



Macy's flagship store in New York. Citi Investment Research believes footwear prices in the US could go up by as much as 10% in the near future because of rising costs of energy, transportation and raw materials, including leather.

CREDIT: MACY'S, INC.

Feeling the pinch

There's nothing quite as uncomfortable as shoes that squeeze or pinch ... but in this instance the pinched feeling is related to the squeeze on credit and the problems that inflation might cause in the footwear market.

Footwear retailers everywhere are trying to get their forecasts right for next year and the remaining months of 2008. The effect of their assessments about the behaviour of their customers will ripple all the way back to the manufacturers and the tanners who supply them.

Especially important will be the market assessments made in the United States, the world's number-one footwear retail market, with almost 100% of its offer imported from around the world. The hackneyed words and expressions pour out of the media every day—sub-prime, recession, credit-crunch, downturn, profits warnings, Dow Jones drops, Footsie falls, rocketing energy prices, fuel pump protests, food prices—to create a mood of unrelenting and unrelieved depression and misery. It's enough to make you want to switch off the TV, and stop buying newspapers. (That's one way to save energy and the rain forest!)

While the banks themselves may have started much of the current economic cycle through taking risks with our money (the sort that they would never have allowed ordinary people or small businesses to take), some analysts are now taking a more level-headed approach and, ignoring some of the issues, are trying to assess the impact of product cost inflation on major retailers.

The fundamental issues behind product cost

inflation are driven by high energy and raw material prices, escalating labour costs, the appreciating Chinese yuan and a declining US dollar and reduced export tax rebates; all of these are combining to create an inflationary sourcing environment in the US at the same time that the US consumer is slowing down and having to keep his or her hands away from a pocket or purse.

Warning for next year

According to Deborah Weinswig and her associates at Citi Investment Research, a division of Citigroup Global Markets, major retailers expect to take on relatively little input cost inflation on apparel for the rest of 2008. However, 2009 could be a little more difficult and the consensus she found was that inflationary pressures could be expected to exacerbate next year and beyond. Top-end department stores could suffer more than others because of the more exclusive nature of the luxury products they stock and the rise of the euro against the dollar.

Those retailers who have a relatively larger exposure to sourcing from China could also suffer, and this would affect the footwear sector specifically, as opposed to the broader definition apparel market.

What makes the current trading climate more complicated than the downturns suffered in the late twentieth century are the developing economies of China and India and others, which were not an immediate part of the equation in the past. China,

particularly the southeastern provinces, and India are experiencing the highest inflationary trends, states Ms Weinswig in her analysis. As a result, everyone along the long retail supply chain will be affected by product cost inflation, beginning with the factories. Strong inflationary problems in those two named countries, however, could provide an opportunity for other supplier nations, which have not come under such intense pressure and where lower costs still apply.

The big squeeze

While inflationary pressure gets passed along the chain, tanners claim that they are being squeezed from both ends. Shortages of food and increased costs for farmers have seen pressure applied at the start of the chain in terms of raw material prices but tanners claim that they are unable to pass on the increased costs they face—not just from raw material costs but all those other increases affecting everyone in terms of energy and transportation. “Leather costs in China are going up because China eliminated the VAT export rebate outright for leather and banned the import of raw hides and semi-processed leather into China,” claims a spokesperson for the American Apparel & Footwear Association. “They are also cracking down on Chinese tanneries for environmental reasons ahead of the Olympics. This is just one of the costs driving up prices in China.”

Margins are being squeezed and it is not too surprising to note that footwear manufacturers have



Fiorelli boots at the GDS exhibition. Leather is becoming more expensive to make, but tanners complain that they have been unable to pass on extra cost and are being “squeezed at both ends”. CREDIT: RENE TILLMANN/MESSE DÜSSELDORF

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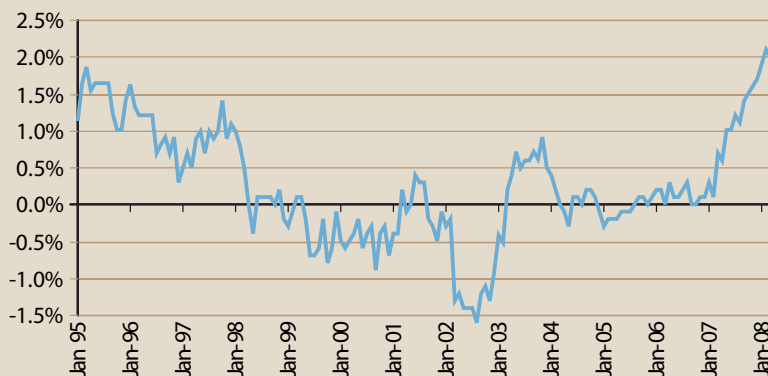
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seen the good times fade away. The last nine months or so have seen more than 1,000 footwear factories close in China.

Wholesale prices continue to rise

According to Citi Investment Research, import prices on apparel, footwear and household goods have increased year-on-year every month since August 2005. Figures up to April show that year-on-year import prices were up 2.1%. What a change against the period December 1998 to February 2003 as the graph shows in Figure 1.

FIGURE 1: IMPORT PRICE OF APPAREL, FOOTWEAR, AND HOUSEHOLD GOODS - YOY % CHANGE



Source: Bureau of Labor Statistics, Citi Investment Research

For years the global economy has enjoyed reasonably stable energy prices. Over the past few years, the deregulated energy supply situation in Europe has begun to show that opening up the market to competition has not resulted in benefits to European consumers in particular, and the major producers and suppliers are now holding ordinary consumers to ransom while central governments have adopted a 'don't-blame-us' attitude. The effect of energy costs vary from country to country but even in those areas where prices have been controlled by governments, prices have nearly doubled. As a result manufacturing costs have risen but the higher cost of fuel has also had negative implications on transportation from factory to port and then to international ports in the US.

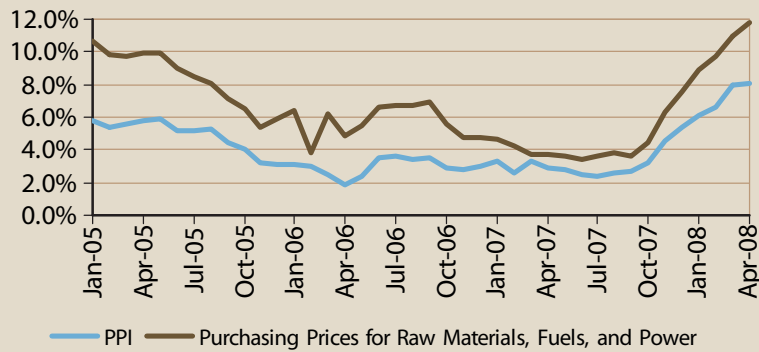
China, such an important player in the footwear industry, has seen its producer index and purchasing prices rise dramatically. This is clearly shown in Figure 2 where the producer price index has risen from about 2% last July to 6% this April.

New labour law

Citi Investment Research also highlights another inflationary factor. China's 2008 Labour Contract Law came into effect in January this year, designed to improve labour practices. It means that factory owners must make certain disclosures to employees about working conditions and compensation; it also limits the hiring of temporary workers. Very

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FIGURE 2: CHINA PRODUCERS' PRICE INDEX (PPI)

Source: Bureau of Labor Statistics, Citi Investment Research

quickly it increased production costs and resulted in jobs moving out of the country. This has happened against a background of climbing inflation and the country's Consumer Price Index hit 8.7% in February this year, an 11-year high. It is estimated that in coastal areas inflation has been closer to 10%. (Food prices in the country have risen significantly—22.1% in April this year—which in turn will add more inflationary pressure on wages.)

If all of this hasn't made life difficult enough for footwear importers and US consumers, the Chinese government reduced its export tax rebate, which further increased the cost of merchandise coming from the Asian giant.

It is not surprising that executives responsible for sourcing are looking for alternative manufacturing bases. Wage inflation is not as high in Vietnam, for instance, which is now quota-free (for US importers—anti-dumping still applies in the European Union) since its accession to the WTO in January 2007. Some Central and South American countries could benefit, too, especially as shipping costs to the US may not be as high as those from Asia.

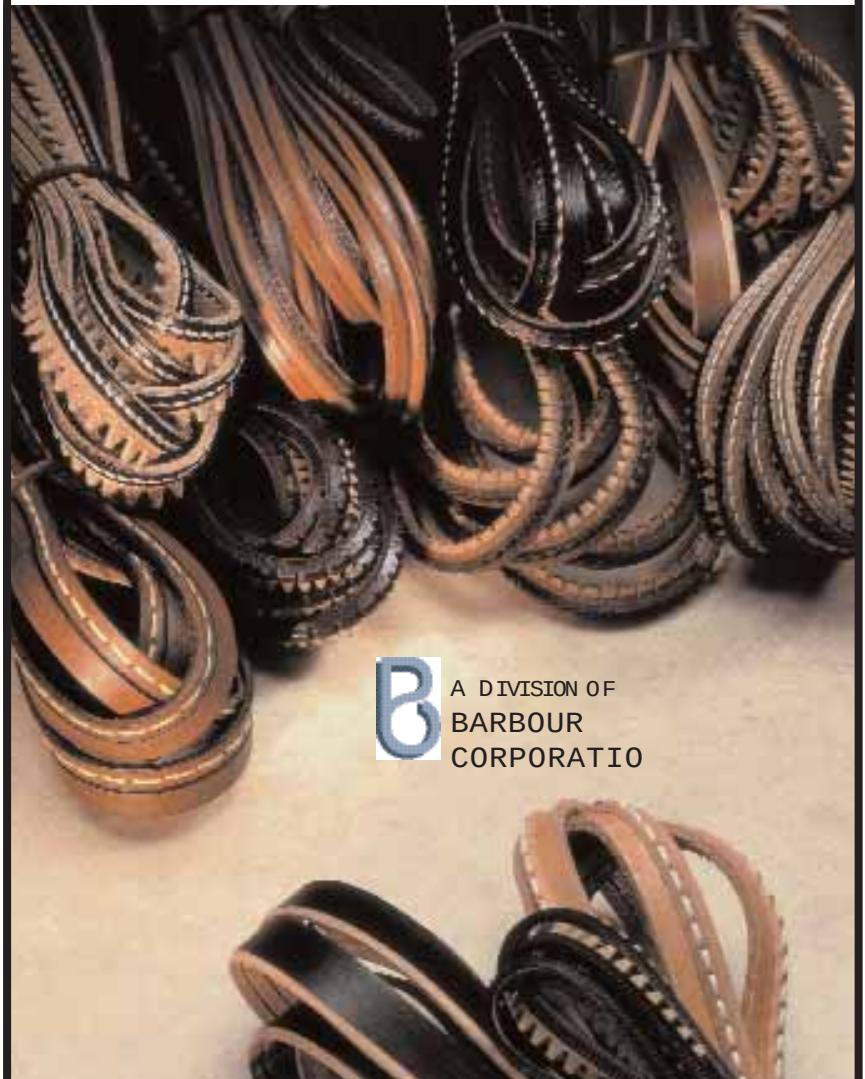
The current macroeconomic climate and weak consumer spending in the US do not allow retailers to easily pass cost increases on to their customers. As a result, some have noticed a deflationary trend on prices in order to persuade consumers to part with their cash. Deborah Weinswig believes that, for the moment, retailers, suppliers and any potential middleman along the supply chain will have to share the burden of product cost inflation. In the past,

those in the early part of the chain have borne most of the burden but this is now too large for vendors to carry alone.

Her analysis leads her to believe that footwear prices could increase by some 10% in the not too distant future. Looking to 2009 and beyond, it could be more and small to medium size retailers will experience the highest inflationary pricing. While much of the inflationary pressure has been absorbed along the chain, next year retailers will have to pass the increases on.

The pinch could be uncomfortable. 🌐

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