



**INSTITUT FRANÇAIS DE LA MODE**

**Study on the competitiveness, economic situation and location of production  
in the textiles and clothing, footwear, leather and furniture industries**

**Final report**  
(volume 1)

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33, rue Jean Goujon 75008 Paris, France T. 33 (0)1 56 59 22 22 F. 33 (0)1 56 59 22 00 E. ifm@ifm-paris.com, www.ifm-paris.com

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The present report has been conducted by **Institut Français de la Mode**, under the direction and coordination of **Danièle Clutier**, and in collaboration with :

**Saxion Universities**

Ariensplein 3, P.O. Box 70 000 7500 KB Enschede The Netherlands

**Michiel Scheffer**

**Maia Sprl – Market Access Information and Analysis**

Rue Berkendael 132 1050 – Bruxelles - Belgique

**Katelyne Ghémar**

**Aidima,**

C/Benjamin Franklin, 13.46950 Paterna, Centro Tecnológico Valencia, Espagne

**Maria José Llaudes**

**Inescop**

Elda Espagne

Poligono Industrial Campo Alto 0 3600 P.O. Box 253

**Enrique Montiel**

*The consultant takes full responsibility for the views and the opinion expressed in this report.  
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and by whom it was financed.*

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## METHODOLOGICAL INTRODUCTION

The present report has been achieved by Institut Français de la Mode in collaboration with consultants from four different organisations :

- Saxion Universities in Enschede in the Netherlands, with Dr Michiel SCHEFFER,
- Maia Sprl – Market Access Information and Analysis, in Brussels, with Katelyne GHEMAR and Tsonka IOTSOVA
- Aidima, in Valence (Spain), with Maria José LLAUDES and Javier IBORRA
- Inescop, in Alicante,( Spain), with Enrique MONTIEL.

Work coordination has been achieved by Danièle CLUTIER (IFM).

This assignment has been carried out between January 2006 and March 2007.

The overall methodology has been organised in different steps.

- statistical research, conducted by Nathalie GENNERAT (IFM), and based on data published by :
  - o Eurostat, Bureau van Dijk (Amadeus and Chelem databases), Global Trade, UN Comtrade, IMF and OECD,
  - o in addition with panel data from Mintel (UK) and ISL (France),
  - o industry trade databases
  - o many other specific sources mentioned in the pages of the report.
- desk research involving analyses produced by a number of specialised authors regarding industrial competitiveness, market and production localisation issues
- 31 in-depth face to face interviews with companies manufacturing in the five industries under review, throughout the Euromediterranean area, representing actual case studies of the sectors under examination
- 35 telephone interviews with experts, brands and retailers regarding sourcing practices and retail value chains
- 12 interviews with organisation representatives for industry, workers, European and national authorities.

An e mailing survey has been made in June 2006, with 1050 questionnaires launched to firms from the five industries, sometimes with the very active help of trade representatives for selecting interviewees (Euratex and Cotance in particular). Despite a reminder few weeks later, the overall result was quite disappointing as less than 20 responses were received and could be analysed.

## **EXECUTIVE SUMMARY**

### ***I ECONOMIC ENVIRONMENT***

*In the context of growing globalisation, with world exports having doubled over the last decade, EU's economic trends have not been particularly favourable to its industrial sectors.*

*Between 1995 and 2005, there was a fairly smooth development to GDP in the EU 25, even though divergence in GDP growth within the EU remains wide as in general the new Member States post faster real GDP growth rates than old Members. However in economic terms and in market potential, the weight of the enlarged EU has only increased by a few percentage points. European growth is supported by a positive international background of world growth particularly helped by the strength of the US and Chinese economies.*

*Business environment in the EU has been supported by a low and stable inflation rate between 2002 and 2005 even though the aggregated figure hides still very high discrepancies, particularly between old and new Members. The present favourable trend for job creations has been driven by a sustained expansion in the service sector. The EU has become a service-led economy, with industry now representing one fifth of the total value added in 2005, despite a relatively higher share in the new Member States.*

*The deterioration of the dollar/euro rate over the decade has been favourable to imports but not to exports. However the general trend has been quite positive and EU's export performance has been roughly comparable to the US one, though lagging far behind China.*

### ***II EVOLUTION OF STRUCTURES IN THE SECTOR***

*The five industries being examined display heterogeneous industrial structures. This can be seen when analysing the average production value per firm and the number of firms in each sector. This is partly due to technological discrepancies, as for example between the highly capital intensive textile sector and the highly labour intensive apparel industry. Between those extremes the furniture sector appears quite fragmented, a little less than apparel and a little more than the leather and footwear sectors.*

*However, the evolution has been somewhat similar throughout these industries in Western Europe. One can observe a concentration process in production which has brought firms in older Member States to reach turnovers and production values in general more than twice as large as firms located in the Eastern new ones. However, the concentration of the sectors remains very low in comparison with the EU 25 manufacturing sector. The most fragmented sector is apparel followed by furniture. On the opposite the textile sector appears significantly more concentrated, even though it remains below the average manufacturing standard.*

*Over the last decade, the overall trend concerning value added which can be observed is a decline affecting most of the sectors under review. The most negative development concerns apparel and footwear which have lost almost half of their value added between 1995 and*

2005. *Leather and textiles have also strongly decreased, whereas furniture displays a net growth over the period. The bad performances can be partly attributed to the rise of the Euro/Dollar rate and consequent deterioration of EU 25 textile position in export markets, but also to China's accession to WTO which has enabled Chinese exporters to benefit from the initial steps of quota liberalization in 2001(textiles and clothing) and 2005 (textile/clothing/footwear). The leather industry (excluding footwear) follows a much less negative trend, whereas furniture displays a net growth over the period.*

*Over the last five years, companies have tried to compensate for production losses by developing their sourcing of finished goods. In the cases of textiles and leather, the increases are quite impressive. It allows companies to offer a broader range of products and reach a critical level of exposure in the wholesale or retail market.*

*A thorough restructuring is taking place in the five industries. While many companies disappear, the others do attempt at concentrating their activities, with a dual purpose: improving market positions and getting global. Concentration allows better market control, as well as cheaper outsourcing of components to remote competitive specialised suppliers. In the new Member States firms often lack the required financial resources to carry this concentration process. Regional concentration does sometimes compensate for the lack of structural consolidation: in Italy such cooperation is an integral part of companies' culture.*

*With 4.1 million workers within the EU employment in the five industries under review now represents less than 12% of total manufacturing. With almost one million employees, Italy is by far the largest employer in the EU, as it hosts one fourth of the total EU labour force. Among the new entrants Romania is a very important employer, with the equivalent of 13% of the total EU employment - largely because of its being an extremely large apparel employer. For the industries considered, the overall trend in the 2000-2003 period has been a significant decrease of nearly 12% while employment in total manufacturing was registering a decrease of "only" 4%.*

### **III. TRADE ISSUES**

*The extra-EU trade of the EU concerning the five sectors considered remains quite important, as it represents 16% of all EU exports and 22% of imports. However the EU trade deficit is gradually increasing, which is essentially due to the apparel sector. Among the five sectors, only furniture has a positive trade balance. Not surprisingly, the trade balance is strongly negative for the apparel industry as imports from Asia have sharply increased the deficit over the last decade.*

*In comparison with stagnating home markets, export markets present a much more promising outlook for developing sales. Over the last decade European extra-EU exports have increased by almost one half. However between 2000 and 2005, the extra-EU trade has more or less stagnated in current euros. Italy is, by far, the first European exporter for these five sectors particularly in leather and footwear.*

*All companies interviewed during case studies are interested in exporting and many do export a very high proportion of their products. Primary existing or potential export markets are the*

*USA, Asia, and Russia. On many markets export opportunities suffer from significant trade barriers.*

*In general one can observe that EU's customer base has been changing over the years, as the USA and Japan have significantly diminished their orders between 2000 and 2004. The EU industries were able to compensate for the loss by developing other final markets but above all by developing the sales to delocalisation markets even though they are not consumption markets per se. Even though between 2000 and 2004 the total exports of the five sectors to Euromed countries have only increased by 16%, the Euromed zone represents a key trade partner with one fourth in the European exports of textiles, apparel, furniture, leather and footwear. This share is particularly high in textiles because of the importance of apparel subcontracting in the Euromed.*

*As far as imports are concerned, the share of the five sectors reaches 8.8 % of the total extra-EU imports in 2005. Textiles and apparel represent three quarters of the whole. Germany is the main European importer – except for leather products (Italy ranks first). The five major European markets are the major importers, with aggregated shares averaging two thirds of the whole. Over the last decade imports have considerably grown particularly before 2000. Imports from the Euromed have significantly grown over the period. They have been multiplied by 2.3 in 10 years, despite a significant slowdown since 2000. Turkey ranks first among Euromed exporters to the EU, with an overall 37% share for the five sectors in 2004, followed by Romania, Tunisia, Morocco and Bulgaria.*

*In the textile sector, Turkey accounts for almost two thirds of Euromed exports to the EU and, as such, remains by far the first European barrier to the imports from the Far East. The top textile position of Turkey can be largely attributed to the competitiveness of its integrated cotton chain, including lightweight cotton knitwear and knitted fabrics and ecological organic products.*

*In the apparel sector the Chinese pre-eminence is quite remarkable, but the Euromed position remains extremely important (43%) in 2004 mostly thanks to Turkey and Romania. Imports from the Euromed zone in leather products are not really important, less than 10% of a relatively small import market. China holds one third of extra-UE imports of the sector. The situation is less positive in the footwear sector, where Euromed's suppliers have a hard time in resisting to the price pressures coming from Chinese and Vietnamese exporters.*

*In the furniture sector, imports are much less important than in the other sectors considered. This is largely attributable to the physical weight of the products, and to the existence of regional markets, held by local retailers. Here imports from the Euromed zone in 2005 represent one fourth of extra-EU imports, among which Romania, with its long historic tradition of wood furniture holds the half of it.*

#### **IV ANALYSIS OF FACTORS OF COMPETITIVENESS**

*When comparing the levels of value added per employee in the various sectors under analysis, the textile, leather and furniture industries appear more productive than do apparel and footwear. However all remain significantly below the average productivity level of the manufacturing industry as a whole. Throughout the five industries a European segmentation appears between one high value added part in the North-West of the EU, particularly Germany, Scandinavia, Belgium, the Netherlands, the UK, a middle region in transition*

*around the EU average, with Italy, Spain, Portugal), an Eastern area (most new Member States), where value added only is one tenth of the amount of North Western countries, and a very low added-value region with the last two entrants : some countries remain specialised in the assembly steps of the production process whereas others are involved in value generating phases like design, retail, branding and material sourcing, to the extent of actually divesting from manufacturing itself.*

*Although each manufacturing industry records specific average productivity levels, the ranking of countries with regard to this variable seems globally approximately the same between sectors. Least productive countries are always 20 or 25 times less productive than the most productive ones.*

*Since 1999 labour productivity in the five industries under review has remained quite stagnant and increasingly low in comparison with the standards of the manufacturing industry as a whole, which follow a regularly increasing trend. This stability, in a context of deteriorating trends regarding total value added, gives evidence that the continuous laying-offs only allow to maintain former levels of productivity.*

*In respect with wages, qualifications and personnel costs, wide discrepancies do appear between sectors as well as within the EU. Textiles and furniture score highest with yearly costs that are 30% above those observed in footwear and apparel. This is largely due to their technological levels and to their location on the largest and most expensive markets, i.e. the most expensive production countries. As far as apparel and footwear are concerned, personnel costs are conversely quite low due to factors like a lower technological content, a location in lower cost countries and an important proportion of non-industrial and unskilled positions due to integrated retail networks. The ratio between the highest and the lowest cost countries averages 20 to 1 in the textile and furniture sectors. It is closer to 30 to 1 in the footwear, leather and apparel sectors.*

*Labour costs have not significantly risen at the level of EU 25 since 2000, particularly in the furniture industry. This is partly due to the fact that there is no single trend affecting Europe in terms of production model: taylorist models of production with a further segmentation of work to fairly low-skilled workers coexist with post-taylorist models implying delayering, multi-skilling and empowerment at the shop floor.*

*As the number of workers, of firms, of education and research centres is growing thinner, it is becoming increasingly difficult to hire specialised labour and most companies do organise training themselves. In general the companies reviewed constantly invest in the training of entrants and in personnel upskilling to enhance flexibility, early problem detection, quality, and client orientation.*

*Another very important driver of competitiveness is investment and in this respect the European situation appears preoccupying. However it is necessary to distinguish between investments in tangible and in intangible assets.*

*As far as intangibles are concerned, the level of firms' investments (i.e. immaterial investments in marketing, R&D, patents, stores etc.) in older Member States (which are also by far the largest producers in the five sectors considered), is much higher than in the new Member States that concentrate more on production activities. Firms' share of intangible assets is especially high for countries like France, the UK, Spain, and Italy; this is less the case for Belgium, Sweden and Portugal.*

However whatever the country the trend is towards a reduction in the proportion of tangible (building, machinery etc) assets over turnover.

As far as tangible assets are considered, in Europe, the only significant Mediterranean textile investor is Turkey, which benefits from its integrated cotton chain to develop a wide-spanning textile strategy. EU's investments since 2000 have been concentrated in Italy and to a lesser extent in Greece, Spain and Germany.

Investment rates in tangible assets for the apparel industry show a significant divesting trend, while the ratio of intangible assets on tangible assets demonstrates that the apparel sector is largely becoming a tertiary industry. Similarly in the leather industry the share of intangible assets has become fairly high, particularly in Italy and France.

In the furniture industry, investment data for tangible assets are contrasted throughout Europe, but asset structure reflects a consistently low level of immaterial integration in firms' activities with little discrepancies between the Western and Eastern parts of Europe.

Throughout Europe, firms are striving at modernising and at innovating. In the textile and apparel industries it has been one primary driving force of the EU to prepare for the dismantling of quotas. In all industries, the process has largely taken place in non-technological areas. In production it involves a combination of proven technologies and incremental innovation like in shoe adhesives and in components, or in the generalisation of CAD/CAM techniques – to optimize issues of production but above all product development- , much more often than breakthrough innovations like digital printing, nano technologies, 3 D techniques or 3 D body-scanning. The furniture industry is the one where automation has most increased, in combination with flexibility.

In most industrial sectors, under review leading firms have made investments in non-EU Euromed countries with modern infrastructure and efficient logistics to reduce lead times and compete on fast response small orders. Mounting environmental concerns and norms foster innovation processes mainly geared at process improvement, process redesign, process integration and sustainable product development. In the fashion and furniture sectors a number of companies even base their production on the ecological marketing and development of products with high environmental strengths.

However all environmental standards and health and safety requirements constitute a significant organisational burden and a sheer cost for smaller firms, often located in older premises. All firms fear that new norms and regulations might form additional incentives for delocalisation.

Competitive companies in all the sectors under review have strongly invested to enhance their design capabilities, to develop several collections per year, with the exception of the furniture industry, to build their own brands, and to heighten their service level. A number of them have actually made very large investments to develop their own retail networks in order to come closer to consumers' expectations and tastes and increase their market response competencies as key elements of their international strategies.

## **V. FINANCIAL STRENGTH OF THE FIVE SECTORS**

The average profitability of the European firms from the five sectors being examined is quite low in comparison with an industrial minimum standard commonly estimated at 6% approximately before tax. It is - on average - higher in the furniture industry (1.34% of turnover), and in leather (excluding footwear) (1.26%). Textile profitability is only 0.53%, apparel 0.18%. In the footwear sector, companies on average generate losses (-0.15%).

*Profit margin is directly linked to company size: the strongest impact concerns the apparel industry where the average profit made by firms in the EU is 0.2% while it reaches 5.1% for the 500 largest firms. In textile and furniture size impact multiplies the average profit by a factor of 3, in leather by a factor of 2. In footwear, the impact is even more significant as large companies do not incur losses but some profit.*

*Among the five sectors considered, the mediocre figure for textile can be directly related to the ongoing overcapacity of the sector in Europe. On the opposite higher profits in the apparel sector are mostly due to the fact that many large companies have delocalised their production, divesting from manufacturing, and investing in retailing or branding, which enables them to command higher selling prices and generate larger profits. In textiles and apparel results are generally worrying for apparel oriented countries whereas technical textile regions like Germany and Scandinavia do fare much better.*

*Over the 2000-2004 period, firms in the textile, leather, footwear and furniture industries have recorded drops in profitability. This is especially true for the textile industry. In the apparel industry, profitability has slightly risen. The general pattern in Europe for the five industries concerned is that large producing countries (mostly old Member States) have seen their profits sink, as their home markets were increasingly attacked by global competition. This has urged them to (further) outsource components and labour-intensive operations to lower cost countries. This has benefited manufacturers in the new Member States and consequently improved their profitability. Over the last decade, profitability has been hit by different factors : the existing overcapacity in some sectors (apparel, carpets, spinning); a downward pressure on market prices concerning activities which are closest to the commodity market segments, mostly affected by low cost competition; investments needed to satisfy strict environmental rules at national and at European level; overstretched balance sheets with high exposure to debtors and longer delays of payments to name some of the major causes.*

*The analysis of cash flows largely corroborates the one of profits. Levels are consistently low and decreasing, particularly in the old Member States where production is fragmented. The situation of the furniture sector is less preoccupying as the industry is somewhat protected from remote competition by factors like transportation costs and regional tastes.*

*Successful companies are now handling their activities as portfolios of strategic business activities. Competitive firms are profitable because they succeed in combining cost consciousness with a focus on added value. Timely delocalisation enables them to allocate production bulk in Euromed while keeping high tech niches in their country of origin or in close by areas. Quite regrettably the present transformation of the industries studied occurs in a context of low or negative profitability, stable or declining turnover and a weakened solvency. Thus modernisation is likely to force a restructuring of activities including a disengagement of non profitable activities or clients and a restructuring of assets. A high solvency combined with a conservative dividend policy appears as a prerequisite for restructuring and redeployment, as even step by step changes often require a strong financial position from the onset and a long term commitment of the shareholders.*

## **VI. MARKET DEVELOPMENTS AND CHANGES IN BUSINESS ENVIRONMENT**

*For the five sectors under review household consumption with 240 billion euros in wholesale value still represents the largest part (two thirds) of their home markets, while industrial and collective uses represent less than 20% each. The clothing market represents more than half of the whole, followed by furniture which accounts for one fourth of the total. Footwear is the third largest segment, followed by household textiles.*

*Germany is the largest market in the sectors being taken into consideration, with the exception of footwear for which Italy is the largest one. Most geographic markets are deteriorating, especially the largest. Actual growth mostly comes from new Member States, but they only represent 4% or less of the total. As a result the overall increase in consumer markets of the sectors under consideration is less important than the all-items consumer market increase which indicates a relative decrease of consumers' involvement in the four segments considered.*

*The situation is the most negative in the apparel sector where prices have been declining. In the footwear sector, consumers' involvement seems to be fairly stable, the result of an increasing desire for comfort, which fosters the sales of casual shoes, and an increasing desire for brands and fashion. As can be observed in the apparel market, consumption in furniture, furnishings and carpets here is driven by high expenses by consumers in the largest economies like Italy, Germany and the UK. Unfortunately expense rates are declining which results in a decrease in market sizes. Between 2000 and 2004, price rises on the segments under examination have clearly been below the all-items index level, with a moderate increase for household textiles, footwear and furniture, furnishings, carpets, and a net decrease for clothing.*

*For clothing and footwear products, the most important price drops could be observed in Member States with a distribution system dominated (or in the process of being dominated) by large retail chains. In the furniture, furnishing and carpets market, only a few countries registered a decline in consumer prices between 2000 and 2005 and it was more than compensated for by significant increases in consumer prices in the others.*

*Changes in consumption patterns and in retail prices largely are a consequence of the growing concentration of the retail systems in Europe. On all segments under review the Northern Member States like France, the UK, the Netherlands, Belgium, Germany display much more concentrated retail systems than in the South (Italy, and Greece and to a lesser extent Spain and Portugal), but the arrival of mass market chains is rapidly changing this situation there to the detriment of smaller independent retailers. The concentration rate of the distribution has grown above 50% in the EU for the five sectors concerned.*

*Overall the perception of the industries is one of stagnating demand and increasing price pressure on all volume markets whereas in niche segments, be they technical or not, at the international level, volumes are rather considered to be on the increase as companies can increasingly catch global market shares.*

*Companies are also striving at capitalizing upon a number of market trends that foster their intrinsic competitiveness: a growth in fast fashion (rather low price) demand, the increasing demand for more environmentally and/or socially friendly products and the growing need for customised, comfortable products with specific design, tailored to the customer request.*

*However the depressed situation of most consumer markets in Europe urges companies to attempt at expanding a B to B clientele according to their field of activity. This sector is important in size (30-35% of home markets in value) - and increasingly so - and not as fiercely price competitive as consumer markets, because the level of expected service and excellence is extremely high, but it is hugely fragmented. Products are extremely wide-spanning, from hi-tech, very costly niche items to the vast area of products for service industries.*

*Sourcing practices obviously are influenced by those changing retail and consumption patterns. They have also been very directly affected by the liberalization processes that were achieved in the textile, apparel and footwear sectors. Since 1995 in the apparel market a gradual (four steps) dismantling of existing quotas has been implemented. In 2001, – when China got the benefit of earlier liberalization steps – and in 2005 – when final total dismantling was effected – there were import surges from China into EU apparel markets with huge import price drops, even though total imports actually did not increase much. The impact was however very detrimental to Euromed non-EU suppliers as well as to EU manufacturers, as production went down significantly faster than per earlier trends.*

*In the footwear sector, liberalization took place at the same time as for textile and clothing (1<sup>st</sup> January, 2005). Quotas had only restricted trade from China and were all lifted. Very similarly to what happened in apparel, liberalization resulted in a strong rise of Chinese imports and pulled import prices down, and hit EU and Euromed manufacturers' production. The re-installation of quotas against Chinese imports in 2005 has provoked a significant rise of the prices of China's exports to the EU. This is largely due to the fact that the quota system directly affects prices – costly quota management, speculation, etc. – and that it consequently urges firms to upgrade the level of their production, to maintain their sales level despite lower volume.*

*All in all, for European firms, the world has actually become a global sourcing market for materials, components, intermediates, subcontracting and final products, driven by considerations of availability of materials, prices, relative volumes, and lead times. The combination of these factors incites some of the companies interviewed to keep their sourcing within the Euromed zone. However for fibres (polyester, silk, cotton), commodity yarns, grey fabrics, tropical wood and intermediates, plastic components, Asia and especially China, India, Pakistan and Indonesia are mentioned as the main and almost unavoidable sources of supply.*

*In the apparel sector sourcing from Romania, Tunisia, Morocco, Turkey is used by EU companies as it allows offering quick response to customers demand for producers and retailers as well. In particular, sourcings in Turkey are very important for the EU textiles apparel leather, footwear and furniture industries as Turkey remains an important supplier of fabrics and nonwovens, leather, etc. and is also a place for investment for European companies willing to produce quality products at good price.*

*In the furniture sector destinations are also linked to raw material supplies: Poland, the Czech Republic and Romania for wood pieces, Hungary and increasingly Turkey for leather items, all countries where labour costs also allow significant gains in production costs even though the fragmentation of the EU industry and retail slows down the delocalisation process.*

*Looking at these phenomena, one should remember that the dynamics behind delocalisation - increasing real labour and energy costs, pressure on prices, limitations to upgrading, innovation and value chain control as well as specific constraints in terms of environment and material sourcing - have not changed, and that a further partial delocalisation of all industries studied is to be expected, be it through trading, subcontracting or investing abroad.*

*However the ability to delocalise depends on the financial means available to the principal and his ability to redeploy assets. The weakening of the financial position of many firms limits the ability to cover restructuring costs and many firms simply do not have the financial strength to finance large scale delocalisation. Quite regrettably many companies of the sectors under review have too long postponed a controlled delocalisation and are no longer in a position to control their fate. Overall, delocalisation appears as a favourable trend in the framework of an enlarged Union as on the balance job losses in old Member States are compensated for by job creations in new Member States. The EU ongoing enlargement fosters delocalisation processes instead of trading developments. This is a positive phenomenon as trading directly results in net erosion of production, employment and control in the value chain.*

## **VII. STRATEGIC ANALYSIS**

*Over the last decade industrial companies have experienced harder market conditions which have driven many of them out of business. However this has also brought about a tremendous change in vision which increasingly constitutes, for many European firms in the five industries under review, a strong competitive advantage based on market oriented and consumer oriented attitudes and less confrontational relationships in the value-chains. It also repositions team spirit and motivation also as significant success factors that can be seen at work in competitive and successful companies. Openness and ability to change are also demonstrated within many successful firms surveyed in this research and one can consider that today's competitiveness is this very capacity of companies to adapt themselves to the challenges they meet, with constant innovation and search for excellence.*

*The analysis of the strategies implemented by the successful companies selected in the five sectors enables to draw the following typology.*

### **o Brand and design strategies**

*Firms involved in these strategies draw their competitiveness from a very strong and very powerfully marketed brand identity, positioned in the high or medium-high price brackets. They may be found in any of the five sectors being examined. Retailing is a key aspect of their strategies and most are actually involved in store management for these companies delocalisation is primarily urged by the need to increase margins, as marketing and retailing costs are huge and constantly on the rise due to global competition. It is slowed down by a dedication to keep historic employment, to maintain their technical know how and to avoid the risks of having their raw materials or finished items misused or counterfeited. Very often delocalisation is not an economic option as production volumes are too small or too fragmented.*

- **Partner strategies**

*Companies which follow these strategies position themselves as the industrial partners of their clients. Generally these clients are industrial or semi-industrial brands. Products sold are components or finished products which will be offered to the consumer under the clients' labels. Quite often manufacturers are highly specialised and vertically integrated in order to provide their customers with an utmost quality, quality control and overall reliability. For these companies the trend to delocalisation is caused by a constant downward pressure from their clients, but also by possible shortages in local capacity. It is primarily slowed down by the necessity to remain reactive and close to their clients, to keep in touch with market trends and by production volumes which may not be large enough to ensure that delocalisation will really bring lower overall costs.*

- **Industry-retail strategies**

*Firms involved in this strategic pattern display a fully balanced mix of activities including retailing and manufacturing. In terms of price segment their products are generally positioned on the consumer market at medium prices with brands well known to the final consumers. Such companies often come from a tradition of industrial production and have gradually integrated retailing in order to offset a growing deficit in existing retail capacity. Companies following these strategies have generally largely begun their delocalisation. Incentives to develop delocalisation practices are to be found in the need for still higher margins (to develop retail networks), in growing volumes, in a lack of local capacity, and in product range extensions. Necessity to remain as reactive and as market sensitive constitutes efficient deterrents, as well as the issue of limited production volumes.*

- **Subcontracting strategies**

*Here, key success factors are cost control, quick response and co-development. Firms have neither brand nor retail outlets; they work on a B to B basis with customers who have their own brands and stores. Flexibility is a fundamental principle of their business model and it is clearly and carefully organised within the firms. It relies – above all – on a client-oriented business philosophy which pervades the whole company.*

*In the case of these extremely labour-intensive strategies, a direct need to lower costs accounts for most production delocalisation, under the pressures of clients. It is also due to an increasing local shortage in labour and capacity, and in some areas, in an increase of the regulatory burden.*

- **Technological leadership strategies**

*Those B to B strategies are only within the reach of large firms, first of all because of the capital investment required, which can be estimated at several tens of million Euros, whatever the specific activity. Such strategies can primarily be found at work in the textile sector. They are both extremely industrial and extremely market oriented. Delocalisation is generally driven by global market pressures on prices, expected local increases in regulatory burdens, and present or expected growth in foreign markets for which local production is an economic and marketing advantage. It is evidently slowed down by existing satisfactory profit*

levels, a constant upgrading of existing markets and by considerations of uneconomical transportation (furniture and panels).

○ **Traditional continuation strategies**

*A large number of firms in the EU do not follow any of the dynamic forward looking strategies mentioned above. In this group one can find firms with a medium or small production serving a captive market, mostly regional or even local, sheltered from globalisation by its size, and requiring a high and constant level of personal implication by the owner into the local circles. For many reasons they display a reluctance to change which prevent them from implementing any aggressive strategy, or even consider delocalisation..*

***Delocalisation could become an option in case of management shift, or deterioration of existing profit levels, but the most probable situation is a mere continuation until the company disappears, sooner or later.***

*Looking at the future, one can forecast some significant changes in today's present competitive situation for the five industrial sectors concerned.*

*The most important phenomenon is the geographical relocation of markets with the essential part of market growth to be located in now emerging economies which means that export skills and competencies are going to be increasingly necessary for EU industries. Concerning China, developments on the inner market and rises in industrial wages are likely to alleviate global competitive pressures even though other competitors do take over China's market shares. The third major change concerns retailers and brands' sourcing trends : they should have a favourable impact for European industries : need for more reactivity, better traceability, higher differentiation, and better environment care.*

*According to these expected changes and to the intrinsic strategic patterns and development models, the present production map is likely to change over the next decade.*

*One should see an overall decrease of production volumes, in the EU high cost areas except (somewhat marginally) for the industrial retailers who tend to maintain production within factories or suppliers with high quality / small quantities / reactive lead times, i.e. quite close to their markets. One should see some growth in production volumes in the medium costs EU countries, resulting from the increase of volumes generated by firms delocalising production from high to lower cost areas in the EU and from the stability of existing locations of production. In both areas, turnovers for the value chains should follow similarly positive trends.*

*In the Euromed non-EU countries there should be a significant increase due to firms implementing all strategies except the industrial retailers whose productions are already largely localised in these areas. The largest development should be seen in the areas of subcontractors. In terms of turnover, the increase for the value chains concerned should also be quite significant. Turkey should be the area with the single largest production growth, due to developments for all strategies at work, primarily brand and design strategies and subcontracting strategies. For the five industries concerned the country should strongly benefit from its long term industrial commitment, integrated value chains with a good access to financing, low-medium cost structures and ease of communication with high income*

*markets. Turnovers of those value chains should also considerably grow, in parallel with the development of the retail sectors.*

*Delocalisation has to be seen as a dual strategic reality, as there is one positive competitive delocalisation which helps the firm lower production costs and/or logistics in order to make necessary investments in marketing, retailing, research etc. i.e. all activities which foster its long term sustainability, competitiveness, profitability and capacity for employment. It corresponds to an increase in the value added generated by the firm and the whole value chain concerned. Conversely there is also a negative passive delocalisation which merely helps lower production costs in order to restore part of former profitability, but does not set the company in a better shape to face the future, representing an impoverishment of both the firm and the European value chain. The EU enlargement process provides an effective support to the development of this positive delocalisation through a better work distribution in the area which reinforces EU's competitiveness, as it facilitates logistics, reduces the risk involved and thus makes it accessible to more numerous and smaller sized players, who might instead have turned towards pure trading low risk practices.*

## **VIII RECOMMENDATIONS : EUROPEAN INTEGRATION**

*In order to enhance the overall competitiveness of the larger Europe and to maximise the value added generated by EU's firms in the sectors under review, whatever the place where production is conducted, delocalisation within the larger European region including Mediterranean neighbours, is to be seen as a key competitive factor for the future of the industries under review. In this perspective, a number of recommendations have to be made corresponding to the following priority objectives:*

### **1. Upgrade knowledge and skills within the industry in the area**

*This issue is of major importance for all companies in the area. It supposes to improve knowledge dissemination processes throughout the whole Euromediterranean area, but also to generate consolidated visions and action programmes, and to foster industrial networks. It also demands that industrial excellence be promoted throughout the area, as well as venture funding, and evidently that education be actively supported.*

### **2. Enhance the consumer value of productions manufactured in the larger Europe**

*This enhancement would obviously benefit all companies manufacturing in the area, in particular those who sell on medium or high price segments, to consumers who are not primarily focused on getting the lowest possible price.*

*Such incremental manufacturing-based value can be derived from social ethical components, or environmental and health issues, but also from notions pertaining to "économie citoyenne", combining a global ethical sourcing approach and/or a regional artisan method, or built around the "Made in" labelling.*

*These developments do not prohibit (further) delocalisations but they foster the growth of well thought, carefully driven practices which are generally easier to implement with close by suppliers, in geographic and cultural terms. As such they are a deterrent against remote sourcing which does not generate any European value added and an effective promoter of*

*Euromediterranean manufacturing. What should be advocated here is a real effort for clarification and coherence, but also in certain areas efforts to rebuild adequate value chains, and to develop a quality content within certificates of origin.*

### **3. Foster trade within the area and exports**

*The importance of having access to all markets from any part of the Euromediterranean zone is crucial to preserve companies' competitiveness and companies in the industries under review would gain a lot of competitiveness from a freer global trade.*

*Optimising trade flows within the Euromediterranean area would help all companies and strategies but primarily those for which the most important competitive factors are (labour) costs, the easy access to raw materials, components and trimmings, reactivity, the development of a local market base.*

### **4. Facilitate a better integration of fashion and design in the industrial value chains**

*Once more almost all companies in the area would gain competitiveness if design and creativity could be enhanced, disseminated and developed. It would particularly benefit firms involved in strategies where high ranking competitive factors are design and/or fashion, innovation, market sensitivity, and also communication skills (in the sense of ease of communicating fashion and consumer' tastes issues).*

*Achieving this integration requires that the existing fragmentation of skills be reduced, between fashion and design, technical and managerial education places and systems. It also supposes that young designers may be supported into becoming successful entrepreneurs and in seeing their ideas materialise into actual products. Obviously this design and fashion integration into the industry can only be transformed in an economic advantage if it is efficiently promoted and protected through the world.*

### **5. Address the issue of job developments and losses within the area**

*In all industries concerned – even furniture however to a lesser extent in the short term - the ongoing restructuring of the industries aiming at a more competitive distribution of work within the area involves major social implications in number of jobs lost and re-qualification of workers. This issue very often deters or postpones delocalisation decisions and many companies in Europe presently are in a very bad financial position due to a late delocalisation. This issue of job developments and losses throughout the Euromediterranean zone should be considered a priority. This would help companies in the five sectors under review, and following all types of strategies.*

*Addressing this issue requires to take into account the geographic differences in anatomy of job losses and the fact that workers' skills are very often not materialised by any degree, diploma or qualification measurement, which is a major cause for low re-employability.*

*Due to the ongoing globalization of trade and industries, a large number of workers will be made redundant throughout the industries under review in the coming decade. Existing European tools should therefore be reviewed and adapted to better fit the coming reality.*

## *6. Improve the efficiency of existing tools and programmes*

*Many tools already exist within the area to tackle the challenges facing the industries concerned but they are not fully taken up or possibly not efficient. There is in particular a lacking in real coordination, an asymmetry that most tools are mainly made available at the regional level, whereas the European level increasingly appears as the most relevant level. This is why the present report advocates thematic approaches, possibly articulated into **programme** platforms that cover the entire zone but that have a specific approach. As far as this study is concerned four federating themes for which a network may assist a better coordination of local, regional or more specific action can be identified : the first one is a European Technology Platform for technology and innovation matters ; the second is a network on industrial excellence fostering improvement of human resources, mobility of workers, improvement in processes ; the third one is a programme focusing on the harmonization of technical regulations of the countries from Euromed with the EU technical regulations ; the fourth one is a network on creative cities/clusters improving the interaction between designers, production labs and pilot-experiment facilities.*

*A better efficiency of all tools and programmes could also be obtained thanks to the positive involvement of intermediate organisations in such matters as observing the delocalisation processes and extend their usual field of action to address non production (marketing) issues, on top of technology oriented ones.*

*Finally special attention should be given to how the tools and programmes available can better reach and help SMEs. They should receive specific attention in the implementation of policies, particularly at the EU and national levels.*

## I – ECONOMIC ENVIRONMENT

### Structure of the economy

The industrial sectors under review in the present report operate within the world's largest economy, as EU's GDP is reaching 10,846 billion euros in 2005. It is approximately 8% lower in the USA and 66% in Japan. However, the economic wealth of the area remains largely concentrated on few Member States: the share of the five largest contributors to the EU 25 GDP (Germany, United Kingdom, France, Italy and Spain) reaches 74.4%. With the exception of Poland (2.2% of the total), none of the Member States that joined the EU in 2004 accounts for more than 1% of the EU 25's GDP. With the 2004 enlargement the population of the EU has increased by close to 20% but its economic weight by only 5.2%.

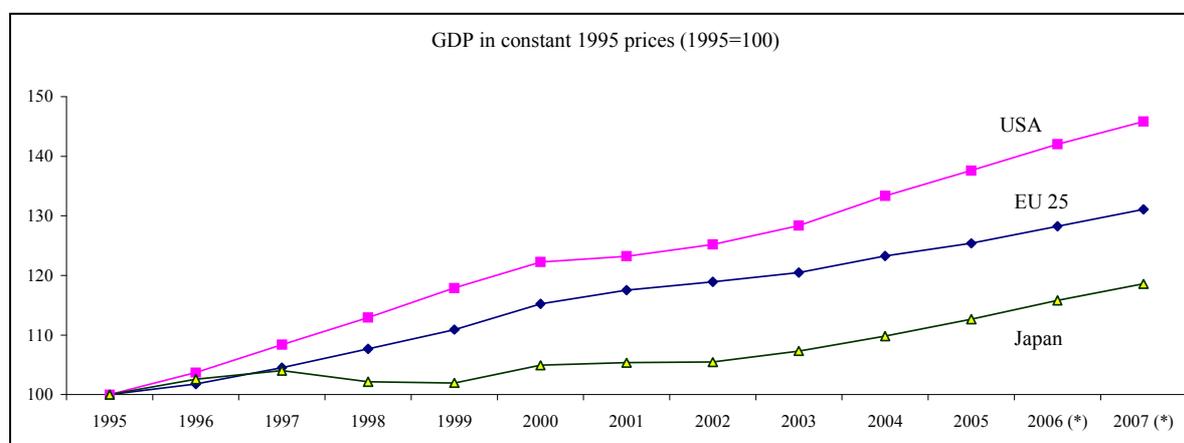
Despite progress in recent years, the gap in income per capita between the new Member States and the EU 15 is still quite high - even if three countries, Cyprus (83% of the EU level), Slovenia (80%) and Czech Republic (73%) reach a level above Portugal (71%) and Greece (82%). The GDP per capita of the last two entrants (Bulgaria and Romania) is below 65% of the EU 25 average in 2005.

Contrary to the situation in the USA and in Japan the five industries do not benefit from a large and homogeneous market.

(See Appendix I. I economic environment of the sectors over the recent years tables 1 and 2)

### Economic growth

Over the last ten years the industries benefited from a rather positive environment, as between 1995 and 2005, there was a fairly smooth development to GDP in the EU 25, with growth during the period 1995 to 2000 somewhat faster than that recorded between 2001 and 2003. Having slowed between 2001 and 2003, there were signs of an increase in the rate at which GDP growth was progressing in the EU 25 from 2004 onwards. EU 25 economic growth is estimated to rebound in 2006 to 2.8% up from 1.7% in 2005. The main impulses stem from a robust increase in investment, continued world growth and an improved outlook in Germany. European growth is supported by a positive international background. World growth is



Source Eurostat

\* forecast

primarily being helped by the strength of the US economy, which expanded by 3.2% in 2005 and by an estimated 3.4% for 2006 and by the very robust growth of China's GDP in 2005 (9.9%) and

2006 (+ 9.5% estimated). China's performance was underpinned by still-elevated investment spending, surging net exports and a fast rising internal market

As far as the five industries under review are concerned the last decade provided them with a fairly good local economic situation in the EU, even though their counterparts in the USA could benefit from a significantly higher overall growth. The USA market thus became more buoyant, but was also increasingly the target of exporting economies. In Japan the lesser growth induced a tighter import market, particularly in the medium price range, with a general unfavourable impact upon the fashion and design European industries examined here.

Buoyant global growth is coupled with acceleration in world trade from an annual rate of more than 6% in 2005 to an estimated rate of 9% in 2006.

### **Evolution of consumer prices**

The relative stability of inflation (2.1% per annum during the period 2002 to 2005, and an estimated 2.3% in 2006) at the aggregate level masks a significant dispersion across European Member States which, despite a slight narrowing of the gap between the highest and the lowest inflation rates, remain high. Between 1995 and 2005, the annual average inflation rates ranged from 1.3% in Germany to more than 6%% in Slovenia (6.6%), Slovakia (7.2%) and Hungary (7.7%). All the new Member States have made some progress in bringing high and volatile inflation rates down to lower levels.

*(See Appendix 1 I Economic environment of the sectors over the recent years - table 3).*

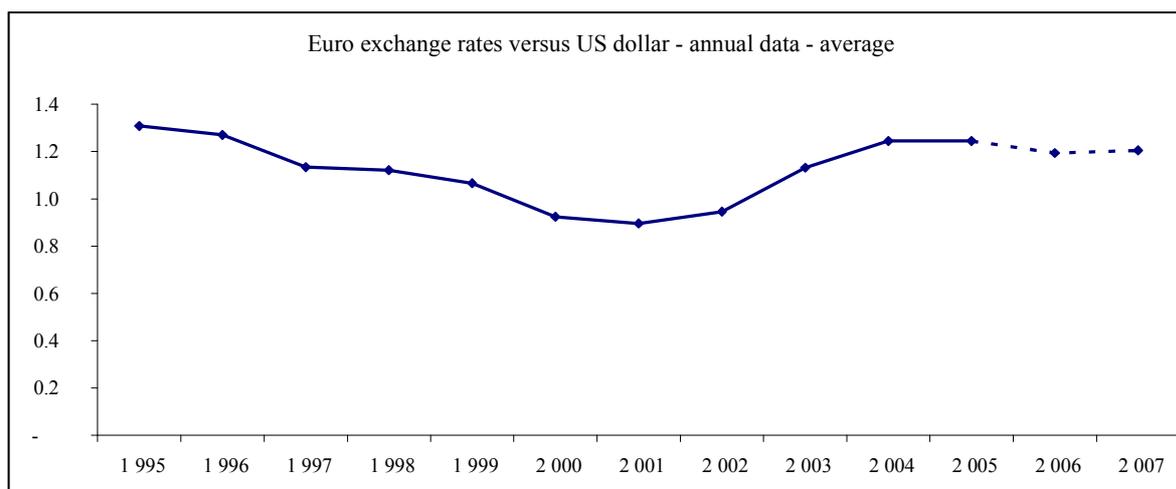
The impact on the fashion and design industries under examination is likely to be fairly negative as it will bear negatively upon production costs. The possible favourable impact upon consumption will be more than offset by these aggravated costs as high inflation areas are mostly production areas.

### **Labour market**

The EU as a whole is expected to create 7 million new jobs over the period 2006-2008, after nearly 3 million in the previous two years. At the sectoral level, job creation has been driven by a sustained expansion in services sector. The decline in employment in the industry sector appears to have ended in the course of 2005, while employment in the agriculture sector continues to fall.

*(See Appendix 1 I Economic environment of the sectors over the recent years -table 4).*

## Exports



Source Eurostat

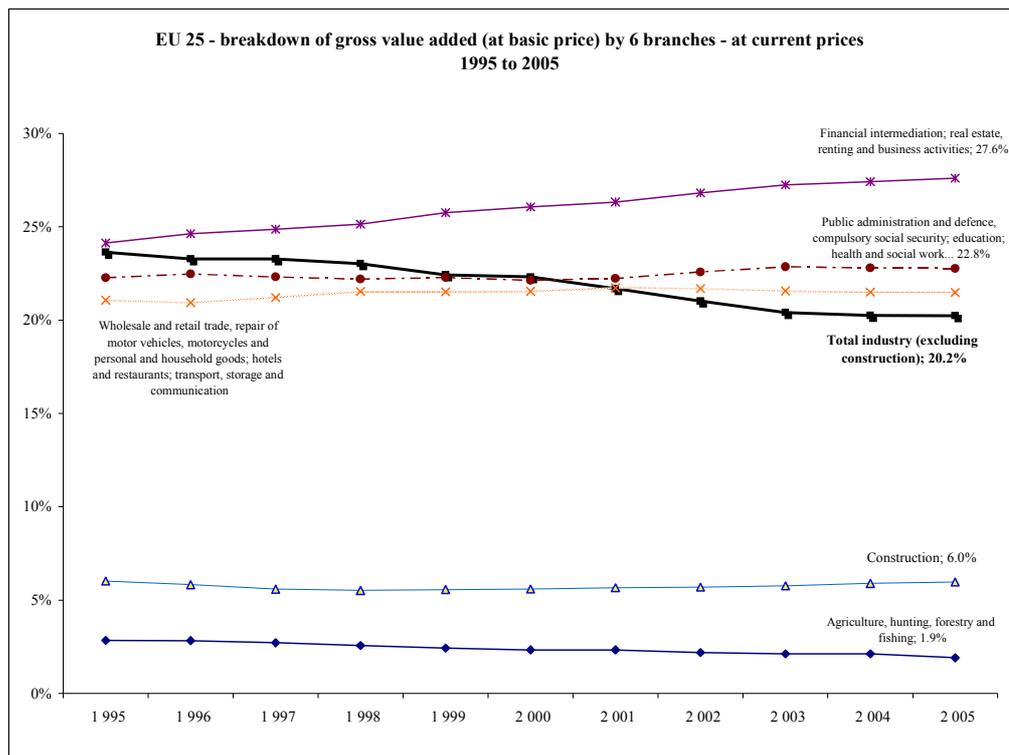
Since 2001, the euro has been increasingly stronger against the US dollar: the evolution of the rate of exchange of the Euro against the US dollar has limited the underlying inflationary pressures and has been translated into disinflation pressures in 2005. The competitiveness of the European exporters has been affected by this unfavourable evolution in the global markets, while foreign exporters were becoming increasingly price competitive in the EU markets price.

Despite the rise of the euro, EU 25 total extra –EU exports have reached, according to Eurostat statistics, more than 1,071 billion euros in 2005, which is a record high. Compared with 2004, EU they have risen by 10.5% in a context of vibrant world trade, and almost doubled since 1995.

In comparison with other countries, EU 25 is the world leader in exports (33% higher (in euros) than the USA, and twice as high as China and Japan. However, EU's export growth has slowed down since 2000 below China's performance.

### Deindustrialisation trends

In 2005, the share of services is equal to 71.9% of total value added, industry generates 20.2%, with the remaining value added being generated by agriculture, hunting, forestry and fishing (1.9%) and construction (6.0%). During the period 1995 to 2005, the share of services has grown from 67.5% to 71.9%% while the share of industry has declined from 23.6% to 20.2%.



There are wide differences between the relative importance of the different branches of the economy across the Member States. New Member States are relatively specialised in industry (in comparison with EU 25 average that is to say 20.2%) : with a 26% share of value added in 2005, while its share in the EU 15 is only 19.9%. In 2005, the share of industry rises to above 25% in Finland, Germany and Ireland but also in five new Member States (Hungary, Lithuania, Slovenia, Slovakia and the Czech Republic). In contrast, industry accounts for less than 16% in Latvia, France and Greece and only for 17.4% in the United Kingdom (See Appendix 1 I Economic environment of the sectors over the recent years - table 5).

This evolution provides a measure of the phenomenon of deindustrialisation which is particularly at work in some Member States.

In a significant number of European economies industrial value-chains are thus weakened, while at the same time the market volumes represented by service industries are on the rise.

## II. EVOLUTION OF STRUCTURES IN THE SECTOR

*The five industries being examined display fairly heterogeneous industrial structures. This can be seen when analysing the average production value per firm and the number of firms in each sector. This is partly due to technological discrepancies, as for example between the highly capital intensive textile sector and the highly labour intensive apparel industry. Between those extremes the furniture sector appears quite fragmented, a little less than apparel and a little more than the leather and footwear sectors.*

*However, the evolution is fairly similar throughout these industries in Western Europe (in particular in Italy, Germany, UK, Spain and France). New firms have appeared between 1995 and 2000 while firms were also increasing their production values. The trend has changed around 2000 when a significant number of firms have disappeared while production per firm was growing.*

*In the EU 27, the five industries represent a total of 410,000 firms in 2004, with the large majority of them in the furniture, apparel, and textile sectors, while footwear and leather industries represent a much smaller number of firms. Italy always displays the highest number of firms and is the largest producer in each industry. The number of firms in Italy is especially high in the leather industries, where it represents 48% of the EU 27 total.*

*While they represent 18% of the total number of firms in the EU 27 manufacturing sector, the five sectors under consideration only account for 6% of the total production value. This discrepancy provides one measure of the very low concentration of the 5 sectors*

*The most fragmented sector is apparel followed by furniture (0.6 and 0.8 million Euros in production values per firm). On the opposite the textile sector (1.4 million) appears significantly more concentrated, even though it remains quite below the average manufacturing standard (2.5 million Euros per firm).*

*Larger firms operate in the old Member States, the best example being Germany, while smaller firms are in a majority of cases located in the new Member States in Eastern Europe. Exceptions to this rule are on the one hand Slovakia which displays the largest average size of firms in the furniture industry, and the 2nd in the footwear industry, and on the other Portugal –and to a lesser extent Spain. The situation is fairly similar there to those of the new Member States: the average firm in Portugal produces less than 1 million euros in each industry.*

*Over the last decade, the overall trend concerning value added which can be observed is a decline affecting most of the sectors under review. A most negative development concerns apparel, which has lost 47% of its value added between 1995 and 2006, following a quite regular decrease over the period. Another very dramatic fall can be seen with footwear, in which case production value added has fallen by 50% over the period. Here a significant deterioration of the trend has happened since 2001 which mostly results from a lower performance on export markets, coincidental with the rise of the Euro/Dollar exchange rate.*

*For textiles, the downward trend displays acceleration after 2001. As is the case for footwear, the Euro/Dollar rate can be held partly responsible for a deterioration of EU 25 textile position in export markets, but the leading factor is China's accession to WTO which has enabled Chinese exporters to benefit from the initial steps of quota liberalization as soon as December 2001. The leather industry*

*(excluding footwear) follows a much less negative trend, fairly close to the one of textiles, with a decrease of 25% between 1995 and 2006. Finally, furniture displays a net growth of 7% over the period with even some slight acceleration since 2003.*

*In proportion of production value, value added has decreased since 2000, except for the footwear and leather sector, showing that these industries have only partly succeeded in keeping the same industrial "involvement" within their respective activities, and that industrial changes within companies have only been partly absorbed within the boundaries of the EU 27.*

*Throughout the industries under review a thorough restructuring is taking place, while many companies disappear (-26,000 firms over the five sectors considered between 2000 and 2004) as numbers are falling quite severely in comparison with the developments in the manufacturing industry as a whole: -6,000. Remaining companies do attempt at concentrating their activities, with a dual purpose: improving market positions and getting global. However for the time being, the general level of concentration of these five industries is quite low in comparison with the manufacturing industry standards, but it is increasing : it is particularly low in the leather and shoe industries, while textile companies score better in this respect. Concentration allows better market control, as well as cheaper outsourcing of components to remote competitive specialised suppliers. In the new Member States firms often lack the required resources to carry this concentration process, even though they may be quite aware of its necessity.*

*Regional concentration does compensate for the lack of structural consolidation: cases in the EU and Euromed show that it provides companies with a higher level of flexibility and also enables them to seize opportunities and orders larger than they could afford by remaining on their own. In Italy such cooperation is an integral part of companies' culture.*

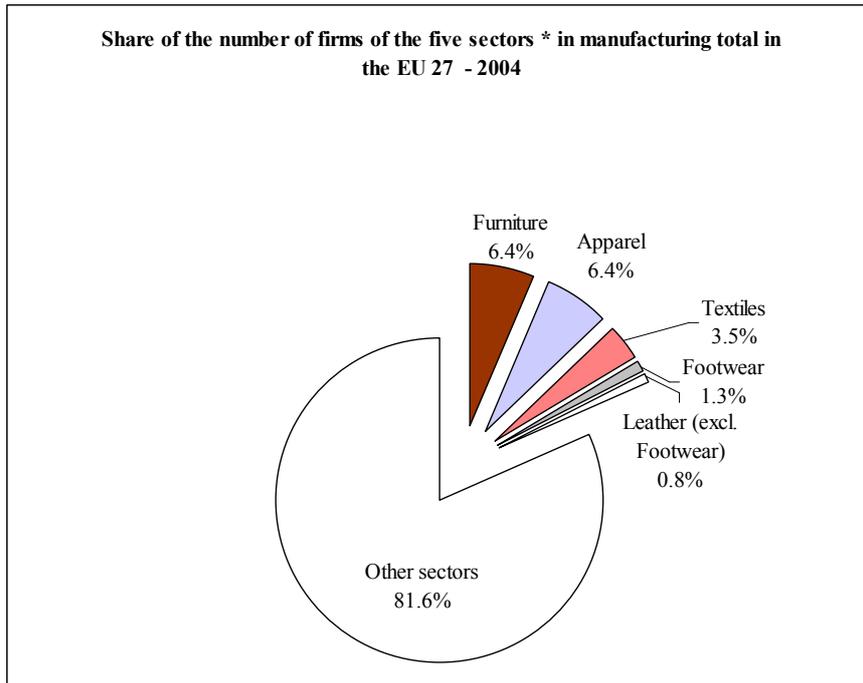
*Over the recent period, companies have tried to compensate for production losses by developing their sourcing of finished goods. In the cases of textiles and leather, the increases are quite impressive. In footwear and furniture one cannot observe any significant development. Trading finished goods allows companies to offer a broader range of products and reach a critical level of exposure in the wholesale or retail market.*

*As far in employment is concerned 4.5 million workers within the EU 27 in the five industries under review represents 13% of total manufacturing labour force in 2005. This proportion has decreased by 2 points since 2000. With almost one million employees, Italy is by far the largest employer in the EU, with shares up to 38% regarding leather (excluding footwear) and 27% for footwear. Italy hosts 20% of the total EU workers.*

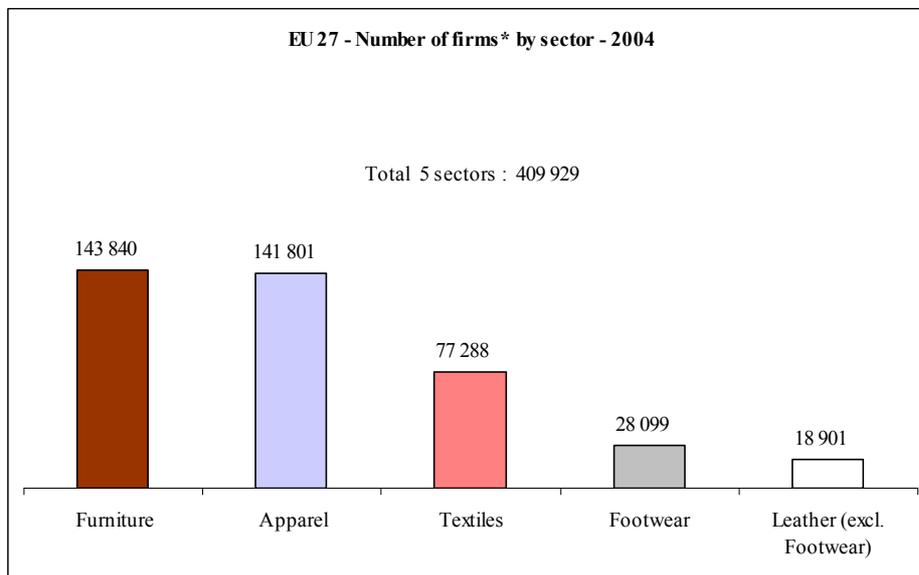
*Among new entrants, Romania is a very important employer, with the equivalent of 13% of the total EU employment - largely because of its being an extremely large apparel employer, with 288,000 workers in this single sector.*

*The overall trend in the 2000-2005 period has been a significant decrease of 17% on average for the five sectors. During the same period, employment in total manufacturing has registered a decrease of "only" 8%. In the various sectors, the trends have been significantly more negative than the trends concerning turnovers. The highest discrepancy concerns apparel where the downward trend for employment (-20%) has been by 15 points higher than for turnover, reflecting the very strong trend to relocation of production in the sector.*

**2.1 NUMBER OF FIRMS**

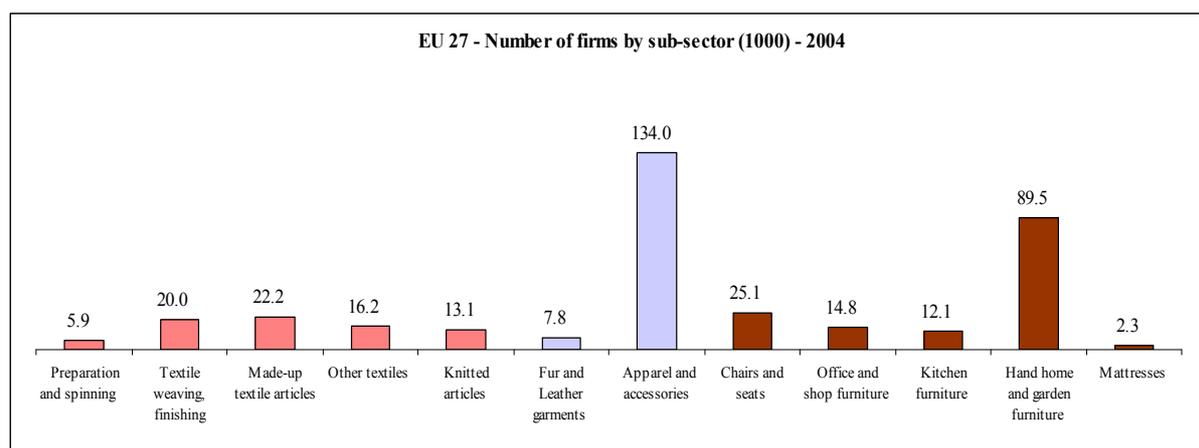


Source: Eurostat and IFM estimates based on Eurostat data \* see definition mentioned above  
 \* all firms included



Source: Eurostat and IFM estimates based on Eurostat data \* see definition mentioned above  
 \* all firms included

The distribution of the number of firms among the five sectors of interest is represented in the graph above. All these industries represent some 410,000 firms in 2004, in the EU 27, with the large majority of them in the furniture, apparel, and textile sectors, while footwear and leather industries represented a much smaller number of firms. Data indicate that within the textile industry, the number of firms is lower in the spinning activity (5,923 firms) than in the following steps of the production process. In the furniture industry, the estimated number of firms is the highest in the hard home and garden furniture<sup>1</sup> activity (89,544 firms), while the lowest is in the production of mattresses (2,287 firms).



Source Eurostat and IFM estimates based on Eurostat data

The analysis of the number of firms by country indicates that Italy always displays the highest number of firms in each industry. It is also the biggest producer in those industries. The number of firms in Italy is especially high in the leather industries, where it represents 48% of the EU 27 total.

In the textile industry, the majority of Italian firms operate in the weaving activity, which is also the case of Germany, while in most other areas and particularly the UK and Romania, the largest number of firms can be found in the sector of made-ups.

In the apparel industry, Italy concentrates 27% of firms and Poland, 14%, while Spain, France and Portugal have each similar share (around 10%).

In leather, geographical concentration is especially high in the footwear industry where Italy represents 41% of firms, while Spain, Poland, Portugal and Romania respectively represent 16%, 15%, 10% and 6% of firms, which means that these five countries alone represent 88% of the EU firms in this industry.

<sup>1</sup> Home and garden furniture activity refers to Nace code DN 3614:“other furniture” (see appendix 7 part 1 for more detailed information).

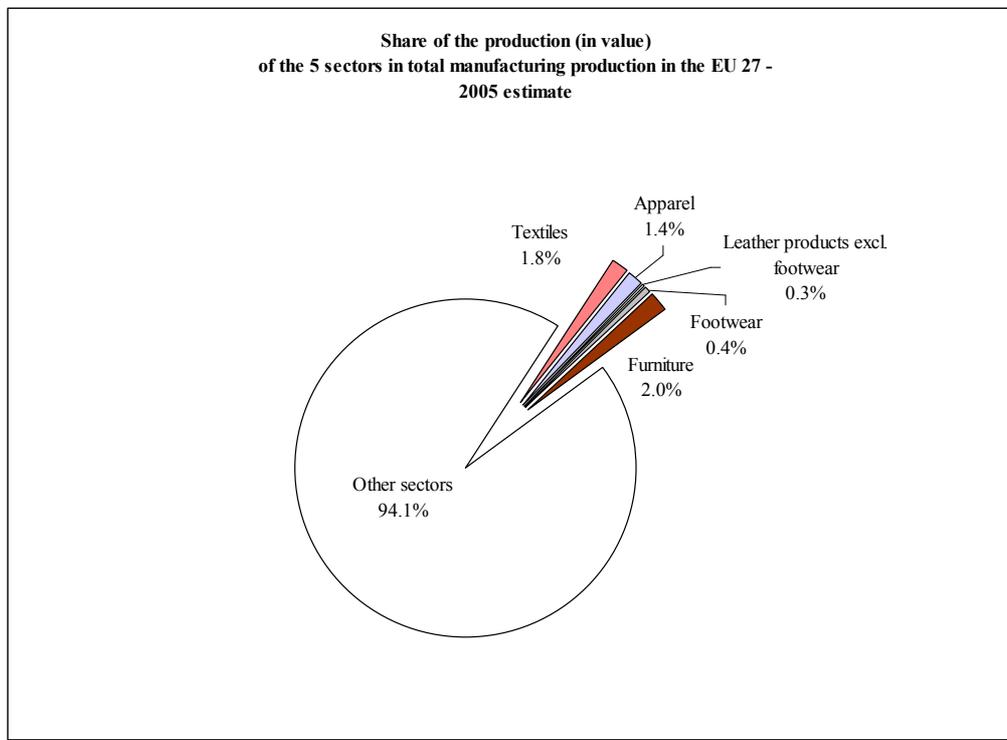
In furniture, the degree of geographical concentration is lower with five countries (Italy, Spain, France, Poland and Germany) representing 64% of firms.

It is also interesting to see that the Czech Republic now represents a significant share of firms in the apparel and leather (excluding footwear) industries.

*See Appendix 1 – II Evolution of structures in the sector 2.1 Number of firms in the EU 27 - for more detailed information.*

## 2.2 PRODUCTION AND VALUE ADDED

- **Production by sector**



Source: Eurostat and IFM estimate based on Eurostat data

While they represent 18% of the total number of firms in the EU 27 manufacturing sector, the five sectors under consideration only account for 6% of the total production value. This discrepancy provides one measure of the very low concentration of the five sectors (see further analysis of production by firm).

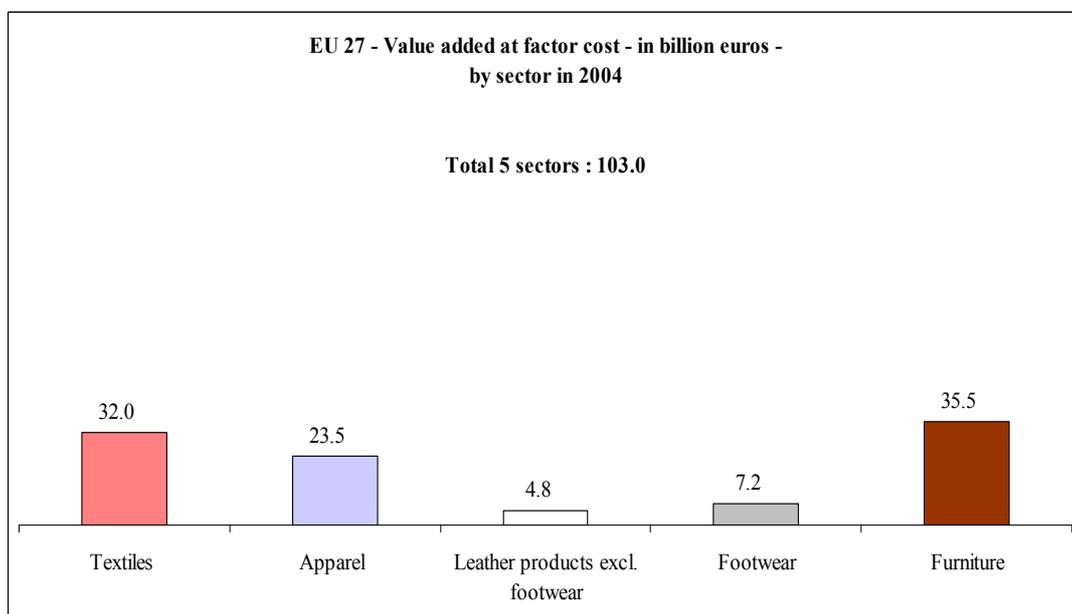
There are large differences in the number of firms between and within sectors, and it is useful to compare it to the production in each industry, in order to see if this heterogeneity is due to a specialisation in some activities. The following graph provides the breakdown of production for the five industries in the EU 27. It is somewhat different from the distribution of the number of firms between these industries. The apparel share in total production is particularly low, which indicates a very low concentration of the sector. The situation is a little similar as far as furniture is concerned, even though in a much lower proportion. On the opposite the textile sector appears significantly less fragmented.



Source: Eurostat and IFM estimates based on Eurostat data

- **Distribution of companies' costs**

It is quite interesting to compare sectors on this criterion : some constant characteristics reveal themselves while some discrepancies also appear.



Source Eurostat and IFM estimates based on Eurostat data

The level of entrants in production is very high in all sectors, as it represents on average 70% of companies' production values, 75% in the case of leather (excluding footwear). Within those entrants one can find raw materials, semi-processed goods and external labour

(subcontracting)<sup>2</sup>, the shares of which cannot be statistically determined. Correlatively value added represents between 1/4 (leather) and 1/3 (furniture) of production values.

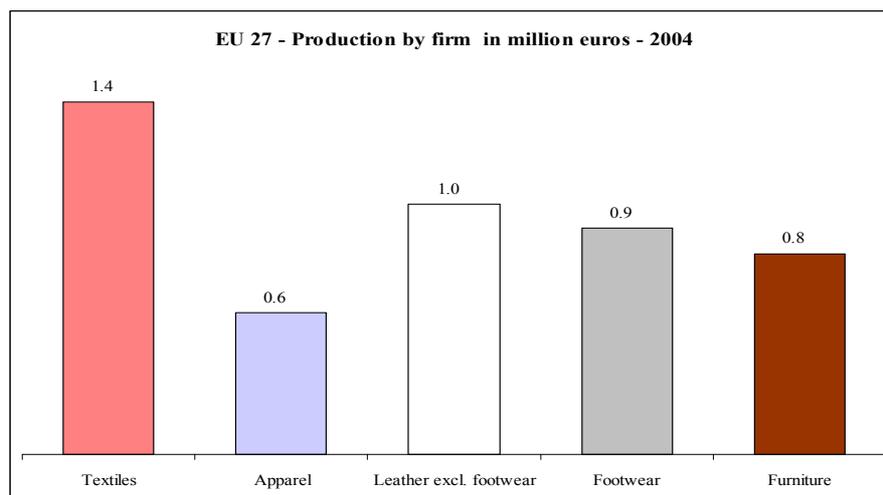
#### Breakdown of companies costs 2004 as % of production values (EU 27)

%	Textile	Apparel	Leather	Footwear	Furniture
Entrants	70	70	75	71	69
Value added	30	30	25	29	31
Production value	100	100	100	100	100

Source : Eurostat and calculations by IFM

#### • Production by firm

The following graph confirms that the average size of firms is much larger in the textile industry with a production of € 1.4 million by firm than it is in the apparel and furniture industries, with a production of respectively € 0.6 million and € 0.8 million by firm. Leather and footwear industries are very close in terms of production by firm, with € 1 and 0.9 million of production by firm. However, all sectors remain much below the estimated EU manufacturing average (€ 2.5 million by firm).



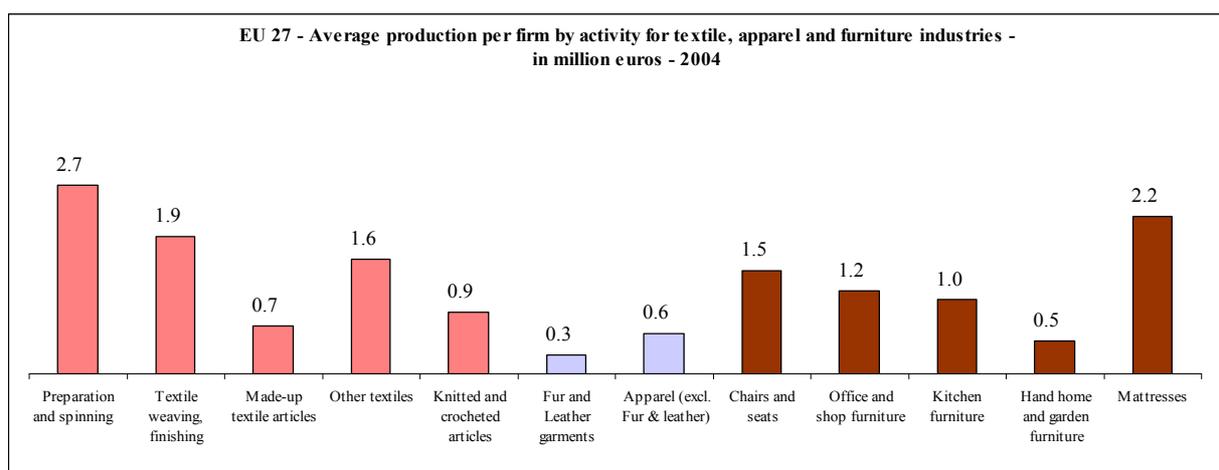
Source: Eurostat and IFM estimates based on Eurostat data

To some extent, firm size differences between industries can be attributed to technological differences. For example, textile firms always have a larger production since they use more capital, whereas firms in the apparel industry use less capital and are more likely to have a smaller size, as data reveal for the EU 27. For this latter industry, lower capital requirements at the entry means that one can run a profitable business without having a large production, whereas firms in the textile sector have to produce more in order to benefit from scale economies, and post a positive profit.

<sup>2</sup> Within those “entrants” is thus included the value added generated by the upstream players. For example in the average weaver’s entrants, can be found the value added generated by the spinner and the yarn finisher who have supplied the yarn. As a consequence the percentage of the value added would be much higher if calculated for the consolidated value chains.

Wide discrepancies do also appear between sub-activities. In the textile industry, the average spinning firm produces almost four times more than the average firm involved in made-up textiles. In the furniture industry, the average firm producing mattresses produces almost five times more in value than the average firm in the hard home and garden furniture<sup>3</sup>. In the leather industry, the productivity is much higher in companies producing leather for cars than in companies producing leather for apparel or footwear.

Overall this particularly small sizing of firms reveals or competitive disadvantage of the sectors examined in comparison with the manufacturing industry at large. There are undoubtedly clear correlation factors between company size and competitiveness. They will be highlighted and described in the chapter dedicated to the financial strength of the industry.

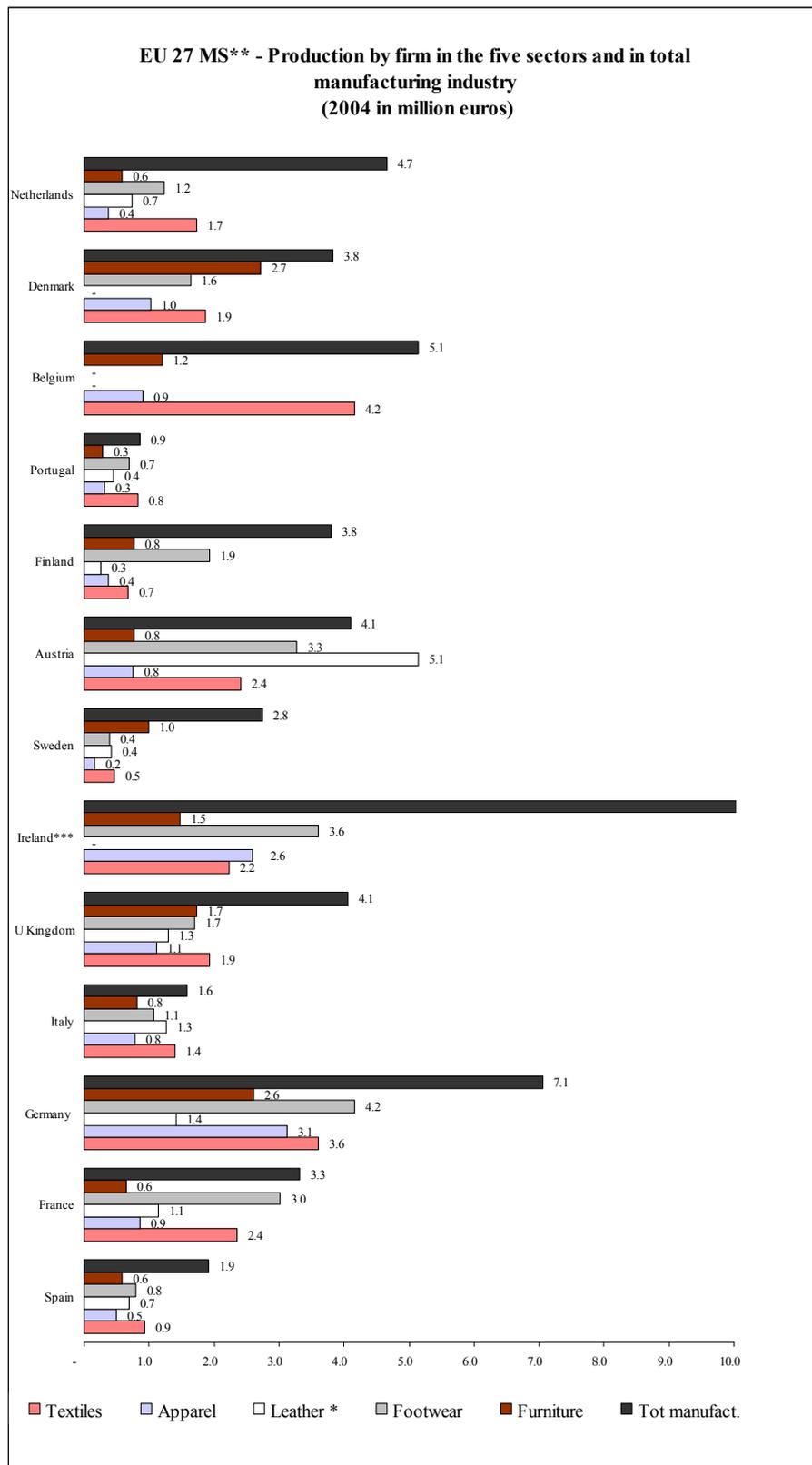


Source: Eurostat

Firm size differences between countries in a given industry also provide evidence of quite diverse concentration levels. The data show that larger firms operate in Member States located in Western Europe, the best example being Germany, while smaller firms are in a majority of cases located in the new Member States in Eastern Europe.

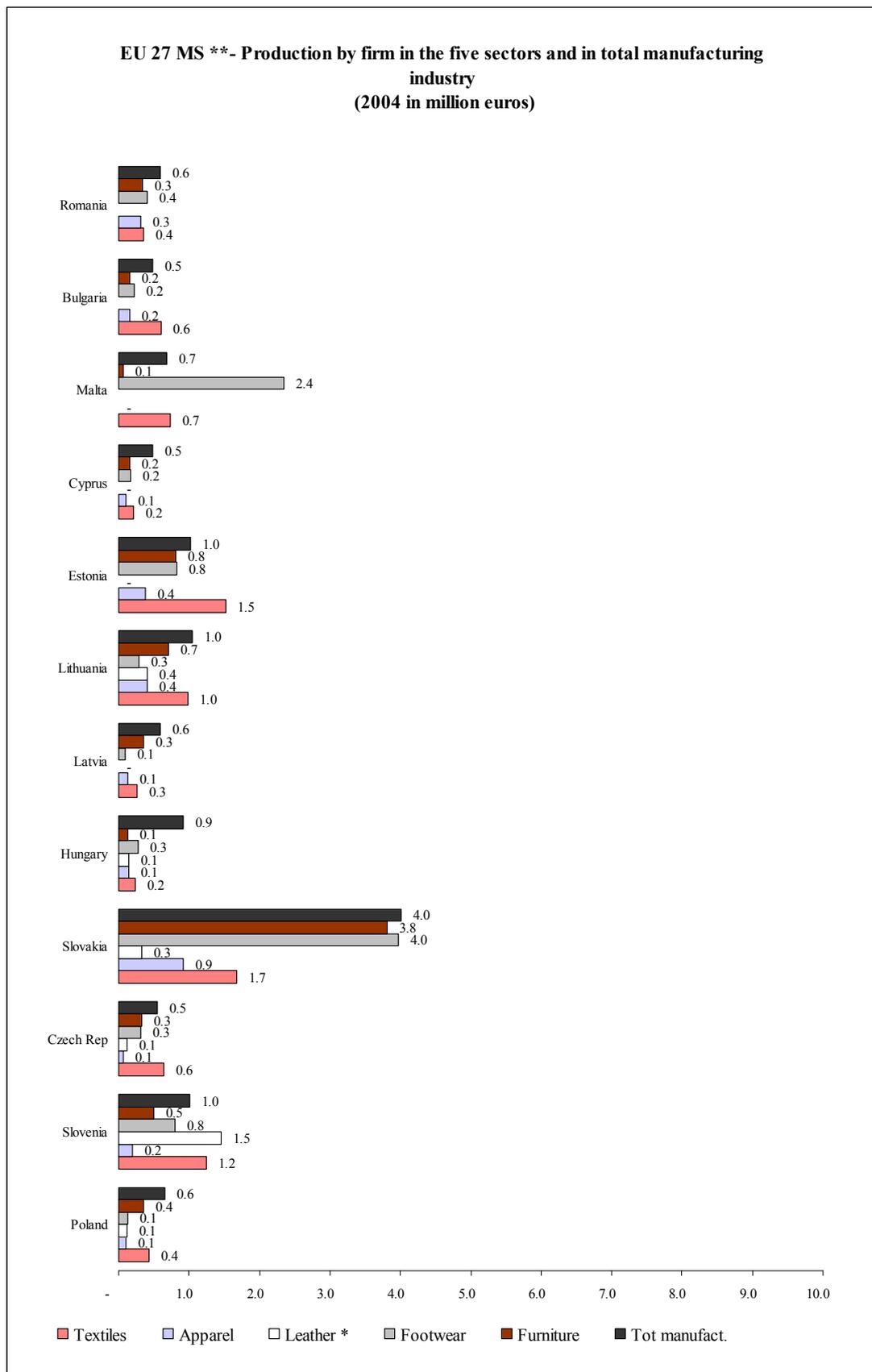
Slovakia is the leading exception, as it displays the largest average size of firms in the furniture industry, and the second (behind Germany) in the footwear industry. This contrasts with the case of the Czech Republic, which ranks 6th in terms of the number of firms in the apparel and leather (excluding footwear) industries, while it reports the smallest average firm size for these two industries. Consequently, the Czech Republic is only the 13th EU apparel producer, and the 11th EU producer in the leather (excluding footwear) industry. The situation of Spain and Portugal is fairly similar to those of the new Member States, and especially Portugal, in terms of firm size: the average firm in Portugal produces less than 1 Million euros in each industry. As a result, Portugal has one of the highest numbers of firms in the textile and apparel industries, but is only the 6th and 5th producer in those industries. Finally, Italy has the average firm size in each industry, but remains the undisputed leader in terms of total production in each sector.

<sup>3</sup> Dining-room, bedroom and garden furniture i.e. excluding upholstered items, kitchen, office, shop furniture and mattresses



blank : not available    \* excluding footwear    \*\* data related to Greece are not available  
 \*\*\* Ireland Tot manufacturing: € 22.6 million

Source Eurostat and IFM estimates based on Eurostat data  
 Blank: not available    \* excluding footwear



Source: Eurostat and IFM estimates based on Eurostat data

- **Value added**

The table below shows the size of each Member State in terms of its contribution to EU 27 value added within both manufacturing and the five sectors analysed in the report. Germany is the largest contributor to EU 27 manufacturing with a 26.8% share of value added in 2004. France, UK and Italy's shares are only one half of the German share. Germany's contribution to EU 27 five sectors is lower (14.5% of value added).

Share in total EU 27 value added	Value added at factor cost (euros)			
	2003	2004	2003	2004
Breakdown by Member State *** of value added	Total 5 sectors *		Manufacturing	
Germany	14.5%	14.5%	26.9%	26.8%
United Kingdom	11.1%	10.9%	13.3%	13.6%
France	11.7%	11.4%	13.5%	13.2%
Italy	28.2%	28.4%	13.2%	13.0%
Spain	9.9%	9.8%	7.3%	7.4%
Netherlands	2.2%	2.0%	3.5%	3.6%
Sweden	1.3%	1.3%	3.1%	3.2%
Belgium	2.9%	2.8%	3.0%	2.9%
Poland	2.8%	3.1%	2.4%	2.7%
Austria	2.3%	2.3%	2.5%	2.5%
Ireland	0.5%	0.5%	2.5%	2.2%
Finland	0.9%	1.0%	1.9%	1.9%
Denmark	1.5%	1.6%	1.7%	1.6%
Czech Republic	1.3%	1.4%	1.2%	1.3%
Portugal	3.8%	3.9%	1.2%	1.2%
Hungary	0.7%	0.7%	0.9%	0.9%
Romania	1.6%	1.7%	0.4%	0.5%
Slovenia	0.6%	0.6%	0.4%	0.4%
Slovakia	0.4%	0.4%	0.3%	0.3%
Bulgaria	0.4%	0.5%	0.1%	0.2%
Luxembourg	0.2%	0.2%	0.2%	0.2%
Lithuania	0.4%	0.4%	0.1%	0.1%
Estonia	0.3%	0.3%	0.1%	0.1%
Latvia	0.2%	0.2%	0.1%	0.1%
Cyprus	0.1%	0.1%	0.1%	0.1%
Malta**	0.1%	0.1%	0.1%	0.1%
Greece	na	na	na	na
Total EU 27	100.0%	100.0%	100.0%	100.0%
EU 15	91.1%	90.6%	93.8%	93.3%
EU 12 new MS	8.9%	9.4%	6.2%	6.7%

\* textiles, apparel, leather excl. footwear, footwear, furniture

\*\* 2002 data

\*\*\*data about Greece are not available but one can estimate that Greek 5 sectors may represent 1.3% to 1.8% to EU 27 value added of the 5 sectors.

Source Eurostat and IFM estimates based on Eurostat data

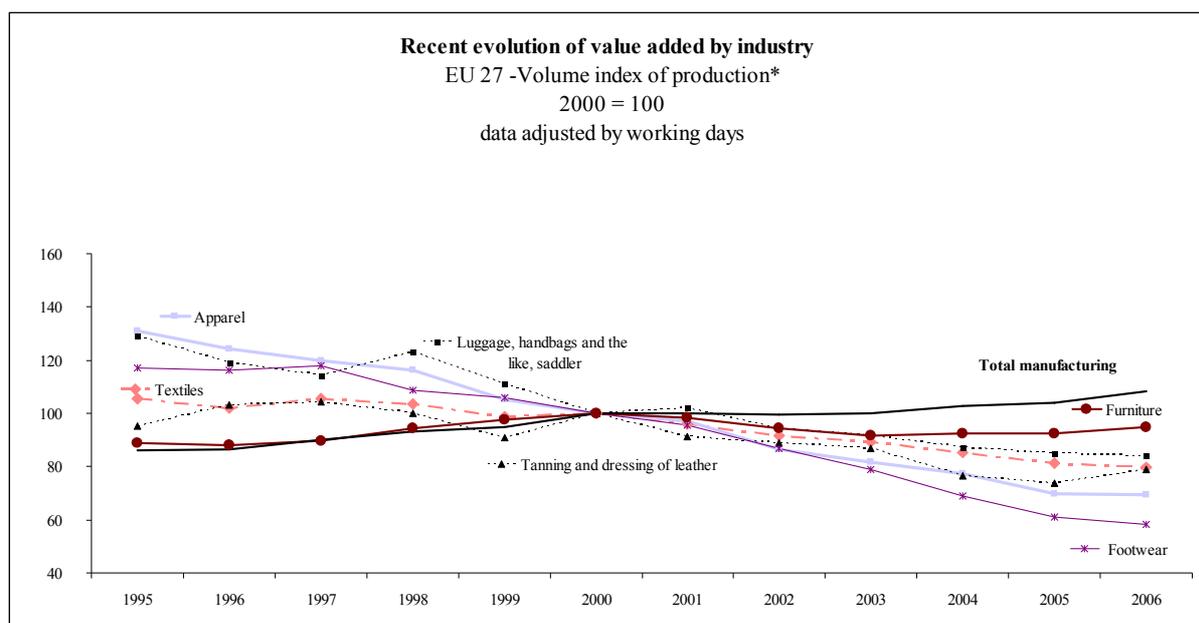
The addition of the United Kingdom, France, Italy and Spain led to cumulative shares of 74.0% of value added in EU 27 manufacturing for the five largest Member States, while the 12 Member States that have joined the EU since 2004 contributed 6.7% to EU 27 value added.

As far as the five sectors analysed in the report are concerned, the main contributor to EU 27 value added is by far Italy with a share of 28.4%.

- **Trends on production and value added**

The overall trend which can be observed is a decline affecting most of the sectors under review.

One of the most negative developments concerns apparel, which has lost 47% of its value added<sup>4</sup> between 1995 and 2006, following a quite regular decrease over the period. It cannot be said that the final quota dismantling in January 2005 has significantly affected the downward trend. As this liberalization had been completely scheduled for many years, and had already been implemented for several product categories importers had clearly anticipated it and had increased their sourcing practices from Asia and in particular from China before 2005. Production in the EU 27 had thus been affected much ahead of the expected shock



Source Eurostat

\*In this graph, the term used by Eurostat (STS) is “production”. However it specifically refers to added-value. See definition of industrial production index (Short term statistics) in appendix 2 - 5 sources of data and definitions of variables used in the report.

Another very dramatic fall can be seen with footwear, in which case production value added has fallen by 50% over the period. Here a significant deterioration of the trend has happened since 2001 and the sector is now weathering a constant decrease which is more important than the one concerning apparel. As trade had only been constrained for items exported from China, other Asian suppliers had long

<sup>4</sup> values net of inflation

organised themselves to impose low-price products onto the EU market. As a consequence the lower price segments of the European shoe market had also been long lost for EU suppliers when the quota dismantling took place in 2005.

The deterioration of the trend after 2001 mostly results from a lower performance on export markets, which coincides with the rise of the Euro/Dollar exchange rate. It also coincides with the BSE crisis (Bovine Spongiform Encephalopathy) which has caused the destruction of a number of hides in the EU, making it a little more difficult for tanners to get their necessary raw material. However the latter phenomenon has had quite a minor effect on the footwear sector as compared with the exchange rate evolution.

For textiles, the downward trend displays acceleration after 2001. As is the case for footwear, the Euro/Dollar rate can be held partly responsible for a deterioration of EU 27 textile position in export markets, but the leading factor is China's accession to WTO which has enabled Chinese exporters to benefit from the initial steps of quota liberalization as soon as December 2001 (see further analyses in section VI of the present report). The leather industry (excluding footwear) follows a much less negative trend, fairly close to the one of textiles, with a decrease of 25% between 1995 and 2006.

Finally, furniture appears quite stable in terms of value added over the period (+7%) with even some slight increase since 2003.

In proportion of production value, value added has deteriorated in every sector except leather and footwear, between 2000 and 2004.

#### **Evolution of companies costs as % of production values (EU 27)**

	Textile	Apparel	Leather	Footwear	Furniture
Entrants 2004	70	70	75	71	69
2000	68	69	75	71	67
Value added 2004	30	30	25	29	31
2000	32	31	25	29	33
Production value	100	100	100	100	100

Source : Eurostat and calculations by IFM

This overall decline reflects that from a macro-economic point of view the five industries have only partly succeeded in keeping the same industrial "involvement" within their respective activities. This means that the industrial changes within companies (as described in the following pages) have been for the largest part absorbed within the boundaries of the EU, presumably anticipating the 2004 enlargement.

Over the 1995-2005 period, the situation in the USA appears quite similar to the one in the EU for the apparel, footwear and leather industries - which display a consolidated drop of 49% (same figure as in EU), but much more positive for furniture (+ 26%) on the background of a buoyant + 40% for all manufacturing, totally out of comparison with Europe.

Broader comparisons are provided by Unido statistics on a larger set of countries, as shown on the table below.

Average annual real growth rates of Manufacturing Value Added at the 2-digit level of ISIC (Rev.3)						
ISIC(Rev.3) - Branch	Average annual growth rate (%) - 1995-2005					
	United States of America	China	India	Turkey	Morocco	Tunisia
17 - Textiles	0.5	na	3.7	1.1	0.8	4.8
18 - Wearing apparel, fur	-5.2	na	-3.3	1.2	-1.4	1.9
19 - Leather, leather products and footwear	-3.4	na	5.1	-1.3	1.3	7.1
36 - Furniture; manufacturing n.e.c.	1.9	na	-6.6	5.4	3.2	1.8

na : not available

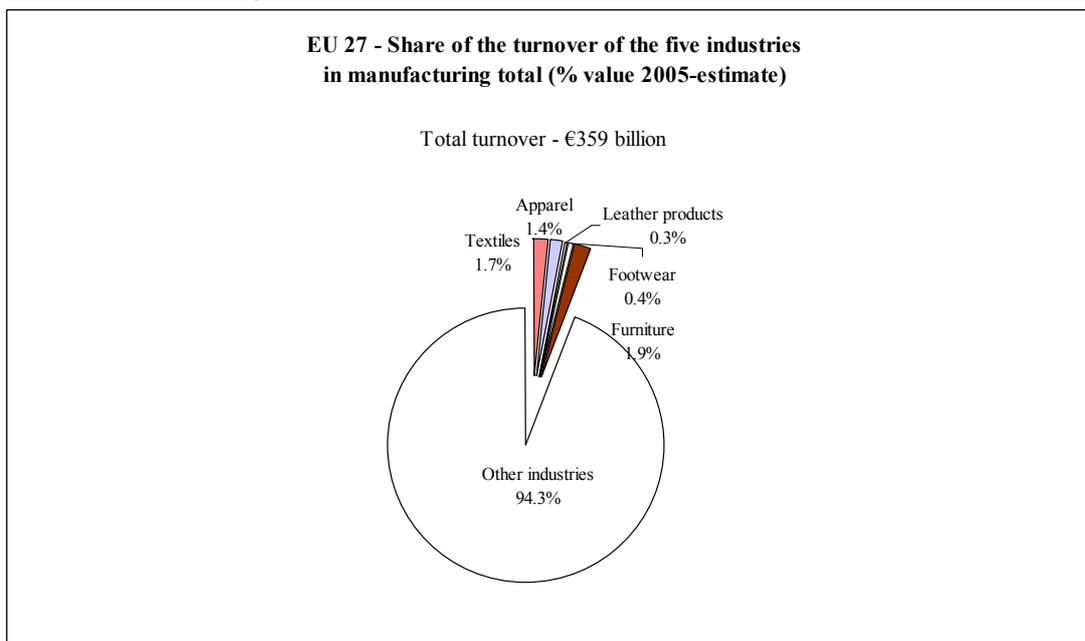
Source United Nations Industrial Development Organisation (Unido)

Over the last decade, it can be observed that the development of the textile sector has been positive in all countries selected, even though major growth differentials can be seen between them. The situation in much more contrasted for the other sectors.

For China the evolution in value added – as provided by other Unido sources - is a very significant growth in current terms, with multiplication factors in the area of 2 for textile and 3 for all other sectors under review, between 1995 and 2005.

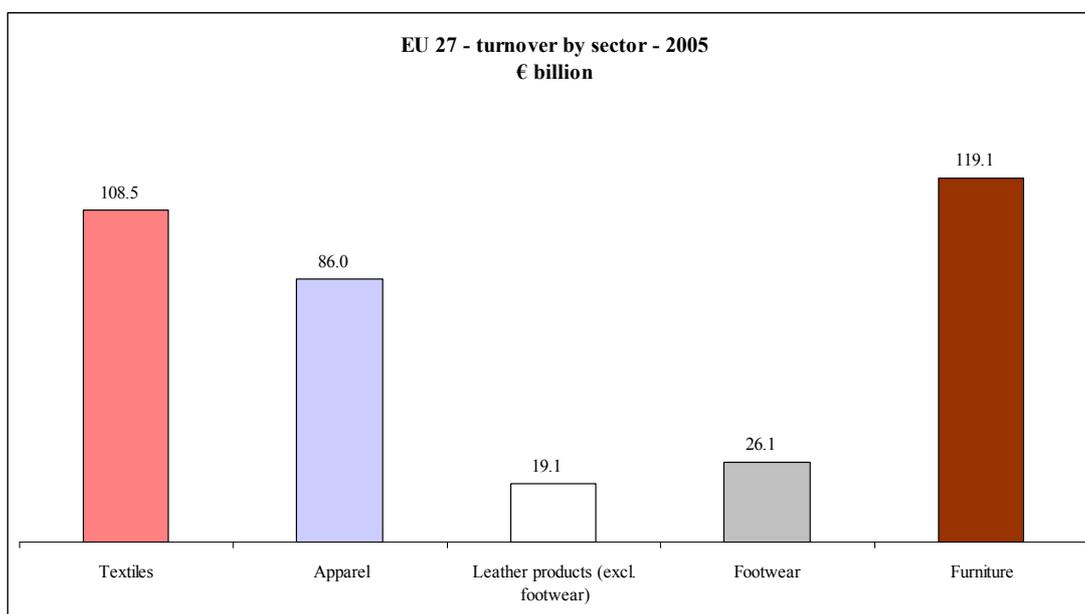
## 2.3 TURNOVER AND PRODUCTION PRICES

- **Structural analysis**



Source Eurostat and IFM estimates based on Eurostat data

In 2005, the five industries account for 5.7% of the EU 27 manufacturing total turnover.



Source Eurostat and IFM estimates based on Eurostat data

The total turnover of these five sectors in the EU represents 359 billion euros in 2005. Out of the total, the textile and furniture industries each represent one third of the whole. For textiles, the largest activity is fabric manufacturing (weaving, knitting and finishing). It is larger than the footwear sector as a whole.

Furniture is dominated by the manufacturing of chairs and of hard home<sup>5</sup> and garden furniture (i.e. furniture for the home, excluding kitchen, chairs and mattresses).

Apparel is the third largest sector, representing one fourth of such activities in the EU, followed by footwear and other leather products.

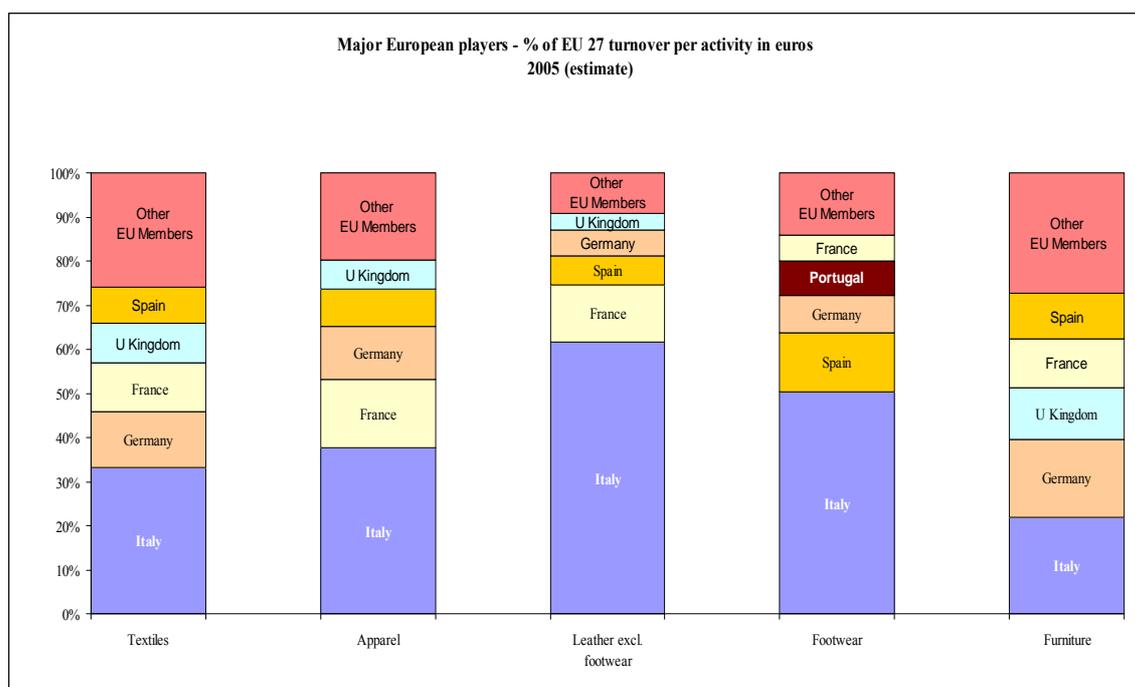
This breakdown can also be observed when considering each Member State, but there are significant discrepancies between national situations due to local strongholds. Particularly high involvements in textiles can be seen in Belgium (carpets and non-wovens), Slovenia (made-up articles), the Czech Republic (made-up fabric manufacturing).

Apparel activities are more evenly distributed, with the exception of three Eastern European countries, which display a very high dependence on the sector : Hungary ,Bulgaria and Romania.

In leather, only Italy, Slovakia and Romania stand above average in the sector, thanks to footwear manufacturing in the latter two cases.

As to the furniture industry, hard home and garden furniture is a stronghold of Denmark, office furniture makes one for the Netherlands and Ireland, kitchen is one for Ireland and Finland and seats for Slovakia and the Netherlands.

### • The major players in Europe



Source Eurostat and IFM estimates based on Eurostat data

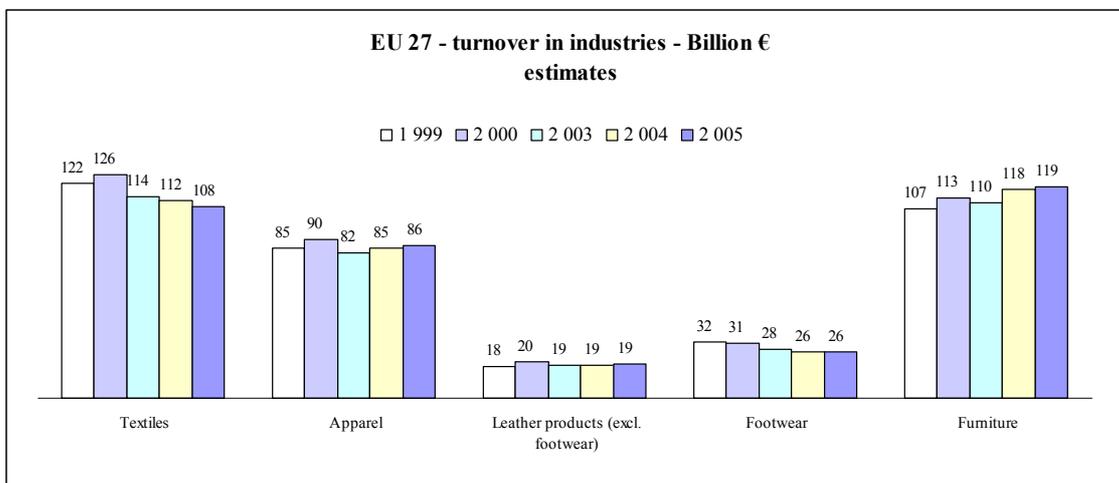
The largest EU countries tend to display the largest market shares and a significant Italian pre-eminence can be observed in each activity, most on leather and shoe (more than half of the EU turnover originates in Italy), less on furniture (22%) due to the rival importance of Germany (17%).

France and Germany appear as major industrial players with stronger sectors (furniture in Germany, apparel in France) and weaker ones (leather in Germany, footwear in France).

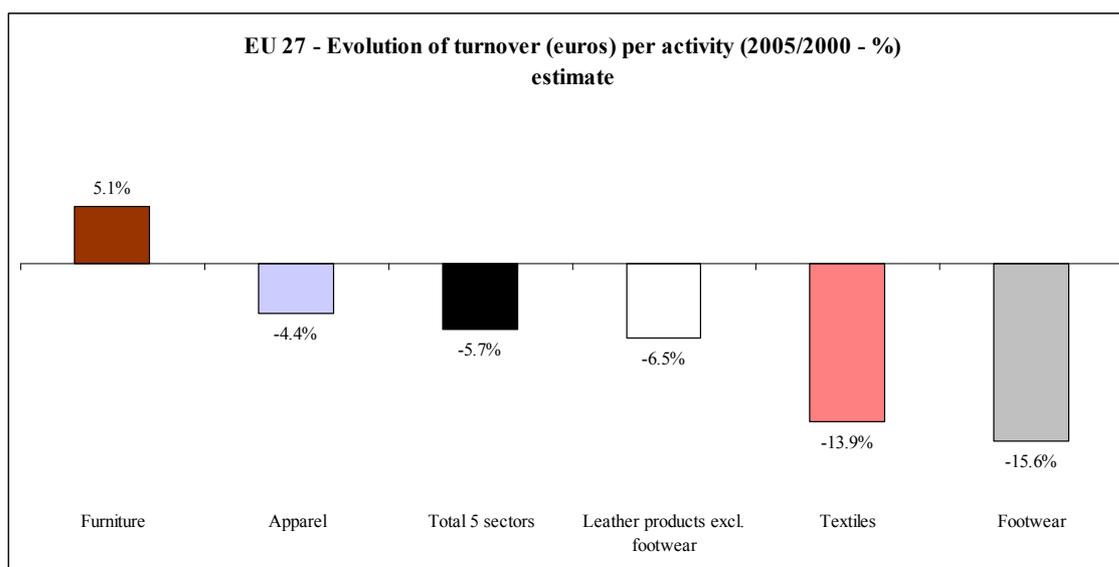
<sup>5</sup> Dining-room, bedroom and garden furniture i.e. excluding upholstered items, kitchen, office, shop furniture and mattresses

Within the middle players, with shares in the area of 5 to 12% of EU turnover, Spain shows stronger activity in footwear, while the UK stands particularly low in leather and footwear. In Portugal the furniture sector is below the national average share.

- **Recent developments (2000 / 2005)**



Source Eurostat and IFM estimates based on Eurostat data



Source Eurostat and IFM estimates based on Eurostat data

The analysis of turnover changes between 2000 and 2005 gives evidence of an overall decrease of the sectors under consideration with the notable exception of the furniture sector. The corresponding drops in turnover over the five years can be seen in the graph above. As far as textiles are concerned, the 14% fall was equally due to decreases in spinning, weaving and knitting activities, while losses have been much less drastic for made-up textiles and other textiles like technical textiles and carpets. In the area of furniture, strong increases can be observed in chairs and seats production (+17% from 2000 to 2004), whereas a loss (-6% over the same period) can be seen for office and shop furniture.

The development of retail networks is a proven trend among companies having brands and design capacities, in particular in the apparel and leather goods industries. Even though the additional turnover

generated by the sales to the public cannot be measured by existing statistical tools, empirical evidence suggests it is slowly growing throughout the EU. However its consolidated importance is not enough to offset the overall production decreases incurred by the five industries under review.

It is interesting to examine the overall evolutions affecting turnover with those concerning production, as seen in the above chapter.

#### Evolution of companies' costs and revenues as % of production values (EU 27)

		Textiles	Apparel	Leather*	Footwear	Furniture
Entrants	2004	70	70	75	71	69
	2000	68	69	75	71	67
Value added	2004	30	30	25	29	31
	2000	32	31	25	29	33
Production value		100	100	100	100	100
Traded goods	2004	6	9	4	5	6
	2000	5	10	5	10	4
Turnover	2004	106	109	104	105	106
	2000	105	110	105	110	104

\* excluding footwear

Source : Eurostat and calculations by IFM

This table shows that, at the level of EU 27, the extra turnover obtained from traded goods has not increased over the period, and that companies have not succeeded in offsetting production losses by developing their sourcing of finished goods. To a large extent one can say that the possibilities for that kind of sales extension are directly linked with the power of the brands concerned. The high proportion displayed by the apparel sector provides evidence of its overall marketing know how, even though the trend is rather negative over the period.

In the cases of textiles and leather, a slight increase can be observed, showing that, to a very limited extent, firms in the two sectors increasingly purchase goods which are either similar to their own (e.g. different types of towels or bags), or complementary like home decoration items for home textile companies or sunglasses for leather goods firms.

In the case of footwear a significant decrease can be observed. The footwear industry has been largely integrated in retail for many decades (Bata, André, Salamander etc.) and has already extended its activities to accessible territories like leather accessories, socks, shoe polish and narrowly related articles, with little success in the area of apparel. The four-year trend reflects a deterioration of extra sales which is even more drastic than the one observed for production values.

As far as furniture is concerned, despite the very large product ranges displayed by retailers like Ikea or Conforama, the industry itself is just beginning to diversify its ranges and to trade complementary goods. It was quite slow to start implementing such strategies as companies succeed in maintaining their sales through their own production better than in the other industries.

As explained during the in-depth interviews with companies, trading finished goods allows companies to offer a broader range of products and reach a critical level of exposure in the market. Examples are given by almost all firms, to a lesser or higher degree.

It is particularly necessary for companies investing in their own retail network to be able to offer customers a selection of products which covers a large part of their needs, within the boundaries dictated, not by the factory, but by the brand. Companies thus have to source products which have nothing in common with their original know-how: furniture makers like Hughes Chevalier, Andreu World and Ahrend offer decoration items or electrical appliances, shoe makers like Alpina and Ecco offer luggage, accessories and fashion or other types of shoes, apparel makers like Boss and Folly Fashion offer accessories and shoes and even technical textile specialists like Ace Protection, Desso or Mehler offer complementary ranges. Of course in the leather sector, groups like LVMH or Gucci have also considerably expanded their product base over the years to all segments where their lifestyles can make any sense for end consumers.

When one compares the changes in turnover with the changes in the production prices, at the EU 27 level, one can observe that the decrease in turnover cannot be accounted for by price changes, as the production price indices have increased everywhere with very few exceptions. On average for EU 27 production prices have grown up by one to two percentage points per year, with the exception of textiles (only +3% between 2000 and 2005). Any decrease in turnover can thus be attributed to a drop in the volumes of production in correlation, for many companies- with an erosion of the profit margins (as can be seen in later pages).

When focussing on the largest European players one can see that the drop of EU turnover since 2000 can be attributed to a few Member States, particularly the UK, with losses in all sectors except furniture ranging from -34% in textiles to -73% in footwear. Ireland, Belgium and the Netherlands have also been heavily affected over the 5 year period.

The very high concentration of the British retail system has fostered the development of low-price imports for the five sectors under examination from remote sources. The situation has worsened when Marks and Spencer officially abandoned their ambition of "buying British" around 2000: the impact was particularly deleterious on sectors such as apparel, textiles and footwear.

Germany has also experienced significant losses in all activities. Particularly bad scores have been registered in the area of spinning, weaving, and knitting but also in all furniture categories except mattresses and seats. Price evolutions have remained quite limited, with a maximum of + 5% in the furniture sector. Therefore the huge losses are only due to falls in production volumes.

The development in Germany has been less dramatic than in the UK. One of the major reasons is that the market concentration is much less high (buying groups instead of chains, as explained in the section dedicated to Retail developments in chapter Market Developments. However the economic difficulties which have followed the reunification have durably depressed local consumption and prices, paving the way for a significant rise of low price imports.

The only significant increase in the period is due to the 12 new Member States, with an average 16% growth of production for the five sectors considered between 2000 and 2005 : the highest growth rates being due to Bulgaria (+114%), Romania (+68%) and Slovakia (+56%).

Italy displays signs of erosion in the textile field (-5% between 2000 and 2005), but some growth in furniture, apparel and leather (+8, +5 and + 1% respectively) and a significant decline in footwear (12%). However in all sectors, Italy's performance stands above the EU average, which brings an increase in Italy's market share in all those activities. Within textiles, it is the relative stability of the fabric manufacturing (and spinning to a lesser extent) sector which has allowed to offset the very dramatic drops observed in all other subsectors. The overall satisfactory performance of the furniture industry is largely attributable to the chair and seat sector, which has more than offset the mediocre developments observed in the hard wood and mattress sectors. As far as subsectors are concerned the situation obviously varies according to specific competitive conditions – like the growing importance of service in areas like the kitchen business - and foreign competitors who may be extremely active on specific segments - for example Turkey and China for knits.

The Italian situation has certainly been less worrying than in most other large EU economies, because, once more, the retail concentration is far lower. However Italian producers now have to face the penetration of large low price retailers which have already gained high market shares in many countries. The situation is thus more preoccupying for the future than can be perceived from Italian past records. Moreover the analysis of profit margins and cash flows (see section E. Financial Strength of the Industry) reveals that sales have been partly maintained thanks to sacrifices made by companies on their very profitability.

The situation is more contrasted for France, which posts decreases above the EU average for textiles and footwear, but much better performances on apparel, leather and furniture. Prices have remained rather stable over the period, with the exception of a 5% decrease for apparel.

The fairly good performance of the French apparel and leather sectors can be largely attributed to the growing importance of the luxury sector and to the development of brands and retail stores, as can be seen in the analysis of intangible investments (see section C investment and changes in asset structures). Such strategies have enabled companies to increase their sales, by the mechanical effect of including some retail margin in their turnover and also by adding a much larger volume of traded goods to their core activities. In the case of furniture, the overall 8% growth is only due to a strong development in seats and chairs (+35%), which offsets decreases observed in all other segments.

Also contrasted is the situation in Portugal, where apparel has been strongly developing since 2000, (+15% between 2000 and 2005) as well as furniture (+17%), while textiles and footwear sectors were more or less depressed. Prices have grown comparably to the EU average, except for textiles where a net erosion can be observed.

The situation in Portugal is one of tough competition in all sectors, aggravated by the fact that many a firm is still positioned in activities with a fairly low value added, where price confrontation with lower cost imports is direct. The better performance of apparel can be attributed to the dynamism of highly reactive retailers like Inditex who largely source apparel from Portugal and other close-by locations to be delivered everywhere on a worldwide basis.

Similarly in Spain the situation is contrasted with a strong growth in furniture (+24%) and a significant decrease in all other areas, from -3% for textiles to -37% for leather.

The price evolution is not directly correlated to those evolutions as prices have generally increased. To a lesser extent than Portugal, Spain's industries are not positioned sufficiently higher (in terms of value

added and prices) than imports. Margins are also strongly receding as companies fight to maintain their present market shares.

In the new Member States price evolutions have been very high in national currencies but they mostly reflect locally high general inflation rates.

*(See Appendix 1 II. Evolution of structures in the sector 2.3 turnover and production prices, tables 1 to 6 for more detailed information about turnover).*

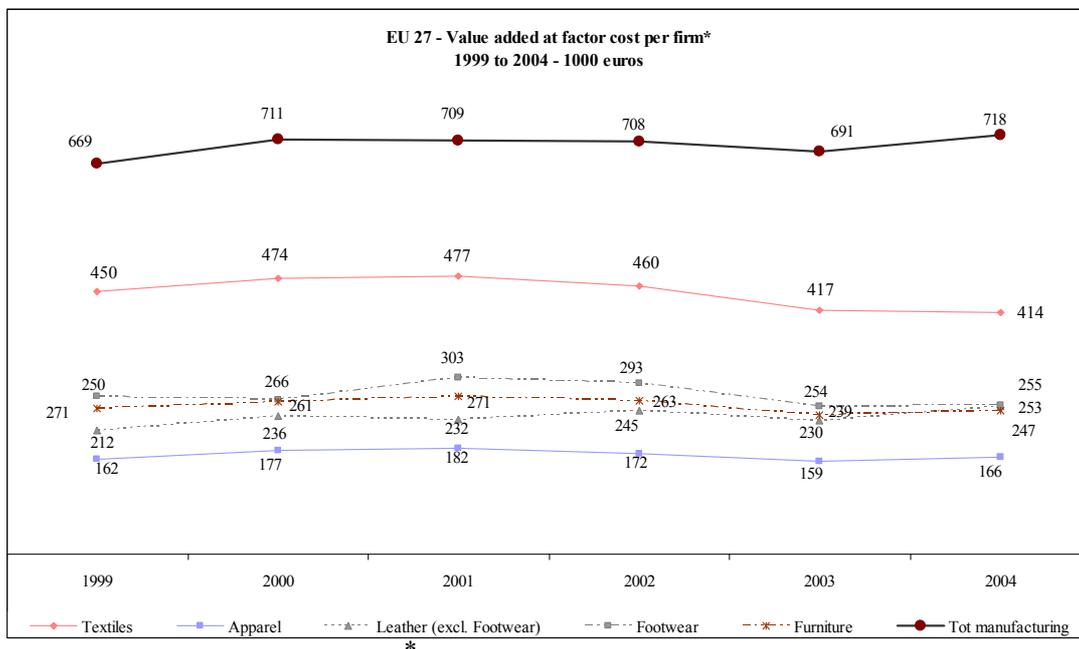
## 2.4 CONCENTRATION

The deterioration that can be observed in the number of firms and in the production indices in the EU is caused by a significant worsening of market conditions over the last decade, largely due to the mounting quality / price competitiveness of Asian economies with fast improving quality levels, and slow increasing labour costs, together with the concentration process of European retail<sup>6</sup>. This increasingly globalised environment demands that firms be able to take strategic moves, which generally are completely out of the reach of small companies and tend to urge medium sized companies to grow to an economically competitive size.

- **Restructuring and consolidation**

Between 2000 and 2004 a great number of firms have disappeared in the EU 27 : 14,100 in the apparel sector, i.e. 9 % of the total ; 7,000 in textiles, i.e. 8 % of the total number; 2,500 in the leather sector, corresponding to a 12% drop; 4,600 in the footwear (-14 %) ; and 1,800 in the furniture sector, which represents a 1 % erosion for this industry. These falls are quite severe in comparison with the developments in the manufacturing industry as a whole : -0.3 % in the number of firms between 2000 and 2004.

This shake out of firms has been correlated with a very limited consolidation of the apparel, leather and footwear sectors, for which value added per firm in the EU 27 has increased by respectively 3,7 and 2% over the 2000-2004 period. On the opposite in textile, value added has decreased by 9% and in furniture by 2%.



Source Eurostat and IFM estimates based on Eurostat data

Even though they may not be visible at the macroeconomic level, there has been a phenomenon of consolidation in some activities due to the mechanism of mergers and take-overs which has been initiated from within companies and from without, by external financial players. It has enabled firms to turn global: the top 100 of Europe firms (evidenced by financial data publications and collected in the

<sup>6</sup> The latter phenomenon is analysed in the chapter dedicated to EU 25 Home markets / Retail developments.

Amadeus database) is increasingly dominated by global brands and international players. In textiles, the top 100 is also increasingly dominated by global specialists.

- **The situation in the five sectors**

For the time being, the general level of concentration of these five industries is quite low in comparison with the manufacturing industry standards, but it is increasing in a number of specific areas.

- The textile sector fares better than the others in the existing level of consolidation. The case studies and research conducted have showed that in some subsectors such as technical textiles, the concentration seems to be both quite important and currently growing, and that this has already enabled companies to act as important players in the market. This can be seen in the case of ACE protection (production of disposable personal protection) in Sweden, now a subsidiary of German based Dräger Group. Quite similarly, Colbond Geosynthetics GmbH (producer of nonwovens and composites with nonwoven cores) also is part of a bigger company -AKZO and has recently become part of Low and Bonar. Another highly concentrated firm in the technical textiles industry is Mehler Technologies GmbH. The company has set up production in Germany and Czech Republic and enjoys market leadership in fabrics for tarpaulins. In the sector, Ten Cate and Gamma are leading consolidators with a clear ambition of global leadership in specific niches. While doing this they have divested from activities restricted to national or regional markets as in interior textiles where differences in taste limits internationalisation.

All these companies estimate that the consolidation of their industry has helped them develop global presence and strengthen their market position considerably. This has been made possible primarily through a much higher availability of capital and the access to global distribution networks. In some cases the takeover can also lead to the closure of one plant. Through a better allocation of human and regional resources, it has also lead, in some cases, to upgrading the activities of the most dynamic and creative part of the companies, for example implementing research and development centres on their facilities. The consolidation process is largely believed to be one major success factor for the industry and, as such, is likely to go on in the technical sector.

Even though concentration in the carpet sector is quite above the textile average for the time being, consolidation has to go on in Europe. On the global competitive market, the EU producers are at a disadvantage in comparison with US producers: in the USA, 3 companies hold more than 60% market share. In the EU, there is no company with more than 8% market share. Therefore, further consolidation of the industry is expected and hoped for, in order to strengthen its position. However in this sector as in technical textiles, consolidation is heavily constrained by differences in taste that do not only have a marketing impact but also an impact on production technologies used. Hence concentration has specific organisational challenges of combining segmented marketing with economies of scale in manufacturing.

In the apparel sector this consolidation process can hardly be observed, except in the luxury segment that has just been mentioned. However in the largest part of the industry companies work in partnerships with competitors, mostly on a local basis. Informal clusters or established districts like in Italy enable firms to benefit from certain economies of scale, be it in mutualising prospection costs or by simply discussing strategic issues between themselves. Such examples can be found in the Biella area in Italy, which have permitted companies to develop their activities through sharing some expenses and investments: recruitment of specialised personnel, increasing of research and development and participation in trade fairs.

Local cooperation does provide companies with a higher level of flexibility and also enable them to seize opportunities and orders larger than they could afford by remaining on their own. In Italy cooperation is an integral part of companies' culture: working with colleagues / competitors, thus enlarging one's own subcontractors' network exponentially, is a key asset of the regional competitiveness.

Regional concentration is also a key strategic trend for the companies in the Euromed non-EU zone. One example is the Tunisian jeans production where companies have taken advantage of the existing cluster in the Sahel region to considerably strengthen their exports to the EU.

- The consolidation in the leather and shoe industries is also fairly low. A large part of the industry is still family owned like Etor, ECCO or Hulshof, and not part of major groups like Tanneries Roux. In the leather sector many firms have integrated themselves to ensure the quality level of the materials used: when hides are rapidly transformed into wetblue, no salt needs be used, for conservation and the finished leather is much more beautiful to the eye and touch. One example for vertical integration is the ECCO Company – the company produces wetblue, leather, shoes and has set up a distribution network. A wise management of the value chain with distribution of R&D and production in Europe and Asia has enabled the company to strengthen its position on the global market. However following the logic of Italian textile companies, other manufacturers go on working in non financial integration with hides' suppliers. Etor, a smaller firm but now one of the five largest shoe manufacturers in Turkey, has succeeded in deriving from their relatively large size a competitive advantage as far as brand building and international promotion are concerned.

- In the furniture industry, consolidation of the industry is also quite low. Global competition is much less fierce in this industry than in the others as high transportation costs do not allow a sheer global price competitiveness to be predominant. The incentive to concentration has thus been less strong in this area. However it is also expected to increase, as can already be seen particularly in the sector of mattresses kitchen and of office furniture. In this segment significant economies of scale can be obtained in the sourcing of wood-panels with increases in production and purchasing volumes: 30% decreases are not uncommon. In traditional wooden furniture concentration trends are less marked as local differences in taste somewhat limits a global outlook.

Already some companies like B&B Italia or Poltrona Frau are emerging as global federators of design brands. In the case of Poltrona Frau, the internationalisation of the activity has been allowed by the building of a large and powerful group of furniture companies, which in turn had been made possible by a change in the firm's capital structure, opening it to non-family investors.

In the case of furniture ensembles as for kitchens or offices, larger European manufacturers have gradually focused their industrial activity on the largest value adding part of it, which is the design and making up of doors and tops, while they have increasingly sourced wood-panel cases and other semi-finished components from price competitive areas, like new Member States or neighbouring countries, mostly in Eastern Europe. It has allowed European manufacturers like Ahrend, better penetration of emerging markets and the outsourcing of components to remote competitive specialised suppliers. In the kitchen sector mergers have helped firms reach the critical size level to implement this policy, as can be observed in the case of Snaidero (Bonnet + Domoform).

Like the apparel industry, the furniture sector is also traditionally organised in regional clusters, particularly in Italy. This form of concentration allows a higher degree of specialisation to be achieved by

the firms concerned. In the example of the Brianza area it has clearly allowed individual companies to increase both their competitiveness and flexibility.

Concentration phenomena have not only taken place between companies within the same sub-sector, as there are various cases of vertical integration as well. Number of companies studied, especially in the textiles and leather sector have opted for more or less elaborated vertical integration. This allows the industry to be more competitive and to upgrade in quality by controlling all steps of production and to maintain high quality. Some companies prefer to have the control of the value chain from researching, designing and purchasing of wool to combing, spinning, weaving and finishing of fabrics. Other companies in the apparel sector have also opted for vertical integration (from production to retailing of their products) in order to control and optimize the value chain of the products.

All companies interviewed in the textile and apparel sectors consider that the concentration will be positive for the textile industry. The oversupply in the EU is leading to mounting pressures on prices and enables retailers to demand very tight prices from their suppliers. Less fragmentation on the suppliers' side is expected to strengthen the position of the industry.

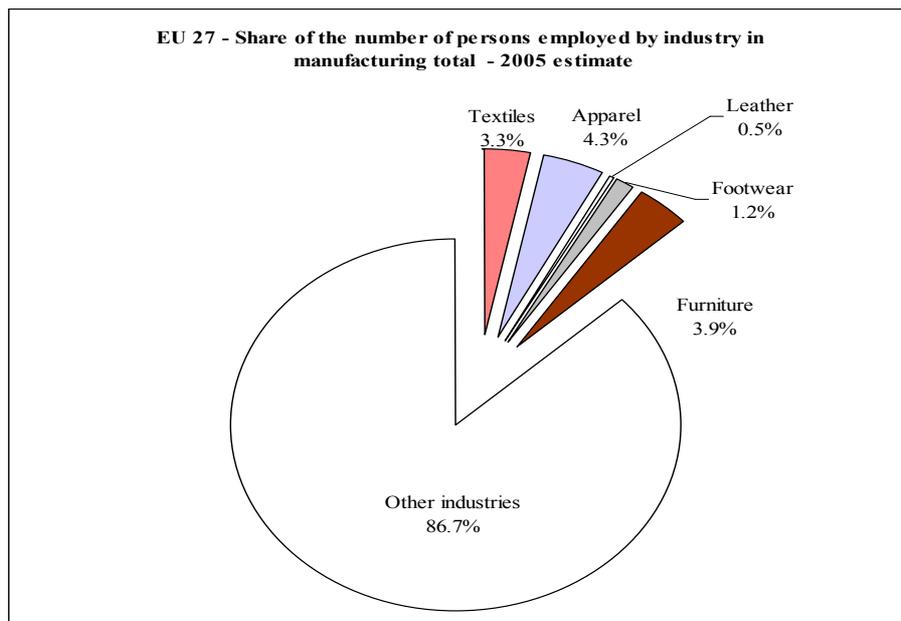
In the new Member States firms often lack the required resources to carry this concentration process, even though they may be quite aware of its necessity. Vertical virtual integration as in the case of the furniture manufacturer Sellaton in Hungary, with tight links with home retailers, may help cancel size disadvantage at least on some commercial aspects. However it does not provide any help as far as industrial restructuring is needed.

## 2.5 EMPLOYMENT

- **Structural analysis**

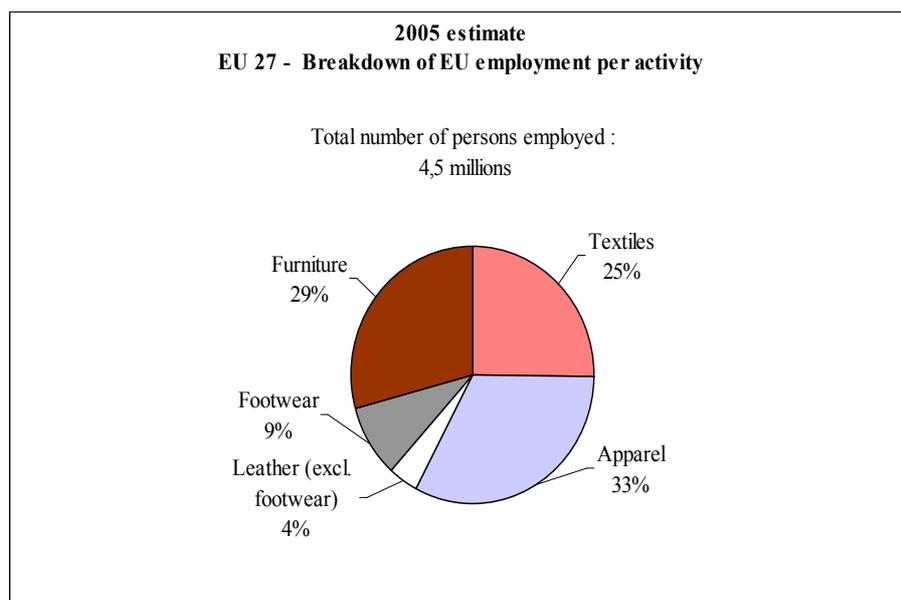
The following graph shows the contribution of the five sectors (textiles, apparel, leather excl. footwear, footwear and furniture) to the employment (number of persons employed) in the EU 27 manufacturing sector. On the whole, the contribution of the 5 sectors to manufacturing employment is twice as high as their contribution to national manufacturing value added.

(See Appendix 1 II 2.5 Employment–table 1 for more detailed information).



Source Eurtostat and IFM estimates based on Eurostat data

The share of employment of the 5 industries in EU 27 total manufacturing reaches 13 % in 2005. It has decreased by 2 points in comparison with 2000.



Source Eurtostat and IFM estimates based on Eurostat data

Total employment for the industries under analysis can be estimated at 4.5 million workers within the EU 27 in 2005.

Three major sectors each employ roughly 30% of the total population: textiles, apparel and furniture. Two smaller sectors, footwear and leather (excluding footwear) each represent 9% and 4% respectively of the total number.

Within textiles, employment is rather evenly distributed between subsectors with the exception of fabric manufacturing which employs one third of the total workforce. Within furniture, the hard home and garden furniture (home furniture excluding chairs, kitchen furniture and mattresses) employs 52% of the sector and chair manufacturing 22%.

These breakdowns can also be observed within Member States but with some notable gaps between countries. In some cases, the national share of employment does not fully correspond to the share of production/value added from a structural and dynamic point of view, these phenomena have been analysed in the section dedicated to productivity.

The table below shows the size of each Member State in terms of its contribution to EU 27 employment within both manufacturing and the five sectors analysed in the report. Germany is the largest contributor to EU 27 manufacturing with 20% share of employment in 2005. France and UK's shares are only one half of the German share but Italy displays a higher employment with a 13% share. Germany's contribution to EU 27 five sectors is lower (7% of number of person employed).

Share in total EU 27**	Number of persons employed					
	2003	2004	2005 e	2003	2004	2005 e
Breakdown by Member State of employment	Total 5 sectors *			Manufacturing		
Germany	7.4%	7.4%	7.3%	20.7%	20.7%	20.4%
Italy	19.5%	19.2%	20.3%	13.5%	13.4%	13.9%
France	6.8%	6.6%	5.7%	11.2%	11.2%	10.1%
United Kingdom	6.2%	6.0%	5.7%	10.0%	9.8%	9.6%
Spain	8.5%	8.3%	8.7%	7.4%	7.4%	7.7%
Poland	9.0%	9.8%	9.8%	6.7%	7.1%	7.3%
Romania	12.9%	13.0%	12.7%	4.9%	4.8%	4.8%
Czech Republic	3.4%	3.3%	3.1%	3.9%	3.9%	4.0%
Portugal	6.8%	6.9%	7.3%	2.5%	2.5%	2.6%
Hungary	2.8%	2.6%	2.5%	2.4%	2.4%	2.4%
Sweden	0.7%	0.7%	0.7%	2.3%	2.3%	2.3%
Netherlands	1.1%	1.1%	1.1%	2.3%	2.3%	2.3%
Bulgaria	4.5%	4.9%	5.0%	1.8%	1.8%	1.9%
Austria	1.4%	1.4%	1.4%	1.8%	1.8%	1.9%
Belgium	1.4%	1.4%	1.4%	1.8%	1.8%	1.8%
Denmark	0.7%	0.6%	0.6%	1.2%	1.2%	1.2%
Finland	0.5%	0.5%	0.5%	1.2%	1.2%	1.2%
Slovakia	1.5%	1.5%	1.5%	1.2%	1.2%	1.2%
Lithuania	1.8%	1.7%	1.7%	0.8%	0.8%	0.8%
Slovenia	1.0%	0.9%	0.9%	0.7%	0.7%	0.7%
Ireland	0.3%	0.3%	0.3%	0.7%	0.6%	0.6%
Latvia	0.7%	0.7%	0.8%	0.5%	0.5%	0.5%
Estonia	0.8%	0.8%	0.8%	0.4%	0.4%	0.4%
Cyprus	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Luxembourg	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%
Malta	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Greece	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
<b>Total EU 27</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>
<b>EU 15</b>	<b>61.4%</b>	<b>60.5%</b>	<b>61.0%</b>	<b>76.6%</b>	<b>76.2%</b>	<b>75.8%</b>
<b>EU 12 new MS</b>	<b>38.6%</b>	<b>39.5%</b>	<b>39.0%</b>	<b>23.4%</b>	<b>23.8%</b>	<b>24.2%</b>

\* textiles, apparel, leather excl. footwear, footwear, furniture

e : estimate

\*\* data related to Greece are not available

SSource Eurtostat and IFM estimates based on Eurostat data

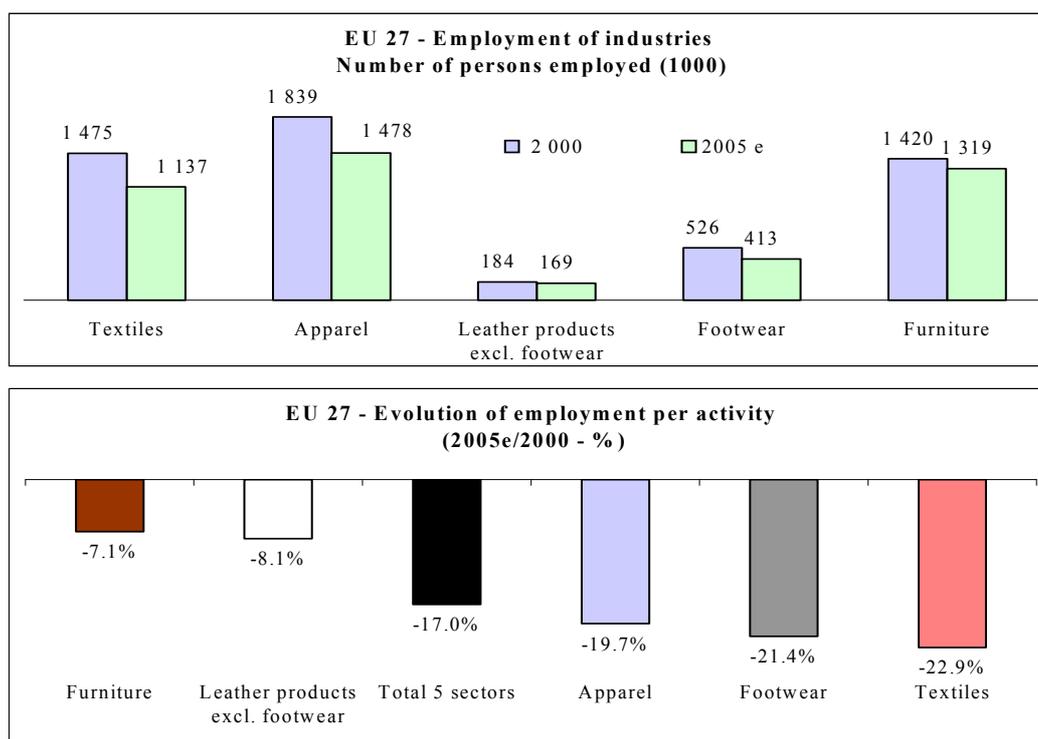
The addition of the United Kingdom, France, Italy and Spain led to cumulative shares of 62% of employment in EU 27 manufacturing for the five largest Member States, while the Member States that joined the EU since 2004 contributed 24% to EU 27 employment in manufacturing. If one focuses on the five sectors under examination the former share is only 48% and the latter 40.

As far as the five sectors is analysed in the report are concerned, the main contributor to EU 27 employment is by far Italy with a share of 20% of employment (against 14% for total manufacturing).

With 910,000 employees, Italy is by far the largest employer in the EU, with shares up to 38% regarding leather (excluding footwear) and 27% for footwear.

One should notice that the new Member State Romania is a very important employer, with the equivalent of 13% of the total EU employment - largely because of its being an extremely large apparel employer, with 288,000 workers in this single sector.

- **Recent developments: 2000-2005**



*e = estimate*

Source Eurostat and IFM estimates based on Eurostat data

In EU 27, the overall trend in the 2000-2005 period has been a significant decrease of 17% very close to the percentage figures observed for the trends in turnover. During the same period, employment in total manufacturing has registered a decrease of "only" 8%.

Over the 2000-2005 period employment in the USA has dropped more steeply than in the EU and in each industrial sector covered by the present research the employment losses have been considerable : - 34% in textiles; - 48 for apparel; - 42 for leather and for footwear; - 17% for furniture

In China, the 1995-2003 period has also seen employment fall in textile (- 26%) and furniture (- 24%), but rise in apparel (+ 65%), and leather/footwear (+ 67%). Over the same period a fairly similar pattern can be observed in India, with a 9% loss in textile in parallel with a + 37% in apparel; at the same time leather and footwear register gains of 12 and 28% respectively.

In Turkey substantial increases in employment can be seen between 1995 and 2001 in all sectors especially furniture (+ 97%), apparel (+ 32%), and textile (+ 19%), with minor changes in the leather and footwear sectors (+ 11% and + 6%).

The employment situation in Morocco appears more stable even though contrasted between industries over the 2000-2004 period, with gains in furniture (+ 33%) and footwear (+ 9%), and losses in textile (- 7%), apparel (- 1%) and leather (- 9%).

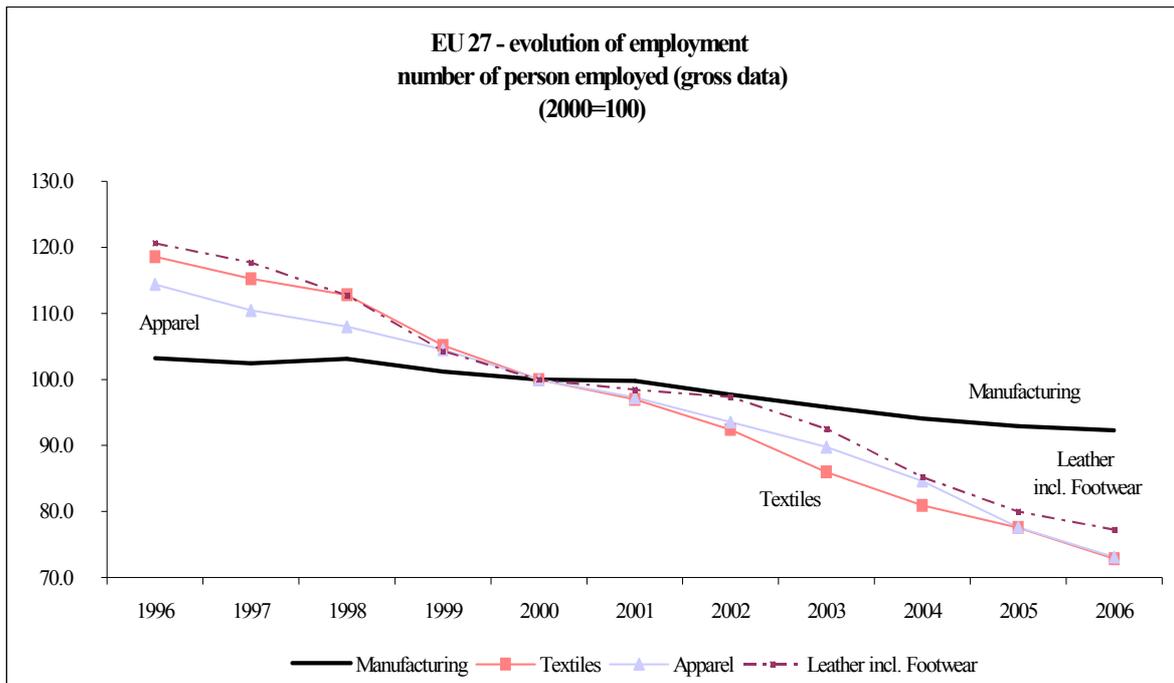
Finally, between 1995 and 2003 data for Tunisia display hugely contrasted evolutions between sectors, with on the one hand + 393% for textile and + 83% for footwear, and on the other – 22% for furniture, - 18% for leather and + 7% for apparel.

In the EU, in the various sectors, the trends have always been much steeper than the trends concerning turnovers. The largest discrepancy can be observed in the case of apparel where the downward trend for employment (-20%) has been by 15 points more negative than for turnover, reflecting the very strong trend to relocation of production in the sector.

At the level of EU 27, the largest part of job losses has occurred in the apparel (39%) and textile (37%) sectors, almost of textile losses being due to the fabric manufacturing industry. The furniture sector accounts for 11% of the losses in employment and footwear for 7%.

In terms of regions, all Member States have seen their workforce decrease in the five sectors considered with the notable exception of Bulgaria, and to a much less positive extent Lithuania. The largest producing countries have suffered the most, with the UK representing 20% of the overall loss, France, 14%, Italy, 13% and Germany 12%. Poland and Romania have also weathered a significant part of the employment drop, with respective shares of 7 and 5% of the EU 27 decrease.

*(See appendix 1 II 2.5 Employment – table 2 - for more detailed information).*



*(See Appendix 2 – 5 Sources of data and definitions of variables used in the report – STS variable – Number of persons employed)*

### III – TRADE ISSUES

*The extra-EU trade of the EU concerning the five sectors considered remains quite important, as it represents 16% of all EU exports and 22% of imports. However the EU trade deficit is gradually increasing: in 2005, it amounted to € 42 billion, largely due to the apparel sector. Among the five sectors, only furniture has a positive trade balance. Not surprisingly, the trade balance is strongly negative for the apparel industry: imports from Asia have sharply increased the deficit over the last decade.*

*In comparison with stagnating home markets, export markets present a much more promising outlook for developing sales. Between 1995 and 2000, European extra-EU exports have increased by 45%. However between 2000 and 2005, the extra-EU trade has significantly slowed down: the extra-EU exports have grown by a small +3.2 % in current euros. Italy is, by far, the first European exporter for these five sectors with a share of 26.7% of the total European exports (intra EU trade+extra EU exports).*

*The Italian pre-eminence in exports is quite remarkable and particularly so in the leather and footwear sectors. Germany plays an important role as an exporter in the sector of textiles, apparel and furniture. France ranks among the top five European exporters in the field of textiles, apparel, leather products and furniture.*

*Primary existing or potential export markets are the USA, Asia, Russia. In general emerging markets are considered as very attractive as they are less price sensitive than mature markets but require specific costly strategies such as establishing retail outlets.*

*Companies are looking on markets such as the USA and Canada, especially for high quality goods, selling through local distributors or launching international subsidiaries. However the US market proves to be a difficult market due to the complexity of exporting documents and the high cost of protection with the reputedly highest risk of counterfeiting problems.*

*The Asian market is also considered to represent a big potential, especially for the apparel sector but the access to this market is considered quite difficult for the EU companies, particularly for SMEs. It is a firm belief within successful firms that export opportunities could be tremendously increased if trade barriers were lowered.*

*The strategy of many players has led them to start operations to secure export markets: examples are to be found in textiles and furniture (production facilities abroad) and in luxury segments (retail facilities). Investing abroad most often represents the combination of short term lower production costs and long term trade benefits.*

*Extra-EU exports represent a mix of industrial or semi-industrial delocalisation – with materials being shipped for assembly to lower cost countries – and of final exports of products to be consumed in the country of destination. This dichotomy can be found in the five industrial sectors considered. Based on existing consultants' knowledge and on in-depth companies' interviews, it can be assumed that Euromed non-EU countries represent most of the delocalisation exports while the other markets mostly account for final exports.*

*In the textile sector, as far as export markets are concerned, one can observe that EU's customer base has been changing over the years and that Euromed countries have become clients of utmost importance: two major traditional markets of the EU textile industry have*

*significantly diminished their orders between 2000 and 2005 : by 22% for the USA and 21% for Japan. However, the EU industry was able to compensate for this loss of almost one billion euros by developing other final markets like Russia and Hong-Kong, but above all by developing the sales to delocalisation markets (+ 10%). This means that the EU textile industry has thus increased its dependency on the Euromed value chains, becoming increasingly vulnerable to downturns in apparel sales.*

*Export prices for textiles have dropped by 10% since 1999, mostly because of a 13% fall concerning the intra trade over the period, as quota dismantling has eased third countries exports into the EU and fuelled price competition.*

*Looking more specifically at carpet prices, one can observe a clear dichotomy between a high-price price strategy within the EU and aggressive volume policies on extra-EU exports (stable prices of less than 4 euros/kg). These developments reflect the up-grading and service strategies at work in the sector.*

*In apparel, as in textiles, exports to the USA and Japan have dropped since 2000 but this fall has been more than offset by favourable trends on the Swiss and Russian markets in particular. Delocalisation markets like Romania and Bulgaria have considerably grown, to the detriment of Morocco and Tunisia since 2000.*

*Export prices have remained roughly stable since 1999. However a 10% price drop can be observed on the intra-EU dispatches between 2004 and 2005 which, same as for textiles reflects the increased competition in the EU inner market due to the quota dismantling of January 2005.*

*Leather exports are a mix of semi-processed materials and of finished, often branded, leather products. Exports to the USA have suffered a significant decrease (-14%) over the 2000-2005 period but recovered in 2005. Sales to Japan have remained stable. China is becoming a more important partner for the EU leather industry than for the other sectors. Delocalisation countries do not represent a large part of the EU industry's client base.*

*In tanning and dressing activities, intra-EU prices are 68% higher than for extra-EU exports, as top quality entrants are supplied to the EU industry by EU tanners and other upstream players.*

*The situation is completely reversed for finished products where the price of extra-EU exports represents 4.5 times the one of intra-EU traded goods. Both trends appear fairly stable over the long term. The EU luggage industry is largely positioned on a luxury global market. A significant part of intra-EU dispatches concerns product parts that are to be assembled within the EU, i.e. in medium (and not low) cost delocalisation countries like Portugal.*

*Footwear markets are also dominated by the USA, which represent 26% of the total extra-EU exports in 2005, despite a considerable fall in value since 2000 (-44%). Here again Romania appears as a major partner for delocalised production.*

*73% of total exports are sold in the intra-EU market, at a price 75% higher than the average extra-EU export. The trend is quite positive with a 52% increase between 1999 and 2005 but only 1% between 2004 and 2005 when imports have risen by 14% in value and volume, thus increasing price competition in the EU territory. However intra-EU prices have gained 5% during the same 12 month period.*

*The export picture for furniture is dominated by the USA which represents 25% of extra-EU exports in the sector in 2005. It used to be 33% in 2000, and the loss has been considerable. It can be largely attributed to the very aggressive and successful strategies implemented by China's exporters for the US market. However overall exports have increased over the period, thanks to the development of sales particularly in the Euromed zone. This growth reflects the increasing delocalisation of the sector, in terms of component sourcing and product assembly.*

*On the various subsectors of the furniture industry extra-EU export prices are somewhat higher than their intra-EU counterparts. Intra trade represents 74% of total export value, due to a significant proportion of subcontracting within the EU, and develops faster than extra-EU exports.*

*Even though between 2000 and 2005 the total exports of the five sectors to Euromed countries have only increased by 10%, the Euromed zone represents a key trade partner with a share of 24% in the European exports of textiles, apparel, furniture, leather and footwear. This share is particularly high in textiles (38%) due to the very high proportion of apparel subcontracting.*

*On the side of imports, the share of the five sectors reaches 8.8% of the total extra-EU imports in 2005 whereas the consumption of related items represents 8.6% of total consumption. This share has remained globally stable since 1995. Textiles and apparel represent three quarters of the whole. Germany is the main European importer – except for leather products (Italy ranks first).*

*Between 2000 and 2005, the extra-EU trade has significantly slowed down: extra-EU imports have increased by 39 % over the period as against by 67 % between 1995 and 2000.*

*The products which are imported into the EU belong to two different categories: Euromed exports are products which have in general only been assembled there, whereas imports from the Far East are generally items fully made locally and traded.*

*Imports from the Euromed have significantly grown over the period. They have been multiplied by 2.3 in 10 years. However most of the growth had taken place before 2000, imports having “only” raised by 29% between 2000 and 2004. Turkey ranks first among Euromed exporters to the EU, with an overall stable 40% share for the five sectors in 2005. The second Euromed exporter is Romania, with a booming performance, followed by Tunisia and Morocco.*

*In the textile sector, Turkey represents almost two thirds of Euromed exports to the EU, five times more than the second exporter, Romania. As such, Turkey remains by far the first European barrier to the imports from the Far East. The top textile position of Turkey can be largely attributed to the competitiveness of the integrated cotton chain.*

*In the apparel sector the Chinese pre-eminence is quite remarkable, as with a 34% share of extra-EU imports in 2005. Nevertheless the Euromed position is extremely important, as the import share of the area reaches 35% in 2005 largely attributable to Turkey and Romania.*

*Imports from the Euromed zone in leather products are not really important, some 6% of a relatively small import market. China represents 51% of extra-UE imports of the sector and is the only steadily growing supplier, whereas India and Brazil have seen their respective positions deteriorate since 2000.*

*With 22% of import share, Euromed's footwear suppliers partly succeed in resisting to the price pressures coming from Chinese and Vietnamese exporters after quotas have been dismantled.*

*In the furniture sector, imports are much less important than in the other sectors considered. Again, this is largely attributable to the physical weight of the products, which considerably increase logistics costs and to the existence of regional markets and tastes. Imports from the Euromed zone represent 18% of extra-EU imports, among which Romania, with its long historic tradition of wood furniture holds the half of it.*

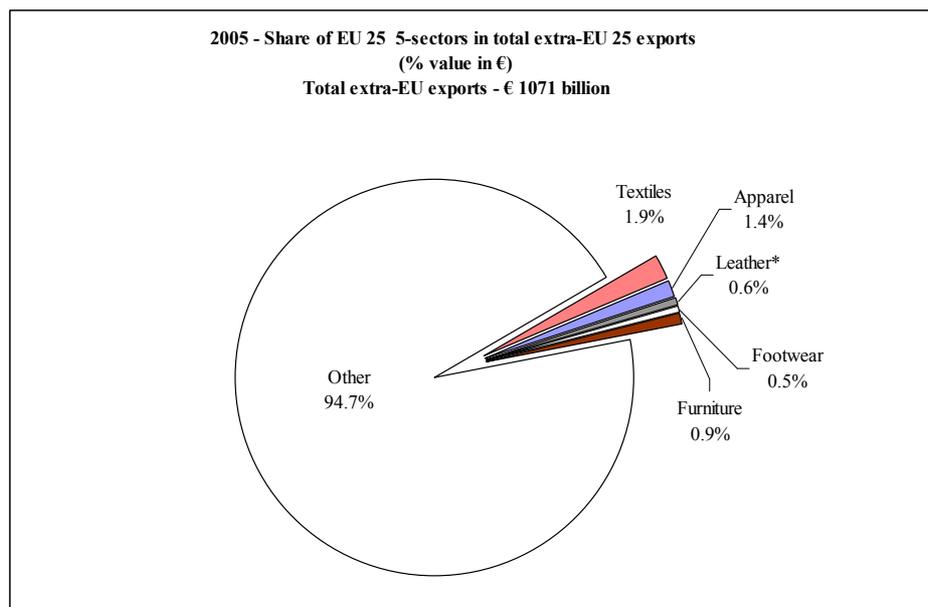
*When comparing the EU situation with the USA trade for the five sectors considered, one can see that China holds a fairly similar place on both markets, being the leader almost everywhere. Since 2000, the strong growth of US imports from China in the different sectors had a very negative impact on the trade between the USA and its neighbours (Caribbean zone, Canada and Mexico), which has not (yet) happened in the EU market.*

### 3.1. EXPORT MARKETS<sup>7</sup>

#### 3.1.1 EU exporters

- **The EU position in world trade**

In 2005, the share of the five sectors reaches 5.3% of the total extra-EU exports which represent € 1,071 billion<sup>8</sup>. This share has decreased since 1995 (6.9%). The total EU (extra-EU) exports of the sectors under examination amounts to € 56.9 billion.



Source Eurostat

The extra-EU trade of the EU concerning the five sectors considered remains quite important, as it represents 16% of the five sectors world<sup>9</sup> exports and 22% of the five sectors world imports. However the EU trade deficit is gradually increasing: in 2005 it amounted to € 42 billion, largely due to the apparel sector.

<sup>7</sup> Note about part II b1) b2) c1° c2) and c3): data in those chapters are extracted from Chelem International trade database issued by the CEPII. See appendix 2 - 2) for more information about corresponding codes between Nace 1 rev 1 and ISIC rev 3.1 used in Chelem database.

<sup>8</sup> In this chapter two different statistical sources are used :

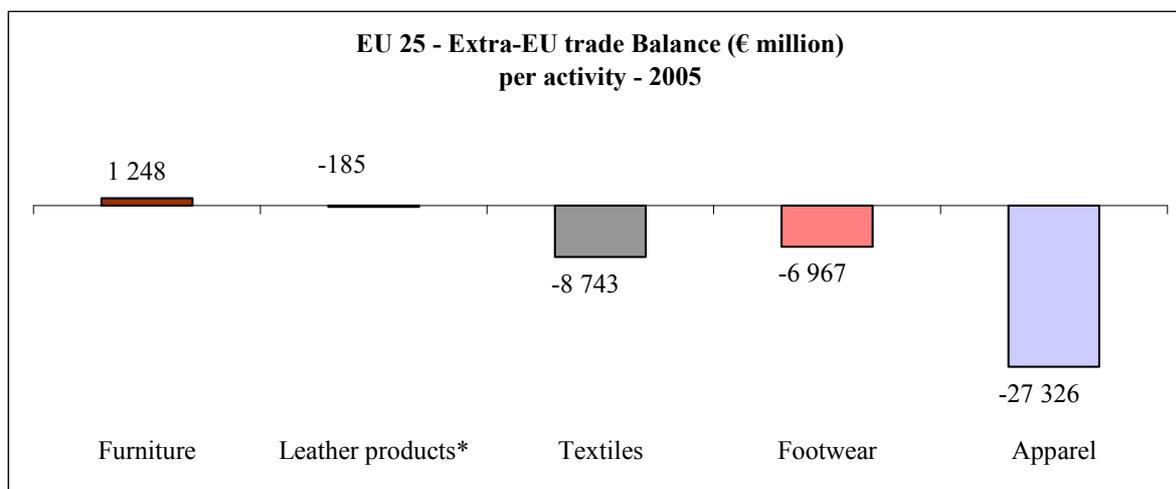
the first one is the Chelem Trade Database (CITI), issued by the Bureau Van Dijk. It provides world trade data only expressed in value. Those data are of excellent quality: the trade flows have been corrected and the following flows are perfectly harmonised: import by a country A from a country B is equivalent to the flow of export by the country B to the country A. However, the Chelem trade database has some limits which are the following ones

- the trade data are not expressed in volume (tons, units, square meters...)
- Some 2005 data were used in May 2007 to update the final report.

The second one is the Eurostat trade database: it provides trade data both in volume (tons, units, square meters) and in value which allow to calculate average export or import prices. Moreover, recent trade data related to 2005 and January-June 2006 are included in this trade database.

<sup>9</sup> World –intra EU 25 trade.

In comparison with stagnating home markets, export markets present a much more promising outlook for developing sales. However the European position is not really strengthening from a macro-economic perspective.



\* excluding footwear

Source Chelem

Among the five sectors, only furniture has a positive trade balance. Not surprisingly, the trade balance is strongly negative for the apparel industry: imports from Asia have sharply increased the deficit over the last decade.

Italy is, by far, the first European exporter for these five sectors with a share of 26.7% of the total European exports (intra EU trade+extra EU exports).

Between 1995 and 2000, European extra-EU exports have increased by 45%. Between 2000 and 2005, the extra-EU trade has significantly slowed down: the extra-EU exports have grown by a small +3.2 % in current euros, while the extra-EU imports registered a + 39.1 % growth.

As a consequence, the evolution of trade balance between 2000 and 2005 has been negative in the five sectors. Trade deficits have been rising rapidly in three sectors: the deficit has been multiplied by 1.6 in apparel, by 3 in textiles, by 8 in footwear. Trade surplus in the furniture sector has been divided by 3.6 between 2000 and 2005. In the leather sector, trade surplus (€ 1.4 billion in 2000) has become a trade deficit in 2005 (€ 185 million).

### The five largest EU exporters

The Italian pre-eminence in exports is quite remarkable and particularly so in the leather and footwear sectors. Germany plays an important role as an exporter in the sector of textiles (18.8%), apparel (15.4%) and furniture (17.5%).

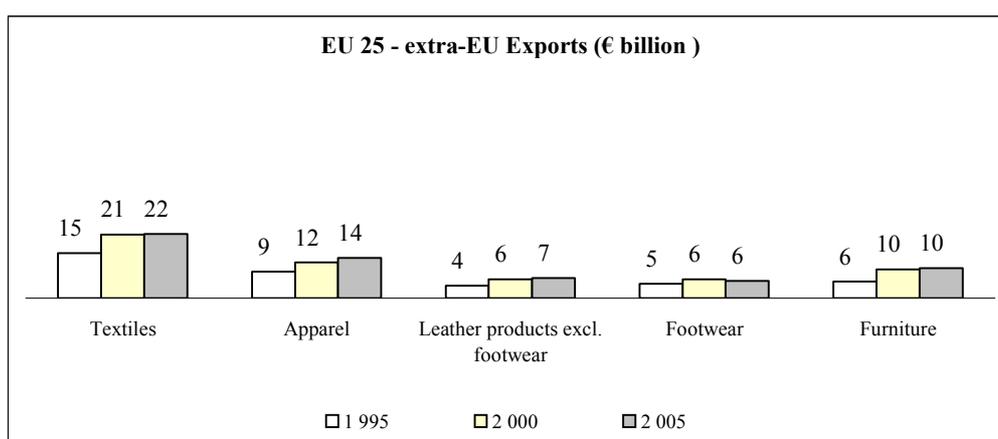
France ranks among the top 5 European exporters in the field of textiles (10%), apparel (11.4%), leather products (18.3%) and furniture (6.4%).

If the United Kingdom is an important market and importer, it is obviously not a major European exporter in these industrial sectors.

Within the middle players with shares ranging from 5 to 10% of EU exports, Poland (10.4%) and Denmark (5.2%) show a strong activity in furniture, Portugal (7.3%) in footwear. One should also notice the importance of Spain in European exports of leather products (5.6%) and footwear (9.9%).

Belgium, due to its particular position as a transit place, respectively ranks 3rd, 4th or 5<sup>th</sup> for textiles (10.2%), apparel (7.7%), leather products (5.2%) and footwear (7.0%).

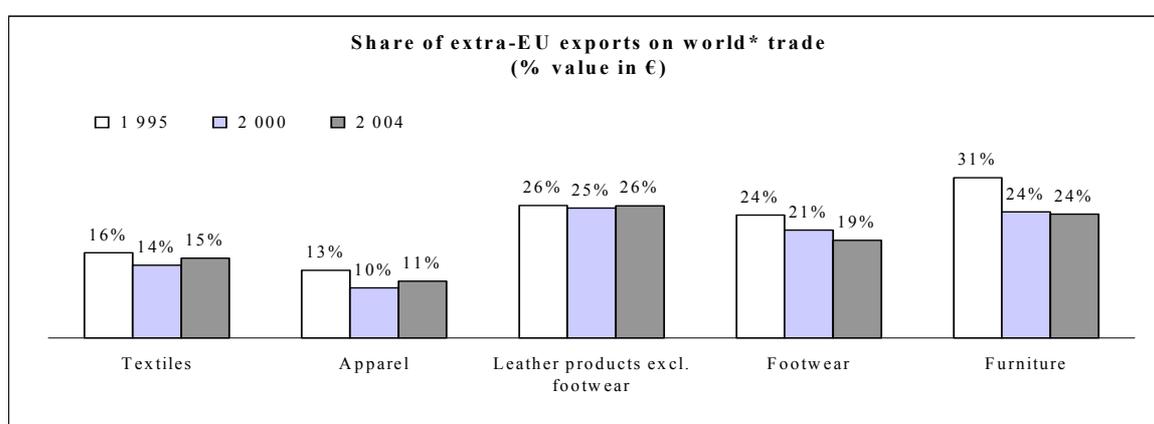
- **The EU position in world exports**



Source Chelem

The European Union remains a major global supplier. In the leather products and furniture sectors, the EU represents more than 20% of the world exports. Shares are less important in the other sectors particularly in apparel.

(See Appendix 1 III. 3.1 EU 25 export markets table 1)



\* world excl. intra-Eu exports

Source Chelem

Over the last ten years, the EU trade share has not changed dramatically. It has decreased by 2 percentage points for exports: in the year 1995, the European share on world trade for these five sectors was 18% for exports.

- **Actual and potential markets for exporting companies**

Most European companies and all those interviewed during case studies are interested to export and many do export a very high proportion of their products. In the industries under examination exports represent (2005 data) on average 16% of the industries' turnover. This proportion is much higher in the case of leather (34%) –particularly due to branded leather goods- and very low in the furniture area (8%) as transportation costs and local tastes prevents huge developments of both imports and exports.

- Markets

Most of the companies primarily quote as existing or potential export markets the USA, Asia, Russia.

Companies are looking on markets such as the USA and Canada, especially for high quality goods. They are using local distributors or are launching international subsidiaries. The subsidiaries can be used for the secure development of the company on the export market and for direct retail action.

The US market proves to be a difficult market due to the complexity of exporting documents and the high cost of protection: protecting a design in the USA is six times more expensive than in Europe for a smaller coverage. Moreover, companies often associate the American market with one of the highest risk of counterfeiting problems.

It should also be noted that in the technical textiles markets norms and standards are not the same as in Europe and this represents very high investments in getting necessary certifications.

The Asian market is also considered to represent a big potential, especially for the apparel sector but the access to this market is perceived to be quite difficult for the EU companies, particularly for SMEs. In general emerging markets are seen as very attractive as they are less price sensitive than mature markets but they require specific and costly strategies such as establishing retail outlets. They do also demand local manufacturing although most emerging markets reward a Made in Europe image and production.

Many companies insist that the European Union should work on the removal of tariff and non-tariff barriers especially in South America, Japan and other Asian countries, even in high tech segments. Among successful companies there is a firm belief that export opportunities could be tremendously increased if trade barriers were lowered.

Companies in technical textile sector estimate as a future threat for their activities in the Asian and European market, the emergence of products manufactured in China at very low cost based on dumping in fibre prices and low interest rates.

- Export promotion

In order to successfully export to these countries, many companies devote an increasing lot of energy to export promotion.

One of the strong assets for EU exporters is considered to be origin labelling. Manufacturing in Europe and using specific labels indicating that products are produced in Europe are essential criteria for many firms. For instance, in the furniture sector, the company Ahrend estimates that its association with Dutch Design is fundamental for exporting market. The Colombo Company in the apparel sector also estimates that the “made in Italy” label is necessary to elaborate their branding strategy and to differentiate them from other companies. This is also a very important competitive advantage perceived by Italian furniture companies.

Developing exports often requires considerable investments abroad. It is not possible to estimate the foreign investments made by European firms of the five sectors in order to secure market positions abroad. However one can consider that the textile and furniture sectors, as well as the luxury segments of the apparel and leather industries have significantly invested in that way.

- In the textile area, manufacturers have largely begun to follow their client markets: lace, fabric, interlining manufacturers, chemical suppliers, trimming makers, and even automotive contractors have set up production operations in Asia and particularly in China to serve local B to B markets and benefit from low cost / high growth environments.
- In branded furniture European firms have started to invest in retail facilities in consumer markets like the USA, the Middle East, Japan, but those investments generally are fairly limited in value. Some of them have also started to relocate labour intensive operations in lower cost areas when the total equation makes it profitable: for instance the production of Italian design leather furniture in China is essentially intended to serve the US market.
- In luxury and better end fashion segments firms constantly invest in their commercial networks: groups like LVMH are considered to be market openers, as they, generally at the same time as large food chains, belong to the first wave of importers in emerging markets. Their profitability levels and the very long term perspective in which they design their strategies allow them to wait many years before any pay-back is in sight.
- On lower price segments, EU brands and retailers in the apparel and shoe businesses have followed luxury players and started to implement retail operations outside of the EU, particularly in the Euromed non EU zone. One example is the number of retail investment projects made in the Middle East<sup>10</sup> (particularly Jordan) and Morocco by EU firms, be it in childrenswear, ladieswear or footwear: they represent one fourth of the total number of EU projects in the MEDA area over the last 3 years.

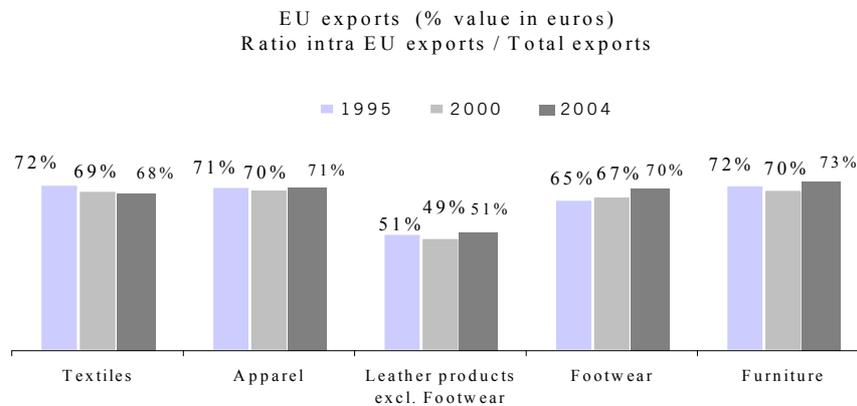
In general one can say that investments abroad are always justified in a dual perspective: on the one hand decrease the cost of products sold in the traditional markets; on the other hand

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<sup>10</sup> Source : ANIMA– Euro-Mediterranean Network of Investment Promotion Agencies

take commercial positions in emerging markets to be known and ready when the market starts to be lucrative.

- **Intra-EU trade**



Source Chelem

The export activities of European firms are primarily directed at the EU markets. For all the sectors considered intra-EU dispatches do represent approximately 70% of EU's trade. The only exception is the leather industry (excluding footwear) which is more globalised than the others, due to the importance of international luxury firms.

This means that overseas exports (America, Asia) are not fully developed for the time being and represent a huge potential for EU industries.

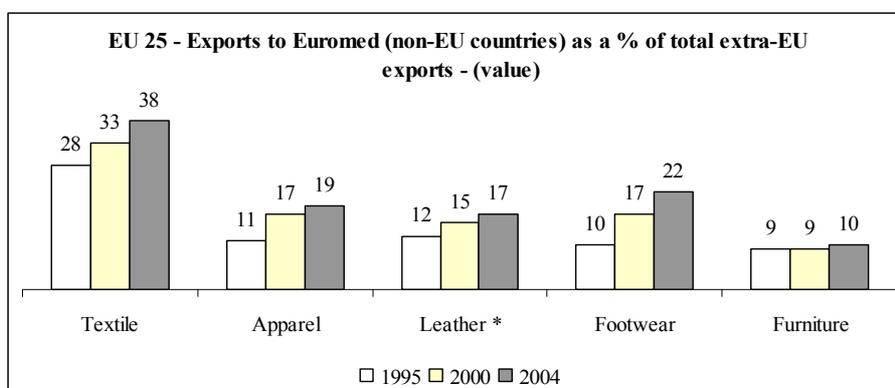
Between 1995 and 2004, the share of intra EU trade has been quite stable except for footwear (+ 5 percentage points in 9 years) and textiles (- 4 percentage points), and according to Eurostat data, this share has significantly increased between 2004 and 2005, particularly in the textile and footwear sectors. On these two sectors, the variation can be interpreted as a certain loss of competitiveness on outer market as exports have remained stagnant and have even subsided in the short term.

### 3.1.2 EU export markets (extra-EU)

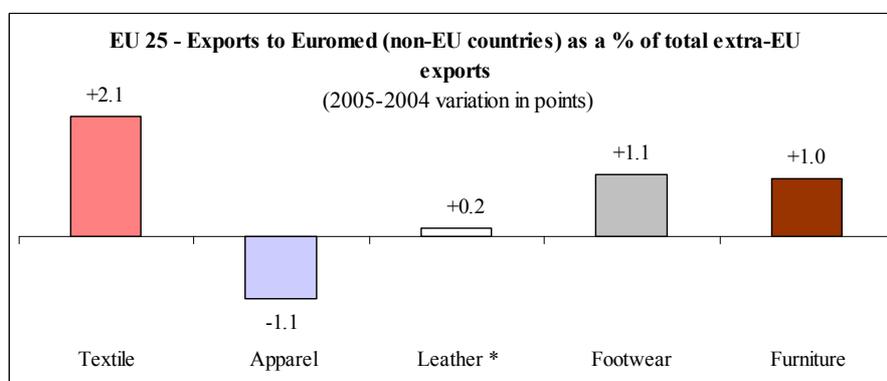
Extra-EU exports represent a mix of industrial or semi-industrial delocalisation – with materials being shipped for assembly to lower cost countries – and of final exports of products to be consumed in the country of destination. This dichotomy can be found in the five industrial sectors considered. Based on existing consultants' knowledge and on in-depth companies' interviews, it can be assumed that Euromed non-EU countries represent most of the delocalisation exports while the other markets mostly account for final exports. From a statistical point of view, taking the clear example of the textile-apparel value chain, EU apparel imports from the major Euromed non-EU exporters represent approximately twice as much as the textile exports to the same countries. In other words the textile (made in EU) content of apparel imports from the Euromed non-EU area represents 67% of Romania's apparel exports

to the EU, 56 and 57%<sup>11</sup> for Morocco and Tunisia. In the case of Turkey the share is only 18% as Turkey produces a large part of the fabrics used locally.

The following graph gives a picture of the situation for each of the five industries concerned by this research.



Source Chelem    \* excl. footwear



Source Eurostat    \* excl. footwear

It can be seen on the above graph that on the short term EU's exports to Euromed countries have gone on increasing as a share of total extra EU exports, except for apparel, i.e. mostly apparel parts shipped for assembly. This is corroborated by a parallel decrease of EU's apparel imports from Euromed countries at the same time. Even though short term statistics should be interpreted with caution, this apparel decrease reflects a certain loss of competitiveness by Euromed suppliers for pure assembly operations against finished imports from non Euromed but also Euromed suppliers. This can be seen as one consequence of the 2005 quota dismantling. However the phenomenon should not be overestimated as textile exports have increased their importance over the period.

As far as footwear is concerned, the share of Euromed trade has increased in terms of exports from the EU but decreased in terms of imports into the EU and that can also be interpreted as a fairly negative consequence of the final quota dismantling.

In the case of textiles and of footwear, the slight increase of EU's exports which is not correlated to an increase in EU's imports can also be attributed to two factors : the first one is

<sup>11</sup> The 33, 43/44 and 82 remaining% represent a mix of: local manufacturing value added + fabrics and other inputs sourced from within the area, e.g. mostly from Turkey. This figure does not take into account EU's semi-manufactured textiles which are considered as apparel parts and exported as such to the area.

the development of Euromed's exports towards non EU clients (USA etc), and the other one, the positive evolution of inner consumption markets.

For all export markets the situation can be analysed as follows.

### **Textile**

In the textile sector, as far as export markets are concerned one can observe that EU's customer base has been changing over the years and that Euromed countries have become clients of utmost importance: two major traditional markets of the EU textile industry have significantly diminished their orders between 2000 and 2005: by 22% for the USA and 21% for Japan. However, the EU industry was able to compensate for this loss of almost one billion euros by developing other final markets like Russia and Hong-Kong, but above all by developing the sales to delocalisation markets (+ 10%). Before the enlargement, Romania remained the second EU client in 2005. Among the first 10 clients, approximately 50% of the amounts are exports to delocalisation countries (the proportion in 1995 was only 34%). This means that the EU textile industry has thus increased its dependency on the Euromed value chains, becoming increasingly vulnerable to downturns in apparel sales.

*(Cf. the 10 leading clients of EU 25 see appendix 1 III 3.1 Export markets table 2)*

Contrary to what can be seen in the apparel sector, extra-EU export prices are 25% higher than intra-EU ones (8.6 euros/kg vs. 6.9 in 2005, see appendix 1 part 2B), despite the fact that textile extra-UE exports are largely (38% of values) destined to apparel manufacturing countries. However the average price has dropped by 10% since 1999, mostly because of a 13% fall concerning the intra trade over the period, which has aggravated after 2004 (- 7% over 12 months 2004-2005), as quota dismantling has eased third countries exports into the EU and fuelled price competition.

Looking more specifically at carpet prices, one can observe a clear dichotomy between a high-price strategy within the EU (15 euros/kg in 2005, some 17% higher than in 1999 and currently on some 15% increase a year) and aggressive volume policies on extra-EU exports (stable prices of less than 4 euros/kg). These developments reflect the up-grading and service strategies illustrated in the case studies and analysed in the sections regarding production and investment.

### **Apparel**

In apparel, as in textiles, exports to the USA and Japan have dropped since 2000 but this fall has been more than offset by favourable trends on the Swiss and Russian markets in particular, EU's first and third markets in importance. Delocalisation markets like Romania and Bulgaria have considerably grown, to the detriment of Morocco and Tunisia since 2000. As new Member States, they represent more competitive and secure manufacturing areas, particularly for the assembly of tailored clothing and wool type garments.

In general it can be observed (see appendix 1 part 2 B Average annual export prices in apparel sector) that export prices have remained roughly stable (16.7 euros/kg in 2005) between 1999 and 2005. Extra-EU prices are somewhat lower (27% in 2005) than intra-EU ones: this reflects

the high importance of extra-EU delocalisation (lower price exports of apparel parts<sup>12</sup>) in comparison with extra-EU final exports. Out of the first ten clients of EU's apparel industry, the amounts of goods shipped outside of the EU to be assembled represent more than 16% of the total (it was 9% in 1995).

However a 10% price drop can be observed on the intra-EU traded goods between 2004 and 2005 which, some as for textiles reflects the increased competition in the EU inner market due to the quota dismantling of January 2005.

The 10 leading clients of EU 25 (See appendix 1 III 3.1 Export markets table 3)

## Leather

One should remember that leather exports are a mix of semi-processed materials and of finished, often branded leather products.

Exports to the USA have also suffered a significant decrease in leather exports (-14%) over the 2000-2004 period but completely recovered in 2005. Sales to Japan have remained stable over the period. China is becoming a more important partner for the EU leather industry than for the other sectors. Delocalisation countries do not represent a large part of the EU industry's client base.

In tanning and dressing activities, i.e. in the tanning and finishing of leather from large bovine and smaller ovine or other hides, intra-EU trade prices (11.8 euros per kg in 2005) are 68% higher than extra-EU export prices, even though they have been slightly eroding since 2001. Top quality entrants are supplied to the EU industry by EU tanners and other upstream players. They get the same value of sales from higher non-EU customers, for volumes which are 1.7 higher.

The situation is completely reversed for finished products where the price of extra-EU exports represents 4.5 times the one of intra-EU dispatches (64.3 euros/kg vs. 14.1 in 2001). Both trends appear fairly stable over the long term (since 1999). The EU luggage industry is largely positioned on a luxury global market. A significant part of intra-EU trade concerns product parts that are to be assembled within the EU, i.e. in medium (and not low) cost delocalisation countries like Portugal.

In both markets (upstream and finished goods) extra-EU exports tend to develop somewhat faster than intra trade, even though values are quite balanced in 2005.

*(See Appendix 1 III 3.1 Export markets table 4 and tables related to average annual export prices by category of products for more information.)*

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<sup>12</sup> As mentioned at the beginning of the section, semi-manufactured textiles like garment pieces already cut and prepared for assembly are considered by Customs as apparel "parts", mixed with finished garments under individual Customs positions, and thus included in apparel trade statistics, in particular in EU's exports.

## Footwear

Footwear markets are also dominated by the USA, which represent in 2005 26% of the total extra-EU exports, despite a considerable fall in value since 2000 (-44%). Here again Romania appears as a major partner for delocalised production.

73% of total exports are sold in the intra-EU market, at a price 75% higher than the average extra-EU export. The trend is quite positive with a 52% increase between 1999 and 2005 but only 1% between 2004 and 2005 when imports have risen by 14% in value and volume, thus increasing price competition in the EU territory. However intra-EU traded goods have gained 5% during the same 12 month period.

*(See Appendix 1 III 3.1 Export markets table 5 and tables related to average annual export prices by category of products for more information.)*

## Furniture

The export picture is dominated by the USA which represent 25% of extra-EU exports in the sector in 2005. It used to be 33% in 2000, and the loss has been considerable (-26% in export value). It can be largely attributed to the very aggressive and successful strategies implemented by China's exporters for the US market, almost the only one in the furniture sector where volumes are important (the EU market is extremely fragmented). However overall exports have remained stable over the period, thanks to the development of many secondary markets, particularly in the Euromed zone (+almost 90% between 2000 and 2005).

This growth reflects the increasing delocalisation of the sector, in terms of companies' sourcing and product assembly.

On the various subsectors of the furniture industry extra-EU export prices are somewhat higher than their intra-EU counterparts (by 15%, between 3.8 euros/kg and 3.3 respectively). Intra trade represents 74% of total export value, with a significant proportion of subcontracting within the EU, and develops faster than extra-EU exports.

For the sectors considered, with the exception of leather products, the two main clients of European exporters are the United States and Switzerland. The USA represent some 15% of the total extra-EU exports.

The Swiss market is much smaller than the American one, but a lot of EU firms have set up logistic centres in Switzerland in order to serve extra-UE neighbouring markets.

Except for textiles – where the Japanese domestic industry is a leading global player, Japan is always among the first five clients of the EU. It is even the first EU export market for leather products. Nevertheless, European exports of footwear and apparel to Japan have declined between 1995 and 2005. Russia is also an important market for furniture, footwear and apparel and is a promising export market for leather products and textiles.

As far as the Euromed zone is concerned, European exports to Romania have clearly increased in textiles, leather and footwear (Romania is the second destination for the European exporters, especially Italian, in textiles). This is a consequence of the ongoing delocalisation process initiated by the EU fashion industry.

Between 2000 and 2005 the total exports of the five sectors to Euromed countries have only increased by 10%.

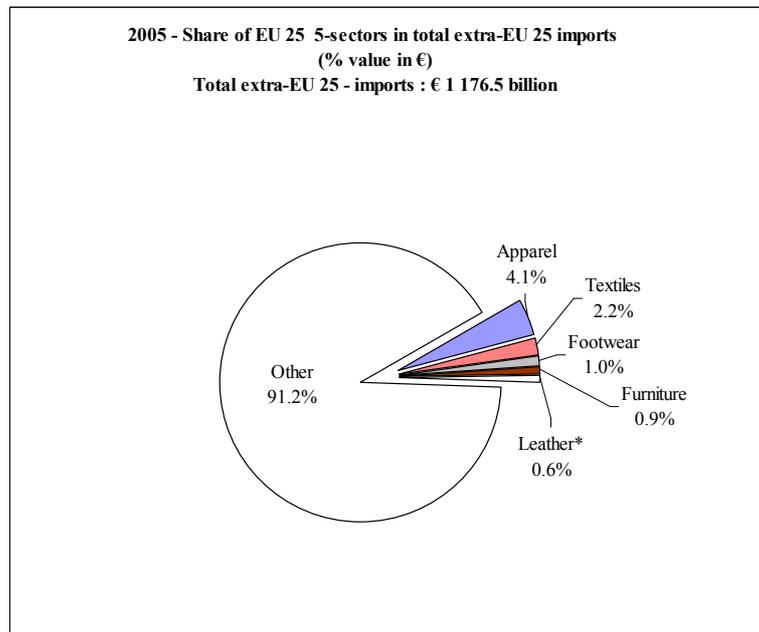
However, even though the growth is somewhat limited, the Euromed zone represents a key trade partner with a share of 24% in the European exports of textiles, apparel, furniture, leather and footwear.

This share is particularly high in textiles (38%).

*(See Appendix 1 III 3.1 Export markets tables 6 and tables related to average annual export prices by category of products for more information.)*

## 3.2. IMPORT MARKETS

### 3.2.1 EU imports

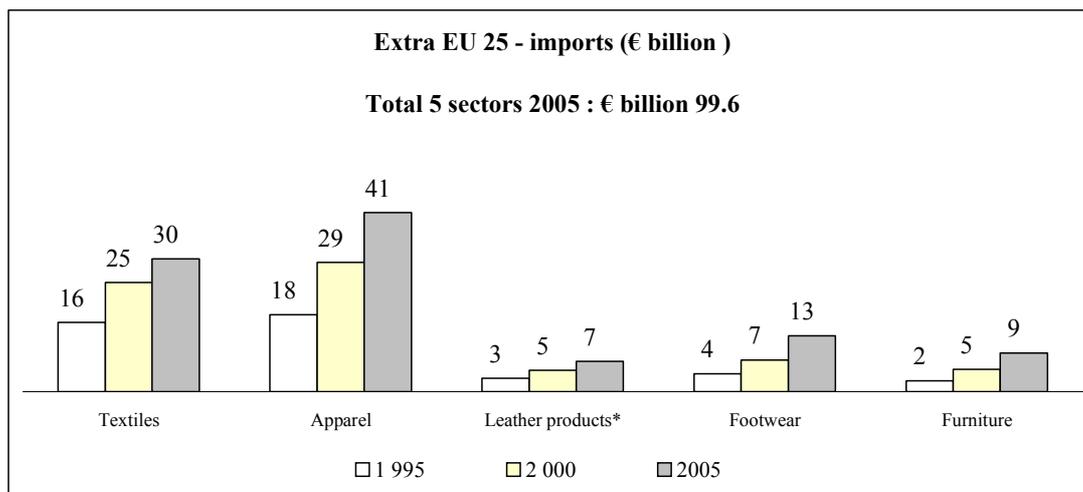


Source Eurostat \* excluding footwear

The share of the five sectors under review reaches 8.8% of the total extra-EU imports in 2005 whereas the consumption of related items 8.6% of total consumption. This share has remained globally stable since 1995 (8.2% to 8.8%).

Out of the total imports, textiles and apparel represent three quarters of the whole. Germany is the main European importer – except for leather products (Italy ranks first).

Between 1995 and 2000, European imports have recorded a 67% growth: during this period, furniture imports have been multiplied by two and footwear imports have increased by 80%.

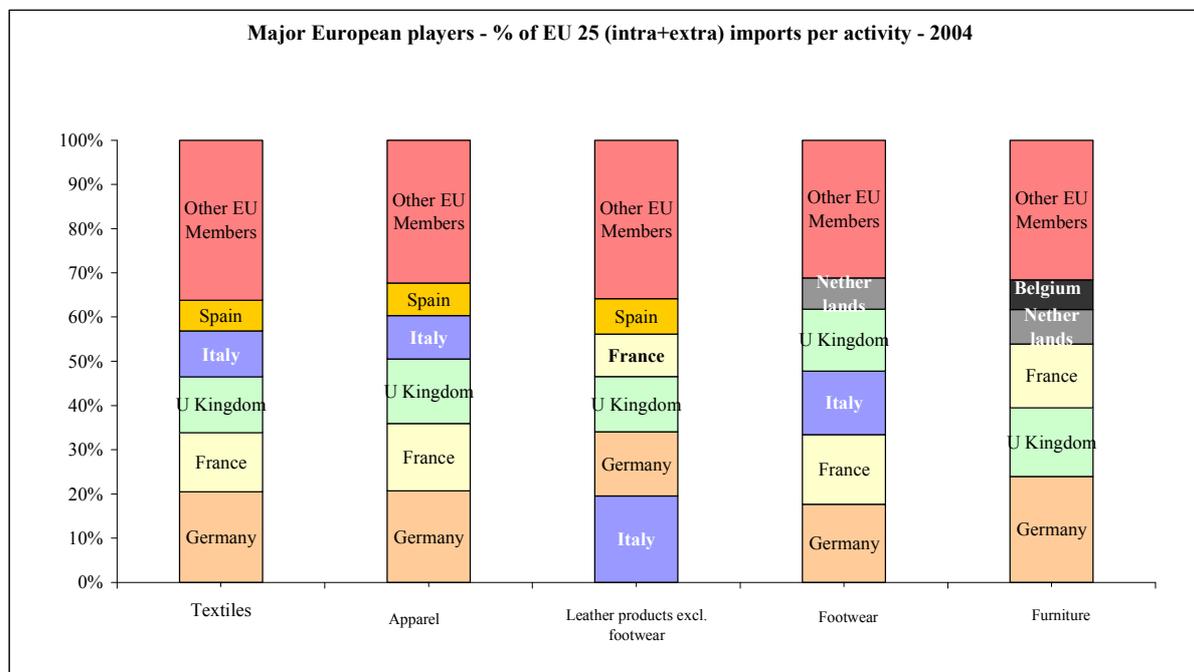


\* excluding footwear

Source Chelem

Between 2000 and 2005, the extra-EU trade for the five sectors considered has slowed down: extra-EU imports have increased by 39 % whereas extra-EU exports have increased by only +3.2 %.

### The five largest EU importers



Source Chelem

In 2004, the five major European markets are the major importers, with shares ranging from 64% of imports in textiles and leather products to 69% in footwear. Unsurprisingly if Germany is clearly the first importer in four activities (textiles, apparel, footwear and furniture), Italy is a major industrial player as far as furniture and leather are concerned: Italy imports a lot of leather (raw hides and skins, wet blue from Latin America) which will be re-exported (mostly as finished leather exports or footwear exports).

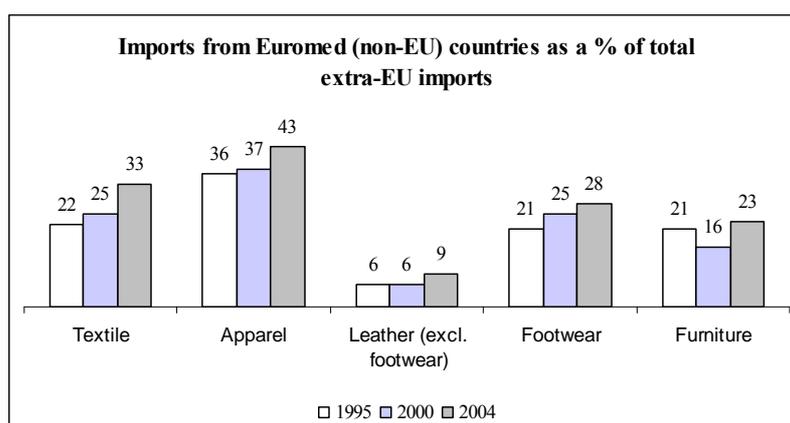
(See Appendix 1) III. 3.2 Import markets table 1: EU 25 position in world imports)

### 3.2.2 Major suppliers of the EU

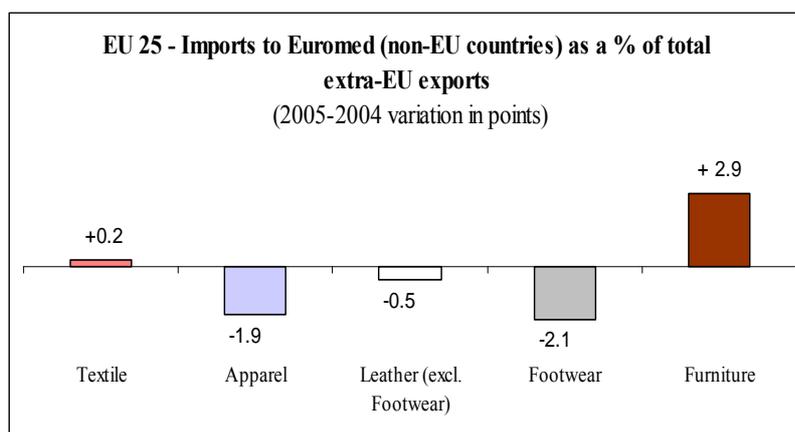
The products which are imported into the EU belong to two different categories: the first includes the items which are designed and manufactured abroad, for which there is no European industrial value added but only a significant retail margin. These can be identified mostly as retailer's imports, with imported volumes fully correlated with the concentration rate of the EU retail system.

The second category includes items which are either finished abroad (outward processing for apparel assembly for example) or for which raw material and/or semi-processed products are sourced abroad. In the latter case, the value chain retains a significant proportion of the total value added within the boundaries of the EU or of the Euromed zone.

It is impossible to distinguish between the two in a very precise statistical way. However based on consultants' experience and on in-depth company interviews it is possible to assume that, for the time being, Euromed exports are products which have in general only been assembled there, whereas imports from the Far East are generally items fully made locally and traded.



Source Chelem



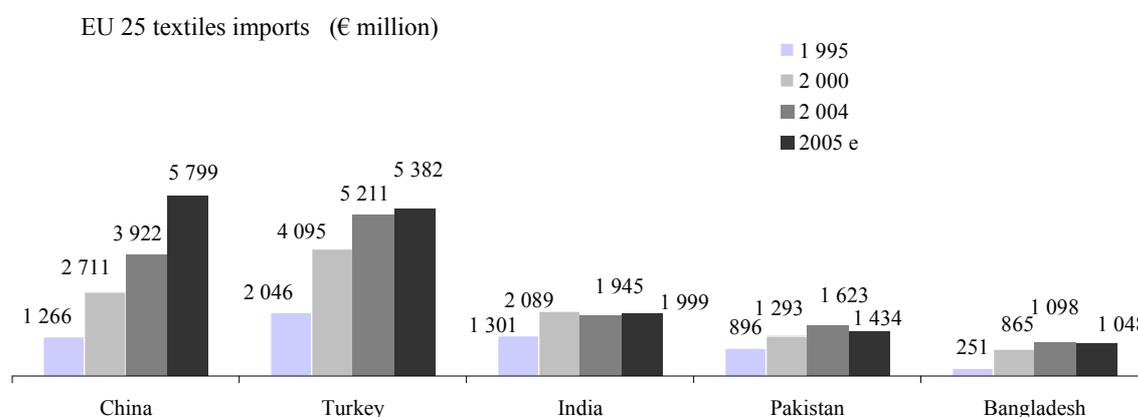
Source Eurostat

Imports from the Euromed have significantly grown over the period. They have been multiplied by 2.3 in 10 years. Most of the growth had taken place before 2000, imports having “only” raised by 29% between 2000 and 2004.

Turkey ranks first among Euromed exporters to the EU, with an overall 40% share of the whole Euromed area for the five sectors in 2005, a rather stable position since 2000 (38%) but which had somewhat eroded itself between 1995 (41%) and 2000. The second Euromed exporter is Romania, with a booming performance, as it represented 15% in 1995, 19% in 2000 and 23% in 2005.

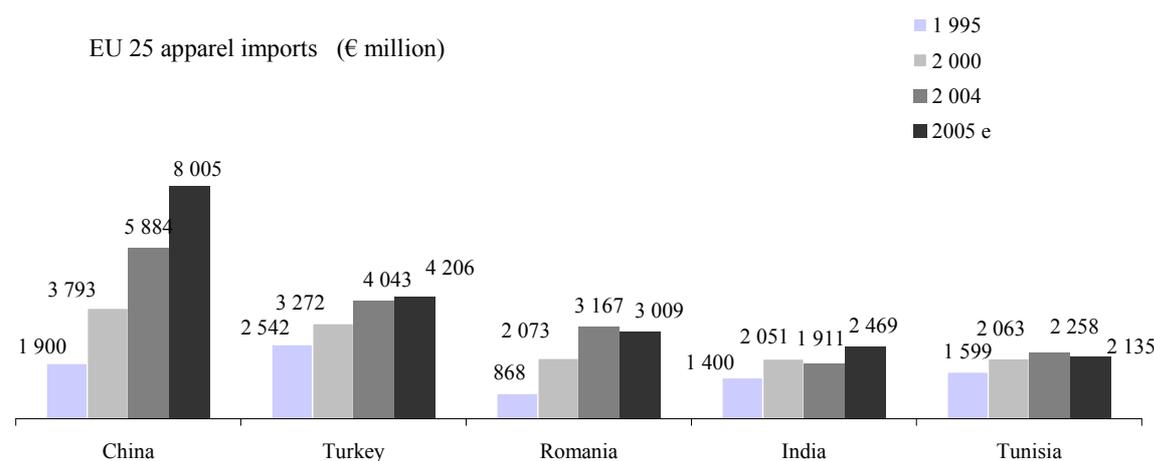
Tunisia used to be second only to Turkey in 1995 but its import share has gradually downslided over the years, and it now represents 11% of Euromed’s exports to the EU. Morocco’s share has grown impressively until 2000 (+8% points) but receded since, representing only 9% in 2004.

A smaller supplier, but in full growth, Bulgaria now generates 6% of Euromed exports.



Source Chelem and IFM estimates based on Eurostat data

In the textile sector, Turkey represents 61% of Euromed exports to the EU, five times more than the second exporter, Romania, but a little less than in 2000 (65%). As such, Turkey remains by far the first European barrier to the imports from the Far East. The top textile position of Turkey can be largely attributed to the competitiveness of the integrated cotton chain, including lightweight cotton knitwear and knitted fabrics and ecological organic product : the success of Romania in textiles is mostly due to a high local know how in knitwear, not to mention very low local costs labour.

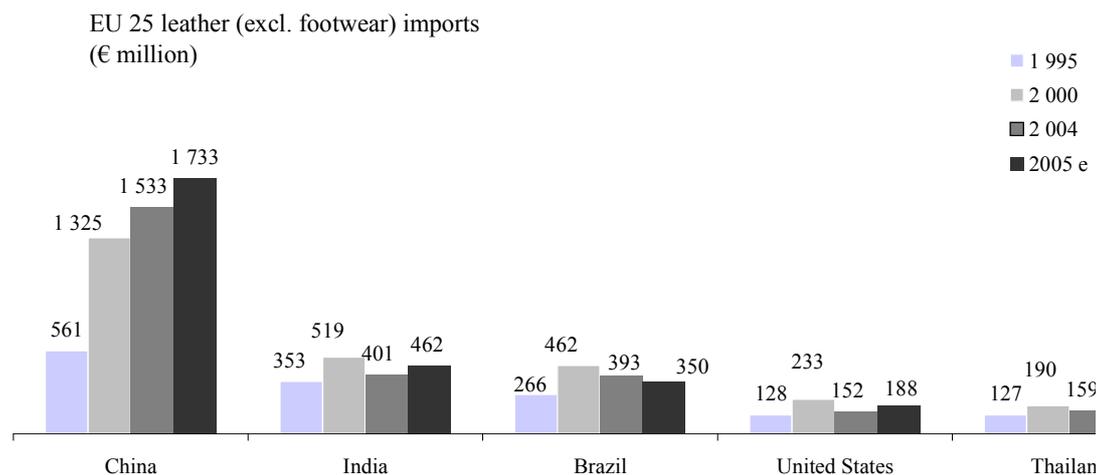


Source Chelem and IFM estimates based on Eurostat data

In the apparel sector the Chinese pre-eminence is quite remarkable, as China holds a 34% share of extra-EU imports in 2005.

The Euromed position is extremely important, as the import share of the area reaches 35% in 2005. Romania has reached in 2005 an extremely strong position (7% of extra EU imports), due to the manufacturing of many items like lingerie and medium to high segment apparel. The first Euromed exporter is Turkey, particularly with sportswear items and jeanswear.

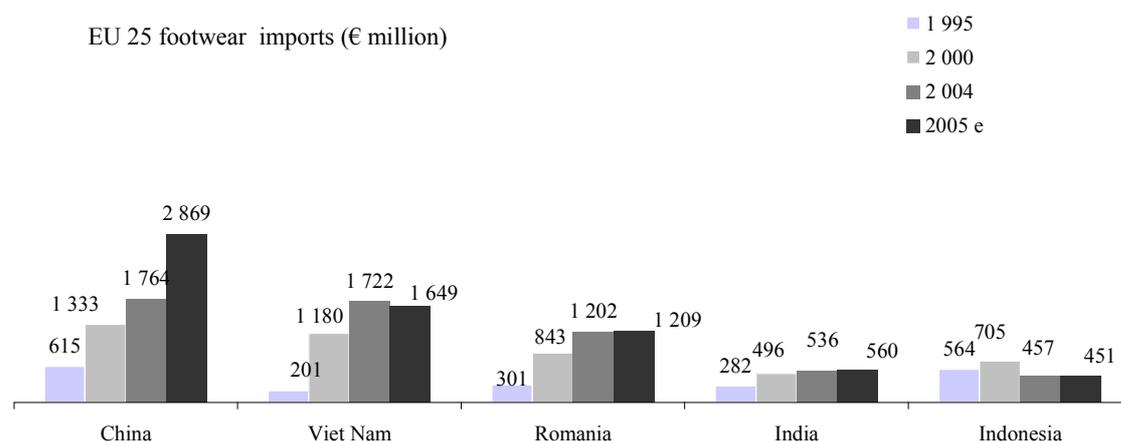
<sup>13</sup> The tables related to EU main suppliers must be considered with much care because they are based on a consolidation of two different databases in which values can considerably differ as changes produce by Eurostat were applied to the 2004 Chelem data.



Source Chelem and IFM estimates based on Eurostat data

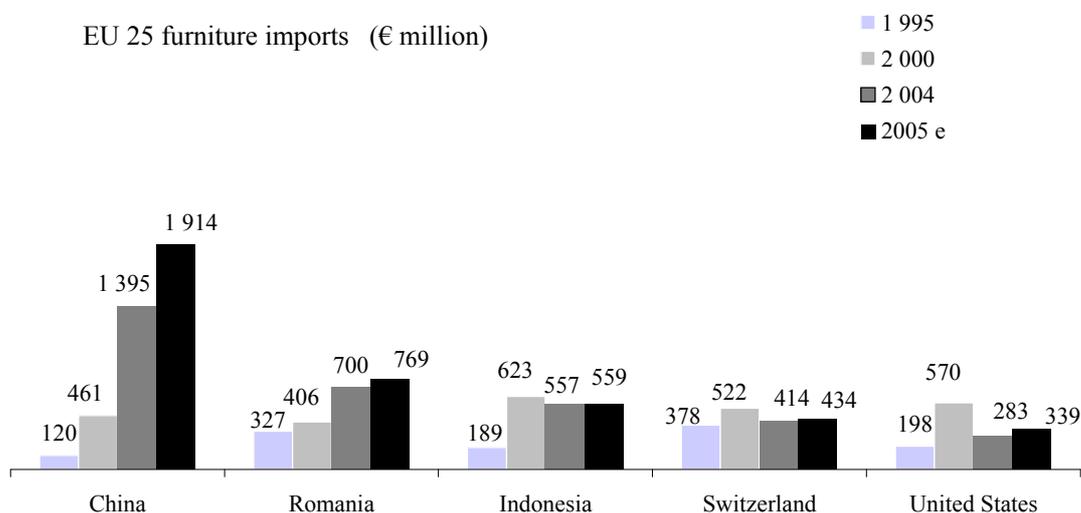
Imports from the Euromed zone in leather products are not really important, only 6% of a relatively small import market. China represents 51% of extra-UE imports of the sector. The only steadily growing supplier is China, whereas India and Brazil have seen their respective positions deteriorate since 2000.

In the footwear sector, Euromed's suppliers (22% of imports share) partly succeed in resisting to the price pressures coming from Chinese and Vietnamese exporters. This sector is the only one where China is so closely challenged by another Asian supplier.



Source Chelem and IFM estimates based on Eurostat data

In the furniture sector, imports are much less important than in the other sectors considered. This is largely attributable to the physical weight of the products, which considerably increase logistics costs and to the existence of regional markets, held by local retailers, tailoring their offer to the specific tastes of local consumers. Imports from the Euromed zone in 2005 represent 18% of extra-EU imports, among which Romania, with its long historic tradition of



Source Chelem and IFM estimates based on Eurostat data

wood furniture holds almost the half of it.

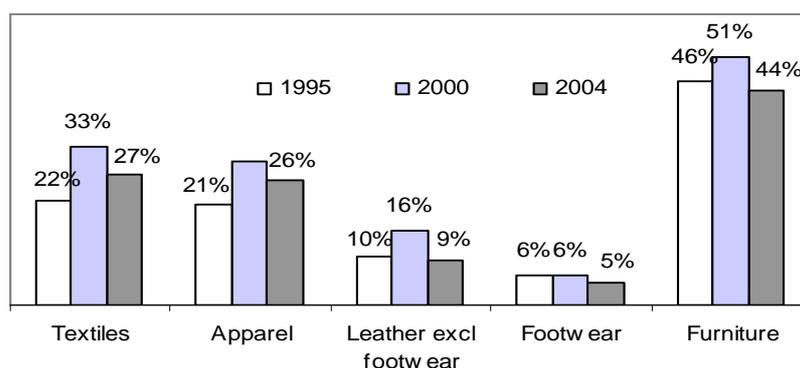
### 3.2.3 A comparison with the North American trade integration model

One major difference between the USA and the EU markets lies in a much higher fragmentation of the latter. The USA market is largely tailored by national retail chains which have no equivalent on the EU territory except Ikea, C&A, H&M and possibly Zara and Bata. However those very large retailers are ones of the fastest growing players in each of their categories. This means that EU markets are less and less fragmented, as retail concentration grows and as pan-European or Even global leaders dictate consumers' tastes. In such a perspective, examining the USA market and industry provides some insight on what the European future could be.

When comparing the EU situation with the USA trade for the five sectors considered, one can see that China holds a predominant place on both markets, being the leader almost everywhere, and holding a consistently high export share, above one fifth of each industry's imports.

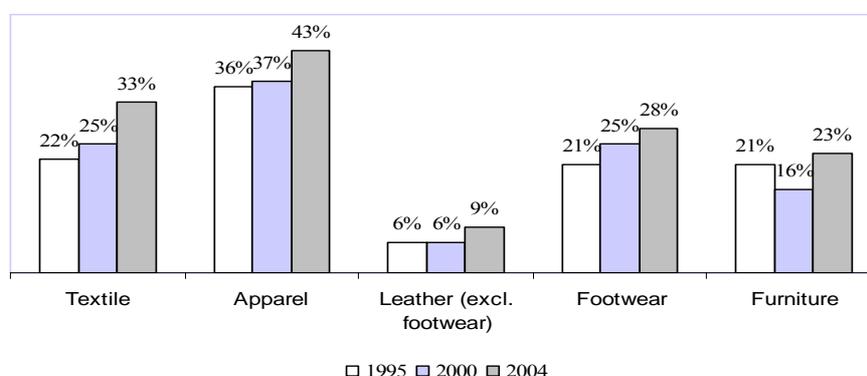
Since 2000, the strong growth of US imports from China in the different sectors has a very negative impact on the trade between the USA and its neighbours (Caribbean zone, Canada and Mexico), which has not (yet) happened in the EU market.

**Importance of regional trade**  
**Share of Imports from (Mexico + Canada + CBI) on the total US imports**



Source Chelem

**Share of imports from Euromed (non-EU) countries on the total extra-EU imports**



Source Chelem

Northern and Central American countries are key trade partners for the United States, especially in furniture (with a share of 44% in American imports in year 2005), textile (27%) and apparel (26%). Many free trade agreements have been signed between these countries and the United States.

However, the surge of American imports from China has negatively impacted on American imports from Northern and Central America between 2000 and 2004: their shares in US imports have significantly diminished over the period.

In 2004 in the textile<sup>14</sup> sector regional trade (Mexico + Canada + CBI) represents an import share which is a little lower (27% in the USA against 33% in the EU) and which is clearly decreasing as Mexico was replaced by China as the first US supplier.

Mexican exports to the USA in apparel do resist better than textiles to the Chinese import pressure, which helps regional trade maintain its positions on the American market. China represents 14% of USA imports in 2004, compared to 26% for EU imports for the same year.

As far as textiles and apparel are concerned, Mexico fights to resist Chinese competition, but its exports to the USA have dropped by 35% in apparel and by 39% in textiles between 2000

<sup>14</sup> See detailed trends for each sector in Appendix (See Appendix 1) III 3.2 Import markets tables 2 to 6

and 2004. These drops are all the more negative as during this period US imports have strongly increased which means Mexico is currently facing huge losses of market shares on the American market.

Leather imports are also heavily dominated by China, followed by Italy. The regional suppliers hold a 9% share which is equal to the share held by Euromed suppliers for the EU.

In the case of footwear, China's imports are approximately 2.7 times larger in the USA than in the EU. This is largely due to the fact that EU's imports are distributed between Vietnam and China, which is not the case in the USA.

The share of regional trade has decreased and represents only 5% in the USA in 2004.

As in the case of leather, Italy ranks second to China. However in both cases the export values are in decline.

Furniture imports into the USA represent only 19% of the five sectors considered, much less than apparel (39%) or textiles (28%). Home producers are still able to retain their shares of the markets. Out of this figure quite a high proportion comes from neighbouring suppliers: 44% for the USA, much more than in the case of Europe (23%). However China is in full growth and seems to be challenging Canada: it is likely to rank first in the coming years.

*(See Appendix 1 III. 3.2 Import markets tables 7 to 9)*

## IV – ANALYSIS OF FACTORS OF COMPETITIVENESS

*When comparing the levels of value added per employee in the various sectors under analysis, the textile, leather and furniture industries appear more productive than do apparel and footwear. This feature especially comes from the fact that the former require more capital than the latter sectors, which are more labour intensive. However all remain significantly below the average productivity level of the manufacturing industry as a whole.*

*Western European countries, and especially technical textile leaders like Germany, the Netherlands, Scandinavia display the highest productivity levels, within the textile industry, whereas new Member States countries have the lowest. Apparel centred countries like Italy, France, the UK and Spain score in between. Larger economies are positioned on quite high price-brackets, whereas smaller countries with a lower level of GDP per capita, and especially in the East, still have to increase their productivity so as to converge towards Western levels.*

*The pattern is fairly similar for leather and footwear industries where Europe again appears clearly segmented between one high value added part in the North-West of the EU from Scandinavia to France, a middle region with Italy, Spain and Portugal in transition around the EU average, an Eastern area where value added only is one tenth of the amount of North Western countries, and a very low added-value regions with the last two entrants : some countries remain specialised in the assembly steps of the production process whereas others are involved in the value generating phases like design, retail, branding and material sourcing, to the extent of actually divesting from manufacturing itself. One should note that, like in the textile industry, Spain has an intermediate productivity level while Portugal reports a score that is close to the one of the last ten new entrants. The analysis of productivity in the furniture industry provides similar result than for other manufacturing industries with somewhat lower discrepancies between countries.*

*Even though each manufacturing industry records specific average productivity levels, the ranking of countries with regard to this variable seems globally approximately the same between sectors. Least productive countries are always 20 or 25 times less productive than the most productive ones. Among the new Member States Slovenia always displays very high performance levels, while among EU 15 Members, Portugal always ranks fairly low.*

*Over the recent period labour productivity in the five industries under review has remained quite stagnant and increasingly low in comparison with the standards of the manufacturing industry as a whole, which follow a regularly increasing trend. This stability, in a context of deteriorating trends regarding total value added, gives evidence that the continuous laying-offs only allow to maintain former levels of productivity. The year 2001 appears as a slight turning point for apparel and footwear industries, as it marks the sudden increase of competition that can both be attributed to China's entry into WTO and to a deterioration of the Dollar/Euro rate.*

*In respect with wages and qualifications Europe does certainly not appear as a homogeneous entity. The lowest costs countries are approximately at the level of Thailand or Mauritius, the Baltic States may be cost competitive with countries like Morocco, while the highest costs in Europe are close to the Japanese average, i.e. almost twice as high as the USA. France, Italy and the UK would be situated in the vicinity of Canada, i.e. 20% above the USA.*

*Wide discrepancies in personnel costs do appear as well between sectors within the EU. Textiles and furniture score highest with yearly costs that are 30% higher than footwear and apparel. This is largely due to their high technological levels and to their location on the largest markets, i.e. the most expensive countries.*

*As far as apparel and footwear are concerned, personnel costs are conversely quite low due to factors like a low technological content, a location in lower cost countries and an important proportion of non-industrial and unskilled positions due to integrated retail networks.*

*From the point of view of wages and personnel costs, a huge diversity exists within the EU 25 and still more if one includes in the analysis the last two entrants. The ratio between the highest and the lowest cost countries averages 20 to 1 in the textile and furniture sectors. It is closer to 30 to 1 in the footwear, leather and apparel sectors.*

*Member States in the North-West region of Europe display the highest personnel costs, while at the other end of the spectrum Bulgaria and Romania always display the lowest, Bulgaria's costs being significantly below the Romanian ones, except for textiles where the difference is fairly marginal.*

*Above this group of countries, among the 10 new Member States, Baltic countries generally post personnel costs which are quite low in comparison with the others: roughly half of the others new Members in textiles, a little less in furniture and footwear. For apparel the difference is not really important. Among the others Slovenia enjoys a leading position, quite close to the EU 25 average and quite remarkably always above Portugal (as was already observed in the productivity analysis).*

*The other South-West countries of Europe, Italy and Spain are also very close to the EU 25 average, generally a little higher except in the furniture industry.*

*Labour costs have not significantly changed at the level of EU 25 since 2000. In particular, in the furniture industry the increase has only been +3%. In the other sectors growth has been +6% in textiles, +8% in apparel, +10% in footwear and leather. This is due to the fact that there is no single trend affecting Europe in terms of production model : taylorist models of production with a further segmentation of work to fairly low-skilled workers coexist with post-taylorist models implying delayering, multi-skilling and empowerment at the shop floor.*

*There is a large historic ground to the various qualification levels in Europe. Industrial tradition accounts for the existence of education, training and research centres, but also for the motivation for the sector in an industrial community somewhat dedicated to keeping it alive. However there are not enough, schools and training centres left to provide for the initial education of the workers. It then becomes very difficult to hire specialised labour and most companies do organise training themselves. Nevertheless employment issues are easier to cope with if the company is located in areas, where there is regional concentration of companies in the same sector.*

*In general the companies reviewed constantly invest in the training of entrants and in personnel upskilling to enhance flexibility, early problem detection, quality, or client orientation.*

*Regarding wage policies, no significant change can be detected over the recent years. Unsurprisingly companies use wage policy to retain the most efficient and necessary workers*

*into their companies. Be it in the technical or fashion sectors, labour flexibility is very important as the demand varies.*

*When examining investment strategies in the EU, it can be observed that the level of firms' investments in intangible assets in old Member States, which are also by far the largest producers in the five sectors considered, is much higher than in new ones, due to their being more involved in innovation, research, brand acquisition and retailing activities than the new Member States that concentrate on production activities. Firms' share of intangible assets is especially high for countries like France, the UK, Spain, and Italy; this is less the case for Belgium, Sweden and Portugal.*

*Even though this broad picture is largely verified throughout Europe, there are some exceptions to the rule. Countries like the Czech Republic and Poland score particularly well in the furniture industry, since they have a ratio that is higher than Portugal, Greece and Belgium. This is a first piece of evidence, indicating that, even if countries in the East are more concerned by production than brand development and research, some of them are very active in a limited number of industries, with the willingness to acquire a full range of activities including the development of their own brands. Besides, Western countries like Italy, Spain and France are still the largest producers of the industries examined and still keep a part of their production at home.*

*However whatever the country the trend is towards a reduction in the proportion of tangible assets over turnover, even in the Eastern part of Europe.*

*In Europe, the only significant Mediterranean textile investor is Turkey, which benefits from its integrated cotton chain to develop a wide-spanning textile strategy covering all segments of the market. EU's investments since 2000 have been concentrated in Italy, particularly as far as cotton-type spinning is concerned. Greece, Spain and Germany have remained significant investors too. Italy also demonstrates a strategic dedication to flat knitting, without comparison anywhere within the EU. However throughout Europe investments have been declining over the period in all segments, except in the new Member States for weaving and knitting equipment.*

*Investment rates in tangible assets for the apparel industry show a significant divesting trend, particularly in Portugal. At the same time, the evolution in the ratio of intangible assets on tangible assets is extremely positive for the apparel industry throughout Europe, demonstrating that in countries like France and Germany the apparel sector has largely become a tertiary industry, as the asset structure of the sector is dominated by intangible elements like brands and store networks.*

*In the leather industry only Italy had a slightly positive tangible investment rate over the period. On the contrary, the value of firms' tangible assets has been reduced in most areas particularly in Portugal. Correlatively specific investments on machinery have been affected almost everywhere in Europe in leather and footwear sectors.*

*As a consequence the share of intangible assets has become fairly high, particularly in Italy and France. In the furniture industry, investment data for tangible assets mostly report a slight growth for Italy, Slovenia, Spain and Finland. A significant divestment rate can be observed for Portugal over the period. Intangible assets do not represent more out of the total assets than in the textile industry, thus reflecting a low level of marketing integration in firms' activities. Discrepancies are not considerable between the Western and Eastern parts of Europe in terms of asset structures. This would tend to confirm that the*

*furniture industry in Europe is not as much partitioned between production oriented and marketing oriented regions, as the other sectors.*

*Throughout the Euromed zone, firms are striving at modernising and at innovating. In the textile and apparel industries it has been one primary driving force of the EU to prepare for the dismantling of quotas. The process involves a combination of proven technologies and incremental innovation.*

*In textiles, the whole industry has made many innovations and some of them have brought fundamental changes to production techniques per se or breakthrough product innovations: examples can be found in the realms of digital printing, nanotechnologies and textile finishing in general. These EU made innovations do confer a significant advance to EU firms and help them retain the better part of their market: greige fabrics are widely sourced from low-cost countries but hi-tech finishings are still carried out in the EU or its neighbours. In apparel the shift from two seasons a year to a constant flow of new products represents as significant an innovation as the development of 3 D techniques or 3 D body-scanning. In the footwear sector, innovations in adhesives and in components are implemented to enhance productivity. However the most important factor is the generalisation of CAD/CAM techniques which brings automation and flexibility in the overall process. In furniture, the manufacturing processes used in traditional wood pieces has not much changed. However in some sectors, as in kitchen and office furniture a strong automation has been achieved in combination with CAD/CAM techniques which increase the overall level of flexibility.*

*In all industrial sectors, leading firms have made investments in non-EU Euromed countries with modern infrastructure and efficient logistics to reduce lead times and compete on fast response small orders. Companies in the new EU Member states have also performed strategic investments in order to upgrade their production in order to reach higher product quality standards thus matching client needs by focussing on quality and functionality.*

*Environment has also become an important issue for modernisation, and environmental efficiency a major source of cost control. This is especially the case for companies where environmental costs represent up to 30% or 40% of added value (non wovens, textiles, tanning/leather). These factors foster innovation processes mainly geared at process improvement, process redesign, process integration and sustainable product development.*

*In the fashion and furniture sectors a number of companies base their production on the ecological marketing and development of products with high environmental strengths.*

*Being a polluting industry, leather processing companies have been obliged to make significant progress in this field and follow strict environmental standards.*

*However all environmental standards and health and safety requirements are a significant organisational burden and a sheer cost for smaller firms, often located in older premises. Large firms tend to favour higher norms provided there are transparent and well timed modalities of implementation. Both share a deep concern that EU and imported products face the same requirements so that new regulations do not form an additional incentive for delocalisation.*

*The increasing importance of product development within companies' strategies also represents an important modernisation of their know how and of their overall offer, be it in technical textiles, in fashion markets, or in furniture. Another factor is the increased rapidity from design to delivery, which requires investment in design strategies and logistics.*

*In-depth interviews have shown that competitive companies in all the sectors under review have strongly invested to enhance their design capabilities by means of associating with designers and of developing several collections per year. They also express a strong commitment to the building of their own brand, for purposes of external and also internal communication.*

*Service has become a keyword for those successful companies, even though in industrial markets (both in technical markets and fashion markets) this represents a commercial revolution. It covers aspects of assisting clients for larger projects such as project management, installation support, after sale services. To a higher or lower extent one can say that intensive cooperation with the clients on product development and adjustment of the products is part of the marketing strategic investment of all the companies studied.*

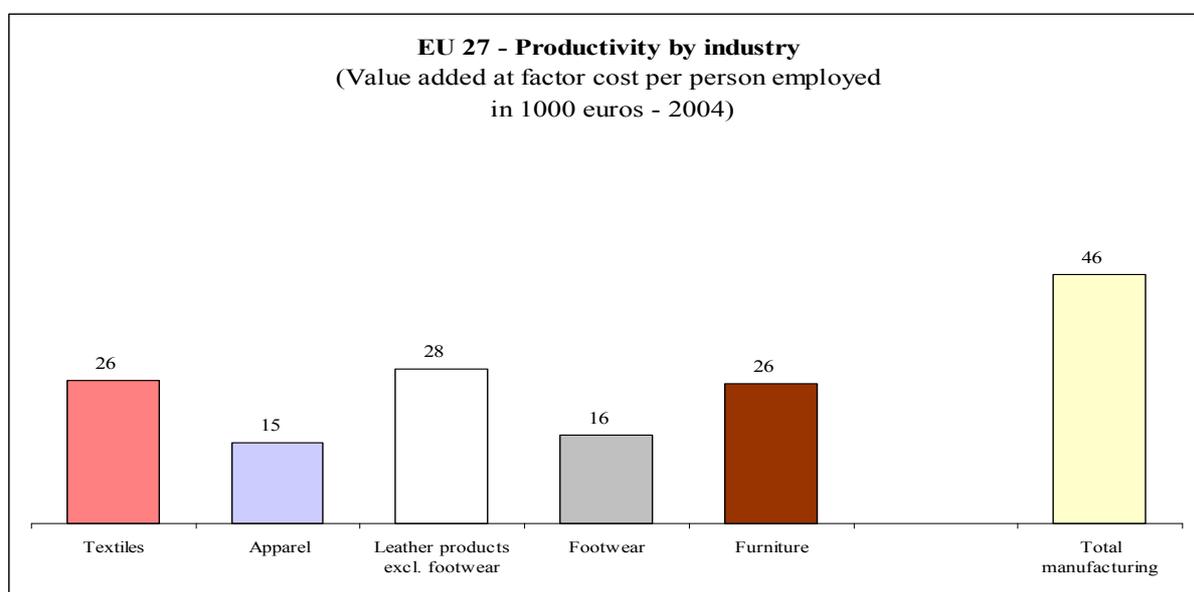
*Finally retailing involves very large investments especially for companies who have started to develop their own retail networks. Actually hit by the deterioration of independent retail networks –who could advise customers on the product and add value to it so as to balance its sales price- industrial companies are facing the needs of taking over their distribution. This also enables them to come closer to consumers' expectations and tastes and increase their market response competencies. It is a key element of their international strategies but represents huge investments, which require higher product margins which can be often provided only by relocation of production to cheaper manufacturing areas.*

## 4.1 PRODUCTIVITY

- **Value added per worker**

The five sectors analysed in the report employed at the EU 27 level 13% of the manufacturing workforce in 2004, while contributing only 6.4% of the value added. In terms of their contribution to total manufacturing employment, the five sectors share is higher in the EU 12 new Member States (22.7%) than in the former EU 15 excl. Greece (10.8%). In terms of their contribution to total manufacturing value added (at factor cost), the five sectors share is a little more important in the 12 new Member States (8.9%) than in the EU 15 excl. Greece (6.2%). In the case of the five largest Member States (Italy, Germany, the UK, France and Spain), their contribution is 75% to EU 27 five sectors value added and 48% of EU 27 five sectors employment.

The following graph provides data on the value added per employee and by industry during the year



2004, as a European average for the 27 Member States.

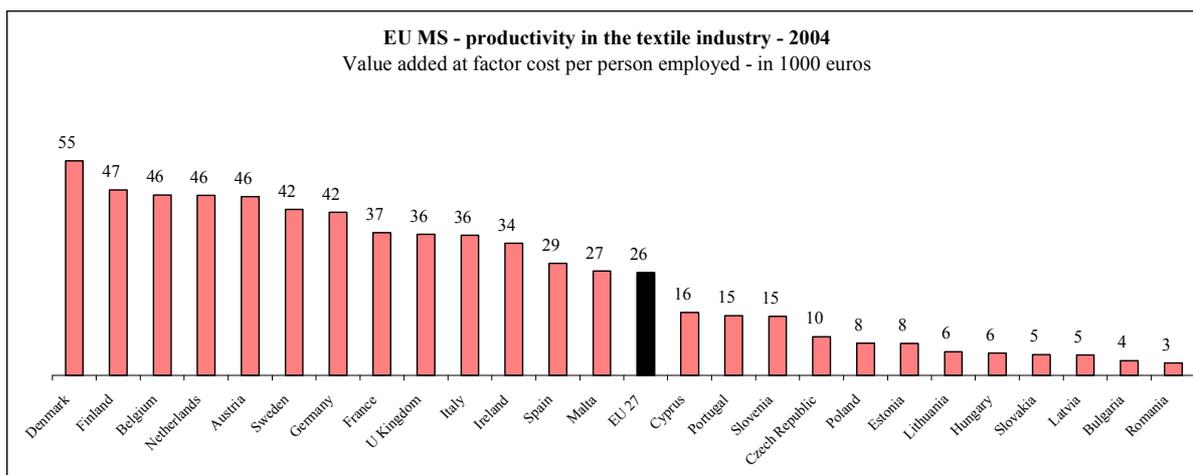
Source Eurostat and IFM estimates based on Eurostat data

Eurostat data indicate that the textile, leather and furniture, industries are more productive – in terms of value added per employee – than apparel and footwear. This feature especially comes from the fact that the former require more capital than the latter sectors, which are more labour intensive. However all remain significantly below the average productivity level of the manufacturing industry as a whole.

The situation is similar in the USA as the value added generated by the industries under review fall far below the manufacturing standards: by 45% for textile and furniture and by 65% for the other sectors together, in 2004.<sup>15</sup>

Beyond the question of labour productivity differences between and within industries, it is also interesting to observe the geographical distribution of productivity levels within Europe, by industry. The following graphs provide productivity data by country and by industry<sup>16</sup>.

<sup>15</sup> Source: US Bureau of Economic Analysis.



Source Eurostat

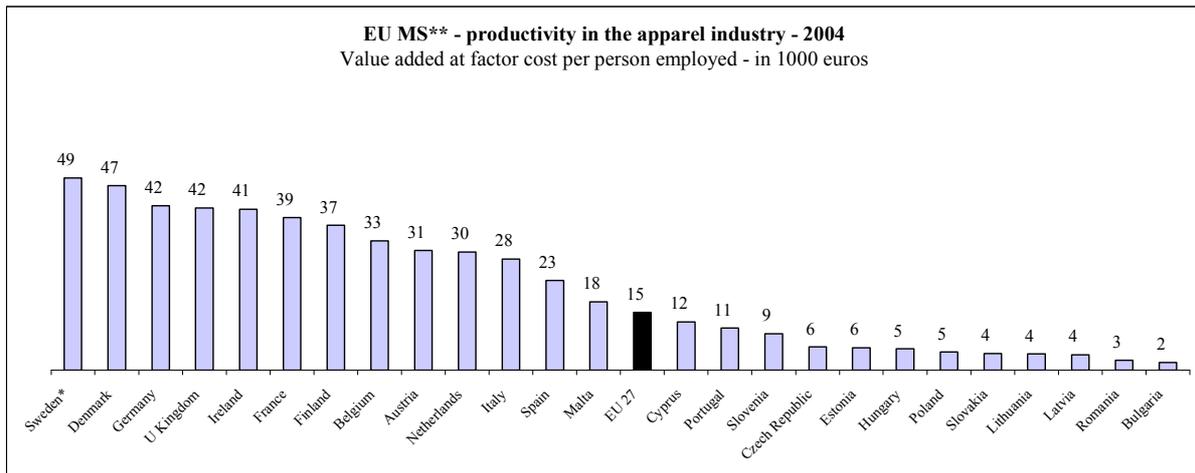
Note : data for Greece are not available

Luxembourg : kilo € 173 per person employed

Most old Member States display the highest productivity levels, within the textile industry, whereas new ones, particularly Romania and Bulgaria have the lowest. More specifically technical textiles leader like Germany, the Netherlands, Scandinavia, display much higher levels than apparel centred countries like Italy, France, the UK and Spain. These countries are positioned on quite high price-brackets, whereas smaller countries with a lower level of GDP per capita, still have to increase their productivity so as to converge towards EU standards, but this will of course require significant investments. It is essential to note that these very large productivity differentials (Denmark was 17 times more productive than Romania in 2004) can hide intra-industry specialisation within manufacturing industries. Indeed, one can see that, looking at European data, some sub-sectors have large productivity differentials within the textile industry, and more or less specialisation within an industry accounts for large productivity differentials at the industry level.

The data on the apparel industry reveal a fairly similar pattern between countries. Old Member States in Western Europe still report the highest productivity levels while Romania and Bulgaria have the lowest. This is largely due to the fact that some countries remain specialised in the assembly steps of the production process whereas others are involved in the value generating phases like design, retail, branding and material sourcing, to the extent of actually divesting from manufacturing itself. One should note that, like in the textile industry, Spain has an intermediate productivity level while Portugal reports a score that is close to the one of the last ten new entrants. This last observation reveals that the catch-up process that begun in 1986 with the EU accession has not been entirely completed and this is especially the case for Portugal, at least for what concerns the manufacturing industries.

<sup>16</sup> Because of missing data, all countries are not represented in all rankings for productivity by manufacturing industry.



\*\*data related to Greece and Luxembourg are not available

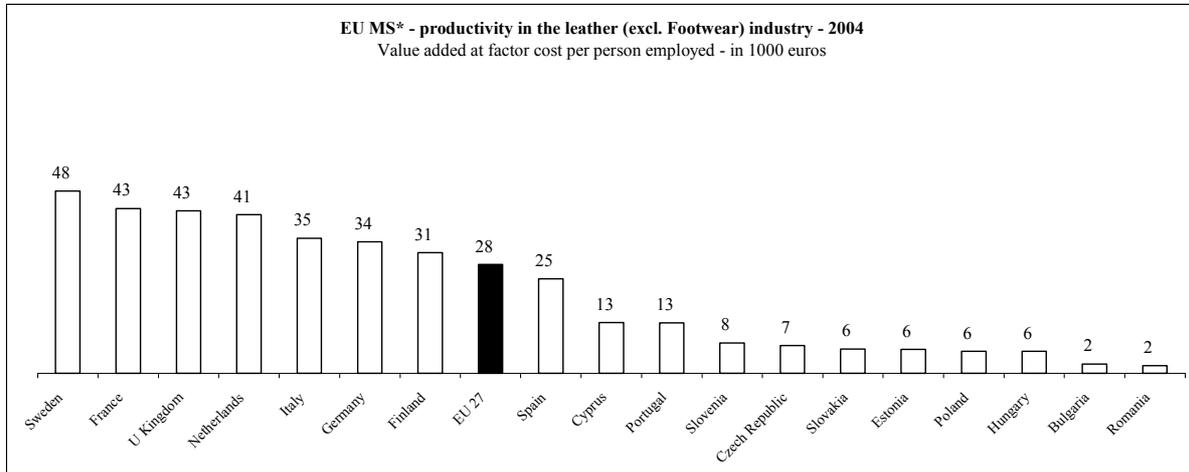
\* Sweden : 2004 Eurostat data related to employment are low in comparison with 2002 and 2005 preliminary data. Therefore the value added per person should be lower than 49 000 euros per persons employed (probably less than 40 000 euros per persons employed)

Source Eurostat

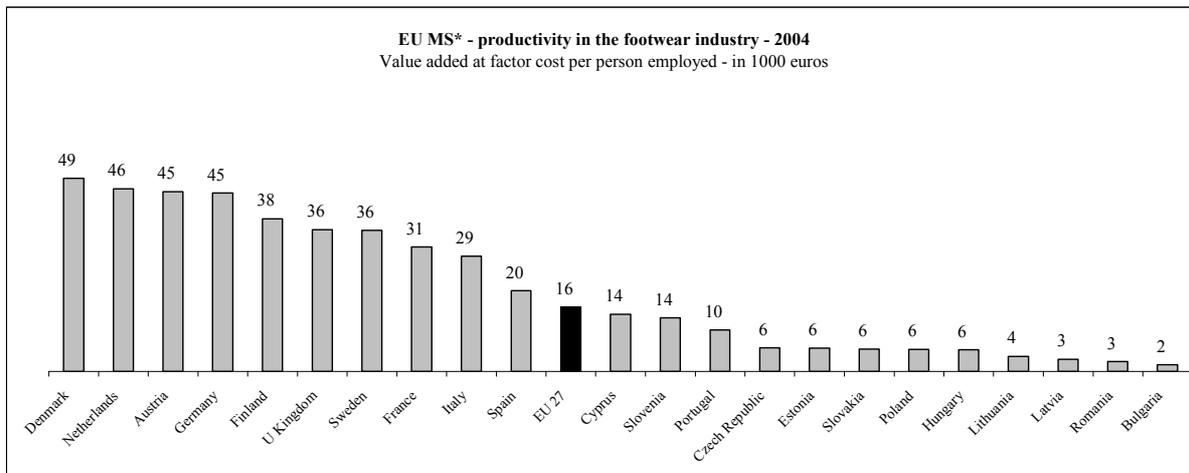
The pattern is also fairly similar for leather and footwear industries where Europe again appears clearly segmented between one high value added part in the North-West of the EU, a middle region in transition around the EU average, an Eastern area where value added only is one tenth of the amount of North Western countries, and a very low added-value region with the last two entrants.

Productivity in Italy is 21% higher in the leather than in the footwear industry. Various explanations account for this difference: the high prices and high margins that can be put on luxury leather accessories, in correlation with the power of the brands (Italian), and in upstream manufacturing (tanning and similar), the price-premium derived both from exclusive raw material (large size flawless hides) and luxury branding. On the other side the footwear market, especially since 2001, has become a battlefield where imports achieve very high penetration levels.

The two charts below provide indications on the leather industry. They indicate that Italy performs rather well in the leather (excluding footwear) industry in terms of labour productivity (approximately 25% below the leaders of the industry), but stands somewhat lower in the footwear industry (approximately 40% below the leaders).

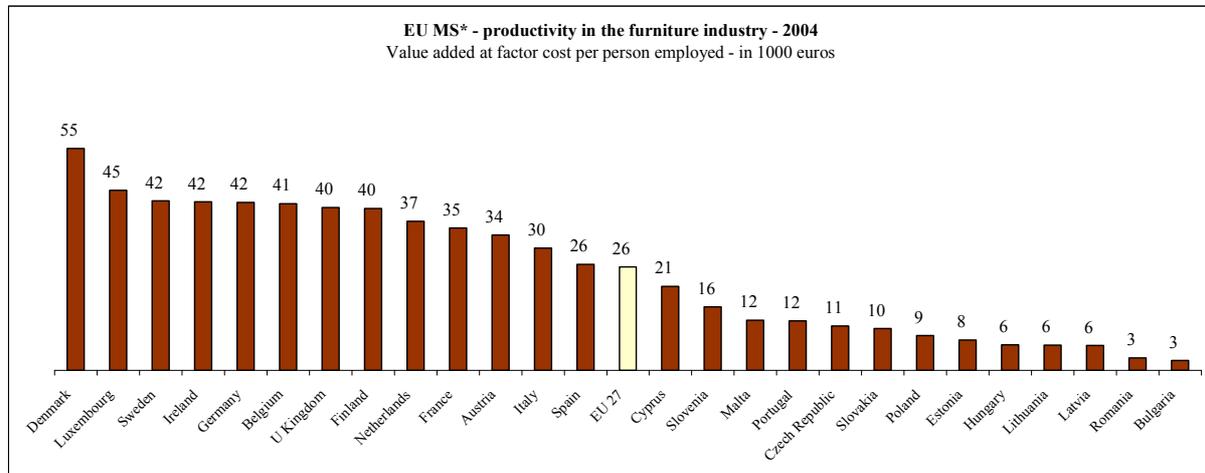


Source Eurostat \*data related to Greece, Denmark, Ireland, Belgium, Latvia, Lithuania, Austria, Luxembourg and Malta are not available



Source Eurostat \*data related to Greece, Belgium, Ireland, Luxembourg and Malta are not available

The analysis of productivity in the furniture industry provides similar result than for the other manufacturing industries with somewhat lower discrepancies between countries. The annual value added per employee in Denmark is more than twice as high as the one in Spain, which is 9 times higher



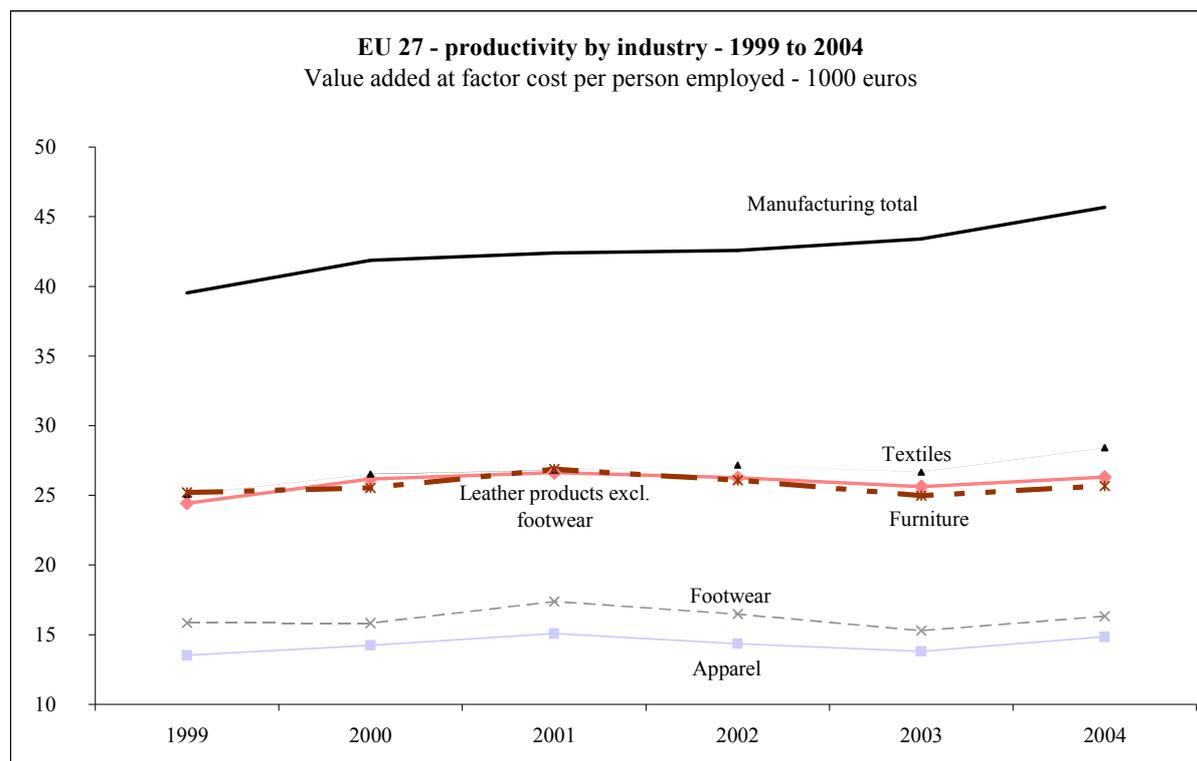
Source Eurostat

\*data related to Greece are not available

than the one in Bulgaria.

Even though each manufacturing industry records specific average productivity levels, the ranking of countries with regard to this variable seems globally approximately the same between sectors. Least productive countries are always 20 or 25 times less productive than the most productive ones. In the same way, countries can be classified with respect to four large geographical areas: North-Western Member States are more productive in manufacturing industries than South-Western Member States. New Member States from Eastern Europe represent the middle-lower category, whereas Romania and Bulgaria, share the last rank in most cases. Among the Eastern Member States Slovenia always displays very high performance levels, while among EU 15 Members, Portugal always ranks fairly low.

- **Trends in productivity developments**



Source Eurostat and IFM estimates based on Eurostat data

Labour productivity in the five industries under review since 1999 has remained quite stagnant (+2.4% between 2000 and 2004 at the level of EU 27) and increasingly low in comparison with the standards of the manufacturing industry as a whole, which follow a regularly increasing trend. This stability, in a context of deteriorating trends regarding total value added, gives evidence that the continuous laying-offs only allow to maintain former levels of productivity.

To some extent 2002 appears as a slight turning point for apparel and footwear industries, as it marks the sudden increase of competition that can both be attributed to China's entry into WTO and to a deterioration of the Dollar/Euro rate. Both sectors display similar trends with an increase of their respective values added until 2001 and a downturn onwards.

A comparison with the major economic partners of the EU is not easy due to a widespread lacking in both reliable and homogeneous – definition of activities and time periods – statistical databases<sup>17</sup> in many third countries. However some comparisons can be made even though they have to be considered with much care.

As far as the USA are concerned, labour productivity (value added at factor cost per worker) has raised much more than in the EU for the industries concerned : + 44% between 1998 and 2005 for textiles, compared to + 8% in the EU 27 between 1999 and 2004 ; + 50% for

<sup>17</sup> Sources used here are: Census Bureau and Bureau of Economic Analysis for the USA and Unido for most other countries.

apparel/leather/footwear in the USA vs. +10% for apparel and +13% and +3% for leather and footwear in the EU 27 ; + 43% for furniture vs. +2% in the EU.

Among EU's trading partners, the largest gains in labour productivity should be attributed to China, particularly in the textile and furniture sectors (+ 190% and + 160% respectively) between 1998 and 2003. Strong rises in labour productivity are also observed in apparel (+ 60%) and in leather (+ 80%).

Very high rises can also be noticed for Morocco over the 2000-2004 period, especially in apparel and footwear (+ 33% and + 38%), and to a lesser extent in textile (+18%) and furniture (+ 14%).

Over the 1995-2003 period India's performance appears highly contrasted between sectors which have considerably increased their labour productivity, like furniture (+ 70%) or textile (+ 11%) and others with deteriorated ratios, like apparel (- 24%), leather (- 25%) or footwear (- 2%).

Over the same time span, Tunisia only displays rises in footwear (+ 94%), and apparel (+ 30%), whereas trends for furniture and textiles appear dramatically negative (- 67% and - 84% respectively).

Finally Turkey shows deteriorating labour productivity ratios, between 1995 and 2001 in all sectors, with - 25% or so for textile, apparel and leather, - 41% for footwear and - 35% for furniture.

As far as Europe is concerned, the overall stagnation hides huge differences between areas and industries.

First it should be noted that productivity in the 12 new Members has considerably grown between 2000 and 2004, with an overall increase of value added per capita of 22% for the five sectors under review. It is only attributable to a dynamic trend in the furniture (+32%) and textile (+25%) industries, as productivity in the other industries has either remained rather stable, like apparel (+6%), or receded like leather (-12%) and footwear (-4). In the case of textiles and with the exception of knitwear (with only +3%), all sub-sectors have seen major rises in productivity, in particular the "other" textiles like technical textiles, carpets etc, with an impressive +40%, and the fabric manufacturing sector (+33%).

In the furniture industry the observed growth in productivity between 2000 and 2004 is to be attributed to all sub-sectors, but predominantly to seats and chairs manufacturing (+164%), hard wood furniture (+63) and mattresses (+61%).

Almost all new Members have made considerable progress in productivity levels, the most striking performance coming from Slovakia (+93%, due to all industries except leather), followed by the Czech Republic (+55%), Bulgaria (+50%), Hungary (+48%) and Lithuania (+43%). In the stagnating leather sector the Czech Republic is the only place where productivity has significantly increased (+47%).

Within the old Member States (EU 15), productivity has only grown by an average 6% for the five industries considered. The only real growth area appears to be the apparel sector, with an overall +16% in productivity, while the other sectors have remained rather stable (from +1% for leather to +6% for footwear). In textiles (+2%), the 9% fall concerning preparation and spinning has been offset by good stability in all other sub-sectors. In the furniture industry the strong increase in productivity due to the kitchen area (+14%) has allowed the whole industry to improve somewhat (+3%).

Major increases can be observed in certain regions, first of all Ireland with a remarkable +30% in the productivity of the five sectors, due to progressions in all sectors but leather (-32%), particularly footwear (+78%), and furniture (+37%). With an overall +28%, Denmark ranks second, with good performances everywhere except leather (-6%). In Sweden and in Spain high growth in productivity (+23 and +19% respectively) are to be attributed to the sole apparel sector (+73% and +30%).

None of the other big players displays very high growth in productivity levels over the period. Italy stagnates with an average +2%, which is only due to good growth in apparel and footwear (+7%). Very similarly Germany's growth (+5) is accounted for by the same two apparel (+18%) and footwear (+19%) sectors, and to an +6% in textiles which is quite above EU 15's average. Apparel growth in the UK (+51%) offsets mediocre performances in the other sectors and a -27% regarding footwear, and allows an average +10% increase. France's productivity (+12%) is also pushed forward by the apparel sector (+30%).

All in all productivity growth in the EU 2 (+2.4% between 2000 and 2004) is predominantly drawn by the apparel sector (+4%). However this trend appears to be a necessary catching up as the overall level of productivity in apparel remains far below the other sectors, in particular some 40% below furniture, leather and textiles. Footwear also displays a very low level but the situation is deteriorating

## 4.2 WAGES AND TRAINING

- **Wages and personnel costs**

In respect with wages and qualifications Europe does certainly not appear as a homogeneous entity. The lowest cost countries are approximately at the level of Thailand or Mauritius, the Baltic States may be cost competitive with countries like Turkey, Mexico or Morocco, while the highest costs in Europe like Belgium and Germany are close to the Japanese average, i.e. almost twice as high as the USA. France, Italy and the UK would be situated in the vicinity of Canada, i.e. 20% above the USA.

The following table presents empirical data observed by Werner Consultants, in textile upstream companies. Even though it cannot absolutely reflect the situation in the other sectors it provides a unique world-wide reliable basis for comparing country levels and trends.

**Textile - Spinning and weaving labour cost comparisons - average cost per operator hour  
(total cost in US\$)**

Area	Country	1996	2000	2002	2004	2004/2000 (%)	2004/1996 (%)
EU 27	Belgium	\$25.00	\$19.55	\$21.27	\$30.42	55.6%	21.7%
	Germany	\$21.94	\$18.10	\$18.91	\$27.69	53.0%	26.2%
	Austria	\$20.61	\$15.80	\$16.98	\$24.55	55.4%	19.1%
	France	\$16.45	\$13.85	\$14.22	\$21.03	51.8%	27.8%
	UK	\$11.71	\$12.72	\$13.93	\$20.17	58.6%	72.2%
	Italy	\$16.65	\$14.71	\$13.93	\$19.76	34.3%	18.7%
	Ireland	\$11.83	\$10.31	\$11.24	\$16.60	61.0%	40.3%
	Spain	\$9.21	\$8.32	\$9.52	\$14.06	69.0%	52.7%
	Greece	\$8.92	\$7.24	\$7.56	\$11.67	61.2%	30.8%
	Malta	\$6.87	\$6.62	na	\$9.53	44.0%	38.7%
	Portugal	\$4.77	\$4.31	\$4.78	\$6.87	59.4%	44.0%
	Czech Rep	\$2.21	\$1.97	\$2.36	\$3.94	100.0%	78.3%
	Poland	\$2.39	\$2.35	\$2.90	\$3.80	61.7%	59.0%
	Slovakia	\$1.67	\$1.61	\$1.90	\$3.43	113.0%	105.4%
Estonia	\$1.58	\$1.53	\$1.98	\$3.00	96.1%	89.9%	
Bulgaria	/	/	\$1.01	\$1.50	/	/	
Euromed	Israel	\$7.34	\$7.43	\$8.17	\$9.35	25.8%	27.4%
	Turkey	\$2.02	\$2.69	\$2.13	\$2.88	7.1%	42.6%
	Morocco	\$1.92	\$1.87	\$1.89	\$2.56	36.9%	33.3%
	Tunisia	\$1.89	\$1.65	\$1.77	\$2.05	24.2%	8.5%
	Egypt	\$0.84	\$1.02	\$1.01	\$0.82	-19.6%	-2.4%
Other Europe	Switzerland	\$27.30	\$22.15	\$24.12	\$35.33	59.5%	29.4%
North America	Canada	\$13.92	\$14.29	\$13.59	\$18.61	30.2%	33.7%
	U.S.A	\$12.26	\$14.24	\$15.13	\$15.78	10.8%	28.7%
South America	Argentina	\$4.60	\$5.90	\$1.70	\$2.86	-51.5%	-37.8%
	Venezuela	\$2.51	\$2.78	\$1.84	\$2.85	2.5%	13.5%
	Brazil	\$3.84	\$3.20	\$2.50	\$2.83	-11.6%	-26.3%
	Mexico	\$1.52	\$2.20	\$2.30	\$2.19	-0.5%	44.1%
	Colombia	\$2.14	\$1.92	\$1.82	\$1.97	2.6%	-7.9%
	Peru	\$1.98	\$1.74	\$1.63	\$1.93	10.9%	-2.5%
Africa	South Africa	\$1.86	\$1.82	\$2.17	\$3.80	108.8%	104.3%
	Mauritius	\$1.40	\$1.47	\$1.33	\$1.57	6.8%	12.1%
	Kenya	\$0.41	\$0.60	\$0.62	\$0.67	11.7%	63.4%
Asia	Japan	\$24.31	\$26.10	\$22.76	\$27.77	6.4%	14.2%
	Taiwan	\$6.38	\$7.23	\$7.15	\$7.58	4.8%	18.8%
	South Korea	\$5.65	\$5.32	\$5.73	\$7.10	33.5%	25.7%
	Hong Kong	\$4.90	\$6.10	\$6.15	\$6.21	1.8%	26.7%
	Thailand	\$1.56	\$1.18	\$1.24	\$1.29	9.3%	-17.3%
	Malaysia	/	\$1.13	\$1.16	\$1.18	4.4%	/
	China coastal	\$0.58	\$0.69	\$0.69	\$0.76	10.1%	31.0%
	India	\$0.56	\$0.58	\$0.57	\$0.67	15.5%	19.6%
	Indonesia	\$0.52	\$0.32	\$0.50	\$0.55	71.9%	5.8%
	China mainland	/	/	\$0.41	\$0.48	/	/
	Sri Lanka	\$0.45	\$0.46	\$0.40	\$0.46	0.0%	2.2%
	Pakistan	\$0.43	\$0.37	\$0.34	\$0.37	0.0%	-14.0%
	Bangladesh	\$0.44	/	\$0.25	\$0.28	/	-36.4%
	Vietnam	/	/	/	\$0.28	/	/
Other area	Oman	\$2.10	/	/	\$2.07	/	-1.4%
	Australia	\$13.91	\$10.85	\$10.38	\$16.47	51.8%	18.4%

**Textile - Spinning and weaving labour cost comparisons - average cost per operator hour  
(total cost in US\$) (continued)**

*Historical data - countries for which 2004 data are not available*

Area	Country	1996	2000	2002	2004	2004/2000 (%)	2004/1996 (%)
EU 27	Denmark	\$25.65	\$22.27	\$23.03	/	/	/
	Netherlands	\$23.02	\$19.48	\$20.29	/	/	/
	Sweden	\$20.94	\$17.00	\$16.97	/	/	/
	Finland	\$16.48	\$14.06	/	/	/	/
	Hungary	\$3.18	\$2.63	/	/	/	/
	Lithuania	/	\$2.23	/	/	/	/
Euromed	Algeria	\$1.68			/	/	/
Other Europe	Norway	\$22.30	\$17.97	\$21.12	/	/	/
South America	Chile	\$3.10			/	/	/
	Bolivia	\$2.63			/	/	/
	Uruguay	\$4.18			/	/	/
	Paraguay	\$1.97			/	/	/
Africa	Ethiopia	/	/	\$0.62	/	/	/
	Nigeria	\$0.77			/	/	/
	Madagascar	\$0.39	\$0.37	/	/	/	/
Asia	Philippines	\$0.91	/	/	/	/	/
Other area	New Zealand	\$8.00	\$7.28	\$8.28	/	/	/

Source Werner International

The analysis per industry sheds light on the wide discrepancies that exist in personnel costs between sectors within the EU. Textiles and furniture score highest with yearly costs that are 30% higher than footwear and apparel. This reflects a high position in several respects:

- technological level: to run costly complex machines, highly skilled workers are needed
- location on the largest markets, i.e. the most expensive countries
- significant proportion of semi – or non – industrial jobs linked to marketing and headquarter functions

As far as apparel and footwear are concerned, personnel costs are quite low. This is the result of several other factors:

- low technological content
- location in lower cost countries
- important proportion of non-industrial and unskilled positions due to integrated retail networks.

From the point of view of wages and personnel costs, a huge diversity exists within the EU. The ratio between the highest and the lowest cost countries averages 20 to 1 in the textile and furniture sectors. It is closer to 30 to 1 in more labour intensive sector like the footwear, leather and apparel sectors.

Member States in the North-West region of Europe are always the ones with the highest personnel costs, even though the share represented by the social benefits may vary quite considerably between countries: Denmark, Germany, Finland, Belgium, Austria, the Netherlands consistently rank highest in Europe, despite variations between industries.

The picture is also quite consistent at the other end of the spectrum with Bulgaria and Romania always displaying the lowest personnel costs of Europe, Bulgaria's costs being significant below the Romanian ones.

Above this group of countries, the 10 other new Member States are not very homogeneous: Baltic countries generally post personnel costs which are lower in comparison with the others, particularly so in textiles, less in furniture and apparel.

Among the new Member States Slovenia enjoys a leading position, quite close to the EU 27 average, and quite remarkably always above some EU 15 Member States like Portugal (as was already observed in the productivity analysis).

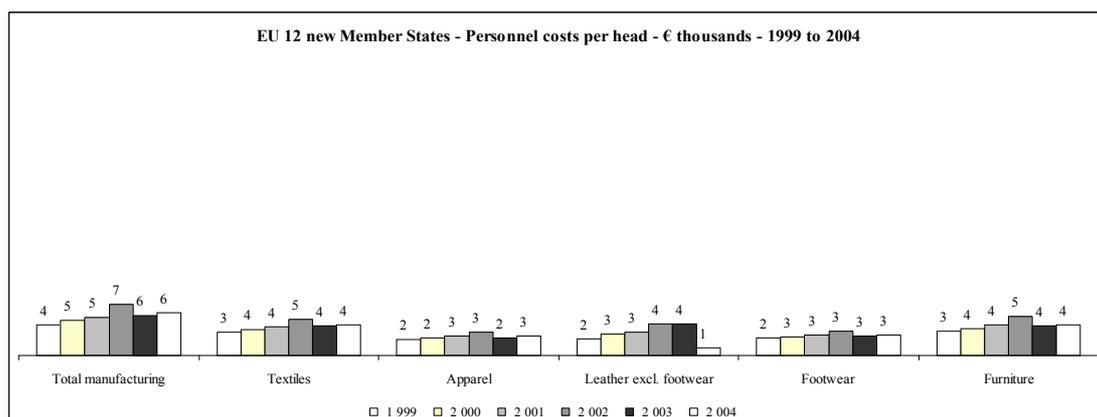
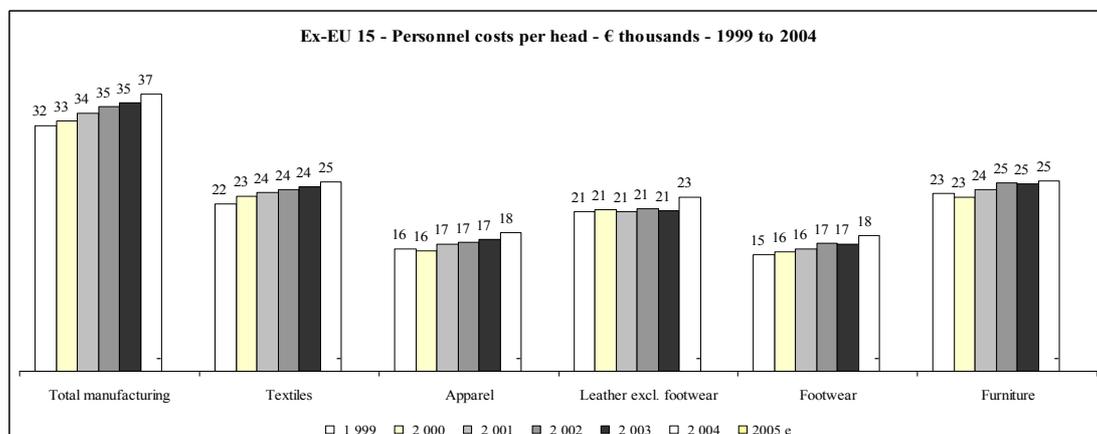
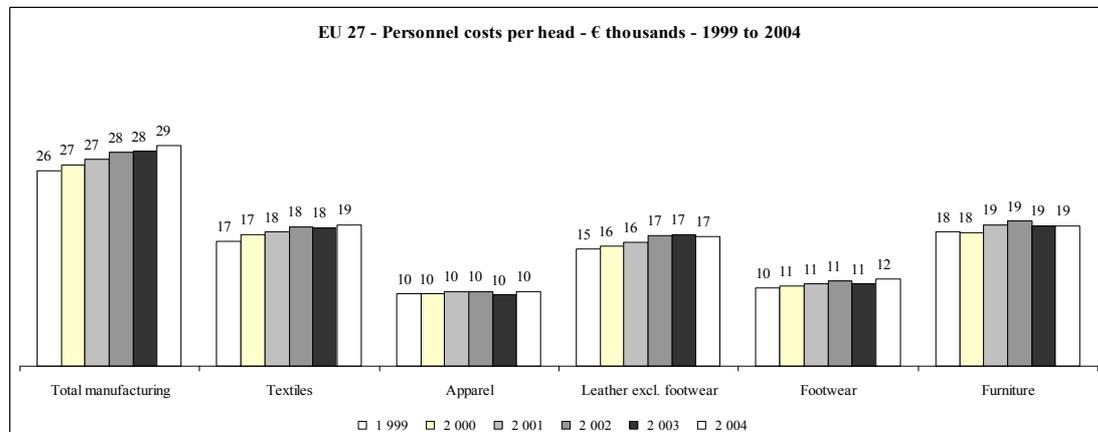
The other South-West countries of Europe, Italy and Spain are also very close to the EU 25 average, and generally higher than the EU 27 average except in the furniture industry. In Italy the level of personnel costs in the apparel (17,000 €) industry is much lower than in the other sectors, which reflects a particularly low level of skills for this industry.

The position of the UK is in general an intermediate level between Italy and Spain on the one hand and the North-West countries on the other hand.

Finally the French position appears to be rather fluctuating across sectors within Europe. It is the most expensive country among leather large producers, presumably due to the importance of luxury groups. It is the same for apparel where many firms follow brand-oriented delocalising strategies. This is not due to absolute variations in France's costs between sectors – the scope is only from € 28,000 to 31,000 a year per employee – but because French average costs per sector do not fluctuate in the same way as the EU average. With "only" € 29,000, France ranks high for leather because the EU average is quite low in comparison with other sectors. In those sectors France is closer to the EU average, a little above the UK in general.

- **Recent developments**

Between 2000 and 2004 labours costs have not drastically increased in EU 27. In particular, in the furniture industry the increase has only been +5%. In the other sectors growth has been +7% in textiles, +10% in apparel, +8% in footwear and leather.



Source Eurostat and IFM estimates based on Eurostat data

Over the 2000-2005 period, in the USA compensation for workers has quite significantly increased (in US dollars): by 12% for textiles and 19% for apparel, by 11% for leather and footwear and by 15% for furniture.<sup>18</sup>

In India the largest increases over the 1998-2003 period can be observed for apparel, with a 34% rise, and in textile (+ 27%), followed by footwear (+ 20%) and leather (+ 12%).

In Turkey data show decreases for textiles (- 14%) and leather (- 26%), while labour costs in footwear (+29%), furniture (+ 16%) and apparel (+ 4%) seem to have all risen between 1995 and 2001.

Quite negative seems to be the evolution of personnel costs in Tunisia, with decreases in all industries under review, ranging from -3% in leather, up to - 30% in apparel and even a reported - 86% in textile between 1995 and 2003.

In Morocco, the trend is evenly positive throughout sectors, from + 32% in textile and furniture, to + 34% in footwear and + 38% in apparel and leather industries.

Even though they are much more limited than in many partner economies, changes in the EU hide some strong increases at the country level.

In Western Europe, Denmark's wages have surged by approximately 30% for most sectors under review over the 2000-2004 period, which seems to reflect an actual upgrading of strategies and jobs and an ongoing strategy of upgrading and developing branding and retailing activities. One should nevertheless be careful when interpreting data as employment figures in some country/sector cases can be small and subject to somewhat erratic fluctuations.

Among the interesting developments one may also remark that in the 12 new Member States textile and leather labour costs have grown quite fast: by almost 20% between 2000 and 2004, reflecting a significant upskilling and upgrading of the local productions. On the opposite, apparel costs have only grown locally by 7%. In the furniture industry the increase of labour costs in the 12 entrants has been more moderate (+14%) even though stronger than the increase in EU 15 (+10%) over the period.

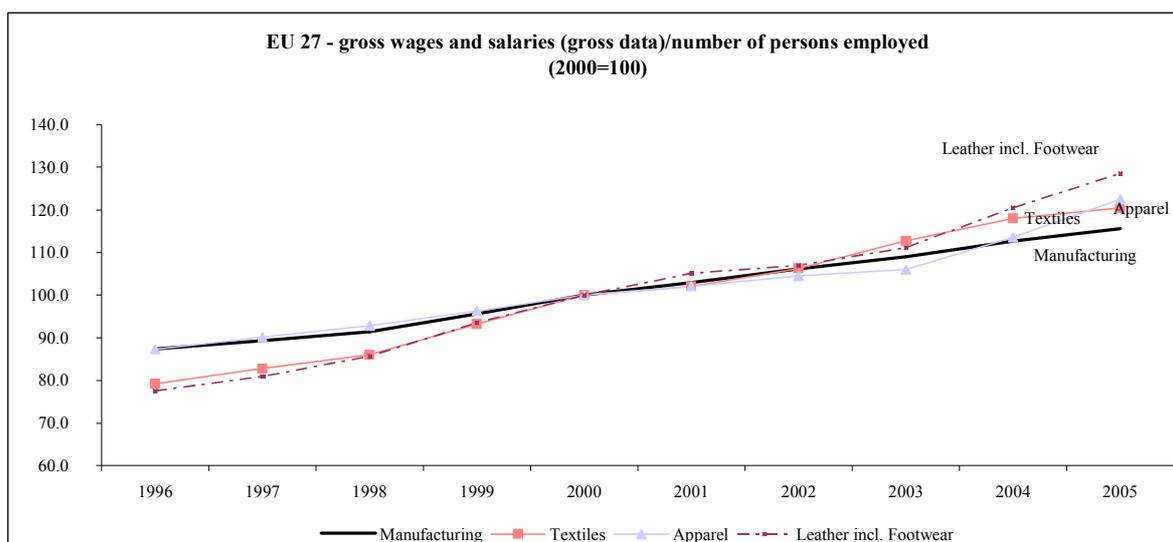
The evolution of personnel costs in Italy has been extremely important over the four year period : especially for apparel (+15%), leather (+17%), footwear and furniture (+19%), consistently above EU 27 and even EU 15 average rises except for apparel. This seems clearly correlated with the negative evolution of profits which is analysed in further pages of the present report.

It is quite remarkable that in the apparel industry labour costs in the older Member States (EU 15) have surged by 26% between 2000 and 2004, as the growing deindustrialisation of the sector has brought significant changes in employment structure (more marketing, middle management and higher skilled manufacturing positions) and consequently raised the levels of compensation for workers.

*(See appendix 1 IV. 4.2- Wages and training for more detailed information).*

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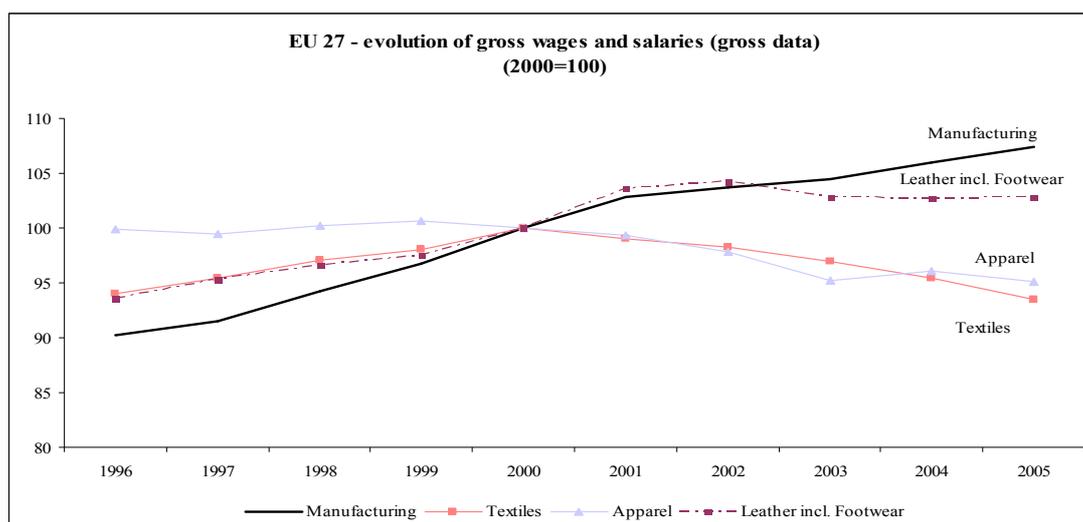
<sup>18</sup> Source: US Census Bureau. No data available for China. For other countries, source: Unido.



The analysis can be extended to 2005 for some activities, by using the Short Term Statistics published by Eurostat. They show that the overall fall of wages and salaries (as total costs, i.e. not per capita) in the EU 27 is only attributable to the drop in the numbers of personnel employed, and that in comparison with the manufacturing average, gross wages and salaries in the textile, apparel and leather industries have increased faster than have manufacturing standards since 2000. The increase has been more important in the apparel and leather sectors. These are the sectors where companies display high intangible/tangible investment ratios<sup>19</sup> (brands, marketing, retail, etc.) and high proportions of entrants (see table below). As such it represents an overall upskilling of the remaining jobs in the EU and can be interpreted as a positive consequence of delocalisation and immaterial investments.

As far as production itself is concerned, social policy for most producing companies remains linked to increases in productivity, hence with replacement of people by mechanical and automated processes. However there is no single model of adjustment of the labour organisation. What can be observed is that taylorist models of production with a further segmentation of work coexist with post-taylorist models implying delayering, multi-skilling and empowerment at the shop floor. In general increased variety in products and shorter lead times have led to flatter organisation systems with devolution of power to multi-skilled operatives on the shop floor. Duties of machine supervision, handling, retooling and resetting as well as maintenance are often combined in one single hand. Especially in textiles and in leather a broader scope of responsibilities is dominant. In assembly operations the pattern is less clear as high labour turnover in some regions do also incite to deskilling / mono-skilling.

<sup>19</sup> See chapter above



Note: data about wages and salaries (STS) are not available at EU 25 level for footwear, leather (excl. footwear) and furniture.

See Appendix 2 –5 for more detailed information on the variable – Short term statistics (STS) - (wages and salaries).

The evolutions illustrated in the above graphs have a direct impact<sup>20</sup> on the part of production costs which is related to labour. A lower labour content makes it a little easier for a European firm to compete on the international market, since labour is the cost area where the EU unit price is highest in comparison with many foreign competitors. However it may be argued that such positive impacts on production costs are not enough to strongly reinforce competitiveness and that it is also and above all very necessary for the industries to improve the consumer – or customer - value (by improving service, style, fashion, immaterial benefits etc.) in order to remain competitive on a world wide basis.

#### Labour costs as % of 2004 production values

%	Textile	Apparel	Leather	Footwear	Furniture
Entrants	68	70	74	72	67
Value added	32	30	26	28	33
Of which labour costs	21	20	16	21	23
Production value	100	100	100	100	100

Source : Eurostat and calculations by IFM

<sup>20</sup>Figures should be interpreted with much care here. In particular the discrepancies between the industries mentioned at the beginning of the chapter should not be forgotten : in the case of footwear companies, low labour contents primarily reveal a significant level of retail integration with low wages for store personnel; in the cases of many firms throughout the scope of industries higher labour costs may reveal a low use of subcontracting.

- **Qualification and training**

Qualification is the result of several factors. The first one is the tradition and history of a particular industrial sector in one country: for example this is outstandingly important in Romania for wood furniture, in the Czech Republic for textiles, in Hungary for apparel, in Germany for technical textiles, and in Italy for most sectors, to name only a few.

This industrial tradition accounts for the existence of education, training and research centres which constantly rejuvenate the culture of the local industry. It also helps create a motivation for the sector and an industrial community somewhat dedicated to keeping it alive. The relationships between the world of education and the world of the industry are considered by many players as a key factor to help companies, whatever their size, keep abreast of foreign competition in areas like attracting young promising workers, or outdistance it in areas like innovation and long term R&D. One example is the University of Zvolen in Slovakia which is reportedly the best in the new Member States and has enabled the whole country to improve on its innovation and qualitative competitiveness in the furniture sector.

However in many regions there are not enough, schools and training centres left to provide for the initial education of the workers. It then becomes very difficult to hire specialised labour: most companies of the sample do organise training themselves. For instance, in Northern France, where the number of textile companies has been significantly reduced, there is no specialised education left, (ex. sewing machinists). In this case, companies like Artex have been going through training phases in order to train entrants, and also to increase the flexibility of the existing workforce through the acquisition of new technical skills.

In such companies the average training represents some 1% of the wage costs.

In other countries like Morocco, it is also difficult to find sewing machinists and the training of the workforce is ensured in the company. A 6 month-training period is then provided to unskilled entrants as can be seen with the example of Filmod. One can also observe that large firms like Sartex prefer internal training to external training.

In general due to the fact that with a more competitive environment workers should become operational as soon as possible, the training periods have been significantly reduced. Normally, it takes 5 years to train a mender and 2 years to train a good weaver, but now a mender should be trained in 6 months and the weaver should be trained in one month.

In the technical textile, the availability of labour force might appear less important as the production is less labour intensive. However, workers in this sector require specific training. Not uncommonly, 3%-4% of the wages are spent on training and management underlines the importance of positive interaction with local education authorities to maintain a dedicated textile competent pool of workers.

In Euromed non-EU countries companies often underline the difficulty to find workers combining creative and technical skills. In more general terms the move towards more client-oriented strategies and increased market focus requires thorough changes throughout companies. The transition from supply push to demand pull marketing requires more reactive, more collaborative sales staff. In order to ensure flexibility and reactivity, companies have worked on training programmes to make people realize the importance of speed.

In Romania the availability of labour force, particularly unskilled, is decreasing as people prefer to take better paid seasonal jobs in Western European countries.

In this context, the existence of specific schools constitutes a competitive advantage for subcontractors: one can say that part of the attraction of Romania as an apparel subcontracting country is due to local schools and to the University of Iasi, which prepare labour force for the sector. However, further training of the workers is also ensured in-company. The existence of specialised engineering schools is also important for recruiting qualified engineers. The case of Tanneries Roux shows also the importance of specialised schools. The company can hire qualified workforce due to the specialised schools for engineers and technical centre for leather located in the Lyon region.

To recruit new workers some companies like Ace Protection have set up cooperation schemes with local employment offices and regional schools. In the case of the Van de Velde Company, the employment office organises 15 days training courses before workers are hired.

The need for cooperation with existing schools and partnership on R&D with specialised schools and Universities has been underlined by all companies under review (Desso – cooperation with Hogeschool Gent and Design Academy Eindhoven, Mehler Technology GmbH – partnership with education and research Institutes). Some companies have insisted on the fact that specific programmes for cooperation between the sectors under review and specialised schools should be developed in order to raise awareness and willingness of students to work in the production sector. According to companies, students in technological schools are decreasing and it could undermine the future of the industry.

The employment issues are easier to cope with if the company is located in areas, where there is regional concentration of companies in the same sector. For instance, the companies in the Biella area, in Svenljunga, or in Brianza benefit from a network of educational establishments for specialised engineering. Companies in the same region are also able to organise joint training boards.

It should also be mentioned that recruitment is easier in areas where a lot of companies have closed. On the opposite, the recruitment of workers is difficult in areas with low unemployment (for example the Netherlands, the Brianza Region for furniture production, Flanders in textiles – the unemployment in the region is very low and the workers turnover is low).

In general the companies reviewed constantly invest in the training of entrants, but also they all invest in personnel upskilling, to provide their workforce with capabilities better suited to changing market requirements, be it in the realm of flexibility, early problem detection, quality, or client orientation.

In most cases the in-company training to young entrants is provided by older workers who are thoroughly experienced but do not necessarily have the pedagogical capacity nor the technological expertise to transfer their know-how. In some cases one may even wonder whether they are sincerely willing to transfer their knowledge. This issue is not anecdotal as it has often been mentioned in this research.

- **Wage policies**

Among the companies interviewed no significant change was mentioned regarding wages over the recent years. However, some companies use wage policy to retain the most efficient and necessary workers into their companies. For example companies in Tunisia use a high wage (and continuous employment) policy as a key instrument to retain the best trained and skilled workers (60%), while they offer short term occupation and lower wages to unskilled workers for peak period.

Wage policy is also used to ensure flexibility. Labour flexibility is very important in the sectors concerned as the demand varies. Even in technical sectors, some orders are to be taken and filled quite fast and the possibility for the workers to work 2 or 4 shift while respecting labour law is important. In the case of Ace Protection this flexibility is achieved through a much broader-spanning motivation strategy which takes cares of the workers and provides them with many related benefits (health programmes, gym, health food provided etc.). In the case of Etor, a Turkish shoe manufacturer who need a lot of flexibility from their workers, a restaurant, prayer facilities and general education programmes are offered to the workers.

Companies in the leather and apparel sectors have also insisted on the flexible work time, which permits to cope with the fluctuation of customers demand.

To some extent, financial compensation to the workers does not seem to be the major element to increase workers' flexibility. It can be mostly obtained through the building of a team spirit inside the factory, with a participative management attitude. In some companies, operators' wages are only equivalent to the minimum legal standard, even though the work is rather skilled. They nonetheless display a high level of dedication to the company and flexibility. This seems to be fairly correlated with a lack in outside alternative employment possibilities for the workers, due to low geographic autonomy (female workers) and less job opportunities due to middle age.

In the new Member States and in the countries in the Euromed zone, wages are increasing. In the last two entrants, for instance in Romania, this is due to the regular increase of wages and social insurance costs in the country. However companies as Hugo Boss, active in Turkey prefer to pay over average wages to the workers, which foster their involvement in the company. The creation of dynamic groups and quality circles motivate workers. The flexibility of the labour force is also ensured by an inclusive and quality oriented social policy. This case proves that a drive to industrial excellence in the better priced consumer segment can achieve higher productivity and efficiency with higher than average wages. However this company operates in a very stable commercial environment.

### 4.3 INVESTMENT AND INNOVATION

- **Methodology**

Companies investments are here measured as the net increase of their tangible and/or intangible assets over time. An increase in intangible assets means the development of immaterial activities, i.e. not directly productive, which may be marketing oriented - when a company acquires brands or opens stores - or technology oriented - R&D investments<sup>21</sup>, patents. On the opposite an increase in tangible assets can be translated as an investment on production capabilities, be them quantitative (increase of production capacity) or qualitative (technological enhancement of production).

The present analysis makes use of the Amadeus database to determine, for each industry and each country, if and how the firms' asset structure has changed over time. This change corresponds to the net investment made by the firms for one given year. Investment rate at time t is calculated using the following formula:

$$investment_t = \frac{(asset\ value_t) - (asset\ value_{t-1})}{turnover_{t-1}}$$

Accordingly, the investment rate is calculated for each firm in each country and each industry, for the years 2001 to 2004. More precisely, the formula stated above is used to define investment in tangible and intangible fixed assets. Firm level data are then aggregated by country in order to obtain an average investment rate of domestic firms in intangible and tangible assets. Finally, an average investment rate over the period 2001-2004 is calculated, so as to obtain a more significant picture of investment over the period.

One should note that firms were taken into account only if they provided all required information for the years 2000 to 2004. This permits to have always the same number of firms – and the same firms – for each year, and consequently more significant results. Correlatively, the analysis disregards firms that have ceased existing between 2000 and 2004, among all firms which have not reported their data.

This firm selection thus leads to a large reduction in the firm sample. The analysis therefore focuses on countries that have data on more than 50 firms in each industry, so as to have more reliable results. In this respect, results on Italy, Spain or France should be considered as extremely reliable, since most of the time information is based on more than 1,000 firms by country and by industry.

The analyses are also complemented by two other sets of data:

- the analysis of machinery<sup>22</sup> investments (Eurostat)
- the analysis of textile equipment purchases (ITMF)

<sup>21</sup> Amounts dedicated to R&D by EU's firms are not always considered as investments (and thus asset) in their accounting. When local tax incentives are granted for R&D expenses or for their increases, companies are more attentive to isolating investments, but in many cases R&D amounts would melt into operational expenses. An OECD directive (to be published in 2008) should make it a legal standard to consider that all R&D amounts are investments and increase the intangible fixed assets in companies' balance sheets.

<sup>22</sup> Machinery includes production equipment but also transportation means, office equipment etc.

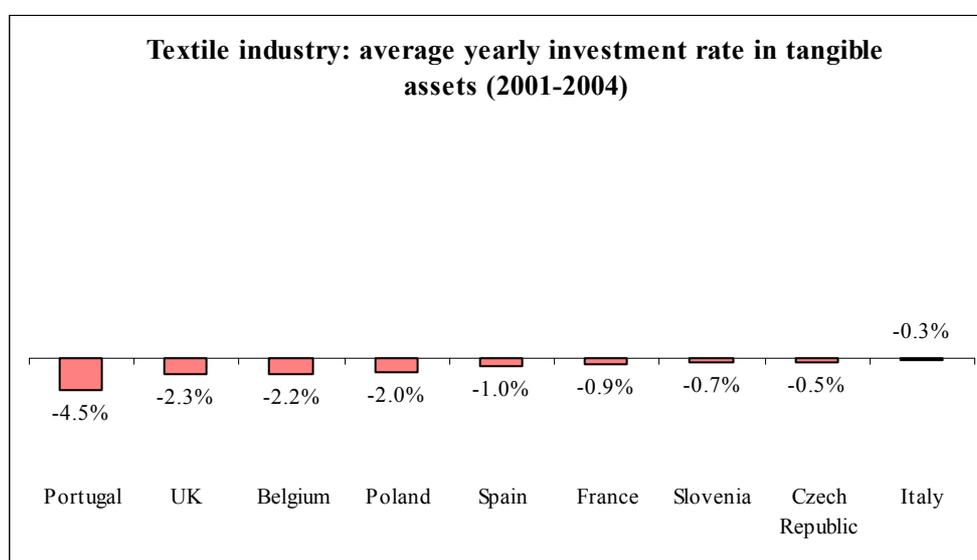
### 4.3.1 Tangible investments

#### Textile

- **General trends**

This part of the analysis reports data on investment rates for nine countries in the textile industry. Statistics on the number of firms indicate that Spain, Italy and France have the largest samples, so that results for these countries should be considered as highly reliable.

The analysis of investment rates in tangible assets shows that the tendency is oriented towards a reduction in the proportion of tangible assets over turnover, for all countries, even in the East.



Source Amadeus

In all EU countries firms that have remained on the market between 2000 and 2004 have sought to reduce the value of their tangible or productive assets, in proportion of their sales and also in proportion of their intangible assets; this is also the case of firms located in Italy, for which the investment rate in tangible assets has been decreasing faster than the investment rate in intangible assets.

However this negative picture can be somewhat alleviated by the analysis of machinery investments over the period (Eurostat), which shows that East European new Member States have increased their purchases between 2000 and 2004. Machinery represents only one part of tangible assets, i.e. production equipment, but also transportation means, office equipment, etc.

For the textile industry, the major increase in investment on machinery was observed for Latvia, with an average growth rate of investment of 20% a year between 2000 and 2003, followed by Lithuania (+13.5% a year). Countries having the most reduced their investment in textile during the period are Ireland (-35% a year), Denmark (-20% a year), Austria and Portugal (-19% a year).

(See appendix 1 III 4.3 investments and innovation – table 2 for more detailed information).

As far as production investments are concerned the analysis of the textile industry can be pushed much further than to the statistics provided by the International Textile Machinery Federation<sup>23</sup>.

Textile machines play a major role in the evolution of industrial competitiveness. As such, investment in machinery is a good reflection of the ongoing strategies of industries in various countries and their specialisation in different types of products.

Investments in new textile machinery worldwide in 2005 continued to follow a downward trend, with the exceptions of traditional short staple spindles and circular knitting machinery. This increase is mainly due to China<sup>24</sup> (with a 60% increase in investments in spindles in 2004, and eight times more investments in circular knitting machinery) and to India (investments in spindles doubled between 2004 and 2005, to a number far superior to investments that had been made since 2000).

In all categories of textile machinery China was by far the first global investor over the 2000 – 2004 period, except in flat-knitting machinery, which means that the Chinese leadership in terms of both capacity and technology now rests on firm bases. India and Pakistan have also demonstrated a strategic will to reinforce their cotton value chains, particularly in spinning and circular knitting.

The only significant Mediterranean investor is Turkey, which benefits from its integrated cotton chain to develop a wide-spanning textile strategy covering all segments of the market. EU's investments between 2000 and 2004 have been concentrated in Italy, particularly as far as cotton-type spinning is concerned. Greece, Spain and Germany have remained significant investors too. Italy also demonstrates a strategic dedication to flat knitting, without comparison anywhere within the EU.

However throughout Europe investments have been declining between 2000 and 2004 in all segments, except in the new Member States for weaving and knitting equipment.

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<sup>23</sup> The textile sector benefits from very reliable and precise data on machine deliveries, which are published by ITMF. This allows an in-depth analysis of investment in the sector. Unfortunately no such data exist in the other industries under review.

<sup>24</sup> Following the evolving needs of textile manufacturers, the textile machine industry is also developing in Asia. The international trade fair ITMA (International Textile Machinery Association), founded in 1951 and held every four years in one of the major Western European cities, organised the first ITMA Asia in 2001 which welcomed Asian visitors along with local exhibitors. It is worth noting that at the most recent ITMA 2003 in Birmingham, there were as many exhibitors from China and Hong Kong as there were from Germany. In addition, since 2000, Chinese textile machinery manufacturers have been giving their figures to the ITMF.

**New machinery purchases (units) cumulative shipments 2000-2004**

<b>2000-2004</b>	spinning machinery short staple spindles	spinning machinery long staple spindles	weaving machinery shuttle-less looms	circular knitting machinery	flat knitting machinery
Belgium	-	432	1 252	81	118
Czech Rep	8 208	16 752	546	44	5
Denmark	-	-	-	-	-
Germany	65 076	9 816	3 022	635	445
Estonia	-	-	24	2	-
Greece	136 560	1 028	315	449	115
Spain	72 000	12 738	2 500	521	1 096
France	8 208	10 008	1 911	417	262
Ireland	22 800	1 680	10	41	-
Italy	339 442	110 860	10 733	1 582	7 490
Latvia	-	-	25	1	6
Lithuania	-	2 496	28	11	4
Hungary	-	-	-	6	10
Netherlands	-	420	97	39	28
Austria	21 264	-	403	98	37
Poland	31 824	2 004	537	272	154
Portugal	55 008	11 112	950	594	318
Slovenia	35 688	-	157	3	-
Slovakia	-	2 916	48	1	17
Finland	-	-	9	10	18
Sweden	-	-	-	-	-
U Kingdom	-	2 408	555	145	250
<b>EU 25</b>	na	na	na	na	na
<i>Other countries</i>					
Bulgaria	2 400	16 608	163	22	71
Romania	-	-	146	13	338
Turkey	1 718 640	216 392	13 508	4 735	6 101
Tunisia	14 352	4 392	115	42	98
Marocco	40 560	25 404	515	199	64
Egypt	118 260	14 856	2 047	802	67
China	11 674 852	747 556	202 944	14 871	8 529
India	4 242 984	13 772	4 798	3 444	305
Pakistan	3 414 024	6 300	5 355	1 231	132
USA	189 600	5 588	2 845	1 937	655
Mexico	293 916	35 840	1 296	745	153
Brazil	255 840	3 312	3 254	1 153	1 350
<b>Total</b>	<b>27 576 958</b>	<b>1 595 974</b>	<b>302 048</b>	<b>50 667</b>	<b>47 844</b>

source ITMF

na : not available

**New machinery purchases (units) shipments 2005**

<b>2005</b>	spinning machinery short staple spindles	spinning machinery long staple spindles	weaving machinery shuttle-less looms	circular knitting machinery	flat knitting machinery
Belgium	-	-	143	35	2
Czech Rep	288	-	82	5	-
Germany	1 776	-	344	129	69
Estonia	-	-	1	-	-
Greece	-	-	17	13	-
Spain	4 608	504	194	39	82
France	-	-	97	26	40
Italy	11 664	13 968	1 194	93	366
Lithuania	-	-	12	4	-
Netherlands	-	-	10	2	-
Austria	-	-	2	3	-
Poland	4 176	-	20	28	18
Portugal	-	-	76	43	16
Slovenia	2 784	-	10	1	-
Slovakia	3 744	-	2	8	18
Finland	-	-	6	-	2
U Kingdom	-	-	72	16	14
<b>EU 25</b>	na	na	na	na	na
<i>Other countries</i>					
Bulgaria	2 400	2 112	4	5	12
Romania	-	4 032	34	3	14
Turkey	307 560	42 268	2 380	962	568
Tunisia	-	-	13	3	3
Marocco	17 328	2 016	115	33	1
Egypt	16 500	192	208	255	25
China	7 183 968	82 896	32 633	22 516	2 803
India	1 429 788	-	4 871	1 154	70
Pakistan	1 037 832	-	1 925	163	-
USA	144	200	277	295	40
Mexico	26 352	960	204	125	4
Brazil	21 600	3 696	667	417	28
<b>Total</b>	<b>11 198 644</b>	<b>182 836</b>	<b>53 476</b>	<b>30 537</b>	<b>10 395</b>

Source ITMF

na : not available

- **Detailed analysis**

- Cotton-type spinning

The fact that Asia has taken over the global cotton-type spinning industry has been beyond question for the past five years. China, with 55% of investments worldwide in 2004, further strengthened its position with 64% of investments in 2005. It is noteworthy that India, an important cotton-producing country, has

finally sped up its investments in the spinning industry, ahead of Pakistan, which has historically been the second largest investor, after China.

China's rise to power in the industry has been relatively gradual. Until 2000, there were far fewer Chinese investments than Indian and Turkish investments. Between 2000 and 2002, Indian and Chinese rates were identical (about 20% of global investments). China's position in cotton spinning exploded in 2003, with 61% of world's new spindles, with Chinese investment representing as much as investment worldwide in 2002.

Another cotton-producing country, Pakistan, has reinforced its position, particularly since 2004, by doubling its new industrial installations in comparison to the preceding year.

The position of EU 25 continues its downslide, now representing only 0.3% of investments in 2005 and 0.6% in 2006. This abandonment of the sector is quite recent. In fact, during the period 2000-2004, overall European investments, while marginal in comparison to the global level, still reached almost 3%. Only Italy and Spain continue investing, but at much lower rates than during recent years, particularly since 2003. Italy, the European leader, invested 10 times less in 2005 than in 2000. It is worth noting that Greece, which has long been second runner in investments after Italy, drastically cut back its investments in 2004, to the point that it invested nothing at all in 2005.

In Eastern Europe, only Poland and Slovenia have invested somewhat.

Turkey is the only country to have invested —admittedly, at uneven rates— but on a continual basis over several years and at a rate superior to that of the EU 25 over more than 10 years.

Egypt stands out among Mediterranean countries in terms of its investments, which, while relatively modest in comparison to its neighbour Turkey, have been regular and over the past two years, superior to those of Italy. Morocco, between 2000 and 2005, invested four times more than Tunisia, but still remains at a level twice as low as that of Egypt.

With investments diminishing regularly since 2000, the USA made no more investments in cotton-type spinning in 2005. Brazilian investments have followed a downward trend since 2003. As for Mexico, after four years of steeply declining investments that hit zero in 2003, in 2005 investments rose back up to their 2002 level.

- Wool-type spinning

In an environment in which global investments in traditional wool-type long staple spindles have been steadily diminishing since 2001, the imbalance between Asia and Europe is not as large. Even in China, which represents 45% of world investments, there has been a 15% decrease in new industrial installations. Nevertheless, this decrease is attenuated by the resurgence in wool-type investments in Italy (4 times greater than in 2004) and in Turkey (2.5 times greater than in 2004), with Turkey responsible for 23% of world investments in 2005.

Leaving behind the wool and linen spinning industry for the cotton and chemical fiber spinning industry, India and Pakistan have invested practically nothing in long staple spindles over the past 5 years.

In Western Europe — with the exception of Italy — Spain, Portugal and Germany are the only countries to have made investments since 2003, though they do not reach the level of Italian investments.

Among the Eastern European countries, the Czech Republic and Bulgaria stand out, as their rate of investment is as high as Spain's.

Turkey, which in 2002 had invested as much as China, has bounced back in 2005, after a decline in investments in the meantime.

Among the Mediterranean countries, which generally do not do much long staple spinning, Morocco stands out, though over the past five years it has remained at an investment level 10 times inferior to that of Turkey.

In the Americas, only Brazil shows an interest in the long staple spinning industry, but its investments have increased only slightly since 2004. Over the past five years Brazil's investments have remained inferior to Italian investments by half.

- Weaving

Global investments in shuttleless looms plummeted 18% between 2004 and 2005, particularly due to China slowing down its new industrial installations by 32% in comparison to the preceding year. Nevertheless, China's investments still represent 61% of installations of looms worldwide.

It is worth noting that 92% of investments worldwide in water jet looms are made by China, which tends to show the strengthening of the Chinese offer of synthetic fabrics, notably technical fabrics.

Participating in a vast plan for facilitating modernisation, in 2005 India invested as much in shuttleless looms as it had during the five preceding years. This figure, however, is still seven times lower than Chinese installations from the same year.

All the great weaving countries in Western Europe have generally seen a steady downward spiral in their investments since 2000. Italy remains the champion nonetheless, with 55% of investments within the zone. Germany, Spain and Belgium still invest in a few hundred looms. These looms, it should be noted, consist practically exclusively of rapier, projectile and air-jet looms, which make weaving a wide variety of fabrics possible.

With a slightly greater presence in the weaving industry than in the spinning industry, the Eastern European countries are also seeing a decline in investments. The Czech Republic and Poland remain in the lead, followed by Bulgaria and Romania. In terms of the overall number of new looms acquired since 2000, the Czech Republic is only at a level comparable to France's investments in 2000.

After reaching a peak in investments in 2003, for two years Turkey has maintained its purchases at a rate that equals the whole of EU 25. Egypt is still investing: its total investments are three times more than Morocco's in 2000. Tunisia's total investments only reach the level of France's in 2004.

Although they have been cutting down on investments, the USA's total investments since 2000 are at the same level as Germany's. Brazil and Mexico maintain their rate of investments, with Brazil's about three times greater than Mexico's. In comparative terms, Brazilian total investment since 2000 is three times lower than that of Italy.

It is worth noting that global investments in shuttle looms were practically nil in 2005 (568 looms in India, 100 looms in Turkey), after years in which investments in shuttle looms represented a quarter of the number of shuttleless looms. It is important to remember that the productivity of a shuttleless loom is

approximately three times that of a shuttle loom, but that the material obtained has a different selvage, and that maintenance on a shuttle loom is generally also simpler than on a shuttleless loom.

- Circular knitting

In knitting investments in new equipment are the most evenly distributed worldwide.

Nevertheless, in circular knitting machinery for producing fine-gauge fabrics, China created quite a surprise in 2005. Until 2004, China had represented about 30% of new machine purchases every year. In 2005, its new installations were equivalent to 74% of all installations globally! China invested more in one year than it had since 1995! This may herald an increase in the offer of jersey-type knits and of finished knits sportswear products such as tee-shirts. Along the same lines, though on a smaller scale, in 2005 India increased its installations of circular knitting machinery twofold in comparison to previous years. Pakistan apparently still has few ambitions when it comes to the knitting industry and remains at a comparable level to previous years, below that of the USA.

In Western Europe, Germany remains a regular and large scale investor, with 44% of investments in the zone; for the first year it is ahead of Italy which is steadily decreasing.

The Eastern European countries, with the exception of Poland, still show no interest in producing knitted fabrics. Total Eastern European investment in 2005 was only half that of Germany.

Turkey, a large scale producer of tee-shirts and other cut and sewn knitwear products, has seen its rate of investment hold steady over the past two years, after two years of sharp increase, 2003 and 2002. Turkey's investment represents more than double that of EU 25 as a whole.

Egypt has stepped up investments and in 2005 came back to its 2000 level, which is equivalent to 60% of the machinery installed in Africa. Morocco is still ahead of Tunisia, but its figures are still low: as many new machines since 2000 as Egypt in 2005 alone.

Another great tee-shirt country, the USA, has kept up investments, but only to the same level as China in 2002. Mexico has taken off again in 2005, though at a rate four times lower than the good years 1999 and 1998, and at more than twice as low a rate as the USA. Brazil, after a downswing in 2003, is repositioning itself on circular machinery and invested practically as much in 2005 as all of EU 25 put together.

- Flat knitting

In terms of flat knitting machinery, China only represented 27% in 2005. Hong Kong, however, which still produces pullovers locally, represents 46% of new equipment purchases in electronic machinery. It should be noted that along with the electronic machines counted here, there are also purchases of semi-automatic and manual machines. The productivity of these machines is estimated to be five times lower for comparable products than electronic machines. They cost almost 100 times less, however. While one hosier runs several electronic machines, manual machinery requires one worker per machine. In 2005, China purchased 74,059 of these manual or semi-automatic machines and Bangladesh 53,289.

India is not greatly involved in pullover-type knits, and its total purchases since 2000 only equal those of Italy in 2005. The total number of new flat knitting machines in Pakistan is limited, and it has hardly invested at all since 2003.

Until 2002, Italy was the world leader in investments in new flat knitting machinery, ahead of China; it has since seen a decrease in purchases. They were three times lower in 2005 than in 2004. Spain, Germany and France still invest in several dozen machines. In Eastern Europe, Romania is the most important country, though its rate over six years equals that of Italy in 2005 alone. Poland and Bulgaria are also noteworthy.

After large scale new industrial installations in 2003 (more than China that same year), Turkey's purchasing slowed down slightly in 2004 and dramatically in 2005, though it is nonetheless equal to 90% of that of EU 25 as a whole.

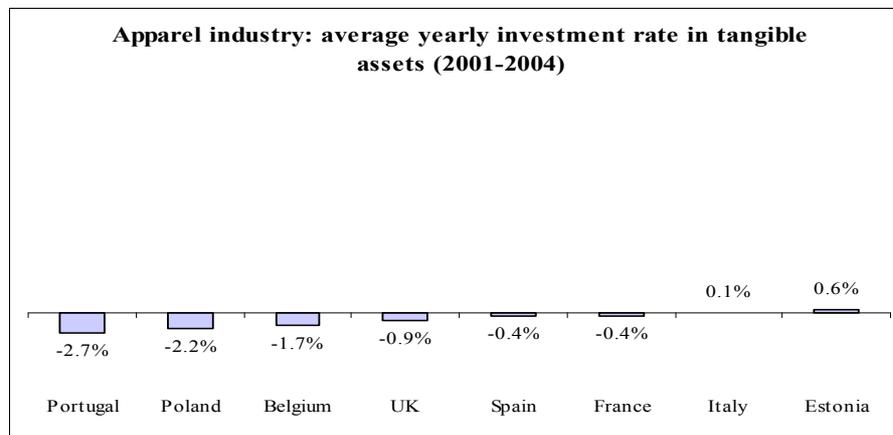
Egypt and Morocco are at the same low level. Tunisia is a bit higher, though over the years since 2000 it has only become as well-equipped as Spain in 2004 alone.

The USA's investments since 2000 have been a roller coaster ride: three times lower in 2005 than in 2004. They were still ten times less than in Italy, however. Brazil's investments have declined significantly and their level for 2005 is almost twenty times lower than it was in 2000 and 2001. And Mexico has so reduced its new industrial installations since 2003 that they are practically nil.

## Apparel

Here again, France, Italy and Spain data are based on the largest numbers of firms in the sample which results in a high reliability of data.

Investment rates in tangible assets for the apparel industry show a significant divesting trend, particularly in Portugal.



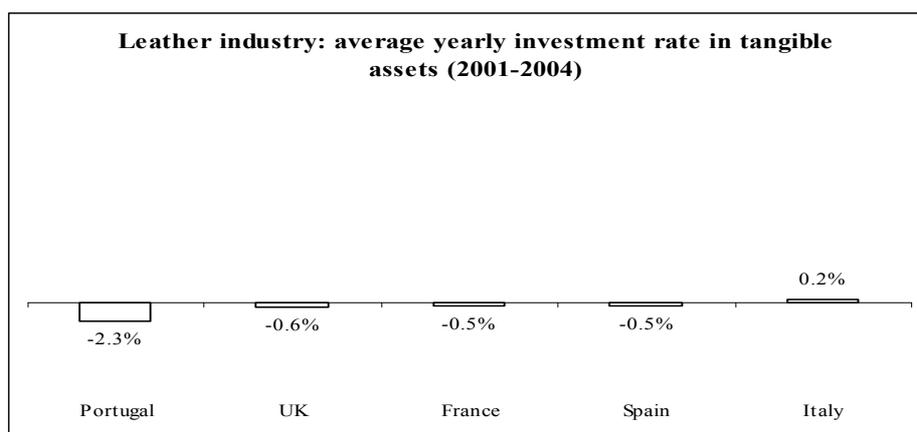
Source Amadeus

In particular, investments in machinery follow a largely negative trend in the EU

They have only increased in Slovakia (+33% a year), in Hungary (+3% a year) and in the UK (+1% a year), while they have significantly diminished in the Netherlands (-28%), and in Ireland (-28%). (See appendix 1 IV- 4.3 Investments and innovation table 4 - for more detailed information).

## Leather

Scarcity in the data concerning leather and footwear here limits the analysis to aggregate footwear and other leather industries.



Source Amadeus

Statistics on investment rates in tangible assets show that only Italy had a slightly positive rate over the period. On the contrary, the value of firms' tangible assets has been reduced particularly in Portugal.

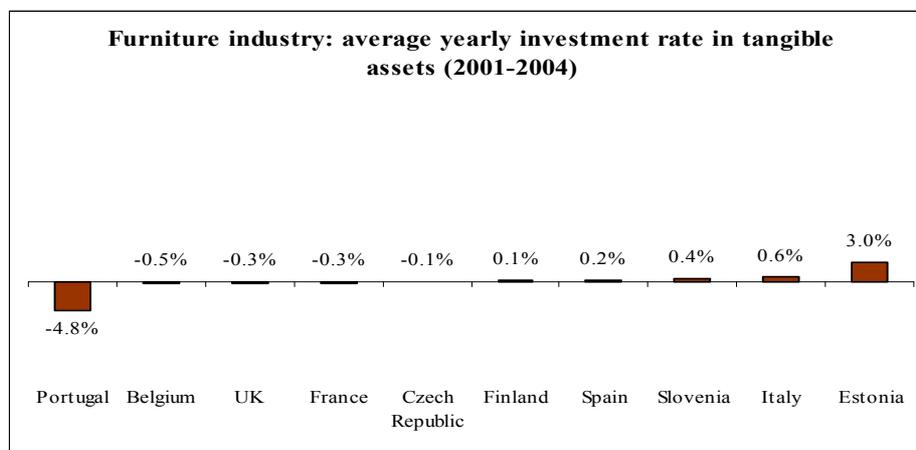
This kind of evolution shows that firms have not invested and that the divestment rate can be linked to a “natural” depreciation in the value of the fixed tangible assets.

Specific investments on machinery have been affected everywhere in Europe except in the Dutch leather sector and in the Slovakian footwear sector.

(See appendix 1 IV. 4.3 Investment and innovation tables 6 and 7 for more detailed information).

## Furniture

Investment data for tangible assets only report a significant increase for Estonia, and a slight growth for Italy, Slovenia, Spain and Finland. A significant divestment rate can be observed for Portugal over the period.



Source Amadeus

Machinery investment increased the most in the furniture industry in the Eastern countries especially in Lithuania (+36% a year), in Latvia (+29% a year) and in Hungary (+27% a year). Reduction in investment in this industry was more pronounced in Portugal and Belgium (-20% a year), and in Germany (-18.8% a year).

(See appendix 1 IV-4.3- investments and innovation - table 9, for more detailed information).

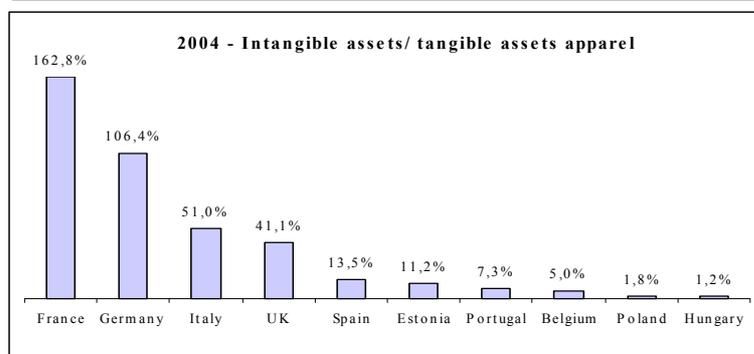
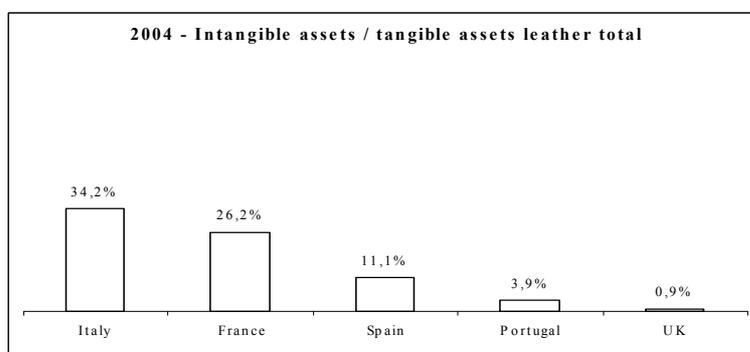
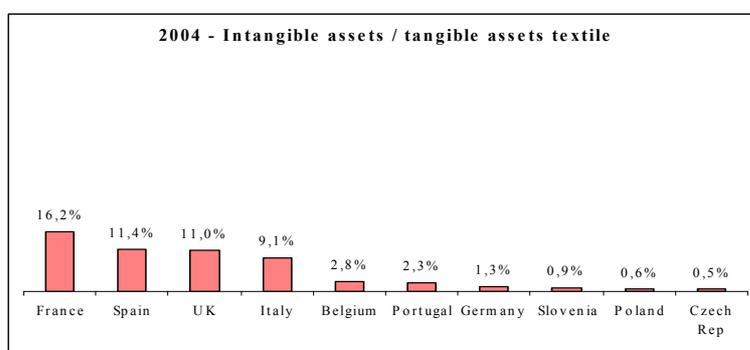
Statistical evidence is corroborated by the in-depth analysis of consultants' fieldwork. There it clearly appears that tangible investments made by industrial firms have seldom taken place in order to increase the productive capacity of existing facilities, nor to build new ones from scratch. Firms which have raised their production capacity have mostly done so by acquiring or merging with another company. In that case they have both developed their production ability and their commercial power (clients' portfolio and market shares). Productive investments that have occurred in the recent years have mostly been very limited as they have been mostly targeted at optimizing existing structures and systems, in order to improve on costs, flexibility, reactivity to markets and clients. These phenomena have been analysed in the above sections devoted to the concentration of the industry and to its modernisation.

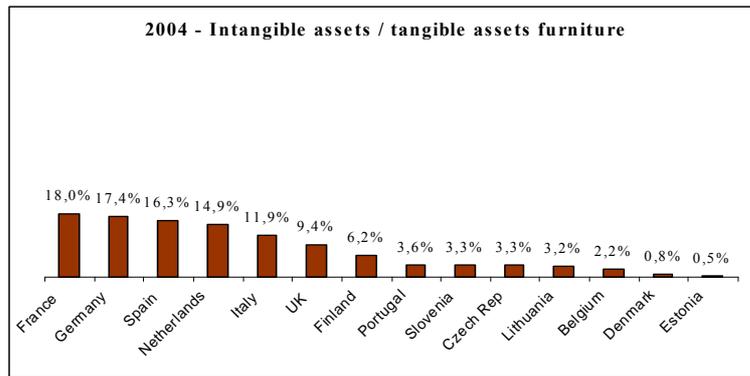
### 4.3.2 Intangible investments

From a statistical point of view (based as for the tangible investments above on the analysis of Amadeus data base) companies in Europe have invested very little in intangibles, consistently less than 1% of their turnover. However, due to also very low and sometimes negative investments observed in tangible assets, the proportion of intangible assets over tangibles has reached fairly high levels in some countries.

Nevertheless figures indicate that on average, in sectors like textile and furniture, industrial companies have not yet turned significantly towards the development of immaterial success factors, tend to remain largely cut off from consumer markets and have not developed strong and proactive value enhancement policies.

On the opposite, in the case of apparel and of leather the high ratios observed in France, Germany but also Italy and the UK demonstrate that a large part of these industries has become focussed on marketing and immaterial issues rather than on directly productive ones.





Source Amadeus

(See Appendix 1 IV– 4.3 Investments and innovation – tables 1, 3, 5 and 8 for more detailed information).

Statistical data do not allow to draw conclusions per country on the trend which has affected this intangible/tangible asset ratio over the 2000-2004 period. However it can be estimated that at the level of the EU, and based only on the countries for which data exist, there is an overall stability (around a ratio of 58% in apparel and 23% in leather and footwear industries) of the ratio, whereas there is a deterioration in textiles (from 12 to 9%) and in furniture (from 14 to 12%).

### 4.3.3 Innovation

The slight deterioration of productivity that has been observed in the present report for the five sectors reviewed is the result of a constant battle within the five industries examined against both sluggish home markets and powerful extra-EU imports. This battle is fought on a day to day basis by a continuous process of modernisation and innovation throughout the industries, led by their most dynamic elements, such as the firms which were interviewed in-depth for the present report and which illustrate the developments described in the following pages. In general, it can be said that innovation has become one primary driving force of the EU textile, clothing, footwear, leather and furniture industry in the recent years. For the textile and clothing sector, innovation has been one of the main tools to prepare for the dismantling of quotas. This is illustrated in all fashion textile and apparel companies selected for the in-depth analysis.

Innovation and modernisation are major factors to enhance productivity, and allow companies to reach better levels of international competitiveness by maximising value (perceived by customers) and service levels while minimising the cost of producing them.

- When directed at improving the production process, they enable firms to directly lower their production costs (for example automation allows to lower the part and cost of labour within production prices) and/or improve on flexibility, which eventually means producing smaller batches at a more competitive cost. In the five industries surveyed in this report the price competitiveness of any product strongly depends on the related labour content. On average labour costs represent 21% of the production value<sup>25</sup> (Eurostat 2003), but technological progress and automation allow to lower this percentage significantly : in some cases in the technical textiles and carpet industries for example, it may be reduced to some 6%. Even in the apparel industry some research led within the Leapfrog (described below) programme target an 8 to 10% labour share in production costs instead of the current 20 to 30%.
- When directed at developing new products and services they enable the firm to offer higher functionalities or fashion or style contents, which can generate incremental value for customers and users, higher market prices and eventually better margins for the firms.

It should be noted that throughout Europe the most important part of this modernisation process lies in non-technological areas. Modernisation first starts with a new way of seeing business life and competitiveness whatever the sector considered, and is first implemented through many changes in the firms' structures, systems and persons. The "mental" part of such changes is further described in the chapter dedicated to strategic analysis. The present section deals with the modernisation of the industrial/productive part of the activities. Non industrial developments are analysed in next section in later pages.

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<sup>25</sup> More detail given in the chapter relating to Social developments

Here one can observe that the main focus of innovation generally is on combinations of proven technologies and incremental innovation. One clear example in the apparel and footwear sectors is the shift from two seasons a year to a constant flow of new products sometimes condensed in themes or intermediate collections. Very few firms have engaged in breakthrough technologies based on new processes, have participated in collective R&D projects and taken patents to protect their innovations.

Depending on sectors and strategies at work, firms have more or less tried and/or succeeded in implementing the various types of innovations described. Based on the case studies and general understanding collected throughout the industrial sectors one may find in the following table an evaluation of the innovations described in the following pages. This table puts in perspective the different focuses which characterise the innovation and modernisation policies implemented by EU 25 firms from the various sectors, according to consultants' experiences and case studies conducted. The number of X gives an estimation of the actual degree of implementation of each category.

### **Degree of innovation implemented within companies**

Modernisation/ innovation focus	Textile	Apparel	Leather	Footwear	Furniture
<b>Process</b>					
EDI	X	XX	X	XX	X
CAD/CAM	XX	X	-	X	X
New materials	XX	XX	XX	X	X
Chemicals	XXX		XXX	XX	X
Nano technologies	X	-	X	X	-
Customisation	X	X	X		X
Operational excellence/quality	XX	X	XX	X	X
<b>Environment</b>					
Energy savings	XX	X	XX	X	XX
Care of environment	XX	X	XX	XX	X
<b>Cost reduction</b>	XXX	X	XX	X	X

- **Analysis per sector**

- Textile

Unsurprisingly the textile sector, with its high level of "upstream" technology (in fibre chemicals for example) is the sector where one can find the largest number of innovations, and even technological breakthroughs. Even though few of them have yet brought fundamental changes to production techniques or products sold per se, they represent a key factor for the competitiveness of the whole textile and apparel value chain.

In the process area, the most important phenomenon is the development of digital printing which now represents an economic alternative for quite small production batches of highly creative products, including fully customised items. Such technologies are widely available and do not provide a global technological leadership to the European industry. However they are extremely promising for EU and Euromed firms as they contribute to develop both their home markets for high value added products and their own sales and profits. This is the case for digital printing which can be used for apparel fabrics or car seat material among other uses, even though one cannot imagine it will replace mass-market cheaper printing techniques.

The other key sector for research is the fibre area. Throughout the world, the textile industry has also begun to address the issue of raw material exhaustion. Viscose fibres have thus been developed out of bamboo pulp and are now used in different countries. This innovation has a stronger marketing than technical importance, as the fibres in question do not display specific properties in comparison with existing viscose fibres. Moreover, the advantage for the EU industry is not direct, as bamboo cannot represent an intrinsic competitive advantage for EU firms as it is mostly originating from China. However it brings one innovation to the EU consumer market which – even though modestly – fights its deleterious sluggishness, as interesting new products (towelling, clothes...) and touches stimulate consumers' appetite. The same could happen with corn-derived fibres and other biopolymers such as PLA that have a European production base. Progress is also been achieved in synthetic fibres by a better targeting of functionalities to end uses. This happens both in low end fibres such as polypropylene and polyethylene whose hydrophobic/hydrophilic properties are modified for their use in nonwovens or in work on tenacity for artificial grass. Bicomponent fibres are also emerging with tailored properties such as combination of high tenacity polyester in the core and polyphenylsulfide in the mantle providing both higher strength and fire resistance. Similar combinations are being developed in composites. At the higher end fibres such as Aramides and UHWPE are finally breaking through after 40 years of research and development as they now get a strong market pull.

Nanotechnologies are also developing quite fast in EU textiles, although relatively few products have found their way yet to the market: the purpose of this R&D sector is to provide all kinds of fibres with core properties which are both more durable and efficient than what is achieved today through hi-tech finishing: selective permeability, water-tightness, aromatic encapsulations, bacterial or electromagnetic protection, etc. While nanotechnologies have found their way into coatings, substantial use of nano-fibres has still to emerge. Behind practical applications of nanotechnologies, the understanding of material processes at nanoscale is important in making processes more controlled, more tailored to desired functionalities and more effective in the use of resources. Nanotechnology in combination with biotechnology has then also the potential to improve traditional processes such as retting (of flax) or

bleaching (of cotton), or tanning (of leather). They can then help to rejuvenate industries were Europe combines an agricultural, industrial and scientific basis.

Innovations have been more fruitfully used in the areas of apparel and home fabrics, and the most successful and widespread innovations have taken place in the sector of textile finishing: thanks to chemical or mechanical processes the industry has achieved significant progress in order to provide finished products with higher functional contents: less shrinkage, softer touch, stain repellency, better absorbency, acid proofness, UV protection. Such EU made innovations do confer a significant advance to EU firms and help them retain a significant part of their market: greige fabrics are widely sourced from low-cost countries but hi-tech finishing are still carried out in the EU or its neighbours.

Non-functional improvements in finishing, particularly in denim or jeans also enhance the fashion competitiveness of European firms.

The positive impact of innovation on competitiveness can also be found in technical textiles, where many patents have been granted. In this sector innovating is the keyword, be it for medical B to B markets (artificial skin, veins or others), the transportation and building industries or the filtration uses, to name only a few. This dynamism helps the EU industry remain competitive, particularly on its home markets but also for exports.

- Apparel

Quite remarkably firms in the apparel sector are not often interested in technical innovations, but more or less completely focussed on fashion and brand issues. For example available innovations designed to offer better fittings should be, but are not, really used by companies to improve on the quality and value added they provide their customers with these better fittings are now available to the EU industry thanks to various 3 D techniques which are now developed on the European markets, in particular 3 D body-scanning, which allows high quality customisation of a selected garment. 3 D computer visualisation of garment on a moving model allows the potential consumer to see how the garment and its fabric fall and move when the person is not static.

Such innovations provide competitive advantages first to retailers, but could also indirectly be helpful to the industry as they can only be used in contexts of close relationships between the value chain: integrated industrial retailers, or simply long term partner companies, both involved in product development.

However EDI and CAD/CAM techniques are somewhat more largely used by apparel companies. Leading EU based software manufacturers, like Lectra Systemes, do develop their new products and solutions in close collaboration with EU firms in the apparel sector : this undoubtedly represents an advantage for the European industry as it confers a kind of pioneering advance to the firms involved.

In the past EDI technologies were a significant help for brand or retail companies willing to place orders with Far East suppliers, and could consequently be considered very detrimental to the industrial competitiveness of the EU. Now European firms are largely equipped with such techniques and are moving to the wider perspective of product data management, integrating all steps from product development to final deliveries. Through this kind of modernisation the European industry is able to provide a more thorough and acute service tailored to the needs of its clients. CAD/CAM techniques have also been implemented by firms wishing to go further into customisation, possibly reaching the objective of producing garments by the piece. However even though innovation projects are conducted

in this direction (e.g. in France Nord) fully customised garments cannot yet be manufactured on an industrial basis.

Most of existing research is fragmented between private players and regions, with the notable exception of Leapfrog. At the European level a number of apparel and textile firms as well as research institutes are presently associated in this Euratex led project, which precisely aims at modernising the apparel value chain by enabling it to take advantage of the latest textile innovations, by making it more responsive to market demands, and by helping it achieve actual production excellence. Automation is part of the overall scheme as far as some operations may become less labour intensive, i.e. less costly and more reliable. This project is broad spanning and ambitious and at the same time quite practice oriented and operational. By embracing themes like mass customisation, 3 D design and prototyping, as well as cost reduction and quality enhancement, Leapfrog works on the very equation balancing production cost, service and customer value. As was the case with the Automated Sewing System in Japan, and the TC 2 one in the USA in the 1980s and 90s operational results have started to appear along various lines and at different steps of the overall scheme.

- Footwear

EDI innovations have also been successfully implemented in the footwear industry.

In parallel the generalisation of CAD/CAM techniques (particularly in the EU and in Turkey), has brought some automation to the actual production process as computer programmes increasingly control cutting machines among others. Moreover they allow a much higher flexibility in the overall process which is a major requirement of the market. CAD/CAM software are developed by suppliers who had traditionally concentrated their efforts on the textile and apparel industry and recently started to pay some attention to the footwear sector.

Some technology trends for actual customisation –in order to offer functionalised products with consumers' personal involvement in the creative process and possibly supported by Internet sales- do also exist but their level of development and implementation is not significant for the time being.

On the opposite a real enhancement to productivity and competitiveness has been brought by the successful implementations of innovations in adhesives (thermoplast) and in components (lasts).

Embryonic as it is, 3 D revolution will be the next step in the modernisation process of the footwear industry. However Asian firms are somewhat ahead of the EU in this field of research. More generally competitors of the EU are also modernising their industries: this is particularly true for China and India, but also for Vietnam, Brazil and Mexico.

- Furniture

The production processes used in most sectors of the furniture industry have not significantly changed over the last decade. For many firms the objective of innovation has largely been to combine enhanced product functionalities –like better resistance to abrasion- with aesthetics.

However in the upstream activities related to the manufacturing of wood-panel frames, as particularly used in the kitchen and office industries, production has become more automated, and wood-panel manufacturing is increasingly integrated with frame manufacturing, one example being Nobilia's 1.4 km long production lines. Such high-speed automation is most

often combined with a complexification of manufacturing logistics, in order to allow very small batch productions, and fully automated control.

The increasing use of new materials like finishing overlays, quartz-based topping materials, quite interestingly, viscous elastic foams for seats that bring an accrued comfort to the body, have to be mentioned in this section. However the largest part of innovation observed in this industry also, rests in non-technological areas.

- **Other process oriented innovations**

- **Operational excellence / quality**

It should here be highlighted that throughout the industries examined in Europe considerable efforts have been made to improve the level of quality of the activities, both in terms of process involved (certifications) and of products delivered. Many ways for implementing this strategy have been retained. In the case of larger companies with important financial capabilities, totally new investments with modern infrastructure have been made, in particular in Euromed, with strong focus on operational excellence and quality. These firms have also set up efficient logistics in order to produce and distribute products on the European market.

Operational excellence is also focused at reducing lead times and protecting itself from competition by competing on fast response small orders in quick modification. A spinner can nowadays be profitable and competitive with volumes below 5 T per order, a response time of 10 days and a choice of over 50,000 combinations of specifications. This requires a change in mindset from economies of scale to economies of scope and hence specific investment in machinery, organisation and control (Filartex).

Companies in the new EU Member states have also performed strategic investments in order to upgrade their production in order to reach higher product quality standards and to remain competitive. The focus is either on operational excellence (Hugo Boss, Gemor) or on matching client needs by focussing on quality and functionality.

- **Cost reduction and control**

Decreasing production costs has been one of the major objectives of the industries, even for the manufacturers positioned on the highest price segments of their markets. Even Couture ready to wear apparel brands keep a strict eye on subcontractors prices and do not hesitate to put some competitive pressure on them.

In most sectors manufacturing companies have become more efficient, "leaner", over the last decade, and many are now reaching the downward limit for their own production. Delocalisation then obviously represents the next step (see Section Delocalisation Trends in chapter Sourcing Channels) for cost reduction.

In technical markets many investments made are also oriented towards reduction of costs, although labour productivity is not the only motivation. In spinning the return to ring spinning has been accompanied by automatic handling that was uncommon before. In scouring and bleaching investments are focused at integrating steps in a continuous process, hence reducing handling and supervision. Increasingly reduction of water and energy is an important driver. Increasing efficiency with lower volumes pro SKU and shorter adjustment times are required. Similar modernisation is also affecting the "river process" of the leather industry (fleshing, splitting, production of collagens, paste and other outlets from waste) in order to increase the performance in all the product chain and to decrease production costs.

Process optimisation has become increasingly important for companies as some of the sectors under review are dominated by cost leadership strategies and that is difficult for the European companies to be cost leaders due to high labour costs and strict environmental regulations, as may be in the carpet sector.

In the specific case of the leather industry, in order to reduce costs. Some tanners have begun to recycle animal waste generated by the initial step of the tanning process to produce bio-gas. This source of energy is used by the firm to reduce their outer supplies. It also increasingly used to produce collagen-rich foodstuffs and cosmetic ingredients.

Within a large part of the furniture industry, costs reduction is increasingly a strategic objective. This has led companies to increase the degree of automation of their activity: this is particularly visible in the kitchen business but also in the other "case-based" sectors as exemplified by firms like Mobalpa, Nobilia or Schmidt.

#### **4.4 OTHER FACTORS OF COMPETITIVENESS**

In the above chapter the various success factors linked with the industrial excellence, have been examined, be they targeted at process improvements or at new product development. Other key factors do exist and have been already implemented by many leading firms, throughout Europe and throughout the industries under review. Some clearly have a service dimension, while the others are aimed at product enhancement.

##### **Design**

Companies in all the sectors under review - apparel and upstream textile, leather and shoe, but also furniture and even technical textile consumer product makers) - have strongly invested to enhance their design capabilities.

In the furniture sector, like Andreu world, Ahrend, Roset or Sellaton companies have all set up partnerships or long term associations with designers whose names and sometimes styles are appreciated by the public. Changing partners then become a convenient way to change the offer and renew interest for the products, both has from the press and the general public.

Throughout sectors companies have intensified their investment in design in order to prepare several collections per year (fashion apparel companies, lingerie, carpets... The combination of design with technology has thus become increasingly important as it provides companies with powerful competitive advantages to build sustainable market positions.

In apparel, Euromed non-EU firms are now used to working with free-lance designers who are not generally known to the public, but who can bring to the companies the fashion sensitivity of the final markets. Some of them may be EU residents, who regularly travel to spend time with product development teams but more frequently they are local professionals who find an international inspiration on the Internet and in the international press.

##### **Branding**

All companies in the selection of interviewees express a strong commitment to the building of their own brand, for purposes of external and also internal communication. Even in the case of subcontracting firms, significant investments are made to increase brand awareness in the market: most companies take part in a number of trade shows (in the case of Etor, the company takes part in more than 20 trade shows per season of sales) and have build Internet sites to describe their activities and actual production capacities. Filmod even offers on-line quotations for prospective clients.

In the own-manufacturing sector, producing companies increasingly need to strengthen their position on the consumer market by creating recognizable trademark by means of powerful branding strategy like Colombo. In the example of Folly Fashion branding is the key to developing a retail strategy oriented at the North African side of the Euromed area.

## Product development

Companies in the textile and apparel sector rely strongly on product development to strengthen their competitiveness. In the EU, firms thus succeed in mixing an extensive industrial know-how in terms of fabric development with a great mastery and control of product manufacturing - in house quality control, centralized cutting, in-house assemblage factories in several countries. Such development is rarely fundamental but requires a combination of skills and routines that are not easily reproducible.

Investing in product development (but generally not in design) is also a common trend for the companies in the non-EU countries from the Euromed zone. One example is Sartex, a Tunisian firm which has heavily invested in research and design in washing, special processing, dedicated trimming of jeans, but also in logistics and electronic systems in order to have constant communication with clients. Leading companies in the area are shifting from a role of simple subcontractors to co-makers taking care of product development, sourcing of materials, leading platforms for further subcontracting and offering logistical services. In most markets a tiered market is appearing as is already the case in industrial subcontracting. In the new Member states and in the non-EU countries of the Euromed region a number of firms have actually upgraded from subcontractors to producers by developing their own products like Davo Star, Filmod, Folly Fashion or Klasikine.

Product development is also a key strategic service for companies in the technical textile sector: end-user marketing has become more important, that is a product development and marketing not oriented towards technical specifications but towards functional requirements.

The competitiveness of companies from the technical textile sector largely lies in the ability to develop new product families through R&D and to modify these products to users' requirements as can be seen with firms like Colbond or Mehler.

In the leather industry companies develop leather in cooperation with their clients or on specifications given by their clients. In the sport shoe industry companies like Alpina do spend a lot on constantly improving their products to better adapt to customers' needs.

In the furniture sector companies have also developed global solution services for their clients – sales of furniture is combined with project management, montage and maintenance, etc starting with the step of product development. This can be seen in the contract sector, where firms have to take into consideration the various functional budgetary and style requirements clients may have. This is also increasingly needed by low cost retailers who try to differentiate their offer from competition and heavily rely on manufacturers' skills in product design and development.

However, one should note that product development can only work as a strategic advantage, if necessary inputs are readily available. The value-chains operating in the furniture, leather and shoe sectors benefit from sufficient upstream manufacturers in the area of wood, leather, technical textiles. On the opposite the apparel industry suffers from a significant weakening of suppliers of fabrics, trimmings, etc.

## Environment care

Environment has become an important issue, for various reasons. In the first place with rising fibre prices, energy costs and water and affluent costs, environmental efficiency has become a major source of cost control. This is especially the case for companies where environmental costs represent up to 30% or 40% of added value (particularly in non wovens, textiles, tanning/leather). These factors foster innovation processes mainly geared at process improvement, process redesign, process integration aiming at higher energy efficiency. However some companies have also engaged in sustainable product development either with the objective of reducing material use or with the objective of developing waste products.

Companies with a strong brand policy and a commitment to ecology have decided to base their production on the ecological marketing and development of products with high environmental strengths. Examples are given by Kuyichi's production of jeans from organic cotton and Ahrend's furniture which insist on environment reporting, reduction of energy and waste and integration of the environmental aspects in their product design.

However, most companies in the industries do not have direct exposure to the final consumer. Ecological processes and compliance with environmental norms and regulations are therefore almost impossible to turn into consumer value added.

In the case of furniture makers, compliance with norms has led to use water paints, powder paints, foams and polyaminates free of CFC, which represent additional costs but no consumer value added.

This can also be exemplified by the situation of leather manufacturers. The leather processing industry is a particularly polluting industry. Strict environmental standards introduced in Europe regarding waste and water treatment have obliged the companies to make significant progress in this field. The compliance costs of these regulations have contributed to the increase of price of leather products in the EU. Besides, producers estimate that the implementation of REACH will lead to further increase the price of chemicals and therefore, the cost of the leather.

Tanners have been very active in this domain, and protecting the environment is the object of a number of patented innovations in the EU leather industry: in particular water free tanning techniques are being developed by some firms. Such modernisation does also actually take place in the regions where EU companies relocate steps of production, which benefits to the technological level of countries like the Czech Republic or Romania.

However in the leather industry as well as in the others under examination environment is an important incentive towards innovation, but the marketing of environmental innovation is not easy and not always sufficient (in industrial markets eco-efficiency is a requirement not an advantage).

It should also be kept in mind that eco-efficiency is a benefit for Europe towards countries with higher real costs for energy and water (e.g. compared to Tunisia or Sri Lanka) but not towards countries with state subsidies on energy and water. Eco-efficiency does not help European production compared to Chinese production. Moreover eco-efficiency does not cover the gap between countries with high energy costs (e.g. Italy) and low energy costs (e.g. Germany).

Norms and regulations concerning the use of chemicals represent heavy burdens for the industries which are not offset by an increase in consumer appeal. Throughout the industry the implementation of REACH is viewed as a threat. Even though everyone tends to agree upon the benefits granted to the

consumer, there are major fears among professionals that REACH is going to hinder the competitiveness of the EU industries, for two major reasons :

- firstly because imports might not obey the new restrictions as systematic controls of imported products are considered impossible to set up,
- as chemical suppliers may be considering moving to other world areas to go on producing substances which are authorised and used by their local clients.

The consequence feared is a decrease of the price-competitiveness of the EU industry.

Another specific set of requirements come from end uses in terms of norms and consumer requirements. This is a combination of the impact of normalisation (e.g. flammability) and of the EU chemical policy (e.g. the VOS Directive and the use of certain substances as PER, PVC).

The impact of all those regulations on the industry is certainly balanced. Non industrial firms tend to transfer all consequences to industrial firms with the consequence of shifting responsibility and investment. Most structured firms do not see considerable barriers in enhanced product requirements. Especially in technical textiles (non woven and woven) normalisation and standards are seen as useful elements to increase the technical level of the industry while restricting market access to newcomers (EU and non-EU). In fashion markets the wide variety of requirements is seen as a limitation both on creativity and on variety in products as well as extra costs. Moreover while many firms desire to shift from consumer markets to institutional markets they see barriers of entry in related norms and standards. Especially for smaller firms in older premises, health and safety requirements as well as modernisation of equipment, is an organisational burden and a sheer cost. In some instances in furniture, costs for avoiding paint damp and wood dust oblige to relocate while firm lacks the fund.

On the balance large firms do favour higher norms provided there are transparent and well timed modalities of implementation. Small firms, unless focused on specific market niches, apprehend the costs and barriers posed. Both share a deep concern that EU and imported products face the same requirements and that all those regulations do not form an additional incentive for delocalisation. It should also be highlighted here that within the furniture industry attentist attitudes are generated (particularly among the wood-panel users and makers) by uncertainties regarding EU legislations in the area of environment protection: large investments are suspended and only incremental improvements made.

### **Service orientation**

In industrial markets (both in technical markets and fashion markets) this represents a commercial revolution. While suppliers were accustomed that the clients came to them, or that smaller clients were served through agents and wholesalers, a disintermediation has largely taken place and can be noticed as well as a much more active involvement of suppliers into their market. Sales departments have been transformed into account management, and product development into product management and joint development with clients.

In technical textiles some companies like Colbond offer specific assistance for larger projects such as project management, installation support, after sale services but more generally they increasingly insist like Mehler on offering constant quality, durability and guarantees. This can also be observed in the furniture market where operators also strive at providing global solutions for their clients – project

management, montage and maintenance, turn key solutions, etc, as examples may be found with Ahrend, Sellaton, Poltrona Frau etc.

To a higher or lower extent one can say that intensive cooperation with the clients on product development and adjustment of the products is part of the marketing strategies of all the companies studied during the case studies.

Mascioni Company, for example has based its strategy on customised production: products manufactured one by one, according to customers requests. The company produces home printed textiles and presents itself as a development partner. De Negri company (weaving of silk jacket interior textiles) is now also involved in customised production in niche marketing (high price and highly specialised products).

In the kitchen furniture business the increase of this service dimension (design and installation) has gone in parallel with the outsourcing of low value added operations like frame building.

### **Flexibility and speed of delivery**

Moving upmarket, attending smaller-batch customers, focusing on fashion trends are strong incentives to shorten times from design to delivery. Throughout sectors Zara (active in apparel, home textiles, footwear, leather goods and decoration) has become a key reference for all players.

Even in technical markets it is essential to reduce time to market and to achieve shorter lead times in production, in order to enable the firm to mobilize lower working capital.

This reactivity has to be obtained in parallel with an extension of the variety of end products offered. In technical markets, particularly textile, this has led companies to combine continuous processing and discrete functionalisation/differentiation such as enabled by digital controlled printing (e.g. jiggers in dyeing) finishing or coating.

The apparel industry, in general, has also modernised itself in the sense that it has become more flexible and reactive: production lead times have been divided by two over the last decade. From a traditional quick-response delay of 6 weeks, deliveries within 3 weeks are required today. Firms in the new Member States are not yet as reactive as their Western counterparts, particularly the large and heavy mills inherited from the state industries but private-owned smaller firms are already positioning their activity on a very reactive business.

This evolution directly enhances their competitiveness against remote suppliers from China or even India.

Some companies have based their marketing strategies on reactivity like Artex which offers possibility for product development in 1 day and delivery to clients in less than 5 days, or Filmod – 4 weeks from order to development for ladies and menswear, or Folly Fashion – 1 to 4 weeks for product development). These companies remain competitive due to the retailers' need for hot fashion products in the low-middle price range at competitive cost. In the case of such products it is uneconomical to ship them by air, so remote sourcing is hardly possible.

EU and Euromed companies increasingly put flexibility at the basis of their business strategy. For instance in the Reda case (production of woollen worsted woven fabrics for menswear), the company

considers that its business model relies on flexibility (small batches), and reliability (stable colours, specialized employees, high technology and punctual delivery time).

A major trend in the footwear sector is the incorporation of interoperability issues into the administrative/management processes (ordering, sales, etc.). Huge changes have been observed in CAD/ CAM techniques use, but still the relationships between companies within the value chain still have to become more flexible, rapid and transparent, permitting development of new products in less time than today. To produce a shoe requires no more than 45 minutes and all the preliminary stages require more than 75 days (from idea to product in the shop). The example of fully integrated chains like Zara, shows the way towards continuous creation and production of new designs in companies.

In the furniture industry a higher level of flexibility has been achieved by firms through investments in both advanced automation and communication technology, with the spreading of systems like Ether Cat within companies. This mostly concerns the largest process oriented manufacturers. In more traditional and smaller firms flexibility is largely ensured thanks to significant inventories of semi-finished goods.

Fieldwork corroborates the conclusions of the statistical analysis regarding intangible investments, and allows to describe in detail what has been effectively done by firms in the area of non-productive investments.

In the companies selected - which provide a picture of successfully managed firms in the EU and Euromed – most of the investment has been focused on intangibles and not on tangible asset building. In other words firms have clearly divested a significant part of their energies from production to invest them in market oriented strategies.

This trend is quite visible for all sectors under review. These strategies can be of different types: the main options being the investment in design, the building and development of brands, the development of service, and the investment in distribution networks. A large part of these investments has also been done in the area of technology, with the primary aim of responding better to market demands and trends by means of innovating and modernising products and processes. The corresponding R&D *investments* belong to the intangible asset accounting within firms' balance sheets, but the *outcome* of those efforts directly concerns productive activities: this is why the analyses of companies innovation and research strategies have been included in the section relating to production developments.

## **Retailing**

Highest investment in this respect is made by companies who have started to develop their own retail networks. For smaller companies like the furniture maker Hughes Chevalier with a narrow marketing focus two stores may represent a significant proportion of the company's sales, while for larger firms small retail networks primarily work as permanent showrooms where other retailers and journalists may get a vision of the whole collection, nicely presented. A few owned stores also allow the company to come closer to consumers' expectations and tastes and increase its market response competencies. In interior and carpets as well as in furniture the trend is to open show-rooms supporting sales as well as combining show room with direct marketing, also supported by internet sales. The argument is that with increasing retail margins, the opportunity to bypass retailers may become profitable. However all interviewees concerned point to the specific skills required to engage into retailing and on the incremental stress on information systems and logistics.

For companies involved in the better end price segments like Van de Velde, retail strategies heavily rely on selective distribution by multi-brand retailers capable of advising on the product and adding value to so as to balance its sales price. However such networks are gradually deteriorating and companies are facing the needs of taking over their distribution.

The companies already well established on the consumers market have their own distribution networks. Numerous examples can be mentioned in each sector like ECCO, Alpina, Ahrend, Hugo Boss.

Furniture manufacturers are very slow to take this strategic move: this is partly due to their fragmentation but more importantly to the high production and region-orientation of most players in this field. Exceptions can nevertheless be found in Europe, particularly in Italy and Germany mostly in the kitchen and high price sofa sector.

Developing a retail networks is essential to expansion in the international markets and represents huge investment: getting sales surfaces, running them and regularly upgrading, updating and implementing their visual merchandising concepts. Such investments require high product margins which can most often be provided by relocation of production to cheaper manufacturing areas.

As a conclusion to this section one may say that the positive trend of intangible investment ratios in Europe provides evidence that companies have actually started to fight in the worldwide marketing battle. However due to the very high investments required European industrial firms suffer from a financial disadvantage in comparison with non-EU competitors, from the USA and Japan but also from emerging economies, primarily because of their limited size and means.

There is regrettably no comparable database in other countries which would allow to analyse how local industries are positioning themselves and investing in e.g. production or retail. The only significant tool in this respect is the ITMF survey presented in this section. One may assume the industrial picture it provides (world production increasingly dominated by China and India, even in capital intensive sectors; most serious challenger being Turkey; EU still dynamic and dedicated industrial players being Italy, Germany, Spain and Greece), somewhat also reflects the macroeconomics of the five industries under review.

## V. FINANCIAL STRENGTH OF THE INDUSTRY

*The average profitability of the European firms from the five sectors being examined is quite low. It is -on average- highest in the furniture industry (1.34% of turnover), and in leather (excluding footwear) (1.26%). Textile profitability is only 0.53%, apparel 0.18%. In the footwear sector, companies on average generate losses (-0.15%). These performances are extremely low as, in the present economic context, one would generally consider more or less 6% as being a minimum satisfactory pre-tax profit level.*

*Company size is directly linked to profit margin: the strongest impact concerns the apparel industry where the average profit made by firms in the EU is 0.2% while it reaches 5.1% for the 500 largest firms. In textile and furniture size impact multiplies the average profit by a factor of 3, in leather by a factor of 2. In footwear, the impact is even more significant as large companies do not incur losses but some 1.9% profit.*

*Among the five sectors considered, the mediocre figure for textile can be directly related to the ongoing overcapacity of the sector in Europe. On the opposite higher profits in the apparel sector are mostly due to the fact that many large companies have delocalised their production, divesting from manufacturing, and investing in retailing or branding, which enables them to command higher selling prices and generate larger profits.*

*In textiles and apparel results are very worrying for Italy and Spain, which are among the five major producers in these industries. In general technical textile countries like Germany and Scandinavia do fare much better than apparel oriented ones. In the leather industry, major EU producers are Italy, Spain, France, Germany and Portugal. Losses observed for Italian and Spanish firms are lower than in the textile and apparel industries, so that the situation appears to be less preoccupying for these two countries. Firms in other large producers still make profits, and it is especially the case in Germany where the profitability of firms is very high. Germany is the country where the average size of firms is the largest in the industry.*

*Over the period, firms in the textile, leather and furniture industries, have recorded drops in profitability. This is especially true for the textile industry, for which profit margins have dropped from 4.6% in 2000 to 1.7% in 2004. In the apparel industry, profitability has remained stable between 2000 and 2003, and then has gained one point between 2003 and 2004.*

*All the largest textile producing countries in the EU have faced a reduction in their profitability, with the exception of the UK. The worrying situations of Italy and Spain regarding the level of profit margins in 2004 are confirmed here by the reduction in the profitability of their domestic firms during the period. Similarly, Portugal had a negative profit margin in 2000 and the loss increased by 0.4 point by 2004. Finally, it appears that firms in the old Member States EU have significantly suffered while firms in the new ones have improved their performance. The trends observed for cash flows are quite correlated to those concerning profit margins. Firms in Italy, France and Spain show an increasingly high level of vulnerability, as they appear less and less able to finance their future developments or restructuring. Obviously the Italian situation is all the more preoccupying at the EU level that the local industry represents one third of the EU turnover in textiles.*

*In apparel, in a comparable way to what has happened in the textile sector the largest producing countries have lost some profitability over the period, in particular Italy and Spain. Both countries display negative results since 2003, and losses have got worse in 2004. French and Greek companies have also seen a significant erosion of their profits, but have remained positive. New Member States have improved their financial performance. UK companies, that have survived to Marks and Spencer's new sourcing strategy and drastic subsequent shake out of the industry, have significantly improved their position. As in the textile sector the cash flow analysis corroborates the bad results coming from the profit analysis for the major EU producers. It gives an even more contrasted perspective between the quite healthy situation of new Member States and the deteriorating position of the others. It is especially worrying for Italy that has not only the largest decrease in cash flow over the period, but also the lowest level in 2004 (less than 1%), while it reaches between 2% and 4% for other large producers like Portugal, Spain, Belgium or France. In Italy 11% of the firms in the sample record negative cash flows.*

*In the leather sector, most countries in the sample had a reduction in their firms' profitability during the period. Again, as in the other sectors, the situation has deteriorated for Italy, Spain and France, while UK companies have fared better. Italian profits have begun to turn to losses (-0.1% of turnover in 2004).*

*Footwear companies in most countries have recorded important falls in their profit margins between 2000 and 2004. Again Italy, Greece and Spain have particularly suffered, in full contrast with the British situation.*

*The cash flow evolution has also been negative over the period. Italy, France and Spain suffered the largest decreases in their cash flows with respectively -21%, -11% and -8% per year on average. Nevertheless, decreases in cash flow were more limited for the UK (-2% per year) and Portugal (-1% per year).*

*As it is the case for textile and apparel, the level of cash flow in 2004 is much lower in Italy (close to 1%) than for other countries, where it is located between 2% and 4% of turnover, the highest level being for Portugal.*

*In the furniture sector, the situation is somewhat less preoccupying though major decreases in profitability have been recorded in Portugal, Italy and Spain, i.e. three of the five largest producers in the industry. The most positive evolutions can be attributed to new Member States' firms. In addition, the levels of cash flow / turnover in 2004 are much higher than in the other industries; it is higher than 2% in Italy, it is also higher than 4% in Spain, 5% in France and Belgium and 8% in Portugal, even though those ratios remain rather low in the largest producing countries.*

*All these results indicate that the furniture industry is in a much less preoccupying situation than the other industries where reductions in cash flows are considerable and where the levels of cash flows are themselves lower. As a whole, the position of firms operating in textile, apparel and leather seem to be in jeopardy, particularly firms located in Italy.*

*In depth interviews confirm that in sectors such as textiles, apparel and leather, the profitability of the companies is low and/or decreasing. Profitability is clearly higher for companies without industrial activities and in those with automated production as in technical textiles. Profitability has been hit by different factors: the existing overcapacity in*

*some sectors (apparel, carpets, spinning); a downward pressure on market prices concerning their activities which are closest to the commodity market segments, mostly affected by low cost competition; investments needed to satisfy strict environmental rules at national and at European level; overstretched balance sheets with high exposure to debtors and longer delays of payments to name some of the major aspects. In the leather sector profitability is decreasing even in very high quality leather production because the demand for such leather is decreasing and the pressure on prices has become stronger.*

*Successful companies are now handling their activities as portfolios of strategic business activities. Competitive firms are profitable because they succeed in combining cost consciousness with a focus on added value. Especially in textiles many companies in a transition from commodity to technical textiles or from mass markets to niche markets combine achieving economies of scale in volume goods and create buying power with high margin activities in niches.*

*Quite regrettably the present transformation of the industries studied occurs in a context of low or negative profitability, stable or declining turnover and a weakened solvency. Thus modernisation is likely to force a restructuring of activities including a disengagement of non profitable activities (e.g. spinning of commodity yarns) or clients (organised retailers), a restructuring of assets (selling valuable real estate or other fixed assets, physical concentration of activities).*

*In comparison with their respective sectors companies interviewed score on average higher than the industry in terms of turnover growth, profitability, solvency. Solvency is a critical variable as it is a proxy for the sustainability of losses as well as well as capacity for redeployment. Solvency should be seen as a consequence of shareholders' commitment to the company. A high solvency combined with a conservative dividend policy is a prerequisite for redeployment. Even step by step changes often require a strong financial position from the onset and a long term commitment of the shareholders.*

*The cases studied in the furniture sector show that the profitability of the sector is relatively high, particularly in comparison with the four others and that it is not falling. The companies do not really resent the competition from low priced imports as much as the other sectors medium to high price market segments. Moreover contributions from the contract activities have become a significant part of their sales and satisfactory margin providers. As in the other sectors it is also necessary to finance required restructuring on time. Self standing companies in the new Member States and in neighbouring countries do suffer from a significant disadvantage in this matter as they often lack the financial capacities of their larger EU counterparts.*

## **Methodological foreword**

The following analyses are founded on the financial database Amadeus. Two variables are used to examine the economic health and performance of companies from various Member States and various sectors.

In the first part of this chapter, profit margins (i.e. pre-tax profits<sup>26</sup>, as percentages of turnover) provide a short term view of companies' ability to generate yearly profit, but disregard investment efforts which may have just been incurred, already representing costs (depreciation) and not yet translating into higher value added. So the analysis of profit must be complemented with the analysis of cash flow which integrates profit + depreciation + provisions, and gives a clear notion of companies' ability to face future hazards and invest. Cash flows are thus examined in the second part of this chapter, regarding 2000-2004 evolutions.

Profit margins and cash-flows are examined over the 2000-2004 period. The analysis only takes into account firms which have posted their data for each year, thus disregarding those, for example, which have disappeared in the meantime. For each sector only countries with samples of more than 50 firms have been taken into account.

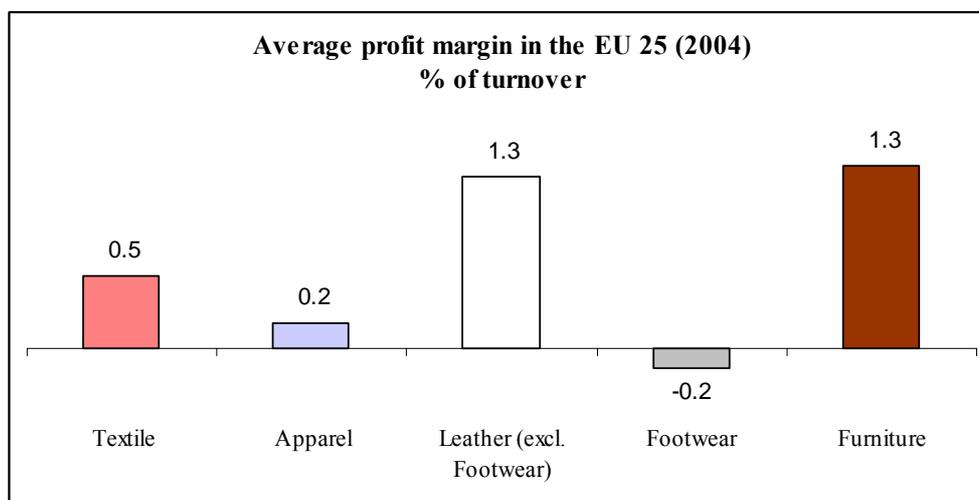
Profit margins have only been calculated for countries having a sufficiently large level of firm data in each industry, i.e. 21 countries in the textile industry, 20 countries in the apparel industry, 14 countries in the leather (excluding footwear) industry, 15 countries in the footwear industry, and 21 countries in the furniture industry. Nevertheless, results rely on a large number of firms, with a minimum of 3,000 in the leather (excluding footwear) industry; in addition, the distribution of the number of firms between industries is very close to that in the aggregated statistics provided by Eurostat. Results should therefore be considered as quite representative of the reality on the EU market.

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<sup>26</sup> Pre-tax profit is calculated before tax and is net of depreciation / amortization.

## 5.1 STRUCTURAL ANALYSIS OF PROFIT MARGINS

- **Structural analysis on the EU sample of firms**



Source Amadeus

As can be seen in the above graph, the average profitability of the European firms from the five sectors being examined is quite low. It is -on average- highest in the furniture industry (1.34% of turnover), and in leather (excluding footwear) (1.26%). Textile profitability is only 0.53%, apparel 0.18%. In the footwear sector, companies on average generate losses (-0.15%).

When one compares these results with the average profit margins made by the top 500 firms in each sector, one can see that there is a tremendous discrepancy between the two sets of data. Company size is directly linked to profit margin : the strongest impact concerns the apparel industry where the average profit made by firms in the EU is 0.2% while it reaches 5.1% for the 500 largest firms.

In textile and furniture size impact multiplies the average profit by a factor of 3, in leather by a factor of 2.

In footwear, the impact is even more significant as large companies do not incur losses but some 1.9% profit.

It clearly appears that in all those sectors the issue of critical size is a crucial one. It might be less acute in countries where a tradition of cooperation exists between competitors (Italy is one example), enabling them to accept larger clients and larger orders and above all to offer quicker reaction times.

Critical size is also different in the case of scale productions in comparison with niche or focussed ones. Throughout sectors the following distinctions have to be made

- Upstream, capital intensive activities require quite high volumes: extruding facilities cannot be made profitable below 30,000 T<sup>27</sup> a year (specialised products) or even

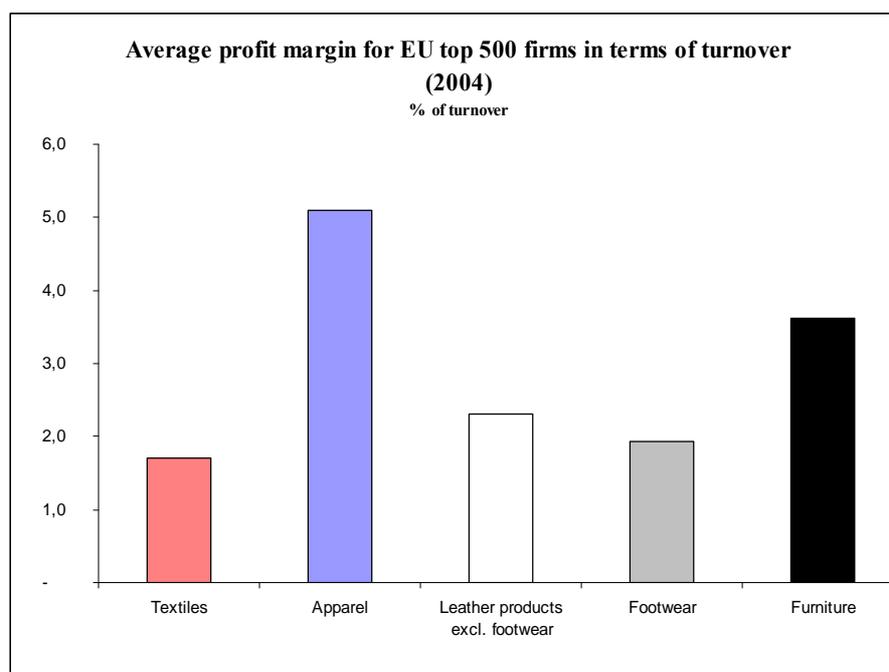
<sup>27</sup> Estimates made by consultants according to their experience and case studies

150,000 T (undiversified products). Those minima can be divided by a factor of six when it comes to spinning.

- In activities like weaving and finishing, or in the production of wet-blue, or in the production of wood-panels, one may assume that a critical size equivalent to 100 Million of euro sales for the upper threshold (undiversified) and three or four times less for the lower one (specialised).
- Assembly activities may be profitable with much lower levels, around some five Millions or so and even a fraction of it for highly specialised firms.
- Branding generally requires higher critical sizes, in the area of 50 Million euros to achieve a profitable global position, and only on third or one fourth of it in the case of niches.

The benefits of size are linked to a high purchasing power, which brings correlatively low prices of inputs, high investing power to gain state of the art technology, high selling power based on extended and specialised selling teams and networks. It should also be highlighted that large sales allow proper staffing and world-class management resources, i.e. a much better capacity for vision and action at the global level. This latter issue is certainly a crucial one for many Euromed companies where senior executives or owners can derive much lower wage levels than international sales managers would demand, approximately 3 times less according to some interviewees. This obviously impedes any active developments on the export scene.

Critical size is also a key to delocalisation and subcontracting and there are clear linkages between the size of the company and the distance it may accept its subcontractors to be located: travel expenses, cultural gaps etc. are difficult to bridge for the small SMEs in the industries concerned.



Source Amadeus

Among the five sectors considered, the mediocre figure for textile can be directly related to the ongoing overcapacity of the sector in Europe. On the opposite higher profits in the apparel sector are mostly due to the fact that many large companies have delocalised their production, divesting from manufacturing, and investing in retailing or branding, which enables them to generate larger profits.

- **Structural analysis: geographical issues**

In the textile industry, from a geographic point of view, four countries can be observed in a situation where the average firm makes a loss in 2004; this is the case of Portugal (-0.6% of turnover), Italy (-1.4%), Slovakia (-2.4%) and Spain (-2.4%). The highest profit margins are observed in Finland (7.6%), Ireland (7%) and Estonia (6.9%). There does not seem to be a clear distinction between Eastern and Western European countries, since new Member States are present in the two groups of profit and loss-makers.

(See Appendix 1 –V 5.1 Structural analysis and profit margins table 1)

The results are very worrying for Italy and Spain, which are among the five major producers in this industry. Countries like Germany and Sweden which are large producers of technical textiles display better results than countries like Italy or Portugal which are more focused on the fashion markets.

In apparel as it is the case for textile, it is difficult to distinguish between old and new Member States and their respective levels of economic development. The three countries having the largest levels in their firms' profit margins are the Netherlands (9.6%), Latvia (6.3%) and Estonia (6.1%). Loss makers are Slovakia (-0.5%), Portugal (-1%), Hungary (-1.5%), Italy (-1.5%), Spain (-2.8%) and Denmark (-3.8%). In this industry, the situation of Spain and Italy, which are among the five countries having the largest turnover in these

industries, is again particularly worrying, with very large losses made by domestic firms. The situation of other large producers in the EU is more satisfying, especially in the UK where the average firm profit margin is equal to 4.8%, while it is equal to 2.7% in Germany and only 0.4% in France.

*(See Appendix 1 V – 5.1 Structural analysis and profit margins table 2)*

The average firm size (in terms of production per firms) in those profitable – and large producing – countries especially in Germany is quite larger than it is in Spain and Italy. It indicates that in countries like Germany but also the UK and France companies where delocalisation of production is largely developed firms succeed in devising higher profits from their overall activities.

Countries having the highest profit margins in the leather industry are Germany (14.2%), Estonia (7.2%), and Finland (5.3%). Firms in Italy, Spain, Czech Republic and Belgium incur losses that range on average between -0.1% (Italy) and -4.4% (Belgium). The sample of countries represented in the leather statistics is smaller because of data availability; nevertheless, it is still possible to draw some conclusions.

*(See Appendix 1 V 5.1 Structural analysis and profit margins table 3)*

In this industry, major EU producers are Italy, Spain, France, Germany and Portugal. Losses observed for Italian and Spanish firms are lower than in the textile and apparel industries, so that the situation appears to be less preoccupying for these two countries. Firms in other large producers still make profits, and it is especially the case in Germany where the profitability of firms is very high. Germany is the country where the average size of firms is the largest in the industry, according to the aggregated statistics provided by Eurostat. However, this is not the case for Finland, where the average firm in the industry is smaller than in Italy, while Finnish firms make large profits. There is not one single direct relation between average firm size in the industry and average firm profitability and small flexible companies which are focused on high price segments or niches can derive levels of profitability comparable to large firms.

In the footwear industry, firms have the largest profit margins in Poland (4.3%), Estonia (4%) and France (2.8%), and the lowest levels in Sweden (-0.4%), Italy (-0.6%), Spain (-1%), Portugal (-1.2%) and in the Czech Republic (-2.2%).

*(See Appendix 1 V -5.1 Structural analysis and profit margins table 4)*

The largest producers in this industry are Italy, France, Spain, Germany, and the UK. Within this group Spain and Italy make large losses. In this industry, the highest profit margins are lower than in all other industries. This can be at least partly explained by the fact that firms have decreased their sales of traded goods (see Breakdown of companies' costs and revenues in chapter II 2.3, whereas such goods are in general heavy profit makers).

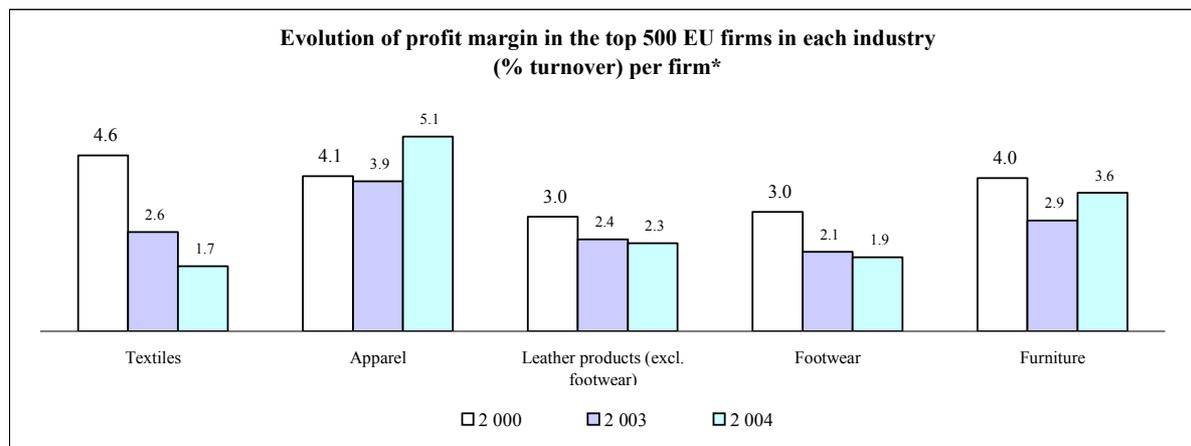
In the furniture sector the highest profit margins can be observed in Poland (6.2%), Hungary (5.9%), and Finland (5.8%). Losses are observed in Portugal (-0.1%), Italy (-0.5%) and Spain (-1.22%). The latter three countries are also among the largest five producers, so that the situation for their domestic firms is quite worrying.

(See Appendix 1 V 5.1 Structural analysis and profit margins table 5)

One should note that positive profits are not only observed in the East, since Finland, Ireland and the UK display profit margin levels that are higher than 5%.

The impact of Asian and particularly Chinese competition can be seen on the fairly poor results of Portugal in the area of furniture manufacturing.

## 5.2 DEVELOPMENTS IN PROFIT MARGINS

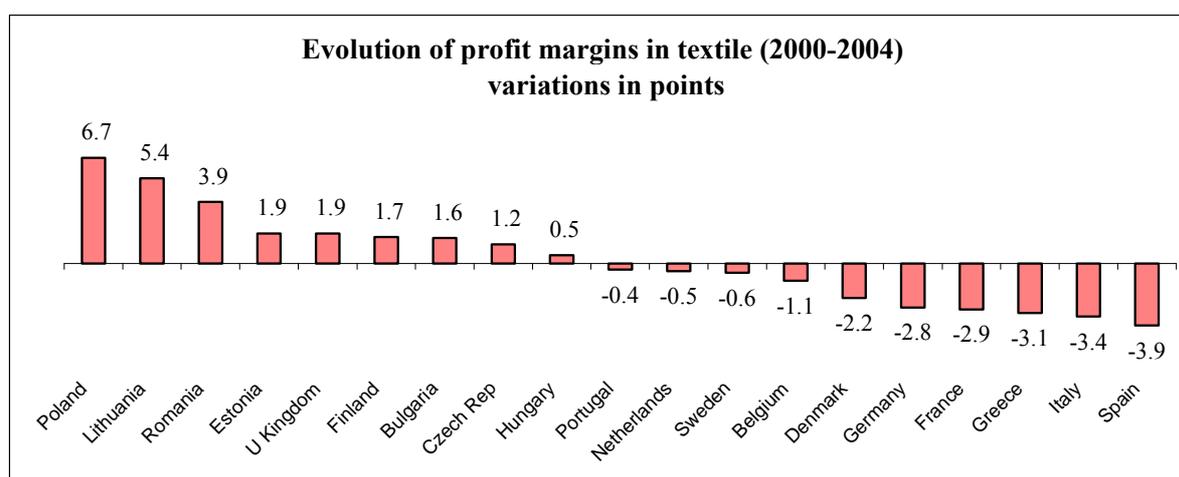


Source IFM : Amadeus

Results indicate that even the largest firms in the textile, leather and furniture industries, have recorded drops in profitability over the period. This is especially true for the textile industry, for which profit margins have dropped from 4.6% in 2000 to 1.7% in 2004. In the apparel industry, profitability has remained stable between 2000 and 2003, and then has gained one point between 2003 and 2004.

### Recent geographical trends

#### Textile



Source IFM : Amadeus

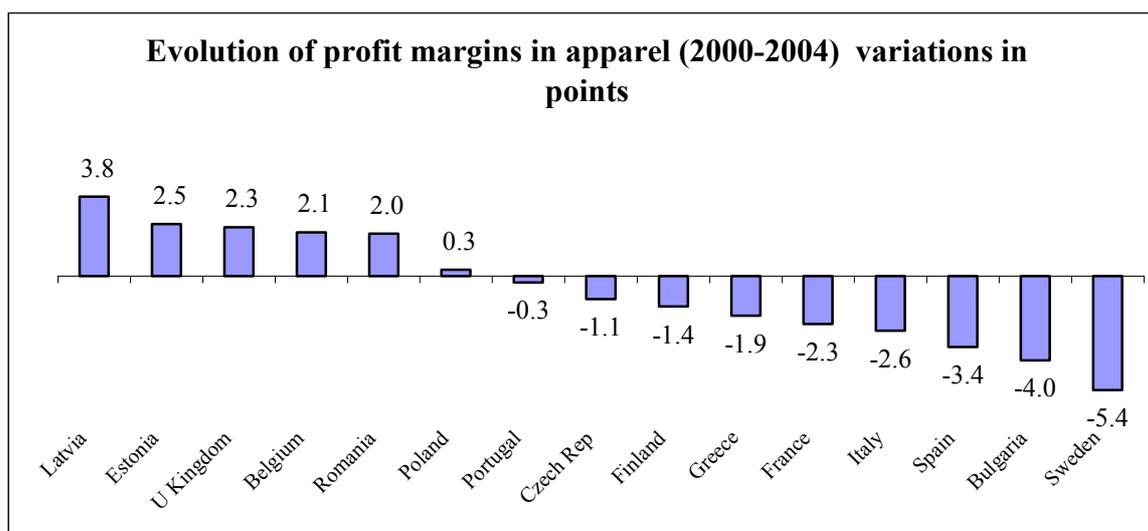
The graph above presents a ranking of the countries according to reduction in profit margins during the period, in the textile industry. It shows that major increases were made by Poland (+6.7 points), and Lithuania (+5.4), and major falls by Spain (-3.9) and Italy (-3.4).

All the largest textile producing countries in the EU have faced a reduction in their profitability, with the exception of the UK. The worrying situations of Italy and Spain

regarding the level of profit margins in 2004 are confirmed here by the reduction in the profitability of their domestic firms during the period. Similarly, Portugal had a negative profit margin in 2000 and the loss increased by 0.4 point by 2004. Finally, it appears that firms in the Western part of the EU have significantly suffered while firms in the East have improved their performance.

## Apparel

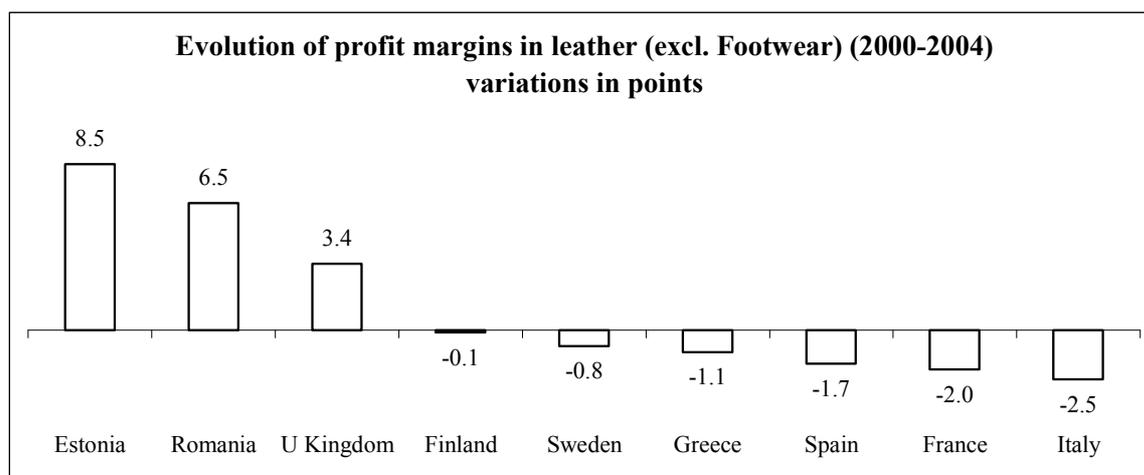
The graph below provides statistics on the profitability in the apparel industry.



Source IFM : Amadeus

In a comparable way to what has happened in the textile sector the largest producing countries have lost some profitability over the period, in particular Italy (-2.6 points) and Spain (-3.4). Both countries display negative results since 2003, and losses have got worse in 2004. French and Greek companies have also seen a significant erosion of their profits, but have remained positive. New Member States have improved their financial performance. UK companies, that have survived to Marks and Spencer's new sourcing strategy and drastic subsequent shake out of the industry, have significantly improved their position.

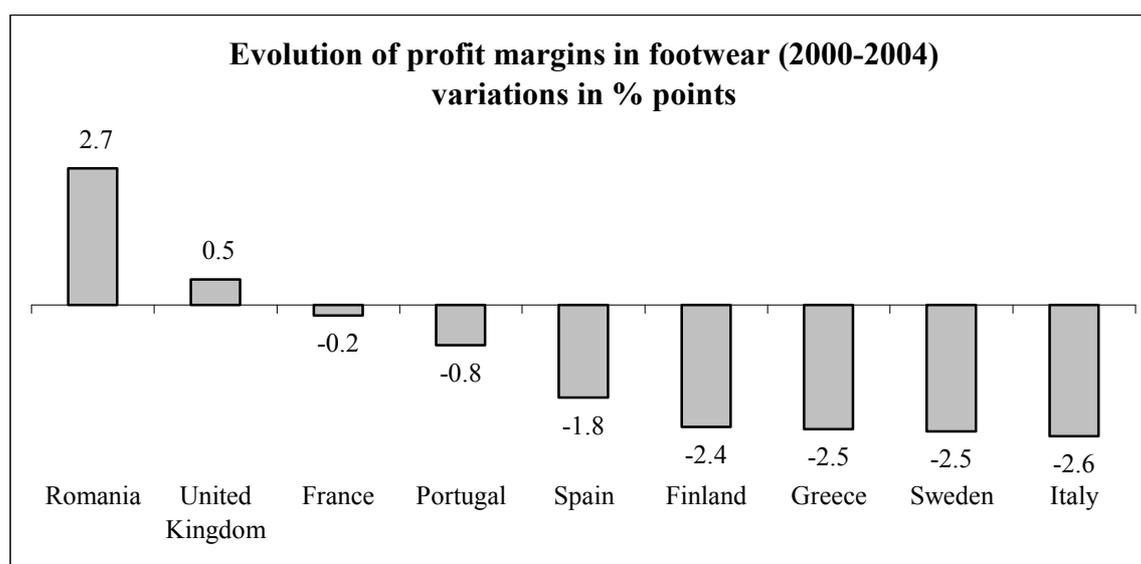
### Leather (excluding footwear)



Source IFM : Amadeus

The number of countries in the sample is more limited than in the other industries, but it still provides interesting results on the dynamics in this industry. Results indicate that most countries in the sample had a reduction in their firms' profitability during the period. Again, as in the other sectors, the situation has deteriorated for Italy, Spain and France, while UK companies have fared better. Italian profits have begun to turn to losses (-0.1% of turnover in 2004).

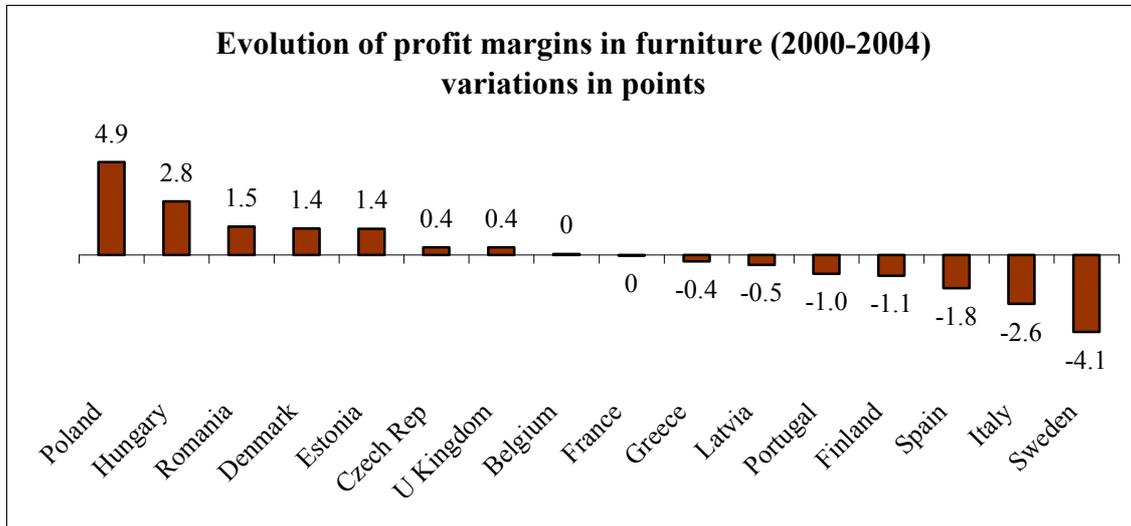
### Footwear



Source IFM : Amadeus

Most countries of the footwear sample have recorded important falls in their profit margins between 2000 and 2004. Again Italy, Greece and Spain have particularly suffered, in full contrast with the British situation.

### Furniture



Source IFM : Amadeus

The graph above shows that most positive evolutions can be attributed to new Member States' firms. The largest increases in profit margins could be observed in Poland (+4.9 points) and Hungary (+2.8). Major decreases in profitability have happened in Portugal (-1.0), Italy (-2.6) and Spain (-1.8), i.e. three of the five largest producers in the industry.

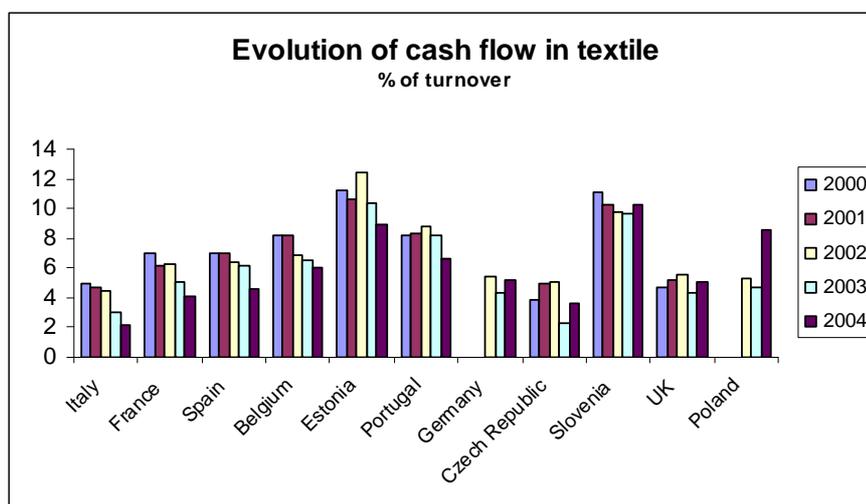
### 5.3 DEVELOPMENTS IN CASH FLOWS

#### Textile

The graph below provides the mean of firms' cash flow in each country and for each year between 2000 and 2004. Countries are ranked from the largest average yearly reduction in cash flow<sup>28</sup> to the highest increase. One should note that the graph only reports three years for Germany and Poland because of data availability; for these countries there is also a limited number of firms in their sample, so that statistics regarding them should be interpreted with care.

Results indicate that the largest yearly negative variations in the cash flow, for the textile industry, can be observed in Italy (-18%), France (-12%) and Spain (-10%), which are also among the largest producers. On the contrary, firms in the UK's sample show a little increase in their cash flow with +1% each year in average. The picture here indicates that firms in all but two countries have faced a reduction in their level of cash flow over the period; this is also the case of Belgium (-7%) and Portugal (-5%) for which there are more than 200 firms in each sample.

Finally, it appears that even in large producing countries like France, Spain and Italy, there can be large differences in the level of cash flow in 2004: firms' cash flow in Italy was on average equal to 2%<sup>29</sup>, whereas it was around 4% in France and Spain the same year. This indicates that firms' capacity of investment in Italy has on average become dangerously low in the textile industry.



Source Amadeus

The trends observed for cash flows are quite correlated to those concerning profit margins. Firms in Italy, France and Spain show an increasingly high level of vulnerability, as they appear less and less able to finance their future developments or restructuring. Obviously the

<sup>28</sup> Yearly average percentage of variation in cash flow over the five years.

<sup>29</sup> 20% of the firms in the sample display negative cash flows

Italian situation is all the more preoccupying at the EU level that the local industry represents one third of the EU turnover in textiles.

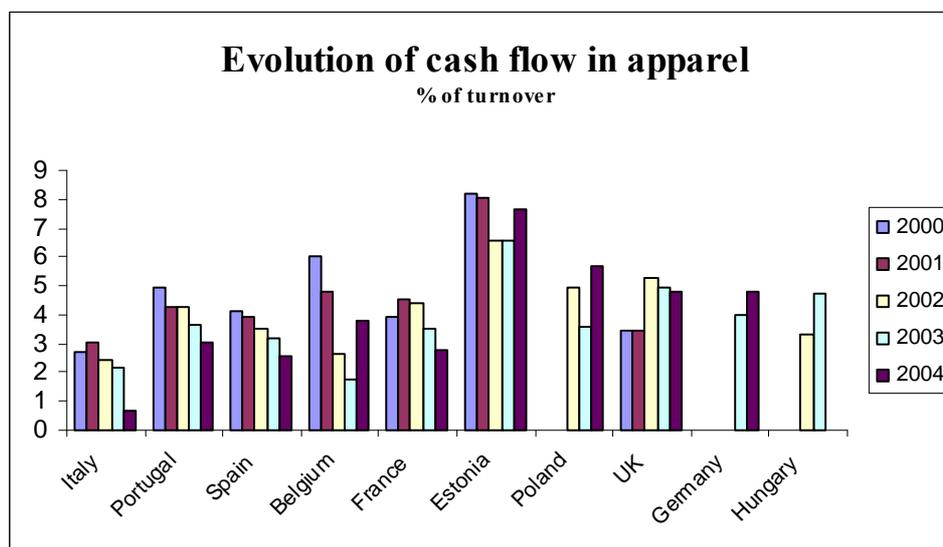
On the opposite Poland, Estonia and Slovenia give evidence of a fairly high capacity of investment, higher than the one observed for the Czech Republic.

## Apparel

In the apparel industry, the final database has the largest samples of firms - more than 1,000 – for Italy, Spain and France. Portugal, Belgium, the UK and Estonia have also more than 100 firms providing data for all years, in their respective samples.

The largest producers in the industry have faced a large reduction of their cash flows during the 2000-2004 period; this is the case of Italy (-30% per year), Portugal (-11% per year), Spain (-11% per year), Belgium (-10% per year) and France (-8% per year). For Italy, the observed loss is much larger than it is the case in textile. The loss is more limited for Estonia (-1% a year), and evolutions are positive for the other countries. The increase in UK's firms' cash flow over the period has been considerable (+8% per year).

The analysis of the level of the cash flow / turnover ratio is also very informative, especially for countries for which there is a large sample of firms. The situation seems to be especially worrying for Italy that has not only the largest decrease in cash flow over the period, but also the lowest level in 2004 (less than 1%), while it reaches between 2% and 4% for other large producers like Portugal, Spain, Belgium or France. In Italy 11% of the firms in the sample record negative cash flows. The level of cash flow is at its highest for Estonia in 2004 (7.6%), but it can be linked to a sample selection issue since the sample of firms for this country is rather limited.



Source Amadeus

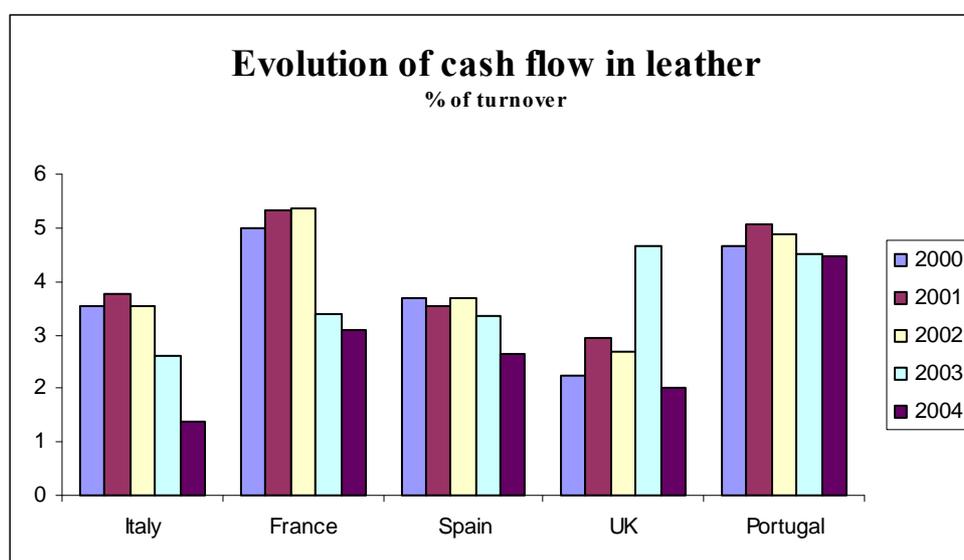
As in the textile sector the cash flow analysis corroborates the bad results coming from the profit analysis for the major EU producers. It gives an even more contrasted perspective between the quite healthy situation of Eastern countries and the deteriorating position of the West.

## Leather and footwear

Very few countries have samples with more than 50 firms operating – and publishing data – each year, so that the analysis concentrates on Italy, France, Spain, the UK and Portugal, which exhibit large enough samples. Only consolidated results for leather and footwear can thus be analysed.

The evolution for all the countries in this sample has been negative over the period. Italy, France and Spain had the largest decreases in their cash flows with respectively -21%, -11% and -8% per year in average. Nevertheless, decreases in cash flow were more limited for the UK (-2% per year) and Portugal (-1% per year).

As it is the case for textile and apparel, the level of cash flow in 2004 is much lower in Italy (close to 1%) than for other countries, where it is located between 2% and 4% of turnover, the highest level being for Portugal.



Source Amadeus

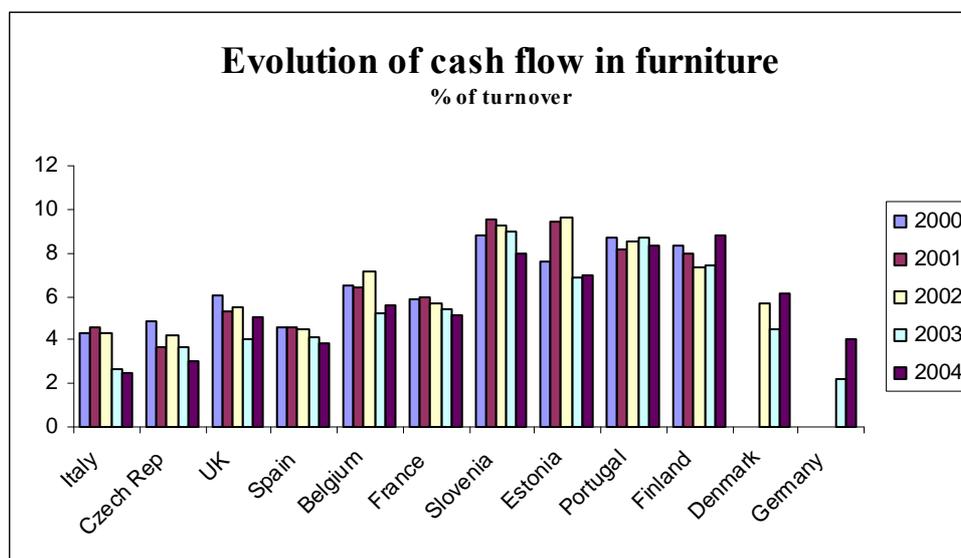
## Furniture

The levels and evolutions in the furniture sector do appear more stable and more encouraging than in the other sectors considered.

The decrease in the ratio of cash flow over turnover has been larger for Italy (-12% per year), the Czech Republic (-11% per year) and the UK (-4% per year). Statistics provide evidence that the reduction of profitability in furniture is lower than that of other industries; this is especially striking for countries like Spain, Belgium, France and Portugal, where the average annual decrease in the ratio of cash flow over turnover is always less than 4% for furniture, whereas it was much higher in other industries.

In addition, the levels of cash flow / turnover in 2004 are much higher than in the other industries; it is higher than 2% in Italy, it is also higher than 4% in Spain, 5% in France and Belgium and 8% in Portugal, even though those ratios remain rather low in the largest producing countries.

All these results indicate that the furniture industry is in a much more promising situation than the other industries where reductions in cash flows are considerable and where the levels of cash flows are themselves lower. As a whole, the position of firms operating in textile, apparel and leather seem to be in jeopardy, particularly firms located in Italy.



Source Amadeus

## 5.4 FACTORS WITH NEGATIVE IMPACTS ON PROFITS AND CASH FLOWS

Companies have implemented different strategies to increase or simply keep their profits. However, the general understanding that can be derived from the case studies confirms statistical evidence: in sectors such as textiles, apparel and leather, the profitability of the companies is low and/or decreasing. In spinning almost no company reports more than one profitable year between 2002 and 2005 and the sector is overall making losses. In the fabric sector the position is slightly better but no company achieves the target of profitability (ROCE of 15% or higher<sup>30</sup>). Profitability is clearly higher for companies without industrial activities. In the technical textile sector, where production is highly automated, there is also higher profitability. However, in this sector constant investment in technology is required to keep profitability. The main causes for decreased profits may be classified as follows:

<sup>30</sup> A return on capital employed of 15% roughly corresponds to a net profit level of 4 to 5%

- Price pressures from customers

In most sectors, even though companies of the sample never are in direct competition with Far East cheap imports they all resent a downward pressure on market prices concerning their activities which are closest to the commodity market segments.<sup>31</sup>

In the jeans business, companies have underlined that the prices of their sector are under-pressure as the “jeans boom” is over. Therefore, the profitability of companies is decreasing (UCO sportswear).

In the leather sector profitability has also been decreasing. The companies studied during the case studies are mainly specialised in very high quality leather production. However, the demand for such leather is reported to be decreasing and the pressure on prices has become stronger

In the short term some companies –mostly subcontractors- are trying to compensate for these price pressures by an increase or a stabilisation of their production volumes over the year. In the apparel sector, to keep their clients and profitability, subcontractors have begun to sign contracts for capacity reservation, in order to guarantee up to 50% occupation of manufacturing capacity and ensuring all products developments.

- Overcapacity

Existing overcapacity<sup>32</sup> in some sectors (apparel, carpets, spinning) in comparison to demand is also a reason for low profitability and pricing of the companies. Overcapacity, sometimes maintained through state support or enabled by monetisation of fixed assets, leads to a constant pressure on prices at the expense of even the more competitive firms. In many cases, investment is also leading to increased productivity and more leverage to use the price tool to squeeze out competitors. This is clearly the case in the few oligopolistic markets in the examined industries.

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<sup>31</sup> From a statistical point of view, price differentials between intra EU traded goods and extra EU imports may be used to evaluate the price pressures imposed by foreign suppliers onto the EU markets. However the huge heterogeneity which exists between products and between firms blurs the overall pattern : a mounting pressure ratio can be analysed as the result of three phenomena which mix in various proportions :

- a. a competitive pressure actually worsening from importers
- b. the strategic upgrading of EU’s product ranges
- c. the outsourcing – outside of the EU – of components or lower skill productions.

(see Appendix 1 V 5.4 Factors with negative impact on profits and cash flows, table 1)

<sup>32</sup> There is no statistical data on the subject and Eurostat only measures overcapacity in the steel industry. This paragraph is based on field research and consultants’ experience.

- Payment terms

Upstream firms also suffer from the additional handicap of overstretched balance sheets with high exposure to debtors and longer delays of payments. Especially in Italian textiles companies are very vulnerable to failing clients and have quite limited means for the redeployment of their activities. It should be said that the financial state of many firms does still reflect a supply driven industry (low payables) while the demand side has increased power (high receivables). This power is being used to maintain long payment terms that no industry cannot afford any longer<sup>33</sup>.

- EU standards

To some extent profitability has decreased for many firms because of investments needed to satisfy strict environmental rules at national and at European level in all sectors being examined.

Self standing companies in the new Member States and in neighbouring countries do suffer from a significant disadvantage in this matter as they often lack the financial capacities of their larger EU counterparts. For example, some companies have to adapt their production facilities to the EU standards concerning wood-dust by 2010. This change requires a removal of the production facilities to non urban locations. However, companies are not profitable enough to raise money on the financial market, nor able to finance the removal on their own funds.

However one can say that all companies interviewed are increasingly handling their activities as a portfolio of strategic business activities. Competitive firms are profitable because they succeed in combining cost consciousness with a focus on added value. In all sectors companies in a transition from commodity to technical goods or from mass markets to niche markets combine achieving economies of scale in volume goods and create buying power with high margin activities in niches. The transition from one segment is often an organised retreat more than a paradigm shift.

Quite regrettably the present transformation of the industries studied occurs in a context of low or negative profitability, stable or declining turnover and a weakened solvency. Thus modernisation is likely to force a restructuring of activities including a disengagement of non profitable activities (e.g. spinning of commodity yarns) or clients (organised retailers), a restructuring of assets (selling valuable real estate or other fixed assets, physical concentration of activities).

In comparison with their respective sectors companies interviewed score on average higher than the industry in terms of turnover growth, profitability, solvency<sup>34</sup>. Solvency is a critical variable as it is a proxy for the sustainability of losses as well as well as capacity for

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<sup>33</sup> Retailers demand increasingly numerous collection themes to be delivered as fast as possible, but have not shortened their payment terms: as a consequence suppliers have to finance 5 or 6 times more product manufacturing than before, on their own financial means.

<sup>34</sup> Solvency represents the capacity of the firm to pay for its debts. It can be measured by the ratio: total assets / total debts.

redeployment. Solvency should be seen as a consequence of shareholders' commitment to the company. A high solvency combined with a conservative dividend policy is a prerequisite for redeployment. Even step by step changes often require a strong financial position from the onset and a long term commitment of the shareholders.

The cases studied in the furniture sector show that the profitability of the sector is relatively high, particularly in comparison with the four others and that it is not falling. Most companies within the sample expect the turnover of the company to grow in the coming years and some report a net profit level around 10%. The companies do not really resent the competition from low priced imports as much as the other sectors. Consumers who buy from them are not in search of mere functionalities as mass retailers are highly competent to provide. In our sample, they have long ceased to work for Ikea and the likes even in the new Member States and have clearly repositioned themselves on medium to high price market segments. Moreover contributions from the contract activities have become a significant part of their sales and satisfactory margin providers. Financial strength is also absolutely necessary in this sector because these markets are particularly cyclical. As in the other sectors it is also necessary to finance required restructuring on time.

However in the new Member States restructuring costs are very high, profits rather low, (laying off people) and companies are under capitalised, which makes necessary structural changes almost impossible to finance be it by external or internal means.

## VI. MARKET DEVELOPMENTS AND CHANGES IN BUSINESS ENVIRONMENT

*For the five sectors under review household consumption still represents the largest part (two thirds) of home markets, while industrial and collective uses represent less than 20% each. This is why an extensive part of this chapter is dedicated to the analysis of its current developments.*

*The household EU 25 markets for the industrial players from the five sectors considered represent some € 531 billion in consumer prices i.e. some € 240 billion in wholesale value. The clothing market represents more than half of the whole, followed by furniture which accounts for 27% of the total. Footwear is the third largest market (12% of the total), followed by household textiles (6%).*

*Germany is the largest market in the sectors being taken into consideration, with the exception of footwear for which Italy is the largest one and household textiles for which the United Kingdom ranks first. The United Kingdom holds in Europe the second position for the size of its whole consumer market. In the three other consumer markets observed, it ranks second for clothing and furniture and only third for footwear. Italy holds the third position for clothing, household textiles and furniture.*

*Some geographic markets are deteriorating, especially the largest. Actual growth mostly comes from new Member States, but they only represent 4% or less of the total: the overall increase in consumer markets of the sectors under consideration is less important than the all-items consumer market increase (7.4% against 18.2% between 2000 and 2005) which indicates a relative decrease of consumers' involvement in the four sectors considered.*

*The situation is somewhat different, depending on the various market segments, but the common trend is a growing concentration of retail and a deterioration of consumer prices due to cheap imports, particularly in the textile and apparel sector. Large retailers are currently setting up networks in the new Member States. Be it H&M or Ikea or the like they fully benefit there from their state-of-the art logistics and Western style image.*

*Brands and retailers are constantly stimulating consumers' desires for new styles, new fashion trends, new fads, and most of them do not favour any quality upgrading or functional innovation. This reinforces the fact that consumption is increasingly driven by price, i.e. markets are declining in value (in constant euro) while they are increasing in quantities.*

*European clothing household expenditures have grown by 7.1% in current euros between 2000 and 2005. The only actual growth – in relation with all-items consumption trends – has been achieved in the new Member States. Consumers' hunger for fashion and brands is particularly strong in those economies, and largely accounts for the development of the clothing consumer market.*

*European household textiles final consumption expenditures have only grown by 4.0% in current euros between 2000 and 2005, despite stronger increases between 1995 and 2003, and due to a recent deterioration of unit prices.*

*The European footwear household expenditures have grown by 12.3% in current euros between 2000 and 2005: double-digit growth rates were registered in the case of footwear expenditures in new Member States but also in Portugal and Finland. The overall consumption trend in the EU is that shoes are increasingly purchased because of their fashion content: this translates into an increase in volumes with a relative decrease in unit prices.*

*European furniture household consumer expenditures have grown by 6.7% in current euros between 2000 and 2005. This is largely due to the decline of consumer expenditures in Germany while Italy only registered a small increase. This phenomenon can be largely attributed to the modernisation of the retail sector. In most other countries the trend in consumer expenditures was clearly positive.*

*In 2005, altogether, the four items, clothing, footwear, furniture and furnishings and households textiles accounted for 8.6% of total expenditures of households for consumption in the EU 25. Since 1995, this figure for the EU as a whole has slightly decreased.*

*Consumers' involvement in apparel is clearly declining -in comparison with other expenditures, like electronics and communication, but also leisure expenses. Traditional growth areas like Southern Europe are beginning to show signs of a slowdown in consumption volumes. However the EU consumption is still largely driven by consumers in Italy, the UK and Germany, who maintain high expense rates although they are regularly declining.*

*At EU 25 level, consumers' involvement in footwear consumption seems to be fairly stable between 2000 and 2005. This equilibrium is the result of an increasing desire for comfort, which fosters the sales of casual shoes, and an increasing desire for brands and fashion, which leads many consumers –especially the youth- to spend large amounts in footwear.*

*As can be observed in the apparel market, consumption in furniture, furnishings and carpets is driven by high expenses by consumers in the largest economies like Italy, Germany and the UK. Unfortunately expense rates are declining which results in a decrease in market sizes, particularly in Germany.*

*The analysis of the evolutions of the EU 25 indices of consumer prices shows that the all-items index of consumer prices has risen by 15.7% between 2000 and 2005. The price rises of the segments under examination was clearly below this level, with a moderate increase for household textiles, footwear and furniture, furnishings, carpets, and a net decrease for clothing.*

*For clothing and footwear products, the most important price drops in 2005 relative to 2000 could be observed in Member States with a distribution system dominated (or in the process of being dominated) by large retail chains who could take advantage of quota dismantling to source cheaper products.*

*In the furniture, furnishing and carpets market, only a few countries registered a decline in consumer prices between 2000 and 2005 and it was more than compensated for by significant*

*increases in consumer prices in the others (+7.0% at EU 25 level). However it remains far below the all-items trend, which means a relative decrease of consumer prices.*

*Changes in consumption patterns and in retail prices largely are a consequence of the concentration of the retail systems in Europe.*

*The concentration rates of the clothing<sup>35</sup> and footwear distribution respectively reach 61% and 54% , with a rough increase of one point per year. Both distribution structures are more concentrated in the North of Europe (United Kingdom, the Netherlands...). But the distribution structure which is still largely controlled by small independent retailers in the South of Europe and in some new Member States is rapidly changing with the arrival in those countries of mass retailers.*

*The degree of concentration of the furniture<sup>36</sup> distribution is lower than in apparel (54% in 2004). It has increased by 3 points between 2000 and 2004.*

*Independent furniture stores retain a high share of the market (41%). This European average, however, masks huge underlying disparities, as these stores only account for 13% of the market in France, as opposed to 67% in Italy or Poland.*

*Retail for household textiles is largely concentrated too, with some specific players like mail order firms, furniture and DIY stores (especially in France and Germany), while Ikea has become one of the largest players for home textiles and bedding. Hypermarkets are quite important in France, and chainstores are increasing their market shares in Italy: interestingly these chains are largely in the hands of producers themselves, like Bellora or Bassetti.*

*The developments in consumers' behaviour and retailers' expectations are considered as key factors for the development of the industries as well as the evolutions in direct customers' expectations on B to B markets. However European manufacturers are confronted with the growing concentration of retail which imposes a heavier pressure on prices, and pushes them into productions with smaller volumes and higher reactivity and fashion/design contents.*

*Growing fashion demand has allowed some companies to specialise in hot fashion at low prices producing a very high number of designs per year according to the fashion trends. The majority of these companies or some of their subsidiaries are located in countries with lower labour costs compared to the average in the EU – Romania, Tunisia and Morocco.*

*The demand for more environmentally and/or socially friendly products can also impact on products such as apparel, furniture, leather, shoes. Firms which have integrated in their development environmental and social concerns attract an environmentally conscious client but have to combine a set of values with demonstrable functional qualities as well as a fashion dimension.*

*The growing need for customised, comfortable products with specific design, tailored to the customer request is an incentive for the development of companies specialised in the production of such goods especially in the furniture and home textiles sectors.*

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<sup>35</sup> Clothing excluding accessories.

<sup>36</sup> Furniture excluding furnishings and carpets.

*However the depressed situation of most consumer markets in Europe urges companies to attempt at developing a B to B clientele according to their field of activity. This sector is important in size -and increasingly so- and not as fiercely price competitive as consumer markets, but it is hugely fragmented. The overall importance of the B to B market is often estimated to represent more than one third of consumer markets in the textile and apparel areas, based on comparable wholesale price levels. Products are extremely wide-spanning, from hi-tech, very costly niche items to the vast area of products for service industries. For these markets, certification is a key success factor for international or local success.*

*In the footwear industry manufacturers are increasingly interested in the industrial protection market segments and in orthopaedics where the high level of quality and service required enables suppliers to charge their clients for a quite high value added. The overall importance of B to B sales is estimated at 30% of manufacturers' activity.*

*In the furniture sector the contract business should also represent some 25 to 30% of industry sales. A large part of this sector is the decoration and furnishing of hotels, headquarters, luxury boats, planes, etc. However, many orders –for instance in the case of hotel furnishings- may involve large quantities of many different items, quite above the grasp of the traditional small SMEs of the sector.*

*This future of these segments largely depends on the long term existence in Europe of the major client and supplier sectors, furniture manufacturers and chemical producers for the leather industry, fashion fabric manufacturers for the apparel, automotive manufacturers for furniture, leather and fabric suppliers, etc.*

*The major changes which currently affect EU's markets have considerable consequences on retailers' product strategies and hence sourcing practices. Over the recent years, sourcing practices have been influenced by the liberalization processes that took place in the textile, apparel and footwear sectors.*

*When China joined WTO at the end of 2001, Chinese exporters at once got the benefit of quota free trade that had already been offered to other WTO exporters. This did not affect the total T/C imports of the EU, but China gained one percentage point of them. Due to Chinese pressures, import prices of the liberalized categories dropped by 13%. Part of the EU import trade was reoriented from intra-EU sources to extra-EU ones, while China took over import shares primarily from other Asian suppliers but also from Euromed suppliers.*

*Within the EU, the production of all liberalized categories suffered an overall drop in volume of approximately 7% between 2001 and 2002, a worsening of the overall decreasing trends for the 1995-2005 period (- 2.6% a year for textiles and -6.5% for apparel).*

*On January 1<sup>st</sup>, 2005, all remaining textile and clothing quotas were dismantled. Liberalized categories resulted in a surge of very cheap imports from China particularly in apparel. EU total imports of T/C went up 6% in value from 2004. China's import share in the EU in T/C surges to 29% in 2005 (up from 22% in 2004) in value. Again in 2005, Chinese exports increased primarily to the detriment of other Asian exporters but also eroded the market share of Mediterranean countries from 27% in 2004 to 25% in 2005. The market share of Central and Eastern Countries (non EU) decreased from 12% in 2004 to 11% in 2005.*

*In the footwear sector, liberalization took place at the same time as for textile and clothing (1<sup>st</sup> January, 2005). Quotas had only restricted trade from China and were all lifted.*

*Liberalization resulted in a strong rise of Chinese imports and pulled import prices down by some 10% on average. The value of EU total imports of footwear went up 13% in value from 2004 and up 20% from 2003. China's market share in the EU in footwear rose to 39% in 2005 (up from 27% in 2004) in value.*

*China's upsurge has been primarily detrimental to other Asian suppliers but also, to a lesser extent to the competitive position of Mediterranean countries (-1 point in import share over the year) and non EU Central and Eastern European Countries (-2 points).*

*In parallel with these liberalization processes, the EU textile, clothing and footwear industries registered a drop in production in 2005 in comparison with 2004. This affected most severely the footwear sector which registered very negative performances in 2005 (-11.6%) following an equally negative 2004. For the textile sector one observed a certain worsening (-2 points) of the long term trend. This worsening was sharper in the case of clothing (-3). In the middle of 2005, quotas were reinstalled for China on several textile and clothing categories. As a consequence corresponding prices have strongly risen in 2006 for imports from China.*

*Now one has to realize that the world has now become a global sourcing market for materials, components, intermediates, subcontracting and final products, driven by considerations of availability of materials, prices, relative volumes, and lead times. The combination of these factors incites some of the companies interviewed to keep their sourcing within the Euromed zone. However for fibres (polyester, silk, cotton), commodity yarns, grey fabrics, tropical wood and intermediates, plastic components, Asia and especially China, India, Pakistan and Indonesia are mentioned as the main and almost unavoidable sources of supply.*

*In almost all sectors sourcing from Romania, Tunisia, Morocco, Turkey is used by EU companies as it allows to offer quick response to customers demand for producers and retailers as well. In particular, sourcing and investments in Turkey are very important for the EU textiles, apparel, leather and furniture industries as Turkey remains an important supplier of fabrics, nonwovens and other components and is also a place for investment for European companies.*

*In the furniture sector destinations are largely linked to raw material supplies: Poland, the Czech Republic and Romania for wood pieces, Hungary and increasingly Turkey for leather items, all countries where labour costs also allow significant gains in production costs.*

*When looking at the future of the industries one should remember that the dynamics behind delocalisation - increasing real labour and energy costs, pressure on prices, limitations to upgrading, innovation and value chain control as well as specific constraints in terms of environment and material sourcing - have not changed, and that a further partial delocalisation of all industries studied is to be expected. It is likely to take different shapes: from pure trading to physical delocalisation (FDI) via controlled trading, subcontracting and co-contracting.*

*Trading is the dominant logic with the Far East while subcontracting is dominant with the non-Member States in the Euromed, and direct investment is becoming dominant in the new Member States. Physical delocalisation is attractive in the enlarged union as it gives a relatively stable macro-economic environment, a known regulatory framework and all benefits of free flow of goods. It is increasingly important in intermediate sectors, such as textiles and secondary processing. According to companies' interviews it may be presumed that the wave of delocalisation of assembling activities has already reached its peak: from now onwards delocalisation increasingly will involve greenfield investment instead of joint ventures and take-overs.*

*The ability to delocalise considerably depends on the financial means available to the principal and his ability to redeploy assets. The weakening of the financial position of many firms limits the ability to cover restructuring costs and many firms simply do not have the financial strength to finance large scale delocalisation. They are hence constrained to constant incremental improvements in situ or to downsizing and subcontracting. Companies in sectors like carpets and non wovens have begun to consider that large scale delocalisations are to be expected at the end of economic life time of existing installations.*

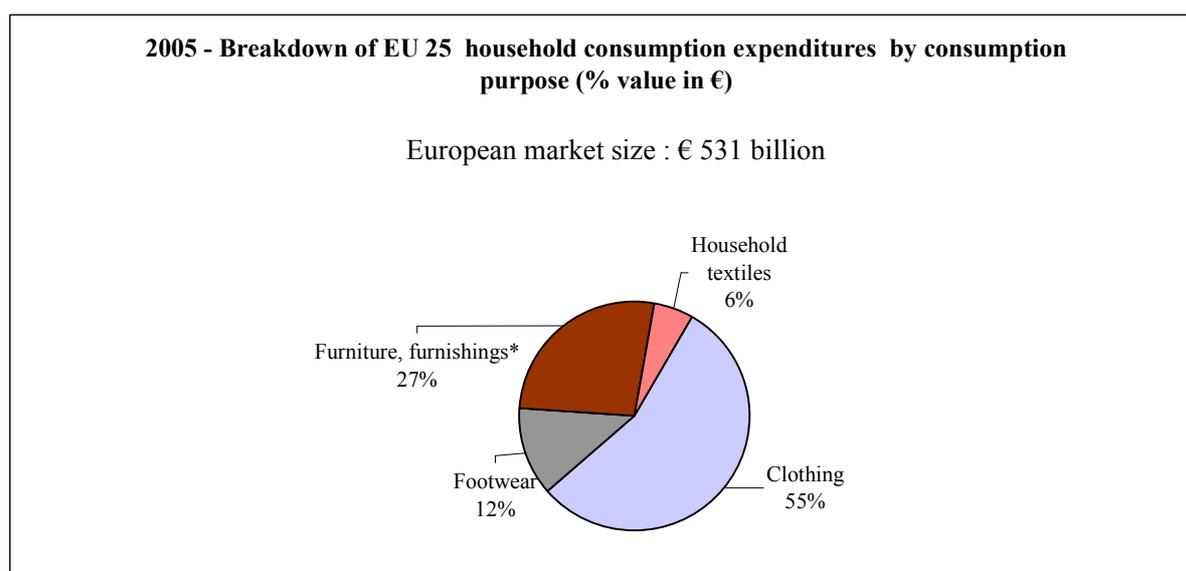
*Quite regrettably in all sectors concerned many companies have too long postponed a controlled delocalisation and are no longer in a position to control their fate.*

*Overall delocalisation appears as a favourable trend in the framework of an enlarged union as on the balance job losses in old Member States are compensated for by job creation in new Member States. However, the handicaps to delocalisation foster subcontracting and above all trading. The EU ongoing enlargement fosters delocalisation processes instead of trading developments. This is a positive phenomenon as trading directly results in a net erosion of production, employment and control in the value chain.*

## 6.1 CONSUMPTION AND STRUCTURE OF DISTRIBUTION

### 6.1.1 Consumption developments<sup>37</sup>

- **Structural analysis**



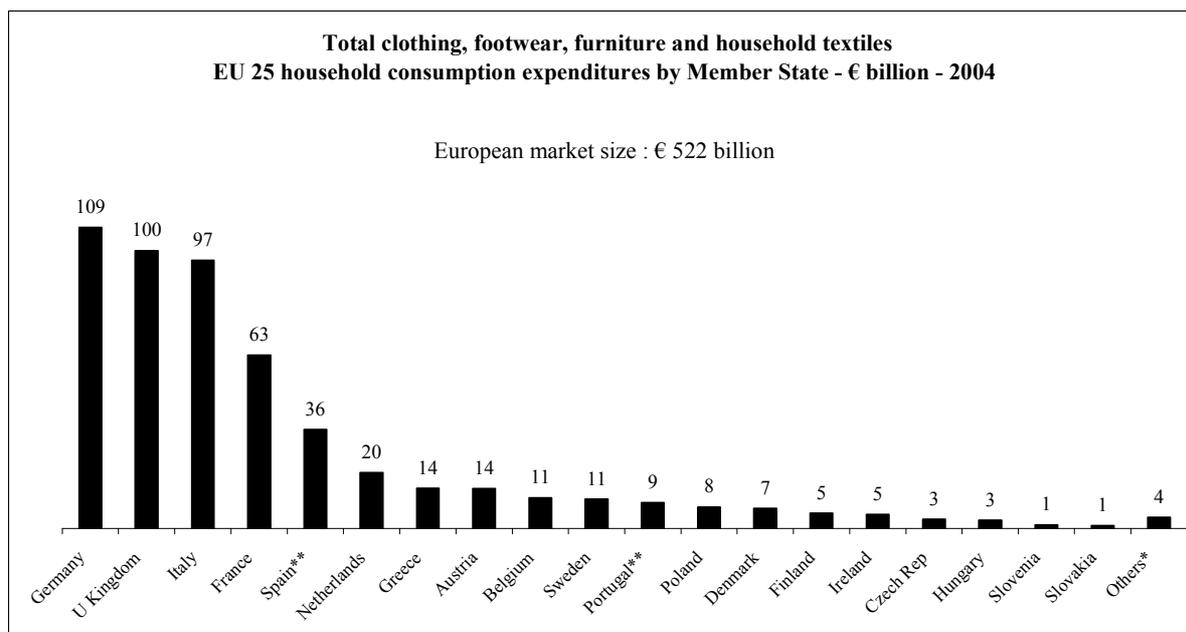
\*including carpets and other floor coverings

Source Eurostat

The European consumer market – comprising\* clothing, footwear, furniture and household textiles – amounts to 531 billion euros. The clothing market represents more than half of the whole, followed by furniture which accounts for 27% of the total. Footwear is the third largest market, followed by household textiles.

*\*Note: the leather products (bags...) – which represent a small but dynamic market cannot be found as such in market statistics. They represent approximately 5% of the clothing market, in which they are included.*

<sup>37</sup> The report covers 4 main categories of household expenditures: clothing, footwear, furniture-furnishings, carpets and other floor coverings, household textiles as defined by COICOP (classification Of Individual Consumption by Purpose adapted to the Needs of Harmonized prices – HICP, developed by the European Union. The commentaries concentrate mainly on the two or three-digit level of the classification, which is a hierarchical classification made up of three levels. (See appendix 2 4. Nomenclature : household consumption and indices of consumer prices by consumption purpose for more detailed information)



note : data are not available for Bulgaria and Romania

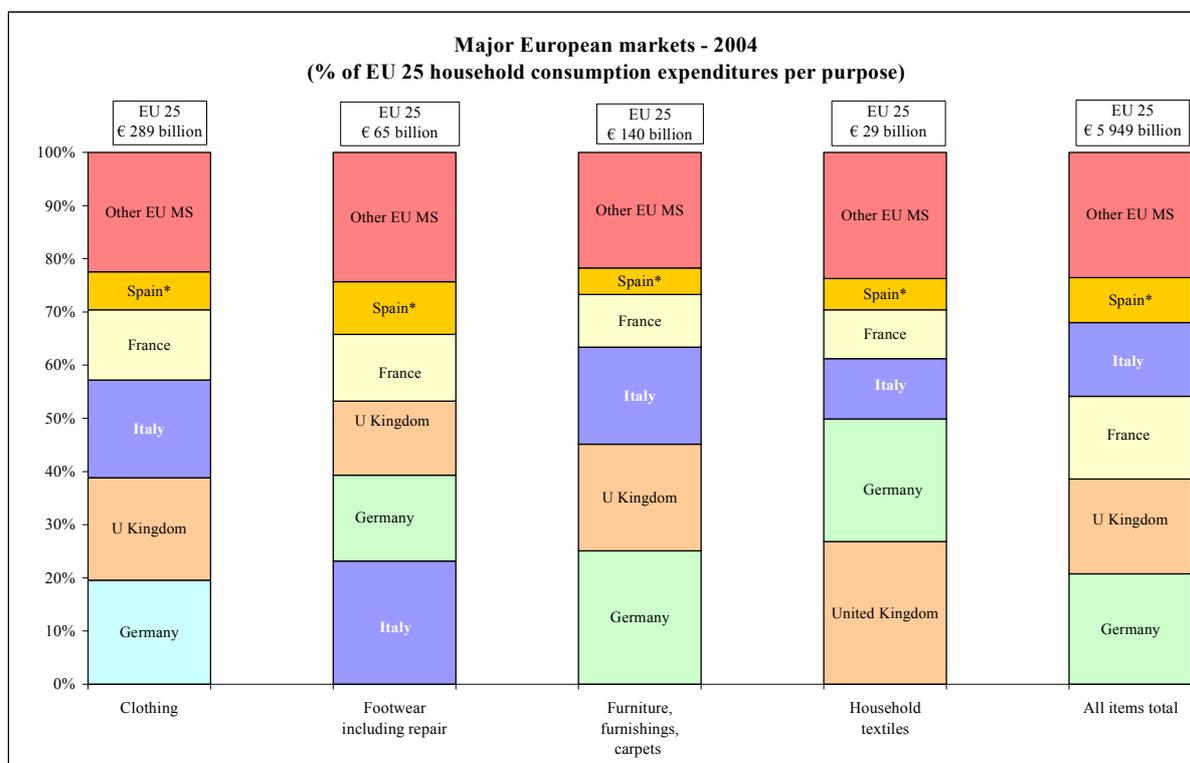
\* Lithuania, Luxembourg, Cyprus, Latvia, Estonia and Malta

\*\*Spain, Portugal : IFM Estimates based on Eurostat data

Source Eurostat

The three largest markets are by far Germany, the United Kingdom and Italy, followed by France and Spain. New Member States represent less than 4% of the total EU 25.

The graph below displays the major European consumer markets (in 2004) for each consumer sector under consideration.



Source Eurostat

*All-items: total household consumption including food and beverages, tobacco, clothing and footwear, housing, water, electricity, gas and other fuels, furnishings, household equipment and routine maintenance of the house, health, transport,*

*communications, recreation and culture, education, restaurants and hotels, miscellaneous goods and services*

The “Big Five” i.e. Germany, the United Kingdom, Italy, France and Spain with a combined population of more than 300 million represent two thirds of the total EU 25 population and 78% of consumption.

Germany is the largest market in the sectors being taken into consideration, with the exception of footwear for which Italy is the largest one and of household textiles for which the United Kingdom ranks first.

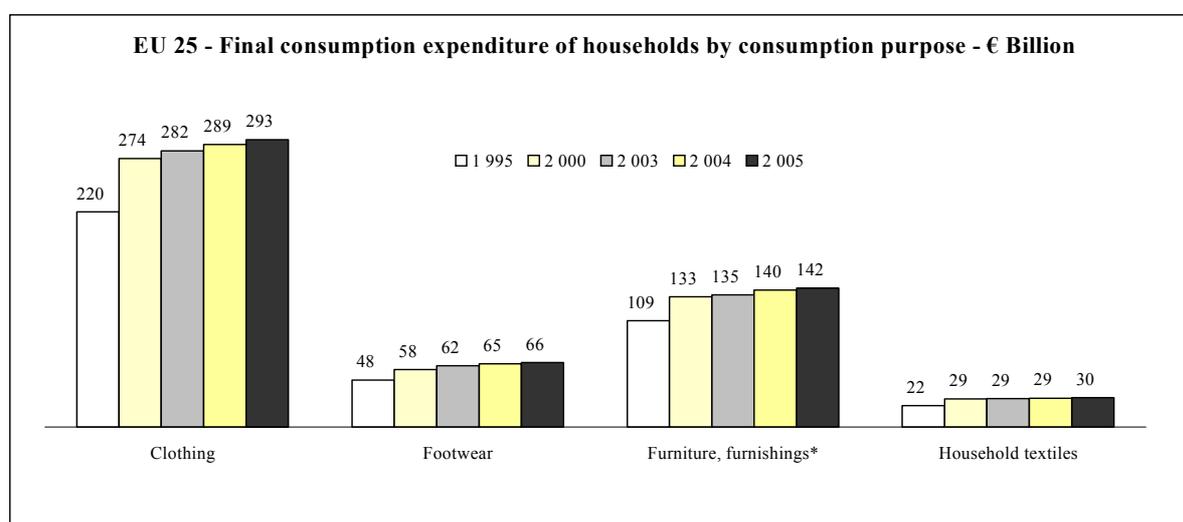
The United Kingdom holds in Europe the second position for the size of its whole consumer market. In the 4 consumer markets observed, it ranks second for clothing and furniture, and only third for footwear.

Italy holds the third position in market size for clothing, furniture and household textiles.

*(See appendix I VI. 6.1 Consumption and structure of distribution, table 9 for more detailed information).*

- **Recent developments**

- **Market changes (2000 / 2005)**



Source Eurostat

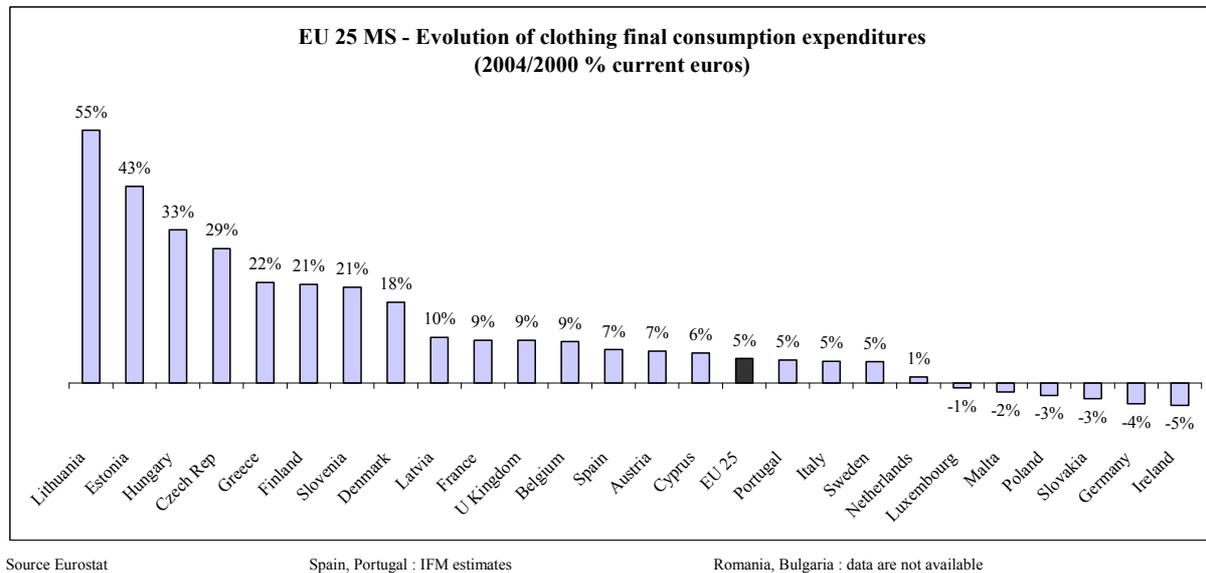
\*including carpets and other floor coverings

The analysis of household consumption changes between 2000 and 2005 gives evidence of an overall increase in consumer markets of the sectors under consideration less important than the all-items consumer market increase (7.4% against 18.2%) i.e. a relative decrease of consumers' involvement in the four sectors considered.

*(See Appendix I VI 6.1 Consumption and structure of distribution table 12 for more detailed information).*

The phenomenon has clearly affected all four consumer markets under consideration, and in particular the sectors of clothing and furniture. With the analysis of price indices shown later in the report one can see that all markets have roughly grown by 7% in volume terms, except furniture for which volumes are stagnating.

## Clothing

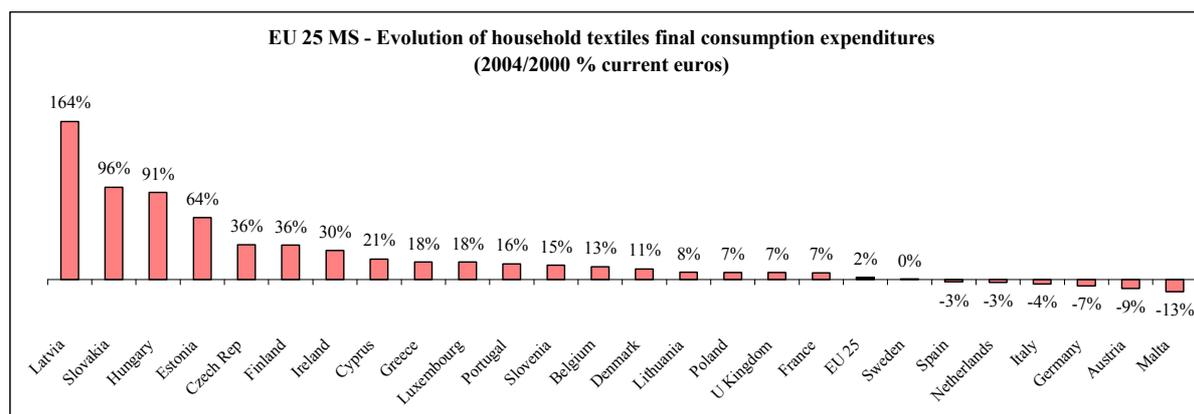


European clothing household expenditures have grown by 5.3 % in current euros between 2000 and 2004.

The only actual growth – in relation with all-items consumption trends – has been achieved in the new Member States with the exception of Slovakia, Poland and Malta, while the Lithuanian, Estonian and Hungarian markets have grown quite remarkably. Consumers' hunger for fashion and brands is particularly strong in those economies, and largely accounts for the development of the clothing consumer market.

In the West, Ireland and Germany have seen the household consumer expenditures fall in value. Member States with medium GDPs like Greece display a consumption pattern corresponding to their economic position within the EU, with a growth rate stronger than the EU average. The Spanish market is somewhat losing the dynamism it used to show while Zara and competitor chains had begun to stimulate it but its growth rate (+7%) remains above the EU average.

## Household textiles



Source Eurostat

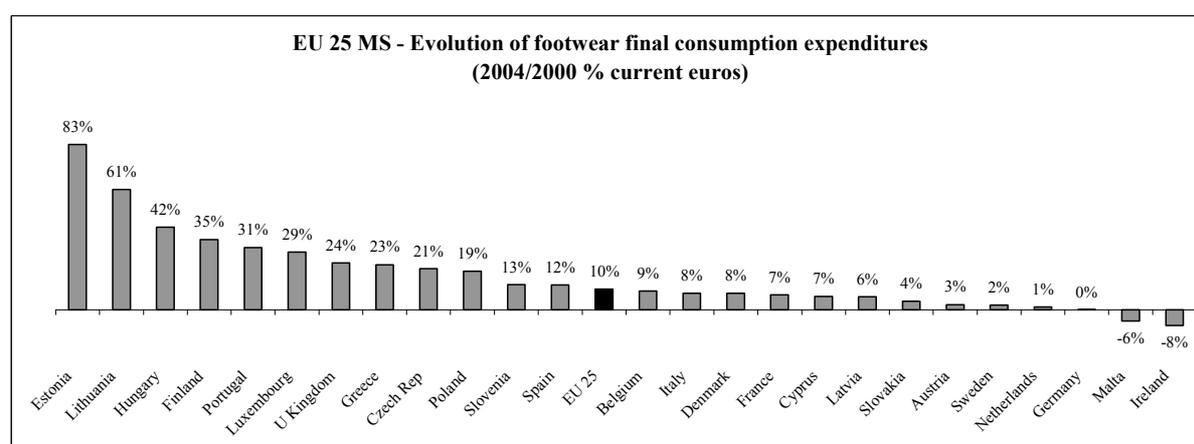
Spain, Portugal : IFM estimates

Romania, Bulgaria : data are not available

European household textiles final consumption expenditures have grown by 2.5 % in current euros between 2000 and 2004. Between 1995 and 2003 the interest in their homes and in family life has proved to be a stronger motivation for consumers than the more social-centred motivations which traditionally stimulate apparel consumption. However in 2004 and 2005 the household textiles final consumption only registered a small increase. This evolution is partly due to a decrease in unit prices.

The situation was contrasted among the Big Five economies: the United Kingdom and France registered moderate growth while consumer expenditures fell in Spain, Italy and Germany. This strongly contrasts with the impressive growth achieved by four new Member States (Latvia, Slovakia, Hungary, and Estonia) and three old Member States (Finland, Ireland, Greece).

## Footwear



Source Eurostat

Spain, Portugal : IFM estimates

Romania, Bulgaria : data are not available

The European footwear household expenditures have grown by 10.4% in current euros between 2000 and 2004.

Double-digit growth rates (above 20%) were registered in the case of footwear expenditures in new Member States (Estonia, Lithuania, Hungary, the Czech Republic) but also in Finland, Portugal, Luxembourg, the United Kingdom and Greece.

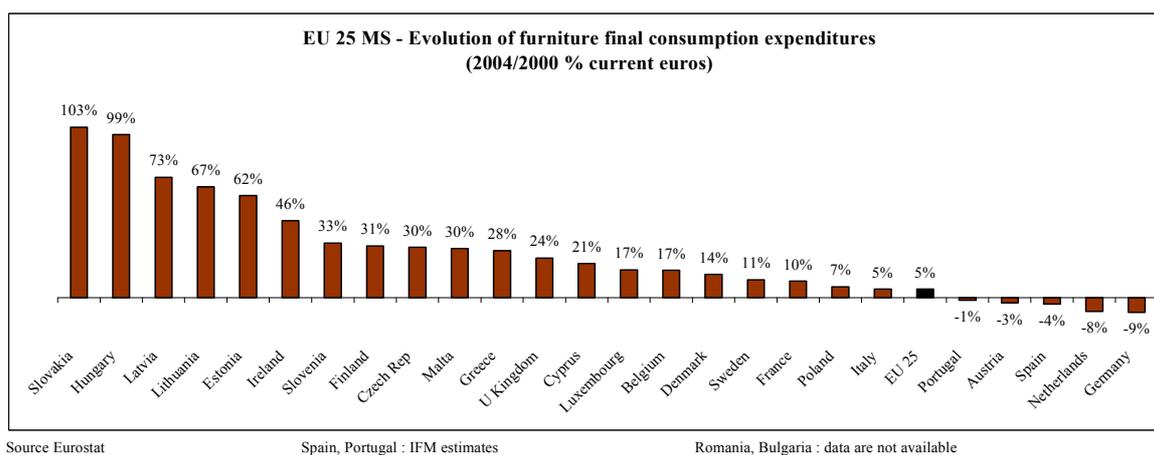
However a majority of the Member States – including the largest economies with this exception of Germany, recorded more modest growths in consumer expenditures. The size of the consumer market remained stable in Germany.

The overall consumption trend in the EU is that shoes are increasingly purchased because of their fashion content : this translates into an increase in volumes with a relative decrease in unit prices (see further).

## Furniture

European furniture household consumer expenditures have grown by 5.2% in current euros between 2000 and 2004. There were high differences between national evolutions:

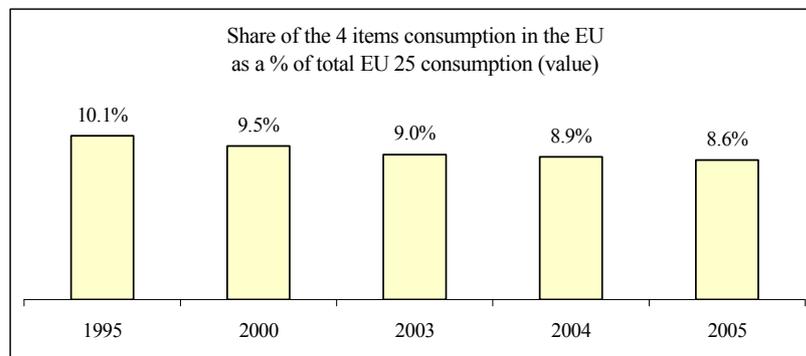
The European modest growth is largely due to the decline of consumer expenditures in Germany (down 9%), and Spain, while Italy only registered a moderate increase. This phenomenon can be largely attributed to the modernisation of the retail sector, as it will be shown later.



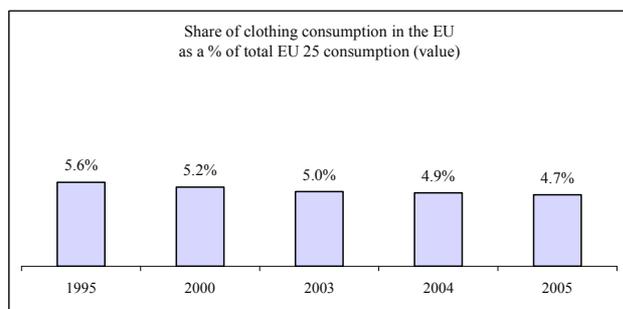
In the other countries, with the exception of Austria, the Netherlands and Portugal, the trend in consumer expenditures was clearly positive, and many new Member States recorded high growth rates (above 20%).

### ▪ Changes in consumers' purchasing behaviours (2000/2005)

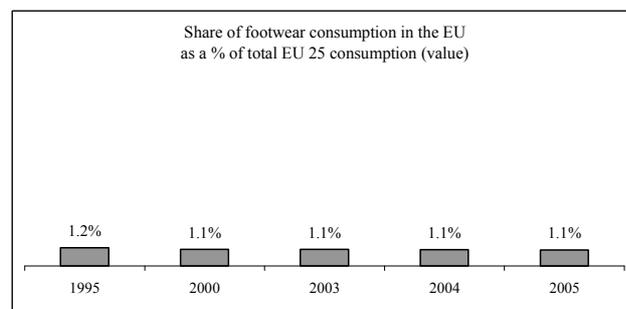
In 2005, altogether, the four items, clothing, footwear, furniture & furnishings and households textiles accounted for 8.6% of total expenditures of households for consumption in the EU 25. Since 1995, the figure for the EU as a whole has decreased by more than one percentage point.



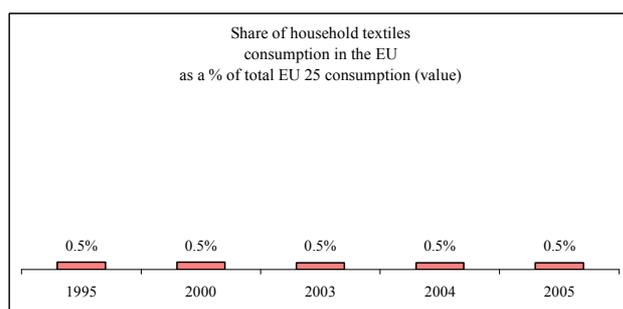
Source Eurostat



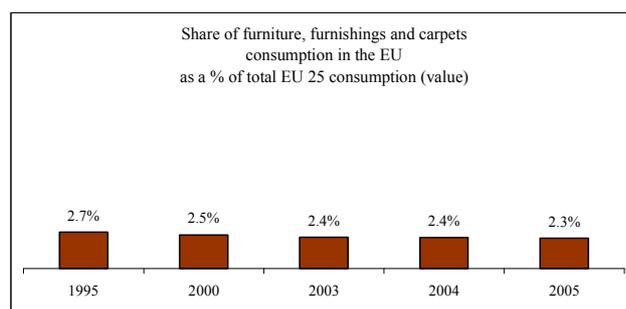
Source Eurostat



Source Eurostat



Source Eurostat



Source Eurostat

## Clothing

Consumers' involvement in apparel is clearly declining (-0.5 point in 2005 compared to 2000 at EU25 level) in comparison with, and to the benefit of, other expenditures, like electronics and communication, but also leisure expenses.

Traditional growth areas like Southern Europe are beginning to show signs of a slowdown in consumption volumes. However the EU consumption is still largely driven by consumers in Italy, the UK and Germany, who maintain high expense rates although they are regularly declining.

*(See appendix 1 VI 6.1 Consumption and structure of distribution tables 1 and 13, for more detailed information).*

At EU 25 level, consumers' involvement in footwear consumption seems to be fairly stable between 2000 and 2005. This equilibrium is the result of an increasing desire for comfort, which fosters the sales of casual shoes, for fast fashion, which tends to favour lower price purchases, and an increasing desire for brands, which leads many consumers –especially the youth- to spend large amounts to acquire the most desirable items.

*(See Appendix 1 VI 6.1 Consumption and structure of distribution table 2 and 14, for more detailed information).*

As can be observed in the apparel market, consumption in furniture, furnishings and carpets here is driven by high expenses by consumers in the largest economies like Italy, Germany and the UK. Unfortunately expense rates are declining (-0.2 point between 2000 and 2005 at EU 25 level), which results in a decrease in market sizes, particularly in Germany (-0.6 point) during the same period).

*(See Appendix 1 VI 6.1 Consumption and structure of distribution table 3 and 15, for more detailed information).*

## Household textiles

From a consumer's point of view, home textiles are the least depressed market, as in all of EU 25 Member States expense rates are roughly stable, which is better than in the other segments observed here.

*(See appendix 1 VI 6.1 Consumption and structure of distribution tables 4 and 16, for more detailed information).*

### ▪ Trends in consumer price indices in EU

#### EU 27 – Harmonized indices of consumer prices (2005=100)

	1996	2000	2004	2005	2006	2005/2000	2006/2005
Clothing	97.2	101.5	100.9	100.0	99.4	-1.4%	-0.6%
Footwear incl. Repair	84.8	94.4	100.4	100.0	99.7	5.9%	-0.3%
Furniture, furnishings, carpets	88.6	93.3	98.7	100.0	100.7	7.2%	0.7%
Household textiles	93.8	97.9	100.9	100.0	99.3	2.2%	-0.7%
All-items index	73.9	88.5	97.8	100.0	102.3	13.1%	2.3%

Source Eurostat

The analysis of the evolutions of the EU 27 indices of consumer prices shows that the all-items index of consumer prices has risen by 13.0% between 2000 and 2005 (+15.6% between

2000 and 2006). The price increases of the segments under examination were clearly below this level, with a moderate increase for household textiles, footwear and furniture, furnishings, carpets, and a decrease for clothing.

This overall situation hides different patterns according to markets and to the distribution systems in the different Member States.

*(See Appendix I VI 6.1 Consumption and structure of distribution table 11)*

For clothing products, the most important price drops in 2005 relative to 2000 could be observed in Member States with a distribution system dominated by large retail chains - the United Kingdom (-26.9%), Ireland (-15.8%), the Netherlands (-5.0%) - but also in countries where the distribution system, still largely controlled by small shops is rapidly changing towards more concentrated retailing structure like Czech Republic (-14.9%). By contrast, retailers in Greece, Estonia, Spain and Slovenia have increased their prices significantly (growth above 10%).

Short term trends for 2006 show a further and faster decrease, mostly due the Member States where highly concentrated retailers could take advantage of quota dismantling to source cheaper products (for example in the United Kingdom, the prices fall by 4.0% in 2006 relative to 2005, in Ireland by 1.7%).

*(See Appendix I VI 6.1 Consumption and structure of distribution table 5, for more detailed information).*

For footwear products, consumer prices have actually fallen in countries where there were important drops in clothing consumer prices between 2000 and 2005 – the United Kingdom (-15.2%), Ireland (-18.4%), the Czech Republic (-25.4%). The footwear consumer prices have also fallen in Sweden (-11.2%), Poland (-15.5%) and Lithuania (-19.2%). By contrast, the impressive increases in consumer prices (double-digit growth rate) were recorded in the South of Europe – Greece (+23.3%), Spain (+15.7%), Portugal (+12.3%), Italy (+11.4%) and in Slovakia (+17.2%) and Slovenia (+15.5%).

The short term analysis shows a further deterioration for 2006 relative to 2005, with a net decrease largely due to the UK (-4.2%) and Germany (-0.9%) i.e. areas with highly concentrated retail systems, able to source their merchandise from the Far East, especially China and Vietnam. One can also notice a significant decline in prices in Poland (-9.5 %) and in the Czech Republic (-8.2%).

*(See Appendix I VI 6.1 Consumption and structure of distribution part 2 table 6, for more detailed information).*

### **Furniture, furnishings, carpets**

In the furniture, furnishing and carpets market, only a few countries among the New Member States registered a decline in consumer prices between 2000 and 2005 – Bulgaria (-1.3%), the Czech Republic (-3.5%), Slovakia (-5.8%), Lithuania (-7.9%). This was compensated for by significant increases in consumer prices in other New Members (Estonia, 10.6%) and Slovenia, +37.3%), but also in larger consumer markets like Italy (+11.2%), Portugal (+11.3%), the Netherlands (+11.5%), Spain (+16.1%) and Greece (+10.2%).

*Carpets: see appendix I VI 6.1 Consumption and structure of distribution table 11 for more detailed information.*

In this sector the average price increase between 2000 and 2005 has been higher than in the other segments (+7.2% at EU 27 level). However it remains far below the all-items trend, which means a relative deflation of consumer prices. 2006 figures give evidence of a continuation of this trend with an increase in prices in furniture of + 0.7% in 2006 relative to 2005, whereas the all-items index for consumer prices increases by 2.3%.

*(See appendix 1 VI 6.1 Consumption and structure of distribution table 7, for more detailed information).*

### **Household textiles**

In the household textiles market, consumer prices have increased rapidly in Slovenia, the Netherlands, Latvia, Estonia, Slovakia and Portugal (double-digit growth rate between 2000 and 2005). Consumer prices have decreased in relatively very few and small markets – Bulgaria (-2.8%), Malta (-7.3%), Lithuania (-8.7%), Cyprus (-10.6%), Sweden (-11.2%), and Ireland (-17.2%) - and in the United Kingdom (-10.5%). They have declined by 0.8% in Germany.

The price decrease observed for apparel in 2006 can also be seen here. This downturn in the longer term evolution is primarily driven by Northern consumer markets like the UK, Ireland, Germany and Sweden. This decrease can be mostly analysed - as in the case of apparel- as a consequence of the consolidation of the retail sector, which is described in the following pages.

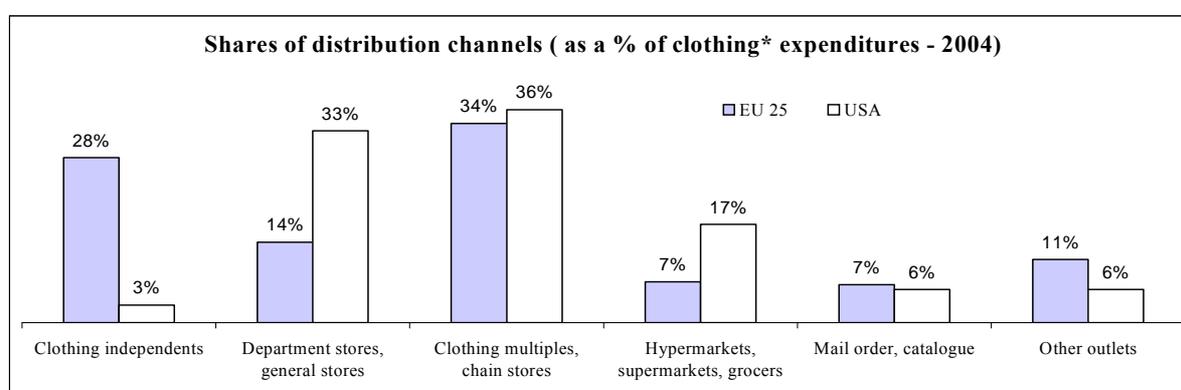
*(See appendix 1 VI 6.1 Consumption and structure of distribution table 8, for more detailed information).*

## 6.1.2 Retail developments

Throughout the five sectors under review the distribution structure is changing towards a higher concentration level.

### Clothing

The concentration rate of the clothing<sup>38</sup> distribution remains much higher in the USA than in Europe (91% versus 61% in 2004), even though it has grown by 3 points between 2000 and 2004, while the US market concentration only increased by 2 points over the period. It seems that in the USA, this figure is not likely to change significantly in the future as the share of retailers in the distribution structure is already very low (3%). This is not the case in Europe – the independents' share still reaches 28%.

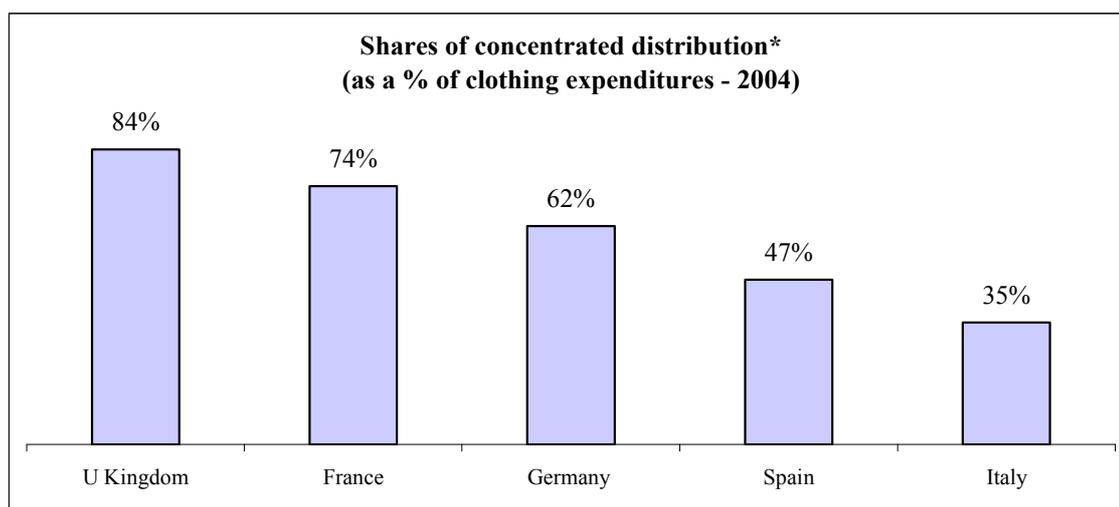


\*Clothing excl. accessories

Source IFM estimate based on a selection of European and US panel data

In Europe, major differences in retail structures do exist from one country to another: the distribution structure is more concentrated in the North of Europe (United Kingdom, the Netherlands...). But the distribution structure which is still largely controlled by small independent retailers in the South of Europe and in some new Member States is rapidly changing with the arrival in those countries of mass retailers (H&M, Zara, Matalan...).

<sup>38</sup> Clothing excluding accessories.



\*Concentrated distribution = department stores, general stores, mail order, chain stores incl. discounters, hypermarkets, supermarkets

Source IFM estimate based on a selection of European panel data

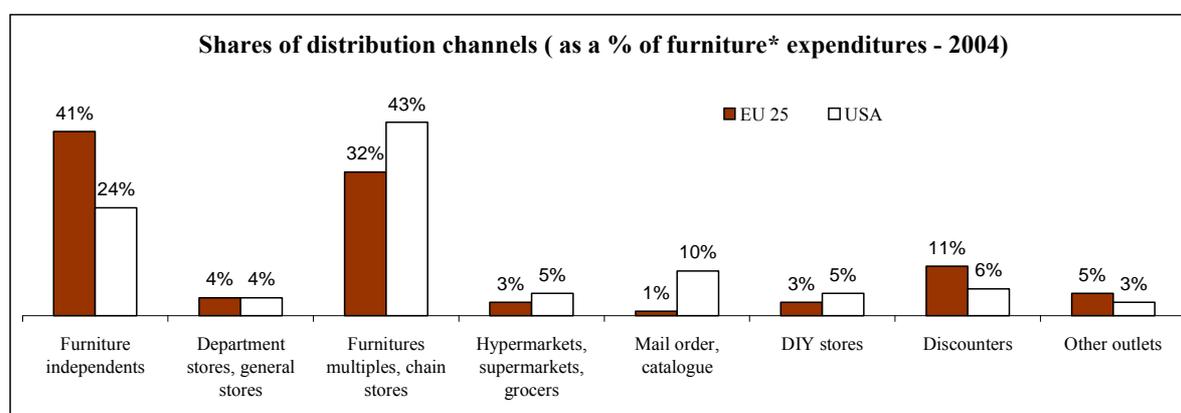
Retail in the United Kingdom and France is dominated by specialised chainstores, who take over point of sales as independent stores disappear. In Germany the existence of buying groups has enabled independents to retain a significant market share. On those three markets the most dynamic outlets are young fashion chainstores like H&M, Esprit, Zara, Pimkie, and discounters like Matalan, Vêt'Affaires, to the detriment of classical apparel stores and department stores. In Spain the distribution system is rapidly changing as Zara, Mango, Cortefiel develop their retail networks.

Italian independent retailers retain an exceptionally high share of the market, however decreasing to the benefit of chainstores, like H&M or other European players, but also to the benefit of industrial firms which gradually integrate distribution, like Vestebene.

### Furniture (excl. furnishings, carpets)

Europe is the world's leading furniture market, far ahead of the United States (€ 64 billion). However the European market is growing much more slowly. This European trend is the result of a very slight increase in sales volumes along with a sharp drop in wholesale prices. The main explanations are: acceleration of industrial concentration in EU 25, consumers' purchasing behaviours as Western Europe goes through a stage of renewal and Eastern Europe equips itself, as well as the beginnings of concentrated retailing and rapid sourcing development in Asia.

The degree of concentration of the furniture<sup>39</sup> distribution is higher in the USA than in Europe (73% versus 54% in 2004). Nevertheless, it remains both in Europe and in the USA at a much lower level than in the clothing sector. It is increasing on both markets: + 3 points in the EU between 2000 and 2004 and + 4 points for the USA.



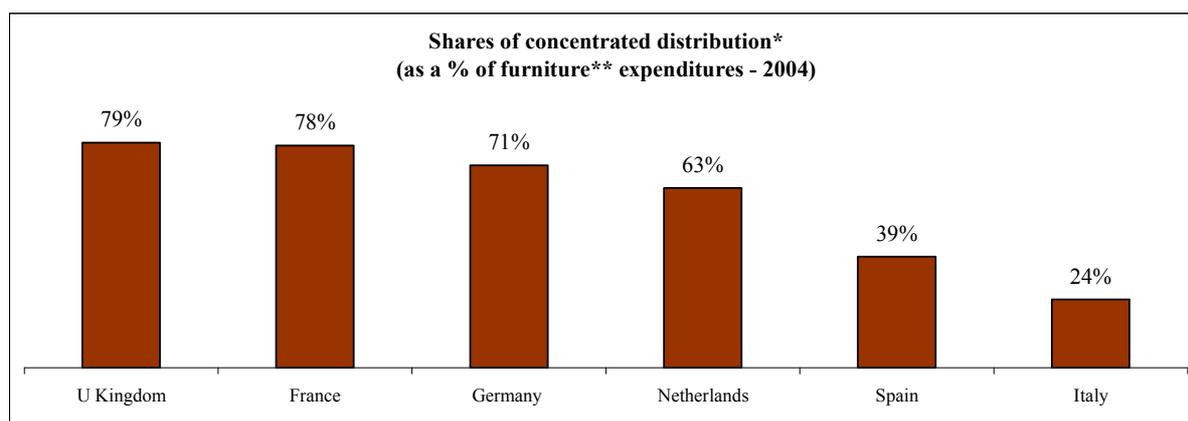
\*Furnitures excl. furnishings and carpets

Source : IPEA - Institut de Promotion et d'Etudes de l' Ameublement

One specific characteristic of European furniture retailing is the still very significant share of independent furniture stores: 41% as opposed to 24% in the United States. The European average, however, masks huge underlying disparities, as these stores only account for 13% of the market in France, as opposed to 67% in Italy or Poland.

Another difference between Europe and the United States is the discount market, held by superstores – in North America, essentially Wal-Mart – while specialty home and furniture retailers control this market in Europe. Historically, discount retailing had its beginnings in France, with the creation of Conforama and But in 1969. In 2006, the most aggressive brands with development strategies for the European market come from Denmark (Jysk, Ilva) and Spain (Merkamueble).

<sup>39</sup> Furniture excluding furnishings and carpets.



\*Concentrated distribution = department stores, general stores, mail order, chain stores, DIY stores, discounters, hypermarkets, supermarkets

\*\*Furnitures excl. furnishings and carpets

Source : IPEA - Institut de Promotion et d'Etudes de l' Ameublement

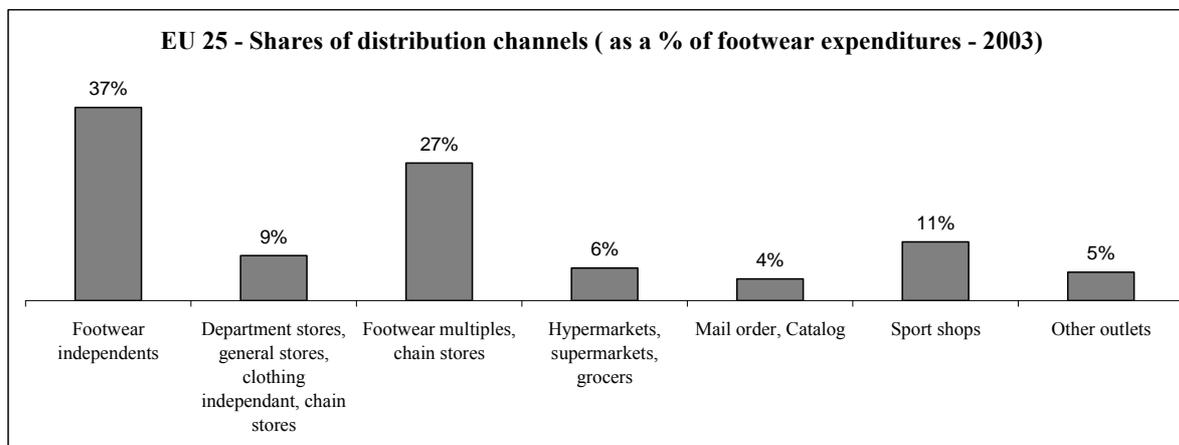
The distribution structure which is controlled by small independent retailers in the South of Europe and in some new Member States is rapidly changing with the arrival in those countries of international retailers from the North of Europe (Ikea...).

In Spain retail concentration has gained 10 points between 1995 and 2004, fairly regularly over the period. Similarly this rate has increased by 5 points in Italy.

Finally, the last major trend in European and American retailing is a growing concern for the logistic aspects of globalisation in the sector. With the exception of the world leader Ikea, in recent years little attention was paid to these operations, which were sub-contracted to manufacturers. The logistics of global sourcing of furniture and/or its components forces distributors to put into place both highly effective logistics centres and high performance sales projection tools.

## Footwear

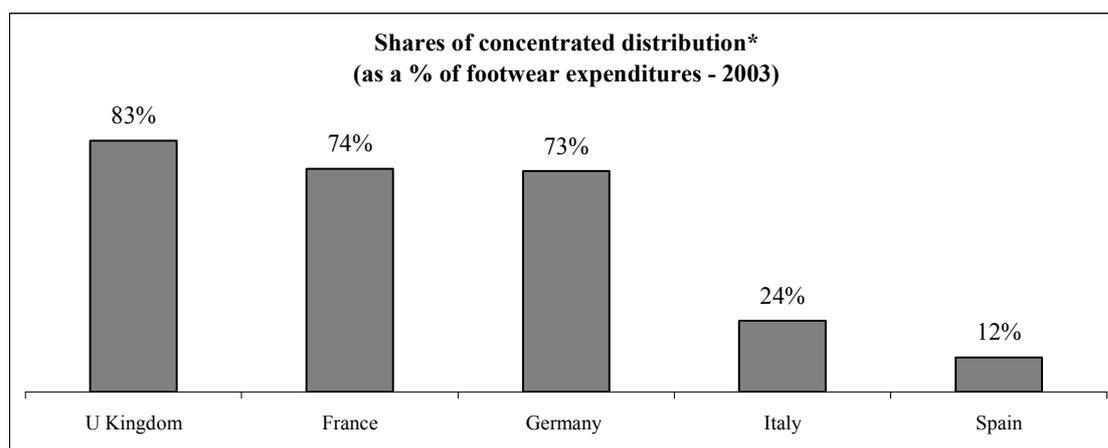
The estimated average share of concentrated distribution reached 54% of European footwear consumer expenditures in 2003, which is roughly the same figure as in the furniture sector.



Source IFM according to Sepic/FFC - Fédération Française de la Chaussure's data

It is impossible to compare European and American statistics on footwear retail as shares of channels in value are not available in the USA. In 2004, American consumers bought more than 70% of their shoes in concentrated distribution channels.

In Europe, huge differences appear between Member States even more than in the clothing sector: the footwear distribution in the North of Europe is highly concentrated while in the South of Europe, it remains quite fragmented, considerably more than in the clothing sector.



\*Concentrated distribution = department stores, general stores, mail order, footwear multiples, chain stores, hypermarkets, supermarkets, grocers, clothing chain stores, part of sport shops

Source : IFM estimate according to Sepic/FFC - Fédération Française de la Chaussure's data

The same concentration process is gradually changing the market picture in those areas. Another important phenomenon in the sector is the increasing role played by clothing retailers, all over Europe. For example Zara, with more than 20 million pairs sold each year, has become one of the largest shoe retailer in Europe.

In Germany there are very few truly independent retailers. Nearly 90% of them work with central buying offices. However, the overall number of outlets is diminishing, due to consumers' extreme sensitivity to prices on the German market. As independents are losing market shares, the market chainstores go on expanding at steady rates. They now only represent 23% of consumption in 2004 (35% in 1995).

The Spanish shoe market has been developing quite fast over the last ten years. The organised shoe business is still insignificant on this market. The vast majority of sales (80%) are done through the independent retail network.

In France, the specialty shoe trade occupies an important place in the French shoe market. Independent retailers have seen their market share fall between 1995 and 2004 from 26 to 20%. They now seem to have stabilised their position. Chain stores have changed little overall during the period studied. The market shares won by hypermarkets on the outskirts of towns have been counterbalanced by the ground lost by inner-city chain stores. The most striking change concerns sport stores whose market shares have gone from 10% in 1995 to more than 23% in 2004. The large food retailers are experiencing a downturn over the entire period studied, to the benefit of suburban specialty stores.

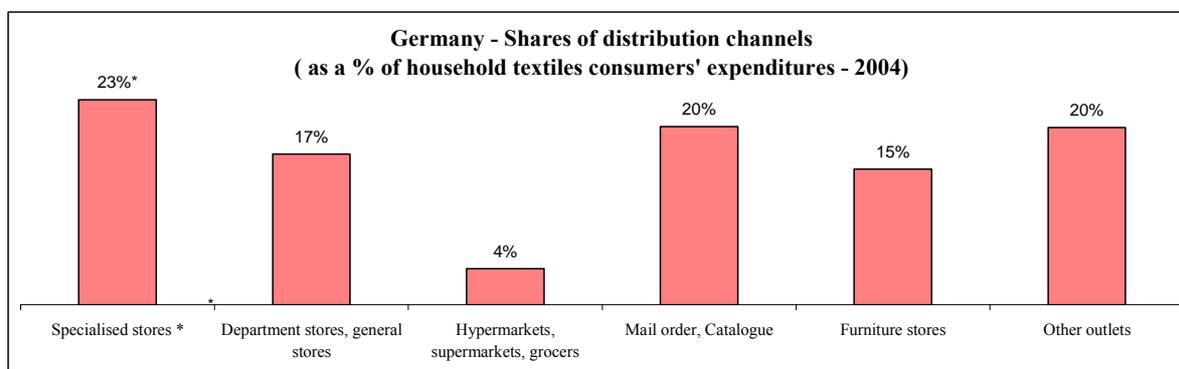
The Italian market is the largest in Europe. The market share represented by independent retail is still quite large in comparison to other countries, though it is constantly shrinking. In 1995, independent shoe retailers represented 72% of the Italian market in value. In 2001, this share dropped to 67%, then to 65% in 2003.

With 10% of the UK market against 14% in 1995, independent retailers have stabilised their position by continually being on the lookout for new brands, amidst the highly standardised offer of organised business. The mid-market range is stagnating, while low price and very up-market stores are gaining ground. In recent years chain stores have been concentrating their business increasingly and more new stores have been appearing.

In the United States, local or regional discount brand-name shoe chain stores are cropping up increasingly. They began to appear on the market two or three years ago and the competition they represent to department stores and specialty stores is now considerable. These large box stores are often located on the outskirts of big cities; they sell American or European brands of shoes in very category (women's, men's, and children's) at prices that are 20 to 60% lower.

## Household textiles

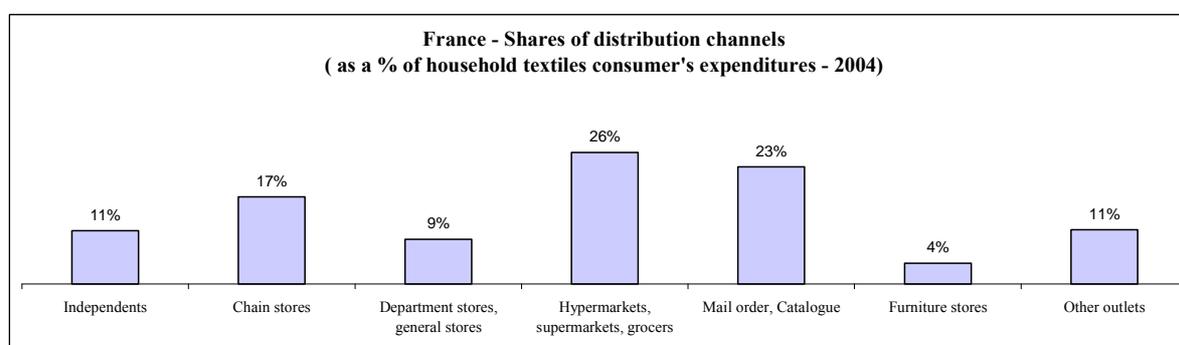
Due to the lack of statistical evidence, it is not possible to estimate the breakdown of sales per retail channel at the European level. However it is interesting to examine the trends which are affecting some of the largest EU markets.



\* Germany : specialised stores = chain stores + independent stores.  
Source BBE

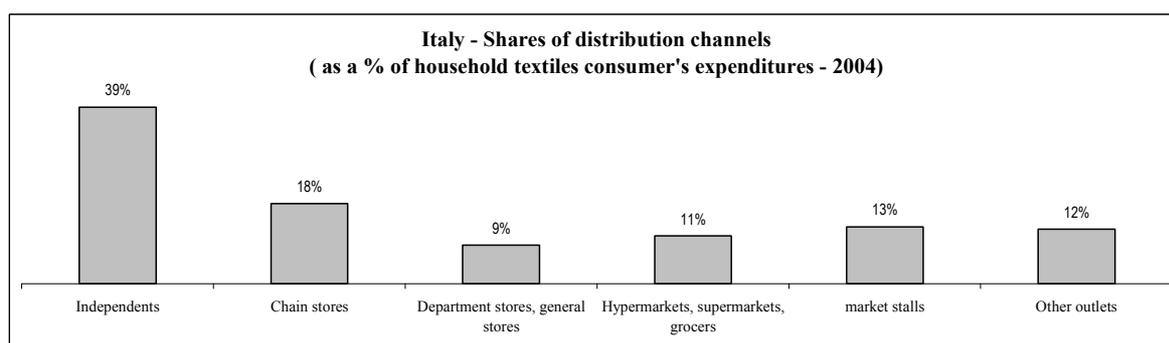
In Germany like in France, one should notice the importance of mail order: market share recorded 20% and 23% respectively in 2004.

In France and Germany, the furniture stores and the DIY stores (classified in 'other outlet') try to broaden their offer to household textiles. At the same time Ikea is becoming one of the largest players for home textiles and bedding.



Source Ifm

In France, hypermarkets and mail order retain a high share of the market. The share of chain stores is correlatively weak, in comparison with the one obtained in the French clothing sector.



Source Sita Ricerca

Study on the competitiveness, economic situation and location of production in the textiles and clothing, footwear, leather and furniture industries

In Italy, the ongoing process of modernisation of the distribution system can be clearly observed. The share of independents has decreased (39% in 2004 vs. 42% in 2000) whereas chain stores have increased their market shares (12% in 2004 vs. 9% in 2000). Some producers like Bellora, Bassetti try to develop their own stores while going on selling their products through independent retailers. One should notice that hypermarkets have gained 3 points between 2000 and 2004. The share of market stalls remains stable.

In most European countries, it seems that there is a growing part of household textiles sold through the Internet. This fact contributes to create a significant further pressure on prices, as internet operators tend to compete with traditional retailers (“brick and mortar”) by offering lower prices to consumers. As a consequence, in order to remain price competitive and maintain sufficiently high retail margins, traditional retailers demand lower prices from their suppliers, thus transferring the price pressure to the whole value chain.

### **6.1.3 Impact on industrial strategies**

Industrial companies are confronted to these changes in consumption mostly through the new requirements they bring into retailers’ demands. Lower involvement by consumers into the five sectors under review is mechanically correlated with a growing importance of the price factor in the corresponding value chains.

All retailers essentially compete on a mix of a price and differentiation. This mix obviously varies from a heavy price-orientation for the lowest price segments to a very large orientation on differentiation for the highest ones. However it should be kept in mind that both factors do play a significant part in all retailers’ competitiveness and, as a consequence, in their requirements. One major objective of retailers’ growth and concentration process is to increase their buying power, as it primarily allows them to source from cheaper sources i.e. from more remote suppliers. Very large low cost retailers in the apparel and furniture sectors in particular tend to buy a significant part of their merchandise through reversed auctions on the Internet. However some players have already done with this type of process, because the level of quality and reactivity obtained is extremely low and merchandise difficult to sell.

Whatever the price range, larger volumes allow brands and retailers to better allocate their purchases in order to get an adequate balance between differentiated “image” products and high margin-lower cost products.

The latter are generally sourced from the Far East –apparel, textile, footwear and leather goods- or from lower cost suppliers in the Euromed, in the EU or not. As retail concentration grows European suppliers are thus increasingly deprived of the large volume orders, even in the highest price segments, except in the furniture sector for heavy weight goods. For example leather sofas which, on average, require almost 30 hours of labour are generally not imported (they are seldom exported either, as EU manufacturers tend to increasingly produce in China to serve e.g. the USA market).

It should also be mentioned that European manufacturers try to escape the dire conditions put on them by EU retailers by developing their sales to new markets. Regrettably the new Member States do not represent and are not perceived as a market with significant potential for manufacturers. On the opposite one can observe that these markets are a primary extension target for EU retailers. Manufacturers try to develop their exports, on high fashion or

technical markets, where companies can increasingly catch global market shares : examples are high protection textiles for ACE Protection, luxury furniture for Hughes Chevalier, exclusive transportation markets for Hulshof, high protection shoes for Alpina, to name only a few. On these segments, when service is right and functionalities fit to the user profile, demand displays a fairly low sensitivity to price. In textiles, apparel and footwear, European manufacturers have to supply retailers with merchandise which is reactive/fashionable/in smaller orders.

### **Fashion**

This growing demand for hot fashion at low prices is growing has allowed some companies like Artex, Davo Star, Filmod, Folly Fashion to specialise in this type of products. These companies have the capacity to produce a very high number of designs per year according to the fashion trends. The majority of these companies or some of their subsidiaries are located in countries with lower labour cost compared to the average in the EU – Romania, Tunisia, and Morocco.

However it should be noted that fashion means risk. For instance, the prices for luxury jeans have increased after 2001, but have decreased in the last two years due to the fact that the “jeans boom” is over. However this very jeans boom had revealed at its beginning that flexible production with highly labour intensive production stages in the larger European area could represent a tremendous advantage in the marketplace.

### **Ethical demand**

The demand for more environmentally and/or socially friendly products also impacts on products such as apparel, furniture, leather, shoes. Several companies like Kuyichi BV, Reda, Falke or Ecco have integrated in their development environmental and social concerns. They attract an environmentally conscious client but have to combine a set of values with demonstrable functional qualities as well as a fashion dimension. It actually is a known fact among apparel players that ethical content is a “plus” to the consumer but is not sufficient by itself to determine a purchasing behaviour.

In more general terms retailers take increasing care of their ethical image and obviously benefit from the high ethical content European manufacturers may be provide.

### **Customisation**

The need for customised, comfortable products with specific design, tailored to the customer request is increasingly investigated by European retailers. However very few large retailers have yet implemented any offer customised to their clients” needs. Smaller ones are considering customisation as a niche strategy valid for their operations. This has been an incentive for the development of companies specialised in the production of such goods. Examples can be found in all sectors, including apparel, home textile and furniture (kitchen, hardwood, offices etc.

### 6.1.4 B to B market trends

The depressed situation of most consumer markets in Europe urges companies to attempt at developing a B to B clientele according to their field of activity.

This sector is both important in size and hugely fragmented. In general those market segments always benefit from two major assets:

- markets are expanding especially in the EU, which is not the case for consumer markets
- prices are not as fiercely competitive as in consumer markets, because there often are high risks or image consequences associated to the purchase of the product, which make buyers willing to pay more than consumers.

The overall importance of the B to B market is often estimated to represent more than one third of consumer markets in the textile and apparel areas, based on comparable wholesale price levels. Products are extremely wide-spanning, from hi-tech, very costly niche items designed for medical vein prostheses, to the low-cost protective nonwovens used in agriculture. Other segments of interest are aeronautics, industry in general, energy, medicine, but also the vast area of services is concerned: movie theatres, shops, sea liners, hotels... all need textiles and apparel specifically adapted to their needs and legal constraints. For these markets, certification – on a world wide basis, which means dozens of different costly procedures and applications – is a key success factor. In the present report no statistical element can be given as no reliable data are available. However case studies have been conducted in several areas concerned. Relevant strategic experts and experiences are thus integrated in the qualitative parts of these reports, especially in the strategic analysis of the final chapter.

The situation appears to be fairly comparable in the other sectors under examination.

In the footwear industry manufacturers are increasingly interested in the industrial protection segments, which includes building and other industry uses. Another expanding segment is comfort and orthopaedic shoes where the high level of quality and service required enables suppliers to charge their clients for a quite high value added. The overall importance of B to B sales is estimated at 30% of manufacturers' activity. It is worth mentioning here that the European Directive on Individual Protective Equipment has forced EU members to regulate safety aspects and that the market for protective footwear has thus been growing over the last years, largely to the benefit of EU firms.

In the furniture sector the contract business should also represent some 20 – 25% of industry sales. A large part of this sector is the decoration and furnishing of hotels, headquarters, luxury boats, planes, etc. Some orders may be quite limited in volume and extremely specific in terms of quality and requirements. However many orders –for instance in the case of hotel furnishings- may involve large quantities of many different items, quite above the grasp of the traditional small SMEs of the sector.

For these markets it is obviously a crucial issue that all industrial client and supplier sectors under review remain in the Euromed zone. For the leather industry for instance it is a crucial factor that both the furniture manufacturers and chemical producers remain in the area. The proximity of the main clients and main suppliers of raw materials is essential for the competitiveness of the industries and for the cooperation with the customers. The delocalisation of industries, for example, the shoe industry and the furniture industry gradually provokes the delocalisation of the leather industry in order to achieve proximity to the customer.

For the apparel industry and throughout all price segments, the continuation of the fabric producers in the Euromed zone and the availability of fashion fabrics at good prices is also very important, for firms positioned in the reactive or in the fashion or in the luxury segments. The automotive and aeronautic industries are also interesting segments for the leather industry. It is estimated that the profitability and the turnover are higher in this segment than in the leather production designed for apparel or footwear

The majority of the case studies have shown that in the B to B markets the cooperation with customers on the development of the product is also increasingly important. It varies from elaboration of a product according to the customers specifications to co-development of the product with the customer. For the more sophisticated products such as technical textiles and furniture items, installation support and after-sales support are essential parts of their B to B strategy.

Among its significant client industries, the textile sector obviously suffers from the very negative trend of apparel production in the EU. The relatively better performance of the automotive sector, which is a client at least 3 times smaller, cannot compensate for the apparel decline. Even more secondary clients, the furniture and building industries also provide rather stable client bases to textile manufacturers. Medical and pharmaceutical uses as well as uses for hotels and restaurants should also represent significant future volumes as the related industrial sectors appear to follow quite positive developments.

The leather sector suffers from the deterioration of footwear production in the EU, which in partly offset by the good stability of the furniture industry. The automotive industry should also bring increasing orders as the sector is growing. However, the production of leather for footwear and apparel and the production of leather for the automotive industry represent different segments of the tanning industry and require different type of leather. Therefore, the shift from one type of production to the other is not easy for the companies.

The furniture industry significantly depends on the situation of its automotive clients, which appears rather positive in the EU. Uses by hotels, administrations and health sectors should display good stability in the future.

One particular word should be said about the strong development of the automotive sector in Turkey, a country which has concentrated one third of worldwide investment projects in the area (MEDA) for the sector, half of them being attributed to EU firms. Second receivers of automotive investments also are Morocco and Tunisia with investments essentially coming from the EU.

## 6.2 RE-LOCATION OF THE PRODUCTION IN A GLOBALISED ENVIRONMENT

### 6.2.1 The impact of past liberalization (2001 – 2005)

Over the recent years, sourcing practices have been affected by the liberalization processes that were implemented in the textile, apparel and footwear sectors. For textile and apparel, the process took place in two different steps.

#### ◆ CLOTHING AND TEXTILE

#### **2001 liberalization<sup>40</sup> in the clothing and textile sectors**

When China joined WTO at the end of 2001, Chinese exporters “suddenly” got the benefit of quota free trade that had already been liberalized for other WTO exporters.

In 2002, the value of EU total imports<sup>41</sup> of T/C is 69.5 billion euros, stable with 2001 value. Greater China<sup>42</sup>'s market share in the EU in T/C equals 21% in 2002 (up from 20% in 2001) in value. EU T/C imports value from Greater China amount to 14.6 billion Euros in 2002, up 4.7% in value from 2001, while imports from other areas have gone down by 2%.

Within the EU, the production of all liberalized categories suffered an overall drop in volume of approximately 7% between 2001 and 2002. Beside a decline in EU output volumes, the trade liberalization has induced a traffic reorientation of EU imports - to the primary benefit of China and to the detriment of other Asian exporters - and a decline in import prices

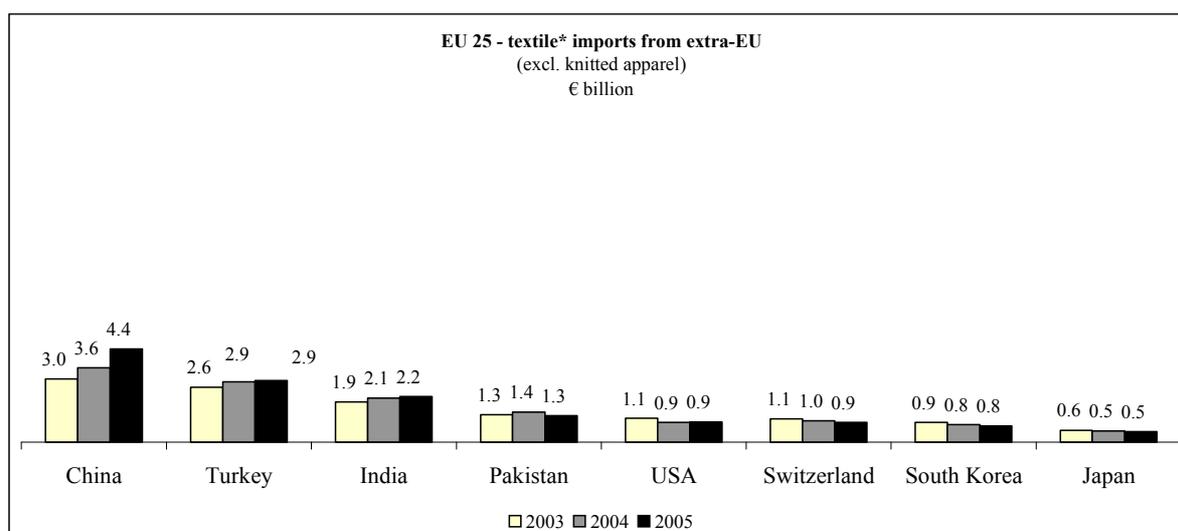
*(See Appendix 1 VI. 6.2 Re-location of the production in a globalised environment table 1, for more detailed information).*

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<sup>40</sup> This section is based on the study on the implications of the 2005 trade liberalization in the textile and clothing sector (IFM and partners). Items concerned were<sup>40</sup> gloves (category 10), underwear (18), handkerchiefs (19), parkas (21), nightwear (24), pile fabrics (32), synthetic filament fabrics (33), artificial fabrics (37), babywear (68), track suits (73), workwear (76).

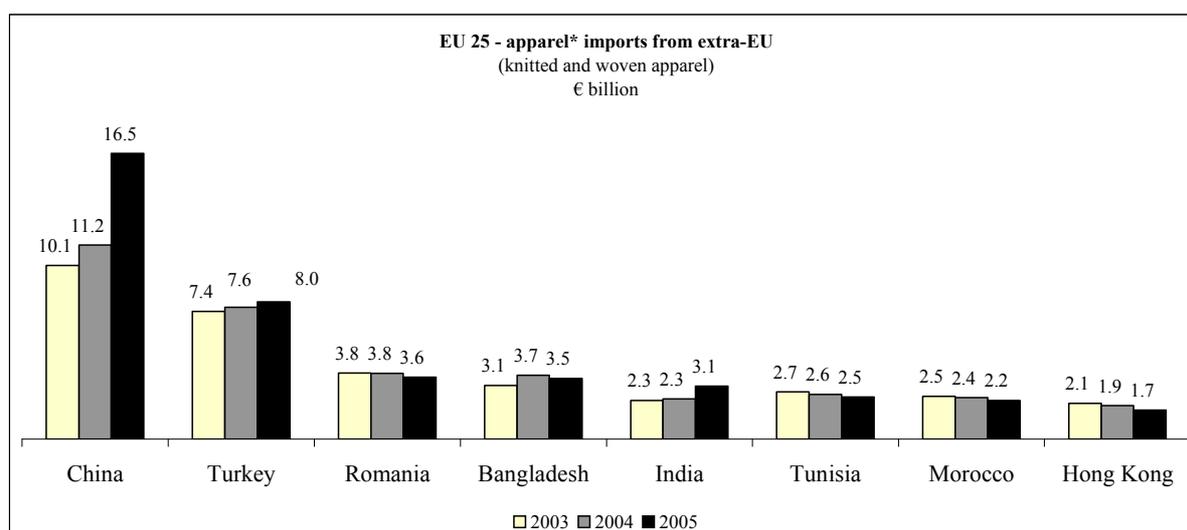
<sup>41</sup>In this section, EU is considered as a unique market. As such EU trade refers to extra-EU trade.

<sup>42</sup>Greater China corresponds to the consolidation of Mainland China, Hong Kong and Taiwan, which represents the first direct sphere of influence of China.

**2005 ATC Stage 4**<sup>43</sup>

Source IFM - Comprendre les marchés n°4 - sept 2006 - based on Eurostat

\* NC code 50 to 60 + 6213+ 6214+ 6215+ 6216 + 63



Source IFM - Comprendre les marchés n°4 - sept 2006 - based on Eurostat

\* NC code 6201 to 6212 + 6217 + 6101 to 6117

<sup>43</sup> In the following section, trade data are issued from Eurostat

In fact, the Chelem trade database (CITI) – issued by the Bureau Van Dijk, provides world trade data only expressed in value (US \$) Those data are of excellent quality: the trade flows have been corrected and the following flows are perfectly harmonised: import by a country A from a country B is equivalent to the flow of export by the country B to the country A. However, there are some limits which are the following ones

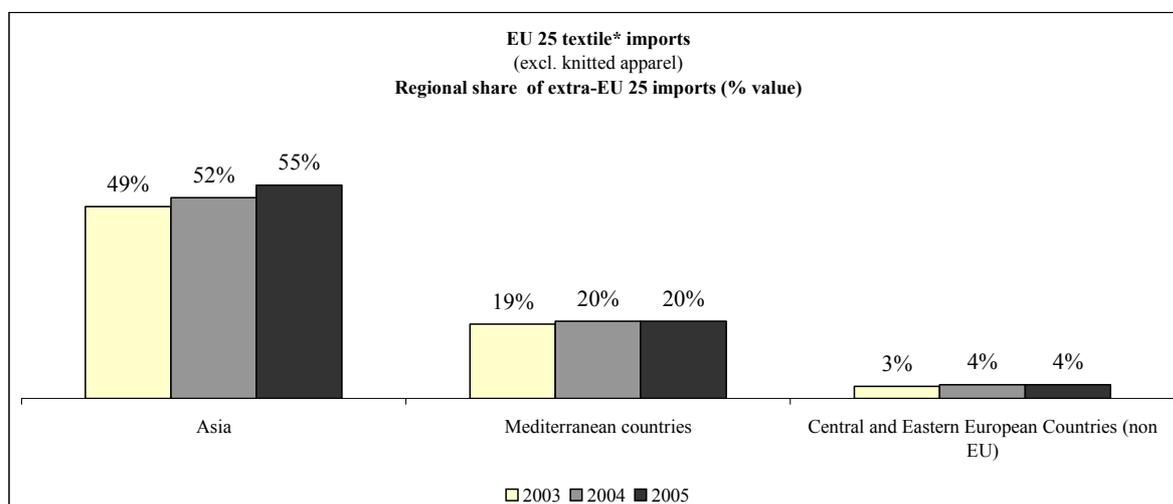
- the 2005 trade data are not available in 2006.
- The trade data are not expressed in volume (tons, units, square meters...).

In order to analyze the consequences of the 2005 liberalisation of quotas both in the textile and clothing sector and in the footwear sectors, IFM has therefore chosen to use trade data issued from Eurostat data base : in that trade database, 2005 and 2006 (until August) data are available, both in volume and value. Those data allow to analyze the evolutions of EU 25 average import prices in 2005 and 2006.

At the end of ATC stage 4 (last phase of the liberalization plan), on January 1<sup>st</sup>, 2005, all remaining textile and clothing quotas were dismantled. In 2005, the value of EU total imports<sup>44</sup> of T/C then reaches 72.8 billion Euros, up 5.8% in value from 2004. China<sup>45</sup>'s market share in the EU in T/C surges to 28.8% in 2005 (up from 21.5% in 2004) in value. EU T/C imports value from China amount to nearly 21.9 billion euros in 2005, up 41.9% in value from 2004, while imports from other areas have gone down by 4%. In the apparel sector, China's market share in the EU now represents 31% in 2005 (up from 23% in 2004), in the textile sector; the China's upsurge is less important: China's market share equals 22% in the EU in 2005 (up from 18% in 2004).

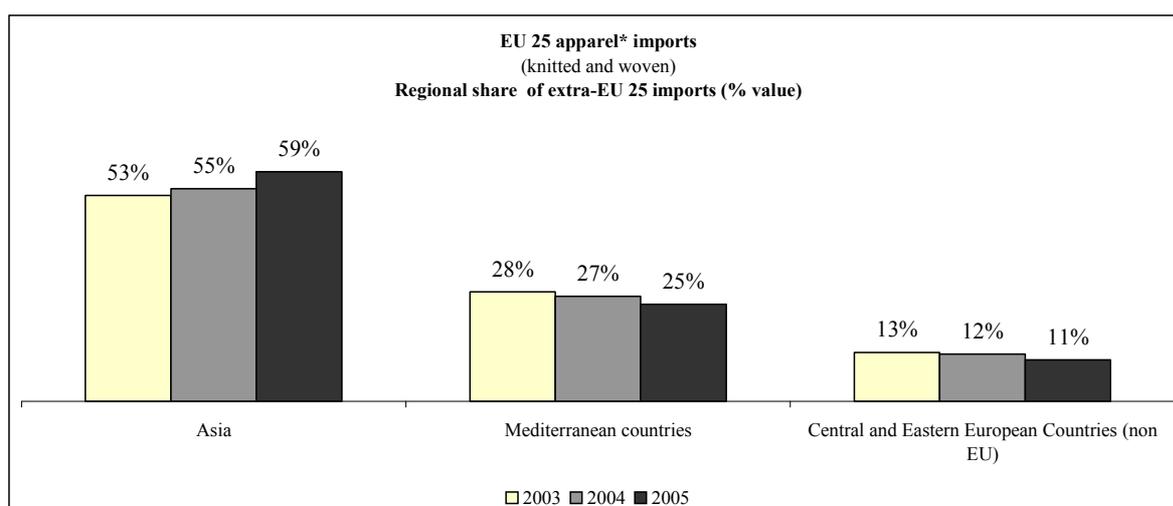
## Trade reorientation

Again in 2005, Chinese exports increased primarily to the detriment of other Asian exporters. It also corresponded to an erosion of the market share of Mediterranean and Central and Eastern Countries (non EU) in the clothing sector.



Source IFM - Comprendre les marchés n°4 - sept 2006 - based on Eurostat

\* NC code 50 to 60 + 6213+ 6214+ 6215+ 6216 + 63



Source IFM - Comprendre les marchés n°4 - sept 2006 - based on Eurostat

\* NC code 6201 to 6212 + 6217 + 6101 to 6117

<sup>44</sup>In this section, EU is considered as a unique market. As such EU trade refers to extra-EU trade.

<sup>45</sup> China (Mainland)

Detailed data about the evolution of EU 25 extra-EU imports (volumes) and EU 25 average extra-EU import prices of T/C categories which have been liberalized<sup>46</sup> on January 1st, 2005 are available in appendix 1 VI 6.2. Delocalisation trends or re-location of the production in a globalised environment, tables 2 a and 2 b.

### **Evolutions in import prices**

It is quite interesting to examine the evolution of EU 25 average import prices from China for the 10 categories of T/C that have been liberalized on January 1<sup>st</sup>, 2005 and for which quotas have been reintroduced on June 10<sup>th</sup>, 2005<sup>47</sup>.

In 2005, the EU 25 imports from China for those six clothing categories have increased tremendously compared to 2004 : in value, imports have been multiplied by 2.6, in volume (units) by 3.4. The six categories of products accounted for 13.4% of EU 25 imports in value (up from 3.8% in 2004). They represented more than 30% of EU 25 imports from China in value (up from 16.7% in 2004).

In parallel in 2005, average import prices from China have decreased sharply for the ten categories concerned. Some categories like dresses (26) or bed linen (20) have even registered price decreases over 40% in comparison with 2004. But these decreases have been partly counterbalanced by much slighter decreases or even increases in import prices from other countries.<sup>48</sup>

In 2006, there is a change in the evolution of the average import prices, for the categories of products that have been liberalized in 2005, and for which quotas have been restored (as can be seen in the table below). After a decline in 2005, the average import prices from China increase sharply during the first eight months of the year 2006.

The phenomenon can be explained by the fact that in 2005 Chinese exporters have offered their customers other manufacturing bases in Asia, whereas these very customers had also been developing new sourcing origins to avoid being stuck with expected China's embargo.

As it was observed in the past, export quotas encourage producers to upgrade their production to compensate in value for volume limitations. If a producer is compelled to buy some quotas, his prices will also mechanically rise, while he also tries to upgrade his exports. Shortly, the

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<sup>46</sup> Liberalised Categories: categories 1, 2, 2A, 3, 3A, 4, 5, 6, 7, 8, 9, 12, 13, 14, 15, 16, 17, 20, 39, 22, 23, 26, 28, 29, 31, 35, 78, 83, 97, 115, 117, 118, 122, 136A, 156, 157, 159, 163

<sup>47</sup> The EU and China have agreed a deal to manage the growth of Chinese textile imports to the EU until 2008. The agreement, signed in Shanghai on 10 June 2005, allows for reasonable growth in Chinese imports to the EU between 2005 and 2007, ensuring a period of adjustment for EU textile industries. The agreement covers 10 of the 35 categories of Chinese imports liberalised on 1 January 2005: Cotton fabrics (category 2), t-shirts (4), pullovers (5), men's trousers (6), blouses (7), bed linen (20), dresses (26), brassieres (31), table, kitchen linen (39), flax yarn (115).

<sup>48</sup> See appendix 1) VI 6.2 the impact of liberalisation (2001-2005) table 3 for more information.

quota which have a cost (actual and speculative) stimulates the increase in prices of products, whereas liberalization stimulates the drop in prices.

#### EU 25 import prices evolutions (% euros)

LIBERALISED CATEGORIES		Total extra-EU imports			Imports from China		
		2004/2003	2005/2004	8m2006/2005	2004/2003	2005/2004	8m2006/2005
LIBERALISED CATEGORIES	CLOTHING CATEGORIES *	-4.2%	-6.5%	-1.1%	8.9%	-13.4%	5.0%
	TEXTILE CATEGORIES**	0.8%	-4.7%	3.6%	6.7%	-9.5%	3.0%
	TOTAL	-3.1%	-6.1%	-0.1%	8.5%	-12.6%	4.6%

\* Categories 8, 12, 13, 16, 17, 28, 29, 78, 83

\*\* Categories 1, 3, 9, 22, 23, 97

CATEGORIES WITH NEW QUOTAS		Total extra-EU imports			Imports from China		
		2004/2003	2005/2004	8m2006/2005	2004/2003	2005/2004	8m2006/2005
CATEGORIES WITH NEW QUOTAS	CLOTHING CATEGORIES WITH NEW QUOTAS*	-4.0%	-7.3%	4.3%	6.9%	-30.6%	76.2%
	TEXTILE CATEGORIES WITH NEW QUOTAS**	1.0%	-5.4%	3.9%	8.1%	-26.6%	39.2%
	TOTAL	-3.4%	-7.1%	4.2%	7.1%	-30.2%	72.2%

\* Categories 4, 5, 6, 7, 31

\*\* Categories 2, 20, 39, 115

Source IFM / Eurostat

#### EU 25 import prices evolutions (% euros)

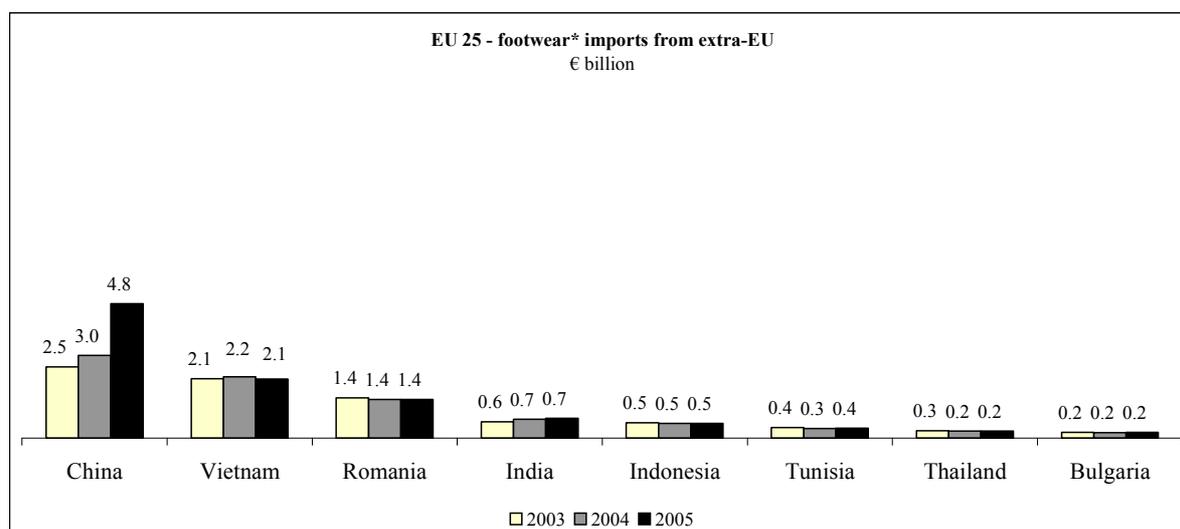
LIBERALISED CATEGORIES		EU 25 import prices from extra-EU			EU 25 imports prices from China		
		2004/2003	2005/2004	8m2006/2005	2004/2003	2005/2004	8m2006/2005
		1	4%	-8%	6%	N.A	N.A
3	-1%	0%	7%	21%	-6%	3%	
8	-5%	-2%	-7%	14%	-11%	11%	
9	-1%	-11%	-2%	12%	-32%	10%	
12	-4%	-11%	-6%	39%	-23%	2%	
13	-1%	-12%	2%	4%	-22%	2%	
16	12%	-10%	2%	30%	8%	14%	
17	2%	-7%	1%	13%	33%	5%	
22	3%	3%	3%	-9%	1%	-2%	
23	3%	2%	2%	N.A	N.A	N.A	
28	-8%	-1%	-3%	-7%	-11%	-13%	
29	-11%	-13%	8%	-20%	-23%	20%	
78	-14%	0%	-3%	-9%	-18%	8%	
83	1%	-14%	14%	11%	-34%	2%	
97	-11%	2%	1%	-11%	-1%	-9%	
CATEGORIES WITH NEW QUOTAS	2	2%	-3%	5%	6%	-12%	32%
	4	-1%	-8%	3%	13%	-38%	94%
	5	-4%	-5%	20%	14%	-31%	27%
	6	-5%	-10%	6%	-4%	-24%	71%
	7	-5%	-2%	-1%	14%	-30%	52%
	20	3%	-9%	4%	11%	-42%	47%
	26	-5%	-3%	N.A	-7%	-60%	N.A
	31	-10%	-8%	12%	-4%	-27%	47%
	39	-5%	-6%	1%	12%	-42%	50%
	115	-6%	-3%	-3%	-10%	-5%	5%

\* N.A : not available

\*\* Categories 26 (dresses) : data are not available due to problem with Spain figures

Source Eurostat

## ◆ FOOTWEAR

**Footwear imports**

Source IFM - Eurostat

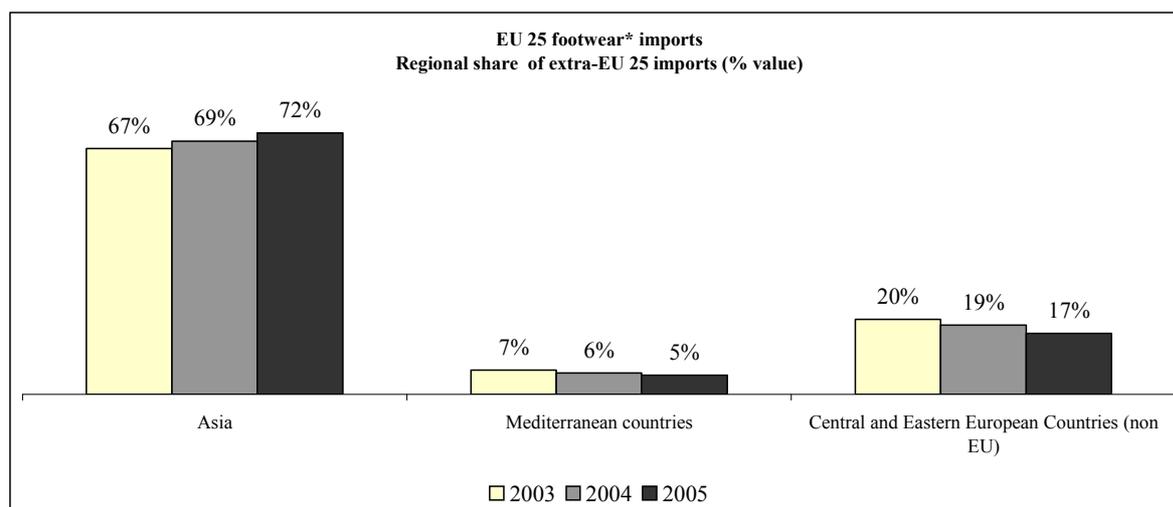
\* CN code 64

In the footwear sector, liberalization took place at the same time as for textile and clothing (1<sup>st</sup> January, 2005). Quotas had only restricted trade from China and were all lifted. In 2005, six categories of footwear imports were thus liberalized, mostly leather and high value textile shoes.

In 2005, the value of EU total imports<sup>49</sup> of footwear is 12.3 billion Euros, up 12.8% in value from 2004 and up 19.9% from 2003. China's market share in the EU in footwear equals 39.2% in 2005 (up from 27.2% in 2004) in value. EU footwear imports value from China amount to nearly 4.8 billion Euros in 2005, up 63% in value from 2004, while imports from other areas have gone down by 5.8%.

The graph below shows that the impact of China's upsurge has been primarily detrimental to other Asian suppliers but also, to a lesser extent to the competitive position of Mediterranean countries and Central and Eastern European Countries (non EU).

<sup>49</sup>In this section, EU is considered as a unique market. As such EU trade refers to extra-EU trade.



Source IFM - Eurostat

\* CN code 64

In 2005, the EU 25 imports from China for all six categories of footwear have considerably risen compared to 2004: in value, imports have been multiplied by 2.7, in quantity by 2. The six categories of products represented in 2005, 21.8% of EU 25 imports in value (up from 9.1% in 2004).

### Evolutions in import prices

EU 25 average imports prices from China of the six categories of footwear imports that have been liberalized, after the elimination of quotas on 1<sup>ST</sup> January 2005, have decreased in 2005 except for two categories of leather shoes (64 0351 and 64 0359). The magnitude of the fall is approximately -11.1% per pair.

(See Appendix 1) 6.2 Delocalisation trends or re-localisation of the production in a globalised environment table 4 for more information).

EU 25 - Extra EU 25 and China import prices evolutions and variations							
Origin	sector	unit	2003	2004	2005	2004/2003	2005/2004
extra-EU 25	textile	Euros per ton	3.4	3.3	3.4	-2.2%	2.6%
From China	textile	Euros per ton	4.3	4.1	4.1	-4.1%	-0.8%
extra-EU 25	apparel	Euros per ton	13.2	13.6	13.3	2.5%	-1.9%
From China		Euros per ton	9.5	10.4	10.5	8.9%	1.0%
extra-EU 25	footwear	Euros per pair	7.4	6.3	6.2	-14.7%	-1.2%
From China		Euros per pair	4.1	3.4	3.8	-15.8%	11.5%

Source IFM-Eurostat

When trying to measure the overall impact of those final two trade liberalizations on the total imports of the EU 25 (extra-EU imports), one can see that price evolutions have been less negative than the trend observed between 2003 and 2004 for textile and footwear, while they

have been slightly more for apparel imports. On the whole the liberalization process had been anticipated by almost all players (cf. 2004 price drops for footwear) and the upsurge of China's exports to the EU was not accompanied by a sudden and severe deterioration of world prices.

#### ◆ IMPACT ON EU'S INDUSTRIAL OUTPUT

The graph below shows that within the EU, when the liberalization process has occurred, textile, clothing and footwear industries have registered a drop in production in 2005 in comparison with 2004.

Volume index of production*	2004/2003	2005/2004
Textile	-4.4%	-4.8%
Clothing	-5.6%	-9.3%
Footwear	-12.3%	-11.6%

Source Eurostat \* data adjusted by working days

The EU 25 textile production in volume declined by 4.8% in 2005, which is slightly worse than the decrease observed in 2004 and the long term trend (- 2.6% a year between 1995 and 2005).

In the clothing sector, the EU 25 production decreased strongly in 2005 (-9.3%), a drop somewhat higher than the one recorded the previous year and also higher than the 1995-2005 overall trend which was a yearly decrease of 6.5%.

In the footwear sector, the EU 25 production registered very negative performances in 2004 and the situation went on deteriorating in 2005. Both figures are much higher than the 1995-2005 trend (-6.4% a year).

As a conclusion it may be observed that even though the direct impact of liberalization on EU's output was clearly negative, it did not reverse existing trends but caused an acceleration in the decrease of EU's output ranging from several months (apparel), to one or two years (respectively for textiles and footwear) in comparison with long term deterioration trends.

### 6.2.2 Delocalisation trends

The statistical analyses developed above as well as the in-depth analyses of the recent liberalization occurred in the textile, clothing and footwear sectors provide evidence that the world has become a global sourcing market. Companies' interviews strongly corroborate this point as much as materials, components, intermediates, subcontracting and final products are concerned. The considerations for geographical sourcing are less and less constrained by information (or lack of it) or sensitivities but determined by facts like availability of materials, prices, relative volumes, and lead times. The combination of these factors incites part of the

European companies to keep their sourcing within the Euromed zone. However for fibres (polyester, silk, cotton), commodity yarns, grey fabrics, tropical wood and intermediates, plastic components, Asia and especially China, India, Pakistan and Indonesia appear as the main sources of supply.

- **Delocalisation countries**

In the apparel sector sourcing from countries like Romania, Tunisia, Morocco, Turkey is used by EU companies as it allows to offer quick response to customers demand. Companies from the apparel sector have delocalised part of their activities in the Euromed zone and retail chains are largely sourcing products from these countries. Morocco has been the largest (53%) receiver of FDI from the EU since 2003, with a huge majority of industrial projects, be it in spinning, leather, shoe, lingerie, apparel and particularly denim and jeans manufacturing. Tunisia comes second with 28% of the FDI.

Sourcing and investments in Turkey are also very important for the EU textiles, apparel, leather and furniture industries. Turkey is an important supplier of fabrics and nonwovens and is also a place for investment for European companies like Hugo Boss or Ace Protection, that are willing to produce quality products at a good price. Like India Turkey is a significant producer of organic cotton that textile and apparel companies like Kuyichi or the French Ideo use in order to offer ethical finished products to their consumers.

Turkey represents a key asset for the apparel industry in the whole Euromed area, as it can provide both competitive and fashionable fabrics. Local subcontractors to European companies estimate that access to Turkish fabrics at preferential duties is a key asset for their activities. In terms of supply the Euromed zone is considered crucial by EU apparel companies, especially for supplies of denim from Turkey, Romania and Egypt as an emerging supplier.

Among the new 10 EU countries Lithuania and Poland are increasingly used by companies from the old Member States to source products (especially apparel). For instance, the Klasikine company has used the impact of the enlargement (e.g. lower cost of working capital) to move up from subcontractor to full manufacturer. Romania, given its future accession to the EU and availability of qualified labour force is also considered as a good location for sourcing and investment for the apparel, leather and furniture sectors.

Companies from the leather sector source their products in Europe for high quality leather as the quality of raw material in Europe is very good. Therefore, they depend on strict quality and health standards for cattle and slaughterhouses. Sourcing from other countries is often impeded by taxes and export prohibitions for raw hides, skins and wet blue. Many tanneries call for global elimination of export taxes and prohibitions in third countries or for the possibility to impose a tax on European hides and skins if taxes in other countries are not eliminated.

In the furniture sector destinations are also linked to raw material supplies: Poland, the Czech Republic, Slovenia, Slovakia and Romania for wood pieces, Hungary and increasingly Turkey for leather items, all countries where labour costs also allow significant gains in production

costs. However the fragmentation of the EU industry slows down the delocalisation process, mainly because companies lack middle and senior managers to carry it through. The proximity of key components like foam (seat industry) and wood panels is a significant criterion for the selection of the delocalisation place (some players consider that 300 km is the maximum economic distance to be respected).

The dynamics behind delocalisation have not changed; hence a further delocalisation of all industries studied is to be expected. Those leading dynamics are increasing real labour and energy costs, pressure on prices, limitations to upgrading, innovation and value chain control as well as specific constraints in terms of environment and material sourcing.

However, it is important to keep in mind that delocalisation can wear different forms of internationalisation of activities.

- **Delocalisation practices**

#### Trading finished goods

One may speak of two different kinds of trading. Pure trading means that goods designed and offered by a foreign manufacturer or supplier are purchased and included into the range of the client-company's collections and sales. This practice is quite limited to the very lowest price brackets of EU markets. Controlled trading is the term used for purchases made upon strict clients' specifications. Even in fairly cheap segments this is a widely used practice which combines cost advantages with the benefits of differentiation.

The situation is the same as with finished goods except that it concerns a much larger part of the industry even in the highest price brackets, particularly in the footwear, textile and furniture industries.

#### Subcontracting

Through this process, European firms only let assembly operations be done outside of their facilities. Subcontractors in general sell minutes of labour, but no value added related to design or component purchases.

One speaks of co-contracting when raw materials or components needed are sourced and paid for by the subcontractor from designated suppliers. As in the case of controlled trading the subcontractor eventually charges his client with a unit product price including labour and components.

There is not a big difference between co-contracting and controlled trading except that generally in the former materials' and components' suppliers are only recommended and not imposed on the contractor. As such, local (foreign) sourcing are more widely used, which means a lower value added for the European value chains, as the one generated by co-contracting.

## Physical delocalisation

In this option European firms simply transfer manufacturing facilities towards lower cost countries or other market areas. The process involves foreign direct investments (FDI) without or with local partners (joint ventures).

In first processed commodities semi-finished trading is becoming the dominant pattern and European companies are largely changing into importers/wholesalers. This system is widely used in the furniture industry for the sourcing of panels, metal parts or other components, mostly from Euromed lower cost manufacturers but also from Far East suppliers. In textiles this concerns the sourcing of fairly undiversified yarns or base-cloths, to be finished by European weavers, dyers and printers, and it also involves suppliers in the Euromed and the Far East.

For both industries the choice of Euromed suppliers is the result of an equation involving volumes, transportation costs and rapidity of delivery more than actual quality level.

Diversified companies with differentiated products tend to shift increasingly to subcontracting and controlled trading. This can be seen in the case of apparel items, where principals allocate their sourcing between low-cost, low-reactivity goods for their basic collections, and medium cost, reactive, fashionable items for their fashion appeal. The former are largely sourced in the Far East, the latter in closer places.

Delocalisation of production involving a physical transfer of activities is required or indicated when industrial control is essential for competitiveness. This can be for reasons of:

- cost control, often linked to economies of scale and process integration (e.g. in non wovens, weaving, tanning),
- quality, exclusivity and service (technical textiles, menswear, wool, leather, high end products across all segments),
- operational control in terms of flexibility, lead times and rotation of capital (non woven, hosiery, textile finishing, mono-component furniture).

In general the delocalisation of downstream industries tends to urge suppliers to follow them: this can be seen in the automotive sector where the delocalisation of car manufacturers prompts first and second tier suppliers (car seats, security belts, carpets) to follow because of JIT requirements. This logic is dominant in technical textiles, but also important in the furniture and apparel areas.

In general one may say that pure or controlled trading is the dominant logic with the Far East. Subcontracting is dominant with the non-Member States in the Euromed, followed by direct investment and at some distance controlled trading (only relevant for Egypt and Turkey). Direct investment is becoming dominant in the new Member States with subcontracting declining. Physical delocalisation is attractive in the enlarged union as it gives a relatively stable macro-economic environment, a known regulatory framework and all benefits of free flow of goods. Delocalisation is increasingly important in intermediate sectors, such as textiles and secondary processing. One may consider that the wave of delocalisation of assembling activities has already reached its peak. Delocalisation increasingly will involve greenfield investment instead of joint ventures and take-overs.

In the case of physical delocalisation, the ability to delocalise largely depends on the financial means available to the principal and his ability to redeploy assets. The weakening of the financial position of many firms as evidenced in the statistical analyses in the researched sectors limits the ability to cover restructuring costs (collective dismissal, writing off assets, losses on property, costs of sanitation of polluted lands, etc.). These costs have been discussed during the interviews: they can be estimated to start at around € 2 Million for assembly activities, € 10 Million for mechanical activities and over € 50 Million for large processing units involving energy and/or water intensive processes. The financial analysis in earlier pages points to the fact that many firms simply do not have the financial position to finance large scale delocalisation. They are hence constrained to constant incremental improvements in situ or to downsizing and subcontracting. The smaller delocalisations are less subject to one off investments and can be carried out step by step. Companies in sectors like carpets and non wovens have begun to consider that large scale delocalisations are linked to take place at the end of economic life time of existing European installations. In some cases of the sample, companies like Sellaton may have within few years to change location due to environmental or urbanisation issues. In such cases, the decision will be more likely to transfer production to a lower-cost Member State or outside of the EU rather than to a peripheral location in the country of origin. In all cases costs of labour, energy and availability of space and skilled workers are essential considerations, as well as a trade off in terms of benefits in redeployment of assets.

Timely delocalisation has allowed many European firms to sustain their future against decreasing profits in the EU, by investing in Euromed countries or in the new Member States. For instance, UCO sportswear has invested in production capacity in Romania for denim fabrics, where the labour costs are much lower than in Belgium. The objective is that the company in Belgium supplies only niche markets and small quantities and keeps the focus on R&D. Similarly in the leather sector, the Hulshof Company has opened a tannery in Romania to produce cheaper leather to satisfy the demand from some clients. Clever and timely delocalisation enables the reinvestment of profits achieved through delocalisation in marketing and hence strengthens the position in the value chain. If production is delocalised under pressure of prices and generates no new pulse in profitability it may only exacerbate competition on price.

Quite regrettably many companies of the sectors under review have too long postponed a controlled delocalisation and are no longer in a position to control their fate.

Overall delocalisation should be seen as a favourable trend in the framework of an enlarged Union as on the balance job losses in old Member States are compensated for by job creation in new Member States. The problem is more that the handicaps to delocalisation foster subcontracting and above all trading. The EU ongoing enlargement fosters delocalisation processes instead of trading developments. This is a positive phenomenon as trading directly results in a net erosion of production, employment and control in the value chain.