

Knowledge Is Power

Embracing Change by Kirk Grundahl



In the October 24, 2001 issue of Layman's Guide, Matt Layman writes the following in an article entitled, "I've Got It! The Lumber Solution...Raise the Bar!" (reprinted with permission):

I have given a lot of thought to a comment I made last week concerning over efficient lumber production and there being "no solution." Consider the following as a possible scenario. When you are the biggest and best at what you do, everyone wants a piece of you. Back in the 60's, the New York Yankees were the baseball team to beat. Mickey Mantle and Roger Maris were the Dynamic Duo of baseball. All other teams attempted to be "as good as the Yankees," looking to put together some combination of players that could bring down the powerhouse, but they fell short. Even if a team was successful at becoming as good as the Yankees, they would occasionally beat the Yanks, but it was always considered an upset. The key to the Yankees success was that they were the biggest and best at what they did. It was New York, and the Yankees...intimidation and perfection at its best. The Yankees fell when they got too comfortable with what they had.

Today, the U.S. is the biggest lumber producer in the world but certainly not the best. The goal of the American lumber industry should not be to squelch others to bring them down to our level. The goal should be to rise above all other potential competitors. How do we do that?

1) Cut the players who inhibit the team's growth. It's nothing personal, but there are players on the team today who consistently bat less than .200, when the team should be made up of hitters who consistently hit .400. (Baseball analogy; nothing to do with lumber.) If a player cannot make a viable contribution to making the US lumber industry the most powerful, productive, cost efficient, well marketed, well managed, lumber producing nation in the world...well, adios!

2) Does that mean we intentionally cut some players? Not if they are up to the task of becoming cutting edge or innovative producers.

3) Seek to discover "what else" can be done to lower the cost of producing lumber. Like I have said in the past...think outside the box. Back in the early 90's I wrote in one of my market reports, "By 2010, the old lumbermen will be telling the new lumbermen, 'We used to make a 2x12. Can you believe we needed lumber that wide?'" The point was, I thought there would be new products that would eliminate the need for large trees. As we become a more technologically advanced society, it is naive to think that lumber will always have the primary

grasp on residential construction. If producers don't get creative, they will continue to lose market share.

4) Here is a novel idea. Make better lumber, instead of more lumber. Make it tougher for steel to steal business because the consumer is so completely satisfied with lumber he wouldn't consider using something else. Raise the bar for anyone who wants to sell lumber in the U.S. How about zero wane tolerance? Can you imagine what your customers would say if you began cutting all your lumber with no wane? If I was a small mill, worried about going out of business, that is exactly what I would do. Make a product that no one else does and price it modestly above your cost. Give consumers a real reason to pay more, not temporary supply problems.

Right now efficiency is the enemy. The solution is turning objections into objectives. Instead of having too much production, why not take that same production and make it the most demanded product in the world? I believe the solution to the over supply of lumber lies in the producers' and wholesalers' ability to become creative. Instead of leveling the playing field, making this one tougher to play on. Make excuses or make changes. Sink or swim. Happy Trading...ML

While some will view much of what Matt has stated as controversial, I think that he makes several good points:

- Change is inevitable in everything. If you are not willing to change at some point in time, you will become irrelevant. Those who embrace change and find opportunity will be the leaders of an industry.
- When you are the biggest and the best at what you do, everyone wants a piece of you. Businesses cannot become complacent and think that they will always be the biggest and the best. Introspection, humility and improvement are the creators of success.
- Be creative or risk losing market share.
- Improve your product. Give buyers a new and better reason to pay more.
- Be unique. Make a product that no one else makes and price it modestly above your cost.
- Listen closely to your customers and serve their needs. Buyers do not need suppliers to tell them what to do and do things for them; they need suppliers to work with them and serve them as members of their support team.

Looking at this list, it's apparent how the component industry has become so successful over the last 50 years. We are a group that is adept at embracing change, listening to our customers, serving them and making things happen. We are entrepreneurs by nature because we had to be and we cannot lose sight of our roots.

Given all of this, as we described in the article from the August 2001 issue of *WOODWORDS* entitled, ["'Building Bridges'—WTCA and SLMA Meet to Discuss Important Issues,"](#) we had one of the best meetings we have had in a long time to focus on change and creativity. The lumber industry and the structural components industry have a great many business issues and problems in common.

We all know that our customers are demanding the following product attributes:

- Lowest in-place cost possible
- Cost stability
- Construction cycle time reductions
- Labor efficiency improvements
- Labor availability improvements or labor replacement
- Durability and quality—no call-backs

The companies that figure out how to deliver on one or more of these attributes stand to either grow their market share, increase profitability far in excess of the industry average, or both.

To that end, the WTCA/SLMA meeting embarked on looking at our industry outside the box.

COMMODITY MARKETS & IMPLICATIONS

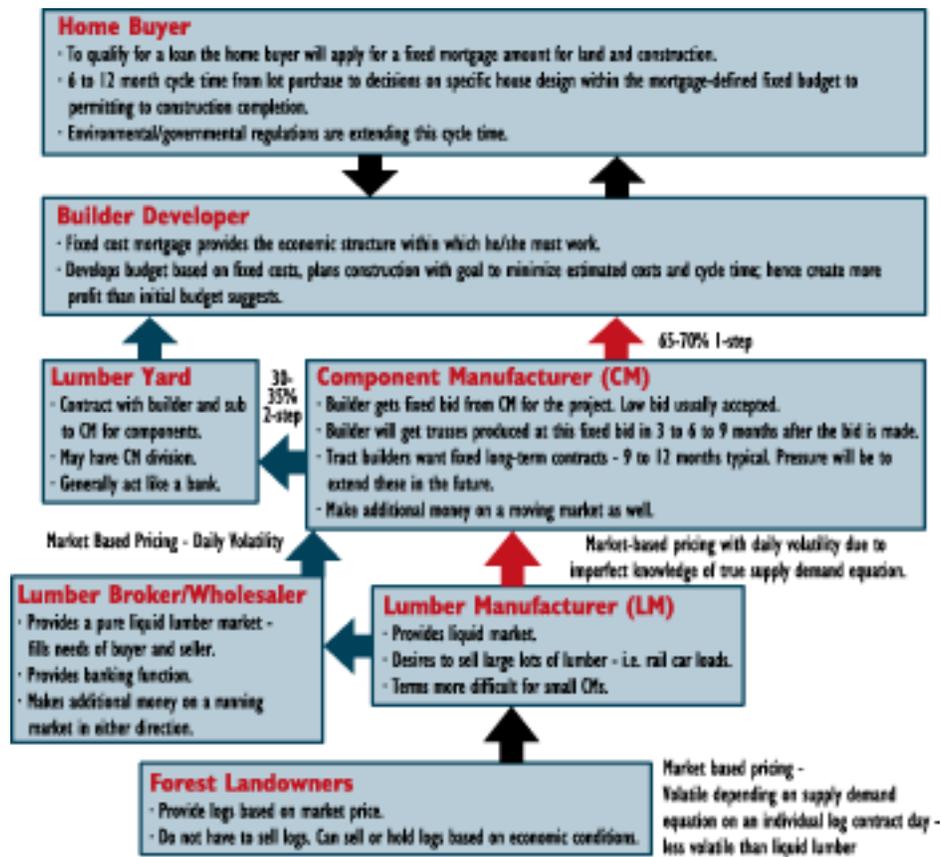
When market-based commodity pricing values a product, like lumber, below its cost of production, a few things happen:

- Customers and the general public begin to believe that lumber companies can make money at these prices. When prices rise to levels where costs are recovered and a profit earned, the general customer and public perception is that they are now being gouged.
- Obviously, all businesses that must sell below their cost due to commodity market pricing, for even short periods of time, are subject to going out of business, unless they have strong capitalization. This applies to both the structural component industry and the lumber industry. The average component manufacturer is far less capitalized (calculated as either a percentage or in total dollars) than the average lumber manufacturer, given that 77 percent of WTCA's members sell less than \$5 million annually. Thus selling below cost for the average component manufacturer has a greater and faster impact.
- Obviously, when the supply/demand equation shifts, the tendency is to make up for any previous losses when the opportunity arises. Business instinct will cause both the lumber industry and the component industry to do this and, unfortunately, they may be viewed as gouging when it happens.
- The whims of the market certainly interject a huge amount of risk into business. Financially, the question becomes, "Is the business able to get a reasonable return on investment, including all business risk? Will the return on investment be such that my business is attractive to an outside buyer?" Too often the answer is "It's highly unlikely," which means the value of the effort put into building a business is deeply discounted when an owner goes to sell. The question then becomes, "How can I consistently provide value to my owners (shareholders) and employees?" Maybe under some conditions, "Why should I continue in this business?"

ISSUES DEFINED IN THE CONTEXT OF HOW OUR INDUSTRIES TRANSACT BUSINESS

The business challenges that we face encompass the entire chain of commerce. How we transact business can be defined by the following graphic:

CLICK ON IMAGES FOR LARGER VIEW



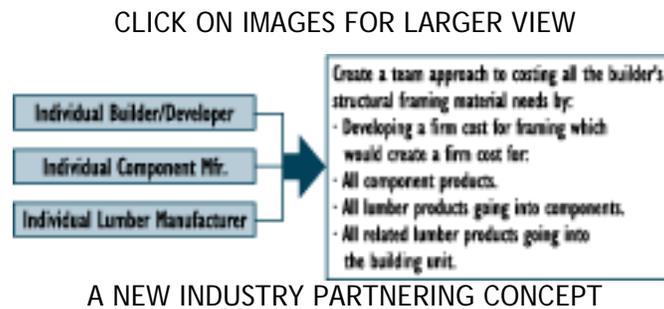
HOW WE TRANSACT BUSINESS

- Cost volatility is interjected into the construction process at the lumber purchase stage of the building construction business model.
- Lumber costs, which constitutes 40 to 50 percent of the cost of production for Component Manufacturers (CMs), are volatile. As is easy to see, a 20 percent increase in lumber prices, after the CM has quoted a price for the components with the builder customer, will reduce the CM's gross profit accordingly.
- Costs are volatile for Lumber Manufacturers (LMs) on 60 to 70 percent of their total cost of production. Landowners who do not have to sell their trees are inclined to sell only when there is great demand in the market for logs, as it is clearly in their best interest to get the highest price that they can. Hence, the volatility of an uncertain supply/demand equation is interjected into the purchase of logs. The volatility of stumpage is less than the volatility of produced lumber, yet is still an issue with which to contend.
- Some CMs, LMs, and brokers/wholesalers, enjoy a moving market so that they can play the market and make more money than "normal" on long and short purchases. These companies can win big, and also lose big.
- Many CMs believe that they buy lumber at the best prices in the industry, so they are less likely to get hurt by a volatile market. There is a gambling culture that has been created over the last 20 to 30 years in our business model and is a tradition that will be extremely difficult to change. This belief certainly adds to lumber price volatility.
- The key problems to solve are:
 - How do businesses make consistent profits and have attractive investor returns on investment where fixed mortgages and framing quotes meet volatile costs?

- How do we minimize the negative business impact of volatile costs that exist for CMs and LMs?

A SOLUTION TO KEY VOLATILITY PROBLEM?

It was agreed that one possible way out of the volatility box, which hampers both industries from making a reasonable and rational return on investment, was to model a new industry partnering concept. This concept would look like this:



The goal of the concept is to encourage the team approach to selling homebuilders so that all of the members of the team can contract for delivering their products in a manner that is mutually beneficial to each business' long-term profit goals and return on investment.

- In order for this to work, the goal has to be developing long-term team, partnering or alliance-type relationships between the individual builder/developer, component manufacturer and lumber manufacturer.
- This is particularly attractive for housing developments that extend on for more than six months. The goal is to reduce the volatility factor regarding lumber for those participating in a team-type approach.

CONCLUDING COMMENTS

The group agreed that this model, while quite simple in concept, is far more complex regarding implementation. It will be up to individual companies to collaborate to see if the model works.

The role that has been demanded by WTCA's Board of Directors, particularly the Past Presidents, is to think outside the box and be advocates of change so that we continually challenge ourselves to learn and improve, and finally, to ensure that every business opportunity for our members is exposed and explored. We know that by doing this, components have the best possible chance of becoming the obvious economic solution, and the future of framing.

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