# WHAT IF……AN ALTERNATIVE VIEW OF REALITY

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What if the Chinese became great marketers? What if North Americans wanted to assemble all of their furniture? What if most customers really preferred to shop for furniture on the Internet? What if the competition could deliver everything in 7 days? There are many more "what ifs" – the question of what would happen if our standard assumptions about the world suddenly needed to change significantly?

Arthur Anderson recently published a book entitled "Breaking the Value Code". It attempts to define how new-economy companies are creating value in comparison to old-economy companies that presumably are not. In the end, it has a great deal to do with either the growth rate of certain sectors of the economy combined with the nature of valuation that the market places on certain activities and their related income and revenue streams. Given the meteoric rise and fall of many tech stocks it is a bit early to draw final conclusions on many of these assertions. Nevertheless, there is a clear pattern emerging where companies are able to focus on those activities that appear to create value versus those that do not. In this discussion I will raise the question of how and where in the home furnishings industry these major shifts could take place and if Palliser could position itself differently to take advantage of these changes.

The furniture industry is suffering very low valuations in the current market. The majority of companies have p/e ratios between 7 and 10. Even venerable companies like Lazy-Boy, Natuzzi and Shermag are in that range. Ethan Allan is above that range and benefits from what the furniture analyst Jerry Epperson refers to as the "Gucci factor" where the market sees them as a visible and premium brand. No company has to this time distinguished itself in any way based on better use of information technology or the Internet. This memo attempts to understand where the "value perception" might come from in our industry that would allow a company to separate itself from the pack.

WHAT IS THE PRODUCT?

Many industries are experiencing a dramatic change because the Internet or other related technologies actually change the product that is being offered or delivered. For example, the various generations of communications equipment from the telephone and telex to the fax, the mobile phone, the Internet, email and the various emerging combinations often change the nature of the product itself. My assumption is that whatever happens in the furniture business will still result in the delivery of a physical product not all that different than what we see today. What could change about the product?

Customization – There has always been some degree of customization in terms of the selection of fabric or leather but little in terms of dimension, seating comfort etc. In case goods there has been even less customization – with some limited exception in the choice of dinette legs and color in a few instances. Customization will not only depend on the ability of the customer to specify but on the factory to produce. Information and production technology may result in some significant breakthroughs in this area. This may place some premium on the ability to configure and deliver within North America.

1. Fashion Coordination – There is limited ability on the part of the retailer to pull together and customize the various items in a room or a home. Given the ability of the computer, it is entirely possible to offer a customer a much larger range of potential coordinating items than can be reasonably offered through a retail environment. Therefore the ability to support fashion can change the product in the eyes of the consumer.

2. Modularity – The current range of furniture offers essentially no flexibility after it is purchased. Part of the problem is that the retailer cannot sell the complexity of modularity to begin with. The ability to customize function, size and fashion would lend itself to a more modular approach – resulting in a greater emphasis on contemporary styling that lends itself to modularity.

3. Specified delivery – The speed and predictability of the delivery of furniture is in fact an important part of the purchase decision. Insofar as the ability to determine delivery is built into the initial purchase decision, this will influence what the customer buys and becomes part of the product for all practical purposes.

DETERMINANTS OF THE COST STRUCTURE

Built into the cost of any product are some inherent material and other costs that cannot be removed under any reasonably imaginable circumstances. For example, a gallon of gas requires a certain amount of crude oil. On the other hand, transaction costs constitute a remarkably high percentage of the cost of most products. There are three kinds of transaction costs relative to furniture that we should consider.

1. The cost of moving materials and finished goods between locations or organizations. These are the indirect costs of purchasing, specifying, quality control, payment systems, management but also the costs related to the change of location in terms of movement, packaging and shipping.
2. Friction in the system. A second type of cost relates to the cost of damaged parts, incorrect specification, surplus or shortage of parts, errors in production etc.
3. Getting to the consumer. When a retailer spends $100 on furniture the industry typically spends almost $50.00 to convince the consumer to buy the product, another $5.00 is spent by the manufacturer to convince the retailer to carry the product and another $5.00 is required to get the product to the retailer. There will be a time when the consumer will be able to obtain the product from the manufacturer without

spending 150% of the manufacturers effective price for the service of getting it to him or her.

WHAT WILL BE THE FUTURE VALUE CODE FOR FURNITURE?

The current situation where the dealer and the consumer seem to be driven largely by price can be discouraging. On the other hand, if technology can attack the cost structure while at the same time delivering on a different value promise, there may be some new opportunities.

Retail margin – The major retailers such as Sears Canada and The Brick are both moving in the direction of expecting more service from the manufacturer while at the same time raising their margin requirements to a level in excess of 55%. It seems that there is an inverse relationship between size and the ability to operate with lower margins. The Wal-Mart phenomenon has not yet hit the furniture industry. Technology may lead to a breakthrough that is not yet evident.

Speed of delivery – Sears demands that we ship in one day and the people at The Brick, Art Van, Seamans, Leons etc all work from inventory. Simply shipping quickly is really not a big deal for many consumers (in the lower and middle price ranges) since they receive that now.

Customization and flexibility – These features do not characterize our industry and may or may not change the industry. If the consumer can perceive this as value it may point to a change in our business.

Flexible manufacturing – Genuinely responsive manufacturing techniques may be the basis of a breakthrough.

1. They could eliminate the inventory friction and financial and space cost related to inventory of imports.
2. Manufacturing that eliminates most of the friction related to production may dramatically lower costs.
3. Flexible manufacturing may combine fast delivery, customization and cost reduction in a package that is attractive.
4. Information technology may improve the nature of the experience for the consumer. For example, the consumer may make the final selection in the comfort of home and away from an environment of pressure.
5. The combination of factors may reduce or in some instances eliminate the role of the retailer and deliver more of the margin to the producer or the consumer.
6. This strategy may also only work if there is some change as to the physical nature of the product.

WHAT WOULD A NEW ECONOMY COMPANY LOOK LIKE IN OUR INDUSTRY?

Can we identify the building blocks essential to become a leader in the New Economy while still surviving and prospering in the old during the transition? On the other hand, is there a self-evident direction that would warrant forsaking all to be first in the new paradigm? It is interesting to note that IKEA, in many ways a paradigm of a “virtual manufacturer”, appears to be actually integrating vertically at this stage. ETHAN ALLEN is also the most vertically integrated and is granted the highest p/e ratio in our industry. This trend is exactly opposite to what is happening in the electronics and tech industries.

There are as yet no examples of furniture companies that prosper essentially on the basis of information technology although some use it better than others. We would like to be open to the new directions but they are not entirely obvious in our type of industry. We welcome your thoughts and advice.