

The Downturn at Mid Year and Beyond

By Herm Isenstein

The overall economy continues to be in dire straits and it is taking its toll on the electrical distribution industry. Because industry performance this year is so bad, relief at this point is relative. Next year industry sales are expected to be negative but not as severe as this year. If it helps at all, you can call that relief but we rarely see back to back declines in this industry's sales performance, so what kind of relief is that?

The last time we saw back to back sales declines was in the recession of 2002-2003. Make no mistake about it, there is no equivalency between the last recession and the current recession. We are in far worse shape this time and the uncertainty in terms of recovery is far greater.

This is not your run of the mill downturn. It is the most severe electrical industry downturn in history and for each of the four major segments served by the electrical industry – contractor, industrial, utility and institutional -- the results are horrific.

We do not expect industry sales to move into the plus column in any meaningful way until late 2010 -- we are looking for low single digit growth in the 4th quarter of 2010. And we think that will be the end of the old cycle and the beginning of a new business cycle for the electrical industry. We are not elated about it because it is still a year and a half away and there are potentially many unforeseen events down the pike.

If you are thinking that what you have read so far is gloom and doom, just wait.

Our analysis indicates that the worst is yet to come. Before I get into that discussion I want to address another issue.

Overall Recovery vs. Industry Recovery

Some are saying they are seeing a glimmer that the overall economy could recover by the end of this year. We want to make a distinction between the forces that govern the overall economy and the forces that govern the electrical wholesale industry.

The overall economy encompasses four major sectors -- consumer, business, government and international -- and they are driven by a different set of forces than those driving the electrical industry.

The government can put money directly into the hands of consumers like a tax cut or a cost of living adjustment for Social Security and stimulate consumer spending for items like household goods, etc. That does nothing directly for the electrical industry. But consumer spending will directly impact GDP and influence a quicker overall economic recovery.

In fact, consumer spending did increase in the first quarter as incomes rose in response to large tax refunds and a big cost of living adjustment for Social Security.

At the same time, key indicators of housing activity (home sales, housing starts and permits) are showing signs of stabilizing. Accordingly, residential

construction could start to increase by the end of the year.

Without belaboring the point, increases in economic indicators that directly impact the overall economy but do not directly impact the electrical industry could result in a faster recovery overall but do little for a recovery in the electrical industry. So let's not get euphoric when we hear economists crowing about a recovery at the end of this year. They are not talking about a recovery in our industry.

Allocating Resources

We have known that the economy and the electrical industry were going to be in for some tough sledding at least since last fall. This gave the industry time to plan for the down year. At this point there are few surprises in terms of what lies ahead for the rest of this year. But it is important to recognize that reallocating resources is always an ongoing process.

This is particularly true when all the important indicators driving industry sales are nose-diving. Is it any easier to reallocate resources when industry sales are down double digits rather than single digits? Reallocations of human resources are always difficult and painful.

There are two issues I want to address now. One is the severe decrease in the real economic drivers of electrical industry sales. The other is the deflationary impact of prices on the electrical industry.

We are currently staring at a 32% decrease in total industry sales this year, led by more than a 35% decline in the distributor served contractor market. What's driving this decline?

First and foremost is a sharp 22% decline in nonresidential construction spending along with a 25% decrease in residential construction spending. These are, of course, forecasts and if the forecasts of the economic drivers are perfect then industry sales will almost certainly decline at the rates noted above, within a small margin of error.

This industry performance requires significant resource allocations. Now let's add another factor. We are in a deflationary economy and in our industry we are facing more deflation than in the overall economy. In fact we are expecting industry prices to decline by about 12%.

There are at least two elements that have to be on target to have a 32% industry sales decline this year. One is the economic drivers and the other is the price. If we are off by half in our price forecast, that is prices decline by 6% instead of 12% then total industry sales will fall by 26% instead of 32%. How much more painful is 32% vs. 26%? How much more resources do you have to reallocate?

One more consideration in the reallocation mix is the change in physical volume. We measure physical volume by removing the effect of price. With a 32% decline in sales and a 12% decline in prices the real physical volume change in industry sales after the price change is negative 22%.

Are we splitting hairs in differentiating between a sales decrease of 32% and one of 22%? In either case the change is huge. But in terms of changing out resources the difference is significant. All I am saying is that in terms of

moving resources around recognize that people are physical and changes here are measurable in physical units not inflated (deflated) dollars.

Industry Performance Slows in the Second Half

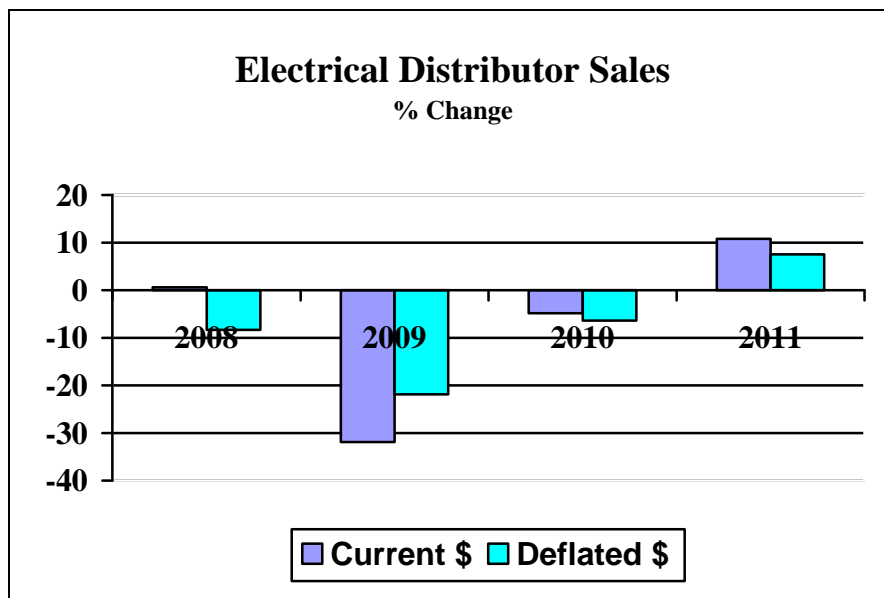
Earlier I had mentioned that the worst is yet to come. The year is more than a single point in time and when we look at how we progress through 2009 we are facing a more severe downturn in the coming months than we faced in the first half of the year. Here's why.

Nonresidential construction will be down about 14% in the first half of the year and down about 30% in the second half of the year compared with a year ago. At the same time, residential construction will be down 25% in the

first half of this year and down 24% in the second half of this year compared with a year ago. So look for total distributor industry sales to be off 25% in the first half of this year and more than 35% off in the second half of this year compared with a year ago.

In summary, we do not expect a quick recovery in the electrical industry regardless of whether the overall economy recovers at the end of this year.

We see a significant amount of deflation in our industry this year. And we are expecting a more severe negative industry performance in the second half of the year vs. the first half. We do not expect the electrical industry to recover until late 2010. All in all, that is quite a lot to handle for anyone.



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