Policy Note

September 2013
TRADE DEVELOPMENT

Improving trade competitiveness: Cambodian footwear exports

Significance

Cambodia's capacity for footwear production has expanded significantly in the past five years, with 20 new factories opening. This was after a period of five years of no investment. Some of the new factories are derivatives of earlier investments, but there are also new, large specialized factories. All factories producing footwear have some level of foreign ownership.

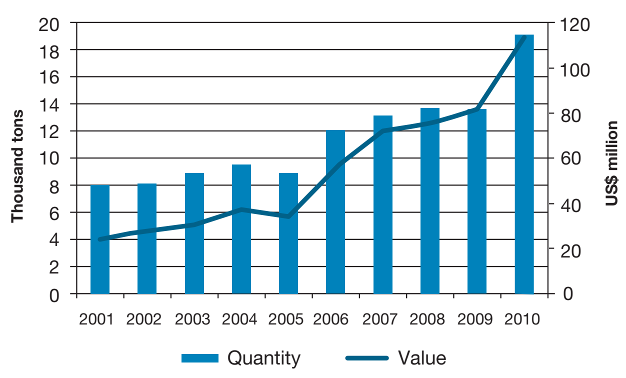
To understand the footwear value chain, one must differentiate between vendor and contract factories. One unique aspect of the footwear industry's growth is that the *value of each unit of output has been growing* at the same time as the volume of the exports has increased. This growth in unit value implies that the footwear industry is climbing the value chain in sophistication and quality faster than other export sectors.

The World Bank published a Transport and Trade Facilitation Assessment (TTFA) report in 2013, designed as a snapshot of a country's trading environment, viewed from the perspective of four key industries, including the footwear industry. The report dissects the inputs and outputs of the sector by analyzing how the inputs arrive at the processing plant and are then exported. Each step of the value chain is examined for logistical issues. The analysis and recommendations are designed to provide an overview of logistics issues that affect the private sector, and to assist the Government in implementing its footwear export policy.

Background

Over the past decade the value of Cambodian footwear exports have tripled (Figure 1). The increase in value was due to an increase in volume but more importantly to an increase in the unit value, which doubled over the same period.

Figure 1: Cambodia's Leather Footwear Exports Source: UN-Comtrade, 2012



Trade and Markets

Growth of the industry reflects a shift in production from neighboring countries to take advantage of low production costs and Cambodia's duty-free access to the EU under the Everything-But-Arms (EBA) initiative.

Business Model

The responsibility for managing the footwear supply chains rests with the shoe factories. However, their roles in structuring the inbound and outbound supply chains vary. The two prevailing business models are vendor factories and contract manufacturers. Vendor factories are locally incorporated production units of foreign corporations. They are directly managed by their overseas headquarters, which allocate orders to factories according to capability, cost structure, and capacity.

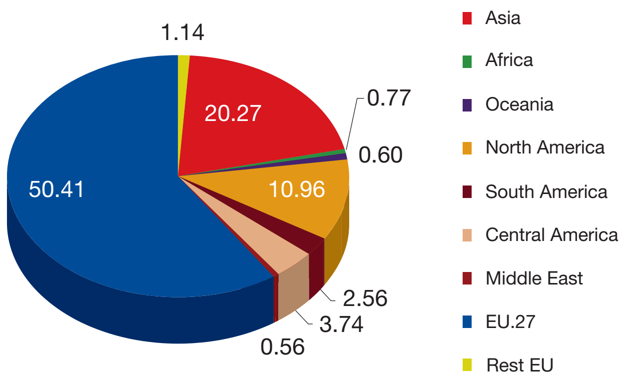
The contract manufacturers have stand-alone factories that produce finished goods according to specifications provided by the buyers. They compete for production contracts and procure most of the inputs. In addition to these factories, there are domestic firms that provide complementary services including dying, trimming and supplying locally produced packaging material.

Supply Chain Issues

Suppliers

Most of the leather and other raw materials used to produce footwear are sourced from within the region but very little is produced in Cambodia. For vendor factories, sourcing of inputs is arranged by the parent company, which takes advantage of its size to obtain favorable treatment. In most cases, the parent company has long-standing relationships with its suppliers and many are from the same country as the parent, e.g. China, Thailand, Taiwan, and Vietnam. The parent often purchases the inputs on FOB terms and arranges for their delivery to the factory.

Figure 2: Cambodian Footwear Export Destinations by % of Value Source: General Department of Customs and Excise, 2011



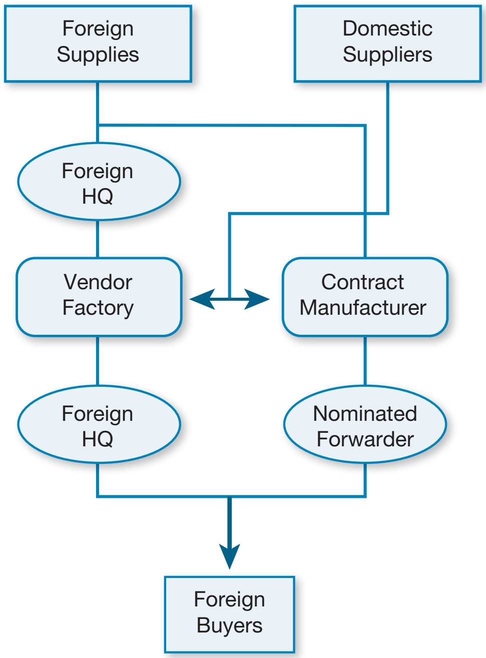
The contract manufacturers are at a disadvantage in sourcing inputs because of their size. Their suppliers are usually smaller and the prices are higher. Most inputs are purchased C&F with shipments arranged by the supplier.

Buyers and Distributors

Vendor factories sell their products to brand manufacturers, wholesalers and retail chains. The contract manufacturers sell primarily to wholesalers and buying agents. The larger factories market their services directly, while smaller manufacturers often rely on the Footwear Order Center of Cambodia (FOCC) to identify buyers and, in some cases, to manage product quality. Footwear exports are usually shipped on FOB/FCA terms with the factory responsible for delivering the goods to the loading port or the warehouse of the buyer's nominated forwarder.

Concentration

Six of the shoe factories in Cambodia are large vendor factories that employ on average about 6,000 workers. They have a relatively high productivity due to investment in modern equipment. The remaining factories are smaller, employing an average of 1,500 employees. These are estimated to produce between 2,000 and 3,000 pairs per day or about 500 pairs per employee per year. Total production in Cambodia comes to about 50 million pairs of shoes per year



Supply Chain Performance

All of the factories surveyed were vendor factories. Their supply chains are relatively simple. There are few intermediaries other than the foreign owners and forwarders nominated by the buyers, as shown in Figure 3. The leather and fabric used for production is imported primarily from China, Taiwan and South Korea. The factories purchase leather direct from tanneries although they frequently have problems with quality. Fabric is ordered from suppliers nominated by the buyers. The suppliers usually arrange the shipments. These are on an FOB basis with weekly shipments in containers.

Most inputs are imported duty-free with a value per container ranging from US$15,000 to US$55,000. The trade documents that present the greatest problem are import permits and technical certificates, which normally require 3-5 days to obtain.

Nearly all the exports are shipped by sea in containers that are loaded at the factory. Principal destinations are Japan and the EU.

Financing for investment and working capital is the responsibility of the headquarters. The principal financial risks are those associated with fluctuations in demand, prices and exchange rates.

The principal trade corridors used for exporting the footwear link the factories with the loading ports. The firms located in Manhattan SEZ near the Vietnamese border use Cai Mep, while those located in or around Phnom Penh usually use Sihanoukville.

Opportunities and Constraints

Growth of the Cambodian footwear sector has been dependent on foreign investments. Opportunities to increase the average value per pair are limited because larger vendor factories are managed overseas and contract manufacturers lack the scale to develop and promote their own designs. Cambodia's duty-free access to the EU has attracted foreign investors from South Korea, Vietnam and other countries that do not enjoy preferential treatment. However, this advantage is fading as Cambodia's competitors have joined the WTO (China in 2001 and Vietnam in 2007) and the EU has reduced its tariffs on footwear.

Cambodia, like its competitors, faces wage pressures as the footwear sector is having difficulties in recruiting skilled craftsmen and qualified supervisors.

Objectives and Strategies

Footwear exports account for less than 2 percent of GDP and this share has changed little over the past decade. Nevertheless, it generates significant employment and has the potential to grow rapidly in the future. The principal benefit to the economy from this expansion is the generation of employment for the urban population. At the same time, its growth will be challenged by rising wages and competition from its neighbors. In order to sustain its growth, it will have to increase both the average value and value addition of its footwear. This can be accomplished by improving the quality of production and the proportion of local inputs. Unlike garments, competition is less affected by order cycle. At the same time, there are greater opportunities for local design and procurement since there is less diversity in fashion and in materials.

Any strategy for achieving growth must differentiate between vendor factories and contract manufacturers, since the activities of the former are controlled offshore whereas the latter are more responsive to local market conditions. With the current structure of the industry, overseas managers make the decisions regarding markets and product value for half of the exports. For the other half, decisions are made locally but the factories are smaller and have limited capacity to move up the value chain.

The strategy for the vendor factories would focus on creating an attractive environment for FDI. In the short run, the challenge will be to improve productivity and quality of output of the factories, so that their owners will allocate to them the production of higher value products. In the medium term, the challenge is to create an environment that will attract companies that produce higher value footwear.

The strategy for the contract manufacturers would focus on incentives for increasing the span of control. This would include greater involvement in sourcing inputs, and marketing their production capacity to buyers interested in small to medium orders of high-value footwear.

Implementation

Specific activities to support these strategies might include:

- developing enclaves to encourage both foreign investment in factories and domestic production of inputs;
- improving training for both management and semi-skilled labor; and,
- increasing the availability of finance to support the growth and evolution of the contract manufacturers.

The enclaves would be in the form of special purpose zones. One would be for leather processing and include the necessary water treatment facilities and other environmental safeguards. This would be used to expand tannery capacity and develop leather dyeing and finishing activities in order to increase the supply and improve the quality of local leather. This would produce a significant increase in value addition, since leather accounts for a significant portion of the cost of footwear with leather uppers. Since there would continue to be significant competition from low-cost suppliers in China and Vietnam suppliers, this enclave would focus on the providing a reliable supply of higher-value leather.

Another enclave would support a cluster for shoe factories, suppliers of inputs and providers of services. It would encourage local production of inputs including lasts, soles, lining and packaging; provide bonded storage for generic inputs; and create opportunities for joint procurement of inputs and logistics services. The access to local inputs and services would be of immediate benefit to the contract manufacturers. Over time, it is expected that the vendor factories would also increase local procurement.

These enclaves would allow for a reduction in order cycles. At present, the typical order cycle up to the point of export is 1.5-3 months with imported inputs accounting for about half of this cycle. By introducing local production and bonded storage for generic inputs, the order cycle could be reduced by 2-4 weeks.

The challenge in developing both enclaves is to provide sufficient value for potential locators. In order to do this, there would have to be substantial private sector involvement in both the planning and management of these enclaves.

Activities related to training require collaboration between the industry and government, to provide training in areas that individual companies lack the capacity or resources to provide. The selection of the curriculum would be done jointly; the private sector would take the lead in recruitment of instructors; and the Government would provide support for the operation of a common training facility. The assignment of responsibility for specific areas would be assigned based on interest, for example:

- a private sector effort to provide management training in lean manufacturing and quality control;
- a public sector effort to train managers in the evolving physical, social and environment standards of importing countries; and,
- a public-private effort to teach new workers the skills of shoe making.

The target audience for the training would be the contract manufacturers, since the vendor factories already have their own training programs. However, if the training is successful, it is expected that the vendor factories would also make use of it in training their employees.

Improvements in trade finance are required so that the contract manufacturers can expand their activity, and extend their involvement in the inbound supply chain to include procurement of inputs and participation in the design process.

In addition to these activities, the development of an efficient corridor connecting to the new container terminals downriver from Ho Chi Minh Port would reduce the order cycle and lower freight rates for both imported inputs and exported products.

Recommendations

1. Encourage the increased use of locally sourced inputs, as well as greater value addition in Cambodia.
2. Develop footwear industry clusters to increase volume, have access to a larger pool of labor, and obtain the benefits from economies of scale from co-location, through public-private partnerships.
3. Develop the trade and transport corridor to Cai Mep in Vietnam, which has a higher frequency of vessel calls to key source markets for inputs, and to markets for exports.
4. Increase the availability of finance, for contract manufacturers in particular, so they can increase quality and capacity.

The World Bank Office

No. 113 Norodom Blvd. Phnom Penh - Cambodia
Tel: (855 23) 861 300
Fax: (855 23) 861 301/302

Visit our website:
http://www.worldbank.org/cambodia

For further information, please contact:

Julian Clarke
Senior Trade Specialist
(jclarke1@worldbank.org)

Vannara Sok
Operations Officer
(vsok@worldbank.org)

Funding for the Trade Related Assistance Cambodia Multi-Donor Trust Fund from the EU, DANIDA and UNIDO is gratefully acknowledged

European Union
DANIDA
UNIDO