Private-Label Sourcing: What's Next After China?

by Gurdip Singh

Economic and political changes are making it far less profitable to source products from China—and forward-looking retailers are beginning to explore other alternatives for creating private-label products. Where in the world will their business land?

It's easy to see why China has risen to become the global center for manufacturing private-label goods. By taking advantage of China's historically low wages, large workforce, strong infrastructure, positive currency exchange rates and relatively low taxes, dozens of Western retailers have been able to increase their profits—while maintaining high quality standards—by outsourcing the production of their private-label product lines there.

But today, many of the benefits that lured these retailers to China are turning into liabilities, and China is beginning to lose its appeal as a trading partner. One i2 retail customer describes the current environment in China as a period of "exponential changes" that are completely reshaping the country's economy and social order.

As the labor pool in China shrinks—both for assembly line workers and skilled technicians—and demand continues to escalate, wages have steadily risen. In late June 2008—in response to double-digit inflation—the Chinese government announced a minimum salary increase of 10 percent in its capital city, Beijing, which will have an immediate impact on the profitability of manufacturing goods there.

In addition, competitive pressures driving shorter lead and response times, coupled with the skyrocketing costs of fuel, are making many retailers question the wisdom of transporting finished goods, especially weighty products, halfway around the world. Increasing fuel costs are dramatically eroding private-label profit margins and forcing retailers to rethink their outsourcing strategies. Shipping prices have increased up to 300 percent since 2000, and are expected to double again, as oil prices settle above $100 per barrel.

Changes in currency valuation represent yet another factor affecting the profitability of outsourcing to China. As the dollar weakens and the yuan strengthens, Western retailers have seen their profits dip even further. Since 2005, the yuan has gained 18 percent against the dollar, and this trend is expected to continue.

Finally, the relatively low Chinese taxes that foreign-owned businesses have enjoyed will be gradually phased out, thanks to China's new Enterprise Income Tax Law, which was enacted on January 1, 2008. While Western businesses previously were subject to tax rates as low as 14 percent on the facilities they own in China, these rates will gradually increase to a standard 25 percent by 2013.

Given all these changes, i2 estimates that over the last two years Western retailers have been paying 20-30 percent more for products sourced in China, and that these costs will continue to increase year over year in the foreseeable future.

Firmly entrenched and heavily invested in their relationships with China, Western retailers have tried to weather this challenging economic situation by managing the few costs they can control—such as inventory management—and cutting their own profit margins drastically, since the soft U.S. economy will not tolerate retail price increases for most goods. But it is becoming increasingly clear that China is not a long-term, sustainable option for manufacturing private-label goods.

The move away from Chinese sourcing of private-label goods will represent an enormous economic shift that is sure to affect the global economy—as well as the worldwide supply chains of every business that is currently doing business in China.

With Western retailers at a true crossroads, a number of critical questions arise: Where will all this business land? What regions will benefit as the new centers of global outsourcing? And what new opportunities and challenges can U.S. retailers expect, as they shift their business to new regions and new trading partners?

Sustainability: The new sourcing priority

One thing is certain: Western retailers will make their next-generation sourcing decisions much more thoughtfully than when they joined the global rush to embrace China as a private-label sourcing partner. The ensuing years have ushered in a new era of financial and social responsibility—as well as a newly flattened world, in which the impact of business decisions is farther-reaching, and far more transparent, than a decade ago.

Perhaps the most important factor guiding retailers' future sourcing decisions will be the emerging concept of "sustainable" sourcing.

What exactly is sustainable sourcing? i2 defines it as a set of sourcing and product flow strategies designed to meet the ongoing demands of a tailored market assortment. Sustainable sourcing is characterized by its ability to provide a continuous, long-term assortment advantage to an organization—while also fulfilling the business's ongoing financial and corporate responsibilities.

For most retailers today—and especially for those in the fashion, footwear, apparel and consumer electronics categories—tailored market assortments offer the single most important strategy for differentiating products over the long term, and sustaining a competitive advantage. While price is obviously critical—and it was China's low-cost structure that initially led many private-label retailers there—a long-term, sustainable strategy based on cost differentiation has become much less feasible, because of the enormous power of the well-established market leaders in the value-based retail segment. Even if China could continue to offer low-cost sourcing, it is doubtful that many retailers would continue to source their private-label products there, unless China could also offer significant assortment advantages.

Thanks to our Retail Customers

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To achieve an ongoing assortment advantage, retailers' private-label supply chains must demonstrate three critical competencies:

- A faster concept-to-store cycle time than competitors, including national brands
- The ability to modify key assortment parameters late into the pre-season countdown
- In-season sales agility and responsiveness, through postponement and margin-driven product allocation

Obviously, there can be significant economic costs associated with this level of speed and responsiveness—and every sourcing decision must begin with a careful financial assessment. To establish a level playing field on which various sourcing strategies can compete, it is critical that retailers determine the total landed cost—or the "shelf cost"—for all their private-label products. Defining this cost upfront provides a fair, objective means by which sourcing strategies can be assessed and compared, based on controllable parameters.

Total landed product costs include obvious expenses such as raw materials, energy, labor, transportation, distribution, handling and inventory holding. But less obvious cost factors—such as the impact of currency exchange rates, legal and government regulations, levies and taxes—must also be taken into account.

In today's fast-changing business world, it is not enough for retailers to look at the current costs associated with achieving an assortment advantage; they must also understand the future trends that will impact each potential sourcing partner. An example is China's "one child" law,

Redefining the Ideal Sourcing Partner: Retailer Perspectives

While low manufacturing costs helped turn China into an international sourcing center in the mid 1990s, today retailers are redefining their criteria for selecting private-label partners. Based on opinions from the experts—the retailers themselves—an entirely new list of attributes defines the ideal global sourcing partner today:

Reliability. In this era of short product life cycles and lightning-fast replenishment, retailers cannot afford a single delivery delay or other mistake. They are using new measures to quantify the on-time, error-free performance of all their private-label suppliers.

Product integrity. With every private-label offering, retailers are putting their own brand at stake. International suppliers must deliver products that meet the highest standards for both quality and consumer protection—for example, ensuring that all pharmaceuticals, food and drink, electronics, and toys meet stringent safety criteria.

Agility. Because fashion trends change constantly and technologies rapidly become obsolete, private-label retailers need to delay their most critical decisions—about colors, technical capabilities and other product features—as long as possible, to ensure the most current and popular assortments. Potential suppliers are judged on how dramatically they can cut their standard purchase order-to-delivery cycle time.

Proximity to markets. As retailers expand into international markets, they are increasingly looking for suppliers who are "local" to these new customers for their private-label products. Identifying a source close to the final consumer can dramatically cut transportation costs, as well as foreign taxes and trade levies.

Visibility and collaboration. To eliminate the element of surprise, retailers are demanding a new level of partnership with their private-label suppliers. These trading partners must be integrated seamlessly into retailers' global supply chains, sharing both information and technology tools.

Innovation. Finally, the next generation of sourcing partners must demonstrate sustainable value by creating new advantages that help retailers achieve the assortment edge they need in today's marketplace. For example, some countries are establishing themselves as technology leaders, providing new product capabilities that make them an especially valuable sourcing partner.

which may not severely affect the country's workforce today—but is expected to have a significant impact on the availability and cost of Chinese labor in 10-15 years.

In addition, today many retailers are adopting a risk-adjusted approach that factors the element of risk into the total landed cost of their private-label products. As they analyze and compare the costs of various sourcing options, they ask themselves questions such as: What is the financial exposure associated with having a longer lead time? What is the bottom-line impact of increasing our responsiveness in product replenishment? While it may be difficult to assign numbers to these kinds of intangible advantages or disadvantages, this risk-based approach highlights the increasing importance of sustaining a differentiated assortment over the long term.

Corporate responsibility: A growing concern

Sustainable sourcing strategies must also address an emerging concern for businesses across the globe: corporate responsibility. While we have all come to consider ourselves "citizens of the world," retailers have a much greater capability to shape the international landscape than the individuals who shop their aisles. The private-label sourcing decisions of these retailers have a substantial influence in determining how our increasingly interconnected, interdependent world economy evolves.

As the business world is discovering, profitability and corporate responsibility are not mutually exclusive. In fact, these two priorities may converge more than they conflict. For example, energy conservation benefits both the environment and the corporate bottom line. Businesses are now considering corporate responsibility as not only a cost of doing business, but also as a strategy that can deliver tremendous rewards, both tangible and intangible.

Retailers have the means, the motivation and the responsibility to pursue sustainable sourcing strategies that benefit three areas:

Human Resources: Private-label sourcing strategies should always support human capital development—providing employees with the skills and sense of ownership that can help improve retailers' product assortments and economic advantages. Investing in human resources may have a slow rate of return in the short term, but offers an enormous long-term payoff, as meaningful employee contributions have a real impact on the success of the sourcing strategy.

Environment: Green sourcing and flow strategies that focus on limiting the carbon footprint, minimizing energy usage and encouraging recycling generally make good financial sense as well as protect the environment. Sourcing strategies based on environmental stewardship provide retailers with a unique convergence of economic and ecological drivers. (For more on this topic, see "Can a Green Supply Chain Be an Efficient Supply Chain?")

Community: Local sourcing certainly supports retailers' pressing needs to cut their concept-to-store cycle time, in addition to reducing the economic and ecological costs of transporting products over long distances. This is a strategic consideration that may have had its roots in environmental concerns, but it is emerging as an increasingly valid financial strategy—though it still offers limited options for most U.S. retailers.

Where are we headed from here?

Given the complicated sourcing decisions they must make—balancing assortment advantages, costs and their corporate responsibilities—where are retailers likely to source their private-label products next?

The answer will vary based on the unique challenges of each retailer, but several international regions are emerging as strong candidates for future private-label sourcing.

The need for speed and agility is driving many retailers to plan aggressive four-week floor sets at regular retail for their fashion, footwear, apparel and consumer electronics categories—a capability that China simply can not sustain. A logical, closer-to-home alternative for Western retailers would be trading partners in the United States, Mexico and South America who can deliver private-label products to U.S. shelves much more quickly, supporting the short life cycles that are becoming a competitive imperative in so many product categories. Many of the capacity concerns that ruled out these "local" trading partners in the past will not be as relevant in the future, as lot sizes shrink dramatically to match shorter selling seasons.

At a minimum, many retailers may consider dual-sourcing strategies that create local rapid response capabilities for the replenishment of hot-selling products—while still leveraging their Chinese trading partners, at least in the short term, to meet less time-sensitive production schedules.

In addition to speed and agility, retailers must still consider the total landed cost of their private-label products, an area where Asian countries have tended to offer great advantages. While nearly all total landed costs associated with manufacturing in China—raw materials, labor, energy, transportation, taxes, currency exchange rates and government regulations—have risen significantly, other Asian countries may represent attractive options.

Even with a weakened U.S. dollar, there are a number of nations where U.S. retailers can still enjoy favorable exchange rates, including India and Vietnam. The currencies of both countries have depreciated by 3-5 percent over the past year, offering an opportunity for profit margin gains.

With regard to infrastructure—which affects both the speed and cost of transporting raw materials and finished goods—China is still the leader among Asian countries. But both India and Vietnam are investing heavily in massive infrastructure projects that rival those undertaken by the United States during the 1930s. Over the next few years, improvements in transportation and logistics systems in both India and Vietnam are likely to make them extremely attractive alternatives to China.

India has also adopted a forward-looking energy policy that focuses on solar and nuclear alternatives, curtailing the country's dependence on fossil fuels. India has an aggressive plan to reduce its overwhelming dependence on imported fuel so that it can meet its own growing domestic energy needs.

Finally, India has invested heavily in its educational system, which—along with its sustainable birthrate—will ensure a steady supply of skilled workers to meet future manufacturing needs. The importance of an educated workforce cannot be underestimated, and it is one area where many nations fall short today. U.S. retailers would do well to seek trading partners that will supply them with not only a plentiful workforce, but also one where well-educated employees can be expected to contribute to overall sourcing effectiveness.

A decision with global implications

It is difficult to overstate the importance of the international sourcing decisions that U.S. retailers are facing today. Western businesses stand at a crossroads, when a historically dominant trading partner is losing its appeal—and other nations are vying to be the next global sourcing powerhouse. The choices made by U.S. retailers will shape their own private-label success and impact the international business landscape.

When making these complex decisions, retailers must first consider the need to maintain or improve their assortment advantages, which will necessitate new levels of speed, flexibility and responsiveness. But they must also balance these competitive imperatives with the performance and capabilities of their global supply chain, as well as with the total landed costs of their private-label products. These costs will vary widely based on where, when and how products are manufactured and delivered.

i2 is conducting thorough and ongoing studies of the global sourcing situation to help retail customers navigate these complex decisions with far greater confidence. In addition, i2 can help retailers to understand the ongoing viability of China as a sourcing center—and to make intelligent, informed decisions based upon a range of internal and external factors. Today, U.S. retailers literally have a world of private-label sourcing options available to them. The best decisions for their own businesses can be made by gathering readily accessible information—about their assortment advantages, cost structure and even their corporate responsibilities—and then using this data to thoughtfully weigh their alternatives. The most important action U.S. retailers can take today is to recognize the changing situation in China—and begin to look toward a more sustainable future for their private-label product lines.

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What's Behind Escalating Sourcing Costs in China?

Since 2000
Shipping costs have risen 300 percent.

Since 2005
The yuan has gained 18 percent against the weakening dollar.

Since 2006
Skyrocketing fuel costs have dramatically eroded private-label profit margins.

Since 2007
In response to a shrinking labor pool and double-digit inflation, a number of Chinese provinces have raised wages by as much as 50 percent. According to China's National Bureau of Statistics (April 10, 2008) "...the mean annual wage for a typical urban Chinese employee grew at an 18.72 percent rate in 2007, to... 99.32 yuan ($14.17) per day. [This rate represents] the fastest growth in six years and [is] higher than the 14 percent on average of the preceding six years."

January 2008
Enactment of China's Enterprise Tax Law, which raised taxes to 25 percent, resulted in cost increases of up to 68 percent for foreign-owned businesses.

June 2008
China announced a minimum salary increase of 10 percent in its capital city, Beijing.

Given these factors, i2 estimates that sourcing products in China today has added 20-30 percent in costs over the last two years for Western retailers—and that the cost of sourcing products in China will continue to increase year over year in the foreseeable future.