

Cutting Edge Newsletter™ February 2009

BUSINESS BRIEFING

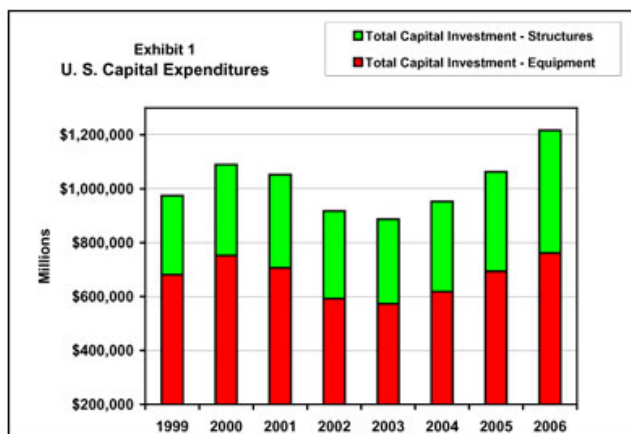
Capital Spending in Perspective, by Art Raymond, araymond@raymondnet.com

As expected, the report on December durable goods orders confirmed the severity of the current economic decline. Core capital expenditures—non-defense purchases excluding aircraft—fell 2.8 percent. Machinery orders fell 5 percent; technology purchases including computers, 7.2 percent. Capital expenditures in 4Q2008 fell 27.8 percent annual rate, the worst showing in 50 years.

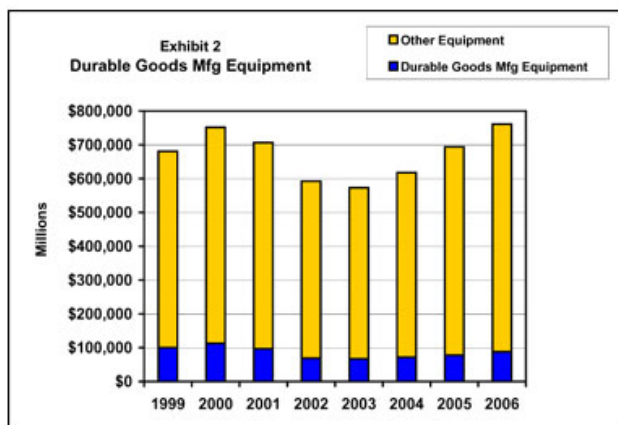


Capital expenditures not only generate immediate jobs in the construction and machinery industries. When that money goes into new and existing manufacturing facilities, more jobs are created, and productivity typically swells. Rising productivity, as any economist worth his salt will tell you, is the key to a growing standard of living.

A recent Census Bureau report provides a glimpse into U.S. capital spending from 1999 through 2006. Exhibit 1 summarizes total private capex on structures and buildings. Over the eight-year period investments in equipment of various sorts fell only slightly from nearly 70 percent of total capex to 66 percent.

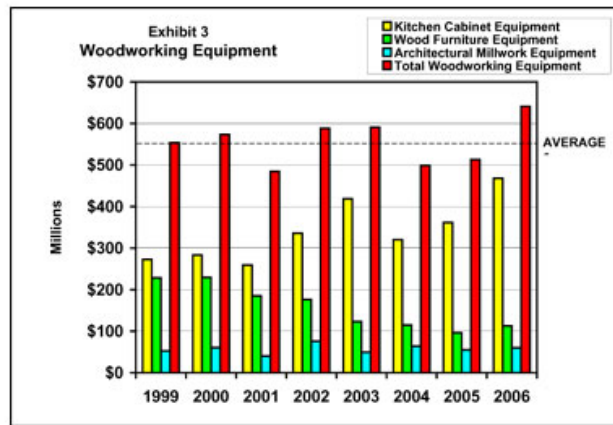


Drilling further into the Census Bureau data, Exhibit 2 compares spending on equipment for durable goods production with all other equipment capex. Most value-added finished wood products like cabinets and furniture are classified as durable goods. During the eight-year period, spending on this category fell from 14.6 percent to 11.5 percent of total equipment investment.

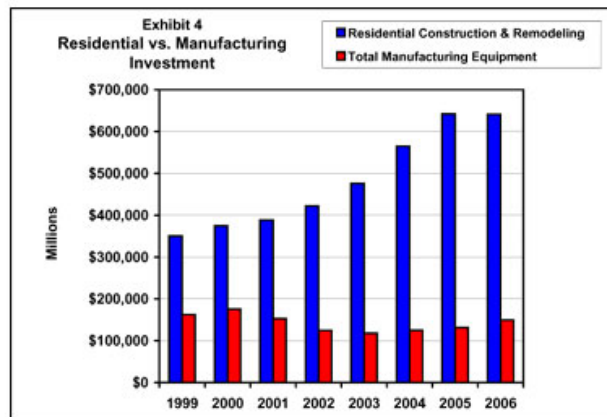


Using other Census Bureau data, Exhibit 3 shows equipment spending in three key value-added wood products sectors: wood furniture, cabinetry, and millwork. The cabinet sector's growth from \$272 million to \$468 million over the period cushioned the impact of domestic wood furniture's demise. In 2006 the cabinetmakers accounted for nearly three quarters of total capex by the main woodworking sectors. Unfortunately spending by the cabinet sector will drop precipitously following the demise of residential construction in 2006.

Average annual spending on equipment by the three sectors was \$550 million.



While spending on all manufacturing equipment in the U.S. totaled \$149 billion in 2006, this number was dwarfed by spending on residential construction. Exhibit 4 shows the stunning growth of investment in housing compared to that in manufacturing equipment.



Not coincidentally, housing is the beneficiary of two large tax incentives: (a) the mortgage interest deduction and (b) the \$500,000 tax shelter for sellers of their primary homes. Given these advantages, it's no wonder that so much capital in the U.S. has been routed toward housing. As we know now, much of that capital has disappeared with the recent, historic fall of home prices and defaults on mortgage loans.

Would the extra capital spent on housing have been better invested in new equipment and technology by private industry? Spending on houses does create jobs in construction and the production of numerous wood products. The National Association of Home Builders claims that three jobs are created by building a single house. But half of those jobs are in construction and are somewhat temporary. And many of the wood products like flooring and cabinetry would be featured in smaller homes in any event.

So let's look at the facts. In 1999 each dollar of Fixed Assets (TFA) in the U.S. produced \$0.379 of Gross Domestic Product (GDP). By 2007 the GDP/TFA ratio had fallen to 0.33. Simultaneously the ratio of Residential Fixed Assets to Total Private Fixed Assets rose from 0.5 to a peak of 0.546 in 2005. The average between 1948 and 1997 was 0.498.

Take away the extraordinary housing boom. If the fixed asset ratios had remained at the values of the mid-1990s, business investment would have grown by \$1.5 trillion in 2007. With that additional

capital employed productively, 2007 GDP would have run about \$15.9 trillion vs. \$13.8 trillion. Today's recession would have been a non-starter. More importantly, the higher investment in business may have preserved a portion of U.S. competitiveness in manufacturing.

Bottom Line: *The law of unintended consequences strikes again. Favoring one industry over another serves to misallocate capital to less effective uses. The result is a hidden tax on the economy and a less efficient economy overall. Let's remember this economic lesson next time we believe something is free.*

More Housing News...

- Starts Hit Historic Low—Housing starts in December hit 550,000 units, the lowest seasonally-adjusted annual rate since January 1959 when these data were first collected. Thankfully new permits dropped to 549,000 as builders finally recognized the market's weakness.
- Smaller Homes—According to USA Today the average size of a single-family home in the U.S. has declined from 2,629 square feet in 2Q2008 to 2,438 square feet in 3Q. In a survey of builders the National Association of Home Builders found that 89 percent are building or planning smaller homes. The American Institute of Architects also sees a shift toward smaller houses. Even high-end buyers are seeking smaller yet better crafted homes that retain the desired amenities like custom kitchens, wood floors, and energy efficient utilities.
- No Pent-Up Demand—Analysts point to the present homeownership rate of 68 percent vs. the pre-bubble norm of 64 percent as an indicator that pent-up demand is low.
- Record Inventory of Unsold Homes—Only 25 to 35 percent of homes owned by banks show up in official listings. This finding means the true inventory of unsold houses is 15 percent higher than that reported by the media or more like 13 months of supply.
- Mortgage Apps—Don't confuse data on mortgage applications with approvals. To refinance or purchase a home banks are now requiring a FICO score of 720 or better, 20 percent equity, and a zero balance on a home equity line. Less than half of the population qualifies under these terms.

Wood Products Markets Continue to Sink...

Prices for wood product commodities have dropped to unprecedented levels. No one is calling a bottom, and financial pressures are building on mills that call into question the survival of many industry players:

- U.S. South and Canadian dimension lumber and stud prices are approaching 1991 lows while West Coast prices have fallen below the lows of 1986. Operating rates at Canadian mills are averaged 63 percent through the first nine months of 2008. U.S. mills ran at 70 percent during that period.
- OSB prices are below cash costs with prices remaining above 1Q2008 levels due to mill closures.
- Particleboard mills are losing money due to higher resin and wood costs.

MDF is the only exception with prices at all-time highs. Even at that level mills are suffering from higher costs.

No Shows at AWFS 2009...

Major machinery producers Weinig and Biesse and the largest U.S. distributor, Stiles Machinery, have decided not to exhibit at this July's AWFS Show in Las Vegas.

Economic Quote

From the OpEd page of the January 6 edition of *The Wall Street Journal*...

"I must have dozed off and skipped a page. Our new policy is to sell government bonds to raise cash to give to private equity firms to lend to non-creditworthy borrowers so they can drive new Chevy Suburbans down our crumbling roads and bridges, converting Middle East oil into greenhouse gases at the highest possible rate? Unbelievable.—Murray Ross, Pleasant Hill, CA

Art Raymond is a manufacturing consultant specializing in furniture, cabinetry, millwork, and other value-added wood products. His firm, A. G. Raymond & Company Inc. develops management and technical solutions for wood products manufacturers around the world. Contact him at araymond@raymondnet.com or through www.raymondnet.com.

Sector Report

Kitchen Cabinets

According to the KCMA's Trend of Business Survey, December cabinet sales fell by 26.7 percent versus the same month last year. Year to date cabinet sales have dropped 19.3 percent vs. 2007. Stock cabinet sales were down 18.5 percent, custom sales down 20.6 percent, and semi-custom sales off 19.9 percent showing weakness across all price points. The 2008 performance follows the 8.2 percent decline in 2007 vs. 2006, the last year of solid growth in this sector.

At the company level...

- Analysts are estimating that cabinet sales by industry giant **Masco** will fall to \$2.277 billion in FY2008 and \$2.108 billion in FY2009 before covering to \$2.312 billion in FY2010. FY2007 cabinet sales totaled \$2.829 billion, down from \$3.286 billion in FY2006.

And plant closures and lay-offs accelerated...

- **KraftMaid**, a division of Masco, closed their West Jordan, UT, plant in late December and idled 813 workers due to the "unprecedented decline in the new construction and remodeling markets". The state-of-the-industry facility opened in April 2006. Many KraftMaid suppliers who located plants in the area will, no doubt, also be negatively affected by the closure.
- **Yorktowne Cabinetry**, division of Elkay, has laid off 70 workers at its Ringgold, VA, plant.
- **Merillat**, another Masco cabinet company, announced the lay-off of 70 workers at their Culpepper, VA, plant; 30, at their Mt. Jackson, VA, facility; and closure of its Ocala, FL, plant idling 279 workers. Last September the company announced the shuttering of its Adrian, MI, plant, that employed 300.
- **MasterBrand Cabinets**, a division of Fortune Brands, laid off 70 workers at its Kinston, NC, plant; the closure of its Littlestown, PA, facility with the loss of 415 jobs; and the lay-off of 60 employees at its Arthur, IL, plant.

Home Furniture

Factory Orders Down

Accounting firm Smith Leonard reported that October orders for U.S. furniture factories fell by 28 percent from the same month a year ago. Shipments declined 20 percent. Of the survey participants, 89 percent reported that orders were down in 2008.

More Anti-Dumping Duties Distributed

Another \$35.8 million in duties collected on Chinese wood bedroom imports has been disbursed to 23 U.S. furniture producers. The Continued Dumping & Subsidy Offset Act penalizes Chinese manufacturers who sell in the U.S. below normal market value. Since 2006 a total of \$92.7 million has been distributed to companies who brought suit against Chinese producers in 2003. Another \$58.2 million is awaiting the outcome of litigation over potential distributions to companies who did not participate in the original legal action.

Mississippi Furniture Makers Petition for Assistance

Leaders for the furniture industry in Mississippi have met with state and local officials to promote a \$14 million incentive package aimed at retaining cut-and-sew jobs in the state. The Mississippi Furniture Association claims that for every dollar invested in the furniture industry the state receives 4 dollars.

Three Mississippi upholstery makers have been approved as foreign trade zone manufacturers by the U.S. Department of Commerce. This designation enables these firms to buy duty-free imported fabrics, reduce their raw material costs, and save about 950 jobs.

At the company level...

- **Furniture Brands International**, the second largest U.S. furniture maker/importer, announced the elimination of 1,400 jobs in management, professional, and hourly positions. FBI is the parent of Broyhill, Lane, Thomasville, Henredon, Drexel Heritage, and Maitland Smith. A new executive incentive plan that provides nearly \$20 million in awards to senior managers at the corporate and division levels has upset industry analysts.
- Producer/retailer **Ethan Allen** announced that the closure of its Eldred, PA, upholstery plant and several of its retail service centers. About 350 workers will be affected. In its 2Q2009 the company reported 27 percent declines in sales and gross profit and a 70 percent drop in operating profit. The

company has cut its dividend.

- **Stanley Furniture** reported a 24.7 percent drop in its 4Q2008 sales while its gross profit fell only 2.9 percent and its operating income declined 48.2 percent. The company has suspended its dividend.
- **Standard Furniture** has laid off an additional 80 workers at its Bay Minette, AL, plant. The latest lay-off brings the total number of employees idled in 2008 to 340 of which 200 were located at its Frisco City, AL, plant.
- **Hooker Furniture** posted a 17.6 percent fall in its 3Q2009 sales. For the nine months sales were down 12.7 percent. The company managed to turn a quarterly profit of \$2.95 million on the reduced volume.
- Upholstery maker **Stanton International** of Tualatin, OR, has shut down operations and closed its three plants. About 175 employees have been impacted. The west coast promotional upholstery specialist had a strong customer base in northern California, a region that has been hit hard by foreclosures, unemployment, and retail closures.
- Chinese furniture maker **Markor International** has acquired U.S. upholstery and case goods importer Schnadig Furniture based in Des Plaines, IL. Estimate value the deal at about \$9 million. Previously a domestic upholsterer, Schnadig ceased U.S. production two years ago and began sourcing its products in China.
- Home office/entertainment furniture importer/producer **Martin Home Furnishings** has acquired the assets of Highland Design, a California manufacturer of bedroom and dining room case goods.
- China-based leather upholstery producer **DeCoro** is being liquidated. In November the company had announced new financing in an effort to stem rumors of bankruptcy. The company was a pioneer in upholstery production in China opening there in 1997 and eventually building two plants totaling 2.9 million square feet.

Office Furniture

BIFMA, the sector trade association, reported a 17 percent decline in December office furniture orders. Shipments fell by 12 percent y-o-y, the sharpest drop since April 2003. Full year shipments declined by 2 percent compared with 8 percent and 6 percent growth in 2006 and 2007 respectively. 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. BIFMA's own forecast for 2009 calls for a 13.1 percent decline in orders and an 11.6 percent drop in shipments.

At the company level...

- **Steelcase**, the world's largest manufacturer of office systems and business furniture, reported an 8.4 percent drop in 3Q2009 sales. North American revenues fell by 11.4 percent. Operating income declined to 1.8 percent vs. 5.9 percent in the same period last year.
- **Herman Miller** announced that its 2Q2009 sales declined by 5.8 percent to \$476.6 million. Incoming orders plunged 25.6 percent; backlog, 18.7 percent. Operating income fell from 12.9 percent to 11.5 percent.

Non-Residential Construction

The American Institute of Architects' Architecture Billings Index increased slightly to 36.4 in December from November's 34.7. Last December the Index was at 55.