



Supply and demand—time to look at long-term strategies

The leather industry appears strange to many outsiders in that while the supply side in leather-related raw materials cannot really be influenced, the demand side can. The consumption of leather can be reduced simply by a change in fashion or through the substitution of synthetic alternatives.

This does not occur too much within a season, but is quite possible as the seasons change and everyone in the leather pipeline has fulfilled their requirements to a level where buyers can withdraw from the market for a period of time. Since more and more business is now done directly with packers/abattoirs or leather manufacturers, the influence of speculation and inventories has declined greatly.

Product flow, as far as a by-product of beef production is concerned, is a major issue with beef producers. Many remember only too well what has happened in the past when they became too greedy in terms of prices and suddenly ran up against a brick wall. Demand suddenly dries up and existing contracts and planned shipments are cancelled. It can then take quite a while for this to be sorted out, not only as far as prices are concerned but also in terms of re-establishing the normal and regular flow of product.

This is one of the reasons why many players have, of late, kept price movements under tight control. They have been far more interested in extending their forward-sales position at acceptable price levels rather than to risk pushing things too far ahead, only to suffer the consequences they have experienced in the past. This is one way that much of the instability of the past has been rectified.

When demand is strong

The demand for leather has remained strong so far this year. At the same time, many tanners were running on relatively low inventories. Raw material trading has therefore been relatively easy, with whatever stock sellers may have had being quickly bought up by customers. As a consequence, raw material prices have remained more than solid and in many cases even advanced incrementally. This is a perfect example of demand influencing price to the benefit of the supplier.

What has been particularly surprising this season is the lack of

the usual complaints from tanners about raw material prices. The normal reaction to a market such as this is one of lament, with every other tanner saying that he is losing money. The easiest interpretation of this, as far as sellers are concerned, is that tanners have very good margins at present and therefore have no reason to complain about rising raw material prices. It is more likely to be a case of tanners having much better orders and production levels this year and these higher levels have made the numbers look better. The global output of footwear continues to rise and shoe factories are consuming more leather. Hence a healthy and rising market.

Another reason might be that complaining would not change anything. Raw material suppliers have found themselves in such a comfortable sold-forward position that complaining is no longer a useful tool with which to open successful negotiations for raw material supplies. In a tight situation, it is probably more astute to give the supplier a good impression of the business situation to stop him from searching for alternatives where he might find a better price because someone else is short of raw material.

A changeable market

The current situation we are seeing has not existed since the just after the first outbreak of BSE some years ago. However, things can change rapidly in the leather market. People need to analyse the current situation in order to forecast how things could develop, and businesses have to make important decisions on how to handle the future.

In a market situation such as this, prices would normally increase far more than they have done. Raw material prices have only increased incrementally and only in a very few cases have prices risen more than 10% during the season. Only a few niche specialities have been able to move significantly higher. So what caused this to happen?

The leather pipeline operates differently to most other raw material markets. The main reason why things have stayed reasonably stable was the high inventories held in the first six months of 2005. These stock levels throughout the global pipeline had to be cleared before anyone was prepared to ask ➤



for higher prices as they were still affected by the difficulties they had had in placing raw material at the right price from 2003 to 2005. During this period, buyers had control of the market and attempts to raise prices were easily quashed.

Due to greater transparency and closer relationships, a deeper and more trusting understanding has developed between suppliers and buyers. Many suppliers have also come to realise that leather cannot be compared with other materials depending on raw material supply. Metals, energy and other resources have many more opportunities to increase in price, because they cannot be easily substituted on demand.

Buyers also noted this new attitude. Their increased security and confidence has, in turn, enabled them to make longer term commitments and plan higher volumes with their customers. As a result, the latter have enjoyed price stability at a time of rising demand due to a healthy global economy and increasing demand for leather products.

A time for change?

We are now at a crossroads because raw material inventories have been depleted and there is now no security buffer available to cushion any further positive developments in leather demand. The leather pipeline must therefore make a fundamental decision over whether price levels can be increased for the 2006/2007 season or whether the demand for leather products will fade quickly if prices rise any further than at present.

If the supply side hardly changed and additional stock was not available to meet further demand or support even existing levels, something has to happen on the demand side and many believe it will decline. But then again, a spread of leather into more products, simply by changing designs or fashion, could offset this. We are approaching the third season where knee-high ladies' boots are in fashion which consume three times more leather than a pair of shoes, so the effect of fashion alone becomes apparent.

In fact, there is still plenty of raw material. Lamb and goat, in particular, are still readily available at historically low prices. This is partly due to a slowdown in the demand for leather garments, making this raw material source available for shoemakers. Many shoes that are now made from lightweight calf can just as easily be made from goat—and historically always were. Classic bovine-related raw material, on the other hand, is becoming scarcer.

Lineapelle saw many tanners and leather finishers experimenting with new raw materials and many of the effects they achieved attracted a positive response. Everyone needs to understand that they are dependent on a limited supply of specific raw materials and must therefore give suppliers the freedom to solve this problem. Complaining about prices without seriously discussing how the problem can be solved benefits nobody.

Looking at the current state of things, one popular theory that the demand and firmness was related to the Chinese buying because of new VAT regulations doesn't stand up. It has become increasingly clear that there was, and still is, more demand and this will not allow the raw material market to react in a way that many might consider logical.

One thing we should have learnt from the past is that timing is more important than the simple rules of supply and demand. So, it might be time to look into the crystal ball once again and consider the possible pros and cons for the market.

Pros

1. The supply chain has used up most of the raw material inventories and supply will not meet demand if it remains

at such a level for the next season—not to mention any possible additional increase.

2. Global sales for shoes have been exceptionally good this season and a cold winter in many areas cleaned out inventories. Retailers will therefore have a positive outlook.
3. Strong growth continues in populous emerging markets with rising incomes creating demand for affordable consumer products.
4. Leather is in fashion again and both manufacturers and retailers prefer volume at reduced margins rather than walking away from potential sales due to budgeting constrictions.

Cons

1. Rising prices for raw material and components make leather products more expensive and manufacturers might decide to keep finished product prices under control by substituting or reducing the leather content.
2. Rising interest rates and a slow US economy in the second half of 2006 may hit consumer spending and sales might not meet forecasts and budgets.
3. Rising energy prices—in particular for heating oil and petrol—may affect big item sales with a significant fall in demand for cars and furniture.
4. Increased oil and commodity prices may lead to increased inflation, resulting in rising interest rates and falling stock markets.
5. Political tensions in the Middle East and general disagreements over world economics could lead to decisions that hinder global trade.
6. Manufacturers may rediscover goat, hair/sheep and lamb/sheep and the use of raw materials with plentiful resources could ease market pressures.
7. If the strong Chinese market has been simply related to the change in the VAT policy and speculation over a revaluation of the RMB, tanners may start to hold extended inventories, which could reduce raw material demand significantly.
8. Some tanners may begin to suffer margin and cash problems which could lead to a cut in soakings for individual reasons.

While these things are always difficult, the cons do appear more convincing than the pros. It is not just the mere number of arguments, but the weight and probability of them happening rather than a simple extension of the existing situation. Although there would appear to be no immediate risk, reading the future remains very much a personal choice, as it always has been.

Predicting the future has always been one of the tanner's greatest skills and, in this regard, nothing has changed. In an unique industry, where complex and sophisticated products are mass-produced from an infinitely variable natural raw material, balancing the risks and interpreting future trends varies from company to company. One thing is, however, sure: the time has come once again to spend some time looking at long-term strategies, and that also includes shoemakers. 🌐

1) This article is taken from extracts of the Market Intelligence reports featured on www.leatherbiz.com. To find out more or subscribe please visit the website.

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