Casual Living

The China equation

Increased production costs translate to harsh reality for retailers, consumers

Jesse Burkhart -- Casual Living, 8/11/2011 6:36:20 AM

NAPOLEON BONAPARTE SAW THIS COMING FROM two centuries away. Even as he reigned over much of Europe during the early 19th century, he cautioned against disturbing the slumbering giant: *"Let China sleep, for when she wakes, she will shake the world."*

Indeed, China got her beauty rest - 140 years' worth between 1839 and 1979 in which the country was beset by wars, revolution and political upheaval - but today, she is a force, changing the economic global landscape by essentially serving as the world's factory.

"I think China is the new economic giant on the world stage," said Joe Logan, executive director of the International Casual Furnishings Association. "And with the growth projected for China, they are a power and will very much continue in that role. She is making her presence felt."

The casual industry is feeling that presence, as many U.S. outdoor furniture manufacturers are doing business with China and engaging in partnerships that have - and still are - proving mutually beneficial. The work that the manufacturers provide is fostering the growth of China's developing middle class, while Chinese factories churn out product more cheaply and efficiently than the manufacturers could get elsewhere.

But several economic variables are disrupting those partnerships. American manufacturers now must tweak business models to adjust for increasing labor wages, rising costs of raw materials and an unfavorable exchange rate, among other hurdles. The collective impact is significant and undulates throughout the industry. As the manufacturer incurs greater production expenses, those costs, inevitably, are passed down to the retailer, and ultimately, the consumer.

The West goes East

China's labor dilemma is one of the most critical factors influencing the way casual furniture manufacturers do business in the country. What with its burgeoning middle class clamoring for higher wages and ironic shortage of manpower in a land boasting 1.4 billion people, the multilayered nature of the issue is perplexing.

Essentially, the principle takeaway is that the labor dilemma is causing manufacturers to incur greater costs in producing their wares, which translates to higher price points. And it all starts with the ambitious Chinese laborer, who now requires more compensation for her time.

"Labor in China is going to go up 20% a year for the next five years, and this is a simple fact," said Bob

Gaylord, Treasure Garden allocates a portion of its 3,500 employees to its Activa facility in Ningbo, depicted in this aerial rendering.president, Agio.

"There are really two countries here: You've got 400-500 million living on the coast that's emerging as a middle class, and on the other hand, there's another billion that is playing catch-up, and that's what the [Chinese] central government is trying to take care of. And they'll do that by forcing people like us to pay more and more for labor."

"The [Chinese] people - with communication being so fast with cell phones, Facebook, you name it - they know what's going on, and they want a fair wage," said Jan Trinkley, executive VP, Gensun Casual. "And so labor rates have gone up significantly over the last couple of years in China. You could say anywhere between 20-30%. And that doesn't include the benefits that they also want."

Not only does this aspiring Chinese middle class want fatter paychecks, they want *faster* paychecks as well. They don't like logging 60 hours per week on the assembly line, and they don't like moving 1,000 miles away from home to do so, only returning for the Chinese New Year. And at that, there's no guarantee that they'll come back to the factory. In essence, the Chinese middle class wants what their Western counterparts have in the way of labor rights. This is what's stimulating the demand for higher wages.

"[The Chinese] are becoming like the United States," said Harold Hudson, VP of sales and marketing for Summer Classics. "There's a cost for that, and that cost has to be passed on to somebody."

The Gen Y Chinese especially pose challenges to manufacturers seeking labor. The younger people in China want to veer from the trail their forebears blazed in the furniture and cut-and-sew factories of not so long ago. In other words, they want to make more money.

"A lot of the young people don't want to work that long. They don't want to work that hard," said Oliver Ma,

president Gloster, a 51-year-old company, knows its way around Asia, having transferred its overseas manufacturing there from West Africa in the 1970s.and CEO, Treasure Garden. "China is a big country, and they still have a lot of people that need jobs. But even so, the labor isn't easy to get anymore." And even if there wasn't a labor dilemma, China's desire to uproot from its manufacturing past must be considered. Just as the cut-and-sew operation left China for lesser developed countries, furniture production will migrate to a region where the workers want it.

"China is the factory to the world," said Steve Lowsky, executive VP, Pride Family Brands. "But with their growing middle class, their domestic needs will change that dynamic over the next few decades. And even if they remain the factory to the world, they want to do it with higher-end commodities. They want to make iPhones and they want to make flat-screen TVs. Furniture isn't on the wage scale toward their middle-class goals."

A bad dollar to the bottom line

Those who have followed the currency battle between the United States and China know that it has been, effectively, a stalemate in perpetuity. By this point, no one would blame any industry for growing to accept the exchange-rate relationship between the two nations as a fact of life.

The synopsis: China is holding its exchange rate at an artificially low level, prompting the United States to accuse China of sustaining a large trade surplus to the detriment of the U.S. (and other countries). In turn, Washington is pressuring the Chinese government to boost consumption and allow for faster appreciation of its currency. Generally speaking, China hasn't relented - at least not enough.

"Essentially, [China] is keeping their exports cheap but making it more expensive for our members to sell into China currently," said ICFA's Logan. "There was an adjustment in the years prior to 2008, but since that

time, adjustments have been minimal. Certainly, Washington is trying to put pressure on China to adjust, but to date, that has not really happened."

"The U.S. dollar has dropped against everything," Trinkley said. "And against the Chinese dollar, you can buy 5% less than what you could buy last year. So costs for our goods, which are manufactured in China, have gone up 5% because of the lower U.S. dollar value. And that doesn't consider anything else."

Translated, "anything else" is a nifty euphemism for other factors that are contributing to a bulkier bottom line for manufacturers. Add the rising cost of raw materials and China's expanding network of transportation to the list of determinants making for an uglier MSRP.

When discussing higher-priced raw goods, aluminum is a good place to start. It's a material watched closely by Gensun, which primarily manufactures furniture made of cast aluminum or cast and extruded aluminum. Trinkley said the price of aluminum has remained mostly level during the recession, but that it is up around 20% over the last year. About 50% of that is the actual cost of the product, so Gensun's cost of manufacturing a chair has risen by approximately 10%.

Tom Murray, president of NorthCape International, explains that resin product, on the other hand, is different in that its price is tied to another commodity - oil. So when the price of oil rises, the price of woven furnishings will likewise trend up. Even with higher labor costs, however, "woven product is high-labor content, so we still have advantages working with China," he said.

These increasing wages are spurring factories in Southern China - where the majority of the country's production is based - to head northbound. This creates the need for a transportation network that can facilitate the product back to the ports along the east and the south. And that's another cost for which manufacturers have to adjust.

"Not only is the labor rate going up, but the transportation rates and lead times are going up," Lowsky said. "So that's sort of the evolution of what is happening in China, and that creates challenges."

China best

Given the spectrum of these increasing production costs in China, a million-dollar question comes begging: What is the next frontier?

The natural inclination is to sift through a multiple-choice pool that includes Indonesia, Vietnam, Malaysia

and Mexico - In spite of the increased costs for U.S. manufacturers relying on Chinese labor, the People’s Republic will remain front-and-center amongst all overseas producers of outdoor furniture.all countries that trail behind China's economic development and don't offer emerging middle classes with which U.S. manufacturers must contend. But the greater majority of the casual industry's manufacturing circle is still interested in leaving the dance with the girl it came with, and her name is China.

"Considering China has the infrastructure and the logistics to produce the product, I think that this is the way it is going to be for a while," Trinkley said. "China ships so much, and I don't see a change in the foreseeable future because there's no one else that can do that kind of volume. There's no place else to go."

Really, Trinkley is using infrastructure and logistics as umbrella terms for all of the individual gears that make overseas production grind forward - manpower, port capacity, factory capability, transportation network, etc. There's no "next frontier" because the current one is still better than all the others.

"After China, I can't imagine where else we can go," said Ma. "Even if the labor wages double, I will still stay in China because China still has a lot of advantages."

One such advantage is the synergies that companies have established with their overseas production facilities. And that advantage becomes even more pronounced when the company owns its factories. By not having to buy from outside factories, a company can better control for product quality.

"I see portions of industries going to other places like Vietnam and Indonesia," Gaylord said. "Indonesia and Vietnam are very similar - you have a lot of little factories - so it's almost like you have to deal with five guys to make one collection of furniture. The Philippines is very much the same way. But overall, there's no new China."

"Furniture is pretty technical," said Lowsky. "It can't just move overnight - it could take a decade. China is definitely going to continue making furniture."

Even for companies that don't own their Chinese factories, there are still ways to manufacture quality goods without straying from the production timeline.

About 40% of Gloster's product derives from its partner factories in China, but the company has its own technical and quality company there that enables it to work with those partner factories on a daily, interpersonal basis.

"We wouldn't plan our company any other way than the way we have planned it," said Gloster Deputy CEO Charles Vernon. "Because being able to deliver what we promise on time is an important part of our brand. Without our structure as it is, I can't imagine how we would operate."

For manufacturers of woven furnishings, the skill level that Chinese weavers have achieved over time is something that would take a while to cultivate elsewhere.

"Even though [China] is taking the shift to make the services sector a bigger part of the economy, I don't see in my mind a better place for what we're going to need out of China, which is basically access to weaving labor," Murray said.

Additionally, China offers relaxed regulation of environmental standards that makes production more convenient for U.S. manufacturers. China has not yet implemented the environmental regulations that the United States has to make production processes "greener." Those regulations are gradually taking hold in China, but there's still enough freedom with respect to less-regimented, code-driven manufacturing methods that it is an incentive to continue operations in China.

Two-way street

The burgeoning Chinese middle class may be driving up labor wages, but it is also birthing a new consumer - a consumer that embraces Western culture and styling. So not only is it making sense for manufacturers to keep their production in China from a logistics perspective, there's now an opportunity to pursue the domestic Chinese market.

"What I'm seeing is that this middle class doesn't want furniture, interior goods or exterior goods that are Chinese - they want something that's Western," Hudson said. "So there's a new consumer in this emerging middle class that's being developed, and they want Western goods, so who better to supply Western goods than Western people?"

In the end, the relationship between the United States and China is a mutually beneficial one. China has America's debt, and America has China's work. Theoretically, the economic marriage could be a long and prosperous one.

"I believe they do need us, and we certainly need them," Logan said. "The relationship is going to be a very interesting one, but I think it will be a challenge for both of our governments to navigate these issues because both economies are so interdependent."

With the infrastructural and logistical means not yet available to escort furniture production elsewhere on a larger scale, manufacturers and retailers will have to consider the dynamic between the United States and China in their business equation. Until then, expect the world to keep on shaking.

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