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How sustainable are Australian retailers' new sourcing strategies?

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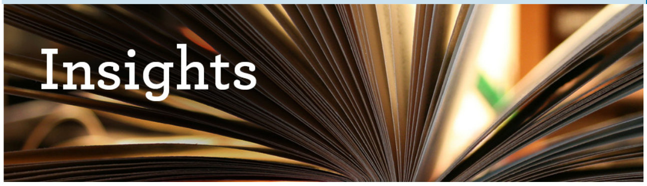


Cautious consumers have led discretionary retailers to increase their focus on supply chain efficiencies. However, only chasing cheaper labour costs can backfire. Investors need to understand the direct and indirect consequences of unsustainable supply chain practices. We recently visited Chinese garment factories and suppliers to get more insights.

Key points:

> Australian retailers are increasing their focus on 'ethical sourcing' but this is from a low base. Poor performance can lead to brand damage and loss of revenue.

> Sustainability of supply chains refers to more than 'sweatshop' and 'ethical' risks. Exploitative labour practices can have a poor risk/ reward ratio, even purely from a financial perspective.

> Too much focus on cheap labour could distract from a number of risks, including quality, productivity and lead times. While more businesses are transferring sourcing to Bangladesh, in many cases we do not see this as a sustainable strategy.

Why should investors care about supply chain sustainability issues?

Some 20 years after Nike's infamous sweatshop scandals, the revelations in 2011 about Foxconn's Chinese consumer electronics factories reminded the world that exploitation of workers remains an unresolved issue. Once again, consumers were told of horrific working conditions and underpaid labour and once again, a retailer was forced to improve its supply chain practices.

Sweatshop issues and exploitation of workers are sometimes referred to as 'ethical issues'. Several studies indicate that consumers are becoming increasingly aware of their social and environmental impact and it is generally acknowledged that exploitation of workers can lead to brand damage and therefore revenue loss. However, the direct and indirect investment risks go beyond that.

At a high level, a company's approach to supply chain risk management is indicative of how it deals with stakeholders in general, including consumers, regulators and shareholders. It can serve as a proxy of management quality. A sourcing strategy that is too focused on finding the cheapest labour costs could easily backfire. In short, exploitation of workers can have a very poor risk/ reward ratio, even from a purely financial perspective, for the following reasons:

> The supply chain consists of a number of activities, each with different scopes for cost savings. However, labour costs represent a small proportion of the total cost of goods sold, which means incremental cost savings from relocation of production can be relatively small.

> Wages that don't cover basic living expenses are not sustainable in the long term. In the short term, underpaid labour can lead to poor productivity, high factory worker turnover, industrial action, supply chain disruptions and product quality issues, as well as aggravated sweatshop risk.

> Too aggressive a cost focus typically leads to increased pressure on suppliers, which in turn typically leads to more sweatshop issues and subcontracting. Subcontracting often leads to even more quality and sweatshop risk.

> While the hourly labour cost and minimum wage varies widely in different locations, when differences in productivity and fixed costs are taken into account, the cost difference can be very small.

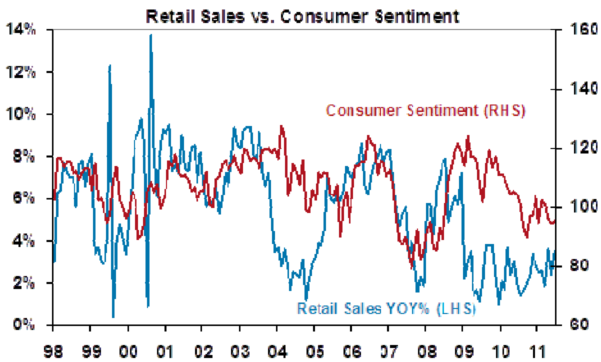
> Labour cost savings need to be balanced against potential infrastructure issues and the impact on lead times between production and market.

Therefore, while retailers have traditionally seen relocation of sourcing to areas with cheaper labour as a preferred strategy to cut costs, we believe building sustainable supply chains with long-term relationships with suppliers will be more successful in the long term.

Companies that are only focused on cost cutting by employing the cheapest suppliers are generally at relatively high risk.

Australian retailers changing sourcing strategies

Sluggish Australian retail sales and continued subdued consumer sentiment are hurting discretionary retail sales. Australian retailers are faced with faster fashion trends and more competition from the internet as well as new entrants in the domestic market. In 2011, the sharp increase in the cotton price also put pressure on retailers' earnings. Retailers have reviewed their cost structures to find efficiency gains to boost their declining retail margins. In particular, retailers have focused on new sourcing strategies.



Source: AMP Capital Investors/ Bloomberg (May 2012)

For instance, **Myer** has chosen not to renew their contract with the Asian sourcing agent Li & Fung. Instead, the company announced that it would increase its direct sourcing. **Wesfarmers** and **Premier Investments** have also increased their direct sourcing. Cutting out the agent means no agent fees but requires a robust ethical sourcing framework and strong knowledge of local business practices – setting up direct sourcing offices is often time-consuming and demanding work.

Many companies, including **Specialty Fashion Group**, **Premier Investments** and **Wesfarmers** have gradually shifted production from coastal China (traditionally, the Guangdong province has been the major hub for garment manufacturing) to inland China, Bangladesh and other south-east Asian locations. This move has been driven by a number of factors but particularly rising labour costs in China.

Many retailers are increasing their focus on 'ethical sourcing' but our analysis shows that this is done from a low base and many ethical sourcing policies are weak in several key areas, including wages. Few companies other than **Pacific Brands Group**, which is a signatory to the Ethical Trading Initiative, commit to a 'living wage', which in several jurisdictions can be very different from the legal minimum wage. In our view, having a gap between living wages and minimum wages is not a sustainable approach in the long term.

In summary, Australian retailers have been forced to review their cost structures and many have chosen to increase focus on direct sourcing and relocation of production to areas with relatively lower labour costs. The question investors need to ask themselves is how sustainable some of these strategies are.

Costs continue to rise in China

Rising wages in China are driven by a number of factors, including the central government's five-year plan, which, among other things, aims to even out the economic wealth between western and eastern China and to boost domestic consumption. The latter is particularly important in the face of lower export volumes to Europe and the US as a result of their economic slowdowns. Rising wages are also driven by rising living costs (including housing) and the Chinese government's desire to avoid social unrest. The Chinese government has been increasing minimum wage levels by 15-25% per year over the past three years. It appears the Chinese government is satisfied with letting low-end and unskilled manufacturing slip to other Asian countries while it keeps high-end and skilled manufacturing.

Minimum wage, which is set by the local provincial governments, differs significantly between Chinese provinces. The picture below shows minimum wages across China as of February 2012. The minimum wage in Shenzhen (Guangdong province) of RMB1,500 is almost twice that of Lanzhou (Gansu province) of RMB760.

Source: www.china-briefing.com

However, minimum wage does not tell the full story. The minimum wage is the legal minimum but our visit to Chinese factories in June 2012 showed that most factories pay significantly above that in order to retain their staff. Chinese factories, particularly on the east coast, are impacted by lack of skilled labour, which puts further upward pressure on wages. Increased enforcement of labour laws, for instance around working hours and overtime wages, also adds to costs. In addition, employers are required by law to pay social welfare benefits, which sometimes add up to 50%.

One of the key themes of 2011 was the move of production from coastal to inland China to cut costs. However, our recent visit to China highlighted that lack of sufficient transport infrastructure means that production for the export markets has not moved far – much is still within 12-18 hours distance from the coast as higher transportation costs offset the difference in cheaper labour costs. In other words, Australian retailers seem to have small margin gains to expect from moving production to inland China.

On the whole, China's labour law is surprisingly relatively strong compared to other Asian countries and even some western countries and the country has come a long way in eradicating some of the worst sweatshop issues, at least in some areas. However, enforcement is far from perfect, particularly in the inland provinces. Our analysis shows, based on confidential company meetings in 2011 and 2012, that breaching overtime rules is the most common problem.

This is partly due to the lack of skilled workers and partly due to the employment of migrant workers from inland provinces. These workers typically move from their families to work in live-in factory dormitories and some work long hours to maximise their pay. Migrant workers are exempted from many welfare rights and are typically one of the most exploited groups in China.

Also, while unions are allowed, they must be affiliated with the All China Federation of Trade Unions (ACFTU) and there are reports about imprisonment of workers advocating formation of independent unions. Another key issue in China is that of corrupt factory auditors. We have been told of cases where companies with 'ethical sourcing' codes have used independent auditors, who have asked for bribes from factories to be approved. In addition, in our experience, independent factory audits can assist in identifying factory issues but not always very helpful in resolving them.

In summary, manufacturing in China faces higher labour costs, partly due to skilled labour shortages and the central government's five-year plan, but as a result of lower export volumes on the back of lower demand from the US and the EU, many factories have spare factory capacity, which means factory prices are expected to remain flat in 2012. Margin expansion opportunities from relocation of manufacturing to inland China are limited. Australian retailers still face sweatshop risk in China although labour laws are relatively strong and enforcement of labour rights is gradually increasing.

How sustainable is garment sourcing from Bangladesh?

The minimum wage in Bangladesh is much lower than China's and this is one of the key reasons for retailers increasing their garment sourcing there. However, as discussed above, minimum wage does not tell the whole story.

Our analysis shows that Bangladeshi factories a) typically operate with lower productivity ratios[1] sometimes, 20-30% below that of Chinese factories) and b) employ more supervisors per employee than Chinese factories and typically have higher fixed costs. As a result, the total cost savings from moving production from China to Bangladesh might be limited.

In addition, our analysis shows that Bangladeshi factories are typically more suitable for large-volume and low-end garment manufacturing. The latter is particularly an issue for Australian retailers although arguably some, eg Kmart (**Wesfarmers**) might have sufficient volumes to make production in Bangladesh worthwhile due to its consolidation of its ranges and Just Group (**Premier Investments**) might have sufficient volumes for basic garments.

Many of the European and US major retailers, such as **H&M** and **Wal-Mart**, have operated in Bangladesh for many years and with relatively large volumes, they have access to many of the best factories. Australian retailers, which are lower in the pecking order, run the risk of only getting access to second or third-tier suppliers, which increases the risk of poor product quality as well as sweatshop issues and associated brand risk. In addition, compared to China, Bangladesh has severe infrastructure issues (including reliable energy supply and transport issues), which can result in production disruptions and longer lead times. This is an issue for production of garments that need to stay in tune with fast-changing global fashion trends. These are important considerations that need to be weighed against any potential cost savings.

Another key feature for Australian companies relocating their production to Bangladesh is the trade agreement between Australia and Bangladesh, which allows for duty-free garment imports when the rules of origin are met (the last process of manufacturing was in Bangladesh and 50% of the total factory costs must be allowable factory costs, ie materials, labour and overheads). However, one of the key features stopping Chinese garment factories from relocating their production to Bangladesh, where at least unit labour costs are evidently lower, is the lack of supporting local sub-suppliers of accessories and other manufacturing input materials. Many of these still have to be imported, mainly from China. As a result, this adds to Bangladeshi production costs and the long transports can cause additional lead times issues.

We met with the owners of one factory on the east coast of China, which was considering relocation of its manufacturing facilities, and had done extensive calculations showing that a t-shirt that cost $2.60 FOB (for a 5,000 unit order) would cost $2.30 FOB in a western China factory (for a 100,000 unit order) versus $2.15 FOB in Bangladesh. However, this ignores potential issues with productivity, quality, lead times and sweatshops. Our own calculations show an even smaller, often negligible, cost difference, particularly for higher-end garments.

Importantly, the analysis assumes that current minimum wage conditions are sustainable. The cost difference between China and Bangladesh is small at best and ignores a number of additional risks. Interestingly, while China's minimum wage has increased dramatically over the last few years, the minimum wage in Bangladesh rose in 2010 for the first time since 2006[2]. Before that, it was based on a law from 1994. Importantly, the current Bangladeshi minimum wage is considered by NGOs to be significantly below that of a living wage. According to our analysis, the gap could be as wide as 30-40%.

The ready-made garment sector accounted for 13% of GDP and 75% of the country's exports in 2010 (source:

McKinsey). This makes the exporters a powerful lobby group to the government, which sets the minimum wage rate, particularly as Bangladesh's economy is currently struggling. However, the Bangladeshi government faces the risk of increased social unrest. For instance, in June 2012, there were violent protests by workers in the Ashulia Industrial area, which resulted in closure of a number of garment factories.

Another potential source of social unrest is the country's energy crisis. While foreign companies are typically treated well in so-called Export Processing Zones (EPZs), the Bangladeshi population suffers from unreliable power supply. The sustainability of the conditions in the EPZs are also questionable. Companies are currently incentivised by freedom from red tape, cheap rent and preferential tax treatment. However, the EPZs are also immune from national labour laws. For instance, there is no freedom of association, collective bargaining is not allowed, etc. The legal age to work in Bangladesh is set to 14 but child labour remains a common issue. Enforcement of the labour laws remains very poor. For instance, in March 2012, a British NGO found that five of six workers making goods for Adidas, Nike and Puma in Bangladesh were not even paid the legal minimum wage[3].

In summary, Bangladesh currently offers lower labour costs but a minimum wage which does not cover basic living expenses is unsustainable and must increase to avoid further social unrest and strikes. When that happens, the small cost difference between China and Bangladesh will become even smaller. In addition, cost differences need to be balanced against a number of additional risks, including quality, production disruptions, and lead times as well as significant sweatshop risk, which can lead to brand damage and revenue loss. In other words, we don't think sourcing from Bangladesh is sustainable in the current format.

How are Australian companies performing?

Australian retailers need to combat weak consumer markets by keeping tight cost control. However, labour costs are a small percentage of the total cost of goods sold and moving production around to capitalise on relatively lower labour costs might backfire as this strategy often increases a number of other direct and indirect financial risks.

For Australian retailers with sufficient volumes, moving other parts of the supply chain, such as pick and pack operations, to source can lead to significant cost savings in Australian distribution centres and cut transportation costs. Some companies that have done this include **Myer** and **Super Retail Group**.

Many Australian retailers have cut out their agents and embarked on a journey of establishing direct sourcing offices in Asia. Increased direct sourcing needs to be accompanied by a robust ethical sourcing framework as Australian retailers bear the brand risk and cannot treat sweatshop issues on 'arm's length' basis. On a positive note, we have identified an increased focus on ethical sourcing among Australian retailers, at least on a policy level. Importantly, ethical sourcing consists of two key elements: a sourcing policy and enforcement of this. The latter needs to address how the company responds in the event of breaches and solutions to often very complex issues, such as child labour.

Sewing in a garment factory and garment dying in a washing factory outside Nanjing, China (source: company visits, June 2012)

Having ethical sourcing policies in place is particularly important for companies with a high proportion of own brands, for instance, **Billabong**, **Pacific Brands Group**, **Premier Investments**, **Specialty Fashion Group**, Target and Kmart (**Wesfarmers**). Also, **Myer** is targeting an increasing proportion of sales from own brands. Our analysis shows that, increasingly, Australian retailers are adopting ethical sourcing policies. However, these policies differ widely in terms of comprehensiveness and depth. Overall, most listed Australian retailers are at a relatively early stage of ethical sourcing compared to many European counterparts.

Only **Pacific Brands Group** has signed up to the Ethical Trading Initiative, which in our view is one of the most effective codes as it goes beyond just compliance with local laws and includes a commitment to living wages, which is a key element in establishing sustainable supplier relations, particularly when skilled labour is scarce. In contrast, we find many companies' ethical sourcing codes are watered down versions of established international codes and too focused on legal compliance, which should be seen as a low watermark. This represents a risk to, for instance,

Wesfarmers, which sources extensively from Bangladesh, a high-risk country in terms of sweatshop risk.

Billabong is the only listed Australian company that has signed up to SA8000, a global auditable social accountability standard. However, the main criticism against SA8000 is that the auditing is not as rigid as it should be. The enforcement of ethical sourcing policies generally remains the biggest information gap (and therefore, an area for investor concern). While some companies disclose auditing statistics, these are often presented in aggregate and few are discussing the results of these and what actions are taken in the event of breaches. In our view, based on analysis of publically disclosed information, the companies with the relatively poorest disclosure are **Specialty Fashion Group**, **Premier Investments**, **Oroton** and **David Jones** (although it should be noted that David Jones has only a small proportion of own brands).

Conclusions

Discretionary retailers continue to face pressure from weak consumption trends and increased competition from online and overseas retailers. As a result, they need to maintain tight cost control, for instance by targeting supply chain efficiencies. However, these efficiencies must not be done at the expense of the sustainability of these supply chains. We believe companies that establish long-term relationships with high quality suppliers are better placed than those that only focus on lower labour costs, as these represent only a small proportion of total cost of goods sold. Relocation into areas with the cheapest labour typically comes with additional risk in terms of quality, lead times and sweatshop issues.

We are sceptical about the long-term viability of sourcing from Bangladesh. Analysis shows that Bangladesh suffers from relatively high quality, productivity and lead time risks as well as high sweatshop risk. Bangladeshi factories are typically suitable for large-scale production and Australian retailers, many of which were relatively late into Bangladesh, might find it difficult to establish relationships with high quality suppliers. Also, the total cost difference with China is small and is based on a Bangladeshi minimum wage that we deem unsustainable as it does not represent a living wage.

Australian retailers have increased their focus on 'ethical sourcing' but this is from a low base. Poor disclosure represents high investment risk.

1 See study by McKinsey & Company in 2011, 'Bangladesh's ready-made garment landscape: The challenge of growth"

2 In 2010, the minimum wage was increased to 3,000 taka a month (from 1,662.50).

3 http://www.guardian.co.uk/business/2012/mar/03/olympic-brands-abuse-scandal

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