
Apparel Supply Chain between Europe and China

A Guide to Apparel Sourcing and Distribution in China

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List of Abbreviations

List of Abbreviations

3PL	Third Party Logistics
AVE	Außenhandelsvereinigung des Deutschen Einzelhandels
B/L	Bill of Lading
BAF	Bunker Adjustment Factor
BHR	Bo Hai Rim
BOM	Bill of Material
C/O	Certificate of Origin
CAAC	Civil Aviation Administration of China
CAF	Currency Adjustment Factor
CFI	Cost Freight Insurance
DSO	Days Sales Outstanding
EDI	Electronic Data Interchange
EU	European Union
FCL	Full Container Load
FCS	Foreign Currency Sheet
FOB	Free on Board
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GOH	Garments-On-Hanger
IMF	International Monetary Fund
IT	Information Technology

List of Abbreviations

JV	Joint Venture
LCL	Less than Container Load
LSP	Logistics Service Provider
L/C	Letter of Credit
MFA	Multi Fiber Agreement
MOC	Ministry of Communication of the P.R. China
MOFCOM	Ministry of Commerce of the P.R. China
NVOCC	Non-Vessel Operating Common Carrier
OPT	Outward Processing Trade
POS	Point of Sale
PRD	Perl River Delta
QC	Quality Control
SAR	Special Administrative Region
SEZ	Special Economic Zone
SOE	State owned Enterprise
T&A	Textile and Apparel
VAS	Value added Service
VAT	Value-added tax
WFOE	Wholly Foreign Owned Enterprise
WTO	World Trade Organization
YRD	Yangtze River Delta

Abstract

China plays a central role in apparel sourcing worldwide. There are many reasons why China accounts for such a big part of the sourcing volume. Besides the lower labor costs in comparison to other emerging countries, China offers many other advantages, e.g. relatively lower political, economical and financial risks, better conditions in terms of infrastructure, better qualified employees, etc. Moreover, the domestic demand in China keeps growing, which makes this market more attractive. “Sourcing in China” is slowly changing into “also selling in China”. However, the apparel companies, who are entering the Chinese market for either sourcing or selling, and the international logistics service providers, who are active in China for apparel transportation, are facing challenges, such as different transportation systems, regulatory restrictions, historically grown fragmented distribution systems, limited use of technology in the logistics sector, etc.

Although there are plenty of publications about “China Sourcing” and the country’s rising economic power, they are often rather general or focus on e.g. automotive or electronics industry. However, this survey captured the current development in the apparel industry. Through intensive interviews with about 50 business professionals from 35 firms, including apparel companies (as buyers or sellers), buying agents, apparel manufacturers, logistics service providers, banks, consulting firms and associations, this paper offers the readers a comprehensive guide for apparel sourcing and distribution in China.

In the paper, the processes along the entire supply chain between Europe and China and the main actors involved are described in detail. After providing the readers an overview of the apparel supply chain, three important issues – transport chain, financial performance and distribution logistics – are discussed in more depth. Besides the description of the relevant processes, critical aspects are analyzed and practical suggestions are given.

1 Introduction

1 Introduction

This paper presents the results from a series of six surveys in the apparel industry, which started in 2005 and ended in 2008. In the first part of this chapter, the motivation for starting this research project and continuing in different selected research fields is introduced. The second part describes the research approach and the selected research areas.

1.1 Motivation for the research

The manufacturing of apparel is highly labor-intensive and cannot yet be replaced by any machines. Hence, the apparel industry has always shifted its production to the countries with the lowest wages. Therefore, the textile and apparel industries represent one of the most dynamic sectors in the global trade.¹

Although the US and the European Union (EU)'s apparel industries were protected through special textile agreements first under the General Agreement on Tariffs and Trade (GATT) and later under the World Trade Organization (WTO), this did not stop them from undergoing several cost-related production migrations since the 1950s, all of which involved Asia. First, the industry shifted from North America and Western Europe to Japan in the 1950s and early 1960s. Later, in the 1970s and early 1980s, the second migration from Japan to Hong Kong, Taiwan and South Korea took place.² These countries dominated global textile and clothing exports, until a third shift happened in the late 1980s and the 1990s, leading the industry from the "Big Three" mainly to mainland China, but also to various Southeast Asian countries (Indonesia, Thailand, Malaysia and the Philippines) and South Asian countries (Sri Lanka, Bangladesh and India).³

Since its economic reform and opening to the world under Deng Xiaoping (starting from 1978) and especially through its accession to the WTO in 2001, China has been on the rise. In the course of globalization and its rapid development, more and more western apparel companies have started sourcing from China and have included Chinese manufacturers in their supply chain in order to gain (or maintain) a competitive advantage.⁴ Although the protectionist quota system that came to an end in 2005 was re-imposed in the form of textile-

¹ See Saheed (2006), p. 59. Together with electrical and electronic goods, textiles and apparel represent the two most dynamic sectors in global trade.

² See Tücking (1999), p. 169.

³ Cf. Gereffi / Memedovic (2003), pp. 8-9 and Steilmann (2002), pp. 4-5.

⁴ For China's textile and clothing sector's main competitive factors, see European Commission (2005), p. 30, and Talwar (2006), p. 53. Cf. also Kerkhoff (2005), p. 127.

1 Introduction

specific “safeguard” import restrictions in the same year by the EU and the US, today China is the world's leading garment producer⁵ and could account for even 50% of the world's textile and garment output in the future.⁶ Moreover, more western apparel companies are considering China also as sales market and a significant part of their international expansion plans.

However, although there is a lot of business-reading and academic literature available about the raising economic power China or even procurement in China, they often come in a very general form or focus on other industries. Few comprehensive readings about China and the export-oriented apparel industry are available. Publications about apparel distribution in China are even fewer. This is why a series of surveys were developed by the Chair of Management & Logistics at Technische Universität Darmstadt. The aim is to provide a guideline for the European apparel companies who procure and distribute in China.

1.2 Research Areas and Approach

The first survey of the series started in 2005 and was initiated by a German apparel company, who was interested in a comparison between the Turkish and Chinese sourcing markets. After the success of the project, a series of surveys were designed and carried out with the focus on China due to the reasons explained in chapter 1.1. Parallel to the first survey, a comparison between Indian and Chinese sourcing markets was carried out. The results of these two empirical surveys are introduced briefly in chapter 2.5, since it is not the main focus of this paper. The surveys in China consist of four parts:

- 1) An overview of apparel sourcing from China: the objective is to give a comprehensive overview regarding the apparel supply chain from the raw material provider, through producers, logistics service providers, buying agents etc. to the retailers. In this part, the main processes, involved actors and their focuses in the apparel supply chain are described in detail. The main results are presented in chapter 2.
- 2) The apparel transport chain within China and from China to Europe: the objective is not only to obtain the transparency regarding the apparel transport chain, but also to highlight the critical aspects of the transport processes. The topics in this part cover the infrastructure in China, required licenses and documents, the specialized logistics unit and means of transport for apparel, and the detailed activities of the involved actors in transport chain. The main results are presented in chapter 3.
- 3) The financial aspects of the apparel supply chain: the objective is not only to obtain transparency regarding the financial flow in apparel sourcing, but also to discover measures for saving costs, avoiding risks and improving financial performance. The main results are presented in chapter 4.
- 4) Apparel distribution in China: the objective is to give an overview of the distribution processes, involved actors and their focus in the distribution chain in China. The focus is also on the logistics aspects and challenges in the distribution. The main results are presented in chapter 5.

The research was based on the perspective of European apparel companies and covered the whole apparel supply chain, including sourcing and distribution in China. The time frame of this series of the surveys is from 2005 to 2008. The research methods are empirical survey and expert interviews. The empirical method was used in the first two surveys for the comparison of Turkish–Chinese and Indian–Chinese sourcing markets. In these two surveys, altogether 103 valid questionnaires were collected from the textile industry.⁷ The method of expert interview was used in the four surveys in China. Altogether, about 50 experts from 35 companies were interviewed. In this paper, the most important results of these six surveys are selected and presented.

⁵ See Leary (2006), p. 19.

⁶ See Lohse (2005), p. V2. Cf. also Abernathy / Volpe / Weil (2004), p. 2.

⁷ There are 61 valid questionnaires for the survey of Turkish – Chinese sourcing market and 42 for the Indian – Chinese survey.

2 Overview of the Processes, Actors and Activities

2 Overview – Process, Actors and Activities

This chapter gives a comprehensive overview regarding the apparel supply chain from the raw material provider, through producers, logistics service providers, buying agents etc. to the retailers. After a short introduction of the fundamentals of the apparel supply chains and the development of the apparel industry in China, the sourcing processes and the involved actors in the processes are introduced in detail. Following up is a comparison between the three important sourcing destinations for apparel – China, Turkey and India. In the end, the trend from sourcing to selling in China is raised up and the fundamentals are introduced.

2.1 Fundamentals of Textile and Apparel Supply Chains

A huge amount of terms used for different aspects do exist related to textiles and apparel. To clarify the use of terms throughout this study we will distinguish between the textile industry and the apparel⁸ industry. The former uses natural and man-made⁹ fibers to produce fabrics, yarns and other textile products. The latter mainly uses these textile products as input to process them into apparel. The two industries together are called the textiles and apparel (T&A) industry.

As illustrated in figure 1, the T&A industry¹⁰, the man-made fiber industry and the wholesale and retail industry together form the textile system. The textile system is supplied by the related industries such as the man-made fiber machine industry, the petrochemical industry, the textile machine industry as well as the apparel manufacturing machine industry. The textile system together with the natural fiber processing industry, the related industries and the consumers and industrial buyers finally shape the textile complex. The research focus of this study is the apparel industry with its backward-connections to the textile industry and forward connections to wholesale and retail. Under the perspective of international sourcing and distribution, the survey mainly focused on the value-added activities of the apparel industry that occurs abroad, respectively in China.

About 90% of the German apparel production has already been relocated to foreign countries.¹¹ The textile and clothing industry was one of the first movers regarding internationalization.¹² Ever since then the

⁸ Synonyms are “clothing” and “garments”.

⁹ A synonym is “chemical fibers, which is a literal translation with origins from non-English terms, see Resil Online (2005).

¹⁰ According to the synonyms for apparel, the synonyms of the industry are “textiles and clothing industry” (T&C) and “textiles and garment industry”.

¹¹ See Jungbauer (2002), p. 23.

2 Overview of the Processes, Actors and Activities

industry has been labor intense and at the same time the division of labor has been easy. Hence, companies started to leverage the wage differentially across different countries. Initially this was done through Outward Processing Trade (OPT) where raw materials are exported to adjoined countries for manufacturing, thereby taking advantage of lower labor cost.¹³ The finished products were then returned to the mother country to be delivered to the retail. Today about 80% of this trade is carried on with Eastern European countries, primarily with Poland, Romania and the Czech Republic.¹⁴ This process was usually supported by governments, e.g. by proper regulations of tax payments. OPT furthermore indicates, that growing internationalization also requires complex logistics solutions.¹⁵

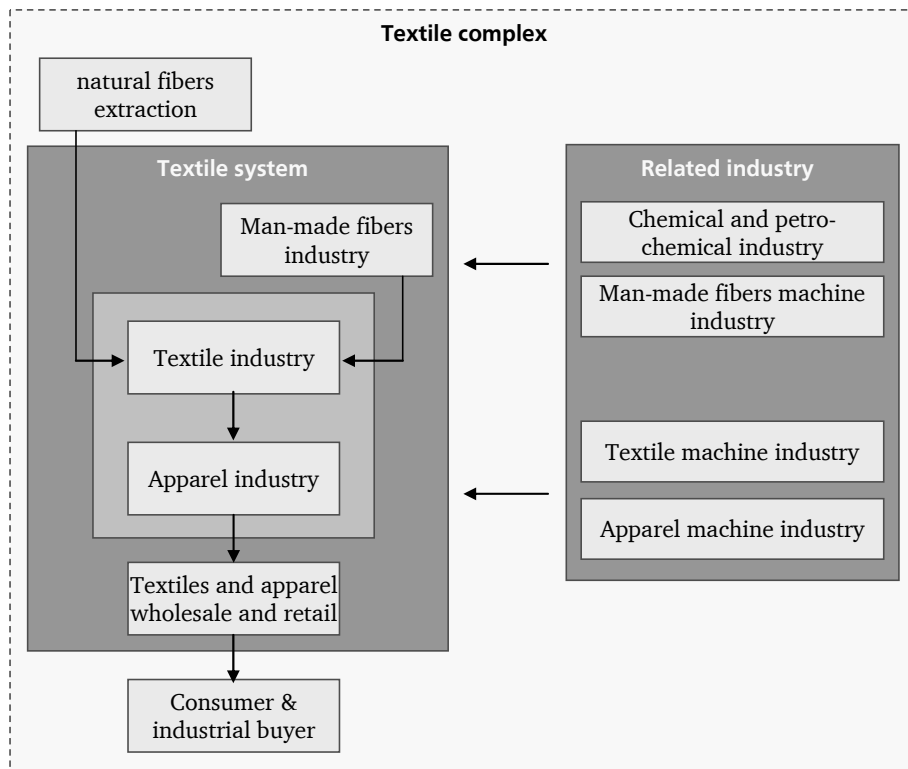


Figure 1: Textile complex

(Source: translated from Hermann (1996), p. 88)

Still, the T&A industry's internationalization did not stop with OPT. Rather the textile agreements such as the Multi Fiber Agreement (MFA), which will be discussed in detail later, further intensified the industry's internationalization. As buyers were "forced" to spread their volume across different countries, these countries entered into competition with each other. One consequence was the establishment of more and more so-called special economic zones, where companies would find favorable conditions for export-oriented production and processing - especially in low-wage countries.¹⁶ These zones are also called "world market factories". Critical voices say that these world market factories actually do not contribute to the countries' development. Besides cheap labor and public resources (gas, water, etc.), no further connection to the local economy exists. Thus, these zones depend very much on foreign companies and underlie high fluctuation

¹² See Hermann (1996), p. 79.

¹³ See Schneider (2004), p. 142; Gereffi / Memedovic (2003), p. 8. Another term used commonly is "cut, make and trim" (CMT), cf. Resil Online (2005).

¹⁴ See Grömling / Matthes (2003), pp. 80-81; Statistics from year 2001.

¹⁵ Cf. Pfohl (2004b), p. 13.

¹⁶ See Ferenschild / Wick (2004), p. 19.

2 Overview of the Processes, Actors and Activities

depending on how favorable the conditions are in comparison to other countries.¹⁷ The fight between countries and even regions for ever lower costs is also called the “race to the bottom”.¹⁸ After the long period of internationalization the industry is now experiencing a period of concentration. Buyers start bundling their buying power to selected countries.¹⁹ It is said that a typical importer might reduce his sourcing locations from thirty down to ten.²⁰ China is still by far the most popular sourcing destinations for the European apparel companies, although it has been discussed recently whether Chinese producers are less competitive than Eastern European ones, due to the increasing labor cost and high logistics cost.²¹

During the internationalization, apparel companies have to decide which activities they should incorporate into their organization. On the strategic level, it basically means “outsourcing” or not and to which extent. The opposite of outsourcing is “integration”. In T&A industry, vertical integration is of high importance. Both outsourcing and vertical integration are strategies that are partly applied single-edged, but are as well mixed up according to specific needs.

In the following chapters, the involved actors in apparel China sourcing and their activities are described in detail.

2.2 Development of the Apparel Industry in China

Regarding sourcing in China it is very important to recognize the huge dimensions of the country. Thus, China consists not only of one supply market, but rather of a whole set of markets with different sets of products available. Just as an executive of a German clothing wholesaler said “China is not China”.²² The most important export regions in mainland China are namely: (See also figure 2)²³

- Perl River Delta (PRD) in Southern China,
- Yangtze River Delta (YRD) in Eastern China and
- Bo Hai Rim (BHR) region in Northern China.

These three regions account for about 70% of China’s GDP²⁴ and 87% of China’s total export volume.²⁵ The statistics of textile and clothing exports do strongly support this division. PRD accounts for about 20% of total Chinese garment exports, YRD for about 46% and BHR area for about 19%. The remaining share of about 15% is spread across all other regions of China. Basically the same numbers, with only little difference, apply to the entire textiles and clothing industry.²⁶

Besides these three regions, Hong Kong also plays an important role in T&A industry. The Western and central regions still don’t seem to be a very good option for the T&A industry, although a campaign was started by the central government in 2000 to develop the Western regions. The following part describes the Hong Kong region, PRD, YRD and BHR in detail.

¹⁷ Cf. Hermann (1996), pp. 244-245.

¹⁸ See Ferenschild / Wick (2004), pp. 18-20.

¹⁹ See Petersdorff (2005), p. 25.

²⁰ See Anonymous (2005c), p. 5.

²¹ See Hollmann (2007).

²² Translated from Anonymous (2005b), p. 46.

²³ See Song (2004), p. 71 (does not regard Hong Kong); Schramm (2005).

²⁴ See Vinck (2004), p. 92.

²⁵ See Song (2004), p. 71.

²⁶ Still these numbers can not be taken as last evidence, because e.g. products sourced from central and Western regions could at first be transported inland in order to be exported from one of the export ports in the main economic regions. It is questionable if the present customs statistics do recognize the products’ real origins within China.

3 The Transport Chain in Apparel Sourcing from China

3 The Transport Chain in Apparel Sourcing from China

This chapter not only offers the transparency regarding the apparel transport chain within China and from China to Europe, but also highlights the critical aspects of the transport processes. In the beginning of the chapter, the special logistics issues in China – infrastructure, logistics services, required licenses and documents – are introduced. Then the specialized logistics units and means of transport for apparel delivery are analyzed in detail. In the end, the four main involved actors and their activities particularly in the transport chain are presented.

3.1 Logistics in China

Whilst the shipment of goods out of the country is relatively easy and straightforward, moving goods within the country is still fraught with some difficulties. Developments over the past couple of years have improved the domestic front, but the local market is unlikely to meet the requirements in a few more years. To illustrate China's logistics infrastructure, this part will present fundamental information about China's physical infrastructure, the market for logistics services and required licenses and documents to operate legally within China.

3.1.1 Infrastructure

China's transport infrastructure has grown rapidly in recent years, but there is still a lot of room for further improvement. Figures in government investment plans were impressive, but often had to be regarded as indicators, rather than concrete figures.¹⁶⁶ Infrastructure capacity constraints still exist, and outside the eastern coastal area, the transport infrastructure is far from being able to support a modern logistics industry.

Road

Road transport accounts for almost 76% of domestic cargo share, while 14% for rail.¹⁶⁷ Compare to the rail system, the road network is relatively well developed. However, road transportation is far more expensive. Over larger distances costs are much higher than by either rail or inland waterways. Whereas the road network is well developed in China's three main economic regions, it is still relatively limited in other areas (see figure 13). That does not only apply to the density of the road network but also to the quality of the

¹⁶⁶ See Bolton/Liu (2006), p. 7.

¹⁶⁷ See Leutner (2005), p. 213.

3 The Transport Chain in Apparel Sourcing from China

roads. Maintenance of the existing network is sometimes neglected.¹⁶⁸ Additionally, the lines of the highway system that link different provinces are not well connected and cannot meet demand.¹⁶⁹

However, due to ambitious expansions in the past, China's expressway network is getting huge.¹⁷⁰ In 1988, China only had 100 km of expressways. By 2006 the length of expressways had risen to 41,000 km and the length of highways reached 1.93 million km.¹⁷¹ The Chinese Minister of Communications has committed to expand the expressway network to 65,000 km by 2020, 85,000 km by 2020, 120,000 km by 2030 and 175,000 km by 2050. Till 2010, 5.8 billion Euros are planned to be invested annually to build additional 400,000 km of highways.¹⁷²

Rail

Bearing China's large geographical size in mind, rail may suggest itself as a preferred transport mode, although it is usually not an option for apparel.¹⁷³ However, not much different from some years ago, its infrastructure is still very limited, and freight trains are especially slow.¹⁷⁴ There is an absence of track in certain regions, particularly in the west (see figure 9). A high proportion of the rail network is not double tracked yet. In 2005, only 24,500 km (39.4%) were double-tracked out of almost 75,000 km of rail.¹⁷⁵ In general, priority is given to coal and other raw materials, followed by passengers over industrial goods. Passenger traffic often clogs rail capacity, especially around Chinese holidays. Some routes require operators to book space as much as 6 weeks in advance. The damage rate is 2-3 times higher than in trucking. In 2006, the government announced that about 10 billion Euros would be invested for rail annually until 2020. It is planned to extend the rail network from 75,000 km to 100,000 km till 2020.¹⁷⁶ China also plans to have 50% of its rail system double-tracked by 2020.¹⁷⁷

One of the most ambitious initiatives is the re-opening of a "new" Silk Route, also known as the Eurasian Bridge that would connect the port city of Lianyungang in Jiangsu Province on the Eastern China coast to Rotterdam, which upon completion would even enable goods to be transported directly to Europe. Cities along the 4,100 km Chinese part of the route, such as Zhengzhou, Xi'an, Lanzhou and Urumqi plan to upgrade their positions as trading and logistics hubs. Another eye-catching project is the high-speed Beijing-Shanghai line, which is expected to start operation by 2010.¹⁷⁸ However, equally important as rail construction is the lifting of quality and efficiency, e.g. by dividing passenger and freight lines along busy trunk routes. Moreover, in the sprint to develop its rail systems, there is a danger that China may acquire incompatible technologies, or build infrastructure in a province by province way, which would probably fail to eliminate bottlenecks.

¹⁶⁸ See Interview Bansard (2007), p. 12.

¹⁶⁹ See Bolton/Liu (2006), p. 7.

¹⁷⁰ These investment plans were pushed, because some years ago infrastructure constrains were still very severe. See e.g. Carter/Pearson/Peng (1996), p. 135 and Speece/Kawahara (1995), p. 54.

¹⁷¹ See NBS (2006), p. 632.

¹⁷² See Bolton/Liu (2006), p. 9.

¹⁷³ See Interview BAX Global (2007), p. 7.

¹⁷⁴ See Gates (2001), p. 14.

¹⁷⁵ See NBS (2006), p. 632.

¹⁷⁶ See Dou (2006), p. 1.

¹⁷⁷ See Kwan/Knutsen (2006b), p. 9.

¹⁷⁸ See Haoting (2006), p. 3.

3 The Transport Chain in Apparel Sourcing from China

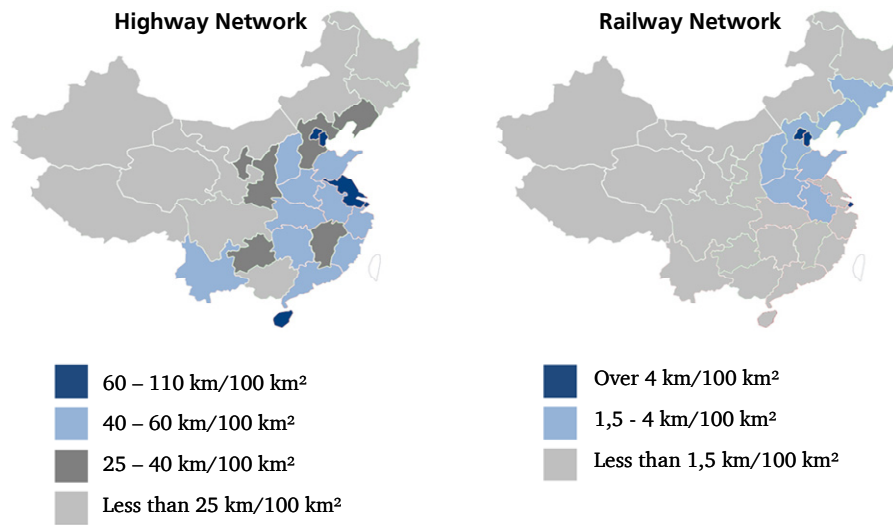


Figure 13: China's highway and rail network

(Source: own drawing based on NBS (2006), p. 631 and Janetzko (2004), p. 22)

Ports and Waterways

Although this mode of transport is not used at all for distributing apparel within China, it should be mentioned because a share of basic garments that are sold in China, but not produced there, are shipped to China by sea.¹⁷⁹ Location of ports might thus influence the location of warehouses and distribution centers. China has one of the world's most extensive networks of coastal ports. Shanghai and Ningbo in the Yangtze River Delta, Shenzhen and Guangzhou in the Pearl River Delta, and Tianjin, Qingdao and Dalian in the Greater BHR are the largest of them. All of China's main coastal ports have grown rapidly due to the country's growing exports. Since most of the companies that are selling their products in China are producing at least a share of them in China as well, warehousing facilities originally intended for export only, which might already exist in these regions, also could be used as distribution centers for the Chinese market.

China's inland waterway system currently has a length of 123,000 km¹⁸⁰ and is dominated by the Yangtze River, which represents the main transport link for inland China. The Yangtze is one of the world's most used inland waterways, but currently only a fraction of navigable capacity is being used. This is about to change because the Three Gorges Dam was finally completed in 2006 and will be fully operational by 2009.¹⁸¹ However, inland waterway transportation is not a suitable mode of transport for consumer goods.

Air Freight

Although air freight only accounts for less than 1% of total freight transported in China,¹⁸² it certainly has significance to the logistics sector, including apparel distribution. Goods transported by air usually have a high value per unit, such as fashion products. If lead time is very important or the volume is small, air freight is a potential option.¹⁸³ Air freight has been the fastest growing segment of the market for a couple of years and airport freight volumes are expected to continue growing faster than port freight, as China moves up along the value chain. Airports are usually well linked to the regional transport network, and therefore tend to be

¹⁷⁹ See Interview Kerry EAS (2007), p. 5.

¹⁸⁰ See NBS (2006), p. 630.

¹⁸¹ See Iliffe et al. (2006), pp. 10-11.

¹⁸² See Anonymous (2006), p. 26.

¹⁸³ See Interview DHL (2007), p. 6.

4 Reduce Costs, Avoid Risks and Improve Financial Performance

4 Reduce Cost, Avoid Risk and Improve Financial Performance

Every member of the supply chain is obliged within its contractual relationship.³⁶⁰ In figure 18, the financial flow and the corresponding flow of goods between actors is shown. The dashed arrows to the bank show that a bank may be interposed in every money flow between actors. Exemplary instruments for setting up regulations between buyer and supplier may be the buying contract and the worksheet for the suppliers.³⁶¹

Along the supply chain, wherever physical activity occurs, financial activity also takes place. Due to this reason, an integrative concept considering not only physical but also financial activities will most likely lead to higher returns. However, within the industry it is doubted that a financial integration, such as adjustment of terms of payments between partners, is possible. The main reason for this is that contracts are drawn on short terms in apparel sourcing allowing flexible spot pricing.³⁶² Perhaps the fear of too much transparency plays an additional role regarding this negative mindset. For a start, some single financial aspects or rather ways to save costs should be at least considered.

4.1 Cost Saving

Three measures for cost saving – ensure quality, offshore to Hong Kong and shift the value-added services – are introduced.

4.1.1 Quality assurance

Quality assurance of the manufactured apparel is necessary in order to avoid defects and keep the rate of returns down.³⁶³ Errors are connected with costs e.g. for incoming goods inspection, reworking and final inspection, new packing, new shipping, and costs of warranty. Furthermore, hidden costs exist, such as testing costs, claims, scrap and reworking, downtime of machinery, and rebates. Additionally, hidden costs include non-measured costs such as loss of turnovers and customers, delay in delivery, errors in disposition, high inventory, and unproductive time for rework.³⁶⁴ If the trading company randomly tests 10-20% of the

³⁶⁰ See Interview Pro China Direct (2006a), p. 1.

³⁶¹ See Interview s.Oliver (2006), p. 1.

³⁶² See Interview Fiege (2006), p. 5, Interview Otto International Asia (2006), p. 2 and Interview CETA (2006), p. 7.

³⁶³ See Interview Kühne & Nagel (2006b), p. 4.

³⁶⁴ See Krokowski (2005), p. 109.

4 Reduce Costs, Avoid Risks and Improve Financial Performance

goods, reclamations normally make up around 5% of the orders, while the reclamation rate would increase to 30-40%³⁶⁵, if no tests are applied.

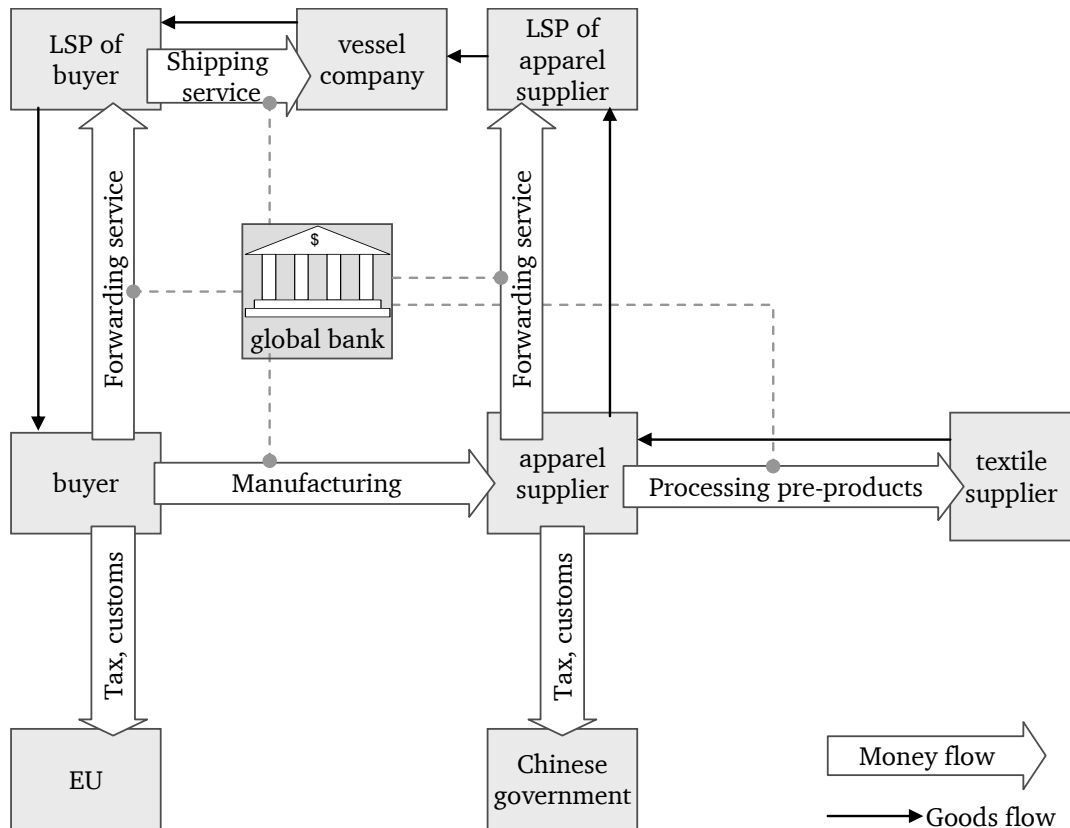


Figure 18: Simplified money flow in the Chinese European apparel supply chain³⁶⁶

Quality assurance by the buyer may be achieved especially by the following measures:

- 1) Inline inspections: inspections during production in order to resolve the problems which have been identified on the spot. Technicians and quality controllers operate as consultants.
- 2) Quality controls: spot checks of the suppliers' manufacturing sites.
- 3) Error avoidance: error prevention at an early stage rather than reacting to errors.³⁶⁷
- 4) Quality certification: final step before the release of payment.³⁶⁸

The above measures may be executed by using one of the following instruments, which mainly depend on the ordered quantities:

- 1) Contract with service agent: He is specialized in quality checks for overseas purchasers.
- 2) Appointment of a service agent: by small quantities, someone may be assigned in order to check contract-based issues such as
 - Starting time of production based on the agreed delivery time,
 - Raw materials based on certain specifications,

³⁶⁵ See Interview Pro China Direct (2006a), p. 3.

³⁶⁶ Shipment of sea freight and FOB pricing is presumed.

³⁶⁷ See Interview Gerry Weber (2006), pp. 2-3.

³⁶⁸ See Krokowski (2005), p. 109.

4 Reduce Costs, Avoid Risks and Improve Financial Performance

- Sufficient production capacity available for specified production time,
- Numbers of quality control measures during production,
- First samples produced,
- And finished product before shipment.

3) Employment of experts in China: e.g. by setting up a buying office.³⁶⁹

Additionally, by developing the suppliers, which is initiated by the buyer, quality, effectiveness, and efficiency may be improved. Some apparel companies (buyers) set up state-of-the-art manufacturing fabrics, which are also used as training centers for their main and new suppliers. So, the suppliers get an idea of the issues, e.g. how a modern apparel company works, what kind of machinery it is used, how a job preparation is operated, and how an inline inspection is implemented by the buyer's grasp. Furthermore, the concepts of a quality management may be transferred. The supplier therefore realizes that certain quality measures lead to a lower return rate and a higher productivity.³⁷⁰

4.1.2 Off-shoring to Hong Kong

The buyers no longer prefer the manufacturers situated in special investments zones, which were formerly established by the Chinese government to encourage investments.³⁷¹ The reason for that is lack of further benefits (e.g. quality or price advantages) for the buyer. In contrast, inland provinces such as Hubei and Anhui, provide more potential for apparel manufacturing, since the Chinese government supports these underdeveloped inland regions with the aim of employment promotion. It results in high advantages, especially concerning depreciation procedures.³⁷² Currently apparel companies are analyzing the possibilities and capacities of sourcing from inland areas.³⁷³

However, the Hong Kong SAR is an exception because it still provides incentives such as proximity to a high quality sourcing market for the buyer and more beneficial tax conditions than the rest of China.³⁷⁴ The income tax of enterprises accounts for 17.5% in Hong Kong³⁷⁵ in comparison to a regular income tax of 30% plus additional 3% local tax in China.³⁷⁶ Tax savings may be one of the reasons for involving a Hong Kong sourcing agency in the value chain of apparel sourcing from China.³⁷⁷ Among experts, Hong Kong agencies are generally known for their competitiveness through high consistency, and a high service level.³⁷⁸ Furthermore, Hong Kong laws are able to provide legal security in contrast to the Chinese main land legal system. Establishing a trading company is also cheaper than in the rest of China. For these reasons, the concept of off shore business in Hong Kong may be favorable: order processing may be executed by a Hong Kong sourcing agency even though the contract of purchase is concluded within Chinese main land. The order placement and the money flow do not happen directly from buyer to supplier, but the Hong Kong agency is interposed in between the two actors. Additionally, a representative office situated in Chinese main land may implement measures such as quality control.³⁷⁹ Figure 19 illustrates the process of off shoring to Hong Kong.

³⁶⁹ See Interview CETA (2006), pp. 5-6.

³⁷⁰ See Interview Gerry Weber (2006), p. 5.

³⁷¹ See Interview Schenker (2006), p. 1. / Interview Otto International Asia (2006), p. 2. / Interview Polymax (2006), p. 2.

³⁷² See Interview Gerry Weber (2006), p. 5.

³⁷³ See Interview Gerry Weber (2006), p. 2.

³⁷⁴ See Interview s.Oliver (2006), p. 3.

³⁷⁵ See Kracht/Mueller (2005), p. 118.

³⁷⁶ China Tax Online (2006).

³⁷⁷ See Kracht/Mueller (2005), p. 121.

³⁷⁸ See Interview CETA (2006), p. 6.

³⁷⁹ See Kracht/Mueller (2005), p. 121.

5 Apparel Distribution in China

5 Apparel Distribution in China

Most companies are still in the initial stage when it comes to distributing their products in China.⁴⁵¹ There are no clear and established procedures. Logistics services for distributing fashion have also only been established in the last two or three years.⁴⁵² In short, most companies seem to be focused on pushing goods into the market often without even basic value-added services. For many apparel companies, logistics is currently an auxiliary function rather than a strategic factor.⁴⁵³ They do not attach much importance to distribution logistics in China and even some LSPs assume that local distribution is easier to handle than the planning of sourcing activities from China to Europe, because several export and import documents are generally not needed and lead time seems to be less important.⁴⁵⁴ However, there is no single Chinese solution just as there is no single European solution that would be applicable from Helsinki to Rome. It is accepted that there are e.g. different lead time requirements for Northern and Southern Europe and for China it is similar. The realities in the Shanghai and Guangzhou area, for instance, are similar to Europe. Those regions can also already be served by foreign LSPs and thus they are often the starting point for a new business in China.⁴⁵⁵

5.1 Impact of China's WTO entry

Prior to recent economic reforms, China's centrally planned and at least three-tier distribution system was the only way to distribute products in China.⁴⁵⁶ After 1978, this system started to change from a socialist mode to a free market mode.⁴⁵⁷ Along the way, distribution in China has been fraught with difficulties, such as limited infrastructure and legal issues. Both local and foreign companies have often been forced by these circumstances to use highly creative methods to bypass regulations and distribute their products.⁴⁵⁸

In the past, the only option available for entering the closed mainland market was via a Hong Kong representative who in the worst case smuggled the merchandise into China or used at least semi-formal ways to do so. This middleman was playing the game, and a fashion brand had no control at all over his activities.

⁴⁵¹ See Interview Kühne & Nagel (2007), p. 13.

⁴⁵² See Interview Kerry EAS (2007), p. 15.

⁴⁵³ See Interview Kühne & Nagel (2007), p. 10.

⁴⁵⁴ See e.g. Interview DHL (2007), p. 11 and Interview Trans-Access Solution (2007), p. 4.

⁴⁵⁵ See Interview Polymax (2007), p. 13.

⁴⁵⁶ See Jiang/Prater (2002), pp. 783-784.

⁴⁵⁷ For different phases that can be distinguished, see Luk (1998), pp. 45-48.

⁴⁵⁸ See Powers (2001), p. 8.

5 Apparel Distribution in China

⁴⁵⁹ However, demand was high, and both distributor and the brand principal enjoyed huge profit margins.⁴⁶⁰ Aside from this doubtful procedure, companies could rely on China's traditional distribution channel, which actually still exists today (see figure 22). Despite its big potential to reach customers far beyond the tier-one cities, companies were and are discouraged by the difficulties of controlling the distribution of their products in this channel.⁴⁶¹ Companies that are still using this channel have at least started to select key accounts that are supplied directly to gain more visibility and increase customer service.⁴⁶²

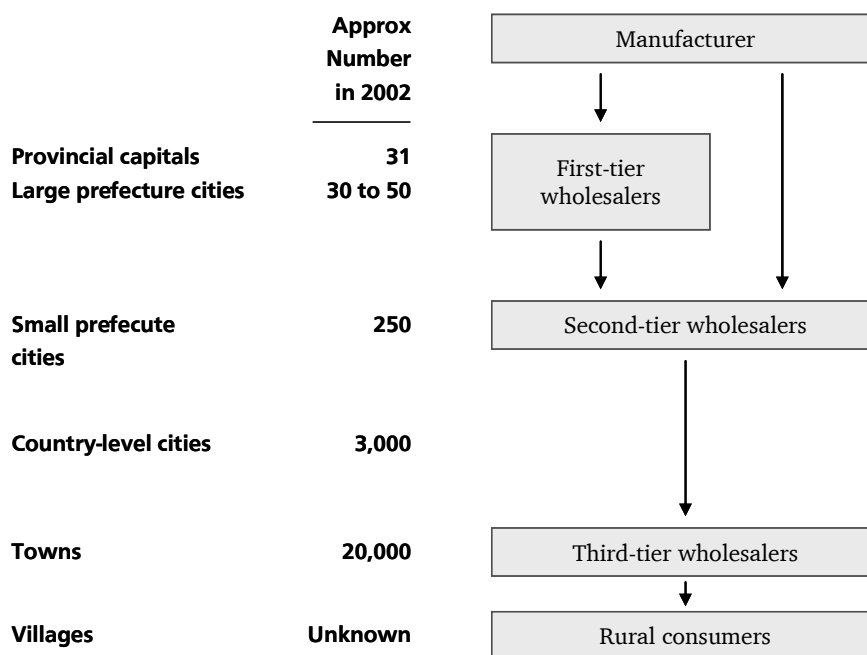


Figure 22: China's traditional wholesale structure

(Source: based on BCG (2004), p. 6)

Today, besides franchisees, there are an increasing number of experienced mainland distributors or commission agents who can effectively act as a company's partner without adding another management layer and additional costs in Hong Kong. A distributor model is still common for very niche-oriented products and is thus used by a couple of high-end fashion companies.⁴⁶³ However, for targeting mass consumer markets, companies might have to contract more than one distributor or agent to cover the entire Chinese market and the differentiation to a franchise model becomes blurry.⁴⁶⁴

5.2 Main actors and their focuses

In Shanghai area, high-street brands like H&M and Zara, both of which recently entered the Chinese market, are simply trying to implement the business model they are already using in Europe. A lot of other, less vertically integrated apparel companies are working together with franchisees and might only operate a few

⁴⁵⁹ See e.g. Interview Kerry EAS (2007), p. 8 and Interview Bansard (2007), p. 3.

⁴⁶⁰ See Chang/Phi (2007), p. 370.

⁴⁶¹ See BCG (2004), p. 6.

⁴⁶² See Mann (2001), p. 27.

⁴⁶³ See Bluebell (2007), p. 2. Additionally, foreign companies that want to "keep clean hands" often view distributors as "useful channels of corruption". See Pedersen (2006), p. 35.

⁴⁶⁴ To reach 80 % of China's population Coca-Cola actually needs a whole web of distributors. See Weisert (2001), pp. 54-55. For an apparel-specific distribution channel with several tiers see Zhang/Dickson/Lennon (2002), p. 173.

5 Apparel Distribution in China

flagship stores in big cities themselves.⁴⁶⁵ Most companies now are avoiding a distribution model that includes several parties. Instead large regional franchisees and huge retail outlets are supplied directly, which cuts distribution costs and potentially raises the company's market responsiveness.⁴⁶⁶ A lot of fashion brands are working together with 3PLs that have a city warehouse or a warehouse around the city. These 3PLs are probably delivering once or twice a week to stores within the region. Stores within the city centre are usually supplied more often, whereas products might be shipped to regional franchisees only once or twice a month or season. A lot of brands are also relying on their distributor or trading company to do the logistics, especially if the products are imported and of higher value.⁴⁶⁷ In that case the entire logistics is often handled by their partner in China.⁴⁶⁸ However, the franchise model seems to be most common for apparel brands targeting mass consumer markets.⁴⁶⁹ Thus, this chapter will focus on the activities of an apparel company, its franchisees and logistics service providers within an apparel distribution system.

5.2.1 The Apparel Company as Seller

Besides focusing on expansion in China and opening new stores at the right locations, most apparel companies are greatly involved in planning the distribution network for their products. In particular, the planning of material requirements is a classical domain of any apparel company.⁴⁷⁰ Procurement and inventory management are normally their spheres of competence. Within the framework of a Continuous Merchandising concept, they have to ensure a steady supply of new products from local suppliers in China or from overseas suppliers e.g. in Turkey. In both cases, adequate vendor management and scheduling of shipments is crucial to avoid running out of inventory or ending up with unsold goods at the end of the season because these products arrived too late in the stores.⁴⁷¹ While quality is always an issue,⁴⁷² subcontracted apparel manufacturers often regard timing as less important as well.⁴⁷³ An apparel company "can go from black to red just because of delays",⁴⁷⁴ but in China it is very difficult to apply penalties. Manufacturers will not understand why they are punished if a delay is the result of their supplier of fabrics being late in delivering the raw materials to them.

That is why apparel companies have to monitor the whole production process. Companies usually require their subcontractors to buy fabrics and accessories only from designated fabric mills and accessories manufacturers, to make sure that an appropriate quality level is reached. Additionally, apparel companies normally send inspectors to the factories to check the production process and whether agreed delivery dates will be met.⁴⁷⁵

Since apparel companies do not manufacture their products themselves any more, they usually attach importance to placing at least one intermediary between their supplier and their retail customer,⁴⁷⁶ which can

⁴⁶⁵ Expenses for distribution logistics depend a lot on the type of customers to which a company sells. E.g. selling and delivering products to individual multi-branded stores or international retail chains would be incomparably more difficult. See Interview Logisfashion (2007), p. 9.

⁴⁶⁶ See Bolton/Liu (2006), p. 16.

⁴⁶⁷ See Interview Bluebell (2007), p. 1 and p. 3.

⁴⁶⁸ See Interview CSCC (2007), p. 4.

⁴⁶⁹ See Michael (2007), p. 8 and Galvin/Waters (2003), p. 406. See also Interview Polymax (2007), p. 8.

⁴⁷⁰ See Interview Kühne & Nagel (2007), p. 4.

⁴⁷¹ See Ashford (1997), p. 68.

⁴⁷² See Hellmann (2007), pp. 8-9.

⁴⁷³ This seems to be the reason why promotions within the industry which would require certain products to be in the stores at a specific date are not common in China. See Interview Hellmann (2007), p. 6.

⁴⁷⁴ Interview Luke (2007), p. 4.

⁴⁷⁵ See Interview Luke (2007), p. 5. Some LSPs provide order management systems to support, monitor and record these activities. See Interview Kühne & Nagel (2007), p. 3.

⁴⁷⁶ See Interview Logisfashion (2007), pp. 9-10.

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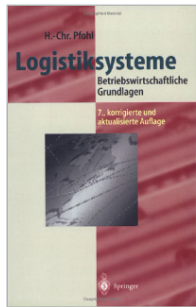
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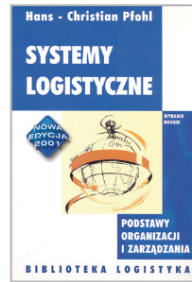
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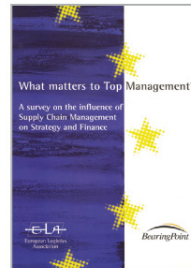
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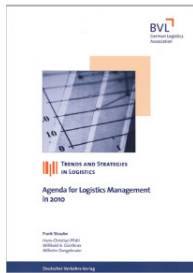
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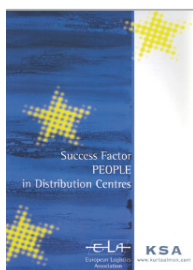
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