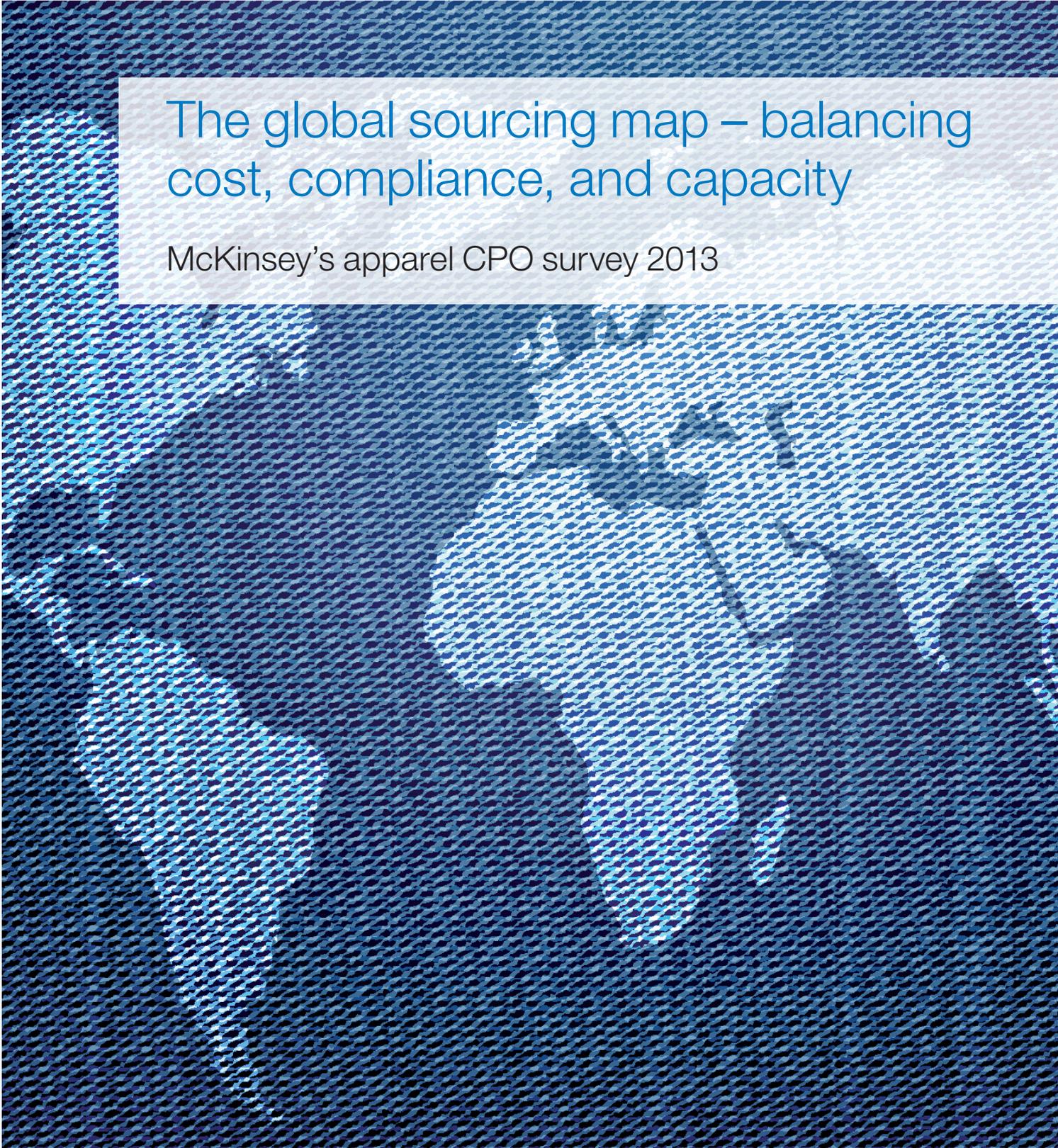


Apparel, Fashion & Luxury Group

The global sourcing map – balancing
cost, compliance, and capacity

McKinsey's apparel CPO survey 2013



The global sourcing map – balancing cost, compliance, and capacity

Introduction

Sourcing continues to be one of the most critical success factors for the global apparel industry. For decades, European and US apparel buyers as well as consumers benefitted from the steady movement of production activities to low-cost countries in the Far East, in what many industry players refer to as a “caravan journey.” Along this route, apparel buyers have long considered five main criteria for the ideal sourcing locations: price, quality, capacity, speed, and risk. Recently, the series of tragic events in Bangladesh’s garment industry focused the world’s attention on the sourcing strategies of large players in the apparel industry and on the role of the ready-made garments (RMG) sector in generating economic growth for developing economies in a sustainable and socially responsible manner.

In 2011, McKinsey & Company conducted a survey among leading apparel buyers in Europe and the US regarding their sourcing strategies and plans. Respondents indicated that in the face of increasing costs in China, companies were starting to explore alternatives. They also stated that they saw Bangladesh as the next likely sourcing destination. They cited prices and capacity as Bangladesh’s key advantages versus gaps in infrastructure and compliance.

The pace of change in global sourcing, as well as the sector’s new trends and priorities, led McKinsey to conduct a follow-up survey in the summer of 2013. The survey was conducted with 29 chief purchasing officers (CPOs) in Europe and the US who are responsible for an annual total sourcing value of USD 39 billion.

Overall trends

Three out of four respondents surveyed say they expect sourcing costs to increase over the next 12 months and that labor costs would continue to be the most important driver for sourcing cost increases. But respondents also said they were devoting more attention to compliance issues. Survey respondents expect that while China will remain the largest sourcing market by far, buyers will continue to seek alternatives, including destinations in Asia and Africa. Despite the tragic events in Bangladesh recently, respondents say that the country is likely to remain the most important alternative for apparel sourcing. More than half of survey respondents include the country in their list of top 3 destinations for apparel sourcing over the next five years, though its popularity has declined in two years since our last survey.¹

¹ In 2011, McKinsey research indicated that Bangladesh has the potential to achieve exports from its RMG sector of USD 36 to 42 billion by 2020, provided that the sector overcomes certain challenges, particularly relating to compliance issues and infrastructure. This was based upon the assumption that there is an annual growth potential of 7 to 9 percent compared to the historical average annual growth rate of 12 percent. After this assumption held true in the last two years and CPOs having reconfirmed their commitment to grow their sourcing share from Bangladesh, McKinsey’s apparel group continues to believe that these growth rates are reasonable.

Costs on the rise

Survey respondents see sourcing price increases as inevitable. In separate interviews conducted with CPOs, many executives indicated the increases may signal a paradigm shift in the industry. McKinsey analysis also finds that while the sector has seen cyclical price increases in the past, the current environment indicates that rising prices are due to structural factors, such as labor and raw materials cost increases. As a result, it may become even more difficult to keep consumer prices stable. In the survey, some 76 percent of survey respondents say they expect an average of 1.7 percent higher prices in the next 12 months, independent of the countries from which they are sourcing. Some 14 percent expect a strong to very strong cost increase of more than 4 percent. The value segment and large players are particularly concerned, expecting an average cost increase of 2 and 3.5 percent, respectively (Exhibit 1).

3 out of 4 CPOs expect a sourcing cost increase over the next 12 months

"What is your overall expectation on sourcing cost (price per piece) independent of sourcing country?"

Percent of respondents, n = 29

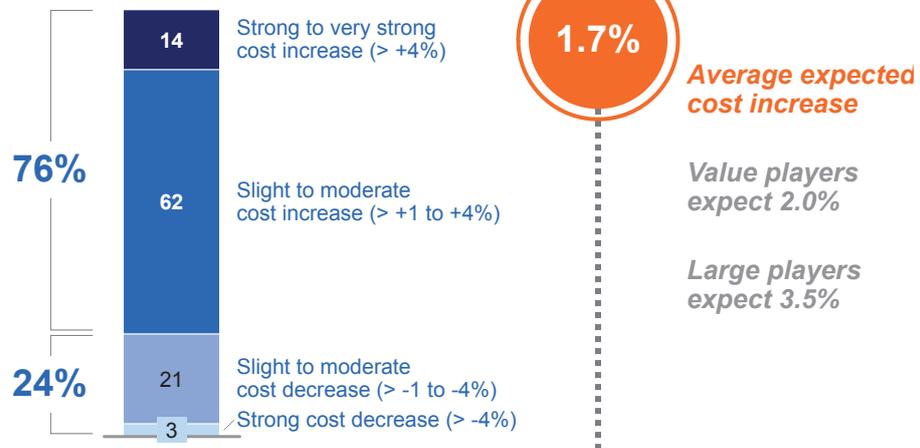


Exhibit 1

Respondents pointed to rising labor expenses as the main driver of increases in sourcing costs (especially in China), followed by costs for raw materials and fabric/yarns. In addition, mid-market respondents say that a shift in purchasing power to suppliers is at least as important as a cost factor for them (Exhibit 2).

Many players have already shifted larger parts of their sourcing from China to countries with lower labor costs. Some 72 percent of the buyers surveyed are planning to further decrease their sourcing value share from China and move it to lower-cost locations.

The survey responses reveal that buyers are continually looking for new opportunities for affordable capacity, but that factors beyond labor cost (e.g., safety compliance and social and environmental impact) have risen in importance. Traditionally, such trade-offs are particularly important for value players that started sourcing in these countries earlier on and for large players that experience capacity problems when shifting bigger volumes (Exhibit 3).

Labor cost is seen as the most impactful driver by most apparel companies

"Which drivers do you expect to have the highest impact on sourcing cost development (price per piece) within the next 12 months?"

Assessment of respondents, 1 = no impact, 5 = very high impact

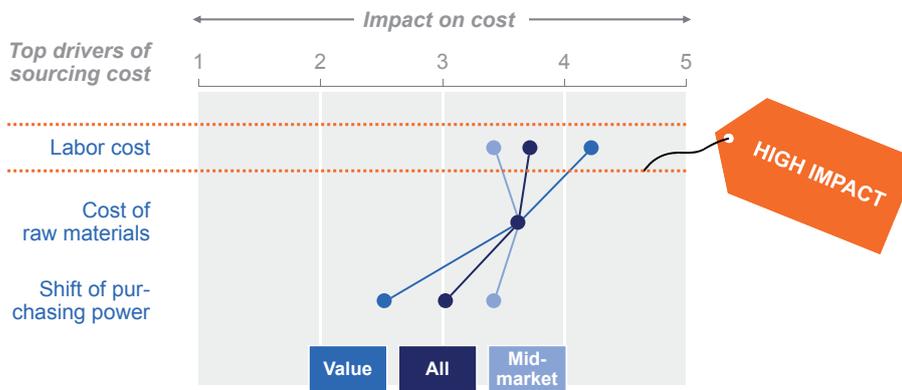
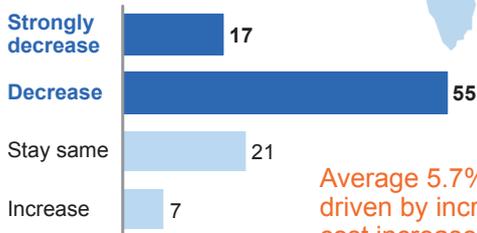


Exhibit 2

CPOs plan to shift sourcing value away from China to other countries over the next 5 years

"How do you expect your sourcing share (value) from China to develop during the next 5 years?"

Percent of respondents, n = 29



Average 5.7% expected reduction in China driven by increased sophistication of the industry, cost increase, and infrastructure issues¹

¹ Five-year plan for the RMG industry in China

Exhibit 3

The Bangladesh effect

The fatalities due to building collapses and fires in Bangladeshi apparel factories have had an impact on apparel sourcing worldwide. In McKinsey's 2011 apparel CPO survey, respondents were asked to pick "The top 3 country hotspots over the next five years" for apparel sourcing. More than 80 percent of respondents ranked Bangladesh among the top 3 (Exhibit 4). However, our latest survey shows that this

Despite recent events, Bangladesh remains at the top of the list of sourcing countries expected to grow in importance in the next 5 years

"What will be the top 3 country hot spots over the next 5 years?"

Percent of respondents who ranked the respective countries within top 3, n = 29

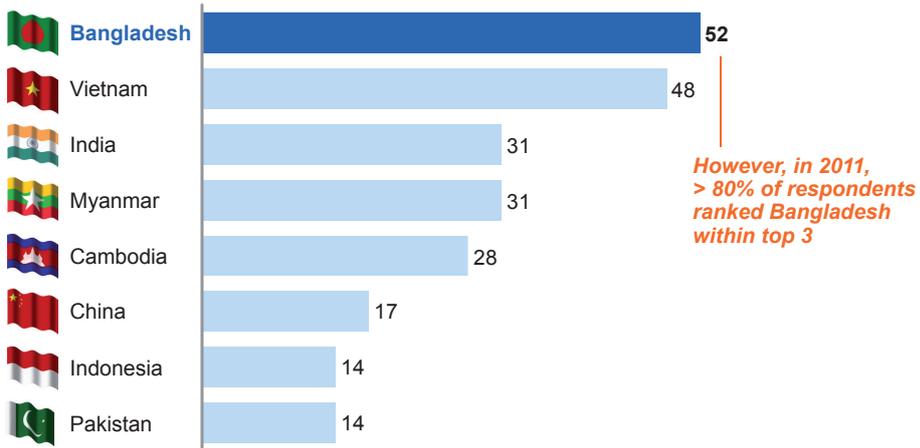


Exhibit 4

Overall, sourcing buyers plan to continue increasing their sourcing value from Bangladesh

"By how much do you expect to grow your absolute sourcing value from Bangladesh over the next 12 - 24 months?"

Percent of respondents, n = 29

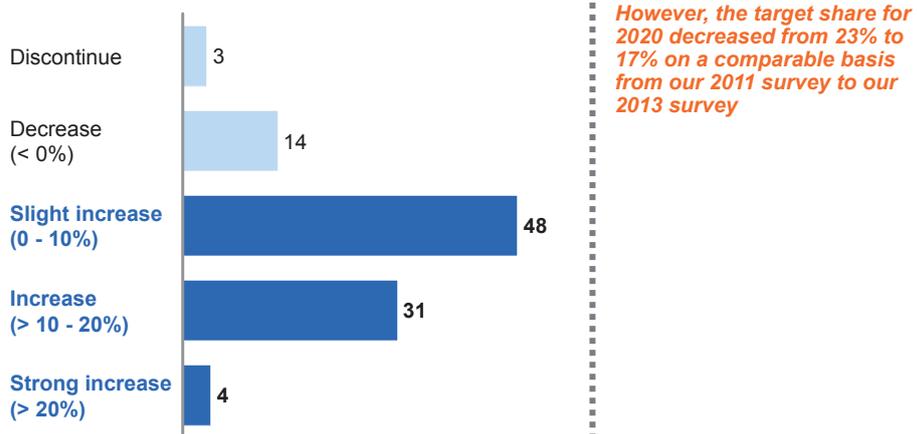


Exhibit 5

number has dropped to 52 percent. Nevertheless, Bangladesh remains the number one alternative to China. Buyers plan to increase their sourcing share in Bangladesh through 2020, even as ongoing debate takes place over safety issues and political developments in the wake of the disasters (Exhibit 5).

The survey responses point to the dilemma that apparel buyers face. Of the survey respondents, 86 percent ranked labor cost advantages among the three most important reasons for sourcing in Bangladesh. But more intense focus on compliance and other issues can be expected to raise costs – 18 percent of respondents expect sourcing cost impact from safety and compliance initiatives and 93 percent of respondents expect labor costs in Bangladesh to increase.

The survey shows that most CPOs have started acting by investing more effort in addressing compliance issues. Questions of fire and building safety have replaced infrastructure as the number one key concern of CPOs regarding sourcing in Bangladesh (Exhibit 6). Nearly 50 percent said they will likely or definitely revise their supplier base in the country (Exhibit 7). And the situation in Bangladesh has also had a broader impact on auditing standards for other low-cost sourcing countries (Exhibit 8).

Companies are becoming more proactive in corporate social responsibility initiatives and are increasing their regime of checks and balances. They are also preparing contingency plans to be better prepared for the challenges they face in these countries.

Buyers are clearly impacted by recent events and growing insecurity regarding upcoming elections in Bangladesh

"From your perspective, which of the current challenges discussed today has the highest impact on the Bangladesh sourcing market?"

Assessment of respondents, 1 = no impact, 5 = very high impact, n = 29

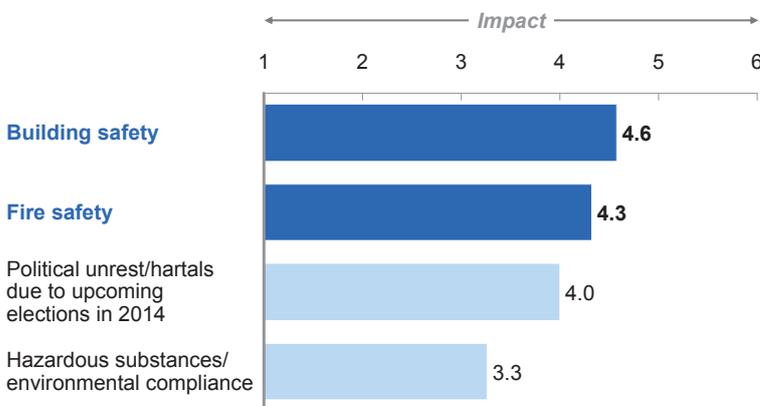


Exhibit 6

Many CPOs are revising their supplier base in Bangladesh ...

"Are you revising your supplier base within Bangladesh?"

Assessment of respondents, n = 29

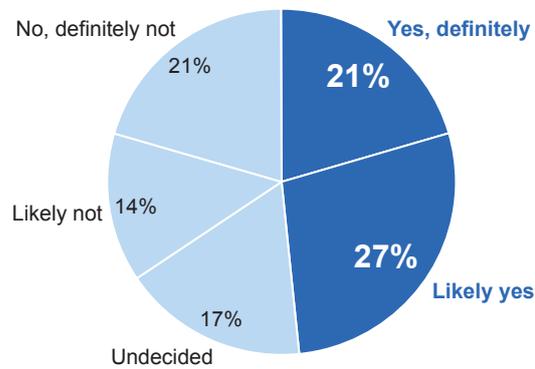


Exhibit 7

... and many are changing auditing standards/frequency in Bangladesh and beyond

"In response to recent tragic events ..."

Assessment of respondents, n = 29

"... are you changing your auditing *standards* ...?"

"... are you changing your auditing *frequency* ...?"



Exhibit 8

New destination opportunities – but no solid alternatives in sight

As companies are becoming more aware of the trade-offs between costs and other factors in current locations, they continue searching for further alternatives. Survey results indicate that CPOs are looking toward Sub-Saharan Africa and new Asian locations such as Cambodia, Vietnam, and even Myanmar.² Proximity sourcing is also becoming increasingly more relevant (Exhibit 9).

Sub-Saharan Africa's longer-term potential

"Will Sub-Saharan Africa gain importance over the next 5 years?"

Percent of respondents, n = 29

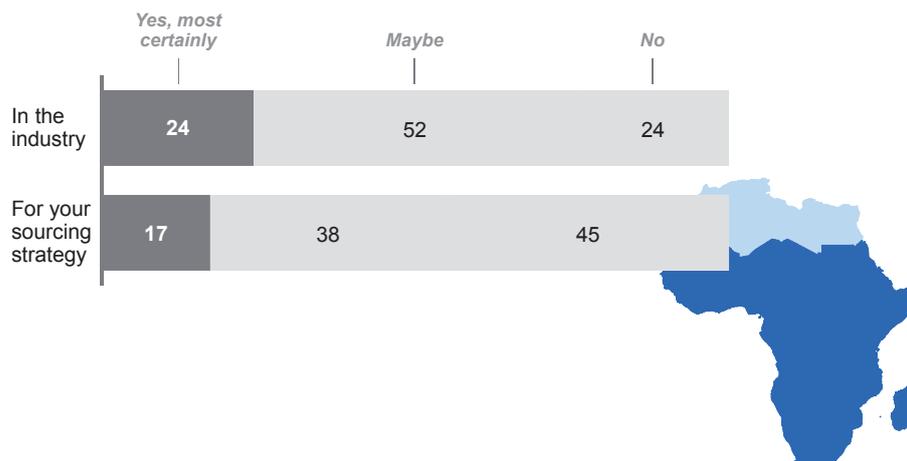


Exhibit 9

But committing resources often requires more. Cost and trade agreements are not the only factors that CPOs – especially among the big players – need to consider. Capacity, productivity, and supplier capabilities are also critical factors. Bangladesh still has a huge advantage in these areas, according to the criteria that respondents cited for the top 3 destinations for sourcing in the coming years (Exhibit 10). Other promising destinations will have to be able to guarantee prospective buyers that they can take on large volumes, are able to deliver against expectations, and will provide the long-term investments necessary to secure success. Based upon our experience, it is unlikely (in many cases) that promising alternative sourcing destinations would be able to take on any sizeable share of the export market within the next five years (Exhibit 11).

² For a more detailed analysis of the prospects in Myanmar, see the McKinsey Global Institute report “Myanmar’s moment: Unique opportunities, major challenges”, June 2013

Decision to source from Bangladesh still driven by cost advantages and capacity

Percent of respondents that ranked respective reasons within top 3, n = 29

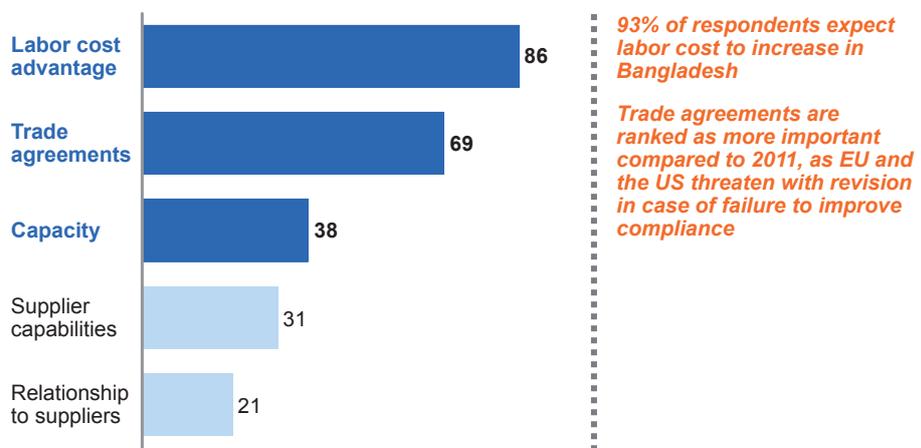


Exhibit 10

The current "Asian league" table shows that no fundamental changes are expected

ESTIMATE

	Apparel exports USD billions, 2012	Number of apparel factories	Population 2012 Million people
China	159.9	18,000	1,354
Bangladesh	19.9	5,000	152
Vietnam	14.1	2,000	90
India	13.8	11,000	1,258
Indonesia	7.5	2,450	245
Cambodia	4.3	250	14
Pakistan	4.2	7,500	180
Myanmar	1.0	200	49

Exhibit 11

Myanmar appears for the first time on the sourcing map in this survey, showing up high on the list of CPOs' future sourcing destinations, though its infrastructure remains limited and economic development is in the early stages.

Survey results indicate that the trend toward proximity sourcing from North Africa and Turkey for Europe, and Mexico and Latin America for the US, might be looked at in a very differentiated way. It is becoming “more important” for value players (53 percent) and even more so for mid-market players (81 percent). Respondents indicated that proximity sourcing was mainly relevant for selected product categories and short lead time applications (Exhibit 12).

Proximity sourcing is becoming increasingly important – especially for midmarket players

“Is proximity sourcing becoming more important?”

Percent of respondents per category, n = 29

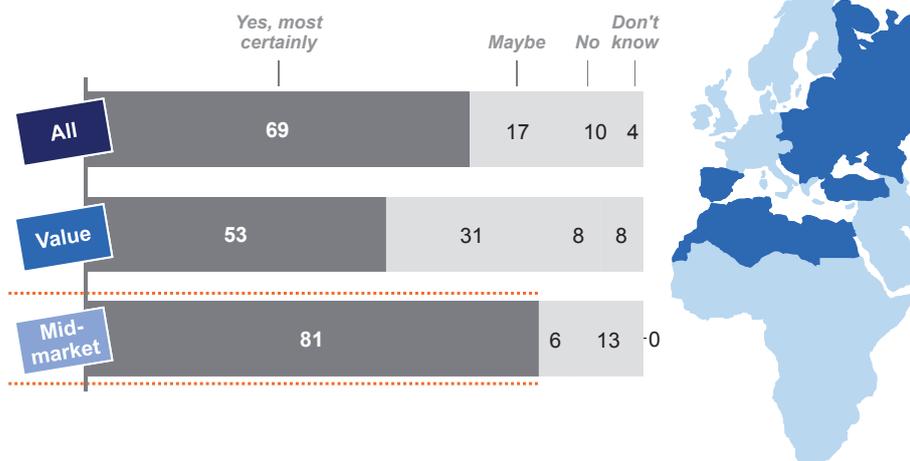


Exhibit 12

Conclusion

McKinsey’s latest apparel CPO survey indicates that apparel purchasing officers see costs rising. Executives suggest that this may reflect a more structural shift in the industry, while the traditional apparel company “caravan journey” becomes more complex. As apparel players seek paths to new sourcing options in order to address increasing cost pressures, they need to intensify their drive for sustainable, socially responsible business models in order to meet new industry demands.

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