STUDI AZIENDALI E MANAGERIALI

The new economics of outsourcing: empirical evidence from italian textile-apparel industry

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Abstract

There is extensive evidence to indicate that many high-end/luxury firms in textile and apparel industry decided not to outsource to other countries. In order to accomplish the objective of the study we will take the propensity not to outsource as the dependent variable, taking into account not only the present degree of outsourcing but also the tendency to outsource at any given time. Having this in mind we asked those people surveyed what factors have they considered in the trade off between advantages and disadvantages. We also asked the relative importance of each factor. Our findings suggest that the main reason for maintaining production in Italy is the crucial role of brand for luxury goods.

1 - Introduction

Protectionism in textile and apparel is almost as old as the industry itself. But since 1974 it has been formalized by a web of curbs imposed by rich countries on imports from developing country producers. The system, known as the Multifibre Arrangement (MFA), come to an end on January 2005. In a few months one of the most highly globalised industry was struck by an earthquake. It sweept away an international division of labour and trade patterns that has endured for decades sending tremors through communities and entire economies in the industrialised and developing world.

Italy's textile and apparel (clothing) industry long prided itself for its ability to produce both high-end and low-end products that could compete well against French luxury goods and cheaps clothes from China, Bangladesh and India. But once quotas finally went, the shock was particularly abrupt.

The biggest winner was China. In many areas of clothing, as in other manufacturing sectors, its efficient, large-scale production and low costs gave it a decisive advantage. US and European importers started to buy most of their needs from China. This country does not compete just on price indeed, it is not the lowest-cost producer of some clothing items. Its biggest advantages are its industry's rapid response, reliability, business-like attitude and keen understanding of customer demand.

Chinese manufacturers began to buy textile and clothing machinery in the '80 and during '90 have increasingly bought the latest equipment. As a result at the medium and higher end of the market, some Italy's larger clothing manufacturers began outsourcing production in early '80. On the eve of quota removal, Benetton produced 80 per cent of its clothing items outside Italy.

Other manufacturers have decided to maintain production in Italy. Recently others decided to return. Luxury goods makers, such as Gucci, Prada or Armani, continue to produce every item in Italy, even if some parts are prepared elsewhere. Executives say: "consumers, particularly Asians, would not buy if they were not made in Italy".

2 - Literature review

Outsourcing is a new concept that partially substitutes the more traditional term "subcontracting". Van Mieghem (1999) defines subcontracting as the acquisition of an item (i.e. a product, component or service) which the firm is capable of developing whereas outsourcing involves the acquisition of an item which the firm is not capable of producing internally to a satisfactory level. (Espino-Rodriguez, 2005).

Firms throughout the world are increasingly turning to domestic and foreign outsourcing relationship to acquire components that they might once have produced internally (Mitchell 2005).

2.1 - *The perception of advantages*

The decision to outsource has been traditionally based on cost reduction or insufficient capacity at a given moment in time, therefore was called tactical. But as globalization sent out in various directions, the integration among developing and developed countries and an increase in strategic alliances for acquiring new capabilities, the reasons why firms opt to outsource have changed, moving from tactical towards the strategic (Hamel and Prahalad, 1989; Reich and Manking, 1986).

According to theoretical literature the reasons to outsource are basically strategic (Londsdale and Cox, 1997; Ford and Farmer, 1986; Welch and Nayak,1992). Outsourcing involves taking into account a set of important factors such as core competencies, value chain activities, value system, supplier and customer relationships. Therefore involves motives related to long term competitive advantage.

Other strategic reasons are related to the increase in a firm's concentration on its core competencies (Quinn,1999; Quinn, Hilmer, 1994) and to the dispersion of risk amongst several suppliers since the firm does not need to invest constantly.

Outsourcing is particularly useful for companies that are involved in rapid growth. These companies need to devote their limited resources to areas rather then on strategic spend.

Outsourcing is a very effective strategy for company selling textile and apparel products in the markets of richer country. They use various off-site sourcing arrangement in order to have access to cheap labour, favourable tariff treatment (imports enter the foreign country duty free, so foreign companies can easily ship raw material and components there for further processing); cheap raw materials.

The theory of comparative advantages suggests somewhere there'll always be a low cost location for manufacturing. If it's not China or India it could be Thailand, Vietnam or Bangladesh. Being flexible and prepared to move to other regions and countries is part of the strategy for successful off-shoring in industries that are largely cost driven.

According to Werner International Inc, the average hourly wage per textile worker in 2005 in France was 19,.82 dollars, in Italy 18,63, in US 15,78, in Egypt 0,88 and in mainland China 0,49.

2.2 - *The perception of disadvantages*

Outsourcing presents some disadvantages as well. If not properly executed outsourcing can lead to certain significant risks for the firm. Quinn and Hilmer have identified three main risks: 1) the loss of critical skills or abilities; 2) the loss of transfunctional skills; 3) the loss of control over the supplier.

If outsourcing is the only strategy, the firm is going to lose. It will lose technical competence and ultimately its ability to innovate. Companies that do this are playing a dangerous game. If the firm want to offer a quality product , it has to be able to control the design, production and the logistics. Vertical integration is be the best way to do this and maintain competence in designing and producing products.

Some companies have began to bring operations back inside. One reason is that the cost saving from outsourcing can be temporary. The labour rates in low-cost areas eventually rise and take away the advantage.

Politicians blame outsourcing of jobs to India and China as a key factor in the sluggish recovery of employment in US and Europe. Meanwhile these countries are going upscale, switching from labour-intensive products to making higher-tech goods as they increase their own level of automatization (Bhagwati 2004).

3 - Object of the research

This study focuses on advantages and disadvantages perceived by managers in the process of developing an outsourcing strategy. There is extensive evidence to indicate that many high-end/luxury firms in Italy decided not to outsource to other countries.

In order to accomplish the objective of the study we will take the propensity not to outsource as the dependent variable, taking into account not only the present degree of outsourcing but also the tendency to outsource at any given time. Having this in mind we asked those people surveyed what factors have they considered in the trade off between advantages and disadvantages. We also asked the relative importance of each factor.

We chose the high-end of the textile and apparel industry because it is representative of luxury lifestyle industry (watches, leather products, sunglasses, etc.).

4 - Hypothesis development

We put forward the following hypothesis on disadvantages of outsourcing for high-end/luxury Italian firms.

4.1 - *Production must be kept close to the market in order to ensure fast turnaround, quality control and feel for fashion needs*

Big companies like local suppliers because: a) product design changes can be handled more effectively; b) short supply chains mean stocks can be minimised; c) there is no need to worry about delays caused by congestion on long-distant routes.

Some high-end firms, for example, contracts outside producers to make its items from drawings by an in-house design team. This system of outsourcing gives the company the flexibility "to better negotiate pricing and timing"…"and allows us to amortize peaks and valleys". "Having local companies producing parts for us means that they can be much more responsive to our needs than if they are long distance away, such as in China.".

Hypothesis 1. The stronger the perception of proximity to the market as an advantage, the greater the propensity not to outsource.

4.2 - *Loss of intellectual property*

A key risk is the loss of technology (governing such areas as design and materials engineering) and creation of competition in third markets.

Concerns are not just quality and logistics, but also the fact that a business in Italy may feel it has less control over intellectual property if it outsources its parts-production to China or India rather than at home.

In contract manufacturing, a company contracts with a foreign manufacturer to produce one or more products in that country. The main advantage of this arrangement is lower-cost manufacturing. The price advantage in manufacturing is often substantial enough to permit shipping the product to the company's domestic market. Unlike a licensing arrangement contract manufacturing allows the company control over product quality.

However, companies must consider a potential pitfall: the extent of transferred know-how required to enable the foreign contractor to produce. Normally, contract manufacturing does not offer legal protection for company technology that would be stipulated in a licensing agreement. In general, contract manufacturing works best for low tech products where manufacturing cost is the prime concern.

Trademark must be protected if a global marketing plan is to succeed. Firm frequently finds that its trademark has already been filed by someone else in the foreign country. This occurs because prior use is not a prerequisite for registration in many countries.

Hypothesis 2. The stronger the perception of possible loss of intellectual property, the greater the propensity not to outsource.

4.3 - *Damage to corporate reputation*

The firm reputation may be irreparably harmed if the contractor does not honor quality standard and if the technology is used poorly.

Hypothesis 3a. The stronger the perception of possible damage to corporate reputation due to failed quality standards, the greater the propensity not to outsource

The firm reputation may be irreparably harmed if the contractor does not honour ethical standard.

Products are sourced from around the globe, often from developing nations where the cost of doing business is lower. Many of these nations have lax regulations concerning working conditions and basic human rights for the factory workers who perform the brunt of the effort in producing apparel goods.

In recent years, high-end companies have began to realize that fair working conditions are an important part of fair trade.

Hypothesis 3b. The stronger the perception of possible damage to corporate reputation due to failed ethical standards, the greater the propensity not to outsource.

4.4 - *Threats of legal moves on imports*

Outsourcing also poses political risk. Unions and competitors may call for government intervention to fight off low-cost imports. Outsourcing can also link a firm with countries whose industrial practice may be less squeaky clean.

The increase in the global labour force has curbed workers' bargaining power and hence wage cost. "Adding 1,5 billion people to the global labour force has boosted the return to capital and richly rewarded rich Westerners; but in Germany, Japan and United States, real wages for the median worker have barely budget." (Economist, 2006)

As wages, for low skilled, continue to disappoint in Europe (as in richest countries), there could be a blacklash from workers and demand for protection from low-cost competition. As far as US and China relations, US textile makers estimate around 600.000 jobs could be lost if China is allowed untrammelled access to the American market. The demand for protection from low-cost competition urges the governments to invoke provisions under the treaty signed by China when it joined the World Trade Organization (WTO), which allow countries to limit import growth if a domestic industry is threatened with significant disruption.

UK has a different story. Textile production in England's north-west is so small that the removal of import quotas fails to alarm. A century ago Manchester's Royal Exchange was handling 80per cent of the world trade in finished cloth and Lancashire mills accounted for 40 per cent of global spinning capacity and close to a third of weaving capacity. Today it is home to an 800-seat theatre.

The great textile companies that once ruled the world such as Courtaulds, Coats Paton, Viyella, English Sewing Cotton and many others have either gone bankrupt or been taken private.

Hypothesis 4. The stronger the perception of threats of legal moves on import, the greater the propensity not to outsource.

4.5 - *Risk of destroying the equity of the brand*

Executives insist that generational knowledge of design and other crafts found in Europe cannot be exported. They are convinced that the top tier of high-end/luxury brands will continue to be seen, particularly in Asia, intrinsically European. Luxury goods are largely a way of buying into the lifestyle of the French and Italian "haute bourgeoisie". A brand is a set of association in the mind of the consumer and one of these is the country of origin. The risk of loosing status symbol is too high.

The "Made in Italy" label, with its centuries-old history of artisanship, has justified premium prices. If their clothes are stitched at low-cost factories, how will consumers react?

But even “Made in Italy” stalwarts such as Prada say they are tiptoeing into foreign sourcing. Many believe that the out of France and Italy is only just beginning. Fashion executives say some production won’t ever move to low-cost countries because Italian craftsmanship is still unparalleled. Sophisticated items made in low volumes may always be made in Italy. For the rest, the industry thinks is only a matter of times.

Hypothesis 5. The stronger the perception of risk of destroying the equity of the brand, the greater the propensity not to outsource.

5 - Research methodology

The area of research we have chosen is the group of firms belonging to the high-end/luxury Italian clothing potentially outsourcer. Simply put, outsourcing allows a company to focus on its core competencies while enabling a third-party partner or outsource provider to manage its non core activities. Earlier we highlighted that many of these firms have decided not to outsource, and others decided to go back and turn inside. Which factors have they evaluated? What degree of importance has each of these factors?

5.1 - *Sample selection*

Our sample selection is based on three criteria. First, the firm has to be established for at least 10 years. This is to insure that the companies have “come through” turbulent years and restructuring due to the removal of quotas.

Second, it has to have revenues in excess of 20 million euro and has to employ at least 100 people. This is to ensure that they are not craftmanship.

Third, only firms with high corporate (or brand) visibility, as opposed to less popular firms, are considered since research has revealed that substantial differences exist between the two as far as “emotional selling proposition” and sensitivity to the risk of reputation getting worse. After determining where to set up for our research, the next step was to find out the number of firms. The company names were gathered from various data bases. We used data including annual reports, other documentation produced by the firm. We then contacted the general management of these firms in order to carry on a personal survey or a telephone survey. We obtained a sample of 24 firms.

5.2 - *Measurement of variables*

The survey was initially vetted via a series of personal interview with three academics with significant expertise in outsourcing research. The interviews with managers of our sample confirmed the suitability of the adopted questionnaire for studying why and when not to outsource.

6 - Analysis and findings

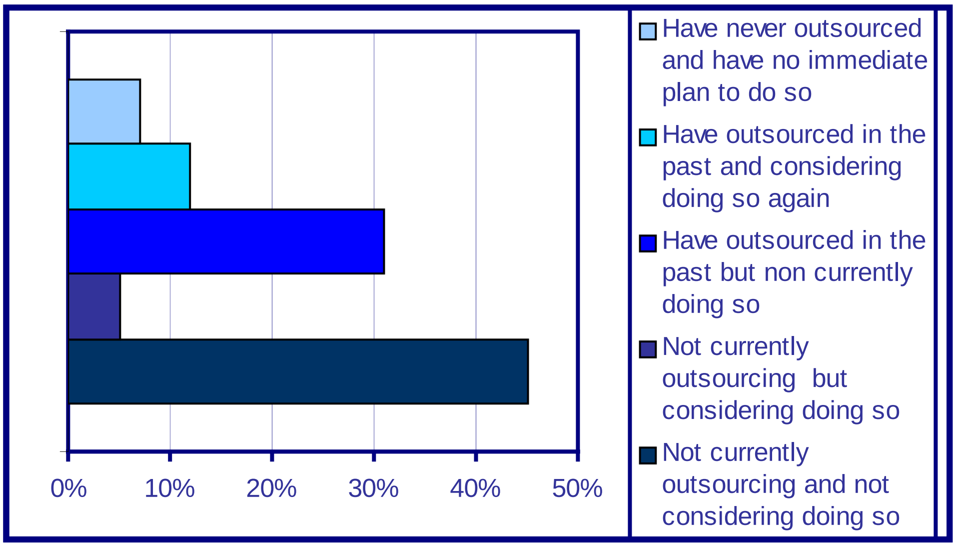
Conventional wisdom underlying much of the research on outsourcing in textile and apparel industry is that having to compete against imports from developing countries Italian firms were able to do more with less: more output with fewer workers, less capital and fewer raw material. Costs went down. Properly implemented outsourcing can provide a number of strategic benefits including improved quality, focus, flexibility and leverage.

The leading brands have resisted the lure of the world's new workshop, comforting themselves with the enduring cachet attached to European craftsmanship. By melding local workmanship with computerized production systems, some firms were able to increase output of clothing goods by fourfold in six years without lowering quality.

But as quality level in Chinese factories rise, the argument for and against offshore production are becoming more finely balanced. Even the grandest brand managers are asking themselves at what point the potential savings to be made from manufacturing in low-cost labour markets will become too great to ignore.

For the more fashion-oriented companies that focus on products with shorter life cycles, aimed at price-sensitive customers, the trend is clear. Almost every fashion label outside the top tier of high-end/luxury brands is either already manufacturing in Asia or thinking of it.

Figure 1 - Outsourcing strategies

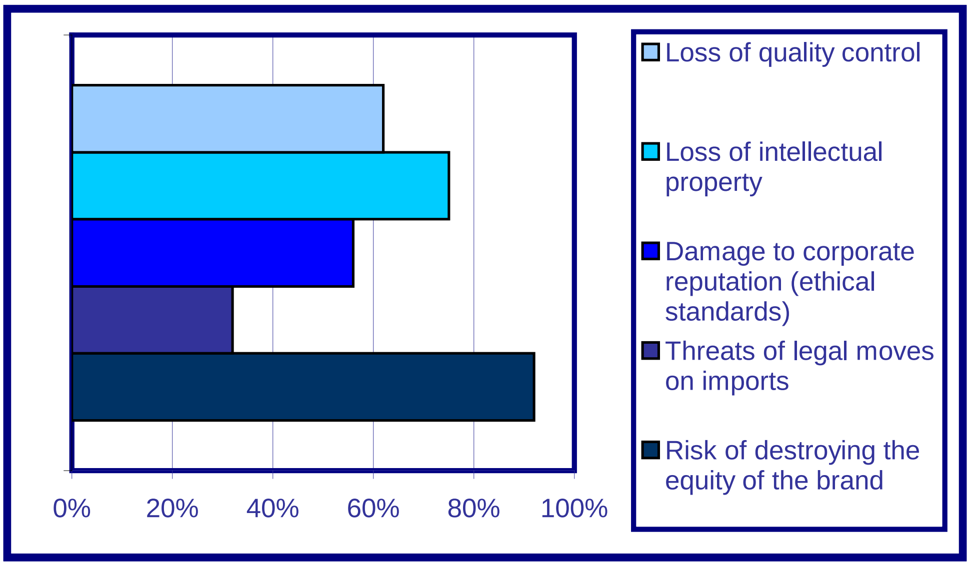


The survey results validate the belief that the use of outsourcing in the high-end/luxury segment was very low. Thirty-one percent of respondents reported to have outsourced in the past but not currently doing so. Another seven per cent reported have never outsourced and 45% reported not currently outsourcing and not considering doing so. Only 12% are willing to consider outsourcing. High-end/luxury textile and apparel companies rarely manufacture in China.

The primary reason provided for not to outsource (by 92% of respondents) is the risk of destroying the equity of the brand. Some of the most frequent comments were "The Asian consumer really does believe that luxury comes from Europe and must be made there to be the best." "In any case our Chinese customers are not going to buy Made in China". "Everything can be taught, but for our level of business you can't replace the quality and tradition".

The next most cited reasons for not outsourcing were a concern about the loss of intellectual property (75%) and that quality control was too important to outsource (62%), followed by a concern over the firm reputation, that may be irreparably harmed if the contractor does not honour ethical standard (56%) and by threats of legal moves (32%). A rather surprising third of respondents worry that their strategies would be jeopardised by demand for protection from low-cost competition.

Figure 2 - Major reasons for not outsourcing



The chief executive of Gucci said: "The Asian consumer believes that luxury comes from Europe and must be made there to be the best. It's a perception, and in our case and in those of many luxury brands, I believe it's true. In any case, our Chinese customers are not going to buy Made in China". "If a true luxury brand starts to manufacture in a low-cost areas only to increase gross margins, it is going to destroy the equity of the brand". The same olds for the CEO of Louis Vuitton. "When customers buy our products they expect western quality".

Pushed by rising labour costs, currency fluctuations and competition from low-price brands, Valentino and other firms are breaking one of the strictest taboos in high fashion. They are starting to produce some products for their most exclusive lines in developing countries[1]. A comment from a leading newspaper was very significant: drop “Made in Italy” for “Made elsewhere”.

Nevertheless, Prada chief executive believes a brand that develops enough of a for top quality could overcome such geographical prejudice, as have German luxury carmakers”. When local laws to permit it, CEO of Prada said he would prefer to insert a “Made by Prada” tag in his product.

7 - Suggestions for future research

The results of this study suggest that a set of factors explain why in the high-end/luxury segment of textile and apparel Italian industry managers decided not to outsource in low-cost countries. This study is therefore a pioneering attempt to test the concept of advantages and disadvantages of outsourcing in a new landscape of global competition. But we focused exclusively on a niche of luxury goods market. An analysis of other industry, like watches, may highlight new explanation and provide interesting results.

8 - Conclusions

The objective of this research was to determine: 1) which factors have influenced the decisions not to outsource taken by many high-end/luxury Italian firms in textile and apparel industry; 2) what’s the relative importance of these factors

Our findings suggest that the main reason for maintaining production in Italy is the crucial role of brand for luxury goods. A brand is a set of association in the mind of the consumer and one of these is the country of origin[2].

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[1] An editorial of Wall Street Journal was devoted to a “Cairo factory that harbours one of the biggest secrets in Italian high fashion: Egyptian tailors”… “They are making 1.300 dollars men’s suits for Valentino, one of the most storied names in Italian luxury, a craft they have learned from videotapes that air on TV sets positioned around the factory floor” (Wall Street Journal, 2005).

[2] Product position is the way the product is defined by consumers on important attributes – the place the product occupies in consumers’ minds relative to competing products. “Positioning starts with a product, a piece of merchandise, a service, a company, an institution or even a person ... But positioning is not about what you do to a product. Positioning is what you do to the mind of the prospect. That is, you position products in the mind of the prospect” (Ries, Trout, 1981).

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