means more than one quarter of the wealth created since our country's founding was produced in the last seven years!

Another example is today's spending on gasoline and other petroleum products. Back in 1960 the average American family spent just under 5 percent of their personal consumption expenditures on gasoline, fuel oil, etc. That number gradually fell until the Arab oil embargo pushed it back to 5 percent in 1975. Oil spending rose to 6 percent in the middle of the 1982 recession. From there it fell to 2 percent in 1999, a figure that made pick-up trucks and SUVs ubiquitous. Today the figure is around 4 percent, still below the 1960 level in spite of \$125 oil.

Sector Report

Kitchen Cabinets

The downturn in cabinet production is now in its 20th month with no one in the sector predicting the timing of a recovery. According to the KCMA's *Trend of Business Survey*, June cabinet sales fell by 20.1 percent versus the same month last year. Year to date cabinet sales have dropped 14.8 percent vs. 2007 with stock cabinet sales down a whopping 19.9 percent. Remember, too, that June 2007 sales were down 12 percent vs. the same month in 2006.

At the company level...

- **Masco**, the largest cabinetmaker in the U.S., reported a 17.5 percent drop in its 2Q2008 cabinet sales to \$608 million, down from \$737 million in the same quarter last year. Operating margin for their cabinet operations came in at 6.1 percent, down from 13 percent y-o-y.
- **American Woodmark** announced a 14 percent decline in its 4Q2008 sales. Sales to the remodeling sector dropped in the mid-single digits while its builder lines fell over 25 percent. With the company resisting idling of its capacity, gross margin declined to 16.3 percent from 20.9 percent in the same quarter last year. Operating margin held just positive at 0.3 percent vs. 5.5 percent y-o-y.

Home Furniture

Prices To Rise

With materials and transport costs rising, furniture prices will be increasing by 3 to 5 percent:

- Foam producers have recently implemented a 20 percent increase due to rising chemical costs.
- Shipping rates from Asia have risen \$250 for containers landing on the U.S. West Coast and \$350 for East Coast shipments. Plus bunker fuel surcharges are being adjusted monthly.

This development reverses the deflationary trend that resulted from the shift of production from high cost U.S. plants to low cost operations in China and elsewhere over the past ten years. Some producers have not raised prices for many years.

The poor profit performances of most furniture companies recently indicate that pricing power remains weak with rising costs not being covered fully by price rises.

Latest on Formaldehyde

The U.S. Environmental Protection Agency has denied a petition by the Sierra Club to make the California formaldehyde emissions rule a national standard. The agency noted that insufficient information is available to conduct the analysis required by the Toxic Substances Control Act.

However the issue is not dead. The EPA is evaluating a possible national formaldehyde standard with plans to provide advance notice of such regulation in the fall.

California's standards will take effect in phases starting January 1, 2009, and will restrict emissions of formaldehyde from composite wood panels. Some producers indicate that compliant board will cost 10 to 20 percent more and drive end product prices higher.

At the company level...

- Retailer **Havertys**, which operates 124 furniture stores, announced that its June sales plunged 23.8 percent vs. the same month a year ago. For the second quarter of the year, sales declined 10 percent.
- **Furniture Brands International**, the second largest U.S. furniture maker/importer, announced the acceleration of its strategic plan. Initiatives include the expansion of its Indonesian capacity; the closure of a Lane upholstery plant in Pontotoc, MS, with workers being transferred to other plants and a case goods plant in High Point, NC, the implementation of multiple shifts at other plants, and faster exit of unprofitable Broyhill and Lane retail stores.
- Producer/retailer **Ethan Allen** announced that its 4Q2008 sales fell 8.8 percent from the same period last year. Operating income fell to \$19.1 million from \$32.3 million y-o-y, a drop of 40.7 percent. The company's network of retail stores totals 295 while it operates nine domestic manufacturing plants.
- Producer/retailer **La-Z-Boy** reported a 9.8 percent decline in its 4Q2008 sales. Sales dropped across all product lines with upholstery falling 8.9 percent; case goods, 24.3 percent; and retail, 10.2 percent. Operating profit was \$(0.8) vs. \$12.8 in the same quarter

last year.

- **Bassett Furniture Industries** announced a 1 percent decrease in its 2Q2008 revenues. The company's network of retail stores totals 127. Bassett no longer produces case goods furniture in the U.S.
- Case goods and upholstery importer/producer **Hooker Furniture** reported 1Q2009 sales down by 8.1 percent. Gross margin improved to 30 percent as the company shifted to higher-margin imported wood furniture. The company no longer operates domestic case goods production.
- **Stanley Furniture** reported 2Q2008 sales of \$59.1 million, down 12.7 percent from a year ago. Gross margin for the quarter came in at 16.8 percent; operating margin, at 1.7 percent. Management announced the closure of its Lexington, NC, plant with the elimination of 350 jobs. Production from that facility will be relocated to its Robbinsville, NC, plant. This transfer will ultimately create about 200 jobs at that plant. The company now operates only two plants: 562,000 square feet at Robbinsville plus the 1.7 million square foot facility in Stanleytown, VA.
- **Salem Frame**, a business unit of **Rowe Fine Furniture**, has upgraded its lumber drying and grading facility in Elliston, VA. The company supplies upholstery frame components to Rowe and kiln drying services to other customers.
- Manufacturer **Stickley** has acquired the designs and other assets of case goods producer Nichols & Stone, the oldest remaining U.S. furniture maker. Nichols & Stone had been seeking financing to convert its factory from a fully integrated production facility to the assembly and finishing of imported components and then in June announced that its factory would close. Plans for the factory were not announced.
- **Brownstreet Furniture** has acquired case goods producer **Vermont Tubbs**. The new owners did not announce plans for the Brandon, VT manufacturing facility.
- Juvenile furniture specialist **Stork Craft Manufacturing** has acquired RTA specialist **Canwood Furniture**, which had announced its closure in March. Canwood, based in British Columbia, had suffered from the rising Canadian dollar, labor shortages, and global competition. Stork Craft will add juvenile items to some of Canwood's existing lines, but a decision on whether to continue operating Canwood's Penticton, BC, plant was not announced. Stork Craft owns 500,000 square feet of production space in Asia and distribution centers in Seattle, WA, New Jersey, and Vancouver.
- Upholstery producer/retailer **Norwalk Furniture** has halted operations at its Norwalk, OH, and Cookeville, TN, plants as the company negotiates new financing. In addition to manufacturing, the company operated a retail network of 59 stores ranking as the 73rd largest furniture retailer in the U.S.
- Contract furniture maker **American of Martinsville**, bought from La-Z-Boy by Hancock Park Associates in 2006, is eliminating 400 jobs at its Martinsville, VA, plant. The idled workers were employed producing wood case goods that will be shifted to foreign sources. The plant will continue to produce upholstery and employ about 150 workers.
- Case goods and upholstery producer **Theodore Alexander** is adding 215,000 square feet to its Ho Chi Minh City, Vietnam, plant. The expansion will increase capacity by 50 percent and will provide additional onsite warehousing. The company operates 1.5 million square feet of manufacturing space and employs about 7,000 workers.
- Producer and importer **Douglas Furniture** has filed for Chapter 11 bankruptcy protection.

Office Furniture

BIFMA, the sector trade association, reported a 4 percent decline in June orders and a 1 percent decline in shipments. Year to date, orders and shipments are flat vs. 2007.

Analysts report that while the sector trend has weakened, industry demand has not collapsed, and their outlook is cautious. The demand drivers – business confidence, white-collar employment, and new office construction – are softer (see the note below on non-residential construction). However, any downturn will not be as severe as the 2001-03 decline when shipments dropped a whopping 40 percent.

At the company level...

- **Steelcase**, the world's largest manufacturer of office systems and business furniture, announced a 0.9 percent increase in its 1Q2009 revenues to \$815.7 million. Operating

margin fell from 6 to 4.5 percent. North American sales fell 9 percent while international sales rose by 29 percent.

- **Herman Miller** reported a 7 percent gain in its 4Q2008 revenues with North American sales growing by 6.3 percent and international sales by 22.8 percent. Operating margin rose from 9.2 to 12.7 percent.
- **HNI Corporation** announced a 2.1 percent increase in office furniture sales in its 2Q2008.
- **Knoll** reported a 7.5 percent gain in its 2Q2008 revenues to \$292.5 million. Operating margin fell from 13.8 to 12 percent.

Wood Flooring

Logging Ban to Impact Flooring Industry

The expansion of the Lacey Act now prohibits the import, sale, or trade of wood products made from illegally harvested timber. Every shipment of imported flooring must carry a label declaring its species and country of origin. As a result, prices of imported flooring are expected to rise.

Price increases ranging from 3 to 5 percent have been implemented by Mohawk Industries, Mannington Mills, and Armstrong Floors.

At the company level...

- **Mohawk Industries**, in its 2Q2008 report, announced that sales of its Unilin flooring products fell 7 percent y-o-y. The operating margin of this product line dropped to 14.6 percent vs. 22.5 percent in the same quarter last year.
- **Armstrong World Industries** reported a 20 percent decline in its 2Q2008 wood flooring sales due to the weak residential housing market. Flooring sales for the quarter totaled \$168.8 million.
- **Shaw Industries Group** has acquired Zickgraf Hardwood Flooring Co., Franklin, NC, for an undisclosed price. Since late 2007 Shaw has distributed Zickgraf products in the mid-Atlantic and Midwestern regions. The 55 year-old company produces unfinished and pre-finished solid wood flooring. Shaw acquired Anderson Hardwood Floors in October 2007.
- **Columbia Forest Products** has sold McMinnville Manufacturing to Preston Millet, previous owner of Millwood Specialty Flooring. McMinnville was one of the last flooring operations remaining in Columbia's stable after the sale of its flooring plants to Mohawk Industries in 3Q2007.

Non-Residential Construction

The American Institute of Architects' Architecture Billings Index rose to 46.1 in June but remained below 50 for the fifth consecutive month. A score below 50 indicates weakness in the pipeline for new projects that will be constructed nine to 12 months in the future.

Those firms specializing in institutional projects report billings growth as this sub-sector is yet to fall below 50 in the current downturn. However the commercial and industrial sub-sectors show no sign of immediate improvement.

Sector wide the only bright spot was an increase in the inquiries-for-new business score, which rose above 50.

The AIA Index score plus anecdotal evidence from millwork firms specializing in non-residential work yield a continued negative outlook for this sector.