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China's footwear industry facing a number of challenges

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Report Highlights:

This report is an overview of the challenges Fujian Province and other large tannery production bases in China are facing. There are about 1,000 tanneries with annual production value at \$2.38 billion in Fujian. In 2011, Fujian Province alone imported \$176 million-worth in U.S. hides. It is estimated that 70 to 80 percent of Fujian's imported hides were supplied by the United States. Tighter inspection procedures and higher prices have been a burden for local importers. Finished leather is mainly supplied to footwear manufacturers within Fujian and Guangdong Province. Xinye, Fengan and Jinxin are the three leading tanners of Fujian. This report was developed from marketing intelligence collected after many meetings and interviews with industry players, officials, and trade leaders throughout the manufacturing chain.

General Information:

Overview of China's footwear industry



ATO/GZ Director and USHSLA Delegation visited a Fujian tanner

According to the Year Book published by APICCAPS, Portuguese Footwear, Components and Leather Goods Manufacturers' Association, in 2011 China remained as the largest producer of shoes (12.8 billion pairs) with 60.5 percent of the world's production, followed by India (2.2 billion pair) and Brazil (819 million pairs). At the same time, China consumed the largest portion of these shoes at 15.9 percent and the United States followed at 12.9 percent. 73.1 percent of shoes produced in China were exported.

The average export price of China's shoes was \$3.87, much lower than \$12.6 from India, \$15.65 from Indonesia, and \$16.2 from Vietnam. In 2011, China's leather shoes exports totaled 891 million pairs.

There are about 1,000 tanneries with annual production value at \$2.38 billion in Fujian. Xinye, Fengan and Jinxin are the three largest Fujian tanners. According to the China customs data, in 2012, Fujian Province imported \$176 million of U.S. hides. Finished leather hides were mainly supplied to footwear manufacturers within Fujian and Guangdong Province. About 70 to 80 percent of Fujian's imported hides were of U.S. origin. The first publically listed tanner in Mainland China was Xinye Leather.

Environmental Policies: In China, official government environmental impact statistics are only made available to tanners with production values over \$20 million. There are 799 tanners who are in this select group, among which, only 46 passed the government's environmental evaluation requirements. Since 2010, China has banned the building of new tanneries and banned state-owned banks from financing new tannery operations. The industry expects stricter environmental policies in the future. In Fujian, there are only three tanneries who have obtained official approval for managing waste water treatment: Xinye, Fengan and Jinxing. With no new tanners in Jinjiang (Fujian tannery base) as a result of a ban on approvals, many smaller scale tanners that have survived several periods of consolidation were setting up new plants in Zhangpu (170 km from Jinjiang) before the November shut-down deadline was implement. Effective November 2012, no waste water containing ammonia and nitrogen will be allowed to be released in Jinjiang and the COD (chemical oxygen demand) level in waste water

is now being strictly monitored by the local government who is coming under pressure from national authorities. Other production bases have also been forced to implement similar policies. For example, Jiangsu Province will only hand out permits to factories with production volumes exceeding 800,000 pieces of hides. In Wenzhou, restrictions on waste water treatment have tightened up as well. Any newly built plants have to be equipped with a capacity for processing over 500,000 tons of waste water. The Chengdu municipal government banned the establishment of tanneries within its confines. Additionally, some of the smaller tanners used to sell gelatin shavings to processors and this was an additional source of revenue. However due to rampant food safety scandals in China, tanners are not allowed to do so anymore. These tanners are grumbling about losing this income stream.

In Fujian Province's Kemu Village there are about 63 tanners scattered among residential buildings. The local government is encouraging them to consolidate into three to five large enterprises. What's more, China is going to increase the cost of industrial use water to \$2.86 (18 RMB) per ton. It is common that Fujian tanneries partnered up with their Guangdong counterparts, because of the stringent environmental policy, and sent raw hides to be processed in Guangdong before they enter the finishing process in Fujian. It remains unclear whether this specialization in trade trend will continue.

National industry analysts are wondering whether China's tanners are going to migrate to other parts of the country or even outside of China. However, industry players say it is nearly impossible to do so, as most of the fixed investment costs are on tied to the land. This move would be prohibitively costly and from a logistical point of view also challenging as there is heavy equipment that would need to be dismantled and re-assembled. A handful of tanners did manage to move, although the damaged drums and equipment replacement costs cut right into their profitability at a time when high hides costs have been forcing the sector to operate on razor sharp margins. In the past five years, the trend has been to set up new production bases in Vietnam, Indonesia, the Philippines, and Thailand.

Diversification efforts have proven successful for the large tanners, although industry leaders mentioned that China still remains their main production focus because the value and quality of production is much higher for good produced in China than in Southeast Asia.

Weak demand

China's largest finished leather markets are located in Wenzhou, Guangzhou, Quanzhou, and Chengdu. According to trade contacts in each of these markets, in 2012, sales dropped dramatically overnight and by the end of the year averaged out to about 20-30 percent. In 2011, many of the same tanners used to produce around 1,500 to 2,000 pieces of hides per month. Currently, they reduced the number to 1,000 pieces, but still expressed having a difficult time to selling their merchandise.

During interviews with Fujian tanners, the most frequently raised question was when U.S. hides prices

would decline. According to Fujian tanners and high hide prices worldwide alone is the single largest contributor to this consolidation period in the industry. Large production plants grew in size and capacity, while the smaller ones were forced to shut down.

Although some companies reported growing sales, China's shoe manufacturing industry reduced production volumes by 7 percent in the first half of 2012. Tanners indicated that prices of finished hides were sold at \$3.3 (21 to 22yuan) per feet and in the second half of 2012 (September-November), there were 25 to 35 percent decreases in prices due to weaker demand for finished leather. Tanners are not optimistic about the remaining 2012, as stocks for shoes and bags are higher than ever and depreciating according to retail analysts. Analysts also indicate that discounted merchandise will hurt the profitability of shoe wholesalers and the retail sector. And, although new e-commerce and online retail channels for leather apparel and footwear have emerged in Mainland China in recent years, expectations on demand range from fickle to weak. Consequently, cash flows are drying up for tanners and forcing this sector to adopt more conservative production practices. Many of them expanded production lines only a few years ago, but are now losing factories because of their heavy reliance in the export market.

Fujian tanners claim the leather market is saturated. Demand from shoe manufacturers is diminishing, but supplies from leather factories are abundant with price speculation disadvantaging tanners. Many tanners claim to be under an exorbitant amount of pressure losing money whether they produce or not and ultimately blame high U.S. hides prices for these shortcomings. The truth is that (1) strict environmental protection requirements; (2) higher labor costs; (3) higher production materials such as chemicals are growing and have outpaced the growth of the business. What some tanners failed to see five years ago during the boom years was that if they had invested heavier in the development of the domestic market instead of focusing on exporting all of their production to the West, they simply would not find themselves in this mess.

Demand in Guangdong Province declined as its production relies heavily on exports. Guangdong factories supply to Nike, Addidas and OEM for many large U.S. and European brands, therefore, business was adversely impacted by the global economic downturn. On the other hand, Fujian Province businesses did not have strong ties with foreign brands five to ten years ago. So many local shoes manufacturers for example invested significantly in the domestic market in the past ten years.

Now, these Fujian shoe brands are well known among Chinese consumers, such as Tebu, Anta, and Peak.

Local tanners reported that hides with medium price tags did not sell well. On the other hand, the high priced hides (such as dairy hides) enjoyed a good market, while the lowest priced hides also moved rapidly. This purchasing trend is indicative of China's production moving up the value chain.

Cargill bagging complaints: Throughout meetings with Fujian tanners, the greatest concern centered

on Cargill's new bagging system. Fujian tanners thought it was a new system that Cargill designed to transfer costs to buyers. Raw hides on pallets were much easier to handle, and now the new bagging system has created difficulties for buyers. For example:

1. Temperature within the bag is higher than the pallets affecting quality
2. Difficult to handle. Bags take up larger space because they cannot be piled up
3. Loading is time consuming as it used to take 10 minutes and now it takes around 30 minutes
4. Difficult to count the number of hides. Inventory management has become a concern for buyers who cannot readily distinguish the number of hides inside a bag. Additionally, traders added that Cargill does not accept counts if the bag's seal is broken
5. Difficult to transport to alternate sites

Concerns over U.S. hides trading



USHSLA Delegation examining U.S. hides in Fujian inside a large tannery

DISCLAIMER: ATO Guangzhou interviewed over 20 traders and compiled a list of issues they cited in these interviews. This portion of the report does not reflect the views of ATO Guangzhou, but is a list of complaints the trade expressed and should be used by U.S. exporters and the industry as point of reference from their buyers in the world's largest overseas market for U.S. hides.

Hide prices - Traders wondered whether there was a larger broker who controlled U.S. hides prices.

Importers are still purchasing U.S. hides, because they said the United States is the only large and consistent supplier, have acceptable quality and with reliable delivery time. In terms of overall quality, tanners indicated they preferred German hides. Since the sales of finished hides have been weak for most of 2012, tanners are hesitating to schedule a large production in 2013. As a result, many of them tried not to source large quantities of U.S. hides unless they are certain they will have a sizable order.

Lower quality U.S. hides – The senior management of Xinye Leather said their production managers complained about the declining quality of U.S. hides in the past three years. (Xinye Leather imports about 300 to 350 containers per month). They asked whether the drop in quality was due to the U.S. banning the use of chemical sprays on animal skins, as it increases chances of defects on skin. They

also asked whether the U.S. Department of Agriculture would allow using some chemical sprays to protect animal skin quality. Other tanners said the quality of hides decreased globally, and not just in the United States. They added the situation was the same in Holland and Germany and asked if climate change had anything to do with this. As a result of a strong Australian dollar, in 2011 and 2012 tanners sourced more hides from the United States than in previous years.

The following are a series of observations gathered by Fujian industry leaders ATO Guangzhou interviewed for this report:

Mixing Mexican hides - When the United States could not meet orders is it possible for some U.S. exporters purchase from Mexico and label as U.S. hides?

Mixing different grades and types of hides – Tanners were unhappy with mixing light weight hides with heavy weight hides or mixing heifers with steers. They want to look for reliable exporters who would not mix hides of different grades or quality. Chinese buyers said they wanted to do business according to contracts. Grade 3 hides were mixed in normal products and this was a deal breaker for one tanner who now purchases hides exclusively from Brazil.

Short of pieces - Normally it should be 630 pieces per container, but it is common for buyers to receive three to five pieces less. In one rare occasion, 40 pieces were missing from a shipment. According to Fujian importers, the U.S. exporters said it was the local buyer's problem.

Lower weights - In contracts, the weight ranges between 60 to 62 pounds, but buyers only received products at 60 pounds. Shipments always contain excessive amount of water, with about 2 to 3 percent of total contents being water.

Contract conditions – a 10 percent difference in hide counts are tolerable for a 630-piece container. When the overall market is weak, sellers would ship up to 700 pieces in a container. When the price of hides is high, buyers would receive only 575 pieces. A container's weight is allowed to have 5 percent difference, but buyers seldom received more hides.

Credibility - Some exporters do not honor sales contracts that were made while hides were at a lower price. They never ship the rest of the contract agreed upon numbers to their buyers. One importer said they had an agreement with one U.S. company with a low price in 2009, but the remaining 60 containers never arrived.

No mechanism to for resolving dispute: According to sales contracts, sellers should visit buyers within 10 days after receiving complaints. It was common that the exporters did not show up. After Chinese buyers called U.S. exporters to complain about product quality, they were asked not to touch the container until an U.S. representative arrived onsite, which held up the entire production process. When there is a disagreement on weight, Fujian buyers were asked to use certification agents in Hong Kong to weigh all containers.

Conclusions: The Fujian tannery industry is a major buyer of U.S. hides, the largest in fact. Tanners have been importing from the United States for years and will continue to do so. However, it is apparent that communication and mutual understanding could be strengthened through more regular meetings, dialogues, and visits from both sides. Fujian tanneries and U.S. exporters are undoubtedly inextricable partners. Post suggests U.S. industry prepare presentations (electronic or in person) to address many of the concerns regarding defects or scratches on U.S. hides. U.S. Hides, Skins and Leather Association (USHSLA) representatives explained to post that the defects were not due to insect bites or as a result of global climate change, but due to uncontrollable circumstances during the cattle raising process. During USHSLA's recent visit to Fujian, local tanners understood that U.S. anti-trust law, bans U.S. companies from discussing prices publically. With funding support, ATO Guangzhou can sustain efforts to bring the two sides to closer together since USHSLA has no in-country representative. It is important the U.S. hides industry partners with local tanners to plan marketing to China's massive domestic consumer market that is beginning to emerge.