



How retailers can soften the blow of escalating cotton prices and supply chain risks

By Su-Lin Watson, North America Trade Sales, Citi

Cotton prices have dramatically increased over the past year, creating stark new challenges for retailers in an environment that is only just recovering from a global economic crisis. What's more, this trend is set to endure as analysts predict cotton sourcing costs will continue to rise into 2011. In response, retailers are turning to their banking partners for tools to mitigate supply chain risks and to best manage the cotton price surge.

2010 has been a rough year for cotton purchasers: fears of a weakening dollar, demand from emerging markets and weather-related supply disruptions have all affected prices, forcing an upward spike in the cost of cotton. At the start of the year, in response to the recession, global retail inventories were greatly reduced. While the economy has rebounded, however, and companies recover, demand from retailers has outpaced supply as inventories fail to respond, pushing prices up. In addition, cotton prices have been exacerbated by flooding in Pakistan and harsh weather in China and India depleting new cotton crops over the summer. This is not to mention growing internal demand from traditionally large global

exporters. China, for example, plans to raise its self-sufficiency levels for agricultural commodities; thus catering to its own rapidly rising consumption needs, but limiting the volume of cotton shipped overseas to critical markets such as the U.S.

Most major retailers and specialty apparel companies with a high dependency on cotton-based goods have been impacted. Retailers in the U.S., where cotton imports from China account for a third of total cotton imports, could potentially be hit hardest. According to some estimates retailers are paying as much as 30% more for clothing products than a year ago. Fast-fashion retailers, sourcing fashionable clothing from low cost markets in Asia, are particularly

challenged: their tight margins leave little room to absorb rising cotton costs. As the pressures of an expensive cotton market continue into the first half of this year, these costs will doubtless yield repercussions for Fall and holiday sales later in the year.

Paradigm shift

The rising cost of procuring cotton is one of numerous related challenges facing the retail and textile sectors. Clearly these challenges are manifold, including retailers' vulnerability to cotton mills, the potential for bankruptcy amongst suppliers, and consequently supplier concentration risk. Increased supplier insecurity during the economic downturn has meant that retailers no longer have the same leverage over their supply base. Some face the uncertainty associated with being dependent on a smaller pool of key vendors and, therefore, the challenge of maintaining a reliable production source. This shift in the supplier paradigm has created new pricing pressures for U.S. textile importers. It has also altered the dynamic between merchants and suppliers as conflicts over

price become more common. In China, for example, some retailers have been driven to pay larger suppliers in local currency as opposed to U.S. Dollars.

Seeking supply chain certainty

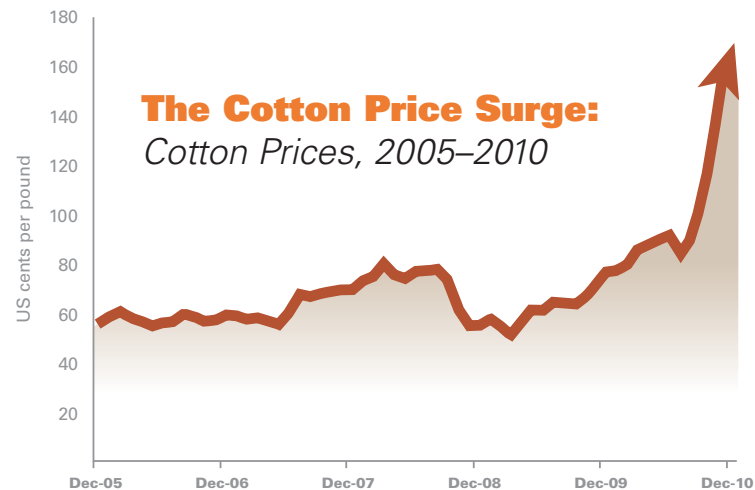
Preserving relationships with vendors and even cotton mills themselves is now more critical than ever, as evidenced by the number of major retailers sending representatives to personally inspect mills. A few retailers are even negotiating directly with the mills in an effort to commit cotton shipments, locking in prices and quantities to ensure adequate production in 2011. Nevertheless, this commitment occurs before purchase orders are issued, and so while this guarantees supply, it introduces uncertainty. Retailers gamble giving advance commitment without knowing the specifics of their purchase or assurance that their prepayment is linked to production due to them. Moreover, they face the risk of supplier default. Other retailers, reluctant to provide such guarantee, are adopting more conservative strategies. What remains clear is that while reactions have not been uniform, today's cotton purchasers are willing to accommodate critical suppliers' requests to ensure a healthy source of supply in the face of rising costs.

Sourcing patterns have inevitably changed for many U.S. companies in this sector. As the market shifts from a "buyer's market" to a "supplier's market" retailers must react quickly to mitigate these risks. Many have joined forces with global banking partners such as Citi that are armed with the expertise to help them find attractive solutions and ease supply chain related jitters. Effective responses to the cotton marketplace challenge vary depending on a company's business profile, strategy and footprint. However, no matter what a company's goals are, it pays to work with a trade service provider that can both assess and respond to these challenges.

Mitigating risks, using trade solutions efficiently

Some of the steps retailers are taking in this environment include:

Pre-payment: Instruments, such as advance payment guarantees, are being used by retailers to prepay their suppliers in order for them to purchase raw materials. Some buyers are now being asked to prepay for garments they will receive in the summer of next year with-



Source: IMF Primary Commodity Prices

out issuing POs, while other buyers are shortening PO terms and charging no interest to their suppliers.

Letters of Credit: Some large retailers have returned to issuing LCs, reversing the trend of trading on open account, with LCs and POs being issued in early January to make Fall and holiday sales. LCs generate liquidity for suppliers who can use them as packing loans to fund their working capital before goods are shipped. For companies pursuing this route, their relationship banks can help them determine the correct LC structure, whether transferable, back-to-back, or red clause, for example.

Supply Chain Finance: Supplier finance programs represent another way for retailers to provide low cost financing to vendors in need of liquidity. Banks can help retailers identify post-shipment financing programs that improve working capital costs associated with rising commodity costs and help them achieve cost efficiencies in the supply chain over time. Banks such as Citi can offer supply chain financing tools to enhance payment visibility, accelerate cash collection, reduce financing costs, and increase liquidity for suppliers.

Local currency payments: As China de-links its exports from the U.S. Dollar, buyers can now use trapped liquidity and pay large strategic Chinese suppliers in yuan. In exchange, savvy Chinese vendors are negotiating material discounts to buyers who pay in local currency, in anticipation of further currency appreciation.

Strategic sourcing: Another emerging trend among innovative retailers is the move towards alternative fabrics,

including silk, wool, and synthetics, as they seek to reduce their dependency on cotton. These retailers are revising their sourcing strategies and diversifying their critical supply base.

Bank partnership

At Citi, many major retailers are looking for advice on how to structure trade solutions and increase business efficiency. These companies realize the advantages of both tracking the market themselves and partnering with a large global bank that can provide an advisory role as the cotton market changes. Working with a bank such as Citi gives retailers the benefit of a worldwide global footprint, on-the-ground expertise in over 100 countries, industry-leading supply chain solutions and a dedicated team of commodity specialists.

Without a doubt, the surge in cotton prices is a true test for retailers around the globe. As the repercussions of this resonate through the year, the winners will be those who can successfully manage and mitigate supply chain risk. Only by teaming with their banking partners, can they find the best solutions for 2011 and beyond.

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