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Economic Environment

Strategies to Lessen Impact of Price Volatility (Part 2 of 2) by Al Schuler

While there is no way to avoid volatility completely, a multifaceted approach to dealing with the commodity market may make the future seem a bit less uncertain.

Volatility in commodity prices is the "Nature of the Beast." It is due primarily to imbalances between demand and supply (production capacity), just-in-time (JIT) buying and less inventory being held by both customers and suppliers. Nobody wants to hold inventory because it costs money, but if there is not enough inventory in the pipeline, sudden increases in demand quickly cause problems by forcing prices up. Nobody likes volatility as we have seen in today's market. For instance, steel building contractors and homebuilders have lost significant amounts of money on projects that were estimated using price assumptions that were based on prices that were "old." Likewise, suppliers (primary mills and distributors) have to face unhappy customers if prices go up too fast. Of course, if prices fall, the mill gets little sympathy. In addition, volatility makes strategic planning difficult for everybody because cash

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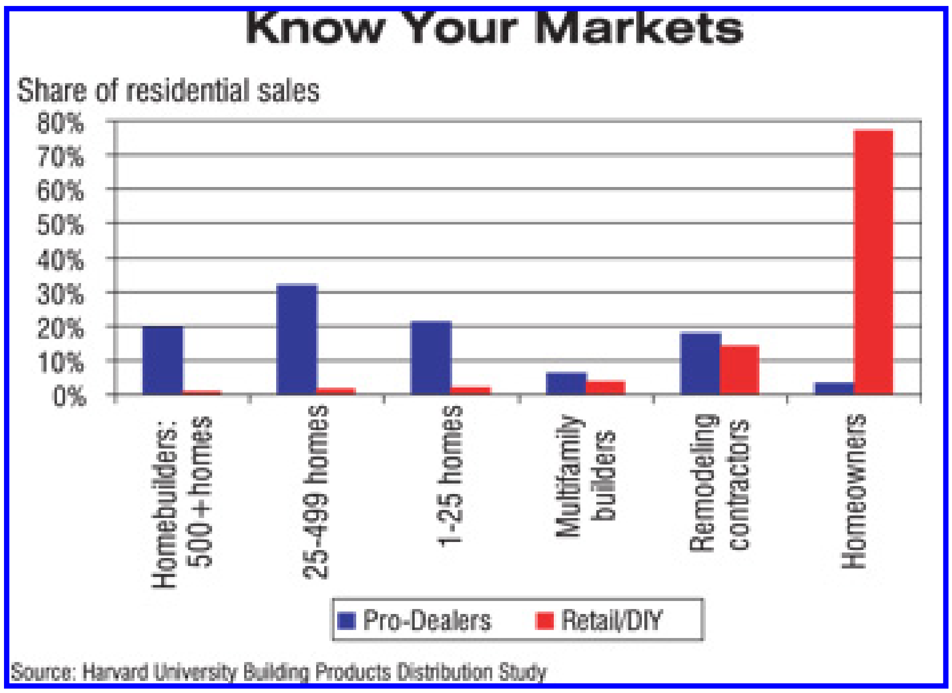

FIGURE 1. BUILDING MATERIAL PRICE TRENDS

flow projections are little more than pure guesses. Capital investment analysis for equipment, software, human resources and capacity expansions are of little use. So how can we lessen the impact of price volatility? There are a number of things you, as the buyer of commodities, can do.

STRATEGIES TO DEAL WITH PRICE VOLATILITY

There is simply no one best strategy or silver bullet for component manufacturers to avoid volatility. In fact, one cannot avoid volatility completely. A multifaceted approach works best. Following are five strategies to consider.

1. Market Intelligence: The best way to lessen negative impacts of price volatility is to stay alert to any changes in market conditions, both short- and long-term. That means finding time to analyze factors and trends that affect short- (less than six months) and longer-term demand/supply balances. Most wood products are consumed in residential construction so you need to follow economic and demographic trends. On the supply side, you need keep abreast of mill expansion and closure trends. The National Association of Homebuilders (www.nahb.org) is a good source for economic news related to housing while trade journals are a good source of information for both economic trends and mill news. Check out Timber Processing (www.timberprocessing.com), Random Lengths, (www.randomlengths.com) and Panel World (www.panelworldmag.com). Other factors to follow include weather conditions (including forest fires) and consolidations in the marketplace (again, trade journals provide this information). In simple

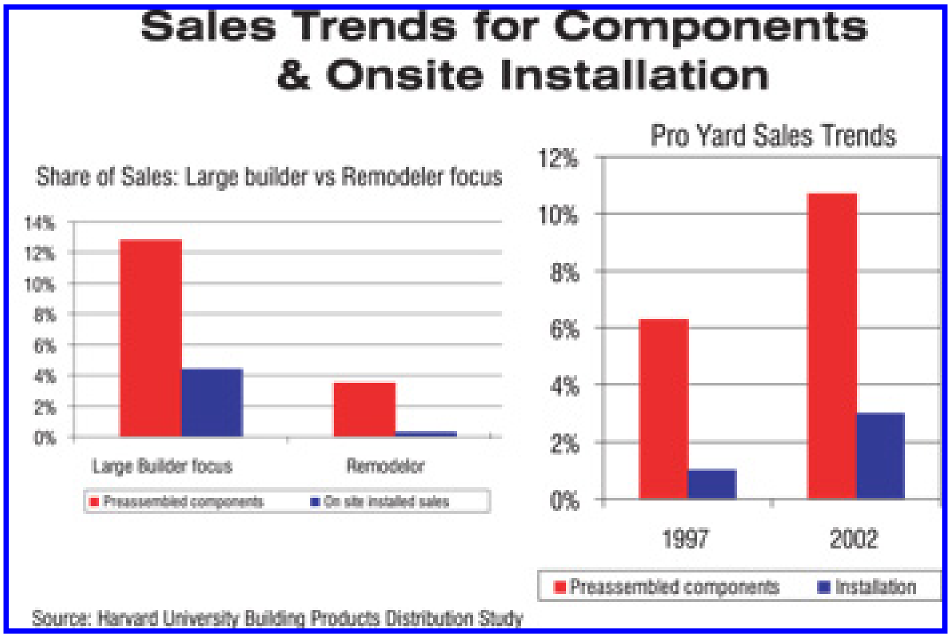

FIGURE 2. NORTH AMERICAN PLANT CAPAICTY TRENDS — ECONOMIES OF SCALE MEAN LAGER PLANTS. [SOURCE: RISI, JUNE 2003]

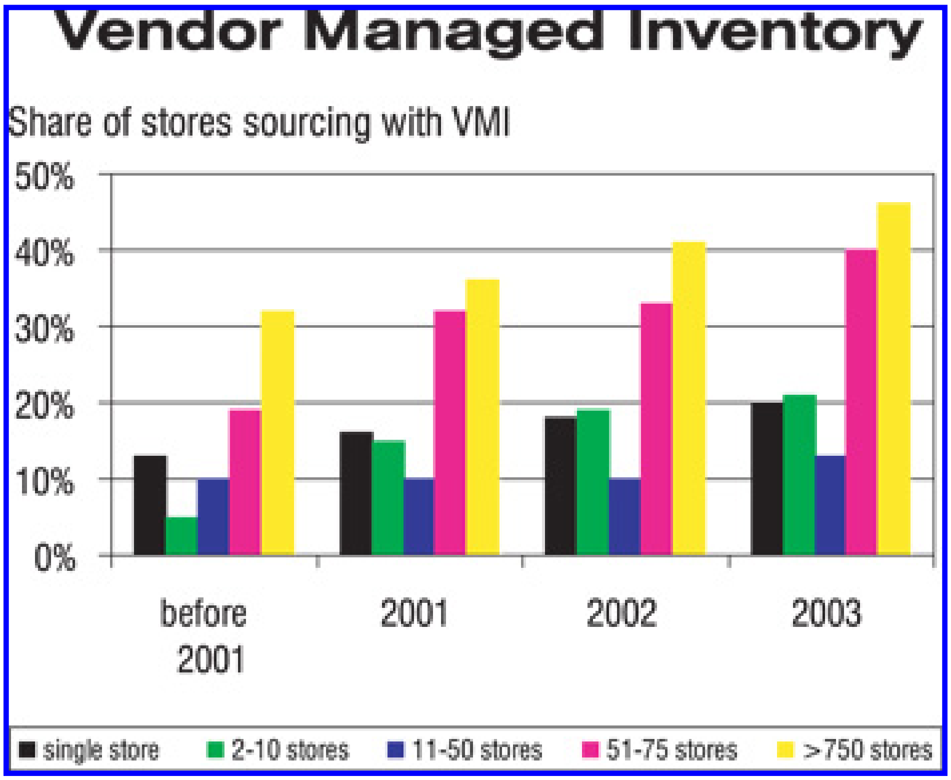

FIGURE 3. CONSOLICATION IN NORTH AMERICAN COMMODITY MARKETS

terms, you want to identify situations that could lead to price spikes. One option is to form partnerships with material suppliers that offer market intelligence as a service. Increasingly, distributors and other segments of the supply chain are offering this service.

2. Know Where Your Customers Are Going: As a component manufacturer, consider adding some value to your product mix to enable you to avoid pure price competition. Then, if your raw material costs increase, you are in better position to pass some of the increase onto your customers. Additionally, as you add value, raw material cost as percent of final product cost gets lower, so the raw material cost increase isn't as onerous. Some value-added options include services like installed sales, preassembled components, help in managing your customers' inventory costs (see discussion on vendor managed inventory), and after-sales service. If you are selling to pro-yards or DIY retail, know where they are going in terms of products and services and figure out how you can become a member of the "team" (see Figures 1 and 2). As the pro-yards consolidate to better serve their customers, they are selling more components and offering more installed sales options to their customers, the large builders. As retail customers get bigger —by significant changes like consolidation/shortening the supply chain—they have more market clout and are demanding more services and products as well as better quality. One of the "services" they will want is "price smoothing" (providing a set price for as long a period of time as they can), which ultimately helps in reducing price volatility. If you are a component manufacturer, figure out some ways to smooth the price of your products (see discussion on contracts later in this article). This can be an opportunity or threat to component manufacturers. Make it an opportunity by partnering with your customers (pro-yards, DIY retail and builders). If you don't, some of your customers will become your competitors (see Figure 2). Some pro-yards are now manufacturing trusses and wall panels and traditional component manufacturers are expanding their product offerings to become more like pro-yards.

3. Contracts to Manage Price and Inventory: In the short-term, volatility is due to the inability of supply to meet demand which is often due to inadequate inventories in the pipeline. Over the past decade, the trend on the buyer side has been to reduce inventory costs through contracts. A common one used by the large DIY chains and the entire U.S. retail sector is vendor managed inventory (VMI) where the supplier (e.g., sawmill) agrees to keep the vendor's (e.g., Home Depot) inventory level within a specified range (see Figure 3). When the inventory drops below this range as product is shipped to the retail stores outlets, the mill automatically ships product to the vendor's distribution center. Price is most often determined at the time of shipment (PTS), and is based on Random Lengths (RL), often a discount to RL although these discounts are shrinking. Price can be a rolling average of past prices or any number of variations one can imagine. The key here is that the terms have to be beneficial to both the buyer and seller. There is lots of room for ingenuity on both sides, but these relationships must be based on trust and understanding, which takes time. Also, there has to be an adjustment mechanism—opportunity to change the terms if either party is not happy.

4. Steel Contractors: Fixed Price versus Variable Price Contracts: Fixed price contracts used to be the norm in the steel industry until 2004. As steel prices went up 50 percent between January and May, many steel contractors were caught in a bind as their contracts were based on last year's much lower steel prices (Jack Naudi, www.post-dispatch.com). One option for steel contractors (or fabricators as they are often called) is replacing fixed price contracts with variable price contracts that would move up and down with the price of materials. Wood truss, engineered floor systems and wall panel manufacturers may also find this option more palatable than playing "Russian Roulette." In other words, when bidding for a big job six months into the future, you might be thankful for some protection if lumber prices increase 15 percent more than your estimates. The key again is that the contract terms must be beneficial for both parties. If the builder or other customer is to participate in a variable price contract by sharing an increase in raw material costs to the component manufacturer, the component manufacturer has to reciprocate to the builder. Find out what the builder wants in return, and try to work out a compromise that benefits both of you. For component manufacturers, this might mean guaranteeing quality, delivery time and provisions for after sales service, or if lumber prices fall dramatically, give the builder a break with the contract price.

5. Avoid JIT Buying Habits: As is the case with the stock market, timing the raw materials market in your favor is very difficult to do on a consistent basis. Depending on your operation and relationships with your suppliers, your buying practices can run the gamut from JIT buying at one extreme and full contract inventory at the other. Keep in mind that JIT buying does not allow you to price manufactured products based on known costs; the best way to achieve this is to buy all of the raw materials for each contract at the time of the contract. This way, all of the hard costs are sure to be covered.

6. Role of Brokers/Wholesalers: Their role is diminishing and that is one reason why volatility is increasing, but at the same time, the average price paid over an extended period of time by buyers is probably lower as the supply chain shrinks. Essentially, the pro-yards are beginning to assume the role of broker/wholesaler, but they are also including more service/value such as installation or installed sales.

CONCLUSIONS

One can't avoid price volatility, and with today's hot housing markets, volatility is naturally more intense. There are a number of options to reduce the negative impacts from volatility and your job is to pick the option that works best for you in terms of cost and benefits. The best single strategy is to stay alert to any changes in the marketplace; trade journals are a good source for both economic information and relevant news on mill expansions and mergers and acquisitions. In addition, getting closer to your customer(s) is always a good strategy, particularly when developing contracts/relationships to smooth prices. Finally, moving up the "food chain" could lessen your exposure to pure price competition and provide a new source of revenue at the same time. Editor's Note: Stay tuned for an article in an upcoming issue of SBC Magazine where we will identify key market parameters, how to find them on the Internet and how to use them to your advantage.

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