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UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Tel: (+43-1) 26026-0 · www.unido.org · unido@unido.org

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STRATEGIC ASPECTS OF THE LEATHER BUSINESS

Summary of survey on the world leather-based industries*

Prepared by

the UNIDO Secretariat

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INTRODUCTION

The background paper entitled *"Strategies of firms in the leather business"* is extracted from a forthcoming leather survey prepared by UNIDO, which will comprise the following three parts:

1. One part, devoted to the structure of world production, consumption and trade, pictures the worldwide distribution of consumption of finished leather; then deals with the distribution of production by stage of processing and finally covers international trade in leather and leather products by stage of processing.

   The main image that emerges is a clear shift of the leather industry towards the South. Many firms have sought and still seek cost minimizing locations. When it comes to mass products, low cost is basically a matter of low wages, good export infrastructure, openness to imports of inputs and political stability. From a technical point of view, state of the art factories can be installed almost anywhere. Recognizing this opportunity more and more entrepreneurs of developing countries have engaged in export-oriented production of standardized leather products and in the related tanning. In turn, the largest manufacturers of developed countries were led to open off-shore production sites to restore their competitiveness.

   To-day there is proportionately much more production in the South than 20 years ago and correlatively trade of final products from South to North has increased very considerably.

2. Another part focusses on the characteristics unique to leather and leather product industries. Two chapters review the raw material problems of the leather industries; one is on the market conditions - demand, supply of the raw and intermediate material, the other is on the price of the raw material. Two more chapters examine the manufacturing technology and the environmental problems related to tanning.

   The top quality hide supply is a major concern because the growth of the industry is underpinned by a general drive towards upgrading the final products. Up to now supply constraints have not jeopardized the industry growth because substitution of sneakers made of low grade leather to walk shoes that use high grade leather gave room to upholstery leather requirements. But simultaneous booms in uses competing for the same leather quality would probably be difficult to accommodate and would result in price pressures. Securing raw material, however, is probably less of a problem than boosting demand. The very survival of the industry depends on a sustained demand for final products made of leather. Threatened by artificial substitutes and by the animal right ethos, the leather industry must keep alive the interest of consumers of genuine leather. In the past it did it superbly by generating popular infatuation for leather-made garments, then sneakers, then upholstery. The future, however, still holds in stock a new wave of growth products.

   The price instability of raw materials is another problem that bears heavily in the mind of tanners. Basically the most acute deviations, those that hurt most and are less predictable, are due to unpredictable disruptions of trade (an embargo) or production (a disease). The impact of a constriction in one source of supply is likely to be softened if alternate sources can easily be tapped. Freer markets and freer trade therefore would be useful to tame price fluctuations.

   The manufacturing technology encompasses a huge variety of techniques. Possibly the only general statement here is that the leather-making sector is more capital-intensive than the leather goods-making sector. However, the emergence of new forms of manufacturing based on intelligence and computerization tend to reverse the ratio capital to labour in the latter sector. Nowadays, what dictates the choice of a technique is the value of time in the product market in which the factory operates. For top scale goods time is an important factor, consequently flexible and quick response techniques must be adopted with the consequence that low labour cost no longer is the unique key to competitiveness in the leather goods end of the processing chain.

Environmental problems are at the same time a burden and a challenge. Firms which have adjusted to exacting environmental norms have had to incorporate additional costs but in exchange they have learned to master clean production techniques and have occupied new markets, those for clean products. Examples submitted in the survey suggest that the gains of environmental investments, considered from the firm point of view, no longer look negligible with regard to the costs. Market niches for clean products are emerging and the ability to produce without damaging the environment starts to become a market advantage.

3. A third part examines the leather industries in selected countries. Korea, Taiwan, Brazil and India represent the developing countries; Italy, Germany (formerly West Germany) and the United States the developed ones. Leather, which is perceived by some as a sunset industry, has actually recently been the most dynamic industry in one of the most dynamic economies of the developed world as well as in the most dynamic economies of the developing world. Furthermore, some leather firms have ranked among the most profitable enterprises recorded in the last decade.

The observations gathered in the third part raise the curtain on the fourth one which is about strategies of firms involved in the leather business. This fourth part, submitted to the Leather Panel as a background paper, may be summarized as follows.

STRATEGIES OF FIRMS IN THE LEATHER BUSINESS

A. The competitive background

1. UNIDO's view of the strategies in the leather business is organized in turn of the notion of *value-added chain*: the set of technical and commercial operations leading from the raw material (Hides and skins) - through leather making, leather goods making, distribution - to the sale of final products.

2. Consumers demand is spread over a wide spectrum with demand for topscale goods (sensitive to exclusivity, indifferent to price) at one end and demand for downscale goods (much more sensitive to price) at the other. In market terms it means that downscale goods are sold in a very competitive environment where price is decisive and marketing is of minor importance whereas upscale goods are sold in many niches sensitive to fashion, to brand and to delivery speed.

3. The value-added chains for topscale and downscale goods differ markedly. With downscale goods value-added is concentrated upstream the chain: the final price being very competitive, the cost of manufacturing is decisive to create a margin. On upscale goods the value added margin emerges downstream, after the production stage: the final price allows room for marketing and selling expenditures.

4. The key to success in downscale goods is:

Low production and transaction costs

a) Low production cost derives from low wages, scale economies, fast learning and easy access to complementary inputs.

b) Low transaction cost is obtained through good infrastructure, good logistics and technical assistance to link distant markets.

Organizational edge and market power

a) Organization is a matter of coordination between design, production and marketing. Since demand is eminently variable, flexibility and speed delivery are important factors too.

b) Market power is created through product differentiation and control of the several stages of the value-added chain. It gives a firm the possibility of selecting its partners and also to decide on the best form of partnership (vertical integration, sub-contracting, joint venture, franchising, etc.).

5. When it comes to downscale products, comparative advantages are in developing countries; because there are no technical barriers to manufacturing and because demand is sensitive to price they can easily export on the basis of their low wage rates. In topscale products, inversely, the comparative advantages are with developed countries which have the rich consumers, the sophisticated inputs, the design and marketing facilities.

B. The competitive dynamics

6. Global competition consists in taking positions along the most profitable segments of the value added chain.

Firms exploiting the comparative advantages of developing countries have obtained the control of the downscale goods markets and are attempting to conquer positions in the upscale goods markets.

Firms based on the comparative advantages of developed countries try to upgrade further their products to place them out of reach of their rivals.

Within both categories of firms there is internal rivalry for market shares.

7. The main strategic variables acted upon are cost, process, product, marketing and organization.

a) *Cost*-based rivalry is 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 in search for lower cost producers.

b) *Process*-based rivalry is an attempt to meet the competition based on low labours cost by reducing material cost, reducing labour inputs and adopting brand new technologies based on computerized automation.

c) *Product*-based rivalry enlarges the market by introducing new products and softens competition by differentiating products into niches that the competitors cannot easily invade.

d) *Marketing*-based rivalry consists of extracting all the revenue the market will bear and avoiding the entry of rivals. Pricing, advertising and retailing are the three major tools that marketers will use to achieve these objectives.

e) *Organizational*-based strategy aims at maximizing the sum of profits made by the whole value-added chain and influencing its distribution across stages. The wherewithal of organizational strategy is market power.

C. The consequences of competition

8. Since value added margins are wider in topscale products, the dynamics of competition (see 7) generate a general drive towards product upgrading and product renewal.

This drive ensures the survival of the whole industry. Its most spectacular achievements have been the successive openings of garments, sneakers, and upholstery markets in the course of the last three decades.

9. Selling higher value-added products is more risky. Demand is more difficult to foresee and at the same time design, marketing, retailing add to the cost of the product. To face uncertainty, supply is led to adjust in terms of flexibility, quicker response and also globalization. The firms involved in the leather business have very different characteristics. There may be multinational groups selling on many markets and niches and present at all the stages of the value-added chain or they may be small family firms located in one spot and fabricating or marketing a few products. Large firms of course tend to have better chances to adjust to the new success profile.

10. The new attributes of supply-flexibility, speed and global reach - plus the greater importance of marketing lead to the emergence of a new type of firm: larger, more computerized, relying more on intelligence and on strategies to defend or conquer markets.

11. As industry concentrates, external growth opportunities (growth through merger with an incumbent instead of growth through market invasion) become an option in an environment which was not long ago basically comprised of family owned enterprises. After the manufacturer and the merchandiser the time of the financier is now coming.

12. As both firms of developed and developing countries are involved in global operations, the world structure of the leather industry is being shaped more by firm strategies than by national policies.

13. International trade reflects basically two influences. First, the respective comparative advantages generate South-North flows of final products and counterpart North-South flows of raw material and inputs. Second, the complex strategies of globalization and niche specialization of top scale value-added chain generate North-North flows.

In both cases intra-firm exchanges represent a considerable share of the trade flows. It follows that trade is more a consequence of firm strategies than the automatic result of resource endowments of countries.

14. With the general upgrading of products, value added moves towards the downstream link of the chain and organizational factors take precedence over production factors. It follows that the offshore sourcing of the production link of the chain does not necessarily coincide with a shift of strategic power from North to South. Qualitative factors should be brought in to correctly evaluate the changing relation of forces.