In-depth assessment of the situation of the European Footwear sector and prospects for its future development

(Contract No ENTR/2010/16, Lot 2)

Task 4: Restructuring and Modernisation

Final Report

prepared for

DG Enterprise & Industry

RPA

April 2012

EXECUTIVE SUMMARY

Introduction

The European footwear industry has been subject to an elongated period of transition since the early 1990s. During these years EU manufacturers have maintained their competitiveness by offshoring the most costly production processes and introducing cost cutting measures, which have included a reduction in employment within the sector.

In response to the challenges the footwear industry is facing, the European Commission has contracted Risk & Policy Analysts Ltd (RPA) to undertake an assessment of the situation of the footwear sector in the EU and prospects for its future development. The aim of Task 4 of the study is to assess past or ongoing restructuring and modernisation processes in footwear enterprises in five regions of the EU (described in Box 1) and to anticipate future modernisation and restructuring. The assessment also aims to identify best practices in anticipating and managing the challenges of restructuring and modernisation that could be transferred to other countries and regions.

Box 1.1: The Case Study Regions
*The **Norte** region, focused around the city of Porto, is Portugal's main footwear-producing area. It contains 96% of all Portuguese footwear companies and employs 98% of people working in the industry.*
***Veneto:** the region is one of the most important footwear manufacturing centres in Europe. There are several footwear clusters within the region, each specialising in different types of footwear.*
***Southern Poland,** encompassing the Malopolska and Silesia regions: the area hosts around 49% of all footwear manufacturing companies in Poland and accounts for 70% to 80% of all employment in the industry.*
***Rheinland-Pfalz** in Germany is located on the borders of France, Luxembourg and Belgium. Shoe production in the region has a long tradition but has declined significantly over the last 20 years.*
*The **Rhône-Alpes** region of south-west France is a traditional footwear production area, focusing on the luxury segment. The sector has seen a decline in production; it now has only seven manufacturing companies with around 400 employees.*

Restructuring and Modernisation in the EU Footwear Industry

Restructuring can involve a range of activities, as companies seek to adapt to changes in market conditions. Although companies will often undertake several different activities, it can be helpful to classify the different types of restructuring. This report therefore differentiates between:

- *operational restructuring (new process technologies; organisation and IT-based process management);*
- *product restructuring (innovation in products, entering new market segments, development of takeover of brands);*

- *reorganisation of sales channels (opening new market channels, investment in downstream or upstream integration);*
- *locational restructuring (offshoring/outsourcing of production, within the EU of third countries);*
- *closure; and*
- *merger with or acquisition of other companies.*

Over the last 10 to 15 years, restructuring of the EU footwear industry has led to steady reductions in production, the number of companies in operation and employment. These job losses are partly attributable to investment in modernisation but also to the transfer of production sites to non-EU countries with lower labour costs and the closure of companies that could not compete in current market conditions. The economic crisis exacerbated the problems already being faced by the footwear sector. There are indications from some countries, though, that although turnover declined sharply in 2009, there was some recovery in 2010

The Process of Restructuring

The process of restructuring has differed between the case study regions, depending on their particular circumstances and the state of development of the footwear industry. One key feature has been that various countries and regions have been through different stages of restructuring:

- *The development of the footwear industry in* ***Norte*** *from a small-scale, domestically focused sector began in the 1980s when it became an outsourcing location for major brands, because of its low labour costs. When these companies subsequently moved their production to even cheaper locations, the industry went through a second phase of restructuring. This focused on innovation, increased development and promotion of own brands based on fashion and quality rather than subcontracting, and the use of technology to improve flexibility.*

- *The footwear industry in* ***Italy*** *has a long history of offshoring production. Within the Veneto region, different clusters have adopted different approaches to restructuring. Companies in Brenta, mainly SMEs**,** have restructured by subcontracting for major fashion label companies that entered the luxury footwear market in the mid-1990s. Montebelluna is dominant in technologies for the production of ski boots and other sports footwear. Companies in the cluster have focused on developing and promoting their own brands, offshoring production to lower labour cost locations.*

- ***Southern Poland*** *has followed a similar trajectory to Norte in moving from mass production (in state owned firms) to a more flexible approach with smaller private companies. However, unlike Norte, this process is not yet complete. These smaller companies combine some subcontracting for major European brands with development of their own brands. As the domestic market is still growing, companies are also focusing on this market.*

- *Companies in **Rheinland-Pfalz** addressed competitive pressures through retaining their technical competence whilst offshoring the high-cost aspects of production to eastern Europe and China (although there appears to be a trend of moving production back from China to lower cost locations in the EU, including Hungary). The main strength of the sector appears to be technical competence and product design, with companies focusing on design, branding and ensuring access to sales channels.*

- *In **Rhône Alpes**, the footwear industry appears to have been squeezed out of the market due to high costs and unsuccessful responses by companies. The few remaining firms have mainly focused on design and pattern production, with some finishing for the luxury end of the market and niche areas. The market focus is on exports, including exports to China.*

In terms of the types of restructuring undertaken:

- *in **operational restructuring** the current focus on niche markets and more fashionable footwear relies on smaller batches and faster response times. This requires innovation in equipment to enable greater flexibility as well as organisation of factories and more effective production management;*

- *for companies that continue to manufacture in the EU, primarily SMEs, the focus in **product restructuring** has been on markets where price is less of a consideration. Innovative design is a key factor, including rapid response to fashion trends and a greater range of styles and colours. EU manufacturers are also targeting niche markets, such as safety footwear with design and fashion elements, specialist work footwear for hospital staff and shoes for people with foot problems. Quality and design are also important factors for larger companies. Brands are vital to the sector;*

- *the key elements in **reorganising sales channels** are developing new sales channels and new markets. Some companies, both large and small, have decided to open their own stores as a way of ensuring access to sales channels, either mono-brand stores or in cooperation with other manufacturers. At the same time as some manufacturers are moving into retailing, some traders are moving into footwear production. Another important focus of reorganising sales channels is on exporting, particularly for manufacturers in countries where the home market is dominated by cheap imports. Although some companies in all the case study countries are embracing internet retailing, others are more reluctant. One reason for this is concern about competing with retail customers. Another concern is the practicality of internet retailing for footwear, given differences in sizing and the attitudes of consumers;*

- ***locational restructuring** has been a feature of all of the case study countries. One interesting trend is the initiative by some companies to move at least some of their production back from China in particular to the lower cost areas of Europe such as Bulgaria, Romania and Hungary. The main reasons for this are the rising costs in China and the awareness that relocation to other (low-cost) countries in*

Asia, such as Indonesia, means high learning costs at the beginning. At the same time, proximity to the market is increasingly required due to the need for product quality, flexibility, and speed to market and due to changing retail structures;

- ***closure** of footwear companies has been a feature of all of the case study countries, and the number of footwear companies within the EU has contracted significantly during this century; and*

- ***mergers and acquisitions** have also been important in several case study countries. These include mergers of footwear companies within a region, acquisition of bankrupt firms with important brands, including by purchasers from outside the EU, and acquisition of retail chains by footwear manufacturers.*

Drivers for Restructuring

*The key driver for restructuring in every cases-study country was **increased competition**, particularly from low-cost producers in Asia (with China being the largest threat). Although few companies mentioned trade policy specifically as a major driver, this clearly underlies the increase in competitive pressure that they are facing.*

*None of the companies and other organisations we interviewed, in any of the case study countries, considered the **availability of funding** to be a driver of restructuring. However, the availability of EU, national and regional funding has facilitated the restructuring process for some companies. This has been more successful in some case study areas than others.*

*The extent of **assistance** available from regional (and national) industry associations varied considerably amongst the case study regions. In Norte, the association has taken a leading role in driving restructuring and innovation. It has developed a Strategic Plan for the sector, which was agreed by all members. Regional and national associations have not played a similarly proactive role in the other case study areas.*

*The overall view from the companies and organisations that we interviewed was that restructuring has enabled the footwear sector to remain relatively resilient through the **economic crisis** so far. Although most companies we interviewed had lost sales initially, they were poised to take advantage of market upturns and in many countries sales had increased in 2010 and 2011. The increased focus on exports had enabled companies to take advantage of better market conditions in some countries. In addition, the luxury market was less affected by the recession than other segments, so the general trend of moving to higher price brackets had helped insulate many companies. However, the footwear industry in Europe remains heavily dependent on the EU market, however, and the state of the EU economy remains a major concern for the companies we interviewed.*

Key Success Factors

Despite the turmoil of recent years in the footwear sector, and the difficult economic outlook, the overall view of most companies and organisations that we interviewed was quite positive. A number of different factors had contributed to this success.

A key reason for the success of the Portuguese footwear industry in restructuring has been the ***close partnerships*** *that exist within the industry and with the Government. A similar situation is found in Italy, with the cluster system still operating despite the effects of restructuring. This level of cooperation does not appear to exist in the other case study regions. In Rheinland-Pfalz companies have only recently begun to cooperate rather than complete. However, there are strong relationships with the local research and training institute. In Poland, too, cooperation appears to be emerging between larger companies, but SMEs continue to be suspicious of their competitors. In Rhone-Alpes, the small number of manufacturers remaining in the area makes cooperation between them difficult, but the industry does retain close ties with the research institute in the area.*

The level of support to the sector from the ***National and Regional*** *Governments also appears to be a factor. The Portuguese Government has been very supportive of the footwear industry and has helped it to access EU funds. The sector has a good reputation with the Government because of its record in exports. By contrast, a company in Germany noted that the shoe industry has always been a small part of the German economy, so is not influential at federal Government level.*

Another key factor in successful restructuring has been ***flexibility*** *in the face of changing market conditions. The manufacturing companies that have remained in business and been successful are those that were best able to adapt to the new requirements. For SMEs, this meant changing the focus of their operations from just production to design and quality and developing skills in marketing and distribution. For larger companies, the ability to remain competitive has been linked to the flexibility provided by offshoring/outsourcing production. This has led to a very adaptable system, where production can be closely geared to market requirements. This flexibility is one reason why footwear companies appear to have been relatively resilient through the recession.*

The ability to ***differentiate their products*** *has been an important factor in allowing EU footwear manufacturers to remain in business. Focusing on factors such as fashion, comfort and safety has enabled them to avoid direct competition with low-cost competitors. The basis for differentiation varies between the case study regions, although fashion is an important aspect for most markets. Ensuring access to* ***sales channels****, through developing marketing skills, acquisition of retail chains or opening their own stores has also been a key factor in ensuring the success of companies.*

Barriers to Effective Restructuring and Transferability of Best Practices

The companies and organizations that we interviewed identified a number of barriers to effective restructuring.

One remaining barrier identified by companies focusing on exports is the ***lack of openness of non-EU markets*** *to EU footwear exports. Most exports by EU footwear companies are still to other EU countries, and exports outside the EU are limited. Given the likely growth in markets in China in particular in future, lack of access to these markets could constrain future growth.*

Another barrier, identified by many of the companies we interviewed, was increasing ***difficulty in recruiting younger people*** *to replace ageing workforces. This was identified as an issue in Norte,, Veneto, Rhône-Alpes and Rheinland-Pfalz. There are two aspects to this problem. Firstly, there is a lack of people with specific skills, such as lasters and finishers, particularly at the luxury end of the market. Secondly, it is difficult to recruit young people to production roles in the industry because of its poor reputation; young people do not consider that footwear manufacturing has a future.*

We identified best practices in this area which could readily be transferred to other regions. In particular, the 'Step up Shoes' campaign in Rheinland-Pfalz appears to have been successful both in increasing the general interest of young people in the sector and in increasing the number of applications for training positions.

Access to credit *is a concern for some footwear firms in some regions, particularly smaller companies in the countries most affected by the recession, such as Norte. As a consequence, most restructuring activities have been financed by companies' internal resources. Nevertheless, cash flow remains a critical issue for the sector, especially for smaller firms and, as with SMEs in other sectors, there is a risk that even companies with full order books could fail because of a lack of short-term credit. None of the regions had found a successful way to address this barrier.*

Several companies and organisations also raised concerns about the difficulties of ***protecting designs****. Many of the companies we spoke to had not taken action to protect designs, because they considered that the current process for protection is not really effective. Companies considered that patenting innovations is costly and takes too long.*

Other barriers identified during the case studies included:

- *the continuing decline of traditional specialist shoe shops, which could have a significant impact on companies that rely on such shops as sales channels;*
- *increases in the prices of raw materials, particularly leather. It will be difficult to pass these costs on to consumers, this could lead to pressure on profit margins; and*
- *the future of family firms. These still tend to seek new managers within the company, which requires the younger generation to be engaged and not want to sell up. While this is the case in some regions, such as Norte, in others such as Veneto younger generations appear less interested, putting the future of the firms in doubt. The reasons for these differences are not clear.*

The extent to which best practices in restructuring can be transferred between regions is variable. Some of the best practices relied on close cooperation between industry associations, companies, research and training institutes and governments. This worked effectively in Norte and Veneto; elsewhere, the level of cooperation was much lower, so that transfer of best practices would be more difficult. However, the experience of Rheinland-Pfalz, where stakeholders had recently begun to cooperate closely, shows that change is possible. In Rheinland-Pfalz, companies had come together with other stakeholders in the campaign to attract young people to the industry. This is a problem in many regions, so could potentially act as a catalyst for future progress.

Other best practices are very much individual-company driven, such as improvements to the design of products, greater fashion input and development of new sales channels. Transfer of these best practices does not rely on a framework for cooperation. However, individual companies may equally be less willing to share experiences in these areas, because they may aid the companies' competitors. Nevertheless, there does seem to be scope for footwear companies in many regions of the EU to invest in better design, greater flexibility in production and improved service.

Future Trends in Restructuring

In general, the companies and organisations that we interviewed expected that restructuring in the industry would continue in future, but at a slower pace than in recent years:

- *the footwear industry in **Norte** anticipates that that there will be further improvements in efficiency, especially in the use of materials, increasing focus on quality and service and moves into additional export markets;*

- *companies in both clusters in **Veneto** plan to continue with their current strategies in future. Work for major brands will continue to be the main strategy for companies in the Brenta region. Companies in Montebelluna plan to continue with the promotion of their brands and the development of international markets;*

- *the companies we interviewed in **Southern Poland** identified continuing competitive pressure as a key future challenge. They planned to respond to the challenge by further investment in equipment to increase efficiency, by improved product design and quality, and by effective marketing;*

- *although the majority of restructuring of the footwear sector in **Rheinland-Pfalz** has is complete, the industry is now one of continual change. Most companies envisage only minor changes in the location of production in future. However, changes to sales channels are likely to continue; and*

- *companies in **Rhône-Alpes** anticipate an emphasis on further reductions in time to market and development of products, including customised ranges and new, more eco-friendly materials and production methods. This factor has encouraged some* *companies to consider switching production back from China to locations nearer to France.*

Conclusions and Recommendations

The process of restructuring in the EU footwear industry has taken place over a number of years and has resulted in a major contraction of the industry. Competition has been the key driver of restructuring; despite technology advances, footwear manufacture remains highly labour intensive so is vulnerable to competition from low-wage economies. The major stages of restructuring appear to be largely complete; the level of output, the number of firms and employment appear to be stabilising. Most companies we interviewed see the focus of the next few years as consolidating their position in the market. Nevertheless, companies recognise that they need to continually adapt to market changes to stay in business.

The EU footwear industry faces a number of challenges in the coming years. One major issue is a growing problem of skill shortages, due to an ageing workforce and difficulties in attracting young people into the industry. Innovative approaches will be needed to overcome the perception by young people that footwear is an industry with no future. If this is not successful, it could result in a further round of production relocation and the closure of small firms that are not able to undertake this step.

In northern Europe (including Italy), the model of outsourced production, with high-added-value activities such as design and marketing within the EU, appears set to continue (although this could change if China develops its own capability in fashion and design). Small-scale production is likely to remain in Europe, focusing on niche markets such as luxury fashion, quality safety footwear and footwear designed for people with health problems. Eco-friendly footwear may provide another niche in future.

In Norte, although good progress has been made in moving to the higher quality fashion end of the market, this process is still ongoing. There is also potential for further improvements in productivity and upgrading of technology. In eastern Europe, the picture is more mixed. Progress is restructuring is more variable and some countries remain vulnerable to changes in outsourcing policies by northern European companies, as they have not yet developed the skills in marketing and design to become more independent of their customers.

*Based on the findings of the task, we recommend that the following actions are considered by **the Commission**:*

- *policy assistance should focus on assisting manufacturers in southern and eastern Europe to upgrade in terms of improved products and sales channels;*
- *trade policy should focus on ensuring that EU companies have open access to other markets;*

- *access to EU incentives should be simplified and industry should be more involved in design and decision-making on these;*

- *examine the potential to develop a more effective platform for producers and potential sub-contractors to get into contact with each other, as existing platforms do not seem to be working well; and*

- *there could be a role in encouraging exchange of experience in training and recruitment activities between countries.*

National and regional authorities *could consider:*

- *upgrading training programmes, liaising closely with industry to ensure training is relevant and promotion of the industry to young people;*

- *providing training in marketing and sales for companies; and*

- *assisting companies to access EU resources.*

For **industry associations***, the priorities should be:*

- *encouraging companies to work together;*

- *assisting with awareness of and access to incentives at national and EU level;*

- *participating in the development of training; and*

- *identifying innovative approaches to showcase the industry's products and qualities.*