# ADDING VALUE: BUILDING VALUE-ADDITION ALLIANCES

## Inter-firm Strategic Alliances in the Textiles and Clothing Industry Examples from Bangladesh and Sri Lanka

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### 1. Inter-firm Strategic Alliances in the Context of the Quotas System

The development of the T&C sector in many countries has been influenced by trade policy and the response of companies to operate efficiently and economically under these policy rules. Government policies have been playing a major role in shaping the location of apparel export activities. The most important tools that governments have been using to shape commodity chains in the apparel industry are quotas and preferential tariffs.

Companies have been responding to these policy pre-settings by developing supply chain networks, taking advantage of differing competitive advantages between countries and regions. This took various forms from triangle trade between the USA, Asian NICs and lesser developed Asian countries, OPT[1] business between Western and Eastern European countries or production sharing between the US and Mexico and CBI[2] countries. Thus, trade policy contributed to the creation of intra- and inter-regional production networks, creating a division of labour between higher wage and lower wage countries. At the same time, developed countries could protect their textile industries. In such a scenario export development strategy making in this sector was limited within the boundaries of the quota system.

Strategic alliances among firms along the commodity chain have been developed within these boundaries. Through alliances, companies were utilising competitive advantages in different regions so as to maintain business and to keep markets. Inter-firm networks in the sense of strategic alliances created opportunities for specialisation among regions and countries but also within countries. Strategic alliances were mainly initiated and developed by companies in advanced developing countries, whereas, as a result of the quota system, lesser-developed countries developed pure CMT business. While many CMT businesses gained extensive experience in assembling garments, they have no familiarity with the wide range of other tasks involved in the production of apparel (purchasing textiles, trims, cutting fabrics, designing and marketing). At the same time, also in lesser-developed countries, some companies successfully developed beyond the CMT business.

Despite the fact that most enterprises in many developing countries remained in the pure CMT business, inter-firm alliances could be a successful way for developing additional capabilities required to perform a greater variety of jobs. These alliances or networks could also present an opportunity for countries to diversify their export base and to create value-addition within the sector. Through strategic alliances, apparel companies, working with retailers and branded manufacturers, can learn by watching their customers. The same learning process could be initiated by developing a linkage between those few successfully operational domestic

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[1] Outward Processing Trade, as developed by EU countries, exporting textiles to selected Eastern European and Mediterranean countries, which transformed these into garments, which then could be re-imported into the EU quota and duty free.

[2] Caribbean Basin Initiative

companies, which developed beyond the pure CMT business, and the majority of pure CMT manufacturers. Their relationship is often determined by sub-contracting arrangements. This process of learning is critical to expand the capabilities to include high-value-added activities such as marketing and design. It would be a possible way to expand the customer base of the country's apparel firms, reducing dependence on a few large customers.

By doing so, companies and often the whole garment sector in developing countries could move up the value chain towards full service production, which is more demanding than assembly contracting as it requires the company receiving orders to source the fabrics and trims for the garments it will make. Developing the capacity to provide this service requires companies to develop networks both with downstream suppliers who can provide the materials needed to put the package together, as well as upstream customers looking to place orders of apparel (backward and forward linkages). Companies performing full services can receive orders from branded manufacturers, designers, or retailers who prefer to provide full service producers with nothing more than their specifications for a particular piece of clothing. Developing networks will be crucial to perform the transition to full service production. To start the development systematically, companies could focus on developing national networks first. These networks would target those larger successfully evolved companies, who developed a service package and the majority of smaller manufacturers purely performing CMT business.

Developing countries will have to lock at this opportunity even more so after the phasing out of the MFA. In 2005 quick response will be one of the important competitiveness determinants. In order to quickly respond, companies will have to have developed networks with other companies, domestically and internationally. Only through joint strategic alliances could companies and whole sectors in developing countries successfully face the challenges of the phasing out of the MFA.

## 2. A Brief Analysis of the Situation in Bangladesh

The clothing industry of Bangladesh is an example of how trade policy developed and shaped the industry, which has become the country's most important export sector. Its ready-made garment (RMG) industry gained extensive experience in assembling garments but so far has not been able to develop a full service production, vital to survive after 2005. The national discussion about inter-firm strategic alliances is focused on the question whether the country should develop a textile industry in support of its RMG exports.

In Bangladesh backward linkages are presently discussed mainly in its technical sense i.e. for developing a supply base of fabrics for the export-oriented ready-made garments sector. While in the knitwear sub-sector a self-sufficiency of around 70 per cent in the supply of domestic fabrics has already been reached, in the weaving sector presently only 20 per cent of the fabrics originate in the country. Despite incentive measures given to attract the establishment of a textile industry in the country (including direct cash incentives) sufficient investment could not be attracted to increase the ratio of self-sufficiency. Various sources confirmed that Bangladesh fabrics are around 20 per cent more expensive than Chinese fabrics. In general, in the fiscal year 2002 the knitwear sector contributed 32 percent and the woven sector 68 per cent of the total RMG exports. Total exports were mainly targeted at two markets, namely Europe with 52 per cent of total RMG exports and the USA, accounting for 42 per cent.

Cash incentives for the use of local fabrics (knitted as well as woven) were provided over the last 10 years. At the beginning, a 15 per cent cash incentive on the value of the exported locally made fabric was given. This was increased to 25 per cent until 2002. From 1 July 2002 (start of the FY 2003) it was again reduced to 15 per cent and will phase out over the next three years until 2005. This will coincide with the phasing out of the ATC. Thus the local textile industry as well as the domestic RMG industry, which rely on local fabrics because of the short lead times involved, will phase a double challenge in 2005.

The establishment of backward linkages is closely interrelated with the need to have forward linkages in place. Only with a clear concept of where and how to export RMG, would the pursuance of establishing a supporting export-oriented textile industry be successful. In order to develop backward linkages, a clear export strategy for RMG needs to be developed i.e. forward linkages with an orientation towards new products and markets. This is not necessarily the case in many developing countries presently benefiting from the quota allocation, including Bangladesh. Exports in this sector are usually not based on a clear strategy. In fact, within the present quota system, backward linkages are not necessarily needed to successfully develop a garment industry. On the other hand, corresponding Rules of Origin requirements of existing GSP schemes encourage the establishment of backward linkages. Moreover, in the future it is expected that lead time (short response) will become a more important factor for major buyers than price. This would be another argument in favour of having in place a textile industry, which could quickly deliver the fabrics needed to satisfy customers overseas. This would specially be important in a country, which has an underdeveloped port and logistical infrastructure with long handling times in import and export operations, among other infrastructural problems.

While the Bangladesh Garment Manufacturers Exporters Association (BGMEA) is not opposing the development of backward linkages, it would not be happy if domestic RMG manufacturers were "forced" to buy local due to subsidization of local fabrics or duties on imported fabrics. The Bangladesh Textile Manufacturers Association (BTMA), however, is fully in favour of developing national backward linkages and criticizes any development in opening the market for foreign fabrics (an example is the SAARC cumulating options under the EU GSP scheme).

With regard to the development of business-to-business linkages in rural areas, many RMG manufacturers believe that the necessary skills, apart from infrastructure and communication, are not available in rural areas to develop business linkages to smaller units. In order to compete on international markets they will have to rely on international competitive imports for all sorts of supplies, including of ancillaries. The only possibility seen is the exploitation of local skills in stitching, lace work and embroidery. Locally available skills, which form part of the national culture, could be incorporated into the process of RMG manufacturing. However, for this, substantial training would be needed so as to develop the necessary knowledge and know-how to transform the national skills into exportable products. Thus, a joint private sector effort, or government inputs are needed to develop these skills, benefiting from and exploiting a cultural heritage. This, however, is a long-term approach, which need to be covered in an export development plan. Successful short-term results in view of 2005 are not likely and would bear the risk that developed skills and linkages would be a victim of major market restructuring, expected to take place with the phasing out of the ATC.

Traditional subcontracting arrangements exist but are not promoted or supported by any organization. Under the umbrella of BGMEA, all association members can subcontract parts of their order to other members so as to comply with specific and larger orders of foreign buyers. This, however, is done on an ad hoc basis where BGMEA is only informed and a notice issued so as to keep the duty free status for exports. In fact, RMG manufacturers see private partnership development as part of their business plan to be undertaken individually by companies. It is presently not supported by any organization or a government programme.

A "deemed export scheme" exists to support indirect exports for enterprises, which supply to export-oriented enterprises. This scheme basically consists of the possibility to open back-to-back L/Cs on the basis of a master L/C to smaller producers. However, not much use has been made of this scheme. It hardly attracted any investment into local areas.

## 3. Sri Lanka and Inter-firm Strategic Alliances

Contrary to Bangladesh, Sri Lanka follows an open market policy. Fabrics for the exports of RMG can be imported freely without any duties. A domestic textile industry hardly exists and thus there is no political pressure for protecting the industry. The Government is not providing any incentives or subsidies for the establishment of backward linkage industries in the country to develop a fabric base for its RMG exports. It is believed that there are other and better ways of improving the competitiveness of the industry. However, Sri Lanka very successfully developed backward linkages in ancillary industries for the garment industry. This includes elastics, buttons, zippers, hangers and labels, etc. Without a vibrant backward integration industry for ancillary products, the local garment industry would not have developed so far. The country has realized that its competitive advantage lies in the production of value-added garments in selected niche markets. In order to stay competitive in these markets, the flexible import of fashion fabrics is regarded as an important competitive determinant. Local fabric suppliers would not be in a position to provide the resources in the quality and flexibility required.

In Sri Lanka some of the larger garment manufacturers have developed very successfully over the last years into world-class garment manufacturers. The majority of enterprises, however, have not progressed that well and are still relying heavily on the CMT business. While the few successful companies have diversified their markets and have specialized in high-value added products, the smaller and medium seized companies have not done so, relying still heavily on quota rents. The successful ones will thus have no major problems in facing the challenges of 2005. However, these companies realized that they alone would face difficulties if the country as a whole could not sustain a critical mass of garment manufacturers. Larger successfully developing companies thus are realizing that they will have to assist smaller companies to adjust to the challenges of 2005. This could be done, inter alia, by creating inter-firm alliances with smaller units to sustain the critical mass necessary in the country.

The Government does not provide specific support to the development of linkages between small and large enterprises. There is presently hardly any close cooperation existing between larger and smaller units beyond simple subcontracting arrangements on an ad hoc basis. Nevertheless, most of the enterprises agree that a long-term cooperation would be vital for the industry. This, however, needs to be supported by the Government following a successful development model, which needs to be identified and implemented under the guidance and facilitation of the Sri Lanka Export Development Board.

The industry strives to develop an image for the country as a whole as a reliable quality manufacturer of garments in general and more specifically for high value-added garments such as in the intimate wear and lingerie sub-sectors. This vision has been expressed in a recently devolved action plan for the industry until 2005. Specific steps towards this end have so far not been undertaken. There are in fact possibilities for the industry to develop such a positive image by exploiting the work of some successful and established manufacturers through inter-firm strategic alliances, as described below in the case study on Stretchline. The crucial point would be to create a win-win scenario for all enterprises; for those enterprises on whose successful work the sector could build on and for those enterprises, who could utilize the positive image already created. In order to oversee and balance this approach an independent body, such as the Export Development Board, would be necessary. It would also ensure that a country image could be created and that benefits are equally distributed among all participating companies. The strategy and its vision of the country in this product sector need to be made known among the major international retail houses.

An overall lesson from Sri Lanka could be seen in the fact that in an open global marketing system, sourcing from the most competitive supply source is advantageous. No domestic production could provide the range of material and designs required for an industry in which demand and styles change several times in a year. Thus, a full integration into the textiles industry is not an essential condition for a clothing industry to develop. Sri Lanka's efforts towards value addition have focused more on forward integration than backward integration. Value addition resulted mainly from product and market diversification and quality upgrading than from backward integration. In the initial stages of developing the industry, however, the state played a lead role in industry clustering and forging alliance between business and the state and even business to business as witnessed by the 200 Garment Manufacturers Programme, described below.

### 3.1 Case study Stretchline

One of the country's main targets in its textiles and clothing sector development strategy is to develop a reputation and image in the world market as a high-quality base for garment making. The focus on garments in general is, however, regarded as too wide for the country. Some of the leading Sri Lankan garment manufacturers are therefore trying to develop an image of a specialty garment-manufacturing base. The successful work of a few companies in the high-value added product range of intimate apparel could be further exploited to develop a brand image for the country as a whole.

One of the successful companies operating in the intimate apparel sector is a company called Stretchline. Stretchline was founded in Sri Lanka and is a joint venture between a Sri Lankan (MAS Holdings), a British (Charnwood Elastic Group), and an American company (MAST Inc.). It has become a reputed manufacturer of nylon elastic for lingerie (viz. woven, knitted and jacquard elastics). Set up in 1995 with an investment of US$ 12 million, the company created an international reputation for high standards in nylon elastic for its products, becoming a leading manufacturer of elastics used in underwear and lingerie. Due to a successful marketing and diversification strategy it has developed a brand name made in Sri Lanka. This brand name is well known in the intimate apparel sector and among lingerie makers in the international market. But the company is even more ambitious as it would like to create a worldwide name from Sri Lanka. Stretchline has its biggest markets in the US with 70 per cent of the production going there. 20 percent of the balance goes to the UK and the rest to other European countries and Australia. The product is basically marketed for higher-end retailers and brands. Designer labels such as Victoria's Secret, Gap, The Limited and Calvin Klein, but also Marks & Spencer, BhS, Target Australia, Tesco, Lerner, Express and Lane Bryant are some of its prominent customer. Its major competitors are Hong Kong and China and contrary to most other Sri Lankan garment manufacturers it looks forward to 2005 as it foresees a bright future. At present the company employs 560 people at its factory at the Biyagama Export Processing Zone, near Colombo.

This successfully developed brand name of a product made in Sri Lanka could be further exploited for Sri Lanka's clothing sector as a quality manufacturer for underwear lingerie if the final garments were also produced in the country. This is presently only done by one company (MAS), which is one of the shareholders and joint venture partners of Stretchline. It is, however, not done on a larger scale with other Sri Lankan garment manufacturers. Producing lingerie in Sri Lanka on a larger scale would be advantageous as "elastics are bad travellers", meaning that a manufacturing into intimate underwear at the same location is an advantage. This could be an opportunity for the country to further exploit a very positive image, which was created by one company. In order to do so, a win-win situation needs to be created, in which both the successful initiation company Stretchline as well as a subsequent garment underwear manufacturers would benefit. Such a private-private alliance needs to be build on trust for a successful long-term relationship. This calls for a facilitating role by an independent body, which could also take over the role of marketing the image of "high-quality intimate garments made in Sri Lanka". The most appropriate and reputed body to do so in the country is the national Trade Promotion Organization the Export Development Board (EDB) of Sri Lanka.

### 3.2 Case Study: The 200 Garment Factory Program (GFP)

In 1992 Sri Lanka witnessed a significant increase in the growth rate of garment exports. This growth was related to an initiative that was known as the 200 Garment Factory Programme. In 1990, a Government Cabinet Sub-Committee recommended the establishment of garment factories in the rural areas of Sri Lanka in the context of very high unemployment in the south of the country and especially among young people. It was an attempt to decentralize the industry away from the Western Province and its capital Colombo, where the country's only international airport and main port are located, and to encourage investors to set up factories in other districts. The then President Premadasa was strongly supporting and personally promoting this idea in a way to explore avenues of providing employment opportunities to the rural youth. He felt that this was an ideal way of providing decent employment to the young generation that suffered from a shortage in education and were living in poverty.

The programme was launched in early 1992 with the aim of setting up 200 garment factories. Existing companies located in Export Processing Zones (but which were not necessarily operating in the T&C business) were asked to set up new factory units in indicated rural areas. The major incentive for investors was the allocation of quotas, with the allocation being greater (and more valuable) for investments in more isolated rural sites. About 40 per cent of the sites were classified as most difficult, another 40 per cent as difficult and under 20 percent as non-difficult. Besides the inducement of quotas, various other incentives were offered, including tax holidays, ranging from 5-15 years, duty-free provisions and access to credit. To be eligible for these benefits, companies were requested to make a minimum investment of Rs 200 million, generate employment for at least 250 to 500 employees and produce 90 per cent for export markets.

Although no company was forced to establish new factories, it was made clear that the Government would like to see their cooperation in combating unemployment and poverty in rural areas. Thus, companies felt obliged to participate so as not to appear ignorant to and outside of an initiative for the development of the country, which was personally supported and promoted by the President. Many companies therefore entered the initiative reluctantly but followed this national initiative.

In the year 1992 and 1993, 164 existing factories located mainly in Colombo and EPZs, established new factory units in 21 districts. Tens of thousands of new jobs were created in rural areas. Since the President personally was behind the programme, involved in each and every factory set-up, and personally opening all new factories, the companies followed strict minimum factory standards. This led to the establishment of modern factories in the countryside with updated machinery, including computer-aided design (CAD) and marker making facilities. This programme gave an important development input to the industry letting it become the country's major manufacturing industry and the highest foreign exchange earner, improving social conditions in the rural areas.

President Premadasa's personal involvement and dynamic approach made the 200 Garment Factories Programme a success. Thus, private companies were successfully motivated to contribute towards the socio-economic development of the country, while following their business in a purely business and profit oriented way. While many companies only reluctantly entered this programme and invested in rural areas, many of them developed successful garment companies located in rural areas, which still exist.

Despite the overall success of the programme it has been criticized on a number of reasons. The major incentives were the allocation of quotas to newly established factory units in rural areas. Besides the point that such an incentive cannot be repeated in a quota free market, the programme was expected to add at least 40 per cent to the garment exporting capacity in Sri Lanka at a time when quotas were already close to full utilization. The necessary reallocation of quotas thus led to a disruption of operations of existing exporters and created a backlog of other problems in the industry. Moreover, the industry needed skilled manpower, which was not readily available particularly at the supervisory and middle management level. This especially, as around 40 per cent of the newly opened factories were opened by exporters with no previous experience in the garment industry. This inevitably meant that the quality of production suffered as a result.

A similar concept was implemented under a new Government in 1997 and called the 50 Garment Factory Programme under which altogether 56 factories new companies were opened in rural areas.

Overall the 200 Garment Factory Programme could be seen as a successful public-private sector co-operation programme.