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ADDING VALUE: BUILDING VALUE-ADDITION ALLIANCES

Backward Linkages In The Textile And Clothing Sector – Sri Lanka

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1. INTRODUCTION

The manufacture of standardized garments is a mobile, labour intensive and systematic form of production which is not dependent upon high capital investments or long lead times to train and establish a manufacturing facility.

Fabrics or textiles are the single largest input ranging from 50-60% of the finished product. This input can readily be sourced world-wide by manufacturers at roughly similar prices, so the cost of production has been the determining factor in locating a clothing industry. That is why the clothing industry is often referred to as a foot loose industry moving from country to country wherever the cost of production is low.

Even with technological improvement, the clothing industry is highly labour intensive whereas the textile industry is now a very high-tech capital-intensive industry. Consequently the clothing industry is the largest employer providing over 25 million jobs around the world. This in turn has led to the Multi Fibre Agreement (MFA) which came into existence in 1974 to regulate the global apparel industry.

Under the Multi Fibre Agreement, developed countries, notably the United States, Canada and the European Union negotiated bilateral agreements with individual exporting countries to restrict exports with a view to protect their domestic industry. The quota restrictions, while limiting the volume of exports by some of the developing countries, also provided an opportunity for smaller manufacturing countries to enter the more developed apparel markets in the world. In fact, it provided a guaranteed market access to the uncompetitive manufacturer or countries resulting in many developing countries encouraging the establishment of clothing industries leading to excess production globally.

Following the establishment of the WTO and the new agreement on textiles and clothing, quota restrictions will be phased out over a ten-year period – from January 1995 to December 2004 resulting in a free trade in textiles and clothing from January 2005. An exception being China where some quota restrictions might continue for a further period.

2. THE SRI LANKAN TEXTILE & CLOTHING SECTOR

2.1 The Textile Industry

Until 1977 the production of textiles was mainly for a protected local market. Three state-owned textile mills produced woven cotton textiles while a few private firms manufactured synthetic and knitted fabrics for the domestic market. The equipment in these mills is antiquated over 50 years, shuttleless looms, narrow width resulting in poor productivity, low quality and high cost.

Consequently with the liberalization of trade in 1977, and even though an import duty of 100% was levied on imported fabric, the local mills suffered a major set back. The Government in turn disposed of all the state-owned mills. Only one such mill, purchased by a Korean Company – Kabul, is presently functioning. This mill has some new machinery and technology but they predominantly import gray fabric to dye and print at short notice. Kabul also supplies the export trade as well as exports some textiles as a result of imposed quota restrictions on textiles.

In 1996 the Government removed the import duty on textiles to ease the documentation and transaction cost of the clothing export trade, further eroding the market for locally made textiles.

Although successive Governments attempted to attract investments in this sector, they failed due to the high cost of machinery, non-availability of local raw material (neither cotton nor synthetic) and the cost of electricity, being the highest in the region.

Consequently, the local production of yarn has declined to around 20 million kilograms per year and textiles to around 140 million per year, from a production of over 250 million meters previously.

In knitted fabrics, however, there has been some success with three joint venture companies – Ocean Lanka with Hong Kong interest as well as investments from some of the garment exporters, Hayleys with Australian collaboration, and more recently Textured Jersey, a joint venture with Mast Industries and MAS Holdings, two of the largest garment manufacturing groups in Sri Lanka and Textured Jersey UK.

The integration of the textile and clothing sector within the country, therefore, is minimal resulting in the majority of textiles being imported leading to longer lead times. Conversely, the lack of a local textile industry has permitted the easy access to import of textiles from all over the world free of any duty or levies.

2.2 The Clothing Industry

The development of Sri Lanka's clothing export industry commenced in 1977 as a result of the liberalization of the economy and the relaxation of import and export controls. This was also at a time when, as a result of quota restrictions placed in South and South East Asian countries, the industry was moving to countries that did not have quota restrictions.

In 1977 the export of clothing was only USD 70 million and since then, with an average increase of over 15% per year until 2001, total exports of textiles and clothing amounted to US\$ 2,538 million or 53% of Sri Lanka's total exports. The clothing industry is the strongest manufacturing sub-sector in terms of its contribution to industrial production, foreign exchange earnings and employment generation. The success of the clothing export industry to achieve high growth rates and development in the last two decades was primarily due to the quota system under the MFA, the liberal trade policies pursued by the Government, the availability of a reservoir of an easily trainable young labour force. In fact, many village girls are exposed to sewing at a very young age because a key investment in a household with young girls is a sewing machine. Moreover, Sri Lanka's benefits from its strategic location on the main sea and air routes and a highly developed port for container handling, also used for transshipment of a large volume of Indian cargo, resulting in frequent sailing to and from Sri Lanka.

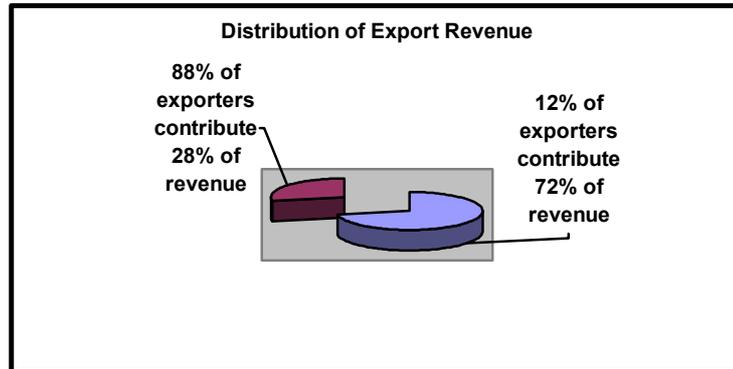
There are 859 registered clothing factories in Sri Lanka, but the statistical details in Table 1 indicate that a significant contribution to Sri Lanka's clothing industry is due to a few very large manufacturers. In 2001 the largest exporters represented 22% of total registered exporters, contributing 85% to the export value. Hence there is a high concentration of the clothing industry in the hands of a few large enterprises, as illustrated in Figure 1.

Table 1: Breakdown of manufacturing units - Classification of Exporters by Export Value (US\$1=Rs.95)

Category	Range Rs.	No. of Exporters		Export Value Rs. Mn	
Small	0.25 Mn – 100 Mn	549	64%	10,335	5%
Medium	101 Mn - 500 Mn	204	24%	48,936	23%
Large	501 Mn and Over	106	12%	149,362	72%
		859		208,633	100%

Source: Sri Lanka Customs / Export Development Board, 2002

Figure 1: Distribution of Export Revenue

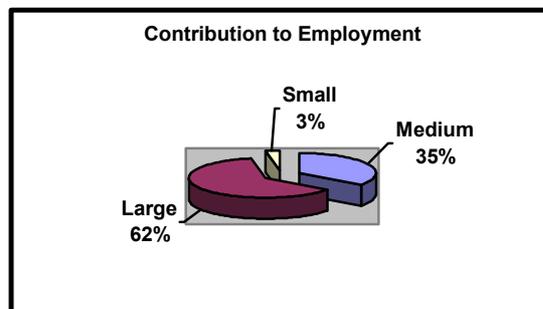


The employment generated by the clothing industry, both directly and indirectly, is estimated at around one million out of a population of 18 million. Direct employment in 830 factories, entitled to textile quotas amounted to 338,704. Details are provided in Table 2.

Table 2: Classification of Apparel Industry by size

Companies		Employment
Small (1-100 Employees)	157	10,501
Medium (101-500 Employees)	438	118,679
Large (over 501 Employees)	235	209,524
	830	338,704

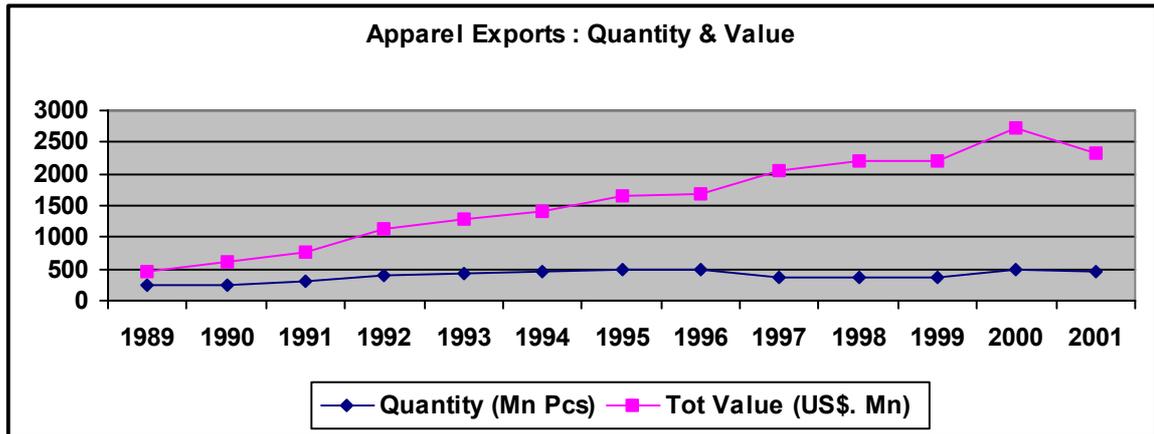
Figure 2: Contribution of Employment



An analysis of the country's export revenue shows that textiles and clothing contribute 46,4% of the total export earnings.

Although the annual average growth rate in the year 2001 was around 15%, Sri Lanka witnessed a drop in exports due to difficulties of the US and EU economies and the disruption of exports as a result of the terrorist attack in the Sri Lankan Airport in July and in the US in September 2001. However, a significant increasing trend over the last two decades indicates a shift in export to high value apparel. The long-term trend in Sri Lanka's apparel exports is shown in Figure 3.

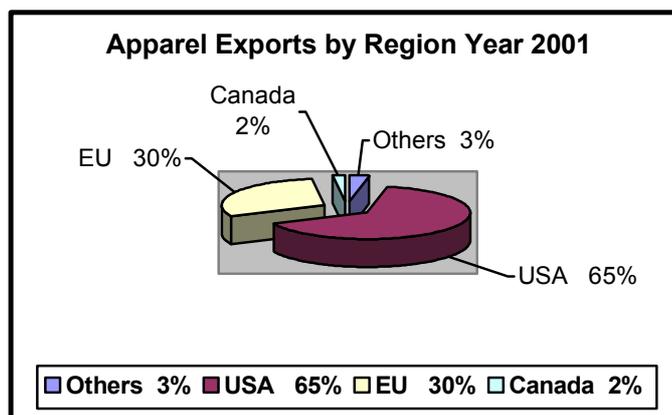
Figure 3: Sri Lanka's Apparel Exports 1989-2001



Over 95% of the clothing production is exported and the local market is supplied by the remainder and to filling production gaps by manufacturers.

The United States continues to be the major export market accounting for 65% of exports whilst the European Union accounts for 30%, as illustrated in Figure 4.

Figure 4: Apparel Exports by Region in 2001



The current quota regime under the MFA does not give a clear indication of Sri Lanka's competitiveness due to the heavy dependence on the MFA and the quotas allocated. The industry's core strategy to survive in a quota free era is to develop an efficient supply chain management, a service orientation towards the global apparel industry, compliance with international labour regulations, free trade agreements with India, Pakistan, the European

Union and the United States, improved technology and marketing, reduced transaction cost and procedural delays. In effect, Sri Lanka's vision is to become "ASIA'S BEST CLOTHING MANUFACTURER".

3. THE INTEGRATION OF THE TEXTILE & CLOTHING SECTOR

The integration of the textile and clothing sector within the country is minimal. The majority of textiles is imported, leading to long lead times. However, the lack of a local textile industry has permitted an easy access and import of highly competitive textiles from all over the world free of any duty or levies. The opportunity to source from the most competitive countries free of any duties gives the clothing industry a competitive edge over many other textile producing countries.

3.1 The lack of a material fabric base

The lack of a fabric base has resulted in establishing relations with textile mills in South and South East Asia, who are in a position to manufacture at international competitive prices. Additionally, the establishment of strong links with competitive textile manufacturing countries and mills resulted in favourable synergy effects, as Sri Lanka's clothing exporters were good customers for their textile exports. A drawback, however, is longer lead times in an industry struggling for quick response.

China and Hong Kong are the main fabric source for Sri Lanka's clothing industry due to price and the frequent meetings in Hong Kong. Hong Kong is by far the main venue for US and European Buyers to meet vendors and Sri Lankan companies find it easy to obtain fabrics and accessories over the shelf to make samples and then place orders for production. Consequently, clothing manufacturers have built up close alliances with mills, which have their liaison or marketing offices in Sri Lanka to service the factories. A South Korean company, as a result of purchasing a state-owned mill, has succeeded in supplementing its local production by importing gray fabric to dye or print at short notice and thereby optimized the supply chain.

3.2 Backward linkages

More recently the establishment of three knitted mills and a few accessory manufacturers was welcomed by the clothing industry as a step in the right direction. However these units have the capacity to supply only a small percentage of the total raw material required by the industry.

Two of the three mills have substantial investments from major groups in the clothing export trade, targeting niche markets in lingerie, resulting in their ability to respond more quickly to market demand so as to strengthen their position in the market.

The third knitted mill is a joint venture between an Australian firm and a very large public company with extensive interests in trading, manufacturing and shipping but which is not engaged in the clothing business. All these mills have large capacities and are structured to supply clothing manufacturers, supplementing regional sourcing. These are not fully integrated mills as they are dependent on imported yarn but they have the machinery and technology particularly in dyeing to produce export quality knitted fabrics at competitive prices.

In woven fabrics, the Korean firm Kabul has a fully integrated mill but a fair quantity of textiles is imported by them from Korea and China for local dyeing and printing. Similarly, there are a few other dyeing and printing plants importing gray textiles for local processing. The main advantage is the reduction in turn round time. However, this only supplements regional sourcing.

In the supply of accessories are a number of locally established manufacturing units, having the capacity to make thread, buttons, zips, poly bags, cartons, labels, tags and hangers. More recently internationally accepted or exclusive suppliers to some of the major retailers in the EU and USA, such as YKK zips, Maintech hangers and Paxar for labels, tags and stickers have established production units in Sri Lanka.

The import duty on Sri Lankan clothing to the EU qualifies for a reduction of 20% under the GSP scheme if the textiles are of Sri Lankan origin. This facility was extended last year to the SAARC region with the result that textiles of Indian, Pakistan, Nepal or Bangladesh origin used by Sri Lankan clothing manufacturers qualify for this duty reduction. This has led to closer alliances being built particularly with Indian mills, who also stock basic textiles in Sri Lanka for supply to manufacturers at short notice.

These regional alliances have been forged and strengthened as a result of government policy, permitting representatives of these mills to establish offices with resident visa's and tax-free incomes as long as they are funded from abroad. Additionally the ability of importing textiles to be stored in bonded warehouses for supply to clothing manufacturers free of any duty or taxes has encouraged these alliances. Again Sri Lanka last year negotiated a free trade agreement with India while one with Pakistan is to be signed shortly. Once these are fully operational the links and alliances will be further improved.

3.3 Forward linkages

The apparel industry is heavily dependent on international buying offices for export orders. This again is due to the quota system, which created a sellers market, forcing foreign buyers to purchase their goods from companies and countries that had allocated quotas. With the abolition of quotas from 2005 the global apparel industry experiences a significant transition to that of a buyers market, forcing Sri Lankan industrialists to market their products directly to the buyer.

The larger Sri Lankan companies are mostly joint ventures with established brands, both in the United States and the European Union, who are well established in design and marketing. As a consequence, the local manufacturing units need to concentrate on productivity and logistics.

4. THE IMPORTANCE OF ALLIANCES

4.1 Business to business partnerships

The liberal investment policy pursued by the Government and the ability of foreign companies to own even 100% of the shares of a clothing company resulted in several strong alliances. As mentioned previously, most of the large companies, accounting for 85% of Sri Lanka's clothing exports, have strong links with retailers and brand names.

Business to business partnerships have also evolved through membership in the clothing export associations. The oldest association – the Sri Lanka Apparel Exporters' Association – has enabled its members to establish partnership for the purpose of quota exchanges, subcontracting, supplying part of the value chain, specialized services such as embroidery, pico edging, smoking, washing, etc. the association acted as a platform to represent the industry on matters effecting trade. Since then a few other associations were established to represent specific sectors. For example the Free Trade Zones have their own associations on issues effecting their trade associations. Together they negotiate with the Government to ensure that their interests are reflected in the decision-making process related to the clothing industry.

All these associations have monthly meetings and discuss issues that need to be addressed by the industry and the Government. Regular seminars are organized with the participation of government officials or foreign experts as appropriate. Information on quota or capacity available or required and other issues of interest to the trade is e-mailed to members several times a day. The association has also organized missions to India to promote regional co-operation with Indian mills and this has been reciprocated by representatives of several Indian mills visiting and holding exhibitions in Sri Lanka.

Apart from sector-specific associations, membership in the Ceylon Chamber of Commerce and the Exporters Association of Sri Lanka, which represents all export product associations, enabled the industry to forge strong links with the public sector and be a part of the decision making process. Representatives of these apparel associations serve on the boards and state institutions, such as the Export Development Board, The National Labour Advisory Council, the Wages Board for the Clothing Industry, the Clothing Industry Training Institute and most importantly the Textile Quota Board, which decides on the policy for allocating export quotas.

The Ceylon Chamber of Commerce and its affiliated members including the Apparel Exporters Association participate in a monthly meeting organized by the Export Development Board to resolve both macro and micro firm level issues. These meetings are chaired by two senior cabinet ministers and representatives of all relevant government institutions attend with a view to resolve issues. Any unresolved issues are taken up at a cabinet sub committee for a policy decision.

The Chambers also meet the Finance Minister and the Secretary to the Treasury prior to the formulation of the annual budget to make submissions.

The last two decades witnessed a close cooperation among key decision matters from manufacturers to various government institutions, Customs, Ports Authority, Treasury, Central Bank the Textile Ministry, the Ministry of Commerce, etc. who meet regularly and are able to speedily resolve problems affecting the industry. More recently, all key players, manufacturers and government officials were appointed members of a task force to prepare a strategy for the Sri Lankan clothing industry to face the challenges of a quota free era.

5. THE LEADING PLAYERS & DYNAMIC FORCES OF ALLIANCES

The major forces behind the alliances are the joint ventures and especially those established by Mast Industries, USA. The main local collaborator – Mast Lanka with about 15 large factories specializing in basic clothing – in pants, blouses, T-shirts and lingerie. This group is also closely associated with MAS Holdings, who own over 12 large factories with investment from Mast Industries, USA, Sara Lee Courtaulds, Triumph and Speedo amongst several other well known international brands. These alliances have succeeded in creating an image both for Sri Lanka and their group as a centre for excellence in making lingerie. These two groups with investments in Ocean Lanka and Textured Jersey (two knitted fabric manufacturers) together with Stretchline (manufacturing elastic) developed a vertically integrated production of lingerie.

Two UK firms S.R. Gent and Desmonds both large suppliers to Marks & Spencer in the UK, also have a number of joint venture factories on the Island with the local Tri Star group, together with S.R. Gent, owning 17 factories in Sri Lanka in addition to factories in several other countries.

The success of these joint venture companies can be attributed to a clear division of responsibility with their US & UK partners, who concentrate on design and marketing, while the local partner is continuously improving the supply chain. The rest of the industry has the opportunity of benchmarking with best practices, resulting in an overall improvement of the clothing industry.

These joint venture companies have successfully assisted small firms to specialize in the supply of a variety of services from garment washing, embroidery to many other inputs requiring hand work, which are more appropriate to small suppliers. Similarly they have successfully helped in upgrading some of the smaller sub-contracted firms to a level they can be comfortable in placing

orders with. This development happened because of the exclusive availability of export quotas to the smaller firms and the prohibition of quota sales, thus necessitating larger groups to place orders with sub-contract to smaller companies and assist them where necessary to upgrade their production and facilities.

Some of the large local clothing manufacturing groups also established manufacturing units in India, Mauritius, Kenya, the Maldives and Madagascar, amongst others to take advantage of duty and quota concessions granted to these countries by the US and the European Union. By doing so, they specialize in making products in the most competitive country. Additionally, companies such as Stretchline, a backward linkage project of the MAS Group manufacturing Elastics, has production units in China, Mexico and Indonesia. The firm is an accredited supplier of elastics for garments made for companies such as Victoria Secret, Gap, the Limited in the US, Marks & Spencer and BHS in the UK.

Moreover, the Government has actually encouraged foreign buying offices to set up offices in Sri Lanka. As a part of a national strategy for the clothing industry the Board of Investment and the Export Development Board together with representatives of the apparel associations have visited the US and the EU, targeting large retailers and encouraged them to establish buying offices in Sri Lanka. They are given the required visas and are not liable to income tax on their inward remittances. This has resulted in many of the large buying offices being located in Sri Lanka. This includes Liz Claiborne, Gap, Tommy Hilfiger, Walmart, May Department Stores, etc. In pursuit of the national strategy, several large retail chains, including companies such as Marks and Spencer have their logistic centres located in Sri Lanka with the facility of distributing clothing to other destinations throughout the world.

6. LESSONS TO BE DRAWN & SUCCESS STORIES

The success of the larger companies is entirely due to their strong relationships, joint ventures and trading alliances with retailers, brand names and major players in the industry in the US and Europe.

Their success is also due to the flexibility of the Government to permit such joint ventures and a healthy dialogue with the Government to remove all obstacles in the free movement of import and export cargo. In 1992 the then President of Sri Lanka announced a policy of establishing 200 clothing factories scattered throughout the Island – practically one in each village within one year. Following this the Board of Investments (BOI) actively canvassed foreign firms to establish manufacturing units in Sri Lanka by offering tax free status of 5 to 10 years, duty free import of plant and machinery, export quotas, residence visas and other concessions making it attractive to invest in Sri Lanka. This policy led to modern factories with the latest equipment including CAD/CAM – computer aided design and marker-making equipment as well as best practices being introduced.

An important lesson from the success stories in Sri Lanka is that in a global market it is essential to build strong relationships with customers and buyers. The need to create an image as a country with special skills, for example in producing lingerie, has an effect on many smaller firms, who in turn specialize in supplying goods and services in the value chain.

Again the need to forge links with other manufacturers through assistance provided by chambers and associations through a platform to discuss and negotiate with Government contributed to a great extent the success of the Sri Lankan clothing industry.

Subcontracting of some parts of the value chain has contributed to higher value addition of clothing exports.

A significant failure has been the lacking development of national backward linkages between the textile and clothing industry. There was lack or reluctance on the part of the textile industry to upgrade their mills to supply the export-oriented clothing industry good quality textiles at competitive prices. In effect, the textile industry did not take advantage of the opportunity of supplying a guaranteed market. This would have resulted in the upgrading of their technology

and machinery to meet the demands of this growing industry and thereby reduce lead times. This, in turn, led the Government, at the request of the industry, to remove all constraints permitting the import of textiles and thus virtually closing the door to the establishment of any large integrated textile mills on the island. Overall, the lesson is that a fully integrated textile industry is not an essential condition for the development of a clothing industry.

Another failure was the heavy dependence on buying offices and joint venture partners to be totally responsible for marketing. A few attempts by some clothing manufacturers to establish their own sales offices in the main markets failed due to lack of capital and proper focus. The clothing industry strategy to overcome this is to develop design capability and, with the support of the Chartered Institute of Marketing London, introduce a CIM course, targeted at the clothing industry, to ensure that the industry will have sufficient trained marketing personnel.