Furnishings Digest Newsletter

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Reading Time
20 minutes

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Celebrating 46 Years of Proprietary Furniture Research

Come See Us! Sunday, October 15th, High Point, NC 9:00AM, at the H.F.A Retail Resource Center, first floor, Plaza Suites building. My partners Howard Armistead (wha@maeltd.com) and Jimm Mann (jmm@maeltd.com) will be at the market as well. Please contact them to discuss valuations, mergers, acquisitions, or our other services.

I hope to see you at the High Point market, the key to having a good year in 2018. Yes, I know not everyone shares my enthusiasm but serious market goers can blend a lot of learning and new ideas, with new, high value merchandise, some relaxation and some free food. Did I mention good food that is free? Adventurous? Go explore a showroom or floor you have never visited before. I believe there are corners of Market Square that I have yet to visit but I hope to. And there are a huge number of new showrooms—too many to list. The HFA, the IHFC and the Market Authority have educational programs to help you be a better retailer, vendor, designer or rep. Every night there are parties, some really good, with free booze. Did I mention the food?

Current Business
It is difficult to get excited about the retail sales of furniture and mattresses these days with the ongoing negative news about hurricanes and the tragic Las Vegas shootings. We have not had a good big sale weekend since Memorial Day and that seems like a long time ago.

There are as many reasons as there are furniture reps but, as I have said too often, the economic news continues to be upbeat and encouraging. The second quarter was just upgraded to +3.1% GDP growth, with expectations now for 2.5% or better for the remainder of the year.

We would rather have good economic news and lackluster retail sales than the reverse because this will eventually benefit us, while the reverse would indicate we are about to fall off a cliff.

Some considerations:
-Boredom: This has been a bad year for a lot of things. Big movies this year have all bombed and, for the most part, have been stinkers. Stay home and wait for the streaming versions. There are NO new exciting consumer electronics. The new iPhone is a snooze, The new Nintendo game console has disappointed. Many are boycotting football. Why? Who cares? NASCAR attendance is way down and as some of the old heroes retire, it will not get better. The same holds true for golf, tennis and baseball. Even the ladies fashion publications are saying we need something bold and different. Can America escape the jeans epidemic? Everyone wears jeans to all events, and the more cut up and nasty, the better. The only thing

more omnipresent is the smart phone in hand, all the time, everywhere. The descriptive phrase "Millennials" will soon be replaced by the "Eye Strain Generation". When I was young, we just had loud, louder and loudest music that left some deaf----what did you say? Repeat that, please. Huh?

-Hurricanes: Yes, I feel guilty mentioning that we will get an immediate and another long term benefit from the severe hurricanes. People often replace mattresses and other necessities with a low-cost make-do alternative and when the residence is recovered, they make a more permanent purchase. The auto industry is already revising its numbers upward expecting the hurricanes to help sell an additional 250,000 vehicles this year. It will keep that industry from having a severely negative year, well below last year's 17.5 million units. One negative thought: 70% of the damaged homes in Houston did not have the correct flood insurance to cover this event.

-Inflation: Get ready now. Don't wait until you see the higher costs to adjust your prices. Look around at gas prices, driven up by hurricanes and other international concerns. Don't you love how gas prices shoot up but then come down slowly? Wonder why? Want an everyday example? For many years, the largest restaurant chain(in units), Subway, has promoted endlessly its "$5 foot long" ----this always make me hope for a hot dog----but the new promotion is a "$3.50 six inch sub". For those who are not math majors, that is a $7 foot long-- a 40% price increase, and they probably put on less meat, too. But the real challenge is employment. We have more job openings today than ever in the U.S., well over 6 million, I read somewhere. That will force wages up which has proven to be the most consistent driver of inflation. And remember, wages do not come back down. Also, higher pay means more taxes and other non-direct costs. I won't mention health care costs because it will just make you cry.

Back to the Economy…
The new University of Michigan economic model was just updated with very encouraging numbers for us. This should result in a better 2018 (**Table 1**). Of course, the economy indicated we should have had a better year in 2017. Even so, there are more and more experts saying 2018 is likely to surprise us all on the upside—unless there is an unforeseen event like….well you know.

University of Michigan Economic Model — Table 1.

	2012	2013	2014	2015	2016	Forecast 2017(a)	2018(a)	2019(a)
Real GDP (Q4/Q4)	1.7%	3.1%	2.5%	1.9%	1.8%	2.4%	2.3%	2.1%
Unemployment	8.1%	7.4%	6.2%	5.3%	4.9%	4.5%	4.3%	4.1%
Inflation Rate (CPI)	2.1%	1.8%	1.7%	1.8%	2.2%	1.8%	1.7%	2.1%
Light Vehicle Sales (millions of units)	14.4	15.5	16.4	17.4	17.5	16.9	16.9	16.9
Private Housing Starts (thousands of units)	783	930	1,001	1,108	1,177	1,203	1,305	1,332
Existing Home Sales (thousands of units)	4,140	4,480	4,330	4,630	4,830	4,940	5,000	5,080
10yr Treasury Bond Rate	1.8%	2.4%	2.5%	2.1%	1.8%	2.3%	2.7%	3.2%
30yr Mortgage Rate	3.7%	4.0%	4.2%	3.9%	3.6%	4.0%	4.4%	4.8%
Real Disposable Income	2.0%	(0.2%)	2.7%	3.5%	1.4%	1.6%	3.1%	3.2%

Sources : University of Michigan's RSQE (Research Seminar on Quantitative Economics), released September 19, 2017
Note :(a) RSQE Forecast

All major retail categories report less walk-in traffic (wonder if that affects shoe sales?), but the internet is not the shiny bright spot many want you to believe. Its costs are going up, online advertising is getting much more expensive, and some online attractions are offering to let you buy into an advertising-free service. Take that online retailers! Folks, it is easier to show and sell almost anything than it is to deliver it undamaged as quickly as most advertise. Truthfully, the "back end" is not keeping up with the "front end", to use retail speak, for online retailing. Some of the models are impractical. My favorite has ladies encouraged to buy five or more pairs of shoes, and only keep the one you really like, after trying on the others, showing them to friends and going for a long walk in the rain to see how they fit. An 80% return rate….with prayers the returns are resellable…knowing that sometimes you get a 100% return rate. Can you offer any real value pricing doing that?

Monthly Trends — Table 2.

% Change y/y	2017											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Total consumption of furniture & bedding (a)	3.4%	2.3%	4.7%	3.0%	2.7%	1.8%	3.8%					
Furniture stores sales (a)	2.8%	1.4%	1.4%	1.5%	6.1%	3.5%	3.1%					
Mattress factory shipments (b,d)	N/A	N/A	(0.1%)	N/A	N/A	(4.2%)	N/A					
Furniture factory shipments (c)	2.0%	3.0%	5.5%	2.4%	7.5%	N/A	N/A					

% Change y/y	2016											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Total consumption of furniture & bedding (a)	6.0%	8.1%	4.8%	5.7%	3.9%	6.0%	3.5%	2.1%	2.7%	2.3%	2.6%	1.0%
Furniture stores sales (a)	1.8%	9.8%	6.4%	4.0%	0.2%	5.3%	0.0%	4.0%	5.7%	(0.6%)	5.9%	1.4%
Mattress factory shipments (b,d)	N/A	N/A	0.2%	N/A	N/A	5.5%	N/A	N/A	(2.5%)	N/A	N/A	4.3%
Furniture factory shipments (c)	(1.5%)	2.5%	3.7%	(3.1%)	(0.7%)	1.6%	(9.5%)	6.2%	6.1%	(6.0%)	4.5%	15.0%

Sources:

(a) U.S. Department of Commerce (b) International Sleep Products Assoc. (c) "Furniture Insights" a monthly publication by Smith Leonard (d) quarterly shipments

The latest numbers for our sector are ok, although I suspect recent monthly numbers will be restated slightly downwards next year. We have easier comparable numbers the rest of the year!

The public company numbers are much more mixed than the government numbers indicate. It is getting more difficult to find those with steady long term gains from operations, not just acquisitions.

Public Furniture Company Latest Quarter — Table 3.

	Q Ended	Sales	Net Income
Furniture Manufacturers			
Bassett Furniture Industries	27-May-17	7.0%	72.6%
Culp	31-Jul-17	(1.4%)	(6.2%)
Ethan Allen Interiors	30-Jun-17	(5.3%)	(30.4%)
Flexsteel Industries	30-Jun-17	(4.3%)	(2.3%)
Hooker Furniture	31-Jul-17	14.8%	45.4%
La-Z-Boy	31-Jul-17	(1.0%)	23.0%
Stanley Furniture	30-Jun-17	3.8%	Profit
Furniture Retailers			
Aaron's	30-Jun-17	3.3%	(5.6%)
Conns	31-Jul-17	(9.7%)	Profit
Haverty Furniture Companies	30-Jun-17	1.1%	15.1%
Pier 1 Imports	31-May-17	(2.1%)	Loss
Restoration Hardware	31-Jul-17	13.2%	Loss

	Q Ended	Sales	Net Income
Bedding Companies			
Select Comfort	30-Jun-17	2.8%	Loss
Tempur Sealy International	30-Jun-17	(18.0%)	15.0%
Foreign Companies			
Ekornes	31-Mar-17	0.4%	(26.5%)
Leon's Furniture	30-Jun-17	4.1%	11.2%
Markor	31-Mar-17	8.0%	5.9%
Man Wah	31-Mar-17	14.9%	88.3%
Natuzzi	30-Jun-17	15.8%	Loss
Samson Holding	30-Jun-17	8.6%	173.9%

Notes:

"Profit" is shown without a % for companies that showed a net loss a year ago

Man Wah & Samson are compared on a 6 month basis

Sources:

PitchBook as of September 25, 2017

Housing and income numbers are going our way; consumer confidence, employment, home values and the stock market are all very positive. Consumer debt is up but relative to accumulated wealth, income gains and the total number of consumers, it is still at comfortable levels. All this is building towards a better 2018 and probably 2019. Want to lose sleep? 2020 and another election (help us all!!).

An important study:
The following is an attempt to explain why this recovery has not been as satisfying as most. Yes, we are opening a lot of stores and yes, we have the internet, but it seems the core business of selling upholstered and wooden furniture has changed.

WHY AREN'T WE MAKING MORE PROGRESS?
The furniture industry is not data rich. A friend is in the tobacco industry and they know monthly how many cigarettes are manufactured and what are sold at retail (yes, they have imports, too) by brand, length, filter, tobacco mix, packaging (soft pack or box) and other measures. And they complain they don't have this information weekly or daily.

We cannot tell you how many sofas or bedrooms are sold each year!

Over the years, we have attempted to keep up with pricing and mix changes. It is far from an exact science, but give us credit for trying. And because our industry does not change rapidly, we are going to compare the most recent year, 2016, with 1985. Now, just to refresh your memories:

- -in the 1980's, imports and the pricing pressure they have brought were much less. In fact, imports were less than 20% of the furniture sold in the 1980's (but by 1989 they were over 19%). For the decade of the 1980's, domestic furniture grew at a compounded annual growth rate of 4.3% while imports grew at 15.3% per year. By comparison, by 2016, imports were 84.9% of all wooden furniture sold in the U.S.; 45.7% of all upholstered furniture sold here; and 93.9% of all metal & other. (Source: Furnishing Digest Import Study: 2017)

- -because of the expensive and complex overseas logistics and other reasons, most foreign manufacturers greatly prefer to make longer production runs of few items than has been true historically in the U.S. furniture industry. It was not unusual in the 1980's for a new domestic wood furniture collection to have 60 to 100 items plus an alternative finish. Importers would cherry pick the best pieces and introduce a similar look but with 14 to 20 items at a better price because of their cost advantages.

- -the retail mix in the 1980's was much different with a robust "High End" in the furniture industry as luxury brands flourished with new collections and fashion changes. The leading fine furniture stores were busy as were the large designer showrooms in almost every major city. In addition, we had fewer massive chains with Levitz being the largest for two decades selling popular priced furniture. There were no Ashley HomeStores or Rooms to Go, and harder to imagine, no internet. The department stores were strong as were malls. All the manufacturers wanted to sell Sears and J.C. Penney. Some of us remember when Fred Daniel and his Group 600 entourage would enter a showroom. The crowds would part, and the company president would come forward. Most didn't bow, curtsey or kiss Fred's ring, but they almost did.

- -as to furniture stores, the larger state chains were strong as were a few multi-state regionals, but not many. This was before the major success of the "lifestyle stores" like Crate, RH, Z, Room and Board, Pottery Barn and others, and warehouse clubs were just emerging as the catalog retailers like Service Merchandise and Best Products were peaking. Family run, local furniture stores were the primary focus of our manufacturers back in the 1980's.

- -in the 1980's, the "Baby Boomers" were dominant, being 77 million young needy consumers (20's to early 40's), following the 40+ million Depression survivors, who were in their 40's and 50's. This surge greatly shifted the focus of all retail to this HUGE new opportunity to grow with this exciting new generation. Because domestic goods were dominant, in furniture, autos, and most other categories, logistics were less of a concern, meaning that smaller quantities being shipped were the norm. Of course, retailers and their vendor/suppliers also recognized the taste and financial differences among the generations.

- -meanwhile, the parents of the "Baby Boomers" were still in the market in their 50's and 60's, helping fund their children and grandchildren and enjoying larger, more opulent homes which included buying quality, fashionable domestic furniture.

- -automation was coming to most manufacturers and with that, a declining number of stock-keeping units (SKU's), but not nearly to the degree that is necessary today.

Over the coming decades with the explosive growth in imports, the "Baby Boomers" saw the shift in many product categories to imports instead of domestic production, not just because of less expensive labor, but because of the increasing severity of U.S. government-dictated regulations and standards, which grew to be more restrictive each decade to the point that building new wood or metal furniture manufacturing facilities was nearly impossible, especially because of EPA and OSHA.

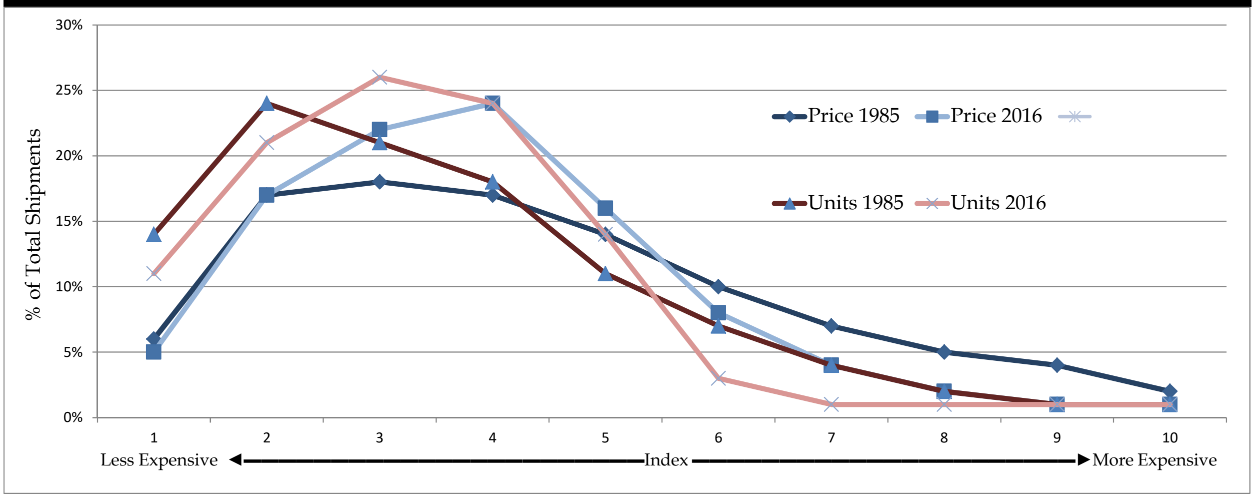
Resistance to imports dissipated as we saw certain categories completely captured by imports like consumer electronics and some appliances, not to mention apparel, footwear and other consumer goods.

<u>In wood furniture specifically</u>, the early use of rubberwood and a few other Asian native wood species were acceptable for lower to mid-priced furniture, but resisted at higher price points. By the late 1990's, so many more containers of imported products were coming east to the U.S., that they greatly exceeded the quantities of North American goods going west, leading to a glut of empties. This created the opportunity for Asian manufacturers to purchase North American lumber and ship it at a very low cost to their factories, improve the lumber used at all price points, and to approach the higher price points for the first time. Thus, the low cost labor for carving, hand finishing, complex veneer inlays and other detailed work could be utilized on U.S. quality hardwoods, and begin to reach into new markets offering lower prices on almost-comparable furniture.

NOTE: In 2016, in a furniture store here in Virginia while shopping for my new condo, I found an absolutely top-notch high-boy from Virginia-based Henkel Harris, priced on sale (of course), for $9,995. It was something I would love to have. Please remember Richmond is still a very dark-wood, Williamsburg-influenced community furniture -wise. As I looked further, thinking how I could buy the Henkel-Harris item without my wife's anger, I found another striking high-boy. It was about the same scale with very similar detail. The finishes were different, but both were acceptable. This Theodore-Alexander, Vietnam-manufactured item was on sale (of course) at $2,795. Was it the same quality? I could not say, nor could I be sure the wood species were equal, but <u>was one high boy worth essentially four times the cost of the other</u>? I was so confused, I bought neither (but I still want them). How does the average consumer know, without a professional advisor, how to decide? If the pocketbook is involved, often it is a no-brainer.

We believe this can be quantified as seen in **Table 4** showing the dollars of wood furniture and units of wood furniture (using a 4 piece wood bedroom as an example, indexed to a scale of one to ten) in both 1985 and 2016. In the 1980's, there was more high-priced furniture sold than in 2016. Why? It is a complex answer but the easy answer includes lower cost labor, less governmental regulation, governmental incentives to capture currency or to provide employment, fewer SKU's, much improved logistics, more automation, possible currency manipulation and Asian factories that have invested heavily in the latest technology. All have allowed factories in Asia and possibly elsewhere to offer a product that has much of the same appearance (or "face" as said in the trade), for a fraction of the price of a similar item made in the U.S. that used more traditional manufacturing methods and our labor. This is not always true, but often it has proven to be.

Wood Furniture by Price and Units: 1985 & 2016 — Table 4.



The result, in my opinion, is the new "high end" in residential wood furniture being at more popular price points, and largely imported. Look at many of our leading high end manufacturers from the 1980's who are primarily if not exclusively imports, if they still exist.

As is clear in our nearby **Table 4** for wood furniture, the quantity of dollars has shifted to more affordable wood furniture which has greatly impacted the units. Of course, while we use bedroom furniture in the example, the same would prove true in all residential wood furniture categories. The middle has taken over from the high end because of perceived value of the imports, and this is certainly reflected at retail by the demise of so many of our former "carriage trade" furniture stores.

As a result, we are selling more units at lower prices, resulting in poor results if you measure in dollars. It is NOT just deflation; it is a shift in mix.

Is Upholstery the same?
NO.

Imports of upholstery from Asia were negligible in the 1980's and most of the 1990's. Our imports were dominated by Canada, some from northern Europe, and if leather, from Italy in the 1980's.

Much of the international trade in leather had moved to Asia, primarily China, to be used in shoes, wallets, pocketbooks and apparel. It had the tanneries and the raw materials, not to mention the labor. In the mid-1990's, we began to see the first leather upholstery come into the U.S. largely because of the currency shifts that made Italian merchandise more expensive in the U.S. At that time (and to a degree today), the Chinese had pegged their currency to the U.S. dollar, so that created an opportunity for China to develop a leather trade in upholstery in the U.S. and Canada that could undercut the historic leadership of Italy.

NOTE: Italy did not have an inherent cost advantage over the U.S., which has a rich heritage of making fine leather upholstery. The tradition in the U.S., however, was to use the more expensive unmarked "perfect" hides. Leather has a much larger share of the seating market in Europe because the European manufacturers were using leather hides that had imperfections or scars (often from the cow encountering barbed wire) which were described as "character marks" and showed that the leather was truly a natural product. Of course, the imperfections were often corrected so they were less noticeable, if they could be seen at all. But unlike the very expensive perfect hides, these hides used in Europe were much less expensive, allowing European leather, primarily from Italy, to gain a fast growing share of the U.S. upholstery market. They captured market not only from the existing domestic leather vendors but because of the good prices, they impacted the fabric market as well.

The currency shifts in the mid-1990's made the Canadian and Italian leather upholstery more expensive, offering an opportunity for the Chinese manufacturers. They took advantage and by 2000, they had become an important leather resource. Learning how to design, pack and ship upholstered furniture to the U.S. did not go unnoticed by the makers of fabric upholstery. In 2002-2005 more upholstery fabric manufacturing was begun in Asia (mostly China) that it had more capacity than the U.S. This was rapidly proven by the demise of many domestic upholstery fabric sources.

Having the lower cost labor, the governmental incentives, and the knowledge of how to not only ship upholstered furniture to the U.S. but how to sell it to U.S. retailers, growth was rapid. As mentioned earlier, while not up to the 84.9% import share of the U.S. market that has been accomplished in wood residential furniture, imported upholstery (leather and fabric fully finished upholstered furniture) now has 45.7% of the U.S. market. Thanks to pre-sewn "kits", made in Asia, and the fabric itself which is broadly used by U.S. manufacturers, the impact of all those Chinese upholstery fabric factories is much greater.

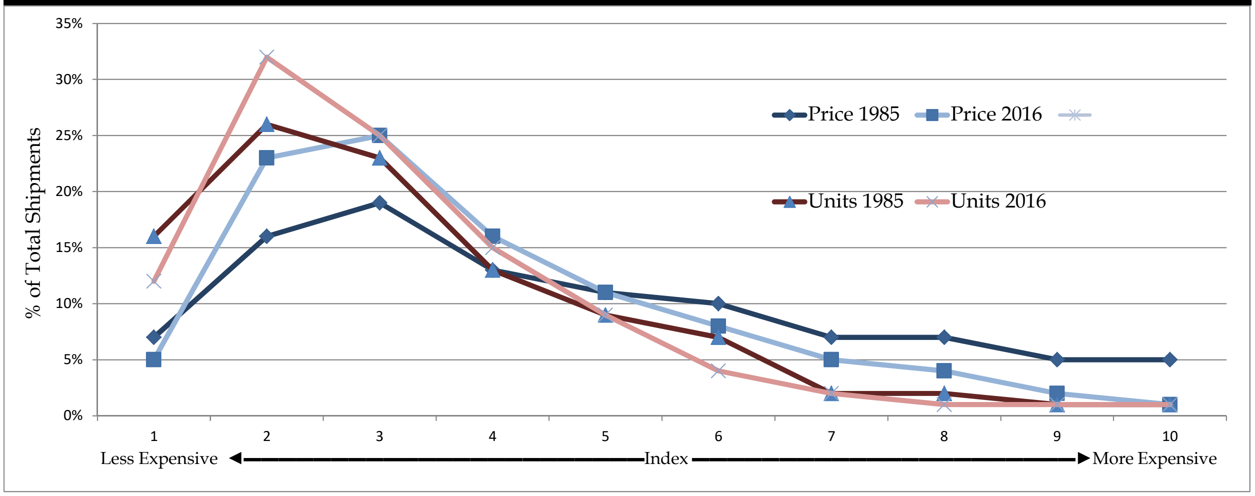
But is Upholstery on the same path as Wood?
No.

There are really two upholstery manufacturing industries. The larger piece with MANY more units, is upholstered furniture that is made then sold to the consumer. It is mass produced here and overseas in large quantities and sold to larger retailers at popular price points.

The second, smaller piece with many less units, is upholstered furniture that is sold to the consumer and then manufactured to their preferences. Customized, if you will, from as simple as choosing the fabric or leather cover to choosing the length and depth, type of fill, skirted or not, welting, and so many more features. Some upholstery manufacturers have as many as 24 options that the consumer must specify. Of course, the manufacturer cannot produce it until the consumer makes all their choices, so this custom furniture usually takes 30 to 90 days before it gets to the consumer. Some consumers will insist on getting exactly what they want and are willing to pay and wait to get it. Others want something they can find immediately and get into their home as fast as possible. It is two distinctly different markets.

These two different manufacturing models are probably going to limit the import share of the U.S. market as many of the Asian and other foreign factories may not like to make customized, one-at-a-time product, that has to be shipped inefficiently with more complications than full containers of one item. As a result, the shifts in the mix of upholstery is not nearly as severe as seen in wood residential furniture, but it is still noticeable. Imports have had a real impact on domestic upholstery manufacturers who have been forced to develop many different strategies to compete. As in wood, better looking and more detailed popular mid-priced upholstery has stolen share from the more expensive custom upholstery, but not nearly to the same degree as shown in **Table 5**.

Upholstered Furniture by Price and Units: 1985 & 2016 — Table 5.



Conclusion?
It is frustrating to sell more units for the same dollars. It also cuts into profitability as you have more deliveries, warehousing and logistical expense, but it is the reality of the furniture industry today. Upholstery has been able to show more growth and be more profitable because of fewer mix changes and the ability to develop more feature-rich products like power motion, to mention one.

Please recognize that most of these factors have been recognized and adapted to, but we expect further change. We expect wood furniture sales to accelerate its growth with additional household mobility, for example. Upholstered furniture (and mattresses) have a more rapid wear cycle than wood furniture. And upholstered furniture has a very high fashion element. We believe stationary upholstery is the most fashionable product in the home, and benefits as such. But recognize that this change is not just because of inflation or in the case of wood furniture where imports have displaced domestic, deflation, but a severe shift in mix.

Forgive us, please!
For many of our subscribers, this is old news and very basic. Our purpose here was to explain and quantify the reasons why our industry at retail often feels so frustrated with minimal growth in dollar sales. It is not your fault. This will shift SLOWLY as the different population groups age and change tastes. Studies have shown, for example, that home owners spend more than twice as much as renters on the same square footage, implying that as more home owners come, we will benefit.

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