THE PARLIMENT PAGES

April 1, 2010

LET'S SLICE AND DICE OUR MARKET FROM A DIFFERENT DIRECTION –

For years our industry and, in particular, our newsletter have closely tracked housing starts and permits. We have used those numbers as predictors of the future and have made many business plans on those iconic statistics. While I don't want to dismiss them totally, I am beginning to see that something else might do a better job of illuminating the future.

A LITTLE BACKGROUND FIRST –

One of my close friends attended a closed-door session of the top executives of the biggest national and regional builders along with a host of key suppliers and financiers. There was a broad based sense of optimism among many of the builders. When he saw that level of optimism, he was shocked. How could there be optimism when housing starts plummeted to an annualized disastrous number of 309,000? To put that number in perspective, remember, peak housing starts in the go-go years exceeded 2.3 million.

It appears the optimism of the big boys comes from what is buried in those numbers of housing starts, and the predictions that they have of the future. They believe the days of the bigger homes are way distant in the future. Instead, the smaller, starter, tract-type homes will dominate housing construction for some time and will be virtually all of the predicted housing starts. This is driven, in part, by tax incentives coupled with a general downscaling of people's expectations. This starter type slice of the market fits their sweet spot perfectly and as a result they are taking massive percentages of market share from the custom home builders. This really doesn't surprise me much as it confirms what I hear from so many of our customers that the custom builder is still on the sidelines just doing a small fraction of the work that they have traditionally done. It is hard to find a custom builder who has any optimism of a near-term turnaround.

My friend, who is a direct supplier to the national builders, also has found that these giants have reduced the cost of their product to favorably compete with the foreclosure market. It is appalling to hear the stories of how these cost reductions have taken place, but after all, we seem to be moving more and more into a Wal-Mart society. With all of this considered, it is easier to understand how the nationals can feel some sense of optimism. Even though the total housing market is small and is not going to grow appreciably in the near future, they believe they will absolutely dominate by grabbing whatever little market share growth there will be.

LET'S SPLIT THE HOUSING MARKET INTO TWO SEGMENTS –

Instead of looking at housing in the traditional segments of multi-family and single family, I would like to suggest that we sub-divide the single family into national homebuilders and custom homebuilders. I think these two segments march to a totally different set of drummers and their futures need to be analyzed with different indicators.

SO WHEN WILL CUSTOM CONSTRUCTION GET BACK IN THE GAME? –

For many of our customers, the return of the custom builder is critical to stability and growth. The question many of us keep asking is how will we know that the custom builder is about to come back? There are a number of factors critical for that event. First, jumbo mortgage lending must become available to the more affluent buyer. Rates must come down and the application process must be simplified so that you don't have to offer your DNA and a pledge on your children's lives as part of the application. Next, the majority of jumbo loans have been offered by the smaller community banks. Across the southeast right now, over ½ of all community banks are on the Fed's watch list and virtually restricted from making loans. This probably will not change until year-end at the earliest. Probably at least 1/3 of these banks will fail because of their mortgage exposure. Additional sources of jumbo loans must appear.

However, even more important to this part of the market is the new statistic that I think we, who are dependent on the custom builder, all need to start watching more carefully - existing home sales. Custom built homes are almost always a second or third home occupancy. Therefore, it makes sense that if a person cannot sell his existing home, he will not be able to start construction on his move-up home.

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Unfortunately, existing home sales are still facing a lot of headwinds. The number of foreclosures continues to rise at an alarming rate and foreclosures are now competing more against existing home sales than new homes sales. This combined with stubborn unemployment and the lowest consumer confidence numbers in history continues to frustrate the real estate community. And until our real estate agents start closing some deals, the custom builder will remain on the sidelines.

The sunny Southeast has historically attracted population. That influx has always been a prime driver of our housing demand. The appeal of the Southeast has not diminished and will always be a factor. However, until homeowners up north can monetize their house investments by selling them, they will not be able to make that move to the South. That further exacerbates our situation.

So, while we will still keep watch over starts and permits, we are also going to tune-in closely to existing home sales. That statistic is becoming increasingly important to the custom builder. (Unfortunately, existing home sales slipped yet again in February.)

THE OTHER SEGMENT – THE NATIONAL TRACT BUILDER –

I think we will find that the normal predictors of housing starts and permits will become a good indicator for this segment. The big guys are thinking this segment will rise about 25% and they will own most of that market growth. A little word of caution – all of these measurements are unit starts and do not measure construction dollars. Because of the cost structure of these homes, I would assume that construction dollars will remain relatively flat despite an increase in unit sales.

THIS ECONOMIC RECOVERY REDEFINES THE WORD SLUGGISH –

As we have mentioned in the past, there is no clear consensus on the future of our economy. Whether it is the bulls or the bears, pay close attention to the agendas that lurk behind their predictions. Those in power want to stay there and will spin the numbers any way they can. Those out of power want to get there and likewise will manipulate the statistics to promote their positions. As the consensus gets more and more diffused, we are seeing predictions made on obscure reports. Stay away from the obscure numbers and let's not make this overly complicated. It really is pretty simple.

About ¾ of our economy is driven by consumer spending. The economy cannot recover until the consumer spends. As we have stated in the past, the consumer is wearing a huge anchor around his neck that will keep the checkbook in his pocket. The real unemployment number is not the reported 9.7%,but is instead over 18%, and that number does not include the huge numbers of under-employed people. Consumer confidence fell a record 11 points in the month of February which is the largest one month drop in history. A confident consumer number is 95 and the present number is 46. That means we have a long way to go before the consumer starts to feel good. Credit remains tight with no sign of improvement anytime during 2010. The only consensus out there right now is that none of these issues are going to improve anytime soon. So, don't expect consumer spending, which again is 75% of our economy, to increase enough in 2010 to have any significant change in our present economic environment. Very perturbing, but, as I said, really pretty simple.

MORE DISTORTED NUMBERS –

While this little tidbit is not particularly germane to our industry, I wanted to bring it to your attention to underscore the absolute unreliability of what you read in the media. The story headlines were, "Credit Card Debt Reduced by $93.2 Billion." On the surface that sounds great. You might think that finally the American citizen is becoming more fiscally responsible. However, what is not stated in that article is that of the $93.2 billion reduction, $83.3 came from write-offs! How can a business owner make decisions when the data is so substantially skewed?

How about another example? Most of us have heard about the massive de-leveraging that needs to take place for economic recovery. For those who are unfamiliar with that term, de-leveraging simply means reduction of debt. Significant de-leveraging in the private sector has taken place. Banks are decreasing lines-of-credit and are virtually out of the term-loan business. As inventories, sales and receivables shrink, less borrowing takes place. New loans are rare or totally non-existent. However, for every dollar of de-leveraging on the private side, the government has increased debt by two dollars. The net effect is that debt is going up much faster than it is coming down. That is not successfully de-leveraging our economy. It is debt, whether it is private or public. Remember, the surplus of debt is what brought on this very economic situation we are in. How can we fix it by going more into debt?

INTEREST RATES, GAS PRICES, etcetera –

Interest rates are going to remain low for some time. It defies the principles of Economics 101 and the only thing keeping them low is the status of the other foreign currencies, which are in far worse shape than the dollar. To illustrate how bad they are, just think about this. Our annual deficit has climbed from 1.2% of our GDP to over 11% and is expected to be above 10% for the balance of this decade. Typically, anytime that ratio exceeds 5% you have an indicator of a currency about to fail. And yet the dollar is still the preferred currency. This will keep interest rates low until some viable alternative to the dollar appears. While we will see interest creep up a little throughout the balance of this year, we probably will not see anything drastic for at least 12 - 18 months from now. That is good news on the mortgage front and the housing affordability index.

I am sure you have seen gas prices begin to creep up. It amazes me that such a tepid recovery can result in such large increases at the pump. The average price has risen from $2.20 a gallon just a few months ago, to over $2.80 a gallon today. That is an increase of 30%. That is a clear warning sign on the instability of gas and how quickly and dramatically it could move if demand picks up. Watch it closely.

We are seeing some rather large price increases in many building material categories. These increases are not being driven by demand but rather the reduction of capacity as more and more production facilities go off-line. As we mentioned last quarter, diminishment of capacity was key to any levels of profitability and many of the larger companies are shuttering plants in order to achieve profitability.

We think the manufacturing side of construction materials will continue to shrink capacity. This capacity decrease will result in further increases in material costs. We think we will experience moderate price increases on many products throughout the end of the year. Parliment sales people are well tuned into these events and give you valuable advance notice.

STRATEGIC VS. TACTICAL LEADERSHIP –

For the past 3 years, most of us have seen the size of our business decline. Along with that decline in sales has come the reduction of employees. It is interesting how this change in business environment has changed some things but not changed others at all. In the go-go days, it was very difficult for leaders to focus on the strategic side of their business because they were so busy with the transactional requirements. Ask about strategic thinking and most owners just replied, “I am so busy, I just have to focus on getting our orders out the door.” Since those glory days, the transactions have drastically dropped and the administrative and support services that we could once afford have also been cut. Now, when we ask about strategic thinking, we hear, “I am so busy doing paperwork and administrative stuff that I don’t have time for anything else.”

And yet, more than ever, this may be the time that we need to think more strategically. In my 30 years of entrepreneurial experience, I am certain that the biggest mistakes are made in times of prosperity and the biggest opportunities are lost in times of despair. I have often said in this very publication that great owners are those who recognize the peak of a bubble and pull back their horns and back off of their aggressive thinking while identifying the waning days of a downturn and begin to look for expansion opportunities. Read on for more on strategy.

WHAT REALLY IS STRATEGIC THINKING ?

Strategic thinking always sounds so sophisticated but what does it really mean and how is it different from tactical management?

Tactical thinking is typically the transactional side of your business. It is the day-to-day purchasing and selling of your product. It is the daily operations of the production side of your business through the management of the resources of your people and your assets. Much of the tactical management of your business will revolve around the profit and loss statement.

The strategic side of your business is focused in the more distant future. Typically strategic thinking will encompass such subjects as:

- Who and where will my future market be
- How will I build a brand and differentiate myself in the market
- How do I build brand equity that permits me to win in head-to-head sales battles
- What product mix will I need and how to get into or out of those products
- What will I need in capital equipment expenses
- How will I finance the future
- How will I structure the company for future ownership

Much of the strategic side of your business will be focused on the analysis and management of your balance sheet. Remember, last quarter we said management of your profit and loss statement is what makes you money while management of your balance sheet is what keeps you in business. We really would like you to put down that stack of invoices for a minute and start thinking about these strategic concepts.

MARKET SHARE AND DIVERSIFICATION –

In the past 8 years, there has never been a more opportune time for strategic action than now. As a child, I grew up playing the game "king of the mountain." In this game, one kid is on top of the dirt mound and he keeps everyone else off the top. If he keeps everyone off, he becomes the "king of the mountain." You can become king of the mountain in your market area by focusing on the following strategic initiatives:

1. Aggressively focus your sales effort at taking market share
2. Diversify your product mix to make your competition irrelevant
3. Out perform and out service your competition at every customer touch point

If you focus and succeed in executing these three initiatives, you will gain a strategic advantage that could be a once in a lifetime opportunity. Wake up every day and ask yourself if you are focused on these initiatives.

CAPACITY, CAPACITY, CAPACITY –

Last quarter we discussed the issue of excess capacity. Having raised this issue and the awareness has created a lot of feedback. Probably nothing ever written in these newsletters has created such discussion amongst our readers and employees.

As stated before, our entire economy and especially our industry are plagued by excess capacity. There is too much supply at all levels, from manufacturing, to distribution, to the ultimate retail seller. This capacity resulted from a debt consuming populace buying everything in sight. With that populace no longer buying, huge capacity gaps have emerged. As we have stated over and over, demand must increase or capacity must disappear before profitability and prosperity returns to our economy. Significant increases in demand are just not foreseen anytime in the next several years. The most aggressive predictors show maximum growth rates of 2% at best. So that leaves future prosperity in the hands of capacity reduction.

Capacity will typically shrink in 3 stages. In our industry, the first stage happened just a few months after the downturn started. These are the businesses that were not well run, were undercapitalized and depended on future work to pay past bills. We all had customers and contractors like that. These guys failed quickly as the future jobs dried up and they had no means of paying their bills.

The second stage comes from those that are not able to adjust their business model and overhead to existing conditions. They are in denial and react too slowly. Their losses begin to mount and then accelerate to the point where they can no longer stay afloat.

The third stage is typically the final stage in capacity reduction. This happens when the survivors of stage 1 and 2 start to lose the head-to-head duals in sales. Since they can't cut expenses any further, they just gradually wither on the vine until one day they will very quietly close their doors. Our industry is clearly in this third stage and we see evidence of it everywhere.

CARPE DIEM –

I remember back to my high school days and the four years of Latin that my parents forced me to take to remember that term translates to "seize the day." It pleases us to see the degree that many of our customers are, in fact, seizing the day. We have the unique perspective of seeing many different competing companies and getting a great comparative understanding of business styles. Not since the height of the stage 1 capacity reduction have we seen such variance in styles as we see today.

We are seeing businesses actually thriving and making money while literally right down the street, their competitor is drying up. We see upbeat attitudes and aggressive business moods from some while across the street, there is nothing but dejected head shaking and negative thinking.

The real superstar companies will come out of this stage 3 capacity reduction with a market share advantage that may only occur once in a generation. Take a step back and look at your business. Are you winning or losing? This could be the most critical time of your business history. Don't lose this battle.

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