

Managing in frugal times

2nd February 2009 Chennai

Things look different after a recession

There is one constant outcome of difficult economic times and that is that life after a recession is always different than before. Spending patterns are one of many things that change and do not return to where they were before. One simple thing we can see here in Chennai is that engineering and scientific graduates will no longer be enticed into the banking and the IT sectors. The CLRI and the Indian leather industry will start to see their best talent stay within the industry to develop their careers.

At the same time political and social instability arrives with financial crises. Iceland, Pakistan and a number of Eastern European and Central Asian countries have already sought help from the IMF. Iceland and New Zealand have changed governments and there are worries about social and political issues in countries even such as Greece and Spain.

For the Leather Industry the Consumer is Truly King

It is very easy to confuse business to business marketing with consumer marketing yet 80% of all marketing is business to business and most of the marketing we here in this room do is b2b. Nevertheless wherever you are in the supply chain, or supply network as it would be better described, you need to consider what is happening with the final consumer. Regardless of whether you are in raw material, chemicals, tanning or finished goods you have to analyse the people who will be buying the finished goods you are involved in. After all they are the ones who decide our prosperity.

It is an interesting point that unlike even fifty years ago there are no, or only very niche, areas where leather cannot be replaced by other materials. Advances in technical textiles, synthetic materials and plastics have meant that good substitutes exist for leather in all end uses. In the first quarter of 2008 for the first time more shoes were made in the world in non leather materials. For most uses leather has much less of a technical importance than an aesthetic one and for the most part the consumer sees leather in terms of its touch, feel, smell and appearance. Thus the tanner must offer value for money and make leather that recognises the emotional connection consumers have with the product. So the first lesson for us all is that tanners must make real quality leather and not take the sort of risks with the “brand leather” that we have seen in the upholstery sector. All sorts of coated and heavily pigmented material have been masquerading as leather and have clearly confused the consumer about our product.

All this is indicative of the fact that leather is increasingly to be considered a luxury. Consider Maslow’s Hierarchy of needs where certain lower needs have to be satisfied before higher needs can be considered. Here you can see that most leather items fall into the upper levels which must be classed as luxuries.



This is the case for nearly all products made of leather apart from footwear and even some footwear cannot be classed as essential. In Europe the average consumption per capita per annum of footwear is four pairs while in the USA it is seven. There is already evidence that in the USA consumption is starting to drop towards the European level. A typical example would be golf footwear where it is already known that in the short US season if the weather prevents play in the first few weeks golfers have a tendency to postpone the purchase of a new pair until the following year. I do not think the US numbers will fall below four but I do think they will diminish and this is already being reflected in orders to China.

But apart from footwear almost all other leather items purchased require the consumer to feel good and to have free disposable income.

However in the US, the UK and large parts of the EU the average household has seen its family net worth drop by some 20-30% over the last eighteen months. This is a mix of the value of their homes and their savings. Different households will be affected differently. Think of someone close to retirement whose savings and pension was mostly in equities; they will be even worse off. In the USA it is quite common for people to have part of their pension savings in the property they live in, selling it on retirement and buying a smaller, cheaper house to release capital. Many of this group will have seen their 401K pension collapse and their house become un-saleable at even a much reduced price. Such people have lost far more than 30% and are in even more trouble should they lose their jobs.

And of course rising unemployment is a layer on top of all this which has to be taken into account which has the knock on of people being unable to keep possession of houses which are often worth less than the amount owed on them. Many companies are taking the opportunity of the recession to reduce their cost basis and making people redundant as a precaution. Reebok for example are reducing numbers by 10%.

Despite the fact that the problem which has arisen is a consequence of governments encouraging us to borrow to spend their solution appears to be to continue to try and make us continue the same pattern. I do not see this as being likely and ask you to consider Mr Micawber's approach:

*"Annual income twenty pounds, annual expenditure nineteen pounds
nineteen and six, result happiness. Annual income twenty pounds,
annual expenditure twenty pounds ought and six, result misery."*
David Copperfield by Charles Dickens

There was time, really up until the 1980s, when people saved in order to spend rather than borrowed to spend, and I believe we will see some return to this mentality despite what governments wish. In the USA after a decade of zero family savings it appears that savings have already moved up to 3% and there is evidence of increased savings in places as far away as Germany and China, which has its own property bubble in Shanghai and Chengdu. Having seen the sort of losses we are talking about and with job uncertainty as well it has to believe that ordinary people will carry on spending until they have rebuilt some of their savings. So every business will need to analyse the consumers in their specific market segment.

Looking forward it is clear that for some time and perhaps for a long time consumer spending in the USA and Europe will drop. If in the US consumer spending drops from the current 71% of GDP to the mid 60% level of the 1990s this will take \$1 trillion out of retail spending. The leather industry will undoubtedly suffer and it must be expected that luxury items will not be immune.

So another conclusion we must make is that the landscape for retail will change towards Asia and the balance of expenditure on leather items of all sorts will see the EU and the USA become less important in the world. So it will be important to view the map more with India at the centre and look at the Middle East, other parts of Asia and even down to Latin America for markets to develop and expand.

There is another aspect of consumer spending that we must consider, especially if families are unable to buy homes and unwilling to buy automobiles. Three trends are important:

- Cocooning
- Small indulgences
- Formality returns

Cocooning arises in times of uncertainty when people stay at home more for eating and entertainment. Those in employment will have money as they are not buying cars or houses and they have seen the price of petrol in the US dropping from over \$4 per gallon to back down to \$2 and they can look forward to a sustained period of low inflation. We can therefore expect them to spend on making their homes comfortable and this can include buying leather furniture. Whether this will replace the volume of new furniture that would have been bought in the times houses were being bought and sold I do not know, but at least it is a positive trend.

We also expect consumers to spend money on small items to bring a little bit of brightness back into their lives and a leather hand bag, well styled garment or other leather item is often the choice. These are called “small indulgences” and along with “cocooning” are two trends set out in the 1990s by Faith Popcorn with her Brain Reserve Company. Many products made of leather products, including footwear, fit into the area of small indulgences, indulging the senses and providing an emotional fix.

I have already indicated that footwear should do much better in the recession, especially in the EU. There is another aspect which supports the strength of footwear and that is that in difficult times when people are worried about their employment and are attending a lot of interviews more formal clothing returns. We have already seen an increase in the purchase of ties and since India is a major producer of more formal footwear this should be a positive.

So there are some good reasons for us not to be too pessimistic. But the one sector which does have troubles which began to really accelerate when oil prices rose last spring is the automobile trade. Right now many car companies including ones like Bentley which we thought would not suffer so much are either closed for fixed long periods or on extended holidays. The best estimates are that in 2009 car output will be down by 30%. This is truly significant as automobile alone counts for over 12% of leather production and this missing 30% means at least 10 million hides. With the speed of the overall decline after the collapse of Lehman in the autumn no one has had time to find alternate outlets and this is why we are hearing of hides being buried in Latin America, lying unsold in Africa and being diverted as full hides into gelatine.

Automotive upholstery tanneries

Quite apart from the fact that car purchasing is down by an estimated 30% we know that there is considerable overcapacity in the car industry and it is unlikely that all the existing companies will survive. Equally at the end of this recession it is hard to judge the sort of cars people will want to buy, with governments starting to tax larger cars much more heavily. Also consumers will be making judgements about the environment and the future price of petrol. Will this mean a major shift to smaller cars and if so will these have the same proportion of leather upholstery as the larger luxury vehicles?

At this stage we need to take note that the car upholstery tanners have been one of the most successful groups over the last fifteen to twenty of them. Many of them have leading edge plants dispersed widely throughout the world from Eastern Europe through Mexico to China. They have also shown that they can make the same leather in different plants around the world – something that we always used to acknowledge as exceedingly difficult. If you take my earlier point that the industry is a supply network rather than a chain can we really expect these highly competent tanning companies to leave their fine tanneries all around the world empty? I would ask you to consider how they may react. Can we not expect some of these tanneries to use this capacity to enter the footwear market? What sort of footwear leather can they make using their exceptionally cheap but high quality upholstery hides in some of the most modern and efficient tanneries in the world? Certainly if I were in their position I would be approaching the top ten shoe makers in the world to see what sort of deal

could be done for specific high volume leathers at excellent prices delivered anywhere they are required.

Industry restructuring

As well as the car industry restructuring as a result of overcapacity we have similar issues with over capacity in tanning around the world. Recession is always a time when industries restructure. Some things that were going to happen anyway accelerate and other unexpected things happen.

For example it was a recession in the 1950s in the motor industry which led to the Toyota lean manufacturing concept. Instead of laying-off large numbers of workers Toyota decided to sit down and rethink the business, retraining accordingly. From this began the lean manufacturing concept, just-in-time, and the involvement of other members of the supply chain in the new approach to doing business.

Similarly it was the recession in the early 1990s that accelerated the move towards outsourcing. The trend had already begun but it was the arrival of the recession that made companies who had previously been opposed to making their products overseas change strategy and start sourcing overseas, especially in Asia. Many famous brands who had always resisted overseas manufacture felt compelled to change their approach at this time.

We do know that business is weakening and I cannot believe that luxury brands will not be hit, and we already have evidence from some of them that sales did reduce after the collapse of Lehman. I think we can also expect some of the brands who have followed the brand extension route into perfumes and leather goods to return to the core product for which they have known skills and great customer loyalty.

Right now we have to look at a company's Balance Sheet more than its Profit and Loss position to see if it will survive. Many good businesses are failing as a result of lack of access to capital; so it is not so easy to be sure who might succeed and who might fail. This certainly means that we will lose some good retailers and some good customers. At the same time credit insurance is sometimes becoming hard to obtain and this is an area where government schemes for exports can help. If you can keep on trading with good people who you think will survive and prosper, but who are struggling to pay right now, this is a good way to increase market share for the future.

One thing we have identified, and is indeed exemplified in the automobile tanners, is the fact that new layouts and machinery have made tanning a much more reliable, reproducible indeed scientific business than it was a few decades ago. We used to think that tanneries had to be somewhat limited in size in order to keep good quality control and we always knew it was difficult if not impossible to move a leather process from one tannery to another. Neither of these rules apply today and with proper investment in new plant and machinery we are increasingly likely to see a polarisation in the industry with larger groups with ultra modern highly efficient plants around the world in locations close to customers or raw material supply and smaller "boutique" type tanneries making very creative, innovative leathers to high specifications for limited run high end uses.

Innovation comes in different forms

When we think about innovation do note that there are different aspects to this subject:

- a. Product
- b. Process
- c. Marketing – business structure, service, logistics.

Frequently tanners that I work with think of innovation only in terms of product and ignore the fact that the items they are making are not at the leading edge of innovation, nor are their customers. Not everyone is suited to be a boutique type tanner, for example. More often we have reasonably long lines of more classic products that need attention paid to the efficiency of processing, minimising costs, improving layouts and the like. Equally innovation on how things get to market and who does what, which often gets called “business model” these days.

This latter links into what we expect to see happening in industry: more groups and linkages, both formal and informal, amongst businesses. The days of Command and Control, largely exemplified by what happened at Lehman Brothers, are thought to be over and decision making is much more likely to be a shared process, and perhaps one shared over a very wide group of people in different parts of the world. It means looking at new kinds of relationships to get access to raw material supplies, access to markets, access to skills and technologies. It can mean ownership but it often falls somewhere a little short of that.

The China Price

At the moment India is seeing China return to the market with very competitive prices and we tend to complain about China that this has to do with underpaid labour and unfair subsidies. It is worth looking at what the Californian Business School Professor Navarro has written, and indeed told US Congress Committees about his analysis of the “China Price”.

He breaks down the price advantage that China gains over the rest of the world, which is often 20% or more lower than other countries, into the following elements:

- lower labour costs and large modern plants account for 39% of the China Price advantage.
- “industrial network clustering” adds another 16%
- export subsidies account for 17% of the advantage
- undervalued currency adds 11%,
- counterfeiting and piracy contribute 9%, (avoid marketing and development costs)
- lax environmental and worker health and safety regulatory regimes add another 5%.
- catalytic Foreign Direct Investment 3%

These figures come from 2007 and we know that things have changed in China as labour costs have risen, especially in the exporting intensive coastal areas, the social contract has been introduced and some serious attention is now being paid to the environment. Also the Chinese currency has risen over the last two years although the USA is still complaining about a near 20% undervaluation. Nevertheless it is valid to consider the variety of items which this research, some of which was done in tanneries, considers relevant.

Certainly in footwear and in some tanning sectors the large plants with very modern layouts and scale are significant. China has over 200 large footwear plants while India has less than five. While the clustering effect should be the same in India, around Chennai for example, as in South China but the Chinese seem to have achieved a more Italian like advantage than India. One aspect worth considering is that the Chinese approach is more often initiated by the end user – shoe makers or garment producers – than from the tanners so is more market oriented. Certainly it is worth looking at China in terms of integrated networks, excellent logistics, innovative processes and business structures

Barriers to entry as a marketing device

Finally I would just like to end on one topic which you may probably put under the term “environment” but is actually more than that. Increasingly we are being asked by consumers, brands and retailers to ensure that our products are free from dangerous, or banned, substances and to demonstrate the life history of a product. This is an area where India should be particularly capable of performing well and avoid the issues of “greenwash” or false claims about leathers that are “natural” or “eco” in a way that no holistic analysis could support

- Testing Regimes
- Enviro-biographies
- Greenwash

One very important aspect of this is testing. In business to business marketing you will be aware of the terms “order qualifier” and “order winner” and of the concept of “barriers to entry”. From my experience companies involved in business to business marketing have been much more effective in looking at building strong barriers to entry for competitors and high switching costs for customers than in running large advertising campaigns.

The cost of testing leathers for compliance is becoming just such a barrier to entry in certain markets and I think India must look to getting world standard and fully certified testing facilities that can carry out affordable testing in a timely manner. There can be no doubt that the high costs and time delays in sending samples to Singapore, Hong Kong or Europe for testing is effectively a barrier to entry to some markets.

With excellent bodies such as the CLRI capable of playing a role in filling this gap, and helping the industry move forward into leadership in this whole area of specification and sustainability I see an opportunity for the India leather industry to convert the whole the environment, compliance and testing debate from one of being an order qualifier which they must achieve in order to sell in the world market to an order winner.

Match further environmental development with honest marketing and make high quality leather that the consumer can understand and appreciate.

Making leather is a good thing; it is something we should be proud of. It is in our blood.

Michael Redwood
February 2009