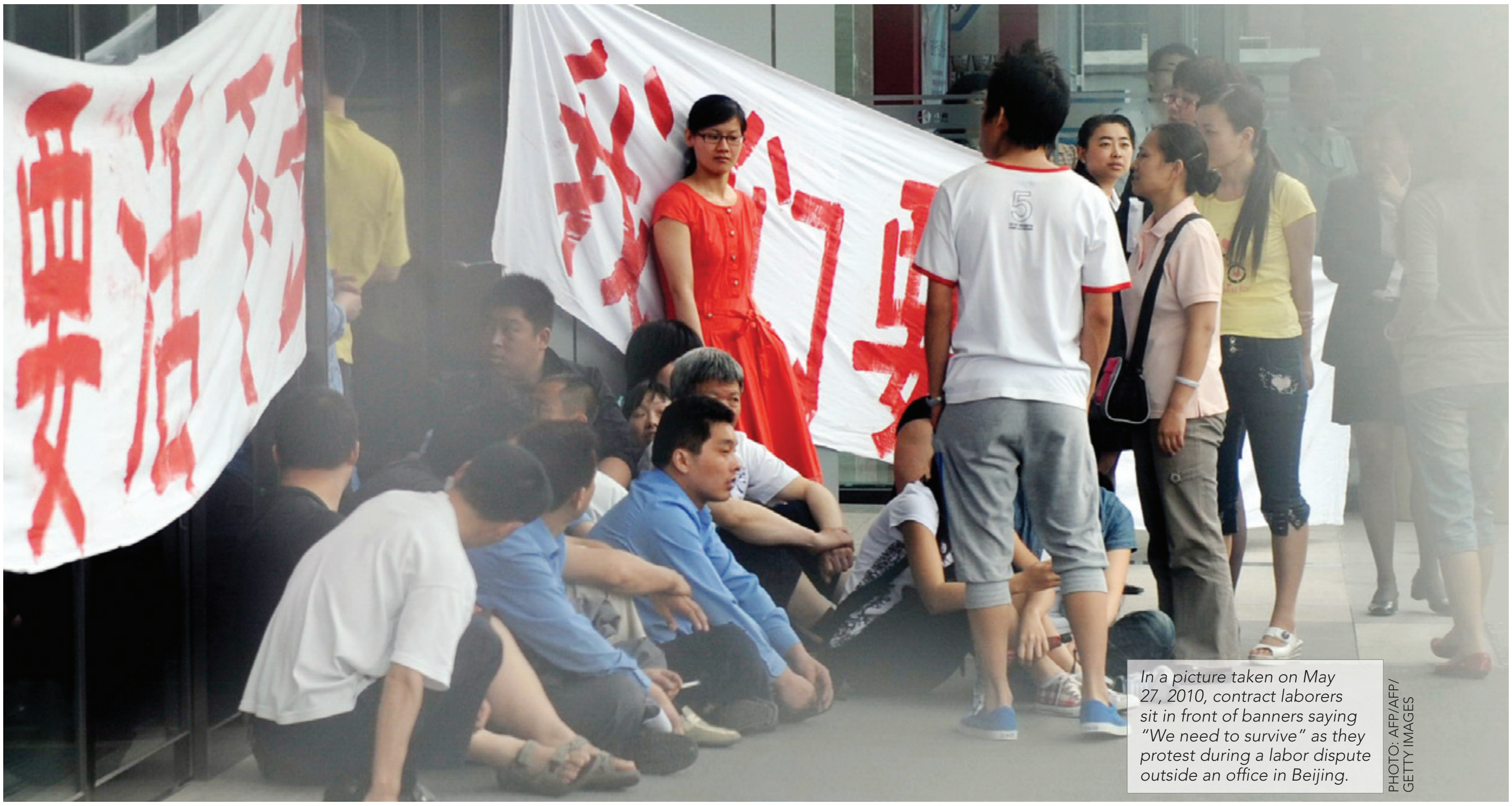

In a picture taken on May 27, 2010, contract laborers sit in front of banners saying "We need to survive" as they protest during a labor dispute outside an office in Beijing.

PHOTO: AFP/AFP/ GETTY IMAGES

Asia's Seismic Shift

With workers striking, wages rising, factory output decreasing and labor pools shrinking, the "world's workshop" is undergoing unprecedented change and growing pains. How will this affect you? Massively, and on a multitude of levels.

BY MICHELE BELL

As if you didn't have enough to worry about with the U.S. economy. Asia, the manufacturing hub for 95% of ad specialty products, is experiencing growing pains and stress fractures of astonishing proportions. The confluence of events happening now will not only affect this industry, but the all products imported into North America. No product categories are immune, and only those supplier companies that offer made-in-the-USA items are insulated from the issues.

So what's the problem? Take your pick: newly empowered workers in China demanding wage increases; factories without enough staff or production capabilities; cargo ships without container space; or surging cotton prices and yarn shortages. Without sounding too dramatic, economists having been throwing around a word lately to describe the extraordinary events in Asia: *seismic*.

"The U.S. ad specialty industry is especially affected by these events because we are an industry known to fulfill any request," says Bonni Shevin-Sandy, executive vice president of *Counselor* Top 40 supplier Dard. "Now we're faced with the issue that our orders may not be fulfilled in a certain time period, or even the possibility our request is being passed on. Just one simple unfulfilled request can shatter the image we've set for ourselves. China needs to take the appropriate measures in order to continue to be a market that's highly sought after."

The tectonic shift in China, specifically, is happening because for some time now, companies have come to rely on the country's low-cost labor to keep a steady flow of inexpensive products. That's no longer the case. Here, we dissect what, exactly, is happening, how it's affecting the industry and if and when it will get better.

"Chinese factory owners will say, 'We're going to give you two options: a price increase or a longer lead time.' And that's their nice way of saying 'no' to your order."

RANDY CHEN, IMPEX

Advantage, Employees

"This story starts with a recession," says Marty Lott, owner of *Counselor* Top 40 supplier SanMar. "And when a recession hits the way this one did, the common thing that's done by people who inventory product is to cut back on their ordering."

Over the last 18 months, with fewer orders coming in, many Chinese exporters cut capacity by reducing headcount, says Jonathan Isaacson, owner of *Counselor* Top 40 supplier Gemline. "Given the growth in the Chinese economy, many workers have been able to find jobs in other industries closer to their hometown, as opposed to being in the South or near some other areas in China where the factories are clustered."

Additionally, Isaacson points to the fact that the Chinese stimulus package, which focused on infrastructure, absorbed a lot of labor that otherwise would have gone to factory production. "Also, the Chinese government has implemented some tax policies which have made it attractive for workers to go back to the farm," he says.

Shevin-Sandy notes that the most pressing issue right now for the ad specialty industry is that China anticipates more than $1.5 trillion (U.S.) in merchandise exports in 2010. "This is an issue because China is sought out for our raw materials, imprinting, packaging, testing and shipments of orders," she says.

Employers are complaining about increasing costs and labor shortages, and laborers are being pickier about their wages, benefits, social status and working conditions. Younger workers are much more aware of how to use their rights to pursue higher wages and a better, healthier working environment.

Much of the change has come from shifts in the nation's population. Demographers expect the size of the working-age population to peak in the next five years or so, and then gradually decline. Experts say that labor-intensive sectors such as garment and toy manufacturing will be hit the worst by labor shortages.

Having a dwindling labor supply may seem odd for a country with 1.3 billion people. But, the trend's been discernable for a while, as the effects of an aging population and China's one-child policy kick in. In the past 10 years, the population of 20- to 39- year-olds – from which most manufacturing is drawn – has fallen 22%.

"A typical 18- or 20-year-old worker was born in 1990, well after the Chinese reforms," Isaacson says. "They matured over the last 10 years and have no memory of anything but a rapidly growing country. These workers now have many options that did not exist before. When I first went to China over 20 years ago, there were no McDonald's at which to work. Today, there are many, and that is seen as a relatively higher-status job than a factory job."

Striking, American-Style

Additionally, young workers in China won't tolerate the harsh working conditions their parents accepted. Many will work

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only for a few months before moving on to another factory or a new town. They are highly mobile and think nothing of moving across the country if they feel like it – a trait similar to young American workers.

Decades of prosperity – along with Beijing's $586 billion infrastructure-focused stimulus package unveiled in 2008 – have created more jobs in China's interior, leaving workers with more choices. Officials in the key export areas are taking no chances that things will turn around on their own. To attract workers, Guangdong labor authorities have urged companies to raise wages and provide better living and working conditions, as workers live at the factories.

"Most young people in China don't want to work in factories and want higher-paying jobs," says Trevor Gnesin, owner of Logomark, adding that a few weeks ago officials found illegal workers from Vietnam in some factories in Guangzhou. "The largest factory in China just gave their 500,000 workforce a minimum 30%-100% increase to avoid a strike. This will impact all factories over China."

Chinese workers have begun doing something unheard of – striking for higher wages and better work conditions and perks such as activities rooms in their dormatory housing. In an unprecedented move, workers at a Honda plant in southern China went on strike, forcing the automaker to give employees raises of 24%-32%. Add to that the horrifying spate of suicides among factory workers in China and you have a workforce speaking out for the first time.

Big manufacturers are moving to raise salaries because they're desperate to attract new workers at a time when many coastal factory cities are struggling with labor shortages. Foxconn Technology, the factory for electronics giants such as Apple and Dell, says its rate of turnover at its two Shenzhen campuses, which employ over 400,000 people, is about 5% a month, meaning that as many as 20,000 workers a month are leaving and need to be replaced. Economists say increased salaries will ripple through the global marketplace, driving up prices of everything from T-shirts and sneakers to computer servers and smartphones.

The Inventory Logjam

"In Asia right now, it's a seller's market," says David Nicholson, president of *Counselor* Top 40 supplier Polyconcept North America. "We're being put in the position to accept price increases or factories won't take our orders. Of course it's much harder for smaller suppliers without the leverage of being a Top 40 company."

Nicholson says pricing, while an issue, isn't the worst of it this time – it's inventory. "The vast majority of suppliers are going through their worst inventory issues ever," he says. "This comes at a time when many are starting to return to profitability. And, it doesn't look like it's going to get better soon, especially with prices going up."

To be sure, during the economic crisis that started in 2008, many suppliers brought down inventories to be in line with demand. Now, demand has returned, and many suppliers are trying to get back into a stock level commensurate with the demand they're seeing today, Isaacson says. "For suppliers with a lot of lines, but without the ability to concentrate orders to vendors, it's now harder to get the attention of the factory," he says.

And while it's unlikely that a supplier would be told flat-out that his order won't get filled, Randy Chen, owner of Impex – a New Jersey-based company that imports, sources and warehouses for ad specialty suppliers – cautions that factory owners in China are using other tactics. "Nobody's going to flat-out tell you that they're not going to take your order," Chen says. "More likely, they'll say, 'We're going to give you two options: a price increase or a longer lead time.' And that's their nice way of saying 'no' to your order."

Then there's the quality control quandary. "The most pressing issue we're dealing with is the manufacturers' increased production times, meaning standard production times are being pushed out," says Jim Hagan, president/CEO of *Counselor* Top 40 supplier Sweda LLC Co. "It's not easy to move production to other countries, due to the fact that we have a stringent qualification process to ensure we are partnered with manufacturers that support our quality, material and social compliance expectations. Not to mention if you're able to move production, there's a long lead time in developing molds, pre-production samples, and quality control checks and balances."

Gnesin agrees. "Getting compliant product is getting harder, as the factories in China would rather deal with easier orders," he says. "This is becoming much more costly, and we are paying a huge premium to make sure our goods stay compliant."

Slow Boats From China

Let's just assume you were working with a factory that had happy and plentiful workers, and enough time to fill every one of your orders. Here's the next hurdle that stops the process dead in its tracks: There aren't enough container ships – or containers, for that matter – to accommodate the revved-up orders waiting to be shipped out of China's ports.

"Everybody's business was so bad in '08 and '09 that they cut down on their ordering, and the freightlines cut their capacity," Chen says. "So everybody's cutting containers and freightliners when all of a sudden business picked up unexpectedly. Everyone got caught with their pants down. Also, the freight companies are almost like a quasi-cartel. They can set their own rates."

Chen says that instead of the normal 70 to 80 days for a shipment from China to reach a port in North America, now it can take upwards of 120 days. "How I'm dealing with that is when I place orders, I'm doubling everything – and expecting a longer lead time," he says. "Back in March and April we told our customers to forecast six months out in advance. This has caused supply chain problem in the industry. Everybody's running out of inventory and nobody has large quantities."

Paul Tsui, Chairman of the Hong Kong Association of Freight Forwarding and Logistics (HAFFA), says most sailings to the U.S. are hugely overbooked, resulting in the constant rollover of consignments.

"There are big-time container shortages, so we trade containers with some of our partners," Lott says. "If I've got one this week that I don't need I'll loan it to somebody, and then I'll look for a favor back next week or the week after, because I have to keep the stuff going."

To put it into perspective, consider this: Richard Owens, Asia Pacific CEO for DHL's global customer solutions unit, told *IFW* that even "a company with DHL's clout" was being forced to fight for space. "Space is going to the highest bidder," he said. "We're among the biggest in the business, so we have the leverage to get capacity. But we're finding it difficult to get all the capacity we need."

The Cotton Conundrum

Lest you think that China's issues are only affecting the hard-goods segment of the industry, the apparel market has its own special set of problems right now.

Garry Hurvitz, the president/CEO of *Counselor* Top 40 supplier Ash City Worldwide, took the unusual step of sending out a letter to the industry, detailing the problems in Asia will affect the industry.

"The cost of raw materials has been impacted with the softening of the U.S. dollar as it has declined against other currencies," Hurvitz says. "Specifically impacting our cotton-based apparel is the worldwide shortage of this product, and with yarns being more difficult to obtain, we're seeing production delays and material cost increases everywhere."

Hurvitz points to the labor issues in Asia, ranging from a 50% increase in wage rates mandated by Bangladesh, to workplace labor shortages in China that originated from recessionary pressures of last year. "Severe production cutbacks in the last two years have shifted workers in Asia from the apparel production plants to government-funded infrastructure projects and domestic production," he says. "The result of this labor displacement is a significant reduction in Asia's production capacity as suppliers look elsewhere for replacement factories. As the economy improves, this overall lower supply of production capacity combined with a greater demand for products has lead to higher prices and longer lead times."

In a Nutshell…

Do you have clients who simply don't understand why inventory seems to be perpetually on back order and prices are rising? Here's a tutorial for you to give them as to where the issues lie:

- **A lack of workers.** A survey by the Chinese government showed a 35% increase in vacancies posted by employers in the first quarter of 2010, but only an 8% increase in the number of applicants for those vacancies. The result is the tightest labor market in recent years.
- **An increase in wages.** Economists say increased salaries for factory workers will ripple through the global marketplace, driving up prices of everything from T-shirts and sneakers to computer servers and smartphones.
- **Fewer factories.** When factories in Asia closed as the worldwide recession hit, your clients might not have noticed because their orders dwindled, as well. But now that ad specialty sales are picking up, there simply aren't enough factories in China to fill the orders.
- **A ship shortage.** Once again, when the global economy went south, freightliners and the containers they carry were dry-docked. Now, when demand is picking up, there just aren't enough of them ready to set sail. Rather than taking a week, which is the norm, to get space for your container to be put on ship from Asia to North America, it's now taking upwards of three.
- **A dearth of cotton.** Specifically impacting cotton-based apparel is the worldwide shortage of this product, and with yarns being more difficult to obtain, there are production delays and material cost increases everywhere. Add to that the labor issues in Asia, ranging from a 50% increase in wage rates mandated by Bangladesh, to workplace labor shortages in China that originated from recessionary pressures of last year.

"Getting compliant product is getting harder, as the factories in China would rather deal with easier orders."

TREVOR GNESIN, LOGOMARK

Hurvitz says that with vendors having greater negotiating power, there are new demands for larger garment production runs spread over the entire year before orders are accepted. Delays in getting garments to the marketplace will result from this change.

"Even when final products have been produced, there are further issues, such as the political instability in several Asian countries delaying shipments in getting from the factories to the ports," Hurvitz maintains, then adds this comment on the situation overall: "It will get a lot worse before it gets better."

Lott says that SanMar orders from 100 different factories in 20 to 22 countries. "It's very broad-based – China to Africa to the Caribbean basin, sort of everywhere in between."

He notes that through March, April and May of last year, receivables for 2010 were on time. "Not early like they had been, but on time," Lott says. "By the time we got to placing orders from January to March this year for a June order, we were told we'd get it in July, and July's order in August, and, well, August's order we're not so sure about."

And to be clear, it's the factories that manufacture inexpensive items that are most hard-hit from labor shortages and production backlogs in China. "It's not just ad specialties, because companies like Walmart are getting hit, as well," Lott says. "So you have a labor shortage for a low-end product. You have a severe cotton shortage because, one, demand went up worldwide and there were quite a few countries that had bad cotton crops last year. So Pakistan, for example, ran out of cotton about 60 days ago, which means that their spinning mills had nothing to spin because they have a law that says they can't import cotton. So you've got cotton shortages around the world; cotton shortages created yarn shortages; yarn prices started sky rocketing because demand was high worldwide. People are stealing each other's yarn at the factory, at the spinning level."

Lott reports that as of over two months ago, the apparel segment of the industry has been bombarded by price increases. "And, we just went to print with our catalog, so that was the last time we could adjust any prices for the next year," he says.

But, what happens to SanMar and other suppliers if the yuan floats and prices rise? It's a genuine concern. "If we have to reprint in the middle of the year, we have to reprint," Lott says. "The world is very squirrelly right now; not nearly as projectable as it used to be."

Still, Lott believes that inroads are being made. "We only have half the back orders that we had in January, but we still have more than we'd like to have," he says. "We've been bringing it up about a half percent a week all year long."

The Only Game in Town (for Now)

Of course the logical question becomes, if China is such a hotbed of a hot mess, why can't suppliers send their orders to factories in other countries? The short answer is that no country right now has the well-oiled machine of production that China does – all evidence to the contrary.

"China is a market that made its mark in manufacturing, while India has made its mark in technology and services," Shevin-Sandy says. "Since China has been well-known for generations in manufacturing, distributors trust China and know its capabilities and what the finished products look like. Distributors need to be comfortable that their orders are in good hands, and they have that despite the issues there right now. Other countries such as Mexico and Vietnam are not as well-known for their production capabilities and don't carry the same reputation."

Even before these problems, manufacturers and buyers of low-cost products were actively seeking alternative locations such as Vietnam, Cambodia and Indonesia, where production of sports shoes has grown 25% since 2007.

What's a Distributor to Do?

Constant among all the industry suppliers we talked to, here's the advice they shared for getting distributors their orders in the quickest, most painless way possible:

1 **Remind distributors to stay in regular contact** with you so they're aware of inventory fluctuations. Assuming that items are in stock and can be shipped in 24 hours isn't going to cut it anymore.

2 **Suggest that distributors order early,** and – if they know their client places repeat orders – order more than they need. Here's where you can step up as the relationship builder and offer to hold the extra stock until they need it.

3 **Give your distributors product options.** If their clients are dying for a certain style of bag, suggest two similar bags as a backup plan in case the first is in a holding pattern on a production line in a Chinese factory.

4 **If the client is a good one** and the item they ordered just isn't going to make their in-hand date, consider offering a similar, though slightly more pricey, item to save the order – and more importantly, the relationship. Don't do this often, but do it when necessary.

Pietra Rivoli, a professor of international business at Georgetown University and the author of *The Travels of a T-Shirt in the Global Economy*, says the effects of rising labor costs will vary by industry, with lower-value goods like garments being forced to move to Western China or even to Vietnam and Bangladesh. It should be noted, though, that these locations have yet to develop Southern China's streamlined manufacturing infrastructure.

For apparel, Nicholson says, there are options outside of China. "This is largely due to the fact that apparel doesn't require advanced manufacturing or a wide range of materials," he says. "But for most hard-goods categories, very few countries have developed the supply and manufacturing infrastructure that China has. It now produces almost all of the raw materials used in its products, it has better manufacturing equipment, and it has a well-developed infrastructure for business. So, while certain countries can offer low-cost labor to match China, none have the other capabilities that China offers."

"Pakistan ran out of cotton two months ago. People are stealing each other's yarn at the factory level."

MARTY LOTT, SANMAR

Chen points out that right now the factories on the shoreline of China are all producing high-tech goods. "The majority of Chinese production is still along the shoreline, but they keep inching inward. What's happening is that China is building up the infrastructure interior and having all the big companies go in and set up their shops. Remember, it costs less to have a factory in the center of China, away from the shorelines, because you'll have a larger worker pool and won't have to pay the higher wages. China's still going to be the cheap place to buy from. Where else are you going to go?"

Jeff Lederer, executive vice president of *Counselor* Top 40 supplier Prime Resources Corp., concurs. "Most products in the world are made in China," he says. "I believe that Walmart alone represents 4% of all Chinese exports. If they could buy elsewhere, they would."

Fallout for the North American Industry

So, how bad will it get? Experts agree that more ships and containers will become available in the upcoming months, and Nicholson believes that the capacity and lead-time issues will eventually resolve themselves and supply-demand will reach an equilibrium.

"I expect that we'll be back to a more predictable buying cycle by the end of this year," he says. "However, I fear that the inflation pressures – particularly due to the structural changes within China affecting the currency and labor – will be long-term."

Nicholson maintains that the effects of inflation are both direct and indirect on the ad specialty industry. "The obvious impact will be higher prices – and this will be largely unavoidable for any importer," he says. "The indirect implications pose other challenges. For example, during periods of inflation, factories and buyers look for ways to mitigate the cost-inflation factors by changing materials, moving production to new regions and altering manufacturing processes. Whether intentional or not, these tactics can lead to increased instances of quality and safety compliance issues."

He acknowledges that another significant effect will be far greater margin pressure on suppliers and distributors. "With an uncertain U.S. economy, it will be difficult for many suppliers and distributors to pass along these increases – or at least there will be this perception," Nicholson says. "On the inflation issue, I expect that suppliers will see increases in the 5%-10% range this year with a minimum 5% increase again in 2011."

Lederer believes that while the confluence of events in Asia will continue on and off for the next 36 months, there will be some inevitable price increases for 2011. "Also, some suppliers who can afford it will have higher inventory levels, like Prime does, to anticipate inevitable delays and cost increases on future orders," he says.

And, the wildcard in the game? The floating yuan. "Because it's so difficult for anyone to predict what will happen with the Chinese currency, it means that factories and importers will have to assume the worst – continued appreciation," Nicholson says. "That means factory owners will be less likely to increase their factory capacities, but will have to increase prices as a hedge. Quite simply, it's the last thing we wanted to see, given all of the other challenges in China right now."

What Your Clients Can Do

"We've all been spoiled," Lott says candidly. "I'm as guilty as anyone of engaging in the trend of taking the order today and shipping it today," he says. "That's going to be tougher to do. Distributors are used to not checking with us, because they assume we'll all always have the items they need. Well, now, we may not always have it."

Lederer maintains that at the end of the day, suppliers need to make a profit. "If costs go up, then it should not be the supplier that bears all of that increase," he says. "And, distributors should not participate in helping to drive prices lower by comparing a premier supplier and their products to a company that does not have the infrastructure and quality procedures in place – thus creating more of a price war. We should all be selling on strength."

Lott's advice to his clients is similar to that of other suppliers: "They should check before they sell," he says. "They need to plan ahead with what they're going to order, always have a back-up product ready to go, and be in close contact with their supplier regarding the status of the supplier's inventory."

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