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STRATEGIES OF FIRMS IN THE LEATHER BUSINESS

Part of the study on the world-wide leather-based industry*

Prepared by

the UNIDO Secretariat

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INTRODUCTION

Strategies are simply defined as sets of actions aimed at maintaining or expanding profits and market shares. For the sake of clarity it may be useful to distinguish broad categories of strategies according to the main variable acted upon: cost, process, product, price, and organization. In practice, however, firms never confine their action to a single variable; therefore, actual strategies are more complex than as categorized here.

LEATHER AND LEATHER PRODUCTS FIRMS IN A CHANGING ENVIRONMENT

Competition before and after the seventies

During the seventies, the leather and leather product industries became the theatre of intensified competition.

Not that competition did not exist before. The 20 years following World War II saw, for instance, the most active phase of a structural shift of the leather-related industries from the richest European countries of the North to the Mediterranean basin. In the United States too the centre of gravity of production moved from richer to poorer States such as Tennessee.

Thus market shares were reshuffled to an extent which was by no means negligible. Yet, the competitive climate was never as tense as it became during the seventies. Three circumstances explain why competition was felt less acutely.

First, in those times, countries losing ground in leather-related industries had no employment problem. Growth seemed set on a boundless growing path that would not only ensure full employment but even require a continuous switch to more capital intensity. In this euphoria, rich countries were only too happy to release labour-intensive industries to make room for capital-intensive ones.[1]

Second, at that time the households of Europe saw growth as a chance to acquire more of the basic products that war and the economic crisis that preceded it had placed out of their reach. Footwear, was one of these products and the fabrication of footwear absorbed three-quarters of the leather tanned in Europe. Demand to the leather industry was thus buoyant enough for all, winners and losers of market shares, to remain in business. Table 1 shows that in those days countries losing market shares could nevertheless expand production as occurred in France, the Netherlands and West Germany. Losing markets meant growing - slower than the competition - but growing.

Third, before the seventies leather and leather products were made almost exclusively in developed countries and by small firms luring trade away from national or, even more frequently, from local markets. Production processes and technology employed were common to all the firms. Differences in labour costs were not very great among developed countries - or, more relevant to the leather and leather products industries, among the under developed areas of developed countries. With the same technology and similar factor costs no firms had a dominant cost therefore, price-cutting, the most drastic form of competition, was not a long-term option.

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[1] As a result of this trend, out of the 16,000 footwear firms that the EC counted in 1986, 9,400 were located in Italy and 4,900 in Greece, Spain and Portugal; these four countries also accounted for 90 per cent of the 3,900 EC tanneries.

Table 1

Leather shoes industries of selected countries

COUNTRY	Year	Number of		Production (1,000 pairs)
		factories	employees	
The Netherlands	1950	369	15,000	10,000
	1970	123	10,000	23,000
Sweden	1950	259	11,000	11,000
	1970	34	2,000	5,500
West Germany	1950	740	80,000	78,000
	1970	739	84,000	150,000
France	1950	660	43,000	68,000
	1970	320	50,000	127,000
Italy	1950	1,800	15,000	40,000
	1970	7,840	235,000	295,000
Spain	1950	1,440	41,000	20,000
	1970	1,790	32,000	99,000

SOURCE: Bata, Th. J.: Shoemakers in a shrinking world. Speech to American Footwear Industry Association, BATA Limited, Don Mills (Toronto). Quoted in Boon, G. K.: Technology and Employment in Footwear Manufacturing. Sijthoff and Noordhoff, Alphen an den Rijn, Table 7.10, p. 148.

More generally, in markets where competition was mainly an affair among small firms with about the same costs, no firm could expect to exert much impact on the behavior of other firms. Of course, from time to time a firm would go for short-term price competition, in the hope of solving a temporary capacity problem by gaining some market share. Firms would also endeavor to squeeze their costs, refurbish their installations, and establish brands. In the process, some would indeed become large enough to exercise some power over the market. Bata for instance became a global firm.[2] In general, however, there was little in the way of strategies understood as actions intended to defend or expand market shares.

Needless to say, the three circumstances that softened the impact of competition in the pre-seventies are now gone. The industries that make leather, leather footwear, leather garments and upholstery rank among the most dynamic and the most export-oriented of the Italian economy; the leather footwear and garments industries have been about the only ones to retain employment when Spain had to adjust to her insertion in the EC. These are not the kind of industries that are easily released to give room to other industries.

In developed countries, the markets for final leather goods is stagnating in volume because the population no longer grows and because the households decrease the share of income spent on footwear. Hence losing market shares has come to mean shrinking in absolute terms. Finally, the third circumstance, the absence of competitive strategies, that characterized the pre-seventies, no longer is relevant.

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[2] Global in the sense of producing and selling in a great number of national markets separated from each other, not in the sense of a firm implementing a global profit maximization strategy.

Today, firms of unequal size, controlling differentiated advantages (cost, organization, technology, brands, etc.), manoeuvre in order to strengthen their position or to penetrate the American, Asian and European markets. As the room for manoeuvering becomes global, the strategies become more complex. Firms not only improve their competitiveness: economize on inputs, widen technology, diversify products, select output, prices, capacity, etc., but they also enter into interactions with other firms: co-operation or rivalry with competitors; control of suppliers or purchasers; control of the range of products, etc.

Investment or acquisition opportunities, technological developments, commercial trends, and competitors' behavior are being permanently watched. Production activities, supply lines, and distribution networks are optimized according to the comparative advantages of alternative sites; the product mix is diversified to suit the tastes of various categories of consumers; across-borders brand loyalty is created by means of advertising and control of distributive trade.

Since the market expands to a global scope, the international movements of investments, goods, and technology takes on increased importance, and national governments become protagonists. Nowadays, the strategies of firms need to take into account, not only their suppliers, customers and competitors, but also governments and international organizations which regulate international trade and investment. Typical strategic management will have to consider whether access to the US market may be restricted, whether the 1992 common market of the EEC will be protective, and what new problems and opportunities will emerge in Eastern Europe. Scenarios like these concern the future, but anticipatory behavior is already taking place today.[3] Why is it that competition changed so markedly since the seventies?

The emergence of new leather countries

Since the early seventies, new countries have become the site of a considerable part of the production of leather and leather-made products.

These newcomers were developing countries that met two characteristics not easily found in developing countries: they could achieve very low manufacturing costs and they could absorb the high transaction costs with which their supplies and products were burdened.[4]

The manufacturing costs were low because the salaries were low even in relation to a productivity which initially was lower than in developed countries. They were low also because their tanned leathers and their leather-made final products benefitted from the considerable incentives that were given by their governments to the export of manufactures.

The barriers to exports created by the transaction costs were overcome because, on the supply side, producers and traders made enormous efforts to penetrate the arcane of international dealings and to adjust to their requirements, whereas on the demand side considerable technical assistance in matters of marketing and manufacturing, as well as open borders, were provided.

When it became apparent that certain low-wages countries had a clear cost advantage in making downscale leather products, internationalization snowballed. In a first phase, Brazil became one of the world's largest women's leather shoe manufacturers; Korea and Taiwan became the top volume producers of leather garments. The second phase started when leather athletic shoes became fashionable; Taiwan and Korea, which were already large-scale producers of plastic shoes, easily occupied the first places in leather athletic shoes. The third phase saw firms in mature leather countries shifting their factories to the low

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[3] For instance, a Korean firm is known to have rehabilitated a Turkish shoe plant in order to have a springboard into the EEC should Turkey become a member.

[4] The transaction cost is the sum of all costs involved in linking the production site to the inputs and outputs markets places. It includes notably the communication cost between buyer and seller and the cost of delivering the goods within agreed delays. Transaction costs are necessarily high in emerging economies which are by definition without links with the rest of the world.

labour cost peripheries of Europe (Portugal, Tunisia, Turkey, etc.) and of the United States (Puerto Rico, the Dominican Republic). In the fourth and current phase, more countries of Asia - China, Indonesia, Thailand, India, Pakistan - are becoming exporters of final leather goods.

Of course, a segment of the leather-making industry followed its downstream clients to the new locations. Korea and Taiwan saw the development of a tanning industry which today makes considerable quantities of standard leather from imported hides and skins. Brazil and India have tanning industries which serve not only domestic buyers but also export leathers processed from local raw materials.

In the United States and Europe firms specialized in downscale products could not withstand the shock. Downscales are easy to copy, they can be chain-made by semi-skilled workers, most of the cost accrues in manufacturing, and the quality of the material they are made of is not decisive. In these conditions, a labour cost advantage is decisive. Indeed, in just two decades, the number of plants and the volume of production plummeted in mature leather countries.

Most of the plants which were eliminated belonged to small firms oriented towards their hinterland. Most of the plants which survived were among those which could find a niche and could export; since marketing abroad is more expensive than at home, these plants were on average larger than the plants which had closed. Most of the new plants specialized their product lines on upscale goods and therefore had to export (the home market being generally too small for upscale goods). This treble trend brought about a new competitive environment with fewer and larger firms and with a wider and more marked international dimension.

The global competition map

A very rough sketch of global competition - one that would focus on the most basic at the cost of omitting many precious details - would oppose a group of firms exploiting a comparative advantage in the making of mass products to another group particularly good at making sophisticated products. The market these groups are fighting for would be the market formed by the few countries relatively open to trade, roughly the OECD countries with the exceptions of Japan and Turkey.[5]

This is of course not all the competition there is. Firms from both groups rival among themselves; firms in countries closed to trade fight for the domestic market where they operate; firms in countries open to trade try to penetrate the protected markets. Furthermore, there is rivalry at the distribution stage among firms which are not involved in the making of leather or leather-made products but in the co-ordination of a value-added chain that goes from product design to retail trade. These rivalries are important but less than global.

If one sought to represent the global competition map on a two-dimensional space - i.e. according to two characteristics only, it would probably be best to take as one co-ordinate some scale of product quality and, as the other, some measure of market maturity. What quality and maturity actually are, is admittedly too unclear to go without a word of explanation.

Quality is here used in a loose sense (but intuitively meaningful to any customer) including not only technical quality of the finish and of the leather fibres but also the degree of design and of fashion of the final product. At the bottom of the quality scale lie anonymous mass products sold in discount stores, fairly indifferent to fashion, designed as standard goods and made of poor leather. At the top of the quality scale, products enjoy such a strongly exclusive identity that they are practically immune from competition. A Louis Vuitton bag, a Rossetti shoe have their own market where bags and shoes of other makers are not really rivals. However, at these heights the air is thin. Between upscale and downscale products flourish

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[5] Japan is reported to have a quota limiting imports of leather to 2 per cent of domestic production. Leather imported within the quota is subject to a 20 per cent duty, on leather imported outside the quota, the duty is 60 per cent. See Leather, July 1991, pp. 16 and 17.

the intermediate ones which aim at bringing some sort of class to the mass. This is a much bigger market, one also more easy to enter. In this arena rivalry takes the form of product differentiation. According to their preferences, consumers address themselves to different product niches. Consumers attracted by a particular niche are aware of relatively close substitutes available in other niches yet would not switch their purchases because they are attracted to the specific characteristics of the goods they buy in their own niche. Niche fidelity if of course not absolute, a price differential, if large enough, would attract consumers to the closest substitute. This is why firms would generally produce a variety of products at different price levels. The formation of a cluster of customers around specific characteristics explains one of the most evident but nonetheless intriguing features of many consumer goods markets, among them the markets for final leather-made goods: firms produce very large varieties of products which are quite similar but not identical.

Maturity may sound a somewhat bizarre attribute when applied to a market. A market is basically a set of interactions between sellers and buyers of a given product and as such can hardly be seen as more or less mature. Yet the term is used as an attempt to characterize at the same time the productive capability of the suppliers and the purchasing power of the buyers. Productive capability depends of course on technology and production factors that can be acquired but also on know-how and skills that come only with experience. Purchasing power comes from the performance of an economy at a given time but also from past accumulation. Thus, the degree of maturity can be taken to be a gauge of both the supply and demand sides of the market.

Within the obviously oversimplified space of quality of products and maturity of markets it is difficult to represent the complexity of global competition. The rival theatres of the leather-related branches are so different that a single functional form could not account for them all. At least four branches must be distinguished: tanned leather; footwear (non-athletic) and garments; upholstery (automobile and furniture) leather; and athletic footwear.

Figure 1 represents global competition in these branches by means of four diagrams. The horizontal axis of a diagram is divided into three segments corresponding to increasing degrees of market maturity. On this axis the principal emerging countries include China, India, Indonesia, Thailand; the new countries are Brazil, Korea, Taiwan; the mature countries are France, Germany, Italy, Spain, the United Kingdom, the United States, and a few more developed countries.

Since three groups of countries and four products are considered, Figure 1 sketches a global rivalry taking place in 12 markets. The vertical axis measures the scope of sophistication of the products sold on a market. The rectangles formed by one of the three segments on the horizontal axis and a distance taken on the vertical axis give a notion of the quality range sold on a market. Roughly what the area under the rectangle says is, for instance, that: the full quality range, from downscale to upscale products, is present in the markets of mature countries and also in the athletic footwear market of new countries; there is no market for upholstery leather in emerging countries; there is a market for down to lower middle class products in new countries.

The dots and stripes indicate the location of firms supplying a market. Dots are firms located in mature countries; stripes ascending from left to right indicate firms producing in new countries, the other stripes refer, of course, to firms located in emerging countries. With the help of this graph it can be seen, for instance, that the upholstery market of mature countries is supplied mostly by firms established in that market, with the exception of a thin downscale fringe of the market served by firms located in new countries. Inversely, producers installed in mature countries are not involved either in the supply of any quality level in the athletic footwear market or in the downscale level of the footwear and garment market of mature countries. Producers in emerging countries ship their products to six markets; in two of these markets - footwear and garment, athletic footwear - they compete against firms in emerging countries to serve the downscale quality level of the market of mature countries; in one case - tanned leather - they challenge not only emerging countries but also firms of mature countries.

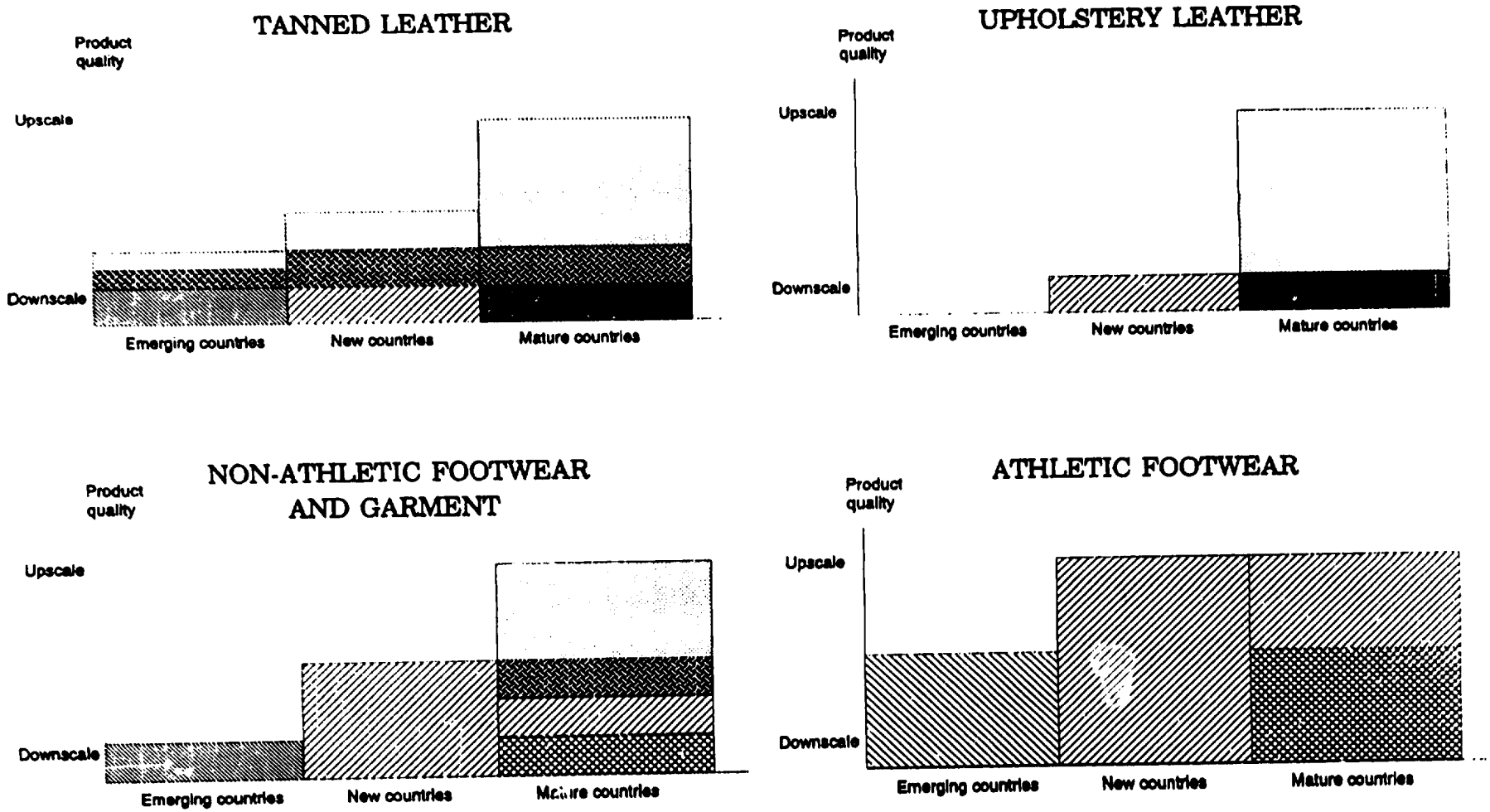
TANNED LEATHER
Product quality
Upscale
Downscale
Emerging countries
New countries
Mature countries
UPHOLSTERY LEATHER
Product quality
Upscale
Downscale
Emerging countries
New countries
Mature countries
NON-ATHLETIC FOOTWEAR AND GARMENT
Product quality
Upscale
Downscale
Emerging countries
New countries
Mature countries
ATHLETIC FOOTWEAR
Product quality
Upscale
Downscale
Emerging countries
New countries
Mature countries

Figure 1

Figure 1 graphically reflects the commonsense notion that product quality and market maturity are positively linked (the height of the rectangles increase from left to right). The link comes in the first place from the demand side. It is in mature countries that the largest number of buyers of sophisticated footwear and garments are found. It also reflects the comparative advantages of the rivals in presence. Mature countries are better endowed with the ingredients of quality products: design capability, marketing capability, manufacturing skills, access to the best raw materials and inputs. New countries are exploiting a capability for large-scale production of good quality products. Emerging countries have the cheap labour which is needed for mass production of downscale products.

Turning now to the salient traits pictured in Figure 1, the following is noteworthy:

Tanned leather markets

Tanning is clearly the strong point of firms in mature countries. It is at any rate the only sector where firms producing in mature countries sell their products to other countries.

In the upper quality range there is no global competition yet. With their traditional skills, their immediate access to quality raw materials, their exacting clients and rivals, tanners in mature countries are at the same time in a trump position and kept on their toes. This is a winning combination and, indeed, they have proved very innovative in product performance (washability, flexibility, etc.) and appearance as well as in marketing (product labelling).

When standard leathers are good enough, the supremacy of mature countries vanishes. Firms in emerging countries make their own standard leathers either because they are in a raw stock-rich environment like India or Pakistan or because they are in an environment where mass products are made, as in China or Indonesia. These firms also export to mature countries with the help of governmental export incentives on finished leathers supplemented by bans on the export of raw material.

Firms in new countries have developed a competitiveness based on large-scale capacity and a constant drive towards technological improvement. With their medium-range products they, too, are present on the three markets for tanned leathers. They penetrated the market of emerging countries via tanneries established to serve offshore manufacturing plants. They penetrated the market of mature countries via low prices resulting from large-scale production.

Upholstery leather

The market - which may be subdivided into four segments - domestic furniture, cars, contract furnishing and aircraft - is almost exclusively in mature countries. An incipient competition from new countries is however setting in. Furniture leathers from Argentina and Brazil have been sold in Europe and the United States for already a decade. Thailand provides high quality buffalo leather to one prestigious European carmaker. Korean firms sell leather to local carmakers and are starting to ship whole hide tanned upholstery leathers to Europe and the United States. On the whole, there is a degree of global competition but mature countries still have the market solidly in their grip thanks to the proximity of the clients and the availability of quality hides.

Non-athletic footwear and garments

The markets of emerging and new countries are sheltered from global competition. By contrast, the market of mature countries is the theatre of intense rivalry. Firms at home in this market have completely lost its lowest quality slice; at the intermediate level, they fight a rearguard combat with firms of new countries. The latter firms in turn have to face the intrusion of firms in emerging countries at the lowest end of the quality scale.

Although the origin and structure of the increased demand for leather garments and footwear differed, the two sectors had developed along very similar lines. With footwear the start and the stimulus had been a shift in focus to the down-market canvas sneaker at the expense of the traditional walking shoe; with garments all existing outlets had expanded though at different rates. The standard black nappa jacket in basic styling echoes the standard white polyurethane coated leather trainer at the bottom and bulk end of the consumer market. Market and production patterns have followed the same path. Europe and North America have remained the target areas for both, except that as Japan had no import restrictions on leatherwear as she had on footwear, garment exporters were able to penetrate this market also. World production moved progressively to the low labour-cost countries, whether or not they had raw hide and skin resources, as the cost of labour replaced rawstock availability as the determinant of location of both leather and leather product production.

The strength of the garment manufacturers in the mature countries is their proximity to the market and the crux of their defence against low-cost imports is to increase the unique fashion element in leather garments and to some extent even to move away from the total leather look. Consumer replacement of leather garments has tended to be long term, governed by the "investment" outlook. Certain fashions, such as the distressed look, the combat jacket, the tie-dye and Jungle Suede finishes, the Afghan shaggy sheepskin, can dominate fashion, often commanding high prices and wide margins initially, but production moves abroad because garment replacement is slow. The "stone-washed" fashion has long gone but appears down-market, supplied by imports from South America.

Athletic footwear

Producers in mature countries have virtually been evicted from global competition. Even the best quality athletic footwear do not really qualify as upscale leather products. Consequently, mature countries have no comparative advantage in manufacturing athletic footwear. The key to competitiveness here is a capability to fulfil large orders exactly fitting the specifications of the distributors. The technology, however, is labour-intensive and tends even to become increasingly labour-intensive as more and more manual operations are needed to decorate the shoes.[6] The technology of long runs of standardized shoes by means of labour-intensive techniques is firmly in the grip of new countries. After having developed and used this technology in domestic plants, the new countries are now transferring it to places where labour is cheaper i.e. in emerging countries. Some of the latter countries are well prepared for this technology - Thailand, for instance - others are less prepared - like China - but on the whole the initial frictions are being overcome and the comparative advantage of new countries starts to shift to emerging countries. Reflecting this trend the lower fringe of the market in mature countries is shared between firms located in new and emerging countries.

[6] The main form of competition in athletic shoes is through the creation of niches. As rivalry is intense, niches have proliferated. To create as many niches as possible, producers have no other choice than to diversify the appearance of the shoes.

LABOUR COST-BASED RIVALRY

This is the salient form of rivalry in the domain of mass products. The strategic theme consists of establishing factories in ever cheaper locations. The initiative of offshore sourcing is often in the hands of distributors. It is a reflection of markets searching for new producers rather than producers with better products or more efficient techniques taking command of market shares.

The initial entry of low labour cost countries

Price-cutting became an option able to force competitors out of the market when competition unfolded in countries with widely different wage rates. It was initiated a little more than two decades ago, principally at the initiative of large buyers from developed countries. To a large extent the demand side of the leather products markets in Europe and the USA was controlled by large buyers: multiple chains, department stores, retailers co-operatives, mail order firms, wholesalers. These large buyers continually sought the lowest cost source of supply. Until the mid-sixties these were found mostly in Italy, Spain and, marginally, in Eastern Europe. It was soon to become clear however that much cheaper sources were emerging in some developing countries.

Of course, market shares built on the basis of low labour cost are exposed to competition from even lower labour-cost production sites. Factories making standardized products tend to use little durable capital and to employ unskilled labour. The technology is accessible to all potential producers and does not involve much sunken costs since the durable capital consists essentially of footloose equipment. On the demand side, since the product is standard, even a very small price difference will suffice to lose the clients to some other supplier. Under these supply and demand conditions, entry is quite easy and the rents created by the pioneers get dissipated by a proliferation of competitors.

Having adopted outward-oriented policies, Brazil, Korea and Taiwan presented a tremendous export potential based on a combination of very cheap labour, reasonable productivity, and government support.[7] Notwithstanding the handicaps of transport distances and lack of experience, this combination gave the NICs a c.i.f. price differential of about one-fourth or even one-third of the prices in developed countries.[8]

This cost advantage hurt the established market shares because it was translated into lower prices[9] and applied where it mattered most: in the market for bottom-range standardized leather footwear and garments. The footwear market was exposed to price rivalry because standard products are by definition easy to copy and could therefore be produced by newcomers and substituted for the products of established producers.

Before the Koreans, leather garment manufacturers throughout the world are relatively small units and the leatherwear sector has still to adopt the pattern of mass production of standard ranges in large units characteristic of other branches of the garment industry.

Not being a mass-made standard product did not however insulate leather garments from cost-competition. Leather garments persist over several seasons, longer than fashions in other sectors of the

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[7] See Chapter IV.

[8] See World Leather, October/November 1989, p.48.See Chapter IV on leather industries.

[9] At that time the only worry of market entrants was to deliver products acceptable to the importers: profit margins were not an essential consideration because the governments would guarantee margins on exports through subventions.

garment trade. Given slow replacement of the products, production can move easily to cheap labour areas because the transaction cost is much less important when time is not a factor.

The adjustment of the incumbents

A great many footwear firms in developed countries could not stand competition and therefore shut down. These were mostly small firms and firms too traditionally managed to adjust. The remaining firms embarked on an all-out attempt to restore competitive balance. Their efforts took three main directions: cutting costs, moving into new techniques, introducing new products. There were many cost-cutting opportunities: trimming employment, eliminating inefficient operations or marginal product lines, squeezing budgets, reorganizing internally. But even fully exploited, these opportunities were not offering enough room to restore competitiveness in the face of a large cost advantage in labour, the one item that, after raw material, looms largest in the cost structure.

Therefore many firms in developed countries decided to join in the cost advantage that they could not beat. American firms went to Asia and US neighbours: Puerto Rico, Mexico, Dominican Republic, Venezuela. European firms went to Asia and to the "periphery" of Europe - Malta, Morocco, Portugal, Tunisia, Turkey, Yugoslavia, and in eastern European countries.

Sometimes this strategy consisted of re-deployment in the strict sense of shutting-down facilities at home and opening up new ones abroad. More frequently it consisted of geographical diversification, whereby production of middle-range articles not subject to fast changes in fashion were moved abroad, whereas products of high quality were kept at home.

Some firms which could or would not engage in the expense of opening-up abroad entered into joint venture agreements. Other firms which did not wish to expose capital to the risks of foreign environment preferred sub-contracting. American firms, for instance, prefer outward processing whereby a factory in the US exports parts for assembly by a sub-contractor in Mexico, Puerto Rico or in a Caribbean country and re-imports the assembled product.[10] The double transport cost involved in this kind of operation is compensated for by tariff treatment which provides that duty be paid only on the value added to the exported parts. Finally, many firms sought to partake of the advantages of cheap labour simply by importing uppers to be incorporated into home-made products. It is perhaps the British footwear industry which relies most on this way of cost squeezing.

High cost tanners and garment manufacturers adopted similar strategies to those of the shoe manufacturers. Initially these took the standard form of first switching to or buying in cheaper materials, then to subcontracting the labour-intensive operations such as assembly to offshore units, setting up subsidiaries in the low cost areas or entering into production, marketing or technology transfer joint ventures.

While adjusting to competition, firms in developed countries also sought protectionist measures. The standard defensive strategy is the political one and Japan's import quotas on footwear show how effective such political defences can be. The European Community and the USA have duties but no other restrictions on leatherwear imports but are losing patience with supplying countries which prohibit access to their rawstock but are seeking additional rawstock from the free market areas. Pressure is growing in America to prohibit exports of raw materials or to impose punitive countervailing duties on imports. In 1990 America succeeded in getting countervailing duties imposed on exports of leather from Argentina on the grounds that restrictions on exports of hides from Argentina were a subsidy. This has reduced Argentinean exports to the States as did the import quotas on Korean footwear earlier in the eighties.

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[10] Sometimes a more complex division of labour is organized. For example, one US firm would have stitching done in the Dominican Republic - where the wage rate is relatively low - and assembly in Puerto Rico (due to advances made in machine assembly, upper production has become the most labour intensive stage of footwear production). In other cases, some operations which are less labour-intensive, such as bottoming, finishing and packing, are performed in the United States.

The consolidation of entrants

As their wage rates rose relative to the new competitors, Brazilian, Korean and Taiwanese firms had to resort to the same methods used by their European and American rivals 15 years before: to upgrade the products made at home and to expand or transfer production offshore to the new lower-wage countries.

The first method is still in the probing phase. Upgrading the products is not simply a manufacturing problem. If it were, Brazil, Korea or Taiwan would have no difficulty in solving it. It is essentially a marketing problem of gathering information on what is trendy and of supplying sellers just-in-time. It is also a problem of overcoming barriers to entry such as brand-loyalties or control of retail trade. Finally, it is a problem of access to suppliers of fine leathers.

The second method is already producing visible effects. China, India, Indonesia and Thailand among others have acquired the attributes of attractive export locations: political stability, outward-oriented policies, abundant labour and competent supervisors. In these countries, the wage rate was roughly one order of magnitude lower than that in Korea and Taiwan, thus offering a clear cost edge notwithstanding lower productivity and higher transaction costs.[11]

Overcoming the transaction cost handicap

Countries with low wages often also are countries with high transaction costs. The transaction cost, it was said earlier, is the composite cost accruing when it comes to insert a new production site into a worldwide network of inputs and outputs markets. From India, exporters are obliged to ship their upscale products by plane because the ports are too inefficient; in China managers moulded by the command-type of economic system need the help of foreign advisers when they have to discover new inputs or to change the relations with contractors and suppliers, these and many other cases of administrative red tape, infrastructure deficiencies, and custom restrictions reflect the heaviness of the burden of transaction costs in countries entering world business.

The burden may be too heavy for beginners. Entrants cannot at the same time set-up manufacturing operations, cultivate distant markets and establish conduits to these markets. Outside help is therefore needed.

Fortunately, market forces have driven agents from developed countries to provide assistance. Initially, most of the leather goods firms in developing countries were created by local entrepreneurs who had no own linkages with the buyers' markets. However, most of the time, these firms were set up with a view to fulfilling orders placed by foreign trading companies. For instance, the footwear exports of Korea and Taiwan were initiated by local firms at the initiative of Japanese merchandising companies well introduced into the US market; later additional export channels were provided by Nike and Reebok.

Trading companies were not the only agents who gave assistance to the incipient manufacturers of developing countries. Help also came from manufacturers of developed countries.

They too had to provide market conduits and technology to their off-shore associates when they initiated manufacturing operations in low wage countries. So had the NICs when their turn came to expand in other countries of South East Asia.

In the process of this massive influx of assistance the relationship between the order giver and the producer changes. A buyer would expect a manufacturer to provide products which match the specifications of the orders in terms of design, quality norms, physical features of the materials, numbers,

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[11] Le Monde reports that the ex-factory price of a brand new factory in Indonesia is 10 per cent lower than in Taiwan. See Le Monde, 31 July 1990, p 17.

sizes, colours, as well as the time schedule for delivery. When, in its search for low-cost suppliers, a buyer selects a new firm of unknown reputation, the goods may prove somewhat defective or may be delivered with long delays or in insufficient quantities. As protection against such risks, buyers usually invest considerable effort in helping the exporting firms meet the specifications. The design and other features of the product are specified in detail by the buyer who also helps with the packaging, shipping, customs aspects of delivery and even finances (pre-pays) the production of the order. If the buyer is itself a firm with manufacturing experience, he will advise on productive operations, train the working force, contribute to quality control, provide pre-cut patterns, dyes, lasts and sometimes even machinery, identify the sourcing of raw material and establish the channels to sales. If, in the process, the exporting firm learns well, a long lasting relationship will develop.

The cost sunk into cultivating a relationship between manufacturer and trader stabilizes their link. However, the trader can always shift his order to cheaper sources. The market position of manufacturers will therefore be stronger when they can use alternative conduits to distant markets.

Such is for instance the case when a large number of independent export traders compete to channel orders from final client to manufacturer. The case of Taiwan illustrates this situation. A survey of 896 firms (884 respondents) conducted in 1986 revealed that the main channel of exports of footwear were domestic trading companies (for 72.4 per cent of the respondents), foreign trading companies (17.5 per cent) and direct export by manufacturers (7.0 per cent).[12]

If and when firms start differentiating their products, the passive role of orders takers will become inadequate. A more active role involves directly establishing a bridgehead in the consumer's market. The easiest form of marketing abroad is to send out sales people to participate in commercial fairs or to contact individual customers. A less direct but more permanent way of being linked up to the consumer is to use large trading companies, who, by maintaining offices abroad, represent the interests of several exporters. In India, for instance, the leatherware division of the State Trading Corporation assists about half of the leather products firms in exporting their products. As sales develop, a more personal representation may become desirable but is likely to be more costly. However, even a small exporting firm can have its own permanent presence in a foreign market by using the services of representatives working on commission. Finally, firms commanding large resources, such as the Korean Chabools, may set up a distribution network, wholesale or even retail, in one or several importing countries. As a rule however this level of marketing penetration cannot be achieved without a well-established trademark and the capability to produce unique genuine designs.

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[12] See Levy, B., op.cit., Table 5, p.158.

MANUFACTURING-BASED RIVALRY

Manufacturers wanting to stay in mature countries and to meet the competition based on low labour cost have theoretically three options:

- to reduce material costs;
- to reduce labour inputs through rationalization and use of more capital per worker;
- to go for a brand new technology based on computerized automation.

Reduction of material costs

Material costs can be reduced by decreasing the unit cost of materials and by accelerating the circulation of moving capital.

Reducing unit material costs is not likely to be a valid option against low-cost competition. Utilizing lower grades or cheaper materials such as hide splits in place of sheep suedes, East Indian sheep nappes instead of Iranians brings the garment manufacturer into direct competition with the imported product and tends to increase price sensitivity. It often involves sourcing from countries like Pakistan or India who use the same material to make their competing garments. Down grading the quality of the leather is usually counter-productive. Combining leather with fabrics is an effective strategy provided this represents a high fashion feature, as has occurred in the 1990 and 1991 seasons, and not simply a cost saving substitution of panels without any fashion content. More effective utilization of the raw material, however, through computerized assessment of the leather and pattern fitting combined with laser or water jet cutting could achieve material savings of 3% to 4% according to studies by SATRA Shoe Technology Centre on shoe leather utilization.

In leather manufacture and in garment making the raw material accounts for about half of the total leather cost or one-third of the total garment cost and absorbs an enormous share of the working capital. Speeding up process times therefore offers considerable opportunities for cost cutting. In the tannery it is governed by fundamental constraints imposed by the need to achieve full chemical penetration and physical stabilization of the leather. Process times have come down substantially and new tanning and finishing technologies are reducing them still further.

With leather garment making new technologies are unlikely to make an impact and it will probably remain a sewing machine assembly operation. Even though gluing of seam turnings has long been practiced, gluing instead of sewing, which has made considerable progress in shoemaking, does not appear to be an option in leather garment making because of the problem of cleaning.

The capital intensity option

In the recent past the shoemaking industry has recorded some remarkable technological advances. In 1978, for instance, machines became available to combine all the lasting sub-operations (toe lasting, heel lasting, side lasting) into a single one, thereby achieving considerable savings in labour inputs.

Inspired by this kind of achievement, firms which have maintained part or all of their production in developed countries have hoped to find an antidote to cheap labour by way of more capital-intensive plants and rationalization.

This hope, however, proved to be misplaced. Production did become more intensive in capital - if only through the release of the operations more intensive in labour - but the resulting increases in

productivity were not large enough to restore competitiveness. Leather making, though capital intensive, is essentially an art and many tanners - the Italians in particular - have increased rather than reduced their labour input and process time in order to impart distinctive performance and character to their leathers even if their tanneries have the most sophisticated equipment. Furthermore, in developing countries too many firms have invested in more capital-intensive techniques, either to face increasing labour costs as in Korea or to compensate for the initial low productivity of the beginner as in Indonesia.[13]

Rationalization of production, by means of factory layout, cell working and continuous processing, similar to what is happening in the shoe industry, has led to increased productivity and reduced rejects. Such techniques are applicable to both tanning and garment making but, again, are not able to neutralize the advantage of competitors with low labour costs.

The new technology options

In the last few years attention shifted from capital-intensity to high-tech. Firms in developed countries are now hoping that competitiveness can be regained through a leap into hyper-modern techniques based on programmable automation featuring computer-assisted design (CAD), computer-assisted manufacturing (CAM), and flexible manufacturing.

There seems to be no limit to the hopes that have been placed on computer-integrated manufacturing. The quality, speed and diversity obtained on production lines would reach previously unthinkable standards; the burdens of design, stocks, and distribution would be immensely alleviated. As far as the rivalry between developed and developing countries is concerned, manufacturing with robots led by computers would have two major consequences.

On the one hand machine and computer processes are expected to reduce the cost advantage of developing countries. Three sources of savings are envisaged. First, thanks to newly acquired precision and versatility, machine and computer intensive processes would replace labour. Second, computer-managed operations would bring about just-in-time flows whereby stocks of raw materials, parts, work-in-progress and finished goods are minimized (production starts after the client's order and delivery follows almost immediately).[14] Third, the new techniques would provide the wherewithal of higher average and more constant quality.

On the other hand, it is hoped that a flexible technology allowing firms to produce a variety of differentiated products will soon become available. New flexible systems capable of being reprogrammed quickly would automatically adjust the production lines in response to changes in the design to be executed. To further reduce response time, the versatile plant operations would be seamlessly integrated to the environment. The client would be integrated into the design department of the enterprise; the product would be designed to be fabricated; the fabrication would respect the design; the suppliers would be integrated into the fabrication process, etc. With this flexibility, firms in developed countries would have an advantage - at least on the markets of differentiated products - over their rivals who are supposed to stick to less flexible techniques dedicated to long runs of standard products.

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[13] Developing countries are supposed to be poor in capital, and it can be demonstrated that capital-intensive techniques in capital-scarce countries is a wrong allocation from a nationwide standpoint. A capital-intensive technique may however have a microeconomic rationality for a firm which has access to cheap capital. In developing countries (also in developed countries), firms which are successful exporters or which have good export prospects are routinely given preferential conditions to use reinvested profit or borrow medium-term capital.

[14] Just-in-Time is helped but of course not conditioned by computerization. American tanners and shoe manufacturers have traditionally operated Just-in-Time raw hide supply and finished leather delivery.

Clearly computer-assisted and flexible manufacturing i an option already available in several industries, for instance, the automobile, machinery, and electronics industries. In leather-based industries however it is still largely Utopic.

Computerized applications have admittedly started to penetrate the processes of the footwear industry and trade, but so far to a limited extent and with little apparent cost advantage. Some inroads have been made into computer-aided design offering the capability to study dimensions, patterns, textures, colours of material through instantaneous variations. In shoe-making all skiving, folding, stitching operations can now be computer controlled from a central system. Lasting and bottoming too, if necessary, can be performed automatically or in highly productive rinks. The one-off nature of garment leather makes marking out and pattern cutting a skilled, slow but critical function not readily subject to mass production. The same problem occurs of course in shoemaking but the smaller pattern sizes of shoe uppers enable the shoemaker to cut the whole shoe from one skin whereas with leather garments three, four or more skins are required for one garment. The application of computer aided designing and manufacturing and computer integrated manufacturing to programming, pattern making, sizing and water jet cutting or laser activated profile clicking have occurred in the shoe industry particularly in athletic shoe construction out of polyurethane coated splits with a uniform finish. Because of the size, shape and finish, garment leathers do not lend themselves either to CAD/CAM or to multi-layer pattern cutting common utilized with textiles supplied in roll form. In theory, both are possible but the cost of the CAD/CAM systems would have to come down considerably before there is any real likelihood of this occurring or of being a cost effective replacement for normal hand or sewing machine garment assembly.

Computerization of leather making, however, has reached an advanced stage, helping to reduce labour and process material costs and to eliminate variations in measurement, dosing, timing and process control. The Just in Time technique in production, under which the work in progress and the material needed are "pulled" as required rather than accumulated in advance of the next process, can make signific ant reductions to the volume of process and partly processed stock in assembly operations like garment manufacture and in chemical and mechanical production such as leather making. Computerization of stock and process control has stimulated the spread of the Just in Time philosophy especially as retailers and wholesalers have tried to shift the cost of stock holding down the line to manufacturers and manufacturers in turn to producers. For the time being, however, the ideal of a closed-loop feedback combination of hardware and software in which the prime inputs are product requirements and product concepts, and the prime outputs are finished outputs, still remains Utopic.

It seems that two obstacles are preventing the vision of full, programmable automation to take shape. In the first place, there are technical problems. Admittedly, operations at the beginning of the processing cycle (design, dyeing, cutting) and at the distribution stage (inventory control, automated stores, orders) to a large extent can be automated with the help of microelectronics. However, the core processes - those whereby leather products such as footwear and garments are actually manufactured - so far resist technological breakthroughs. To understand why, it must be considered that hides, skins and leather are materials very adverse to automation because of their irregular textures and also because they are too limp to be handled and gripped by devices and tools used in other industries.

Furthermore, a process governed by computers must be fed with a stream of information, stating with mathematical precision, all the conditions of the material and the actions to be taken by the machines. Without human operators, sensors must be relied on to detect the position and orientation of the material, inspect its texture, recognize its defects and programmed controllers must tell the machine how to react to what the sensors signal. Since leather is such a "capricious" material, the requirements of production-control data, interpretation, and instructions are too exacting - at the present stage - for an automation of core processes.

Processing leather is in itself already difficult to programme, even to make a single product line. When it comes to a programme for a variable product-mix the difficulty is of course compounded.

Owing to the very complex and erratic information structure involved in small-batch manufacturing, this technology requires considerable investment in a support information-processing system which can be

thought of as the "nerve-system" in the production plan. Making this nerve system fit together with the software needed to process a capricious raw material is indeed a high-order task.

Yet, the fact is that the core processes - assembly and particularly sewing - absorb the largest portion of the low-skill labour force, which constitute the major competitive advantage of developing countries. A decisive breakthrough into labour-saving and flexibility will require efforts in research and development. In this respect, leather firms have little strategical initiative at their disposal. Very few of them, if any, have the capability and the resources to develop radically new core processes. All the advances recorded up to now in computer-integrated manufacturing have been made under the impulses of the machine industry, and it is likely that in the future it will remain like that.

The second obstacle in the way of computer-integrated manufacturing systems is economical. Microelectronic-based technology is still in an early development phase where costs are high. Furthermore, computer-controlled production systems cannot be introduced without a complete overhaul of the existing management and production environment.

Thus, both financially and organizationally, introducing flexible manufacturing is a formidable task at the present time. It therefore appears that only firms that can afford a period of trial and errors, ascribe to innovative management skills, and mobilize the necessary funds to finance the investments, will be in a position to acquire new manufacturing systems.

Not many leather manufacturing firms have this kind of profile nowadays. In leather, value-added and profit are not generated through manufacturing but through marketing. As will be seen later on, the firms which made the highest profit are precisely those which have specialized in the commercialization side of the market and have disengaged themselves from manufacturing. Manufacturing firms have to content themselves with the low profit margins typical of mature industries with easy entry and slow growth.

What then is the outlook with respect to the diffusion of a brand new technology in leather-making? As far as the technical obstacle is concerned, it is reasonable to suppose that solutions will be proposed in the medium term. The leather industry is not the only potential user of new microelectronic-assisted equipment. Its cousin, the clothing industry, is a much larger client with about the same requirements and one with enough jobs involved to be able to enlist the support of governments. In the US, in Europe and in Japan private machinery firms supported by governments or by the EEC have entered joint R&D work to bring automated sewing systems on to the market. Once available, such systems could very well trickle down to leather applications.

As a new technology will be invented, its diffusion will take place according to market forces and strategic decisions. The major advantage expected from micro-electronic-based technologies is flexibility: the capability to swiftly alter the characteristics of the products while keeping variable costs at a low level, even for small runs. The choice between flexible and dedicated techniques will certainly have a strategic dimension. Flexibility will be expensive to acquire, but once available it will allow the firm to be present on several product markets including, if it so wishes, those of its rivals. Dedicated equipment has a lower fixed cost but confines a firm to a single market. Doubtlessly, the choice between these two possibilities will be made on the basis of strategic considerations, that is with a view of the impact the choice will have on other firms.

Recent research, in turn of likely outcomes of this choice, points to the role of basic market features in determining the speed and extent to which an industry will opt for flexibility.[15] Specifically, it appears that more firms will go for flexibility as products become more differentiated, as the markets grow larger and as the difference between the fixed costs of the two technologies diminishes.

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[15] See Röller, L.-H. and Tombak, M.M., "Strategic choice of flexible production technologies and welfare implications", The Journal of Industrial Economics, Vol.XXXVIII, June 1990, No.4, pp.417-431

PRODUCT INNOVATION

Cost economizing is a strategy to defend market shares against competitors with lower cost or to penetrate the markets of vulnerable rivals. In both cases it is about sharing an existing cake. A more creative strategy consists of enlarging the cake. This strategy involves stimulating the demand on the industry by introducing new products on to the market.

To sustain long-term growth, any industry needs to bring new products on to the market - but this rule is particularly true for an industry as ancient as leather which caters to needs which are easily saturated. Indeed, the major source of post World War II dynamism for the leather and leather products industry has been a demand boost generated by product innovation in three areas: garments, athletic footwear and upholstery.

Innovation in garments

Retrospectively, what the industry did to stimulate demand may appear as audicious and imaginative marketing. As a matter of fact, however, innovation in leather clothing started very much as a defensive operation.

Leather has always been used for garments but for special applications without any general acceptance - lederhosen in Austria and southern Germany, combat jackets in wartime, police official coats in Germany and France, sleeveless truck drivers' jerkins in Britain. All of these were in effect marginal outlets.

When Dupont launched the poromeric materials at the beginning of the sixties they had identified a 24 million shortfall in hide supplies for the footwear industry. They calculated that a high-priced sophisticated micro-porous synthetic which had many of the characteristics of leather could fill this gap. Their launch coincided with a shoe fashion for patent, where leather's unique plus characteristics were least evident and where PVC finished leathers were already on the market. For shoe manufacturers these poromerics had a number of distinct advantages. They came in continuous rolls, in regular widths and without any surface defects or colour variations and they quickly established themselves as an acceptable material for shoes and handbags.

It soon became clear that the poromerics were not supplementary to upper leather but a substitute that could destroy the market for upper leather in the same way that synthetics had taken over from sole leather, which had dropped from 70-80% utilization to below 20% within a decade. Leather industry marketing specialists proposed two strategies:

- defensive research into the building into leather the plus points of the poromerics without losing the plus points of leather;
- reorientation of the market for leather from almost total dependence on footwear to one third footwear, one third some other high volume outlet, one third the rest.

The market breakdown at the beginning of the sixties was

footwear	70%	saddlery	2%
leathergoods	15%	chamois	2%
upholstery	5%	mechanical	3%
garments	3%		

Of these markets only garments appeared to offer any chance of volume development. Poromerics threatened the leathergoods market even perhaps more than footwear because their performance

specification made them specially suitable. Luggage had already been lost to synthetic fabrics though leather was still holding its own in personal leathergoods. Only clothing could provide the opportunity for both volume and value exploitation.

Garment leather utilized a relatively cheap raw material - sheepskin with the wool on and de-wooled sheep pelts and was divided into five basic markets

- low value heavily pigmented motor cycling nappa
- cheap pigmented nappa for truck drivers' jerkins
- sheepskin with the wool on for country sporting coats
- beaver lamb furskin
- leisurewear nappa and suede with some degree of fashion content, mainly in Italy, Sweden, France and the Netherlands.

The marketing strategy

The campaign focused on expanding the leisurewear sector without any reduction in the others. Suggested targets were one leather garment of any sort - jacket, costume, dress, skirt, trousers, coat, waistcoat, shirt - to every person over the age of 15 every five years or making a start with at least one in their life-time, and at least one garment to every under 15.

The fundamental objective was to convince the free-spending teenage group, who were becoming the fashion leaders, that a leather garment was desirable because it was leather and for this reason the theme emphasized the second skin aspect of leather. Pop groups were encouraged to wear leather gear at all times. The two sections of the motor-cycling fraternity - the macho "Rockers" and the way-out fashion conscious "Mods" - were also targeted. To increase the manufacturing infrastructure, which was small even in those countries where leatherwear had a higher profile, exhibitions were organized either exclusively for the leather garment trade or as a distinct section of outdoor apparel and leisurewear fairs. Couturier selections in leather were featured at the main international leather fair in Paris. Collections were commissioned from design schools and competitions organized to make the new generation designers aware of leather as an exciting garment material. Leather began to appear in the French and Italian couture collections. Press relations campaigns succeeded in getting extensive coverage in the fashion press, the women's magazines and the national dailies. Tanners and garment manufacturers were persuaded to advertise in the fashion glossies, but advertising coverage was negligible. At retail a handful of specialist shops stocked leatherwear and a primary objective of these press and public relations activities was to force department stores, chain stores, men's and women's wear shops and boutiques to stock leather garments as a standard item. However, the underlying objective was to establish leather as an exciting, ultra-modern, sensual, young material and a reason in itself for buying whatever it was made into.

Within seven years, leather became the top fashion material in the designer collections and the garment leather share of the leather market rose to 14%. In Britain, on the basis of leather production, an estimate of 100 000 garments made in 1961 with a retail value of 2 million had risen to 1,5 million garments with a retail value of 45 million. Between 1967 and 1972, OECD imports of apparel and clothing accessories of leather, of which leather garments were estimated to account for 55% to 60%, rose from $96,3 million to $390,1 million; American consumption reached $129,6 million in 1968 and $210,2 three years later; German consumption jumped from DM 241 million in 1970 to DM 625 in 1972.

The success of this initial leather industry generated campaign established a springboard for the astonishing leap that the leather garment made in the next 20 years. By 1987 world imports of leather apparel and accessories had reached $4373,6 million and is still growing. The share of the leather market has moved up to 33% in some countries and footwear has dropped to 40%, so one of the original targets has been reached. It is now feasible to consider that leatherwear will overtake footwear in the leather market split, as upholstery has done in many western countries. Also the consumption target no longer looks Utopian. An analysis by the French garment manufacturers' association indicates that the market

share for men's leather garments is currently only about 6% but, from observations in Britain, Italy, Germany, Austria, Spain and France, 40%-60% of the population already possess one leather garment.

Tanners rather than garment manufacturers stimulated the innovations which have led to the successful merchandising of leatherwear by steadily improving product performance and appearance as well as the fashion stimulus mentioned earlier. The development of dry-cleanable leathers enabled suede garments to be cleaned. Hand and then machine washable leathers opened up further marketing potentials. Colour-fast aniline finishes with excellent rub-fastness and later even washability replaced the original heavily pigmented nappas. Improved splitting techniques and dry-drumming led to thinner, flexible leathers suited to the softer styling in high-class leatherwear. Although no technical specification has been promulgated universally, tanners of the European Community have adopted draft performance guidelines (appendix A). With the exception of the tie-dye finish, introduced by the Indians, and the ultra-soft plonge leathers of the Japanese, these fashion and technical improvements have originated in the west and mainly in Europe.

These high performance and fashion oriented leathers are, of course, available to all manufacturers in all locations, unless there are specific import restrictions, but proximity to this leather supply is also an asset for garment manufacturers in the market countries. These can employ a Quick Response, Just in Time, short colour run, last minute finish instruction strategy which on-the-spot tanners can cater for with the help of computerization. One of the reasons why the Italians have both successfully resisted import penetration and been amongst the leaders in exports is the close cooperation between designer, tanner, small manufacturer and small specialist retailer to produce a distinctive and individual product.

Innovation in footwear

Innovation touched the footwear sector with the promotion of the basic rubber and canvas sneaker into a leather high-tech athletic shoe. When it became apparent that a promotion of performance and appearance of the basic items was meeting with an enormous latent demand, a wave of innovation followed. A combination of technical and decorative innovations - supposedly enhancing the athletic performance of users - and advertising campaigns, made it possible to replace a single product, the multi-purpose sneaker, by half a dozen specialized products considered by the buyers as unsubstitutable (for example the jogging shoe will not be used as a substitute for the aerobic shoe or the tennis shoe).

North America and, to a lesser extent, Europe witnessed a fantastic infatuation for athletic shoes. Probably never since the 14th century's strange passion for slashed and curled pointed-toe shoes, had footwear been given so much attention on the part of the public. Somehow, athletic shoes became emblematic of the decade of the eighties. From a breakthrough made in the fitness rooms, athletic shoes penetrated all segments of the market; sports and street, adult and teenagers, men's and women's.

The combined drives of fashion and fitness pushed the sales of athletic shoes so much that the value of all footwear sales multiplied by two in the last five years of the decade on the US market.

In doubling the demand to the footwear industry, the athletic shoes fever created room for new forms of competition. It fostered powerful firms which had a vision and gathered the means of a global organization of the value-added chain linking designers, suppliers, producers, distributors and retailers. These firms saw that, with the right doses of design and advertising, mass-made products could be sold at prices previously fetched only by luxury items. They stirred demand by developing designs specific to all athletic and sport niches and by promising buyers the invaluable satisfaction of enhanced performance. They also developed the organizational talent that was indeed required to have production licensed to scores of factories and retailed by thousands of specialized shops, department stores and mail order companies.

Innovation in upholstery leather

Leather has long been a traditional material for men's world official, home and office upholstery - the study, the gentleman's club, the courthouse, parliamentary state rooms, official offices and banqueting rooms and carriages. Its strength, durability and solid appearance gave leather a masculine appeal which made it very suitable for these purposes. Its relatively high cost ensured that it remained in the upper class luxury market. Today its prestigious luxury image is the primary consumer motivation and durability and strength are secondary.

The four leather upholstery segments - domestic furniture, cars, contract furnishing and aircraft - have different characteristics which require individual marketing approaches and targeting.

1. Domestic furniture

Although leather is one of many competing furnishing materials and in the furniture showroom is often effectively presented in this way, the desirable image of leather which has been so successfully established helps to make it less price sensitive than one would expect. The consumer accepts and is prepared to pay a very considerable price differential although today the price of leather and the extra cost of upholstering in leather compares with many of the other furnishing fabrics being offered.

The critical factor in furniture retailing is the showroom model. The model on the shop floor is not usually sold except at sale time and at stock changes but serves together with the material swatches as the basis upon which the customer order is placed.

In the UK when the demand for domestic leather furniture first escalated in the sixties and seventies under the stimulus of Scandinavian and especially Danish design leadership, furniture retailers at first chose to present the Leather Look in look-alike synthetics, offering "hide" as an expensive alternative. Without being able to experience the sensual, visual and tactile appeal of leather the customer could only make a decision between synthetic "leather" and more expensive genuine "hide" on price.

Leather furniture marketing therefore in the first instance focused on persuading the furniture manufacturer at least to offer leather as an alternative or preferably that the demand for high priced leather furniture was so strong that it was cost-effective to bring out exclusively leather upholstered ranges. The secondary target was the store furniture buyer, to convince him that the demand would ensure that he could gain the extra mark-up provided he had leather upholstered models in the showroom. The tertiary target was the interior decoration boutique selling exclusive high class furniture to use the designer suite, the upholstered easy chair, the high back buttoned chair in pleated or plain antiqued and plain fashion coloured leather as the focal point of his display.

The demand for leather furniture multiplied in the eighties with the growth in consumer confidence and affluence and the boom in house purchases, all of which influenced furniture buying. The accelerated development of specialist leather furniture stores and chains was both a result of and a contributor to this demand growth. These specialist leather shops concentrated on keenly priced and relatively cheap items based on lower cost imported leather and cut panels from in particular Brazil, which ensured the widening of the consumer market. This initial retail campaign succeeded in establishing leather upholstered furniture as a permanent and central feature of the furniture showroom.

Inspired by the spread of interior design ideas through the women's glossy and the prestige house and garden magazines leather furniture acquired a fashion element which further enhanced the image of leather and stimulated sales.

To cater for this fashion image tanners replaced the traditional pigmented rather stiff leather in standard brown, burgundy and dark green with new ranges in contemporary colours and softer handle. An early example of the new approach was a high gloss, easy clean leather which was particularly suited for the cut and sew panel assembly technique being adopted. This look was

superseded by soft matt smooth and textured leathers in clear fashion colours or pastel shades complementing modern home interior decoration styling and colour themes.

The young first-time house buyer and the older family with new property or replacing existing furniture made up the consumer profile. In continental Europe the family setting up home for the first time regards first purchase furniture as a long-term investment and leather upholstery as a natural, desirable and immediate purchase. It is estimated that as many as one third of first-time family home buyers in Germany and Scandinavia buy leather furniture as their initial purchase. In Britain the pattern is markedly different. The immediate furniture purchase is seen as a temporary expediency well down the priority list of a restricted budget and furniture is usually replaced after four years. In the United States the pattern is more like that in Britain than in Germany but the move up-market occurs sooner because both American and imported Italian models are cheaper in relation to incomes than the corresponding ratio of prices to incomes in Europe and especially Britain in these early stages.

The middle-aged relatively affluent consumer sector in the 25 to 44 year old age group, which is the biggest spender on furniture, and the next age group up comprise the most important consumer sector. These two consumer groups have high incomes; they have already catered for their major capital expenses; and their freely available disposable income is the largest.

The campaign to enhance the prominence of leather upholstery in the retail store was so successful that it was not unusual to find whole selling floors filled exclusively with sofas, suites and chairs in leather. Expanded incomes and sales turnovers ensured that this strategy would continue. Polyvinyl chloride upholstery, which had at first been successfully promoted as a reasonably priced genuine alternative to leather in looks and prestige was displaced in Western European and North American markets and retained a foothold only in Eastern Europe.

2. The market for car upholstery

Leather has also been an established material for car upholstery, originally because it could withstand the exposure to the elements of the open car and later because it was practical, comfortable, readily cleanable and stain resistant. In addition, it had an aesthetic, luxury and prestigious appeal which helped to enhance the image of the driver. As with furniture, it was this attribute which carried the most weight with the end-consumer.

Leather upholstery was standard in the top-of-the-range models and up to the end of the seventies offered as an option in models quite far down the price range. Marketing strategy aims at trying to extend the standard and the option ranges and therefore, as with furniture, targets manufacturers to continue to offer a leather option in down-market models and dealers to order leather upholstered versions for their showroom models. The car dealer is primarily concerned with moving showroom stock and, rather than risk losing a sale if the customer asks for an option not readily to hand, will become a strong advocate for whatever model is in the showroom. Unlike other options supplying, leather upholstery is a major exercise that has to be fitted into the car assembly time schedule. Until the Japanese abandoned straightforward uniform mass car assembly for personalized production with the help of advanced automation, operator flexibility, robotry and computerization, European and American car makers were keen to eliminate small variations from the standard and dropped any option that fell below 5% of the production run. As a result of this policy, the number of lower priced models declined markedly and although some have been reinstated leather upholstery is now available in the top-of-the-range, where it is still standard, and as an option in the next price bracket down. Car manufacturers fitting leather upholstery are Rolls Royce, Jaguar, Rover, Jensen, Mercedes, BMW, Audi, Saab, Volvo, Renault, Peugeot, Citroen, Lancia, Ferrari, Maserati, Cadillac, Buick, Toyota, Nissan and Honda. In Rolls Royce the leather utilization is 98% and in Jaguar 95%. Although leather is standard in only one Cadillac model, traditionally nearly all Cadillac purchasers demand leather and the proportion is over 82%. Volvo's is 20%, a lower than original share after Volvo expanded its model range.

The leather upholstery share of the market has traditionally been higher in Europe than in USA - roughly 10% as against 5%, reflecting the rather different attitude towards the car of Europeans, who have tended to regard it as a luxury, and the Americans, to whom a car is an everyday necessity. As the demographic structure in both continents has changed and the proportion of relatively affluent middle-aged and elderly people grown, sales of the higher priced cars have risen and the leather upholstery proportions in the two areas have merged at about 11%. The Japanese started to fit leather upholstery in 1978 and the proportion of the total consumption is growing rapidly both in Japan and in Japanese car markets in Europe and USA.

Personalizing the car is the manufacturer's strategy to maintain market shares and the Japanese have shown that this can be taken to a high degree of individuality without sacrificing productivity or quality and, by reducing the cost of idle process stock and work in progress, with considerable cost savings which can be passed on to the customer. Leather upholstery provides a means of enhancing the prestige image and providing environmentally acceptable differentiation and individuality.

The model range gives a clear indication of the profile of the consumer - the affluent, the top executives and all who have to project a successful image. For these the extra $1000 or $2000 for leather upholstery is not a deterrent. For the manufacturer and the dealer the option is a cost effective operation giving a very high margin of added value and profit as well as a valuable selling point for the high priced car. For environmental reasons status, prestige and recyclability are replacing speed, power and engine size as the promotion arguments. Already in national advertising car manufacturers universally are strongly emphasizing the value of the car interior.

3. Aircraft

Aircraft upholstery is a small but growing market appealing mainly to the top executive. The immediate marketing target is the designer and the manufacturer, promoting both the sales appeal of leather seating and its fire resistance and performance.

4. Contract furnishing

Contract furnishing is the third largest outlet for leather upholstery and has grown rapidly during and since the sixties with the development of large commercial corporations and the re-furbishing of new government and other public buildings. In these areas image projection is the key aspect and leather furnishing fits the desired image. Leather upholstery seems to be standard for parliamentary and courtroom seating, for ministerial offices, for boardrooms and executive suites and it is usual for prestige company and hotel reception areas. Originally it was used in airport lounges but here the much improved synthetics have generally taken over.

The immediate marketing targets in this sector are the interior designer, the architect and the specialist manufacturers concentrating on contract work. In government and other public buildings, the design approach is usually traditional though in the Melbourne Centre and concert hall, which aimed at competing with the Sydney Opera House, leather was used for panelling the walling of the whole access area and staircase. With commercial and corporate contract work, the design and product approach, especially in Italy, is far more innovative, moving away from the antiqued padded buttoned look towards using the leather constructionally and capitalising on its intrinsic strength.

The limits of product innovation

Notwithstanding the tremendous impact of product innovation in recent years, the scope of initiative in this domain remains necessarily limited when it comes to leathergoods. The main outlets of leathergoods are personal uses such as footwear and garments. These are sensitive to fashion but too specific to give room to systematic innovation. Furthermore, the ground for new products needs to be prepared by socio-cultural changes upon which the industry has no influence. The success of garments was driven by the emergence of youth as spenders. The success in athletic shoes was borne by the leisure society's addiction

to fitness and sports. The success of upholstery derives from the growth of corporations and bureaucracy. The marketers of the industry have demonstrated how effectively they could take advantage of these trends, but of course they have not created them.

It is because of the limitation of true innovation that product differentiation deserves the first place as a strategical variable in the hands of managers of leather firms.

PRODUCT DIFFERENTIATION

Unlike innovation, product differentiation does not diversify the product-mix by creating a new product, but gives a distinctive identity to a variation on an existing theme. Differentiation exploits the diversity of consumers' tastes to segment the markets into compartments more or less isolated from each other and therefore less exposed to the pressure of competition.

The basic features of product differentiation

Two kinds of differentiation are generally found. In horizontal differentiation, a given item is offered in several versions differentiated by minor characteristics. The markets for these versions are, to a certain extent, separated from each other, either because the consumers are sensitive to the characteristics that best materialize their ideal version of the item (since tastes differ from person to person there is room in the market for many differentiated products) or simply because consumers may have a taste for diversity itself (certain persons have a preference for variety over uniformity; accordingly any characteristic, provided it differs from existing ones, will make the item incorporating it more desirable than other items).

In vertical differentiation, the industry offers a range of products which are basically similar, and therefore rivals, but which differ in "quality level" and prices. Any consumer would prefer the versions at the higher quality levels but the price differentials ensure a stratification of markets according to the purchasing power of buyers.

Between perfect substitutes, consumers have no preference; they automatically buy the cheapest item. In this situation, no firm can charge a higher price than its rivals without losing its market share. If there is no barrier to competition, the price is driven to the marginal cost level of the most efficient firm.

In contrast, product differentiation establishes market niches. Consumers do not see equally priced, but differentiated products, as equally desirable. Between these products consumers have an order of preference.

The point of differentiation is the loyalty of consumers to the variety they prefer to buy which then confers on the firm a certain market power. Thanks to the specific attributes of its variety of product, a firm can raise its price without losing all of its customers. Some buyers would switch to other varieties but some would accept to pay a higher price in order to acquire their preferred variety. Thus, consumers' loyalty, reflected in what economists call demand inelasticity, is a source of profit. By exploiting the inelasticity of demand, firms can charge prices higher than marginal costs.

Differentiation strategies

Horizontal and vertical differentiation are instruments of strategies aimed at capturing markets. When markets are differentiated, the number of firms in existence on the various niches is by definition small enough to allow for interaction between them, thus creating room for strategies. How these strategies are implemented varies according to the particular circumstances of the markets considered. However, a few stylized features can be pointed out:

1. **Who takes the initiative of differentiation?**

   The initiative is likely to be taken by a new entrant or by the incumbent of a minor share of the market. When it comes to differentiated products, market niches are protected by barriers in the form of brand-loyalties or by control of the incumbents on retail shops or huge expenditures in advertising.

In the presence of these barriers, firms which are small in relation to their rivals cannot compete frontally for an occupied niche because defeat is almost certain to result.[16]

With a sufficiently different product there is still a risk of losing, but at least there is a reasonable chance of success. Challengers thus have an incentive to create a new niche rather than to copy an existing one. This is for instance what L.A.Gear did when it went for a share of the sports shoes and what Adidas is doing in order to conquer its lost share of that market. Whereas Nike and Reebok are locking their horns for the high-tech heavily decorated segment of the market, L.A. Gear positioned itself on its fashionable segment and Adidas is trying its luck on a high-tech no-frills segment.

A successful incumbent would not introduce additional niches on its own initiative. However, under the pressure of competition he may do so either to occupy a niche preventively or to join in once a new niche has been created by a challenger. The decision to create a niche is not taken by a firm on the basis of a microeconomic calculation made in isolation from what other firms do. It is instead a strategic decision, one taken to exert influence on other firms or to react to the actions of other firms.

The dynamic of differentiation strategies can be illustrated by the rivalry of Nike and Reebok for dominance of the US athletic footwear market. Nike used to have about 50 per cent of the market, thanks to a stronghold in track shoes at a time when jogging was becoming a social phenomenon. With a view to a share of the existing market, a US marketer obtained a license from the British firm Reebok to distribute running shoes. Under the shadow of Nike, the market share of Reebok remained negligible until the follower inaugurated a new path by launching women's aerobic shoes. These shoes proved to be a hit, not only in the fitness places, but also in the streets as fashion. Nike lost its dominant market share, whereas the sales of Reebok soared. The leader had become a follower. To mount a comeback, it did what followers do: further differentiate the product. But this time no chances were taken, it was decided to crowd the full product space. Today, Nike is in the market with 300 models in 900 styles, including such unexpected products as special shoes for cheerleading and, for good measure, several versions of all-purpose trainers.[17]

2. **How many varieties will the market take?**

By definition, a product is differentiated when its buyers are ready to pay a premium for this particular product compared to others which have the same use. Obviously, the premium can be larger if not too many acceptable substitutes are around. It follows that any entrant would like to come up with a product as distinct as possible from those of the incumbents. Furthermore, the volume of sales is larger when exploiting a niche all by oneself than when sharing a niche already occupied. Hence all firms want to differentiate.

There is an obvious limit to niche proliferation within individual plants and even production firms. Firms willing to broaden their product lines will be faced with the problem of diseconomies of scope. Although progressing all the time, the technology of flexible manufacturing cannot suppress the fact that it is more costly to produce more variations than less. Furthermore, marketing management may get out of hand as the range of products broaden. This is reportedly one of the causes of the setback suffered by Adidas on the US market. At one time Adidas was preponderant in athletic shoes on the US market. The footwear range consisted of 1,200 varieties among which included "even shoes for left-handed bowlers" according to an interview given to Business Week by the Adidas manager for

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[16] See Aron, D.J. and Lazear, E.P., The Introduction of New Products, American Economic Journal, AEA Papers and Proceedings, Vol.80, No.2, May 1990, pp.421-426.

[17] See Report on Business Magazine, May 1990, pp.91-95.

logistics.[18] The firm had trouble co-ordinating the marketing of this wide range of products, and through delivery problems lost hold of many of its distributors.

Is there also a limit to the total number of niches that the market will bear, hence to the total number of firms that can co-exist on the market of differentiated leather products and footwear?

Apparently, the total number of niches is limited by structural factors. Firstly, it is not easy to generate acceptable variations on a theme as old as footwear and leather products. Functionality dictates the major theme and fashion proposes a few variations. All firms want to be where the demand is and fashion correlates the preference of consumers around a few characteristics of colour, texture and design. Selecting a variety too distinct from what the others do may throw the baby out with the hot water. The firm would get rid of competition but at the same time would lose too many customers.

Secondly, the consumers have a budget constraint. The size of the market, given by the total amount of consumer expenditures on leather defects, limits the number of varieties that can be efficiently produced.

Thirdly, what can efficiently be produced depends on the fixed cost of differentiation. To differentiate a product requires to produce a specific design and to impose this design on the market by means of advertising and marketing. Designing a specific look or a specific functional feature is a very expensive activity. Nike keeps a permanent crew of industrial designers doing just that;[19] advertising the designs is also expensive;[20] finally, marketing is costly too because intense promotion is needed at the retail level to skim the market in a campaign that will last only 3 to 6 months. The fixed cost of differentiation plus the risk premium associated with it[21] imply that differentiating firms should have a minimum market to survive even though their production processes themselves are not subject to scale economies.

Combined, these structural features indicate that varieties cannot be boundlessly multiplied. For the industry as a whole this may sound worrisome since differentiation is the main way of growth. An interesting question is therefore to find where the limit is. How many varieties a market will actually take is very difficult to tell, but it is possible to identify the factors that will influence the number of varieties.

In the case of horizontal differentiation, consumers have the choice between varieties equally priced. The number of varieties will increase as the market grows and as the fixed costs associated with entry decline. Hence, trade or economic growth, because they expand the market, or computer-assisted design, because it reduces the cost of design, open the gate to more and more varieties.[22]

In the case of vertical differentiation, the market is structured by quality levels. Formalized reasoning on highly stylized features indicates that an upper boundary limits the number of firms which can

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[18] See Business Week, March 11, 1991, p.45.

[19] See Report on Business Magazine, May 1990, p.92.

[20] To penetrate the European market, Nike will spend US$39 million in advertising in 1991. See Business Week, March 11, 1991, p.45.

[21] That a risk is involved is indicated by the sharp variations of market shares from one year to another among big competitors (see end of this Chapter on this subject).

[22] Concerning the role of trade, see Helpman, E. and Krugman, P.R., Market Structure and Foreign Trade, The MIT Press, Cambridge and London, 1986, pp.140-151.

co-exist on such a market. Here, however, the upper boundary is not given by the relative magnitudes of demand and entry costs, as in the horizontal case, but by the interplay of technology (the change of unit cost associated with quality improvements) and tastes (the willingness to pay for better quality).

The limit expands as the distribution of tastes among consumers becomes less homogeneous and as technology brings about ways of increasing quality without increasing costs too steeply.[23] Since this limit does not depend on market size, economic growth or trade cannot alter it.

As a matter of fact, it has even been argued that the impact of trade would be to reduce the total number of products by wiping out those at the lowest quality level.[24] Trade, and more generally all forms of increased competition, brings prices down. Some of the firms which lose ground in downscale products shift their product-mix towards higher quality products. Thus rivalry is stirred at the upscale level even if the initial competitive pressure was at the downscale level. As rivalry is stirred, prices of upscale goods tend to fall - given the preferences of consumers (who presumably prefer better quality products) demand will be diverted from the lower to the higher level. With time, the downscale products are eliminated because the smaller price differentials between quality levels increase the gravitation to better quality. Even extremely cheap, low quality articles are not attractive to buyers if better quality is available at not much higher prices.

The pertinence of these reasonings to real world situations if of course limited. However, they corroborate intuitive expectations and they are corroborated by certain empirical observations. It is a fact for instance that consumers' products at the lower end of the quality scale tend to disappear. It is the case of the Trabant in the automobile sector and it is the case of rubber and canvas tennis shoes in the domain of footwear.[25]

All in all, product-differentiation, horizontal and vertical, is on the increase in rich societies.[26]

The impact of mass product competition from developing countries has fostered a quick escalation of the quality scale in developed countries. Within each quality level, trade has generated a profusion of differentiated products unknown in the recent past - 20 years ago no retail shop would have offered American, Danish, French, German, Italian and Spanish versions of upscale outdoor shoes at the same time as is current today.

Strategic differentiation works through continuous creation of new niches and through gradual enhancement of products quality. These two developments cannot be sustained concomitantly unless some mechanisms provoke the artificial obsolescence of the products. This mechanism that shortens the shelf life of the products notwithstanding quality enhancement is, of course, fashion.

As the trend in leather products involves generating more varieties of more costly and shorter-lived products, it should be clear that marketing takes on a central importance in the business of strategic interactions.

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[23] See Shaked, A. and Sutton, J., Natural oligopolies, Econometrica, Vol.51, No.5, September 1983, pp.1469-1483.

[24] See Gabszewicz, J.J., Shaked, A., Sutton, J., and Thisse, J.F., International Trade in Differentiated Products, International Economic Review, Vol.22, No.3, October 1981, pp.527-534.

[25] At the time of writing these lines, the rubber and canvas tennis shoes, which prevailed 20 years ago and had become almost impossible to find in the shops of developed countries just two years ago, are reappearing. This time however not as downscale products but as an original alternative to the hyper modern sneakers. Similarly, the Trabant may come back in the future to signal the originality of its owners.

[26] "The number of products in supermarkets has soared from 13,000 in 1981 to 21,000 in 1987", McKenna, R., Marketing in an Age of Diversity, Harvard Business Review, Sept.-Oct. 1988, p.88-89.

MARKET STRATEGIES

Innovation and product differentiation make products different from those of the rivals. The next step is to sell these products at profitable prices. The problem consists of extracting all the revenue the market will bear and avoiding the entry of rivals. Tackling this problem involves action by the buyer and interaction with other firms. The buyers will have to be persuaded to pay prices that not only remunerate all the ingredients that contributed to the product but also include some pure profit margin; the rivals firms, potential or actual, will have to be kept at bay or attacked. Pricing, advertising, and retailing are the three major tools that marketers will use to conduct their strategies.

Price rivalry

Having described in chapter 2 how prices are formed on the basis of a mark-up over normal costs, it remains to discuss some typical price behaviors in the leather and leathergoods markets.[7]

When demand is not fully elastic, a firm can exert a certain degree of market power. Then, price becomes a strategic variable. With power over its market, a firm can determine, within a given range, the price of the product. If consumers are known to differ in their willingness to pay for the product (different tastes, different incomes), then the firm may find it profitable to adopt a pricing policy known as price discrimination.

Price discrimination involves charging different prices to different consumers for the same goods. An example is that of discounts to chain stores below the prices charged to single stores. This practice is frequent because the chain store may decide to supply the goods itself if the firm does not concede advantageous conditions. The single store is not in a position to integrate backwards as its low volume of sales would not cover the fixed cost of production. Hence, it cannot negotiate a discount. When such a situation occurs, it is more profitable for the supplier to charge two prices - low to the chain store, high to the single store - rather than a uniform price at a level low enough to prevent vertical integration on the part of the chain store.

To realize price discrimination, arbitration between the downstream firms must be prevented. If it is not, then the single store could buy from the chain store rather than from the upstream supplier, and a uniform price could set in. Preventing arbitration can be achieved in several ways. A contract precluding it is one of them; the determination of exclusive sales territories is another way. But quite often price discrimination is prohibited by law. A loophole then is vertical integration. The firm acquires one chain store and sells its product exclusively to its own chain. This practice attempts to circumvent the law by internalizing the downstream transactions in order to conceal them from the law. It is not likely though that the exercise of market power will remain unobserved for long.

Another form of price discrimination consists in charging different prices for the same item at different periods of time. Prices of raw materials undergo wide fluctuations, amplified by speculative behavior. Obviously, firms do not wish to adjust their prices every time the cost of raw hides and skins goes up or down; consequently they hold inventories to balance differences between production and shipments. Stocks are held because of their convenience (they keep prices stable, they respond smoothly

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[7] Price behaviors take place only to the extent that firms have at least a little control over the market; the following paragraphs therefore apply only to markets where the number of firms is not so large that any individual firm would be deprived of any influence on the prices it faces.

to demand fluctuations), but storage has a cost[28] and is also risky.[29] These stocks can be held anywhere along the processing chain - by the tanners, by the leather products makers, by the wholesalers, by the retailers.[30] According to a study of Kurt Salmon Associates, the time it takes in the United States to transform raw material into a footwear retail sale is 55 weeks of which 11 are spent in production.[31] As a cost is involved, one of the strategic themes of the industry involves, for every notch on the scale, shifting the storage cost from one stage to another.

Intertemporal pricing discrimination is one way storage costs can be transferred from one stage to the other. This strategy consists basically in selecting the most profitable distribution of total supply (production plus stock change) among markets considered at different times in the future. Discrimination, it must be noted, is feasible only by firms in a market with imperfect competition.[32] These firms are able to set prices, and thereby output, to optimize these variables over time. This is not the place to discuss the rules leading to optimization,[33] but to draw attention to a consequence of discrimination for vertical integration. It has been said that, if the distribution channels are comprised of many firms competing with each other, intertemporal discrimination will not be possible; all producers can do, if they want wholesalers or retailers to stock their products, is to set a price that changes through time in order to fully absorb storage costs. In order to be in a position to profit from intertemporal discriminations the atomistic structure of distribution must be upset. Producers will therefore attempt to control the storage capacity of the distribution system. Such a control can be obtained directly through downward integration (and indeed most of the large leathergoods firms have their own distribution channels) or indirectly. Indirect control is obtained when, by means of advertising, strong firms manage to glamorize their products in the eyes of the public to the point that retailers have no other choice if they want to sell anything than to handle the branded products at prices which are set by the firm which markets these products. In the case of athletic footwear for instance, both direct and indirect controls are combined to exercise a strong influence over the distribution channels in the USA.

A second case of intertemporal pricing discrimination occurs in the realm of fashion. In footwear and leathergoods, many articles are subject to fashion. On the demand side, fashion implies that the maximum price that consumers are ready to pay for the fashionable article is a function not only of their income but also of the time at which the purchase takes place. A firm having a certain degree of market power will try to set its prices on a temporal path that takes advantage of time dimension of the demand schedule. Without entering into a detailed analytical examination of this pricing strategy, it may be said that prices will be set so that each class of income buys at a particular time. The most affluent class buys as soon as the product is marketed, and the poorest class will buy in the last instance. To obtain this effect the prices must decline in such a way so as to ensure that the difference of price between two moments in time is not so large as to encourage the rich to delay their purchases nor so small that the producer would forego part of the feasible profit.

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[28] Interest on working capital, rent of storage rooms, insurance, management, etc.

[29] As stocks increase, the possible loss resulting from a price fall gets more important; beyond a critical point the size of the loss would expose the firm to a loss of creditworthiness. In the tanning sector many firms had to close due to this effect.

[30] The convenience yield of holding stocks is probably greater for tanners (exposed to wide fluctuations of raw material prices) and for wholesalers and retailers (which have a vital interest in responding instantaneously to demand). This is why storage capacities happen to be concentrated at the two extremities of the chain.

[31] See World Footwear, May/June 1988, p.41.

[32] Firms which have to take prices as given cannot discriminate between markets. All they can do is to accumulate stocks when price increases are anticipated and sell all their output if the present price is higher than the expected future price.

[33] An optimum path demands that prices be fixed so as to equal the variation of marginal cost to the marginal storage cost, and that stocks be adjusted so as to equal the marginal cost of storage to the variation of the marginal cost of production.

This pricing strategy lies behind the recurrent occurrence of sales at mid-season. In the course of the lifetime of a product sellers give increasing importance to the maximum prices consumers are willing to pay and decreasing importance to production and marketing costs (because the volume of sales has increased in the meantime). After a certain date prices are discounted, even under the marginal cost, to sell off the remaining inventories.

Intertemporal pricing is obviously linked to the commercial obsolescence of the products. In some circumstances obsolescence tends to accelerate. One form competition takes is research and development to bring new products on the market. Intense rivalry sometimes leads to an acceleration of the R&D race. In sports shoes, for instance, the shelf-time of upscale products has gone down from 12 months to six, and in some cases three months. Such brief shelf lifetimes often characterize products which have been very heavily advertised. Therefore, the market must be thoroughly skimmed to recoup expenditures, and pricing becomes an extremely important marketing instrument.

Advertising

There are basically two types of advertising: one that informs and one that influences.

Informative advertising does not contribute to protect a market. On the contrary, when it conveys information on firms, on products, on shop locations, advertising does more to provide competition than to insulate markets. Buyers learn of available substitutes, their scope of choice is thereby enlarged with the result that demand gains in elasticity.

Tanners and leather product makers spend a lot on informative advertising in the trade magazines and in the trade fairs in which they participate. They do it because they have to remain visible to the customers and because they need to introduce their new products. At the downscale level, products are bought because of their low price, but upscale goods are bought in view of their quality. Price information is easy to convey, but quality information always contains more complex elements of appreciation. Through years of informative advertising, existing firms have acquired an established reputation. When coming up with a new product all they have to do is to circulate the news. The customers, themselves in the trade for many years, will have an opinion on what the product is worth based on past experience.

In this respect newcomers are not as well placed as incumbents. The chances are that a newcomer, especially if he comes from new or emerging leather countries, will be regarded with suspicion. Professional buyers can be convinced through samples and tests, but customers will be reluctant to try a product which is new on the market and is expensive (as quality goods are). The problem for the newcomer is then to induce them to at least try their products, and for that purpose he must be prepared to spend more than incumbents do.

Since high-quality products are likely to generate repeat purchases, attracting initial customers is expected to yield sustained income. Hence an entrant accepts to use part of its current income to attract initial customers.

Rational buyers will not take advertising at face value; they are reluctant to buy because they do not have experience with the item and advertising in itself cannot substitute for experience. Fortunately, there are ways that firms can send quality signals addressed to the rationality of buyers. A firm can do this, for instance, by burning its vessels in a campaign of conspicuous expenditures. By means of the money wasted, the entrant declares that he commits himself to being on the market for a long time. The buyer understands that such a commitment could not be held if the real quality does not match the promises. Alternatively, high-quality may be signalled by low prices. Seemingly, this practice goes against the general view that high prices and high quality go together. Yet, low prices may work as a quality signal if the marketers manage to convey the message that today's sacrifice means that the quality is good enough to ensure that the firm will stay on the market and will make profits in the future.

Considering that fashion, planned obsolescence, and product differentiation, are basic facts of market life no firm wants to push the Sysyphean stone of advertising each time a new product or a new variety is to be launched. Firms will therefore try to establish a brand with a reputation for satisfying quality expectations. Risk-adverse consumers will tend to remain loyal to such a brand and the firm will tend to remain loyal to its reputation, precisely because it matters to the buyers. Thus, the brand name stays, while the products pass.

Brands are not only useful as indicators of quality, they are also image carriers. As everyone knows, advertising is far from being strictly informational, it is also persuasive. In this latter function, it persuades buyers that a brand confers the owner of its products a desirable image than other brands cannot give.[34]

Proclaiming a quality that consumers cannot observe immediately, and providing a desirable image, brands tend to soften competition by generating loyalty on the part of buyers.[35] The key element in this marketing strategy is product labelling and identification, as it is with Reebok, Nike and Timberland in shoe marketing. The Leathermark, Woolmark, Cotton, Silk and similar labels serve the same purpose in the overall industry marketing campaigns, but, of course, are equally valid for high and low cost productions and garments of all origins. The newly formed American Leather Clothing Association launched their ALCA label in 1991 to stimulate leatherwear sales in the US but did not restrict its use to American productions. Over half of the leather garments sold in Japan carry the ALCA label of the All Japan Leather Costume Association, the leading wholesalers' organization. Such labels not only identify the material of the product and give instructions on care and cleaning but also convey a quality assurance even if they do not guarantee compliance with a performance specification as does the Woolmark.

Individual company labelling is equally important though again no guarantee of origin. In 1991 Le Tanneur, the major French leathergoods manufacturer with a long history of poster advertising in France, launched its first own-label range of designer men's leatherwear but manufactured in Turkey. Large trading companies like those in Japan have established buying subsidiaries in source countries like Hong Kong and market garments under their own brands. Wholesalers and the larger department stores also follow own-label and house design policies. It is important therefore for manufacturers in the market countries to establish a separate, individual identity through distinctive design and a quality image. The top fashion designers in Europe, USA and Japan all now include leather in their collections and some, such as Jean Muir in England, have specialized in leatherwear. Such designer labels have helped high cost prêt-à-porter leather specialists like Loewe of Spain and MacDouglas of France to maintain a presence in the market place.

The world-wide demand for aerobic footwear demonstrated the enormous power of multinational promotion and advertising to pull sales through the retail trade. The demand for leather garments and leather upholstery demonstrates the power of unobtrusive but sustained image building to do the same.

This image building was a contrived operation initially but is now rolling along under its own momentum. In neither the leatherwear nor the upholstery sector is there any market leader on whose brand name an effective marketing label can be hung which would establish in the public mind an automatic connection between garments or upholstery and leather and its acceptance as a consumer buying motivation for these products. The only possible candidates might be Loewe for garments and de Sede for furniture, but both have only limited recognition outside of the glossy fashion or interior decoration magazines. For the time being that momentum seems to be all that is needed, but there are signs that the image may need some deliberate polishing.

Brand loyalties can be solid barriers to the entry of newcomers. Brands will therefore be a weapon in the strategic arsenal of firms. A brand can either be bought - like Adidas and Puma have recently been

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[34] People who knowingly buy fake Rolex watches buy an image, not a quality label.

[35] This loyalty can go as far as the revolt of Coca Cola buyers when the firm attempted to modify its traditional product presentation.

by a French and a Swedish company respectively - or created ex nihilo like Nike and Reebok were a few years ago. Buying - or leasing a brand - gives immediate access to a market but it will generally be a market in decline, at least in relative terms. The alternative is to create one's own brand. However, as will now be seen, to create a brand commanding buyers' loyalties can be a longlasting operation.

Since all firms have access to the same media and can hire the services of equally skilful advertisers, it is the amount of expenditure that ultimately differentiates the advertising strategies of the rivals. What can be achieved by advertising outlays is however confined within the limits set by the following considerations. First, it would be difficult for a firm to hold a niche if its share of voice in the advertising theatre declines by too much or for too long under its market share. Second, it is hard to win market shares by virtue of advertising alone; specialists in that branch reckon that in order to encroach significantly on a competitor's territory, big spending differentials (one to two) would have to be sustained over very long periods (3 to 6 years). Third, advertising is subject to a cumulative effect whereby the effectiveness of additional expenditures made today increases with the amount accumulated in the past.

Put together, these considerations suggest that advertising by itself is not likely to upset market shares.

In a market where no competitor has a decisive advantage in terms of product, organization or cost, market shares are relatively stable and not too concentrated. In this situation, the ratio share of voice/share of market are likely to be close to one. Firms investing in a niche will probably have a ratio somewhat higher than one, whereas well-established firms will probably be somewhat under one. The latter spend relatively less because their voice has been heard loud enough in the past that an echo still reverberates in the present; the former spend more because they want to introduce something new on the market.

As long as no competitive edge emerges, there is no incentive to alter the behavior reflected in ratios close to one. A newcomer has no incentive to start an advertising war because it would have to increase its ratio to a very risky value to match the benefit incumbents derive from past expenditures. Well-established firms would have the wherewithal to spend so much in advertising that it would be cost prohibitive for anyone else to compete. However, a preventive strategy of permanent overspending may not appeal to shareholders because it would not leave profits to milk.

Thus, marketing managers are likely to stick to conservative outlays large enough to ensure adequate reach and frequency but not to alter market-shares.

Clearly, the same restraint will not apply when it comes time for a large firm to invade the territory of small incumbents or when a firm uses advertising to support the exploitation of a competitive edge. A firm like Nike, for instance, which is a large one in the sense that it holds half the US market of sports shoes and which also thinks it has an organizational advantage over its rivals, will not hesitate to mount an expensive advertising campaign to dislodge competitors from a coveted market segment. To grow in Europe, where it holds the third place, Nike plans to spend $39 million on advertising in 1991.[36] Considering that the $100 million that Nike already spends in the United States also exerts some impact on European buyers, it is certain that no more than one or two firms are able to match Nike's budget. In this case, the odds are that smaller firms will have to adjust by conceding market losses, and consequently to quit or to develop new niches.

Efforts in advertising may dissipate in vain if not supported at the retail level. Experience shows that firms in the business of leather articles must keep a balance between advertising and promotion. Point-of-sale promotion is important for most consumer goods but, in the case of many leather articles it is particularly important due to their status of "experience goods", goods the value of which can only be assessed after purchase.

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[36] See Business Week, March 11, 1991, p.45.

To a certain extent, the attributes of leather products can be ascertained before a purchase, because design, leather quality, colour, size, etc. are more or less self-evident. However, some of them only become apparent with time. Leathergoods, for instance, are bought for their durability. Since only experience brings direct information on durability, and since the frequency of purchases is not high for durable (upholstery) or semi-durable (shoes, garments) goods, consumers are reluctant to try new products. To gain a market share will then require more outlays and more time from new entrants than it did from the incumbents when they pioneered the market.

Because of this uncertainty, retailers play a considerable role in shaping the preferences of the consumers. It is therefore important for the outcome of a differentiation policy that a convergence of action exists between producers and retailers. Such is not necessarily the case.

Producers commanding some market power may wish retailers to promote their products by offering services such as luxury premises and well-styled attendants. In the view of the upstream firms, these services are expected to boost demand, but downstream firms may not be willing to take the risks of additional costs for an uncertain increase in sales. The straightforward way to obtain these services from the retailer would be to specify them in a contract. But such a contract would often be exceedingly difficult to write (how exactly should a well-styled salesforce behave?) and to enforce (what exactly was missing in the pre-sale information given to the customers?). An incentive should then be given to the retailer to behave in a way desired by the producer.

The incentive may simply be given by leaving the retailer a profit-margin and a local monopoly.[37] But whereas profit gives the wherewithal of promotional services, it cannot guarantee that the right amount of effort will actually be provided.

Alternatively, the upstream firm may attempt to directly supervise the provision of services. There are several forms of control. One is takeover. But absorption is not always desirable,[38] nor feasible.[39] An alternative means of control is franchising. In this system, the upstream firm itself provides the retailer with promotional services (for instance, shop decoration, vast stocks). Demand is boosted and the marginal cost of the upstream firm decreases. The upstream firm then prices its products at marginal cost. That price is, of course, lower than the level that would be charged if the upstream firm took advantage of his market power. But, it gives retailers an incentive to make decisions that will maximize the profit of the vertical structure. The retailers set the retail price on the basis of their cost (equal to the marginal cost of the upstream firm), on the one hand, and the elasticity of final demand (as enhanced by the promotional services) on the other. The retail price thus maximizes the profit that the combined structure of upstream and downstream firms extract from the market. This profit is made by the retailers having charged a price equal to marginal cost but it does not remain with them. The upstream firm does not realize any profit, but because it has market power, it will charge a franchise fee calculated to absorb part or of all the profit from the downstream firm.

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[37] A retailer offering, say, an oversized salesforce, must charge more than a self-service shop. But consumers may make their choice in the former shop and buy in the latter one. Granting exclusive territories would prevent free-riding.

[38] Retailing is a technology which has little to do with manufacturing. For a manufacturer to control hundreds of retail shops may be an unmanageable task.

[39] For instance, the merger between Brown Shoe and Kinney Shoe Stores was considered illegal by US antitrust authorities

ORGANIZATIONAL STRATEGY

In general the retail price of a consumer good is a multiple of the ex-factory price and the multiplication factor is larger for upscale goods than for standard goods. This rule applies of course also to leather articles. For instance, a pair of standard shoes in the cheap range will be, say, two or three times more expensive in a shop than ex-factory, whereas a branded pair of pumps may be 15 times more expensive. The increment over the factory price is comprised of the distribution cost and of profit if any.

It is along the value added chain linking manufacturers to retailers - often through wholesalers or importers - that organizational strategies take place. These strategies aim at maximizing the sum of profits made by the vertical structure and influencing its distribution across stages.

The wherewithal of organizational strategy is market power. In some cases market power is concentrated at one stage of the structure; for instance, when the supplier of a differentiated product faces numerous retailers, who in turn compete among themselves to sell the product to the final consumer. But market power may also be distributed more or less equally among the stages, as when the retailers form a collective organization to bargain with the manufacturers.

When power is concentrated there is often no need for a strategy because a decision made at one stage is transmitted without interference throughout the whole structure. For instance, a manufacturer with market power will charge a profit-maximizing price to competing retailers, Assuming, for simplicity, that the retailing cost is negligible, the price charged by the manufacturers is the marginal cost of the retailer. Under the pressure of competition, the retailers will charge a price equal to their marginal cost - hence equal to the price set by the manufacturer - to the final buyers. Thus, the profit-maximizing price of the manufacturer is charged to the consumers as if he had sold his product directly to them. However, if the retailers too are monopolists within their respective retail area, organizational strategies are likely to enter the scene. The retailers would then charge a price exceeding their marginal cost. Facing a higher price, the consumers would buy less than if they had been charged the profit-maximizing price of the supplier. Thus the total profit of the manufacturer would be lower than if he had himself dictated the retail price. In a case like this it is clear that there is room for an organizational strategy.

In the first part of this century the initiative of organizational strategy was in the hands of manufacturing enterprises because the engine of competitiveness was then technology. For instance, Bata took the initiative when it developed large-scale production techniques applied to footwear. The traditional distribution channels were unable to respond to the pressure created by the great volume of inventories required by mass sales. Hence, in order for the volume of sales to keep pace with the volume of production, distribution had to be modernized too. This was achieved by integrating downwards by means of a managerial innovation which gave Bata teams able to monitor and co-ordinate both production and distribution.

Nowadays market power no longer comes from an advantage in manufacturing operations but from product differentiation. The initiative of organizational strategy therefore no longer lies with the manufacturers.

Product differentiation is performed to a certain extent in manufacturing, where the product is given its physical shape, and in retailing, where promotional efforts enhance the product in the eyes of the consumer. But the crucial contribution is made by a specialized set of services - essentially design and advertising - which are functionally dissociated from the technologies of production and distribution and can therefore be mobilized by any stage in the vertical structure. Accordingly, no stage has the privilege of market power. Retailers for instance can integrate backwards into the supply of differentiated products if upstream suppliers exert too much market power on them (assuming of course retailers organize in buyer co-operatives or in chain shops so as to reach a size large enough to support scale economies in production).

It follows that organizational strategies involve all kinds of interactions: from upstream on downstream firms or vice versa. Actually, as will be seen in the following paragraph, one of the most noticeable manifestations of organizational strategy is the control taken by service firms on the vertical structure.

In order to illustrate the variety of organizational strategies, three companies operating in the largest market of the world, the United States, will be examined in depth. They are Genesco, a large-scale manufacturer; US Shoe, an integrated manufacturer; and Nike, a marketing company leaving manufacturing to others; the strategies used by these firms will be termed strategy 1, 2 and 3 respectively.

The strategy menu

There are two overall points to be made about the strategic choices which firms in the footwear industry face.

The first is that many strategies can co-exist. There is no one best or most appropriate strategy.

Second, strategies differ in comprehensiveness. At one extreme, firms can choose merely to be low cost manufacturers serving one or more wholesalers. At the other extreme, firms can elect to be fully integrated designers and wholesalers, responsible in addition for the advertising, public relations and image creation of their products. In this case, the consumer is being made aware of the name of the designer/manufacturer rather than, as in the first case, the name of the retailer.

In the case of strategies 1, 2 and 3, the strengths, weaknesses and prospects of the strategy will be looked at. The intent will be to predict which elements of the menu will be attractive over the long-term and which will be threatened by forces at work in the competitive environment. The forces are discussed at the end of the section, after a financial comparison of the strategies.

Strategy 1: Low-cost manufacturing

This category includes a number of companies in the $5 million to $700 million/year sales category. Typically the larger companies have established some degree of vertical integration into retailing (either through owned or licensed stores), while the smaller ones have not. All are engaged in wholesaling, with production for large retail chains the dominant practice. Among the larger of such companies is Genesco, whose 11 brands accounted for 1989 footwear sales of $490 million. In 1987, 34 per cent of its output went to its own stores (numbering 700) and the remainder was wholesaled by a direct sales force. Seventy-five per cent of its output is men's shoes; 24 per cent women's; 1 per cent children's. Genesco provides 40 per cent of the shoes sold in its outlets, while the balance is bought in, 31 per cent from the US and 29 per cent imported. Its six US plants in 1987 ran at 77 per cent utilization. It also owns two leather tanning plants, 14 per cent of whose output is for its own use, with the other 86 per cent of output wholesaled. A leather sole manufacturing operation was sold in 1987.

The financial results of the company reveal consistently low profit margins: in 1987, its retail sales of $187 million attained $3.5 million pre-tax profit, while its manufacturing and wholesaling unit with sales of $114 million attained $3.7 million pre-tax. Pre-tax margins have been low or even negative (as in 1986) for most of the 1980s. Asset turnover (sales divided by assets) was a reasonably high 2.9 in the retail group and 3.0 in manufacturing.

Other companies pursuing a broadly similar strategy have obtained comparable results. Wolverine Worldwide, the largest US tanner of pigskin, and owner of the Hush Puppies brand and 120 dedicated outlets, averaged operating profit margins of 3-5 per cent over the 1985-89 period. Its sales were flat over the period, posting revenue of $353 million in 1983 and $325 million in 1989. Similarly, Brown, the largest US domestic manufacturer, reported an operating profit margin of 5.0 per cent in 1989 on sales of $1,820 million.

Prospects for Strategy 1

The outlook for companies following this strategy can be surmised by looking at the aggregate US Census of Manufacturing data, which is heavily weighted by firms in the $5-$200 million/year range. For 1986, value added per production worker in men's footwear, except athletic, and women's footwear, except athletic, averaged $32,000, only 37 per cent of the US manufacturing average. Sales per employee were $50,000, only 48 per cent of the US average, and capital employed per employee was $500, or only 12 per cent of the US manufacturing average. Salary per employee in 1987 was $11,804. All of this suggests that typically these companies are without the resources to invest in better manufacturing or to market aggressively. These companies are essentially price-takers, and the price is likely to fall in real terms over time as foreign competition intensifies. Also, to the extent that retailing becomes more consolidated, small footwear manufacturers will find their price-setting scope further undermined. Pricing pressure felt by retailers will of course exacerbate these problems. A survey of US retailing for the 1990s stated recently that "in this gloomy environment, most retail enterprises have come under heavy pricing pressure ... the outlook is for flat to lower profits."[40]

Strategy 2: Fully-integrated producer

The second type of strategy is that of a company with more downstream integration into retailing. US Shoe is a broad line, fully integrated company. It designs shoes in 21 different brand names - primarily women's non-rubber moderate-to-medium-high priced shoes - and seven brands of boots. Total sales in 1989 were $777 million, most of which was women's shoes. Recent designs include an attempt to straddle the athletic shoe/traditional shoe gulf with a shoe which, to quote the company, "looks like a pump but feels like a sneaker."

The company manufactures 50 per cent of its sales from 12 plants in the US, and sources the rest from independently-owned plants in Brazil, Italy, Spain, Republic of Korea, and the Dominican Republic. It wholesales about 90 per cent of its output through its Cobbie Division, but retails the remainder through a mixture of owned and licensed outlets. These outlets, which number 306, with a further 192 leased spaces within department stores, are matched to particular shoe brands, so that there is a retailing "concept" (location, positioning, service-intensity, etc.) for sub-sets of the 21 brands. Thus, the Hahn Division sells branded shoes; the Cincinnati Shoe Group leases departments in low-priced outlets like the Burlington Coat Factory chain; the Banister Division uses factory outlets on the outskirts of cities; and concept stores (using three different brands of their own, Cobbie Shop, Joyce-Selby and Shop For Pappagallo) sell a wide variety of US shoe brands.

Two aspects of this strategy are worthy of attention. First, to manage its dominant market share in the industry (data suggest that US Shoe accounts for half of total women's shoe sales in the US with $777 million out of total industry shipments of $1,554 million) the company has decided it must co-ordinate the product/channel interface very carefully. It is therefore continually buying, selling, growing, and shrinking its channels as tastes and costs change. Thus in 1988 it changed the name of its largest division, the names of many concept stores and adopted the umbrella brand Cobbie after extensive market research showed the previous name denoted a slightly older woman than the market then being pursued.

Second, rather than looking wholly overseas to source its lower-priced shoes, the company has invested heavily in its US plants. Manufacturing investment over the period 1986-1989 totalled $30 million. The objectives were twofold. First, by reorganizing the traditional shoe production line with its 97 steps into a much smaller number of work cells, each responsible for far more tasks, it collapsed the work-in-process inventory and total cycle time (i.e. the time it takes to move one pair of shoes from 3 square feet of material into a boxed pair). This not only saves assets; it allows faster response to new tastes since fewer pairs of an obsolete style are under production at any one time. Second, the new layout improves

[40] Forbes, Jan 8, 1990, p.198.

quality since effort is now rewarded at group, not individual, level, and the group is motivated to maximize throughput of quality pairs rather than simply to maximize volume. Those changes allowed leather shoes to be sold at under $40 per pair, for instance, a hitherto unattainable price-point.

Prospects for Strategy 2

The financial results obtained by even the best companies pursuing strategy 2 suggest that there is a ceiling on their long-term profitability, created by the low-cost-based threat from strategy 1, on the one hand, and the slow character of much of the market pursued traditionally within strategy 2, on the other. Virtually all the growth in the footwear industry is being captured by - and, indeed, often created by - strategy 3 competitors. Moreover, these companies are also fuelled by being in the highest-growth parts of the apparel business too. A third constraint is provided by competition within the retailing industry. As the collective share of general retailers like Sears falls, an increasingly fragmented set of niche retailers is growing up. As part of their need to differentiate themselves, these shops are looking continually for new, unusual products to stock (including footwear) and thus establish shopping patterns in which customers compare these idiosyncratic offerings with those of the outlets run or owned by the likes of U.S. Shoe. There will thus be continuous competition, both product- and channel-based, with ensuing shorter product life cycles and tougher manufacturing/retailing co-ordination decisions facing strategy 2 companies. The decline in return on sales (ROS) suffered by U.S. Shoe, as will be discussed at the end of this section, suggests that even a well-run firm will face difficult times in this strategic group.

A view of the relative outlook for firms pursuing strategy 2, as compared to strategy 3, can be obtained by looking at the experience of Stride Rite, a Boston-based children's leather footwear company, which has moved some of the way from 2 to 3 in the last five years. In the first half of the 1980s, Stride Rite was similar to U.S. Shoe (although smaller, with 1985 revenues of $238 million) in that it manufactured most of its own shoes in the U.S. Between 1983 and 1987 it shut seven of its ten US factories and consolidated its manufacturing and international divisions into one sourcing division. As of 1988, the company sourced its raw materials in eight countries, had sourcing offices in four countries, had factories in two countries, and had independently-owned source plants in another two countries.

This change from a US manufacturer to a marketing distributor has been associated with a big change in operating results, with sales growing from $238 million in 1985 to $454 million in 1989 and net income growing from 4.7 per cent of sales to 10.1 per cent in 1989. In part, this growth reflects the acquisition and subsequent repositioning of the Keds brand. Sales/employee rose from $42,000 in 1985 to $116,000 in 1989. The fundamental change, reflected in the financials, is that of a company becoming a marketing- and distribution-focused concern with modest manufacturing.

Strategy 3: Design and marketing focus

Companies in the athletic footwear sector best illustrate the strategy of maximizing control, but not ownership, over selected activities in the value chain. The objective of this approach, as distinct from strategy 1, is not to provide a range of shoes which retailers will then offer using their own brand names, but instead a range which consumers will pull through the distribution channels themselves.

There are six *critical elements* here:

1. Control over the distribution channel: this is effectively ceded by the retailer to the supplier because of the recognized power of the shoe brand to create shopping "traffic". In general, the specialist athletic shoe stockist wants as broad a range of brands to stock as possible, while the generalist (independent or chain) wants to carry three to five brands and three to five use-categories (e.g. basketball, tennis, aerobic, running) in each brand, plus two or three others.

Whenever a successful brand is created, demand explodes so that shortages occur, and only retailers in good standing with the manufacturer can expect to obtain delivery. Since loyalty here is to the shoe, not the store, the prospects of converting a shopper to a different brand are remote. Surveys carried out, for instance by Sporting Goods Dealer magazine, indicate that the criteria by which specialist retailers rank Nike, Reebok and other strategy 3 companies, include: product innovation, product quality, advertising, packaging, point-of-sale product support, on-time delivery, returns policy and responsiveness to complaints. Note that strategy 1 allows competitors to differentiate themselves only on four of these eight attributes.

2. The nature of shopping: within this sector there is competition of different kinds between different companies. It appears to be primarily intra-sectoral rather than cross-sectoral in that individuals thinking of buying an athletic/casual shoe will probably go straight to a choice between Nike, Reebok, Converse, Adidas, etc. rather than first evaluating such products vis-à-vis the traditional manufacturers' shoes. The competition between these companies within the sector has led to three size categories emerging: two dominant companies (Nike and Reebok, with a 55-60 per cent combined share since the mid-1980s), then a second sub-group (Converse, Adidas, New Balance, Pony) in the $100 million range; then a third group (such as Hyde) in the under $100 million sales range. Since 1985 only one company - L.A. Gear - has sprung to the top rank, and its success has been based as much upon apparel as on footwear.

3. Brand name transferability: once a prominent name has been established, with care it can be transferred to adjacent products and used to create similar premium-priced items outside of footwear. Nike has helped create 37 distinguishable athletic footwear and apparel segments (see Table 2). Establishing a brand of this power requires massive advertising expense. As Table 3 show three of the top companies pursuing strategy 3 on average spend 6 per cent of their sales on advertising.

   Clearly, a critical component of the strategy is ensuring that harmony and consistency exist between each stage of the strategy - all the way from design and materials' selection to the choice of retailers, celebrities to endorse the product, and advertising. Not many companies are able to juggle all these elements at once, explaining the small number of companies which are able to earn consistently higher returns than the average being achieved from strategies 1 and 2.

4. Short product lives: product life-cycles are typically short - a brief as one year for a major (say $200 million/year) shoe line - and can be managed to the disadvantage of competitors. Evidence of this comes from the volatility of market shares. In 1986, Adidas, based in West Germany, was the largest worldwide athletic shoe producer, with a revenue of $2.4 billion, with Tiger ($800 million), Puma ($500 million), Nike ($240 million) and Reebok ($92 million) a long way behind. Since then, Reebok and Nike have redefined the market and introduced many new categories, such as aerobic shoes (bought primarily by women) and fitness shoes (requiring no breaking-in period, unlike conventional athletic shoes). Table 4 indicates the changes in sales and share which have taken place.

   The success of individual brands within manufacturers' product lines can be extraordinary. For instance, in 1985 Nike developed the Air Jordan shoe to be promoted by basketball star Michael Jordan. They expected sales of $5 million in the first year; instead, revenue in the first year exceeded $100 million (including Air Jordan apparel). However, the following year sales fell off just as dramatically.

5. Served market growth: since the growth of the market is so rapid, extra strains are placed on competitors. The US athletic shoe market grew from around $1.5 million in 1981 to $3 billion in 1987, an estimated $5 billion in 1989 and forecast $10 billion in 2000. From 1977 sales of $29 million Nike alone grew to 1989 sales of $1.7 billion and forecast 1990 sales of $2.6 billion. This is equivalent to more than the entire shipments of US men's non-athletic shoes in 1988. Each year Nike and Reebok are each experiencing revenue growth to the order of $300-$700 million.

Table 2

NIKE's product segments

SPORT ACTIVITY		Footwear	Apparel	Accessories
CORE	Basketball (M,W)	X	X	X
	Running (M,W)	X	X	X
	Fitness (M,W)	X	X	
	Cross training (M,W)	X	X	
	Tennis (M,W)	X	X	X
	Racquetball	X		
	Aerobics	X	X	
CHILDREN'S/ INFANTS SPECIALITY	Cycling	X	X	
	Track and field	X		
	Hiking	X	X	X
	Walking	X		
	Golf	X	X	
	Soccer	X	X	
	Baseball	X		
	Softball	X		
	Football	X		
	Squash	X		
	Field hockey	X		
	Lacrosse	X		
	Volleyball	X		
	Cheerleading	X		
	Wrestling	X		
	Water sports	X	X	

Note: M = Men's; W = Women's

Table 3

Advertising/promotional expenditures of top three athletic shoe companies

($ million/percentages)

COMPANY	1988	1987	1986	1985	CAGR %
Expenditures					
NIKE	$110.3	$ 75.6	$ 64.3	$ 66.0	18.7
Reebok	73.9	35.6	15.5	5.6	136.3
L.A. Gear	12.6	5.4	2.6	0.5	197.4
TOTAL	$196.8	$116.6	$ 82.4	$ 72.1	39.8
Percent of sales:					
NIKE	7.3	7.9	6.8	6.3	4.5
Reebok	4.1	2.6	1.7	1.8	4.5
L.A. Gear	5.6	7.6	7.2	4.5	
TOTAL	5.6	4.8	4.3	5.3	
Percent of SGA:					
NIKE	36.6	35.9	30.1	32.0	18.5
Reebok	18.0	14.3	11.2	10.5	18.5
L.A. Gear	23.4	26.3	25.2	18.5	
TOTAL	25.7	23.4	22.8	27.4	

Shearson Lehman Hutton

Table 4

Athletic footwear market share and revenue estimates

	1986 worldwide		1989 US	
Manufacturer	Revenue	Share	Revenue	Share
Adidas	$ 2,040	22		
Asics Tiger	$ 800	9		
Puma	$ 500	5		
Nike	$ 241	3	$ 1,710	26
Reebok	$ 92	1	$ 1,710	26
Others: total	$ 5,6'0	61	-	-
Others: LAGear			$ 329	5
Others: Adidas USA			$ 263	4
All others			$ 2,558	39
TOTAL	$ 9,282	100	$ 6,570	100

6. International management: the brand management of the kind required here is inherently international in scope, even though the essence of the product can be managed by 10 or 20 brand managers based in the US. Virtually all athletic footwear sold in the US is imported. Having first established a manufacturing plant in the US in 1974, Nike now obtains its shoes from 35 or so overseas plants, with products coming from the Republic of Korea (54%), Thailand (18%), Taiwan (15%), Indonesia (5%), and China (7%). Reebok and LA Gear source virtually all their production in the Republic of Korea. Nike's apparel products are sourced about half from the US and half from Taiwan and Thailand.

Other foreign involvement includes the ownership of distributorships in nine countries in Europe, with sales in a further 50 countries handled by independent distributors and licensees. Foreign footwear sales amounted to $280 mm in 1989 and foreign apparel sales to $70 million for Nike. The bulk of foreign sales were in Europe ($233 million) and Canada ($32 million).

Prospects for strategy 3

The outlook for companies in this group over the next decade will be shaped by three main forces:

1. The market for athletic wear of all kinds will be fast-growing. Shoe sales are forecast to double between 1990 and 2000, to reach $10 billion per year.

2. The intersection of leisure, fitness and fashion is likely to be full of opportunity for manufacturers.

3. US-based companies are well-placed to gain a growing share of this expenditure since much of the trend is fuelled by interest in US sports and culture generally.

All this suggests immense opportunity for the four, six or eight companies which can keep balancing the manufacturing/marketing judgements needed to stay in the public eye. But there will be few such companies: for others, the best option will lie in being suppliers of inputs.

The strategies compared

It is possible to characterize the results of these different strategies in three ways.

First, a simple comparison of return on sales (ROS) shows that, largely by virtue of the premium prices its products can command, Nike and others in group 3 are able to achieve high and consistent ROS (see Figure 2). US Shoe, by comparison, has experienced a falling ROS and a lower average ROS than the strategy 3 group. This reflects the fact that the customers are more price-elastic, and have more substitute non-branded products available to them. The ROS attained by strategy 1 is even lower than this, and reflects the fact that these companies are typically price-taking, atomistic suppliers to their customers. The bar chart of ROS for 1989 shows the full dispersion of results, and reveals a broad mapping of ROS to strategy (Figure 3).

The second comparison is illustrated by return on managed assets (see Figure 4). This shows that Nike enjoys both high gross margins and high asset turnover (or sales/assets ratio) reflecting its use of other companies' assets for production. It also reflects the way it locks its customers into six-month forward orders for shoes (this will be discussed later in detail). US Shoe is again showing a less advantageous position on both axes, despite its efforts to shorten manufacturing cycle times and inventory in general. Its asset turnover in 1989 remained at 1.7. Strategy 1 companies tended to have higher asset turnover if they were not also integrated into retailing.

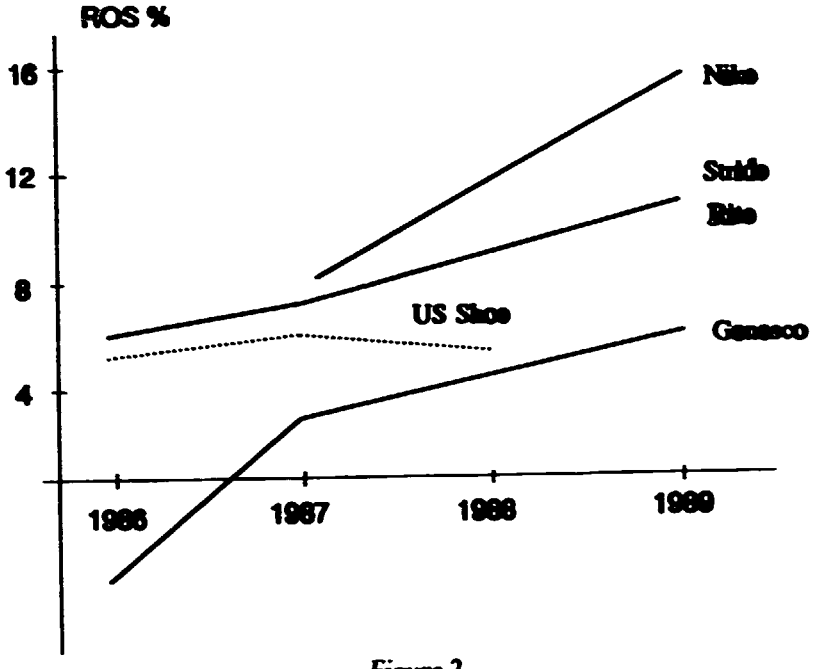

Figure 2
Return on sale over time

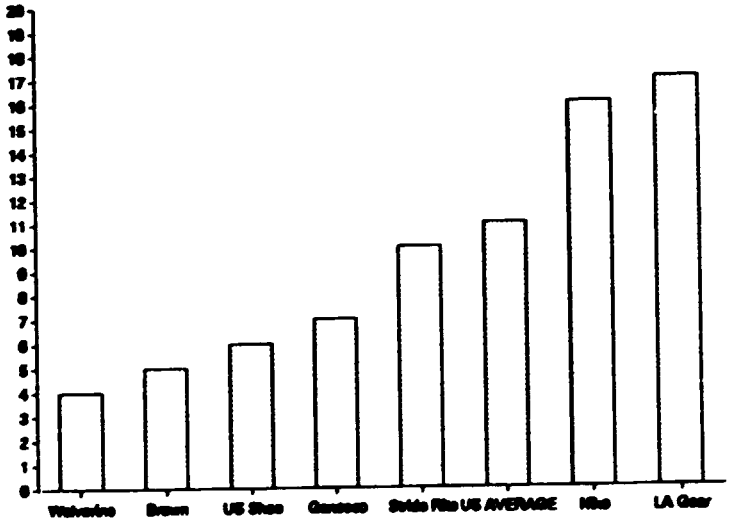

Figure 3
Retun on sales compareded, 1989

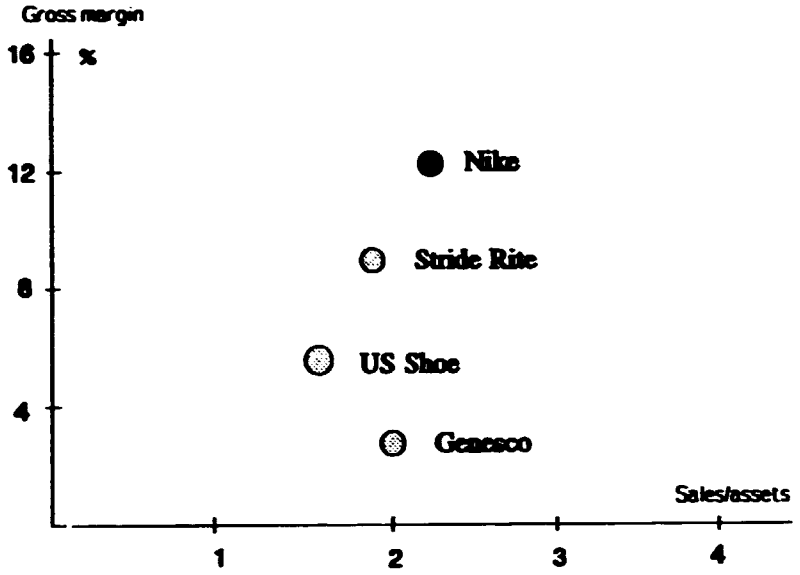

Figure 4
Return on assets employed, 1989

Finally, Figure 5 compares sales/employee for each company for 1989. The range there is large - with about a 10 to 1 range between the high and low observations. This indicates the different degrees to which companies have been successful in their pursuit of efficiency and it also hints at the degree to which different strategies allow different efficiency levels to be reached. Clearly, running an operation with only sales and marketing in the US requires very different levels of employment and asset intensity from a fully-integrated manufacturing and retailing operation.

The evolving strategic environment

1. Internationalization

a) Retailer-led

An important aspect of the athletic shoe market is that it is being taken international by retailers to a large extent. For instance, the FootLocker division of Woolworths is growing fast in Europe, and, as the biggest Nike customer in the US, will funnel sales growth into Europe for that supplier. Adidas and Puma, the established brands in Europe, are expected to see some share declines as a result.

b) Product-led

Foreign sales of shoes by Nike in 1989 amounted to $349 million, up from $303 million in 1988. This suggests major new trends in the international flow of value added in footwear. If one assumes a 63 per cent cost of goods sold on Nike's shoes (the reported figure in their 1989 annual report) then total import value accounted for by the company must have been 63 per cent of total sales ($1,710 million) or $1,074 million. Export revenue was $349 million, so that the US net shoe deficit for Nike was $725 million. However, this figure is falling fast, as exports are growing much faster than total

sales. Exports are forecast to grow 25 per cent per year over the next five years, whereas the unit cost of imports is falling by 4 or 5 per cent per year.

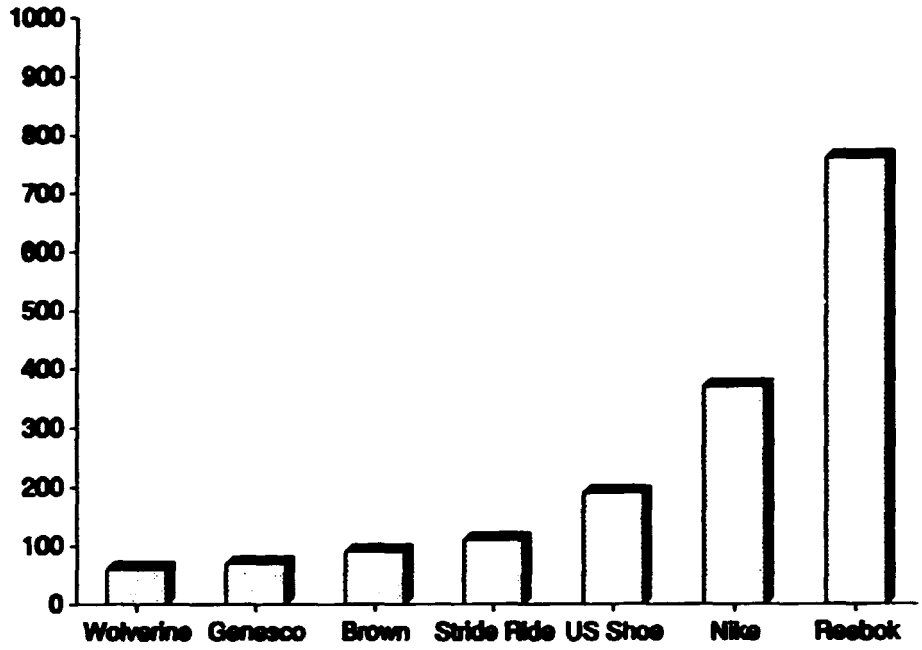

Figure 5
Estimated sales value/employee, 1989 ($000)

c) Design-led

For years, design studios - typically small and often in Italy and Spain - have sold designs to footwear manufacturers in the US. Now US design groups, like those within Reebok and Nike, are able to export their work back to Europe and other regions.

2. Technological change

a) Process improvement

As noted in the discussion of US Shoe, manufacturers in developed market economies have the option of tightening product cycle time by re-organizing the flow of work through their plants. In the case of US Shoe this has resulted in an estimated inventory/sales ratio of 16 per cent which is comparable with the 13 per cent achieved by Nike, which does not have any US production and merely imports. (See Table 5 for several comparisons of asset efficiencies.)

b) Design improvement

CAD/CAM is increasingly used in the design of shoes, both to allow prototypes to be looked at early in the design cycle, and to help build "manufacturability", or ease of production, into the shoe from the start. As the number of parts in a shoe and the number of assembly steps required fall, cost savings will follow, although there is as yet no clear evidence of this in the ratio of cost of goods sold to sales revenue in aggregate US data. Between 1972 and 1987, materials as a percentage of non-rubber footwear shipment value actually rose from 43 to 48 per cent, while for men's non-athletic shoes it also rose, from 48 to 50 per cent.

c) Inventory improvement

Using information technology and decision support software to help predict the length of the product cycle, has allowed some manufacturers to further reduce their shoe inventories. Nike has introduced the "Futures" programme, whereby if retailers book their orders 5 to 6 months ahead, Nike guarantees 90 per cent delivery within the targeted date and at the agreed price. In 1989 this agreement covered nearly 80 per cent of all its US orders. For Nike a dramatic fall in inventory to sales, from 31 per cent in 1984 to an average of 15 per cent over 1987-89, has been achieved, allowing the company to save on its working capital.

Table 5

Asset efficiencies compared

Strategy	Company	Inventory/sales (%)	Sales/assets	Plant/sales (%)
1	Genesco (1987)	31	2.0	N/A
2	US Shoe	16	1.7	20
3	Nike	13	2.1	5.3

Note: Assumes US Shoe footwear assets are proportional to weight of footwear within total company sales.

Short term opportunity for newcomers to leather footwear

The nature of the changes described above should imply considerable opportunity for developing country-based suppliers. The evidence for this would be:

a) Rapid growth of demand in some shoe categories;
b) Price level reaching $200 per pair for some categories;
c) Increasing need for suitable sub-contractors able to deliver quickly at high quality, with cost no longer the paramount criterion for retaining the business (although still important).

Nevertheless, opportunities for developing countries are still somewhat limited for three types of reasons. First, the key value-adding functions outside manufacturing tend to be tightly controlled by the companies with brands. Thus, while some revenue growth will pass to suppliers, the bulk will be retained by the holder of the rent-producing asset, which, in the case of strategy 3 companies and somewhat in strategy 2, is their brand name. Second, where opportunity most plainly exists, it will continue to be in the most margin-sensitive parts of the business, specifically provision of hides and skins to lower-value manufacturers following strategy 1, and to a lesser extent, strategy 2. Design opportunities will exist, but by their very nature will be modest in revenue terms. Third, the improvements being made in the manufacturing by some strategy 2 companies suggest that the traditional role of developing country companies in manufacturing may be constrained in future. The tension between the return of production to the market country the one hand and the use of overseas production on the other will probably evolve company-by-company rather than crisply along strategy group lines. But the recent experience of companies in the US, who have found that there are many changes they can make which enhance their cycle times, time to market, asset efficiency, and response to retailers' needs, indicate that in the future, developing country suppliers will be competing against capital improvements within their clients' plants in developed countries. Table 6 summarizes these points.

Table 6

Opportunities for new entrants in the leather footwear industry

STRATEGY GROUP		OPPORTUNITY AS			
		SUPPLIER	WHOLE-SALER	OVERSEAS AGENT	DESIGNER
1	Low cost manufacturer	Always chances to bid below current suppliers; low margin the norm	Low fashion content millitates against shoes being keenly sought	Value/weight ratio unfavorable	Moderate; depends on good communi-cations
2	US Shoe	As above	Always opportonuties	Limited appeal beyond narrow niches (e.g. boots)	Opportunities exist
3	Nike	Restricted to highest quality, high-volume, flexible-mix suppliers	None; company in US controls this key lever	None	None

Short term opportunity for Brazilian companies - *a brief case study*

To take a fuller look at the forces just described, a selection of leather footwear companies in Brazil was examined. This section reports on the ways in which they are responding to the increasing competition they face from tied suppliers in Asia, on the one hand, and to a revitalized US footwear industry, on the other.

The background of this endeavor is as follows:

- about 4,000 companies produce 570 million pairs per year;
- Brazil was the fourth-largest footwear manufacturer in the world in 1989;
- Brazil was the sixth-largest footwear exporter in 1989, with exports worth $1.3 billion and 155 million pairs sent abroad;
- 85 per cent of exports are women's shoes, made primarily in the Rio Grande do Sul area. Men's shoes are made chiefly in Sao Paulo state;
- 69 per cent of exports in 1989 were sent to the US; most of the rest to Europe;
- Average export price per pair in 1989 was $9 for women's shoes;
- 95 million pairs of athletic shoes are made per year, of which 10 per cent are exported. Most of these are low-end canvas shoes.

Needless to say, within this large collection of companies, there is a variety of efforts under way, directed at three objectives:

a) An effort to sell directly to USA retail chains rather than going through importers;
b) An effort to establish and support indigenous brands rather than relying on brands established by US retailers;
c) A general effort to enhance design and material quality, particularly for export customers.

While there are clearly a variety of strategies under way in the Brazilian footwear industry, one can see in them an echo of the experience of the US industry. Two starkly opposing approaches stand out: staying with anonymous exporting of shoes, sold in bulk to US importers, in competition with many other Brazilian manufacturers; or trying to gain more of the value added by creating a brand to which, ultimately, consumers in the importing country will be attracted. Neither path is easy, given that many companies can pursue both simultaneously, but the forces at work in the US suggests that the rewards associated with the latter justify the efforts required to compete at this level.

Longer term implications

a) The internationalization of consumption patterns

To the extent that tastes become more similar across countries, athletic shoes will be among the products most affected. Moreover, as brands increasingly assume cross-border power, the outlook for strategy 3 companies based in the US will be immense. The challenge for companies in the importing countries will be to try to convert some of this growing demand into domestic value added. Some of the appeal of US shoes is, however, their very foreignness, so this will present considerable problems. As the section on Brazilian manufacturers indicated, some are trying to do this now, having seen the disproportionate benefits which can accrue to this approach. The problem, of course, will lie in managing a new brand from overseas. Successful cross-border brand introductions tend to have been achieved with already-established brands, such as Mercedes Benz, Perrier and Perry Ellis, where the company has already had experience with all the aspects of brand management in a market that is close to home.

b) Market adjacency issues

Increasingly, companies following strategy 3 are redefining the distinctions between consumption categories, so that an acceptable shoe brand can become a desirable apparel brand. This naturally gives the shoe manufacturer a chance to create a broader product range over which to exercise premium pricing and channel control. The old adage about development being the difference between the price of a kilo of beans in Ghana and a Hershey bar in New York is relevant here in providing a paradigm for thinking about how much value added in manufacturing will always accrue to the owner of a successful brand. This suggests again that smaller competitors face considerable challenges in the leather footwear industry of tomorrow.

SUMMARY

The shoe industry in the US and in other developed market economies has been revolutionalized by a small number of companies pursuing an integrated policy of product development, accompanied by intense advertising and public relations. These companies have enjoyed the fastest growth-rates the footwear industry has seen in generations. Seeing this, many of the more traditional companies have been forced to imitate some of the innovations for fear of losing even more of their revenue growth. Some have been partially successful in cutting the cost of production and the notoriously long cycle times associated with shoe production. Others have not. Even more traditional companies, selling shoes to wholesalers for subsequent branding and distribution, have found the returns to their activities continuing to fall.

For companies not already able to exploit the changes underway, the challenge is severe. The drift of value-added is unmistakably towards the brand. The drift of value is also towards those parts of value added that are closest to the end-user (the customer) and away from the manufacturer. All the trends point to the extreme difficulty of being a newcomer; having said that, it must be remembered that in 1974 Nike was a newcomer to an industry which 60 looked mature, low-profit, and staid - and twenty years later it had created revenues greater than the entire industry had earned when it had started. Evidence from Brazilian shoe manufacturers suggests that some at least are reacting aggressively to these changes, and will attempt to create and retain more value per pair than hitherto has been the norm.

The shelf-time of leathergoods tends to decrease, particularly for athletic footwear which are strongly glamorized by advertising relating them to the popularity of certain athletes.

Product differentiation

Cost economizing is a strategy to defend market shares against new entrants with lower cost labour. A more offensive strategy, seeking growth through quality and diversity, consists of developing products that are distinct and cannot easily be copied.

At first sight, there seems to be only narrow scope of products in the leather industry. But the industry actually includes a range of products with each being differentiated according to certain attributes. Footwear, for instance, includes different products intended for different uses: dress, casual, sport, work, home; they are used by men, women, or children. In every cell, matching a use and a user (say men's athletic shoes), footwear may in turn be differentiated in terms of design, quality, image, comfort, price, etc.

Among the various shapes that shoes can take, some may be considered as different products (a ski shoe differs from a ballet shoe), others merely as variations of a given product (high-heeled women's shoes of different designs). Economists will talk of different products when the items cannot reasonably be substituted for each other (ski shoes for ballet shoes) and of differentiated products when the items are similar enough to serve the same purpose and yet possess distinct characteristics allowing the buyers to rank them by order of preference (for instance anonymous high-heeled shoes and branded ones can both serve as dress shoes but buyers will normally prefer the latter). It may seem pedantic to dwell on the nuance that separates the concepts of different and differentiated products; however, it is important to understand this distinction in order to delineate the strategies of product innovation and product differentiation.