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FTMA Trussted Insight

PRICE IS NOT THE ENEMY: IT'S AN UNPROFITABLE SUPPLY CHAIN THAT'S OUT TO KILL US!

WITH TIM WOODS OF INDUSTRYEDGE

Price is not the enemy: it's an unprofitable supply chain that's out to kill us!

With Tim Woods at IndustryEdge

A new year is the perfect time to challenge some of the old thinking that may have been holding us back. New year's resolutions and all that.

Sometimes, the challenges are confronting and that may prove the case here, also.

We all know that in 2021, building costs and building material prices rose sharply. It is hard to avoid the commentary that: 'someone else is making money from these prices, but not me'. The problem with that approach is it suggests higher prices are a problem and bad for business.

That is a serious error and is the type of thinking that creates behaviours that bring supply chains unstuck.

What has been very difficult for the timber supply chain is very sharp price increases for materials, including timber.

A supply chain with little experience of managing price movements has literally been shocked by the magnitude and pace of the required increases.

Here we set out why higher prices are good for supply chains, including for the housing industry, fabricators and the timber supply chain and how we might manage prices in the future, to maintain a healthy supply chain.

Supply chain health should not be a competition

There is an adage that a successful business is one with both successful suppliers and customers. In part this means every business is dependent upon the success of the supply chain, from the start to the end.

For fabricators, that means success relies on the customers being successful – that's the builders – and everyone is across that. We know we need them to be profitable!

However, it also means success depends on the suppliers and the supply chain being successful and profitable. For fabricators, that means we are all tied to the success of sawmillers, trucking businesses, wholesalers, harvesting contractors, forest owners, maintenance businesses, investors and everyone else playing a part, regardless of how small, in delivering a house to a family.

A truly healthy supply chain would result in each business being paid adequately for the value they add in the process. That does not mean each business receives an 'equal' share, but it does mean they earn sufficient income for them to continue to invest and stay part of the supply chain.

Supply chains without this adequacy – could we call it fairness? – are fragile. The risk of part of the supply chain losing interest and under-investing or even divesting increases if their returns are inadequate.

Ultimately, the final price paid by the end consumer represents the total value that can be shared throughout the supply chain. The price you receive represents the total value that can be shared in the supply chain, up to and including your business.

If that final price is inadequate to meet the income needs of the entire supply chain, one or more businesses in the chain are at risk. In a supply chain, the weakest link (from an economic standpoint) is a threat to the health, and sometimes even the survival, of all.

In the most dramatic situations, a supply chain fails and businesses and sectors disappear or decline to irrelevancy, usually because a 'disruptor' product enters the market with a more efficient and durable supply chain.

Supply chains are always at risk

There are a variety of ways supply chains can be broken, including from within:

- **Some failures are driven by the supply chain being so transactional the participants compete for value throughout the supply chain**, with 'winners' (usually the more powerful) earning some, or most, of the share that would otherwise have gone to the 'losers' (usually the weakest), to the point where they cannot continue to operate. Think about supermarket milk for $1 per litre being paid for by dairy farmers not the supermarkets and we get the idea.
- Other failures are **driven by changing consumer preferences ripping the capacity to earn income away from the supply chain**. It is not our fault, but when's the last time you bought a newspaper? The world over – Australia included – newsprint mills have been closing for years.
- In less dramatic situations, **entire stages in supply chains become so unprofitable there is constant churn in the businesses undertaking the work, to the point they become inefficient because no expertise is developed or maintained**.

  Usually this will be a link in the chain where there are many operators, providing the same service, with standardised capital and relatively low costs and barriers to entry, compared with the rest of the supply chain. So called 'independent' truck companies (a single truck and driver often) are an example. Home delivery services another.

- **One of the more insidious supply chain value failures arises when competition in the market is defined on price alone, especially for the final product (upon which all rely for their income).** In this scenario, in order to secure work, a supplier suppresses their own prices and passes the low price back to their own suppliers.

  Over time, and when many suppliers participate in the same way, they undermine the total value of the supply chain. In turn, that reduces the incentive to invest, from the start of the supply chain to the final product and price.

Competition on price alone is very bad for the health of the supply chain.

Prices tell us the timber supply chain has not been especially healthy

Among other measures, at different points or stages of value adding, we can measure prices to understand the supply chain health. This is best done over time, to see the broadest picture possible.

Unfortunately, there is limited price information available on the average cost of house frames and trusses. The data is there – it is inside your business at a range of points – and most times, fabricators know their own prices, but are perhaps a little less clear on the full and real costs of their business and the supply chain supporting them.

However, unlike some other sectors, there are no price series that would provide the sort of data from which to undertake detailed assessments. Fortunately, there are long run data series for softwood on which we can rely.

Inflation is a price signal

Too much inflation – prices rising too quickly – is a bad thing. High and uncontrolled inflation provides uncertainty and makes planning and managing a household, a business or a government very difficult.

Too little inflation is a less discussed problem, but it also is a bad thing. Moreover, it is insidious because the lack of a positive price signal can suggest to businesses that there is no opportunity or incentive to invest.

That is, when the general inflation rate (prices) are rising and a supply chain is not seeing similar or better price increases, those making investment decisions will start to look elsewhere.

In part, this has been the challenge that has seen Australia's softwood plantation estate – used to frame the nation's houses – stagnate over the last two decades.

That has resulted in a stable amount of available wood and no supply for sawmills and other processors to expand very significantly. Import reliance has been growing as demand has expanded.

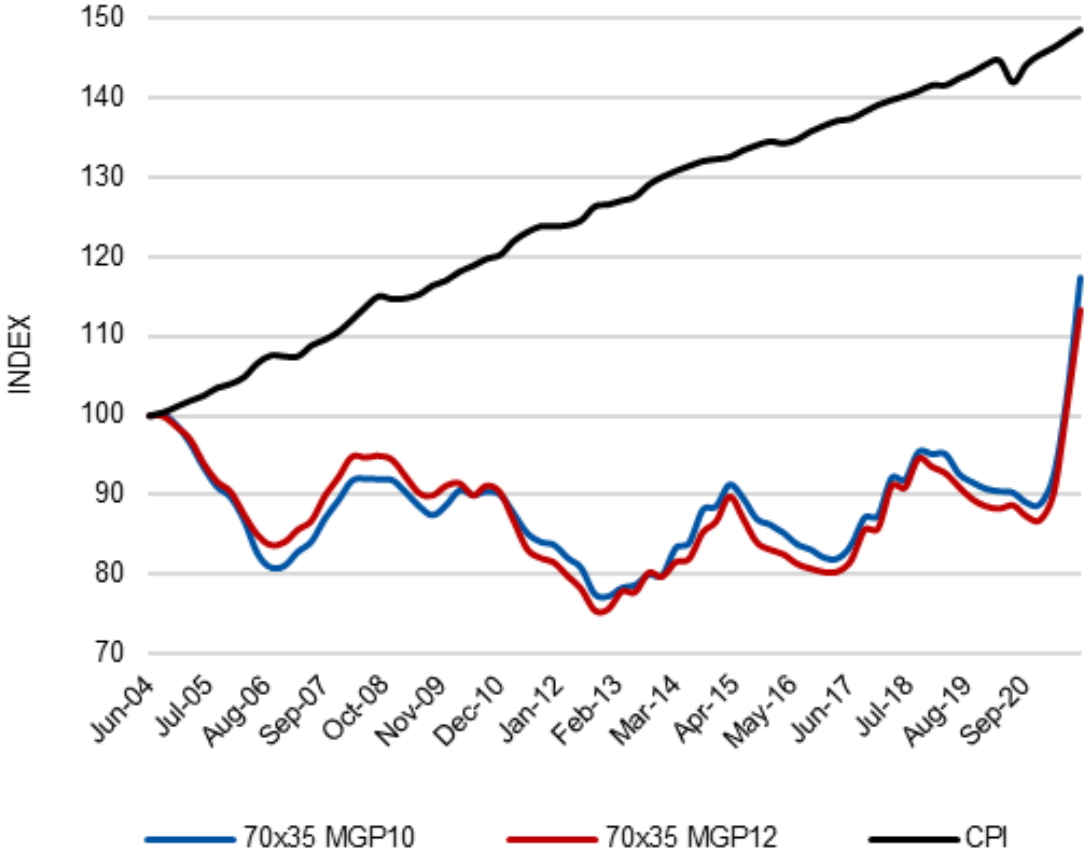
The supply chain – ultimately represented by the price of the final product – has not returned sufficient income to make investment in new plantations attractive.

How do we know?

Here, we can see the quarterly inflation rate, compared with the reported quarterly average price movements for the main grades (local and imported) of structural timber.

Timber prices lifted sharply over 2021 and that has been very difficult for fabricators and builders to manage. Yet, even after those huge price spikes, structural timber prices remain 35% (MGP12) and 31% (MGP10) lower valued in real terms than eighteen years ago!

Structural Timber v CPI: JQ'04 – SQ'21 (INDEX)



Source: ABS, TMS, Omega Consulting & IndustryEdge

If you are a plantation grower, sawmiller or other processor, there is little to cheer about from these prices. In the face of those prices, where has the investment incentive been for the supply chain on which fabricators rely?

The short answer is 'elsewhere'!

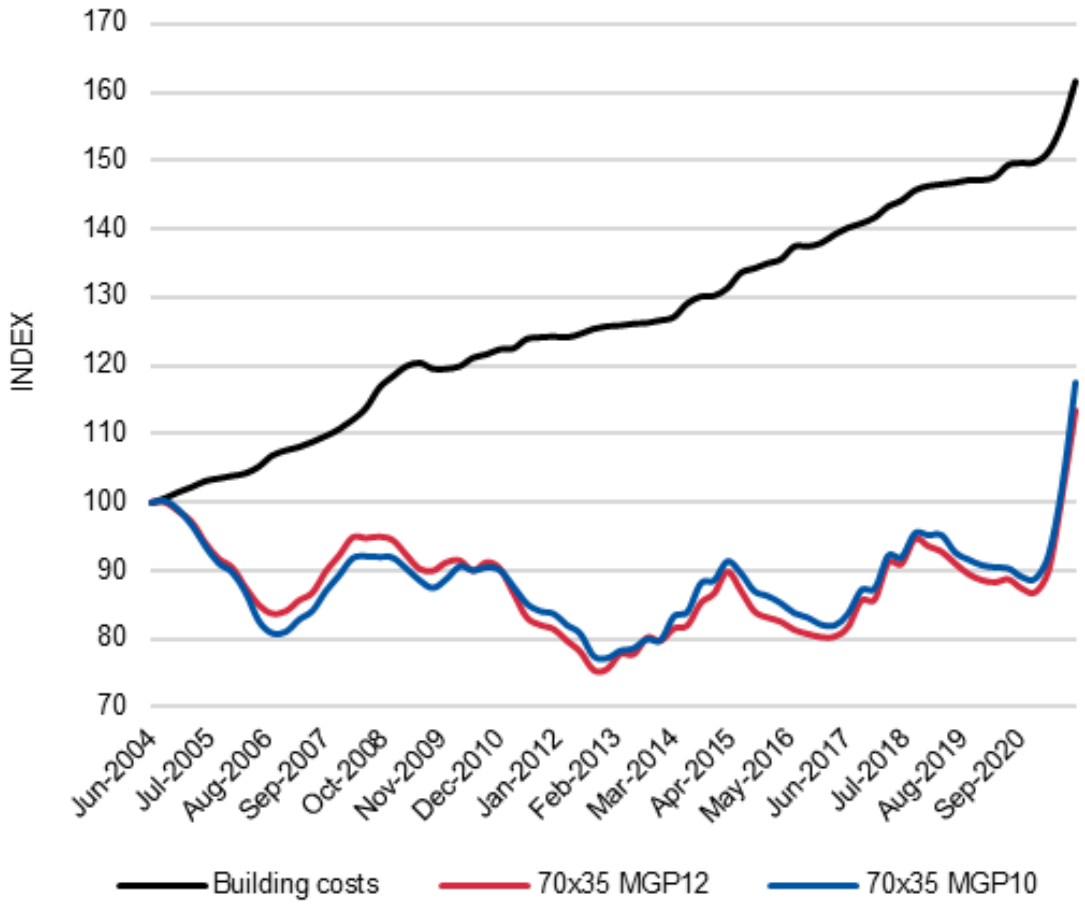
How did this situation of stagnating real prices for timber come about?

One reason is the supply chain – no blame here, we're all in this together – failed to factor in the real cost of supplying one of its key materials, even as the general cost of building a house increased.

Here we can see the same structural timber prices, indexed against the Australian average building cost index. The chart (following page) shows that compared to the overall cost of building a house, structural timber prices are lower by 49% (MGP12) and 44% (MGP10)!

Some will say otherwise, but from where IndustryEdge sits, this was never sustainable – and the remaining gap demonstrates it still is not sufficient to drive massive investments in new plantation resources and subsequently, in new sawmilling and processing activities.

Structural Timber v Building Costs: JQ'04 – SQ'21 (INDEX)



Source: ABS, TMS, Omega Consulting & IndustryEdge

What's a reliable inflation rate going forward?

The situation is dire with timber prices and we need to ensure two things happen to sustain and grow future resource.

First, we have to maintain the price gains of the last year or more – the supply chain cannot afford to back slide now it has finally achieved some pricing momentum.

Second, we need to ensure the pricing improvements flatten out, but continue to grow at something better than the inflation rate – there is still ground to be made up for the entire supply chain. That means fabricators must earn more, so their suppliers can earn more. It does not mean fabricators earning the same and just paying more for materials. That is not a solution either.

Some will argue that higher prices will drive substitution, but the evidence of that is thin on the ground. It tends to be supply issues that drive substitution, not price, although there are obviously limits.

So, what will inflation look like over the coming period?

Central banks like the RBA expend great effort keeping inflation inside target ranges. For years, the RBA has targeted an inflation rate between 2.0% and 3.0% per annum on average. The chart above shows that (pandemic aside), they have done that with a relatively consistent level of success for the last eighteen years.

Now, past performance is no guarantee of future success, but for all that period, the average annual inflation rate has been 2.2% per annum, and we can safely surmise over the next two to three years, it will be only a little different, probably tracking higher than 3%, but not for very long.

How to avoid price 'stags' and maintain supply chain health

In business, as in life, uncertainty is death. If you don't know the future price of your materials, how do you quote the next job, for instance?

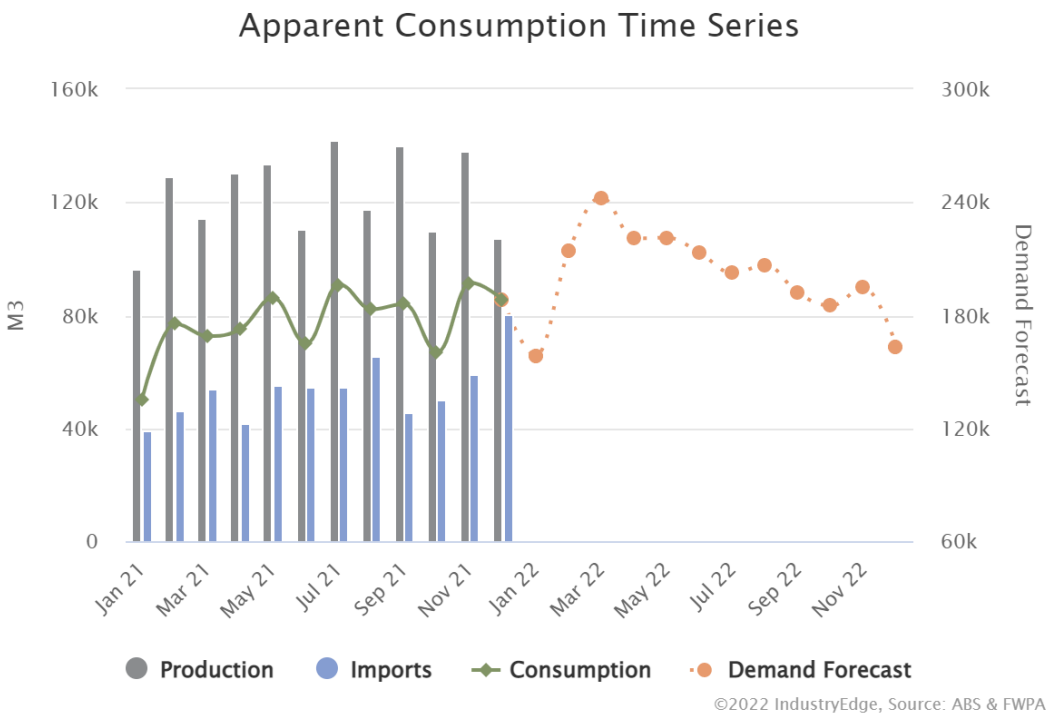
To achieve some certainty, most businesses use tools that provide assessments of demand for their entire supply chain, as a means of assessing the demand for their own products. That allows them to order materials and coupled with other data – like the CPI we looked at earlier – can even allow for some price planning.

The latest structural timber demand forecast – which is theoretical and based on housing approvals and historic consumption, continues to show that demand for timber will peak in March 2022 – in around one month's time – before it begins to decline and returns to manageable levels late in the second-half of 2022.

This forecast, from IndustryEdge's Wood Market Edge online platform does not tell us about two other important elements: supply-chain capacity and supply. The forecast only tells us how much timber the market is likely to need at a particular point in time, to build the housing in front of it in normal times.

On supply-chain capacity, the reality is that much of that theoretical demand will not be built for some time. The building supply chain has no spare capacity and in fact, much of the system has reduced capacity over the last two years. Labour, materials and the 'friction' of work here, there and everywhere and all the associated delays, has taken its toll. That includes fabricators, of course.

In any event, the forecast is below, uses a combination of new approvals and uncompleted work, along with two decades of consumption data.



The demand peak in March 2022 is interesting, but the important point lies beyond. Slowly, demand for timber (and therefore for frames and trusses) is working down to manageable levels. By the start of 2023, we can reasonably safely predict that demand will be back to normal levels.

That is information businesses can use to plan their supply needs.

In any event, supply is different to demand and needs to be considered separately, to some extent.

For example, what if demand declines as predicted, but supply falls further? Especially imported supply, impacted by say another surge in US or Western European demand or a big ship stuck in a canal for a month, or some other improbable logistics challenge?

Ultimately, what if we cannot get enough imported timber?

If we learned nothing else the last two years, we have surely learned that 'she'll be right' is a dangerous assumption!

To protect against that kind of eventuality, we can use these expectations of demand to secure some or all the timber we might need.

When we lock a volume, we can lock a price, including orderly price increases that track the inflation rate and take account of the needs of the supply chain we rely on.

Providing our own business with stability and certainty supports our supply chain and allows it to plan its response, maintain its economic health, and ideally, encourages it to reinvest.

The lessons of the current era are many. They include analysing and adopting supply chain behaviour to create certainty and deliver financial health to our own businesses and the entire supply chain.

After all, as we learned in the midst of this pandemic – we are most certainly, all in this together.

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