Focus on the customer¹

by Tom Stephens²

Let me revisit the trade issue because the reason it remains a problem is that the Canadian lumber industry has not focused on the customer. The only way Canada will ultimately win unfettered access to the US market is playing by the US rules which are based on politics, not true justice and doing the right thing. The only way to level the political playing field is to make it very clear to George Bush that voters do not want to see the cost of housing go up by subsidizing a few sawmills in Mississippi.

That message has to be delivered to the White House by people who build homes out of Canadian lumber. I can assure you that only a small majority today understands the importance of Canadian lumber to the US economy and many do not even know that 35% of the lumber comes from Canada.

The Prime Minister is doing a good job of dropping not so delicate reminders about trade linkages so I will leave the sabre-rattling to him. I will stick to talking about the importance of customer relationships.

I was taught a long time ago that there were basically three ways to create a successful business. The concept was to build competitive advantage by being superior at either:

- Product innovation
- Customer relationships, or
- Operational excellence

There are a few companies that are clearly superior at one of the skills in an industry and occasionally you will find a company that is good at two. Being the best at all three is as rare as the number of people who voted NDP in the last election.

In the forest products business the strategy that most pursue is operational excellence. To put it in simpler terms, the conventional strategy has been trying to become the low-cost producer. The problem with that focus is that in volatile markets like lumber, pulp, and newsprint, being the low-cost producer only guarantees that you will be the last mill to close down.

Michel Porter at Harvard describes what happens in an industry where everyone pursues the same strategy, using the same technology and the same management approach. He called it "convergence." In commodity industries where cost is the only differentiator, the aggregate returns tend to be petty ugly. He must have had our industry in mind when he did his study.

I am delighted with the conference theme, "Focus on the customer," because now I am one. It is kind of fun having a salesman from four paper companies sitting out in the waiting room all ready to come in and lower the price to get the next order. The problem is, when the economy turns around, the roles

reverse and there are no salesman in the waiting room and prices go up beyond what I can pass on to my customers. What is missing is a salesman in the waiting room who has ideas about how we can sell more of my product so that we both can win.

I am not a customer for lumber but the situation there is even more dramatic because there are not even any salesmen in the customer's waiting room. People who sell lumber wear headset telephones, sit in front of a computer screen, call themselves traders, not salesman, and probably never meet the buyer they talk to on the telephone. Most lumber producers put their product on a rail car and send it south not knowing or caring about who the customer is. In many cases, a carload of lumber will be traded more than once before it is finally unloaded.

The builder that ultimately uses the lumber generally has no idea who produced the wood he is using and unless there is a quality problem, probably does not care. What he cares about is how much the wood cost relative to his bid on the job and if it was delivered when and where he wanted.

Sawmills do not sell lumber; they generally trade it. There is an opportunity to help stop the trade wars and create competitive advantage if Canadians redefined the way the business works and built a new relationship with its customers. It may mean spending some money to get more involved downstream in the distribution system, but it could well be worth it. It means that Canadian producers need to work together to protect your interest rather than looking over your shoulder and worrying about some other mills or some other province cutting a better deal.

In the long run, a dollar spent on marketing and building a better relationship with the end user will be better than a dollar spent on legal fees fighting trade issues. I have done a little survey and not to my surprise I found out that:

- Most Americans do not have a clue how much our home building depends on Canadian lumber.
- Many traders in the supply chain believe that they make more money if Canadian shipments are restricted because they work on a mark-up.
- It is not high lumber prices that builders fear; it is the volatility.

I suggest Canadian lumber producers stop the infighting and join together to promote your product and better serve the common interest you have with your real customer, the home builder and home buyer.

The paper industry is a little better with customer relationships, but not much. I now work as a director of two big buyers of paper. Mail-well buys \$1 billion of paper products a year for its envelope, label, and printing business and Qwest is one

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of the largest consumers of directory paper. Having spent most of my life in the paper business, I look back on many opportunities lost in not building a better business through a better relationship with my customers.

Paper suppliers and paper consumers spend 10 times the energy fighting over how to divide up the pie rather than how to make the pie bigger. Rather than partnership, the paper business has a history of an adverse relationship where next week's price is more important than growing the market for the end product.

In both paper and lumber we produce our products like commodities, trade them like commodities, and lo and behold, the returns on investment are like commodities. The only time we seem to make reasonable returns is when financial markets cut off our access to capital, enough mills go bankrupt, and supply and demand gets in balance. But being slow learners, the first thing we do with a little extra cash is ignore the market needs and build a new mill to make the same old commodity and start the cycle all over again.

At this conference last year, Mark Connely told us in no uncertain terms what a horrible record our industry has had. He describes us as being the best at only one thing; destroying shareholder value.

The roots of the trouble in the forest products industry go back a long time, but the cumulative impact has come to a head in the last few years. This industry has not come close to earning its cost of capital over the cycle. In fact, I think Mark made a good case that the industry has been one of the biggest destroyers of investment value of any industrial sector. The only thing that has kept the industry going is the cash flow from harvesting trees someone planned fifty years ago and bankers who made loans against collateral, not earnings growth. We have lived off the wealth of our timber assets and that value has subsidized some very bad investment performance in plants and equipment.

Investors are not stupid and they have pressured companies to separate trees from plants and earn an acceptable return on both. The emergence of Plum Creek, Timberwest and their success is a direct result of those pressures. The recent announcement by GP that they were interested in exiting the building material business is the next step in that disaggregation.

The predictable result of a miserable record of return on capital in an industry is a decline in new capital spending. If you cannot improve the profit, you can decrease the investment. I do not know the details, but I can assure you that the capital budget in BC mills, like in almost all mills in North America, is a fraction of what it was, probably less than what is needed to keep the operations in top shape, and certainly there is almost no capital available for growth. The only place I know where the paper industry is growing and investing in new capacity is Brazil, parts of Asia, and producers of a few specialty grades.

The business that is the worst of all worlds is the pulp business that produces someone else's raw material rather than a finished product. I look at the recent sale of Skeena and marvel that so much iron and steel surrounded by so many trees can be worth so little.

As a result of destroying capital for decades, the name of the game in the industry today has become merger and consolidation followed by shutting down redundant operations and duplicate overhead. The math of a combination is simple:

- Two companies with a market cap of \$1 billion
- Merge and save \$100 million in annual cost
- Wall Street will give the combined companies a multiple of 5 on synergies or \$500 million in additional enterprise value
- The shareholders of both companies have increased their market value by 25%.

That is a one trick pony that can only be played out so many times before the regulators get concerned about market share.

The forest products business is very capital-intensive and without capital, you die. Capital will either come from internal cash flow or from new investment. Until the industry can demonstrate a better track record, we are going to have to eat what we shot. There is a real danger that without enough capital, the mills in BC will look like the shut-down steel mills in Pittsburgh, or several of the recently shut-down paper mills across the south.

Paper mills and sawmills die first and then the communities in which they operate. Here in British Columbia, the threat is even more real and the problem more advanced because of our lack of productivity and high cost. Mills are closing their doors and the towns they are in are literally becoming shrinking cities.

What gets your attention is that these mills are surrounded by some of the best forest in the world that provided some of the cheapest wood in the industry. Cheap and abundant trees will not save this business in the long run. The irony is that the mills that are surviving often have expensive wood as raw material. Because of that, they have learned to offset high raw material cost with high productivity and value added to the customer. Instead of cheap trees, they have learned to make money with smart people that are focused on the customer and unique products that fill a need.

My friends in the environmental community may not ultimately keep us from logging by picketing our customers, but simply waiting until we run out of capital and shut down because we could not add value to the trees we harvest. The ultimate end to the BC provincial past time of strike and lockout may finally end when there are no jobs to fight over.

I probably really have you wondering why you wasted your time listening to such a negative story. Now let me tell you how I think we can escape the fate of those steel mills in Pittsburgh and how BC's economy can grow and how you can provide good jobs for your kids here at home. Start by getting out of your comfort zone because the answer is likely outside the box. The answer lies in the theme of last year's conference; dramatic change, and the key to change is leadership. The focus of change needs to be the market and the customer.

We need different and better results. So how do you do it? If you want to change the results in a business, there is a sequence that has to happen:

- A. To change results you first must change the behaviour of a lot of people.
 - B. To change behaviour of a lot of people you have to change their attitude.
 - C. To change a lot of collective attitudes, you have to change the culture or environment in which they operate.
 - D. To change culture takes a huge input of leadership.
- The sequence is Leadership, Culture, Attitude, Behaviour, equals Results.

Leadership is what the challenge is all about and it is better results that you want. You cannot get to A without changing

C and B first. Leadership starts with setting a new agenda and defining winning goals. Leadership is about change and if you are afraid of change, you will not be an effective leader.

When it comes to goal setting I am a believer in keeping it very simple, very focused, and as constant as possible. This is something I learned from a guy named Sam Walton back home in Arkansas. I had the honour of serving on a board with Sam and hearing him talk about leadership was better than any class they teach at Harvard. Sam changed an industry; I want to change companies.

At each of the last three companies I have worked for, starting on day one and continuing every day, I asked the organization to focus on three simple goals. In fact, I wanted every employee, every day as they walked into the workplace to roll over in their mind three objectives. In every decision and action, test it against:

- Creating and maintaining a safe place to work;
- Becoming and retaining the right to continue to be the partner of choice of our customers, communities, and employees; and
- Not being satisfied with anything less than outrageous success.

The theme of today's conference is the customer; so let me take the rest of my time to suggest different approaches to our markets and earning the right to partner with your customer. And I challenge you to provide the leadership to get us to the results our investors demand.

Successful partnerships require some basics. There needs to be common objectives and a relationship based on trust and respect for each other's needs. Believe me, we have a lot of work to do in our industry before our customers think of us as partners.

The lumber and wood products business spends less money on sales, marketing, and product development than any business I know. The problem is our results show it. The volatility of lumber prices is among the highest of any product I am aware of. That volatility is bad for the producer and the consumer. One more carload of lumber shipped into the US market than there is demand for can drive down the price of all lumber by 10% or more in a single day. In many years, the difference between the high and low price of a 2 x 4 can be two times. This is hardly the best environment to build a partnership.

The lumber business will likely always have a large trading component to it but I suggest that there is an opportunity to stabilize the business risk for both the sawmill and the builder through a different relationship. Under the existing system, mills run flat out until the price falls below their cost. In fact, price is the only feedback most mills get from the market.

When I was working for MacMillan Bloedel (MB) and had the opportunity to participate with TrusJoist, I thought I had died and gone to heaven. The products that company sold had three attributes that were highly desirable; they were unique, they added value to the customer's business, and they had double-digit growth rates. It was delightful to sit in a board meeting and talk for hours about the customer and how to better fill his needs rather than spend most of our time talking about stumpage policy and trade issues.

I realize that there is a big difference between making studs for Home Depot and selling I-joists to an architect, but there are some common principles. In particular I think the BC Coastal industry can turn a problem into an opportunity by

converting the old green products shipped to Japan into redesigned products that meet the future needs of the Japan housing market.

MB was the largest producer of cedar in the world and old growth western redcedar is a unique and irreplaceable natural resource. My oldest daughter just built a new house in West Virginia and I could not talk her into using western redcedar on her deck because she wanted to use plastic. It made me wonder, "is wood as a building material a declining market?" Are steel studs from Korea going to replace wooden studs from BC? The last new product in the wood business in BC came from MB's research 15 years ago. Is there anyone interested in developing the next LVL? Is anyone working on new building systems that use wood more effectively?

It is hard to kill a bear unless you take a gun into the woods and look for bear tracks. In the hunt for new products, our industry does not have a gun, gets lost in the woods, and will not know a bear track when we see it. I will translate that Arkansasism into the view that the industry does not have the equipment or organization to develop new products, does not know where the market is, and cannot identify a customer need because we do not talk to our customers.

The last century in BC the lumber business was all about controlling the trees. The next century could be all about controlling the value added in the eyes of the customer. Converting second growth timber into a new generation of products is one element of the challenge and re-engineering the distribution system will be the other. I do not know how to win the battle but I can tell you where I believe the battle will be fought. I believe the winner will be that organization that can re-invent itself and create competitive advantage by being the partner of choice with sales, service, and products that help him grow his business.

In wood products, new products and new relationships need to be accompanied by new markets. In my travels, I have come to the conclusion that places like China and India could well be important markets to replace wood that we have been sending to the US and Japan. The need for housing is there. The question is: can this industry develop products and systems that fit the needs of these emerging markets?

Perhaps the best example of building a business around the customer rather than a product was the company I spent most of my working career with. That company today is called Riverwood. A group of very savvy businessmen built a great business back in the early '60s by focusing on the beverage industry and converting some old linerboard machines that had high cost to specialty products. They saw the business not as a paper product but as a total system to deliver beverages in bottles and cans to the consumer. They had the foresight to partner with customers like Coke to supply the paper, the carton, and the packaging machine that put the bottle in the carton. It did not stop there; Riverwood did the marketing research on customer package preference and even the artwork on the outside of the six-pack. In that relationship we spent far more time talking about growing the business and serving the needs of the final consumer than we did about price.

The results speak for themselves. For decades, the business had some of the highest growth rates in the industry and our profit margins were top quartile. Further, in the 25 years I was at Riverwood the price of our products never went down. You cannot say that about many paper products.

I suggest that the successful companies in the forest products business will move more of their business from the commodity to products designed to help our customers grow their business. Innovation added to operational excellence is an unbeatable combination.

Let me conclude with a challenge to all of you to provide the leadership that will change the culture, that will change the attitudes, that will change the behaviour and deliver outrageously new and better results to a tired old industry.

There is an alternative; you can stay the course and watch your plant sites turn into brown field sites like those old steel mills in Pittsburgh. You can stay the course and continue to battle over access to the US market.

Thank you for the chance to be with you again and best wishes and good luck as you deal with the challenges before you. My passport says US, but my heart says, "Go Canada!"