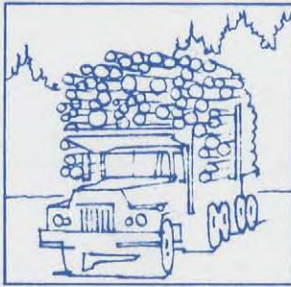


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Review of the Canadian Kitchen Cabinet Industry



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REVIEW OF THE CANADIAN KITCHEN CABINET INDUSTRY

Converted Wood and Paper Products Division

Forest Products Directorate

Resource Processing Industries Branch

Department of Regional Industrial Expansion

Published September 1986

FOREWORD

I am pleased to be able to provide this review of the kitchen cabinet sector to members of the industry. It is one of several reports which have been prepared on the major sectors of the converted wood and paper products industry in Canada. The others include wood windows and doors, manufactured housing, converted papers, and the paperboard packaging industry. These reports were prepared by the Converted Wood and Paper Products and the Pulp and Paper Divisions of the Department of Regional Industrial Expansion.

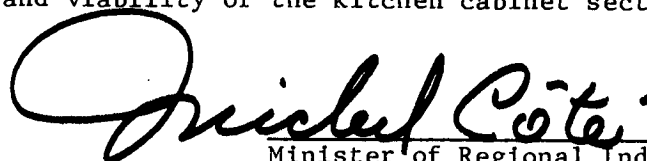
The Subcommittee on Converted Wood and Paper Products, under the aegis of the Forest Sector Advisory Council (FSAC), has reviewed and advised on the reports. The FSAC, comprising executives of forest industry companies and labour unions along with some university representation, was established to provide the Minister of State for Forestry and myself with advice on the full range of resource, industrial and trade issues affecting Canada's forest industry.

These reviews are, I believe, the most comprehensive descriptions and analyses of the sectors published to date. In addition to providing a detailed examination of the characteristics of each sector, they also identify a number of key issues currently affecting their well-being, as well as a number that are looming on the horizon. As wood fibre resources become increasingly scarce on both the domestic and international fronts and unemployment continues as a major concern, the potential contribution of these value-added sectors to regional development and employment will become more significant.

The primary intent of the reviews is to encourage companies and industry associations to focus on the pertinent issues, be they company-specific or industry-wide. It is my hope that the reviews will stimulate companies to assess their performance and future opportunities and focus their attention on continuing improvement to productivity and marketing. The key objective, one that has been emphasized by the advisory Subcommittee, is the improvement in international cost competitiveness which is required not only to maintain domestic market share, but also to expand exports. The competitive position of the Canadian industry will be particularly important if further trade liberalization takes place.

The Department would be pleased to hear the views of the industries and associations concerned. I believe it is essential that we have strong communication links between management, labour and government to address industrial issues whether they be productivity improvement, adjustment to changing economic forces, export market development or questions of trade access.

In summary, I welcome an open dialogue on all matters affecting the future performance and viability of the kitchen cabinet sector.



Minister of Regional Industrial Expansion

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INDUSTRY OVERVIEW

In this report on the Canadian Kitchen Cabinet Industry (SIC-2544), the primary source of data has been Statistics Canada publication 35-205 (Sash, Door and Other Millwork Plants). This has been augmented, where possible and appropriate, by information contained in divisional files, company visits, specific studies concerning pertinent economic factors affecting the sector and consultation with key industry members.

The sector, as defined by Statistics Canada, is composed of those manufacturers whose primary activity is the manufacture of wooden kitchen cabinets and kitchen cabinet doors, and herein lies one of the data problems encountered. Since the SIC classification includes only those firms whose primary activity is the manufacture of wooden kitchen cabinets or doors, it fails to capture that portion of activity carried on by manufacturing plants that do manufacture these products, but where the chief activity is the manufacture of another product. In addition, due to the large number of very small companies in the sector which report on the short form format as opposed to the more comprehensive long form, the amount of data available is limited. While it appears that these discrepancies result in an understatement of about 50 per cent in the number of companies included in the sector, the classification still captures the major proportion of shipments and companies, and as a result the assessments made and conclusions drawn are considered valid.

Companies in the sector can generally be divided into two different types of operation: those which produce basically for stock and tend to be among the larger operations in the sector, and custom manufacturers which generally have smaller sales volumes, but comprise the major proportion of member firms (in excess of 80 per cent). The majority manufacture what is termed a traditional style of kitchen cabinets, but recent years have seen an increasing number of companies adding a European line, which features a frameless cabinet, hidden hinges and modern, clean European styling. The European line lends itself more readily to production line techniques of manufacture, standardization of cabinet sizes and knock-down components which make it more suitable to the stock concept and export. In addition, the majority of companies also manufacture shelving and a small range of furniture items such as tables, stools and the like, as an adjunct to their major manufacturing activity. This trend parallels that which is taking place in Europe, where the distinction between the manufacture of kitchen cabinets and furniture is now almost non-existent because basic construction of a kitchen cabinet, a bedroom closet, a bookcase, a living room wall unit or an entertainment video cabinet is virtually the same.

The sector is a classic example of a "small industry" sector: very few companies have sales volumes of more than \$20 million, and a very large number (more than 50 per cent) have sales of less than \$1 million. As a result, it is highly fragmented, extremely competitive and exhibits a wide range of sophistication in the manufacturing process, from fully automated production lines to a very labour-intensive, almost handcraft type of production. The companies place considerable emphasis on marketing and distribution, and a full range of unique and different arrangements is discernible, through builders, exclusive and non-exclusive dealerships, agents and company-owned sales outlets.

The dollar value of total factory shipments from the sector was \$325 million in 1982, the latest yearly figure available, and is estimated to be in the neighbourhood of \$400 million in 1984. This reflects a period of significant growth in the sector from the early 1970s, when factory shipments totalled less than \$50 million. On a constant-dollar basis, this represents a healthy average annual growth rate in excess of eight per cent.

CONTRIBUTION TO THE ECONOMY

The kitchen cabinet sector, while not large in terms of the dollar value of shipments when compared to the total forest products industry, is important nevertheless in terms of employment generated, regional impact and value added. The sector is considerably more labour-intensive than the primary sectors and, because it further processes primary wood materials such as lumber and panel products, it provides significant potential for additional economic value from increased levels of export. In addition, a number of companies, particularly in Quebec and the Maritimes, are primary employers in smaller communities and hence are of vital importance to these communities in terms of employment levels and economic impact.

Total employment in the sector stood at 6 126 in 1982, reflecting expanding employment opportunities in the sector over the period. But while clearly exhibiting a healthy growth pattern since the early 1970s, mirroring the strong upward growth trend experienced by the Canadian housing sector over the period, it characteristically remains a small industry sector dominated by a large number of non-integrated, small, privately-owned companies serving primarily local markets. This is exemplified by the fact that of the total 566 firms reported to comprise the industry in 1982 by Statistics Canada, 545 or 96 per cent employed fewer than 50 persons. The majority of these companies can be termed custom manufacturers as opposed to the small group of larger companies which produce mostly on a stock basis. Distributions by size groups and by region are given in the two following tables.

TABLE I

Distribution of Companies by Size, Number of Employees and Shipments

1982

Size Categories	Companies		Employees		Shipments	
	Number	%	Number	%	(\$000 000 current)	%
0 - 4	275	48.6	529	8.6	28.7	8.8
5 - 9	131	23.1	844	13.8	39.3	12.1
10 - 19	93	16.4	1 262	20.6	64.4	19.8
20 - 49	46	8.1	1 300	21.2	71.3	21.9
50 - 99	12	2.1	815	13.3	48.3	14.8
100+	9	1.7	1 396	22.5	78.5	22.6
Total	566	100.0	6 126	100.0	325.4	100.0

TABLE II

Distribution of Companies by Region, Employees and Shipments

1982

Regions	Companies		Employees			Shipments		
	Number	%	Number	%	Average Number/ Company	\$000 000 current	%	Average/ Company \$000 000
Maritimes	27	4.8	162	2.6	6	7.1	2.2	.3
Quebec	193	34.1	1 563	25.5	8	76.2	23.4	.4
Ontario	150	26.5	2 117	34.6	14	111.0	34.1	.7
Prairies	101	17.8	1 222	19.9	12	64.6	19.9	.6
B.C.	95	16.8	1 027	17.4	11	65.1	20.4	.7
Total	566	100.0	6 126	100.0	11	325.4	100.0	.6

Source: Statistics Canada Publication, Catalogue #35-205, Sash, Door, and Other Millwork Plants.

Of additional significance from Table I is the clear dominance of the nine larger companies in terms of total factory shipments, contributing \$78.5 million or one-quarter of the total. This dominance, however, is generally regional since only one or two companies approach what may be considered national in sales distribution. Furthermore, the preponderance of smaller companies is more pronounced in the Atlantic and Quebec regions, where firms employed an average of six and eight persons respectively, compared with a range of 11 to 14 in the other three regions. In these two regions, approximately 60 per cent of the companies are located away

from the major metropolitan centres of Halifax, Saint John, Montreal and Quebec City indicating the significance of the sector in the small-town economies of these two regions. In the regions of British Columbia, the Prairies and Ontario, some 70 per cent of the companies are located in or adjacent to the major metropolitan areas. On balance, therefore, the sector has been more of a factor in metropolitan centre growth where companies are close to labour, markets and other suppliers than in the rural areas. The metropolitan-based companies can, through their marketing and distribution networks, effectively supply these smaller centres. Since economic factors favour the location of kitchen cabinet companies in or near urban centres, the sector is not particularly suited to the support of new employment in remote regions or single-industry communities.

The growth which has occurred in the sector since the early 1970s has not, however, been evenly spread across the country, even though the actual number of operating companies and total factory shipments in each region has increased. Of the total 402 new companies formed over the period, for example, only 70 were in Ontario, while 165 were in the province of Quebec. Table III shows the regional breakdown of this growth over the period from 1972 to 1982.

TABLE III

Growth in Number and Shipments of Kitchen Cabinet Companies

1972 - 1982

Region	Establishment			Shipments		
	Number		Numerical Change 1972 - 1982	(millions of dollars)		
	1972	1982		1972	1982	% Change 1972-1982
Atlantic	1	27	26	1.0	7.1	+ 610
Quebec	28	193	165	9.0	76.2	+ 746
Ontario	80	150	70	33.2	111.0	+ 224
Prairies	30	101	71	9.5	64.6	+ 580
B.C.	25	95	70	11.7	65.1	+ 456
Total	164	566	402	64.4	325.4	+ 405

The economic impact on labour, raw material usage and value added in this sector vis-à-vis sawmilling and pulp and paper is evidenced by a number of other measures. First, the sector is characterized by a higher intensity of labour usage related to the two primary sectors requiring \$0.32 of labour cost per every \$1 of shipments in 1982, as opposed to \$0.27 in sawmilling and \$0.19 in pulp and paper. The higher hourly wage costs in these latter two sectors, due to the high incidence of unionized labour and the nature of product markets, suggest an even wider divergence in labour intensity among the three

sectors than the data indicate. This difference reveals the significantly greater economic impact achieved on labour per unit of capital expenditure in the kitchen cabinet sector compared to the primary sectors.

In addition, raw material usage (wood-based products) per worker and value added per dollar of raw material costs are significantly higher in the sector compared to sawmilling and pulp and paper, suggesting a number of implications in employment generation and exports. In the former, calculations show that, in the kitchen cabinet sector, every 1 000 cubic metres of wood-based input supports 24 jobs, as opposed to 0.7 in sawmilling and 2.0 in pulp and paper. Value added per dollar of raw material wood cost stands at \$1.33 in 1982, compared to \$0.61 in sawmilling and \$0.97 in pulp and paper, indicating the economic benefit of increased levels of export of products from the sector.

COMPETITIVE SITUATION

Competition in the industry is very intense, a situation that, both domestically and internationally, has direct impact on the industry's ability to respond effectively to the changing demand scenario and medium-term potential discussed in the next section. On the domestic front, the industry is severely depressed, particularly in the west, a situation resulting from significantly reduced levels of new housing construction, price-cutting, marginal or negative profit margins, strained financial situations for a number of companies and a relatively high rate of bankruptcy. Some of the major firms in the industry are on the brink of insolvency, while unemployed woodworkers have set up garage-type operations and are effectively competing for market share. This has resulted in a squeeze on working capital which has stalled productivity improvement and export market development when both would have assisted the industry. The sector, therefore, exhibits a high degree of fragmentation: a large number of very small firms with low scale of production and low level of capacity utilization.

On a somewhat positive note, however, the severe depression has weeded out a number of the less efficient operators in the sector, while survivors have been forced to hone their performance and increase their efficiency levels by cutting overheads, reducing inventory levels to a minimum, increasing product innovation, actively pursuing new export markets, instituting productivity measures and effecting new and innovative labour/management relationships as an avenue to reducing labour costs.

These severe domestic market problems, however, have particular relevance to the important question of the competitive position of the kitchen cabinet sector on the international front. This question is particularly significant vis-à-vis U.S., German, U.K., Spanish, Italian and Taiwanese manufacturers, which have significant economies of scale advantages over Canadian manufacturers due to the size of their markets and resultant scale of operations. These foreign manufacturers have penetrated the market in certain regions of Canada. The Americans compete in the low to medium price range, while the Europeans compete in the higher price/quality range of the market, in spite of a tariff wall in excess of 15 per cent and a significant exchange rate disadvantage, which has exerted additional pressure on Canadian

manufacturers already suffering from a significant downturn in domestic demand. Although imports totalled only \$3.4 million in 1981 and \$1.7 million in 1982, this is anticipated to change significantly in the near future due to a possible market thrust into Canada by at least one major U.S. kitchen cabinet manufacturer and several large European manufacturers.

From all indications, this market thrust on the part of the U.S. company is expected to be across Canada, and should there be any narrowing of the present exchange rate differential, this pressure could be expected to accelerate.

On the other side of the coin, however, a small number of Canadian kitchen cabinet manufacturers have been able to penetrate the U.S. market with respect to cabinets and cabinet components (doors) and the European market with respect to kitchen cabinet doors. More than anything, this has resulted from a favourable exchange rate situation vis-à-vis the major trading currencies, particularly with respect to the U.S., and declining market prospects at home, a situation which has prompted these companies to look at market potential outside Canada. These companies, numbering between 10 and 15 in total, have been able to exploit, in some cases quite successfully, select export market opportunities in the U.S. and Europe, primarily related to the strong growth in renovation and do-it-yourself, although a significant softening in the European currencies in 1984-85 has limited this potential temporarily. In these cases, new product development, a reasonably sound financial base and an export-oriented management philosophy have been the primary elements in this success. In addition, these companies generally exhibited a higher level of technology in their production equipment, produce for stock and are among the largest in terms of annual sales.

The wide variance in company size and type of operation characteristic of the sector make it somewhat difficult to establish the base cost structure of a typical firm in the sector. However, utilizing a number of financial statements from the Industrial and Regional Development Program (IRDP) requests and Dun and Bradstreet, raw materials are found to be the largest single component of costs by a relatively wide margin, averaging some 40 to 45 per cent as a percentage of cost of goods sold in the case of companies producing for stock (among the largest in the industry) and 35 to 40 per cent in the case of the custom manufacturers. Labour on the other hand comprises some 13 to 16 per cent in the former and 20 to 25 per cent in the latter. Production overhead costs comprise approximately 15 per cent in both.

In recent years, a number of economic factors affecting the basic cost structure of the sector have affected the ability of these companies to compete in international markets, some of these advantageous and some detrimental. The most obvious single factor has, of course, been the depreciation of the Canadian dollar vis-à-vis the U.S. dollar. While this has meant increased raw material costs to these Canadian producers since many of the species, such as oak, come from the U.S., it has meant on balance a 10 to 12 per cent price advantage for Canadian manufacturers, in spite of higher labour and transportation costs. It has also meant an increased level of protection against foreign competition in the domestic market over and above existing tariff levels of 15 per cent. Recently, as has been noted, a similar

advantage vis-à-vis the major European currencies has been eroded, and potential has declined temporarily in these markets.

However, not so beneficial to the competitive position of these companies have been certain economic factors which have tended to reduce or eliminate much of this advantage. First is the much smaller scale of production of the Canadian sector vis-à-vis those other countries such as the U.S., where each of 20 companies has sales greater than the largest Canadian firm, and Germany and Italy, which are major international competitors. Where the largest company in Canada has sales of only some \$30 million, competing companies from the U.S., such as Merillat and Triangle Pacific, command sales in the range of \$100 million. Companies from Europe, such as Beckerman and Pogenpohl, have sales in the range of \$150 million to \$200 million. These companies, as a result, are very highly automated, have larger financial resources for R&D and production and command lower overhead costs per unit of output. They also reap the benefits of reduced raw material costs through large-scale buying. Per unit labour costs also tend to be lower, in spite of higher wage levels in most cases, because of the higher level of automation and hence lower labour input per unit production. Studies done in the U.S. indicate the advantages of larger-scale operation to be in the neighbourhood of three per cent in the case of raw materials, six per cent in respect to labour and three per cent in overhead manufacturing costs.

Coupled to this is the additional disadvantage of a generally higher level of debt among Canadian firms compared to their average U.S. and European counterparts, a situation which has been aggravated significantly over the last two or three years. In 1980 and 1981, when virtually all markets turned downward, most Canadian operations found themselves operating at capacity utilization rates of 50 per cent or less. As a result, discounting became rampant and is still a major factor in the sector. Firms trimmed their cost structures to the bone in an attempt to lower their break-even positions, renegotiated wage contracts to reduce the labour cost burden and borrowed heavily to maintain their operations. The result at the end of the economic downturn was a trimmer sector in terms of cost structure and inventory control, but an increased debt load tended to eliminate many of the benefits of the cost-cutting measures. This compares unfavourably to counterparts in the U.S. and Europe, which have lower levels of debt and weathered the downturn much better because of their large markets, a situation that places the Canadian industry in a rather tenuous position. While the recent upturn, which has lasted about six months, has helped to create a slightly healthier financial structure in the industry in the east due to the higher capacity utilization and healthier profit margins, it has not been enough to correct the poor situation discussed above. Should the upswing abate, and there are recent signs it may, the sector will be in dire straits and certainly in a weakened position to counter the increased import measures anticipated.

MEDIUM-TERM OUTLOOK

Traditionally, the Canadian kitchen cabinet industry has been highly dependent on the level of new housing starts and, as a result, sensitive to cyclical

variations in the level of activity in the housing and construction sector. This is evidenced by the strong upward trend in activity experienced by kitchen cabinet manufacturers through the 1970s. New housing will continue to be a major demand factor. However, with the expected decline in the level of new housing activity in response to projected adverse population and net family formation trends in the 1980s and 1990s, it will be a factor of lessening importance.

The impetus for new growth will come from renovation and do-it-yourself (DIY). This shift in market emphasis is evidenced by the growth in Canadian residential construction expenditures for major alteration and improvement from a total of \$253 million (current dollars) in 1970, comprising 8.1 per cent of total residential construction expenditures in that year compared with \$3 029 million in 1983 or 23.5 per cent of total expenditure. This eleven-fold increase compares to a modest two-and-one-half increase in total new residential construction expenditure over the same period from \$2 769 million in 1970 to \$9 323 million in 1983.

Export markets also provide opportunity for future growth. The larger Canadian companies are being forced to place more emphasis on export opportunities, particularly in the U.S., to maintain production growth in the face of declining domestic housing starts. As a result, exports have increased from virtually nil in 1970 to some 10 per cent of total factory shipments in 1983 (\$30 million to \$35 million). This strong upswing in renovation and exports represents a significant shift in the underlying demand factors affecting the sector over the period.

Until the end of the century, movements in these demand factors are expected to accelerate, given a multitude of major influences expected to affect the Canadian economy in the late 1980s and 1990s:

1. A significant slowing in total population growth and net new family formation, two of the basic factors affecting the demand for new housing;
2. A major decline in the annual level of live births after 1985 along with an accelerated aging trend in the total population base;
3. A stabilization in the rate of immigration at a level of 50 000 to 60 000 per year, compared to the level of 180 000 to 190 000 experienced during the 1970s;
4. Continued aging of the existing housing inventory;
5. Continued strong upward inflationary trends in the costs of new housing;
6. The emergence of the 35-to-44 age group as the most rapidly expanding age segment of the population. For the most part, those in this group have already upgraded to their preferred housing accommodation and will not require new housing;

7. Expanding export potential, particularly that related to renovation of existing dwellings in select market areas such as Western Europe, the Middle East and Japan;
8. A developing worldwide shortage of wood fibre and wood-based products in the long term and an increasing emphasis, by a growing number of countries, on adequate housing accommodation for their respective populations.

New Housing

Recent forecasts of new residential housing requirements by Canada Mortgage and Housing, based on future population and net new family formation trends, to which a high degree of reliability can be attached, suggest declining levels of new housing activity to the end of the century. These projections are outlined below in Table IV for both single-family homes and multiples.

TABLE IV

Housing Requirement Projection by Five-Year Intervals

Type of Tenure and Province

1981 - 2001

(Units)

Type of housing Unit & Province	1981-1986		1987-1991		1992-1996		1997-2001	
	Units	Annual Rate	Units	Annual Rate	Units	Annual Rate	Units	Annual Rate
Single-Family Homes	710 000	142 060	641 500	128 300	484 600	96 900	356 300	71 300
Multiple Units*	340 700	68 140	267 300	55 500	180 100	36 100	138 600	27 700
TOTAL	1 051 000	210 200	908 800	183 800	664 700	133 000	494 900	99 000
Newfoundland	20 100	4 020	14 800	2 960	10 600	2 120	10 800	2 160
P.E.I.	4 400	880	4 100	820	2 900	580	2 500	500
Nova Scotia	30 100	6 020	26 700	5 340	16 400	3 280	12 000	2 400
New Brunswick	25 800	5 160	25 700	5 140	18 900	3 780	15 800	3 160
Quebec	215 900	43 180	166 100	33 220	105 600	21 120	71 900	14 300
Ontario	360 000	72 000	327 800	65 560	234 100	46 820	144 400	28 880
Manitoba	33 200	6 640	21 400	4 280	10 200	2 040	9 200	1 840
Saskatchewan	31 700	6 340	22 300	4 460	15 900	3 180	13 500	2 700
Alberta	167 400	33 480	154 400	30 880	125 000	25 000	114 600	22 920
B.C.	155 900	31 180	140 300	28 060	115 000	23 000	95 300	19 060
Others	3 600	720	3 600	720	3 500	700	2 900	580
Total **	1 051 000	210 200	907 200	183 800	658 100	133 000	492 900	99 000

* Includes all units over one family.

** Totals may not add due to statistical error in provincial estimates.

Regionally, the major brunt of the projected downturn is expected to be felt by the three regions of Quebec, Ontario and the Maritimes with projected declines in these areas of 50 to 70 per cent over the 15-year period. In all regions, however, the metropolitan areas have been forecast to reflect higher rates of decline relative to the non-urban portion of the province. Medium-term projections summarized in Table V reflect this movement by a projected annual growth decline of 0.9 per cent over the forecast period.

Renovation and DIY

If present trends continue, the most significant single factor influencing the direction of growth for the kitchen cabinet industry in Canada over the next few decades is expected to be renovation and DIY with expenditures at a level of some \$7 billion or \$8 billion annually by 1990, roughly paralleling that of new housing. While data and information on the Canadian situation are very limited, some rough estimates of future impact on the sector are possible through extrapolation from studies done by the U.S. Bureau of Building Marketing Research (BBMR). The study suggests that, of total renovation expenditures in that country, some 12 to 13 per cent are for kitchen remodelling and that one-quarter of these expenditures are for new kitchen cabinets. These ratios applied to total renovation expenditures of \$3 029 million in 1983 in Canada yield a global estimate of some \$95 million, and by the end of the century of some \$250 million annually or roughly half of total projected shipments. This is reflected in the summary medium-term projections in Table V and suggests an average annual growth rate in real terms of some seven per cent annually. There is, however, less confidence in this forecast due to the very limited data and information available on the Canadian situation as noted above. There is a demonstrated need on the part of both government and industry for a major study in this area from both policy and planning standpoints.

Trade

Trade considerations are important, additional key elements in the medium-term outlook of the sector. In this regard, there are unquestionably numerous export opportunities in certain product lines which exist for leading companies in the sector, primarily in the U.S., Western Europe and Japan in the longer term. The successful penetration of these markets by Canadian companies in future years, however, is very difficult to determine due to a multitude of factors such as the attitude and aggressiveness of Canadian companies in pursuing perceived market opportunities; the ability of companies in the sector to develop adequate resources and scale of production to achieve successful penetration of these markets; the ability of companies to finance the high costs of developing export potential; the ability of companies in the sector to compete in international markets; the degree of government support available in pursuing these opportunities; the currency exchange situation; and the ability of the Canadian industry to innovate and adapt their products to the demands of these foreign markets. The forecasts below assume a positive stance in all these areas and indicate a significant level of export penetration by the leading companies in the sector. This growth has been projected forward at the historical growth rate of

seven per cent annually, which is about half the growth rate experienced by the total manufactured wood products sector since the 1976 depreciation of the Canadian dollar. The proportion of factory shipments devoted to export markets, as a result, has been forecast to achieve a proportion of some 30 to 35 per cent of total industry shipments by the early 1990s.

A major concern, however, in achieving these moderately optimistic results is the increasing danger, referred to above, of any domestic potential being syphoned off by increasing import competition and the present relatively weak competitive ability of a large portion of the sector to counteract this threat. This situation threatens the ability of the sector, as a whole, to look at the expanding potential outside the country and hence maintain product levels above the break-even point. Over time, large-scale imports would lead to reduced levels of investment in the new and state-of-the-art equipment necessary to maintain a competitive position in the market.

All this considered, the medium-term outlook for the sector is given in the following table showing estimated potential shipments by major market component for the period 1981 to 1996 in constant dollars.

TABLE V
Projected Kitchen Cabinet Shipments by Market Component
1981 - 1995
(Constant Dollars)

Market Component	1981	1986	1991	1996	Average Annual Growth Rate
	\$000 000	\$000 000	\$000 000	\$000 000	
Domestic Market					
- New Housing	231	223	213	204	-0.9
- Renovation & DIY	90	118	165	232	7.0
Exports	25	35	49	69	7.0
TOTAL	346	376	427	505	1.7

MAJOR ISSUES

In the latter part of this century, a number of critical issues will confront the Canadian kitchen cabinet sector. These fall into eight primary areas of concern, which have been touched upon briefly in the main body of the report: capacity utilization, investment and modernization, fragmentation, technology and innovation, financial situation, raw material supply, labour/management relations and export opportunities.

Capacity Utilization

The utilization of existing capacity in the Canadian kitchen cabinet sector, while a vital concern heading into the period to the year 2000, has traditionally been a problem in this industry. Tied very closely to the cyclical nature of the housing sector in Canada, which can and has experienced wide fluctuations both by season and by region, the maintenance of adequate production levels by companies in the sector is a constant concern.

Scope for improvement in this situation is limited given the projected trends in the domestic market. Levels of capacity utilization have improved recently, primarily in eastern Canada, from levels of 40 to 50 per cent on a single-shift basis experienced during the depressed period 1981 to 1983, to levels of some 60 to 70 per cent over the last six months due to improved housing activity and renovation activity both in Canada and the U.S., very close to the pre-recession rates of 70 to 80 per cent. A number of firms were, in fact, able to add additional shifts. Strengthening trends in interest rates in 1984, however, threatened to cut this off quickly and return the sector to operating levels insufficient to cover the basic costs of production. The shortened upswing in activity was not sufficient to put the majority of firms on a strong enough financial footing to withstand another recessionary period. This situation was particularly critical in British Columbia, Alberta and Quebec where the downturn in activity had been very severe and price discounting had been excessive. Lower interest rate levels in 1985 have reduced this concern, however, and a number of companies have regained a measure of relative financial stability.

As an example of the variation in operating rates, some western Canada operations had been labouring under operating rates as low as 10 per cent. It should be pointed out, however, that few firms in this sector have seriously considered double-shifting their operation on a consistent basis, although many firms throughout the industry would have the capability to double- and even triple-shift, should demand for their product materialize. This potential underscores the very serious nature of the overcapacity situation in this sector.

The recessionary period of 1981 to 1983 was beneficial in some respects in that the majority of firms responded with stringent cash-reducing measures in their operations, thereby reducing their break-even points in most cases to below 50 per cent, by slashing overheads, reducing marketing and administration costs and by instituting unique labour/management relationships. However, the increase in long-term debt which also occurred over the same period while these companies attempted to weather the storm has placed them in a very precarious position with respect to another downturn in activity and consistently low operating rates.

Investment and Modernization

The foregoing scenario has had a significant impact on historical levels of investment in this industry and has serious implications for the future. With the exception of perhaps 10 to 15 of the larger operating companies, the level of investment has been minimal and has resulted in an industry burdened with old, antiquated machinery and equipment and, as a result, lower efficiency of production. Even in the larger plants, new investment has been low with the majority of it having been made in the late 1970s when activity was at its highest due to the unprecedented levels of housing activity at that time. During this period, annual capital expenditures averaged 1.5 to three per cent of sales. In contrast, over the last three or four years, investment has dropped to virtually zero throughout the industry, although there are some notable exceptions where a small number of companies have made significant investments to effect efficiency improvements.

In general, therefore, the industry finds itself poorly positioned to react to: (a) the changing demand scenario facing it in the 1980s and 1990s, (b) the maintenance of its competitive position in world markets, and (c) increasing competition from imports forecast in the near term. What is clearly developing is a deficiency in the application of new technology through investment in the Canadian industry relative to other producing areas such as Europe and the U.S., and this limits the Canadian industry's ability to compete efficiently. As a result, there are opportunities for investment to modernize and improve the production process in areas such as computerized control of raw materials, component cutting, assembly, spray painting, edge banding and inventory control.

In Canada, while the production process generally has grown on an ad hoc basis, a small number of companies, even companies with sales as low as \$1.5 million, have initiated integrated controls for inventory, warehousing, purchasing and distribution. These innovations have substantially reduced raw material and work-in-process inventories and, in many cases, have virtually eliminated finished goods inventory. On the whole, indications are that such measures have effected a 15 to 20 per cent increase in efficiency with the corresponding reduction in production costs.

The investment requirements to secure the long-term viability of the key firms in the sector vary somewhat from company to company, but are judged to be modest in comparison to the investment required in the primary sector such as pulp and paper. The machinery and equipment of most of the group could be brought up to a state-of-the-art position through an investment of less than \$1 million per firm, for the largest firms, spread over the next five years, or perhaps a range of some \$20 million to \$30 million for the sector as a whole. It is recognized that such modernization projects would have to be economically justified and show adequate returns on investment to be undertaken, a requirement which is difficult to meet when existing capacity is underutilized. The custom shops, which form the major portion of the group, by their very nature, would not benefit from such a program, since they operate predominantly on a one-of-a-kind basis, something that requires

flexibility in operation, simple machinery and equipment and high labour input.

Given the present and anticipated situations in the sector, new investment in production capacity would be counterproductive in the medium term, since a conservative judgment is that the existing in-place capacity could accommodate twice the level of current production. Modernization of plant and equipment, on the other hand, is felt to be important to the sector to achieve or maintain its competitive position relative to import competition and export development. As indicated above, the investment level required would be minimal compared to the installation of new facilities with state-of-the-art equipment, conservatively estimated to be in the neighbourhood of \$6.6 million in Ontario for a 10 000 m² plant (\$660/m²) and \$5.9 million in Quebec (\$590/m²). British Columbia would be closer to \$7.5 million. A 10 000 m² plant would typically be in the medium-size sales range. Depending on the degree of mechanization, more than half of these capital expenditures would be for plant as opposed to equipment.

Fragmentation

The Canadian kitchen cabinet sector has traditionally been a classic low-capital-intensity industry. As a result, any small company with a minimum of capital investment is able to set up shop and supply a local or even regional market. The sector, therefore, continually exhibits an overabundance of small, non-integrated manufacturing operations competing with firms of a more substantial size for shares of the market. With housing activity being so highly cyclical, as already noted, expanding and contracting consumption results in a high turnover rate as firms enter and leave the industry. Not only does this mean a continuous state of overcapacity where the available capital is underutilized, it also creates a situation where economies of scale are difficult to achieve. The result of the fragmentation is an inherently low level of efficiency throughout the industry because companies are unable to maintain a viable share of the market.

Recognizing the fact that only the larger, more efficient companies in the sector will be able to export at significant levels, a positive trend in future years in the industry would be one moving toward company consolidations and rationalization of operations.

Technology and Innovation

Technology and innovation are two vital elements in the future health and vitality of the kitchen cabinet sector in Canada. Research and development expenditures have traditionally related to new product development and have been made in-house on the basis of ideas from competitors, foreign visits, new product literature and consumer dictates. Research and development related to machinery and equipment have primarily been done by equipment suppliers and adapted to the specific needs of companies. Major suppliers of new state-of-the-art machinery and equipment have been either Germany, Italy, Britain or the U.S., since Canadian capability in the area of equipment supply is very limited.

The changing market scenario facing the sector (i.e., declining new housing demand, expanding renovation and DIY demand and expanding export potential) underscores the future importance of product development and innovation in the ability of companies to compete domestically and outside the country. The adaptation of the European style of cabinet (frameless, hidden hinges, standard sizes, etc.) to Canadian designs has been one such innovation in recent years. These cabinets now represent between 10 and 50 per cent of total sales of a number of the larger Canadian companies. In addition, a number have taken this one step further to a knock-down concept and, as a result, have been able to tap both the renovation and DIY markets. This concept has also opened export potential in a number of instances. The future suggests innovation in new finishes and a move to more abundant species of wood, as oak becomes more expensive and less plentiful, along with more efficient kitchen design concepts. The utilization of the computer in respect to the latter has been a recent innovation in a number of companies, providing for the most efficient configuration of cabinets in a given kitchen area. Innovation in styling, finishing and hardware are other examples.

In international terms, leading companies in the sector have applied new technology as effectively as kitchen cabinet companies in other countries. It should be noted, however, that, while innovation and technical improvements in products and process are fundamental to this sector, the activity tends to be of an ongoing nature and single large projects represent a relatively small share of total expenditures.

Financial Situation

The present financial situation of the sector can only be described as tenuous. Historically, the recurring capacity utilization and fragmentation problems of the industry, even at the height of the building boom in Canada during the 1970s, have meant that the industry as a whole was never operating much above break-even, although individual companies have been successful. As a result, many companies have weak working capital positions and an inability to invest in new machinery and equipment for future growth.

The recessionary period, from 1981 to 1983, severely aggravated the situation in that capacity utilization rates dropped significantly and price discounting was rampant in the industry as firms attempted to maintain production rates. Both short- and long-term debt increased significantly as firms attempted to avoid closing their doors. As an example, the evidence suggests that total debt to equity now stands at between \$2 and \$2.50 per dollar of equity for many firms, one of the highest ratios in manufacturing. In a large number of companies, equity levels have been reduced to zero or are negative as a result of the depressed levels of activity. In addition, companies in the sector are experiencing considerable difficulty in obtaining equity capital, working capital or capital for modernization or export development from traditional financial sources.

Significantly, during the period the banks and auxiliary financial institutions serving the sector tightened the availability of funds considerably as the fortunes of the sector declined, with the result that much

of this debt was high risk and hence at high interest rates. With the ominous signs on the horizon due to the recent upswing in interest rates, this debt burden could spell difficulty for a large segment of the sector.

Raw Material Supply

Another concern of the sector, although one that has eased somewhat in 1984 and 1985 is a developing raw material supply problem with respect to oak, the key wood species utilized at the medium to high end of the market where the greatest potential for export lies. Prices had been escalating in the early 1980s, shortages were occurring and quality was declining. This latter problem was particularly disconcerting because of the impact on the wastage factor in the plant which increases costs dramatically. This spurred interest in alternative species and new finishes which create the look of oak. The problem is that, at the high end of the market, these alternatives have so far been meeting some market resistance.

While the supply and price of oak is a primary concern, the high cost of Canadian sources relative to foreign supplies of materials, such as particle board, hardware, packaging materials and supplies, all important to the production process, is also cited as a problem.

Labour/Management Relations

Given the prevailing economic situation facing the sector, labour/management relations have emerged as an important concern in the industry. This factor, while always an important one, was given special attention by a significant number of companies during the depressed 1981 to 1983 period when the industry was forced to take a hard look at costs and to lower break-even points in order to survive. While layoffs were an obvious and essential element in this process, re-negotiation of existing labour contracts and the development of unique profit-sharing and incentive arrangements in a number of companies were also major factors. A number of these have been surprisingly successful and have led to significant efficiency and productivity gains throughout the industry. This trend can be expected to continue and should be encouraged as an essential element in any concentrated effort to improve the market competitiveness of the sector.

Export Opportunities

The Canadian kitchen cabinet industry has substantially increased its level of exports since the 1970s, but particularly in recent years with the added impetus of the devalued Canadian dollar relative to that of the U.S. With a continued exchange rate advantage and increased emphasis on further productivity improvement among the leading companies in this sector, exports can be expected to continue this strong growth pattern. The key market areas in this anticipated growth would be in the U.S., but Western Europe and Japan also provide opportunity should these currencies again strengthen relative to the Canadian dollar.

While it is recognized that there are constraints to successful export market penetration such as high development costs and risks associated with such efforts, the industry does possess a number of distinct advantages relative to these markets including high-quality image, technically advanced product, reliable delivery, competitive cost in their product range and unique styling. As a result, companies have sold kitchen cabinets not only to the U.S., but also to Hong Kong, Australia, Saudi Arabia, Japan, Korea and the U.K. Several kitchen cabinet/door manufacturers have sold their specialized products in Western Europe. Given the proper attitude on the part of leading entrepreneurs in the sector and aggressive industry/government initiatives for export development, the medium-term projection of better than doubling future export activity by 1996 should be attainable.

FEDERAL/PROVINCIAL GOVERNMENT CONSIDERATIONS

Given the existing and anticipated economic scenario confronting the sector, there are a number of important considerations to be taken into account when contemplating its future development:

1. The high value added and employment-generating characteristics of the industry, which rank well ahead of the primary forest products sectors, although this divergence would decline somewhat given more modern, technologically-equipped plants;
2. The excellent export potential of the sector in the U.S. and certain offshore markets such as Japan, the Middle East and Western Europe;
3. The mounting import threat at both the high and low end of the market;
4. The opportunity for significant productivity improvement through both plant and equipment modernization and improved labour/management relations;
5. The continuing state of overcapacity in the sector. Present capacity in place is judged sufficient well into the 1990s;
6. The undesirability of additional proliferation of small plants or further fragmentation of the sector and the desirability of a trend towards consolidation and/or rationalization;
7. The present dependence of the sector on the fortunes of the housing industry and its susceptibility to cycles in housing activity;
8. The low levels of profitability and tenuous financial state of the sector;
9. The significant locational advantage of the large urban centre for companies in the sector;
10. The importance of innovation and product development in the sector, particularly for products that meet changing consumer preference.

SUMMARY AND CONCLUSIONS

The four major issues which face the sector and which will dominate its development over the next 15 years are (1) its tenuous financial situation, (2) chronic and serious overcapacity, (3) its critical need for improved productivity and increased cost effectiveness and (4) the significant export opportunities seen on the horizon. This report has dealt with each of these in turn along with their underlying causes.

In facing these issues, the sector operates with a unique set of characteristics which will determine, to a large extent, its ability to respond. At present, firms in the sector run the full gamut from semi-automated and sophisticated operations to ones which are highly labour-intensive, almost handcraft-type operations. Management quality is variable throughout the sector and in some instances is highly competent and, as with many small industry sectors, the company president is the dominant figure and key to the success of the company. Labour/management relationships and arrangements are also varied and in numerous instances exhibit some very unique and progressive arrangements in profit-sharing and labour incentives. Other significant characteristics include the constant requirement for product innovation, high value added and a tendency towards intense competition and fragmentation.

To survive as a viable industry sector and realize its maximum potential, it will have to address the above issues over the next decade. Ideally, by 1995 the industry should achieve:

- (a) reasonable financial stability;
- (b) significantly improved levels of capacity utilization (at least 80 per cent);
- (c) an increase in average company size through the process of consolidation and rationalization for reasons of productivity;
- (d) economies of scale and international competitiveness;
- (e) a higher proportion of total shipments devoted to export markets (i.e., 30 per cent range); and
- (f) consistent application of progressive arrangements in labour management relationships to the benefit of employees and company productivity.

The kitchen cabinet industry should be emphasizing modernization, innovation and consolidation/rationalization rather than projects that would lead to new capacity or the further fragmentation of the sector. As companies in the sector are more advantageously located in the larger urban centres, the sector itself generally is not a prime vehicle for regional support. The kitchen cabinet industry does, however, have an export market potential, which will require relatively large resources to develop, and there are opportunities to replace imports. Training, particularly in the areas of marketing, production and management, is important to the industry and should be recognized as an area of high priority.

APPENDIX

CONVERTED WOOD AND PAPER PRODUCTS DIVISION

FOREST PRODUCTS DIRECTORATE

RESOURCE PROCESSING INDUSTRIES BRANCH

DEPARTMENT OF REGIONAL INDUSTRIAL EXPANSION

MANAGER

C.J. Copeland

OFFICERS AND RESPONSIBILITIES

- | | | |
|-------------|---|---|
| G.D. Bird | - | Special Projects Involving All Product Sectors;
Converted Paper Products: Institutional, Decorative
(Wallpaper), Packaging - Coated, Laminated, Reinforced
or Metallized Paper Packaging Materials and Bags |
| M.S. Hardie | - | Timber Frame Construction, Manufactured Buildings
(Including Houses), Structural Housing Components,
Mobile Homes, Log Homes, Laminated Timbers |
| J.T. Melnyk | - | Kitchen Cabinets, Architectural Millwork,
Remanufactured Products and Specialty Items, Handles,
Brush, Broom, Mop, Charcoal, Fire Logs, Fencing,
Wooden Containers, Wood Flour, Cooperage, Wood
Turnings, Spools, Dowels, Woodenware, Miscel. |
| R.J. Aubrey | - | Millwork (Windows, Doors and Mouldings, etc.),
Pallets, Hardwood Flooring, Furniture Components,
Dimension Stock; Converted Paper Products: Consumer
Disposables and Specialty Commercial |

