



# nerves of steel



**THE PRICE OF STEEL HAS WEIGHED DOWN**

**MANY INDUSTRIES, INCLUDING FITNESS. INSIDERS REMAIN CAUTIOUS OF THIS VOLATILE MARKET'S IMPACT ON RETAILERS' AND MANUFACTURERS' BOTTOM LINES.**



◉ BY JOHN AGOLIA

**t** HIS IS A STORY OF HEAVY METAL: STEEL. THERE IS NO GETTING AROUND THE FACT that the fitness industry relies heavily on this raw material. Over the last two years, the fluctuation in global steel prices, mostly in an upward direction, has caused pain and worry among many manufacturers. Especially on strength-training pieces, prices for steel since 2003 have shot up anywhere from 30 percent to more than 100 percent, depending on the type of manufacturing required.

The same issues that have bit at the heels of automobile manufacturers and office park developers have also left fitness manufacturers struggling, albeit on a smaller scale. Sure, the steel-related price hike is going to be less on a \$1,200 home gym than on a \$30,000 car or even a \$500,000 building. But the price influence on the end product is just as key to the livelihood of the fitness industry's manufacturers and retailers, not to mention to the buying consumer, who more frequently these days seems to shop on price.

"We've never done a study on raw material prices and how they impact the suggested retail prices in the stores," said Mike May, spokesman for the Sporting Goods Manufacturers Association. "But as those prices soar—along with the cost of gasoline used by trucks to transport the finished product—the final price at retail will rise as well."

## HOW WE GOT HERE

There were several factors involved in climbing steel prices, but most indicated the main culprit was the economic theory we all learned in high school: supply and demand. Put a crimp in the supply pipe. Lessen the flow of raw materials. Those who want or need the material are willing to pay more to secure the supply. That demand increases the prices. The demand climbs as the supply lessens and the prices keep increasing. Repeat. From a low averaging near \$360 a ton in mid-2003, the average price of cold-rolled sheet steel more than doubled, hitting \$800 a ton in late summer 2004.

What happened by 2004? That's the year steel buyers have called "a perfect storm."

"In 2003 and 2004, summer-to-summer, prices went from a very low level to a very high level," said Peter Morici, a professor of international business at the University of Maryland. "The increase came from an increase in demand from evolving markets such as China."

In addition to higher demand in China due to a construction boom, the Bush administration also lifted tariffs on imported steel in December 2003 in an effort to decrease the price of steel, but the weakened U.S. economy and dollar along with the demand for steel in the expanding economy of China had an opposite effect. Now, according to the International Iron & Steel Institute, nine of the top 10 producing steelmakers are outside the United States. The sole remaining producer—U.S. Steel Corp. in Pittsburgh, Penn.—is in seventh place worldwide and producing about a third the amount of steel as the No.1 company in The Netherlands.

Additionally, rising energy costs have had an impact on the energy-intensive steel production process (see the "High Energy" sidebar on page 24).

Indeed, the perfect storm swept over us.

## PRICE HIKES STRIKE

While prices increased rapidly for raw materials, it took time for those increases to be reflected in the prices of finished products in fitness and beyond. In fact, automaker Honda Motor Co. announced its first across-the-board increase for its product in February 2005.

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While fitness equipment manufacturers didn't wait as long as Honda, it still took several months for the wave of higher steel prices to hit the fitness industry—especially strength equipment, which tends to be more steel-dependent than traditional cardiovascular pieces, which include more plastic- or electronics-dependent treadmills and bikes.

Cybox International was one of the first to take the step to add a steel surcharge, announcing that surcharge on some products in March 2004. The surcharge equaled 3 percent to 6 percent of the manufactur-

Peter Leemputte said in a quarterly earnings call in April 2005 that price pressures were strong, that 25 percent of its direct spending on materials was for steel, and that Life Fitness' margins on strength products were much lower than they had been. CEO George Buckley added that the company's cost of steel had gone up 60 basis points, year over year.

Even smaller, private companies, such as Paramount Fitness Corp., held on as long as they could to prices before being forced to roll with the price boat.

"Prices had not really gone up in years,

to absorb the often very substantial increases we have seen in steel and iron," Rojas said.

While that has partly helped retailers, some feel that the impact from the steel pricing hasn't really hurt the retail business as much as other economic factors. And lower prices on the cardiovascular side, from contrastingly and increasingly lower costs for the electronics that run most cardio pieces, have helped retailers stay balanced.

"We have seen some increases on the strength side of the business, while car-

“ We try to absorb as much of the increase as possible rather than pass it along, but at some point, you just can't absorb anymore. —John Aglialoro, Cybox CEO ”

er's suggested retail price, varying from product to product depending on the amount of steel necessary to manufacture each product.

"We saw prices that increased from 50 percent to 100 percent in some cases, and at some point you have to pass along some of those costs," said John Aglialoro, Cybox president and CEO. "We try to absorb as much of the increase as possible rather than pass it along, but at some point you just can't absorb anymore. We have increased prices by 10 or 12 percent and been able to absorb some of that still."

While manufacturers have done their best to absorb as much of the costs as possible in an effort to help retailers hold slim margins on strength equipment, most, like publicly traded Cybox (NYSE: CYB), have had to pass along the higher costs to keep their margin and profits in line with expectations, be them company, board or stockholder.

"Life Fitness experienced a rapid increase in steel prices for raw materials in 2004 due to the unprecedented global inflation in steel commodity prices," said Joe Pedone, vice president of worldwide manufacturing operations at Life Fitness, owned by publicly traded Brunswick Corp. (NYSE: BC). "These price increases adversely affected our material input costs on both cardiovascular and strength products. Although steel price increases negatively impacted our costs, we were able to minimize the effect on our customers through internal productivity improvements and cost reduction efforts."

While Life Fitness declined to reveal its exact price increases, Brunswick CFO

but the price for flat stock and tube went up as much as 90 percent over a six-month period," said Steve Rhodes, Paramount vice president of sales and marketing. "Commercial strength equipment is a low-margin product category. Manufacturers in this industry can only absorb such increases in material cost before having to pass them along.

"It was not until April 2004 that we announced a price increase. Based on information from our suppliers, we made an educated guess as to when steel prices would stabilize and what cumulative impact these increases would mean in terms of our selling prices," added Rhodes. "The average net effect on our selling prices varied in the range of 6 to 10 percent, depending upon the steel content. Fortunately, as we anticipated, steel prices did begin to stabilize in June of 2004."

### MARGINS ON BOTH SIDES HIT

At Iron Grip Barbell Co., where steel is one heavy metal that makes the world go around, President Michael Rojas said the company has eaten its higher costs, which has impacted its own margins.

"That, of course, cannot continue," Rojas added.

But with steel costs being a relatively small portion of expense in the general manufacturing process for even the most steel-intensive products, experts said, some companies have been able to find ways around price increases to retailers and consumers.

For Iron Grip, that means operations: "We are working very hard at improving operating efficiencies and achieving additional economies of scale, in an effort

to absorb the often very substantial increases we have seen in steel and iron," Rojas said. "Commercial strength equipment is a low-margin product category. Manufacturers in this industry can only absorb such increases in material cost before having to pass them along."

But paddling through the storm and staying afloat doesn't mean that prices and retailer margins haven't been hit.

"When prices for steel jump as much as they did, you are bound to see an impact on the price of product and on margins. But it actually gave us a bit of a boon as manufacturers were late to raise the prices, and we were able to sell a lot of product to people that were looking to beat the coming increases," said Richard Miller, president of New York-based retailer, Gym Source. "The price increases have really impacted the commercial buyers more than the retail consumer. There are just more price-point choices (at retail) for consumers than there are for commercial buyers."

### FALLING STEEL COSTS, LOWER PRICES?

As slow as the industry was to react to rising prices, it has been equally slow to react to the price drops seen in the first six months of 2005.

"In the current environment, prices are falling. Demand is weak in most markets, reflecting de-stocking, as well as a slowdown in the rate of economic growth in many regions," Neil Buxton, managing director at London, England-based, GFMS Metals Consulting Ltd., told GearTrends®.

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“At the same time, production continues to increase despite some moves by high-profile mills to reduce output,” Buxton added. “Manufacturers who had been forced to accept large price increases in 2004 are now staying on the sidelines wherever possible in the expectation of lower prices. Companies who are locked into longer-term contracts will be forced to pay higher prices.”

While steel prices have dropped steadily over the last few months—the price of the benchmark steel sheet in the United States was \$535 a ton in late May, down 29 percent from the peak of close to \$800 in September 2004, according to pricing service Purchasingdata.com—many have yet to adjust prices or feel secure that prices will continue this downward trend.

“We believe that prices will weaken further over the next six months,” metals consultant Buxton said. “Inventories are high, demand growth is lackluster, and producers have yet to make sufficient output cuts.”

While manufacturers and dealers may be thinking the dog days of price increases and margin cuts are finally behind them, steel production cuts may be coming soon. And that could once again drive prices back up.

In fact, steelmakers seem to be playing games with the supply-and-demand economic theory, insiders have reported. Some of the larger U.S. steel producers reportedly have cutback production to try to keep prices from rolling back to pre-2004 rates. Both U.S. Steel Corp. and Mittal Steel Co. USA have cut production by banking furnaces and moving up maintenance to slow down production. And they may take further steps to reduce production: U.S. Steel recently announced its second-quarter flat-rolled shipments are expected to be 7 percent lower than the first quarter, resulting in a drop in annual shipment levels below the 14.5 million tons it had projected.

### CONTROLLING SUPPLY AND PRICES

What the future holds, however, is hard to predict, especially if steelmakers continue to control supply while demand increases. And although steel prices have dropped nearly a third this year, any calm in the storm may be short-lived.

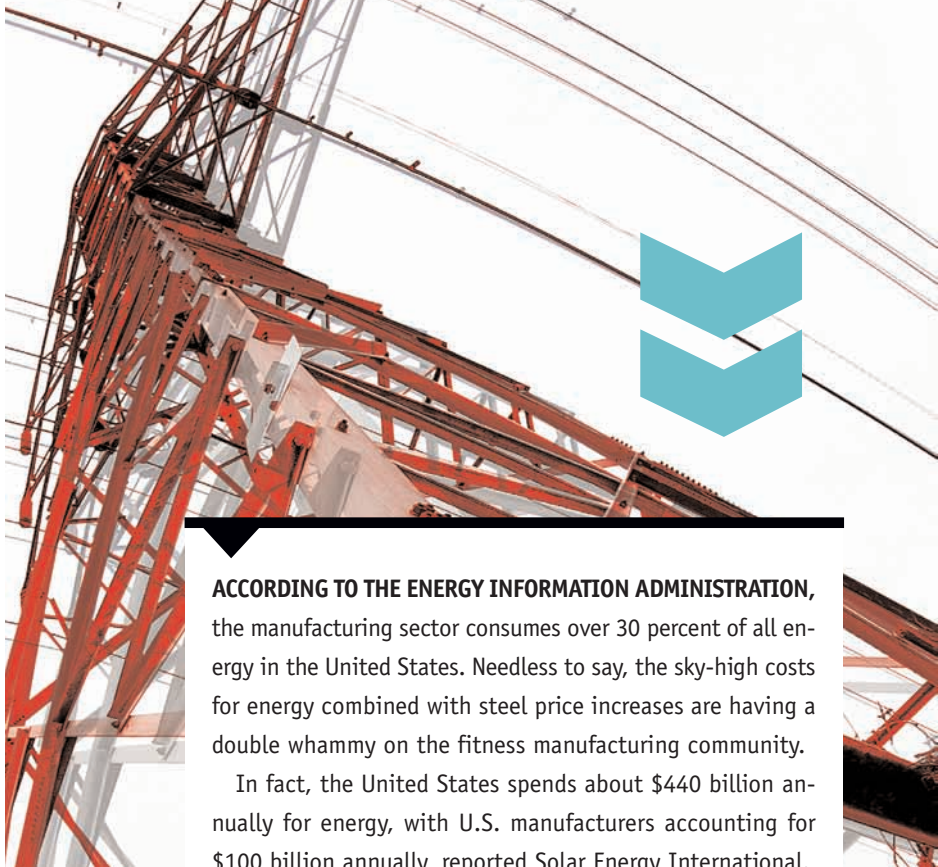
“We all operate in a global economy, and price changes occur globally,” said Nathan Pyles, CEO of Matrix Fitness. “It is very difficult to predict future prices, though the continued increase in global steel demand will keep pressure on the pricing.”

Some are not as sure that the prices will continue to drop, especially with the steel industry continuing to be so volatile.

“The prices for the type and quality of steel that we use have not come down; in fact, they have continued to rise,” said Iron Grip’s Rojas. “We expect steel pricing to continue to rise in the future, although we hope at a slower pace.”

Even with lower prices today and perhaps lower prices to come, some retailers don’t expect to see that reflected on the sales floor with lower equipment prices.

“No manufacturer has lowered the prices,” said Gym Source’s Miller. “Once you get across-the-board



# HIGH ENERGY

**ACCORDING TO THE ENERGY INFORMATION ADMINISTRATION,** the manufacturing sector consumes over 30 percent of all energy in the United States. Needless to say, the sky-high costs for energy combined with steel price increases are having a double whammy on the fitness manufacturing community.

In fact, the United States spends about \$440 billion annually for energy, with U.S. manufacturers accounting for \$100 billion annually, reported Solar Energy International.

Energy costs have not only helped drive up the costs of steel, but also of plastic and of other petroleum-based products and raw materials. In 1998, the steel industry alone accounted for roughly 6.7 percent of all manufacturing energy use and 1.5 percent of U.S. energy use. At the same time, equipment manufacturers have had to pay the higher energy costs for the production of the finished product, as well.

“There have been substantial labor and energy cost increases during the last couple of years along with the steel increases,” said Michael Rojas, president of Iron Grip. “Energy costs, raw material costs and labor costs have all negatively impacted margins.”

Rising oil and petroleum costs haven’t helped create smiling faces in boardrooms: “Higher oil prices are the one factor that seem to be driving everybody’s mood,” said George Buckley, CEO of Life Fitness parent Brunswick Corp., in a quarterly earnings call in April 2005.

Retailers too are facing higher energy costs for electricity, heat, and of course, at the pump for freight and delivery.

“Freight has gone up a lot due to fuel prices as have our costs for deliveries,” said Dave Aykanian, owner of Natick, Mass.-based, retailer Precision Fitness. “We have had to pass these costs along to the customer. We are hopeful that gas prices will stabilize, but that probably won’t happen until after the summer.”

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price increases, you rarely see them drop back down again.”

One side effect to higher prices that is certainly not advantageous to the fitness industry would be an associated slowdown in new product introductions.

“Pricing and margin considerations always factor heavily into any new product development, and those considerations are, of course, impacted by raw material costs,” said Rojas. “Since most of what we manufacture contains iron or steel, costs for those materials will impact the development, construction and design of any new product we might consider.”

The ship of the once steady steel industry has been tossed asunder over the past two years, and the tiny fitness industry has discovered it too is a part of the global economy. The perfect storm of 2004 may have passed, but the gale force winds to follow won't likely let up for a long time.

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“Part of the impetus to being a full-line provider was in part the price of steel,” said Alan Gore, co-owner of Bodycraft. “While the steel prices have gone up, the electronics used in cardio have continued to drop. There is just so much more steel used in home gyms than in cardio equipment. And the profit margins are lower for strength, too.”

As others did, Bodycraft tried to maintain the margins and to absorb costs, but that became impossible: The wholesale price of the company's No. 1 selling gym has gone up again, hitting \$166 more than two years ago—from \$486 to \$652. Bodycraft now has three pieces of cardiovascular equipment—two ellipticals and a rowing machine.

“We are going to raise the prices again as we are still seeing increasing costs at the factory level,” Gore said. “It hasn't all been steel; there has been the devaluing of the U.S. dollar, tariffs and other costs. The biggest problem is that once the steel companies have established a higher price, they will try to keep it there, and we'll have to keep up with it.”

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