

Is the World's Retail Sector overexposed to Chinese Manufacturing Capacity?

Over the last several decades China has gradually become the world's factory. Apparel retail prices have fallen not only in nominal terms, they have also fallen in real terms. But China's remarkable growth has put pressure on labour supply, transport networks and commodity prices and the government has begun to withdraw support for industries such as apparel by removing tax rebates and allowing the exchange rate to trade more freely. The retail clothing industry is left with several strategic dilemmas. How firms respond to these – along with the course of China's economic development – will determine if prices continue to decline and whether retailers begin to battle on other dimensions.

Should firms reduce margins to maintain volume and competitive position in the hope that rising supply costs are temporary?

Manufacturers' and retailers' margins are being squeezed by rising costs and sticky prices. But whether this will affect the manufacturer or retailer is debatable as is the question of how and when these cost increases will be passed onto the consumer. Chinese manufacturers are mitigating cost pressures through vertical integration and alliance building, creating scale and scope, and attempting to capture more value in the supply chain.

The establishment of these sub-contracting relationships by Chinese manufacturers will not just save their margin in the short-term, but it may also slow or stop the creation of future competition in the form of large vertically- integrated firms in countries such as Cambodia. Chinese manufacturers will also focus on further developing their competitive advantages in quantity, quality, response time and consumables. We expect further rationalisation in the industry, although due to the large numbers of people employed in the apparel industry in China, we understand that the situation is carefully monitored.

Western retailers have the upper-hand in the supply chain. They have the largest margin and, have forced manufacturers to absorb input price increase through blind bidding processes. However, cost increases are here to stay and could even increase more rapidly in the future. The question then is not whether but when manufacturers will no longer be able to make a grey T-shirt for GAP at \$2.00 and the loss, such a contract would force on the firm, will be more than it can or will want to cope with. This is especially pertinent given rapidly rising domestic demand in China. Verdict research suggested this point would come mid-way through 2009 when the UK clothing market would see a return to inflation after a decade of deflation. But, no one knows for sure.

Should firms diversify their supply contracts to other countries or maintain relationships with Chinese manufacturers who have turn-around time and scale advantages?

Our primary research suggested that diversification has already been happening since the quota fiasco of 2005. But there are two twists. First, mass retailers and global brands need scale and they have helped create that scale in China. If your business model requires significant volume, there are few alternatives to China. So, while retailers have been diversifying supply, among mass retailers, this is happening only for certain product lines. Second, Chinese manufacturers are already diversifying for their customers by off-shoring certain portions of the supply chain.

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No. Diversification is already happening and the development of new 'measures' of competitive advantage such as CSR trends and faster turn rates which require near sourcing are decidedly not in China's favour. But China will continue to supply certain product lines and there will be more instances where China mixes with other Asian countries across the garment value chain. Although consumers have come to expect lower prices, retailers are seeking ways other than just price to differentiate their businesses. This will further diversify the pool of retailers and trigger changes in the apparel supply chain and value capture models.

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