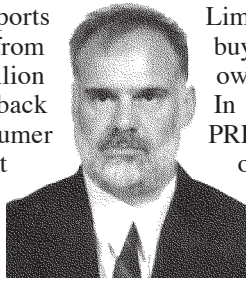


China and the American importer

The demand for consumer goods has transformed China's economic landscape. The PRC has become "factory to the world." Over the past two decades, US retailers have played a greater role in the design, manufacture and shipping of consumer goods from China. Is a new wrinkle in this relationship in the cards?

By George Lauriat, Editor-in-Chief, AJOT

Over the past two decades a profound transformation has taken place in sourcing retail consumer imports. The most dramatic features of that transformation in retail sourcing has taken place in only the last six or seven years. Outwardly, it is easy to see that the geographic sourcing of retail goods has shifted from Europe to the Far East, and particularly to China. Imports from China alone have grown from \$45.5 billion to over \$243 billion since 1995. One decided drawback to the flood of cheap consumer goods is that the trade deficit with the People's Republic of China (PRC) rose from nearly \$162 billion in 2004 to \$243.5 billion in 2005.



Wal-Mart alone is reported to have purchased \$18 billion worth of Chinese goods in 2004. That figure likely topped \$25 billion last year. From an ocean transportation perspective, this surge in trade has seen container traffic between the Far East and US rise from around 200,000 teus per month in 1999, to a staggering 1-1.2 million teus per month now. It is estimated that the PRC's container traffic to the US has risen from around 1.24 million teus in 1993 to nearly 7.4 million in 2004 and is believed to have topped the 10 million teu barrier last year. Retailers have been the biggest contributors to the import boom from the Far East. Since 2001, it is estimated that Wal-Mart, the world's largest box shipper, went from importing 250,000 teus to over 600,00 teus in 2005. Wal-Mart is not alone. Target is estimated to have imported some 291,000 teus and rival J.C. Penney, over 83,000 teus.

To satisfy consumer demand, retailers like Wal-Mart, Costco, Target, JC Penney, and specialty retailers such as CVS, Home Depot and Lowes, the import side of the business had to be reinvented. This was not an easy transition for retailers. Most retailers looked inward at the domestic challenges of building their supply chains, rather than looking outward to the problem of sourcing products to fill the shelves. This attitude is understandable. Traditionally, merchant trading houses acted as the go-betweens either finding product through local buyers, or in the case of some of the larger Japanese trading houses like the Marubeni Group, actively seeking participation in the factories producing the goods. Many of the department store-style retailers had their own in-house buyers who made annual buying trips to Asia, meeting with middlemen, or in some cases traveling to the factories themselves to set up deals.

REINVENTING PROCUREMENT

In the 1980s, Wal-Mart turned the retail world upside down. How Wal-Mart became arguably the world's largest company is more about how the mega-retailer re-invented procurement than it is about opening new stores.

Wal-Mart wasn't the first chain store to enter the China market, but rather the first to realize the enormous potential of the PRC factories. Virtually all of the department store chains had been sending buyers into the PRC for years. The real difference in the Wal-Mart approach was that the company viewed the procurement

of goods as vital to the strategy of putting low cost goods on the shelf. Wal-Mart opened its own buying office in Hong Kong in 1981, at the time Deng Hsiao-ping was opening China to global commerce. Wal-Mart caught the China wave and has been riding it ever since.

A short time later the company established Pacific Resources Export Limited (PREL) as their exclusive buying agent. Wal-Mart sold its own Asian buying offices to PREL. In a corporate turn about in 2002, PREL was rolled into Wal-Mart's own Global Sourcing division.

Wal-Mart wasn't alone in establishing "global sourcing" companies to handle overseas buying and arrange transportation. Associated Merchandising Corp. (AMC) has for over a half century bought garments and other consumer goods for Target Corporation. A subsidiary of Target, AMC is reputed to be the third largest sourcing company in the world with a client list that includes Marmaxx, Saks, Bloomingdale's, Boscov's, Lord & Taylor, and Stage Stores. Other mega-retailers like Kohls, Carrefour, M&S, and specialty retailers like Home Depot, and Lowes also have their own dedicated sourcing divisions.

Although Wal-Mart was not the first to use global sourcing as a means to gain leverage over competitors, the company took the lead in the late 1980s. The main difference between Wal-Mart and its department store competitors was that Wal-Mart began using PRC factories to roll out low cost in-house label products that it placed alongside US national brands. This strategy enabled China's cheap brands to compete with US-based household name brands. US brand name manufacturers reacted to Wal-Mart pressure by shifting production to China to match the lower priced in-house brand PRC-made goods. Almost overnight, Wal-Mart's "China" strategy was emulated by other retailers around the world. This ignited what amounted to a global revolution in manufacturing. American and European brand name manufacturers adopted a system of "designing" (often at the instigation of the retailer) the products to be put on the shelf. The assignment of the Chinese factory, assembly of materials, and the ultimate products for shipping were themselves the result of a virtual "production line" that might have begun with consumer demand in Chicago, LA or New York, collaboratively designed in Hong Kong, London, Paris, New York or St Louis, and ultimately assembled in Shenzhen for shipment from Hong Kong.

It can be argued that the process of shifting manufacturing was already well underway by the time Wal-Mart entered the China market. The enormous distribution system that Wal-Mart stores made available to Chinese products provided an impetus for a transformation that turned the PRC shop industry into the world's factory.

It was clear to retailers in the late 1990s that a tremendous improvement in information technology was needed to prevent the consumer product from disconnecting from the supply chain that

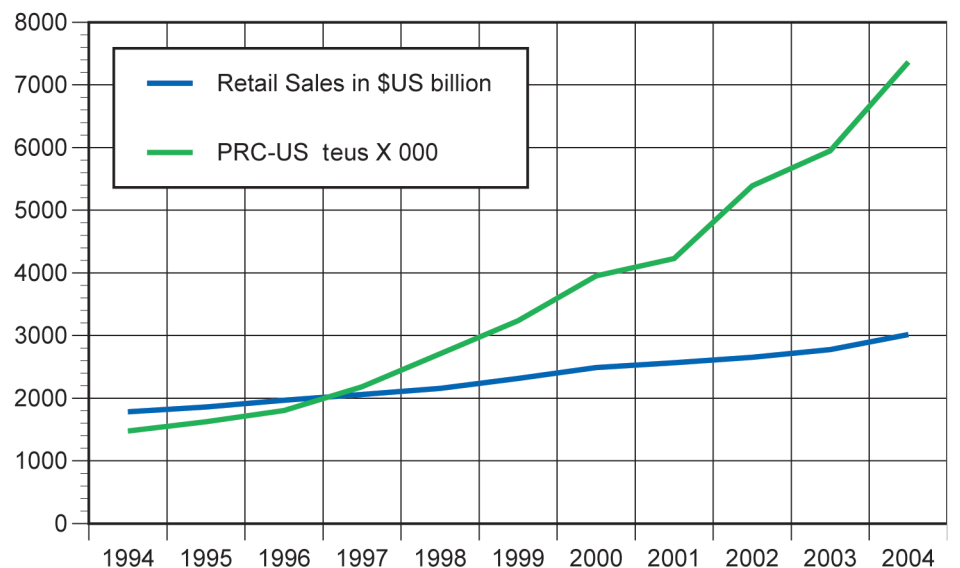
(IMPORTER - continued on page 2)

TOP AMERICAN IMPORTERS

Importer	Business	Location	TEU
Target Stores	Retailer	Minneapolis, MN	265,320.95
LG Sourcing (Lowes)	Specialty Retailer	Wilkesboro, NC	107,831.50
JC Penny	Retailer	Plano, TX	83,882.15
Costco	Retailer	Issaquah, WA	70,406.25
Ashley Furniture Industries	Retailer	Arcadia, WI	67,925.00
Kohls Department Stores	Retailer	Milwaukee, WI	63,775.75
Nike	Footwear Retailer	Beaverton, OR	53,474.10
Matel	Toy Maker/Distributor	El Segundo, CA	41,186.00
Dolgen (Dollar General)	Retailer	Goodlettsville, TN	32,161.50
Big Lots Stores	Retailer	Columbus, OH	29,328.25
Mervns	Retailer	Hayward, CA	26,717.20
Michaels	Arts and Crafts Retailer	Irving, TX	26,484.50
ABC Packing	Small Parts Packing	Arcadia, WI	26,396.00
LGE US	Electronics	Englewood Cliffs, NJ	23,375.25
Ikea	Retailer	Lebec, CA	22,405.00
1 Wholesale	Retailer	Perryville, MD	21,382.75
ADC/Samsung	Conglomerate	San Diego, CA	21,274.00
RTG	Electronics	Seffner, FL	17,799.75
COA (Coaster Company)	Furniture Importer	Santa Fe Springs, CA	17,062.00
ABB	Power Equipment	Miami, FL	16,982.50
Newton Buying (TJ Maxx)	Retailer	Framingham, MA	15,662.25
Ikea	Furniture Retailer	Mount Holly NJ	14,432.75
Fred Meyer	Supermarket Retailer	Portland, OR	13,822.75
Linens and Things /LNP Merchandising Co.	Apparel Retailer	Clifton, NJ	13,716.20
Loblaws	Food Distributor	Los Angeles, CA	12,758.50
HSBC	Int'l. Bank	New York, NY	12,572.75
Marubeni (USA)	Trading House	Los Angeles, CA	12,246.00
American Honda Motor (USA)	Auto Maker	Torrance, CA	11,679.00
CVS Pharmacy	Retailer	Woonsocket, RI	9,601.25
L Tile (Dal Tile Int. Inc.)	Tile	Dallas, TX	9,300.00
Cabelas	Clothing Retailer	Sidney, NB	9,139.50
KB Toys	Toy Reptiler	Pittsfield, MA	8,714.25
Phillips Van Heusen	Apparel Retailer	Bridgewater, NJ	8,579.75
Euromarket (Crate and Barrel)	Retailer	Northbrook, IL	7,988.90
Scottish Newcastle Importers	Beer Importers	San Rafael, CA	7,713.00
Swift Amh	Meat Distributor	Greeley, CO	7,685.00
Lifestyle	Furniture Importer	High Point, NC	7,126.00
Family Dollar Services	Retailer	Matthews, NC	6,473.75
Fastenal	Construction Retailer	Winona, MN	5,471.25
GNT	Neutraceutical Distributor	Tarrytown, NY	5,358.25
Liquor Control Board Of Ontario (Crown Corp.)	Liquor Distributor	Ontario CANADA	3,629.00
UPM Kymmene	Paper Manufacturer	Westmont, IL	2,995.00
Caterpillar	Industrial Vehicles	Peoria, IL	2,469.75
The following are estimates for selected importers:			
Wal-Mart	Retailer	Bentonville, AR	630,720.00
Home Depot	Specialty Retailer	Atlanta, GA	335,815.00
Sears/K-Mart	Retailer	Chicago, IL	202,740.00
Dole Foods	Food Distributor	Westlake Village, CA	180,000.00
Chiquita Brand	Food Distributor	Cincinnati, OH	145,600.00
Heineken USA	Beverage Distributor	White Plains, NY	100,000.00
PaylessShoeSource	Footwear Retailer	Topeka, KS	55,000.00
Pier 1 Imports	Retailer	Fort Worth, TX	50,000.00

Sources: Zepol Corp. and data drawn from public records.

US Retail Sales versus PRC-US teus



(IMPORTER - continued from page 1)
rolls from factory to store shelf.

MAKING ADJUSTMENTS FOR SUCCESS

Nearly all of the mega-retailers have had to play IT catch up. Bob DeRodes, executive vice president and chief information officer (CIO) of The Home Depot, Inc., said in an interview that four years ago he found one networked PC in the stores. Since then the company has invested over a billion dollars in networking. The Home Depot experience is more the norm than the exception. The import floodgates opened long before the IT capacity existed to handle the demand.

Another adjustment that retailers made was opening large-scale "sourcing centers" in Southern China near the factories. In 2002, Home Depot opened two facilities in Southern China to handle exports. Duane Goodwin, vice president, Global Sourcing for Home Depot said at the time, "With offices in Shanghai and Shenzhen, we will greatly enhance our opportunities to purchase more goods directly from manufacturers. The offices in China will allow us to rapidly expand our purchasing throughout China and Asia."

Although in absolute terms US imports have soared, the mega-retailers have actually been consolidating the list of Chinese manufacturers they prefer to employ. A high percentage of goods are produced from this grocery list of "strategic," or "preferred" vendors. In its ultimate form, the investment to build the "factories" is initiated by the US retailer. This provides the retailer with a great deal of control over the manufacturing process. Still, there are limitations to this strategy. On one hand, if the main customer of a Chinese manufacturer is a Wal-Mart or Home Depot, the dependence on the US retailer provides a real basis for producing goods up to the retailers' standards. Conversely, flexibility is an issue.

To address the sourcing conundrum the idea of "virtual sourcing" or "virtual manufacturing" has come into vogue. In

simple terms, a global sourcing company "outsources" themselves to the thousands of Chinese factories (or Indian, Thai, Indonesian, etc.). Through IT networks they mix and match factory capabilities against products that the retailers order. The largest practitioner of virtual manufacturing is likely Hong Kong-based Li & Fung, Ltd. The 90 year-old trading house turn exceeds \$6.5 million a year, with close to 70% related to US trade. Last year, the company took an important step towards what may become a new phase in the relationship between Chinese manufacturers and the US retailers. China issued Li & Fung the first license granting direct export rights to a wholly owned foreign company through the subsidiary Li & Fung Trading (Shanghai), Limited. This license enables the Group to export directly the goods it sources from Mainland China. Under the license LI & Fung is now allowed to import raw materials and components for its exports, and is also entitled to a portion of the Value Added Tax rebates. With no little fanfare, Mr. William Fung, Group Managing Director, explained, "With the ability to directly export products from China to our customers worldwide, Li & Fung is now able to offer an even more complete supply chain service."

There are, however, other socio-economic forces shaping a new paradigm between foreign retailer and Chinese manufacturer. Wal-Mart, Home Depot, Carrefour and other mega-retailers have also entered the China market as exactly what they are: retailers. Selling in China is rapidly becoming a very important area for the global retailer. With this new relationship comes a new interest from the Chinese manufacturers in the design and sale of the products hitting their shelves. For the moment, most of the consumer goods sold in the China market are made in China. Wal-Mart says that local (Chinese) sourcing accounts for around 90% of the product. There is a pent up demand for foreign goods, however, that ultimately could kick back like a wave hitting a sea-wall. Will the future hold an export boom from the US or Europe to China?

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