

Sourcing in a volatile world

The East Africa opportunity

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Sourcing in a volatile world – the East Africa opportunity

Within the last year, macroeconomic developments such as increasing wage levels across Asia and the big shifts in foreign exchange rates, as well as global retail trends and changing consumer behaviors, have complicated the challenge of sourcing for apparel companies across the developed world. At the same time, political changes and investment shifts allow new countries to emerge as potential sources for apparel production even in parts of the world that previously played only small roles in apparel sourcing.

Africa, in particular, has received a great deal of attention thanks to the high publicity around the sourcing activities in East Africa of some of the leading global apparel brands and retailers, and to the expiration and the expected renewal of the African Growth and Opportunity Act (AGOA), which provides 39 African countries with duty-free access to the US.

Compared to parts of the world with advanced garment industries, how does East Africa¹ compare? And what is the potential of East Africa to grow into a major garment-sourcing hub? To answer these key questions, we visited factories, interviewed stakeholders, analyzed granular market data, and focused the third edition of our survey of chief purchasing officers (CPOs) on this intriguing region. This year 40 CPOs, representing the full spectrum of the global apparel industry, responded to our survey on recent sourcing trends, the expected shifts in the global sourcing map, and East Africa specifically. The survey participants, combined, represent around USD 70 billion in sourcing expenses in 2014, so their perspectives, in combination with our rigorous analysis, form a well-rounded perspective on this volatile market.

THE MACROSTATE OF PLAY IN 2015

The apparel sector is facing a significant number of recent trends that are complicating the sourcing strategy for all players. Among the macroeconomic trends that impact sourcing, financial policy implemented due to economic pressures in Europe and the US led to a rise in currency exchange rate volatility, with the US Dollar Index rising more than 15 percent over the last six months, against a basket of currencies. At the same time the euro has declined by 25 percent versus the dollar. These currency fluctuations also have roiled the commodity markets, none more so than the price of oil, which has fallen sharply. Interest rates are also at historic lows across much of the developed world.

Looking at the regions where most of the clothing worn in the developed markets is made, a different picture emerges. Political instability and an increase in labor disputes are factors that inject risk of disruption into the apparel value chain. Rising labor costs are also challenging buyers, as well as players in some of the traditional sourcing strongholds, to rethink existing operating models.

The majority of our CPO survey participants foresee increasing prices against historically low inflation rates, independent of sourcing country. Value players are most bleak in their outlook expecting a cost increase of around 2.4 percent in the next year, and European players are less optimistic than the average given recent currency trends (see Exhibit 1).

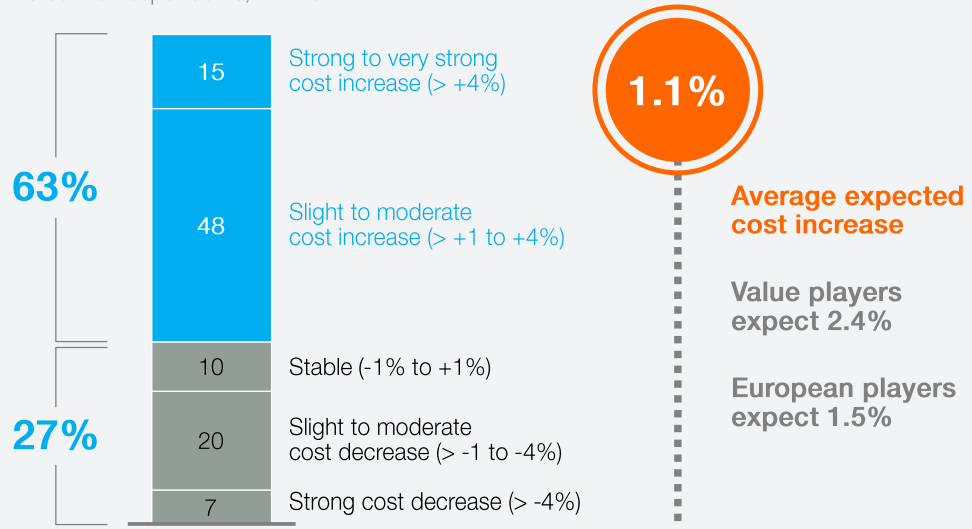
¹ We focus on four East African countries: Ethiopia, Kenya, Tanzania, and Uganda.

Exhibit 1

Almost 2/3 of respondents expect price increases

"What is your overall expectation on sourcing costs (price per piece) independent of sourcing country within the next 12 - 18 months?"

Percent of respondents, n = 40



SOURCE: McKinsey CPO survey, January/February 2015

When we asked respondents to discuss the specific drivers of the changes in cost, labor costs are still top of mind for the majority, but as to be expected, European CPOs cited the impact of foreign exchange rates as their top concern. In the third place, respondents listed raw materials costs as a key driver (see Exhibit 2).

Stagnating apparel markets in the developed world and expected future shifts of consumer markets are leading apparel players to rethink their sourcing and supply chain setups. The rise of omnichannel and fast fashion require players to adapt to higher flexibility, more collections, the ability to deal with small batch sizes, and quick responses. Additionally, compliance is more important than ever, as the industry increasingly seeks joint solutions instead of "everybody on their own" behavior.

Navigating the volatility

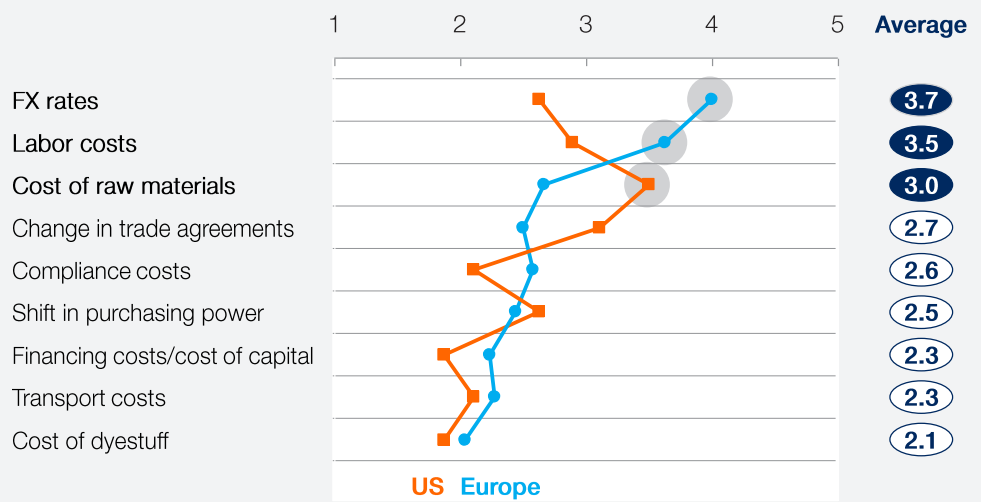
From our work on the optimization of apparel sourcing with retailers and brands internationally, we believe we have some ideas that may help apparel buyers reduce or rein in the volatility they encounter in their sourcing strategies. The four suggested actions presented below are not a complete risk elimination program, but rather elements of a broader plan that buyers may consider along with an analysis of their existing sourcing strategies. In all, we believe these steps could make a positive contribution to a more balanced sourcing strategy. They are:

Exhibit 2

Labor costs are still a key driver, but FX rates are the top-of-mind issue for European players today

"Which drivers do you expect to have the highest impact on sourcing cost development within the next 12 months?"

Assessment of respondents, 1 = no impact, 5 = very high impact, n = 40



SOURCE: McKinsey CPO survey, January/February 2015

- 1. Optimize country selection:** Our work suggests that apparel companies should consider the costs, capacity, speed, quality, and compliance of their sourcing portfolios and reflect on the mix of these factors when allocating their sourcing activities in various countries. Most companies will strive for a balance of countries to have the right mix for different product types and needs. This also creates flexibility in the sourcing options so buyers can allocate production in low-cost currencies to balance out production in high-cost locations. In addition, a balanced portfolio should reduce the impact of external events, such as political struggles and labor/compliance problems.
- 2. Improve supplier management:** We believe apparel companies should establish a professional supplier management program, which helps identify, develop, and retain strategic suppliers. As part of that effort, they should create systematic evaluations for each supplier and establish differentiated relationships (for example, strategic versus transactional suppliers), which will allow for quick analysis of the key accounts. This segmentation also helps buyers prioritize investments in the strategic suppliers within their footprint. Negotiations are an important aspect of working with suppliers, and we recommend holding structured talks with detailed cost comparisons. In addition, we believe that one focus of negotiations should be the locking-in of long-term prices for critical fabrics and materials.
- 3. Manage risks:** All sourcing activities are exposed to risks that should be addressed from within the overall sourcing strategy. For example, what can be done to limit the risk of operational disruptions or improve resource management? How can a company

reduce the environmental impact in its value chain? How can the company get credit for its positive actions, and improve collaboration with all stakeholders? These issues impact not only costs, but brand perception and consumers' assessment of the overall value of the company's products. As a result, buyers should develop clear guidelines and codified procedures to manage social and environmental compliance.

- 4. Aim for end-to-end efficiency:** Lastly, we believe apparel companies should aim for end-to-end efficiency. This includes, for example, the optimization of supplier operations with lean manufacturing programs, as well as the leveraging of technology and tools to streamline processes from design oversampling to production. They should also consider using design-to-value techniques to identify savings potentials early on in the design process.

While we focus this article on the changes in the sourcing landscape on a country level, which is aligned with point number one above, we hasten to note that it is important to integrate all four levers into any well-rounded sourcing strategy.

[The changing sourcing landscape: 2015 CPO survey results](#)

Given all of these disruptive elements, how are CPOs from western fashion companies reacting? After the phase-out of the Multifiber Agreement², apparel sourcing has largely concentrated on China as the manufacturing powerhouse of apparel. However, buyers increasingly were starting to diversify into other low-cost Asian sourcing countries, as best exemplified by the rise of Bangladesh. But even that conversation has gotten markedly more complicated in recent years.

However, nearly three-quarters of our respondents continue to say, as they did in 2011 and 2013, that they expect to decrease their allocation to Chinese firms over the next five years. One might feel this spells trouble for Chinese firms, but so far export statistics do not reflect the statements of the CPOs. Additionally, China is turning more and more of its apparel production capacity toward its own domestic market serving its growing middle class. To do this Chinese OEMs increasingly invest in developing their own brands supported by the easier access to consumers online, as the emergence of new brands on the online platform T-Mall shows. Though Chinese production of apparel has fallen since 2010, we believe the dominance of the global apparel-sourcing market, the mix change toward Chinese consumers, and the substantial size of its growing middle class, will keep China the apparel production powerhouse for the foreseeable future.

It is also important to note that many of China's garment makers are now looking to open facilities in Cambodia, Vietnam, and Myanmar, as well as in other up-and-coming sourcing countries, in an effort to tap into lower-cost labor pools and utilize trade agreements to better feed both the global garment buyers and the domestic market at an appealing price point. In addition, CPOs are always on the lookout for the next great opportunity in sourcing, and increasingly, there are new names on the list of up-and-coming buying locations. For

² Between 1974 and 1994 the Multifiber Agreement subjected garment exports to quotas limiting the volumes sourced mainly from developing countries. After the ten-year phase-out which ended in 2004 China was the main beneficiary of sourcing shifts to the Far East, growing its share of global clothing exports from 22 percent in 2004 to 39 percent in 2013 (WTO).

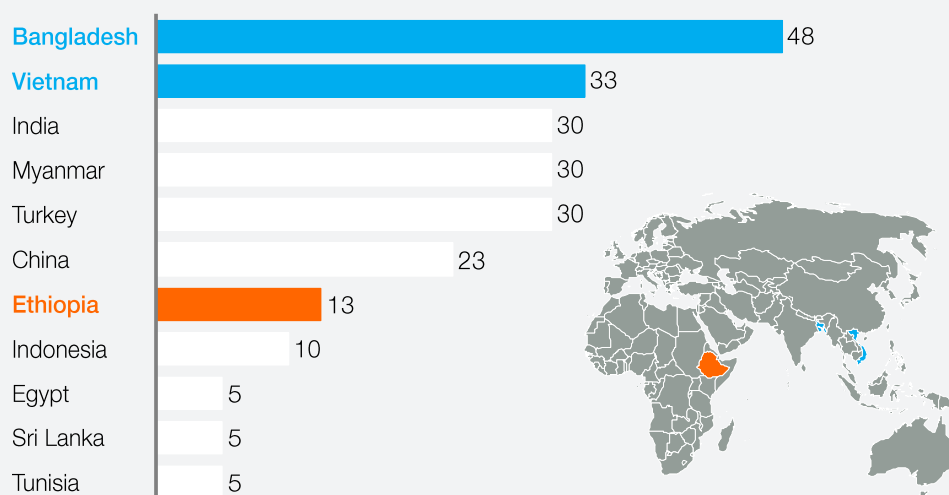
international CPOs Bangladesh remains the top future sourcing destination, as 48 percent of respondents put it in the top-3 up-and-coming sourcing markets. Sixty-two percent of our respondents said they intended to increase their sourcing value from Bangladesh over the next five years, indicating that the forecast annual growth rate of 7 to 9 percent in our 2011 report still stands³. Other top-3 sourcing countries include Vietnam and India, where respectively 59 percent and 54 percent of responding CPOs plan to increase their sourcing value in the next five years (see Exhibit 3).

Exhibit 3

Bangladesh and Vietnam seen as key – and Ethiopia on the list of top up-and-coming buying locations for the first time

"What will be the top-3 countries over the next 5 years?"

Percent of respondents who ranked the respective countries within top 3, n = 40



SOURCE: McKinsey CPO survey, January/February 2015

We must note that even these three top countries combined export only one-third of the dollar value coming from China currently. China remains the undisputed giant of garment exports, with eight times the dollar volume of exports than the number two Asian apparel sourcing country, Bangladesh. Vietnam and India are tied for third place, with roughly USD 17 billion in exports shipped each. Despite high growth over recent years neither country poses a threat to China's dominance at the moment, as all are facing their individual challenges in terms of political stability, garment industry structure, or competitiveness. Only over the longer term is China's manufacturing base expected to weaken due to macroemployment trends. A recent report by the McKinsey Global Institute⁴ forecasts China's labor pool could shrink by one-fifth over the next 50 years. But any trend that is expected to play out over 50 years is only just beginning to be visible in the distance, in 2015.

³ "Bangladesh's ready-made garments landscape: The challenge of growth," McKinsey, November 2011

⁴ Growth: Can Productivity save the Day in an Aging World?" McKinsey Global Institute, January 2015

While low-cost Asian sourcing is one sourcing theme, proximity sourcing has developed into a serious alternative for apparel companies. The importance of proximity sourcing is increasing, as 68 percent of our respondents indicated in their survey submissions. European CPOs, it should be noted, reported this theme being a priority even more fervently, with 78 percent agreeing to the statement. Especially for small and medium-sized players, the CPOs expect near shoring to increase over the next five years.

THE EAST AFRICA OPPORTUNITY

From our extensive work with leading apparel buyers, and on-the-ground experience in these markets, we know there is much interest among apparel executives in the next market for garment sourcing. There is a general agreement that the “next China,” if you will, does not exist and as we noted above, there is no single market likely to absorb that much of the business anytime soon. However, there are attractive candidates in other parts of the world that might help an apparel company improve the balance in its sourcing footprint. None of them are immediately ready to take on substantial volumes, but an analysis of population trends can point to potential contenders over the longer term.

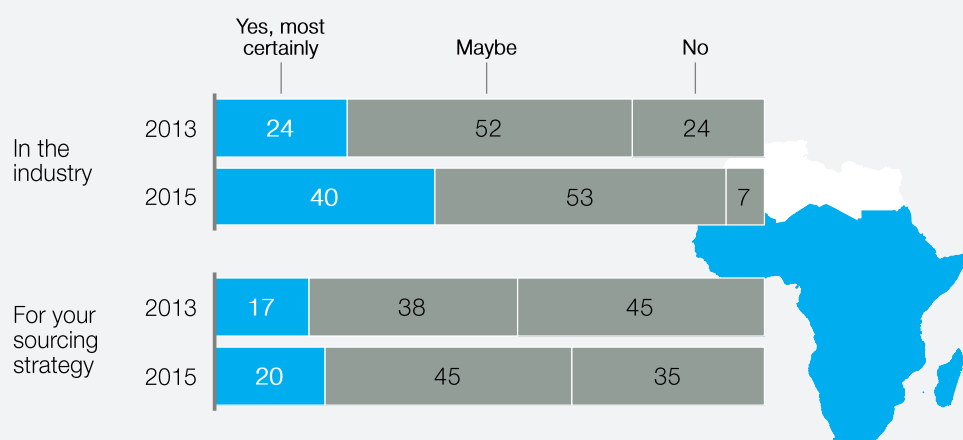
Population trends point toward sub-Saharan Africa, as it is expected to enjoy the most energetic growth in working-age population anywhere over the next 20 years. By 2035, the working population in the region is expected to pull even with China today. While this is encouraging, we believe that sub-Saharan Africa must be understood at a granular level because the degree of each country’s development and potential for garment exports differs.

Exhibit 4

Sub-Saharan Africa is seen a potential "watering hole" for the industry, but few players have concrete plans

"Will sub-Saharan Africa gain importance over the next 5 years?"

Percent of respondents, 2013: n = 29, 2015: n = 40



Respondents expect to increase their sourcing share from sub-Saharan Africa from 0.3% to 2.8% by 2020¹

¹ Excluding responding CPOs from South Africa, including their increase from 1.3 to 3.6 by 2020
 SOURCE: McKinsey CPO survey, July/August 2013; McKinsey CPO survey, January/February 2015

Our CPOs, when asked to assess the prospects for the importance of sub-Saharan Africa over the near term, noted they expect to be sourcing a greater share of their overall portfolio from the region in 2020 than they are in 2015. Granted, the dollar volume exported to western markets at the moment is small, but if those figures are borne out, the sub-Saharan share could grow exponentially in the next five years (see Exhibit 4).

The geographic split once again presents itself, with 33 percent of US buyers noting the rising importance of sub-Saharan Africa for their own sourcing strategies, while only 11 percent of European CPOs agreed with that statement. The same is true among industry segments, with more interest from value-oriented players and premium players, but less for middle-market apparel companies.

Of the 28 CPOs already involved in sourcing from sub-Saharan countries, a bit more than half deal directly with local suppliers. Not quite 15 percent source via Asian suppliers' headquarters, and 32 percent source via agents.

It is important to mention that sub-Saharan Africa's potential as a sourcing hub is largely untapped at the present moment. The global export data from the World Trade Organization shows the export value of clothing from the continent as a whole stood at USD 9.9 billion in 2013, but the majority of those exports came from the countries in North Africa, such as Morocco and Tunisia, rather than the sub-Saharan nations.

Exhibit 5

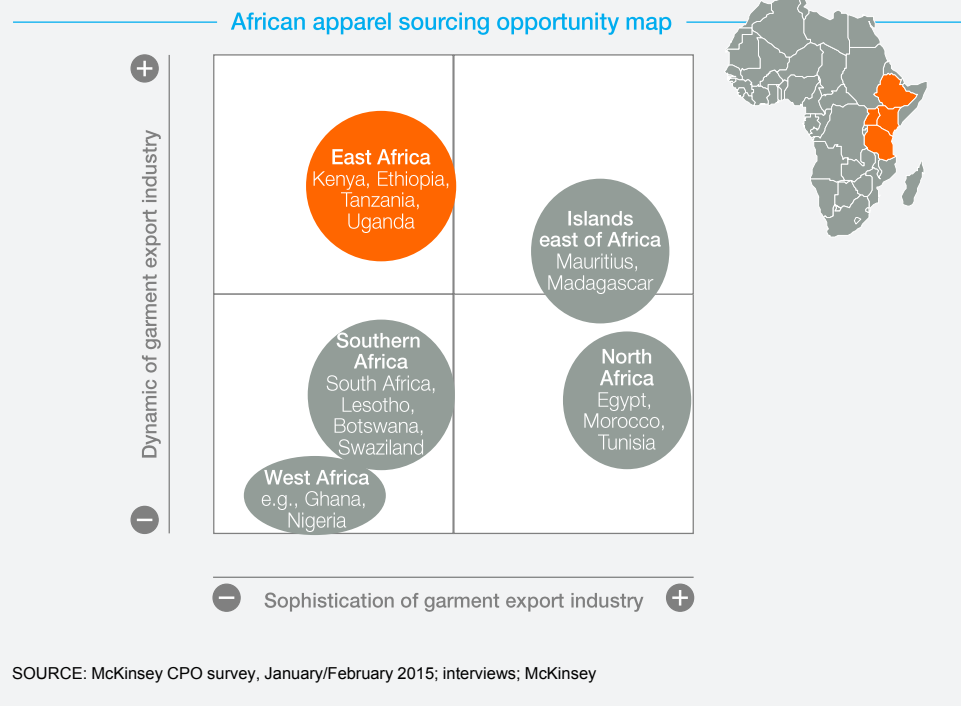
Today, top-10 garment-exporting countries in sub-Saharan Africa account for only 0.55% of global exports

	Apparel exports, 2013 USD millions	Percent of world exports	Approx. number of apparel factories	Population 2014 Million people
Mauritius	761.3	0.17	174	1.2
South Africa	502.9	0.11	450	53.1
Lesotho	417.9	0.11	43	2.1
Madagascar	381.1	0.08	71	23.6
Kenya	279.3	0.06	22	45.5
Botswana	72.4	0.02	~ 10	2.0
Swaziland	52.8	0.01	~ 18	1.3
Ethiopia	36.5	0.01	66	96.5
Tanzania	17.0	0.004	22	50.8
Malawi	10.6	0.002	< 10	16.8
	£ USD 2,531.6 m	£ 0.55	With USD 337 m East African countries Kenya, Ethiopia, Tanzania, and Uganda account for 0.07% of global exports	

SOURCE: SWTO; UNCTAD UN DESA; EPZA Kenya; Mauritius Export Association; Lesotho Textile Exporters Association; TIDI Ethiopia; press; SAPI Swaziland Investment Promotion Agency; BIDPA Botswana Institute for Development Policy Analysis; MFDP; International Business & Trade TZ Initiative

Exhibit 6

East African countries are the most dynamic for global apparel sourcing



If we examine the top-ten garment-exporting nations in sub-Saharan Africa, we see they collectively amount to only a 0.55 percent share of global apparel exports. However, many governments in the region are using legislation and incentives to leverage the textile and apparel industries as tools for the broader industrialization and economic development for some of the least-developed countries in Africa (see Exhibit 5).

In assessing the various African regions where one might invest in garment-sourcing capacity, we analyzed each region in terms of the dynamism of its current garment export industry, as well as the industry's sophistication. Given the low volumes of exports noted in Exhibit 6, it quickly becomes apparent that East Africa has the preferred mix of high dynamism and decent sophistication. Later in this report we will present deep dives on Kenya and Ethiopia, two neighboring nations with high potential but also significant differences in their garment industries (see Exhibit 6).

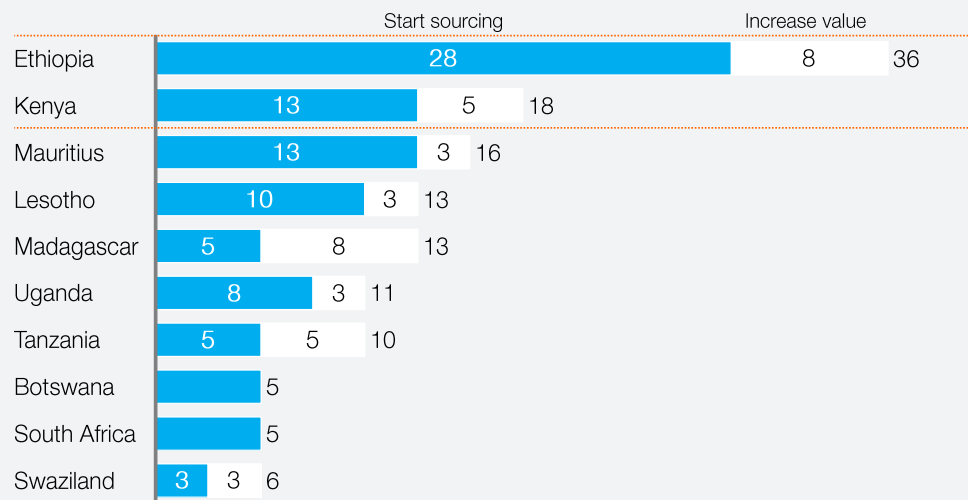
Global buyers' preferences also indicate real interest in those specific countries, Kenya and Ethiopia. The largest US brands and retailers, as well as selected European retailers, including some of the influential fast-fashion players, have begun sourcing in these locations. Over the next five years, many respondents indicated that these two markets will occupy more share in their sourcing portfolios (see Exhibit 7).

Exhibit 7

Ethiopia and Kenya on top of the list for global buyers

"How do you expect your sourcing value share to develop until 2020?"

Percent of respondents, n = 40



SOURCE: McKinsey CPO survey, January/February 2015; press

A closer look at Kenya and Ethiopia

If one examines recent legislation in these two nations, it is clear that both are taking steps to encourage and develop their domestic textile and garment industries.

As shown in Exhibit 8, the two countries share the traditional strengths and weaknesses of nascent apparel-sourcing countries. Infrastructure in both countries is a challenge, with roads, rails, and ports being challenging to navigate for many players. The number of trained garment workers at present is also a limitation for Kenya and Ethiopia. It is clear from the analysis that Ethiopia has certain advantages in terms of costs, whereas Kenya's garment industry has reached higher productivity levels. In all, either one has the potential to gain share in the global apparel-sourcing market.

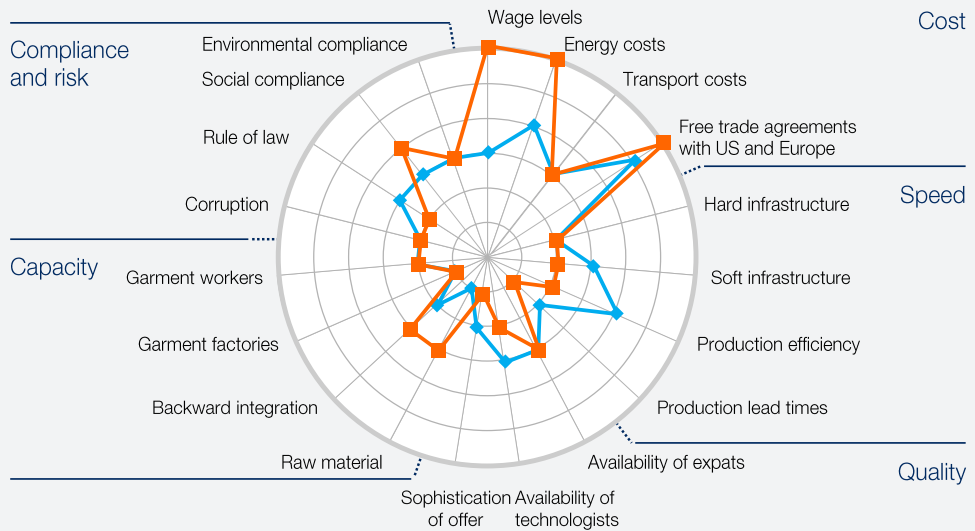
Future scenarios for Kenya and Ethiopia

As part of our analysis, we created, tested, and refined a set of scenarios describing the future evolution of the four East African markets, Ethiopia, Kenya, Tanzania, Uganda, with most apparel-sourcing potential over the medium term. As with any prognostications, caveats apply. For example, each of these scenarios presumes that the region enjoys a degree of political stability and economic progress, while avoiding conflict, natural disasters, compliance issues related to rapid growth or other negative outcomes. Here, the gradations between one scenario and another hinge upon the level of volatility in global currency markets, the investment patterns of garment manufacturers as well as the willingness of suppliers and global apparel buyers to invest in East Africa.

Exhibit 8

Both countries show typical strengths and weaknesses of nascent sourcing countries with clear low-cost focus for Ethiopia

Rating from 1 = very poor performance to 6 = very strong performance



SOURCE: EPZA Kenya; European Commission Tariff database; FAO, ILO, ITUC, TIDI Ethiopia; Transparency International; UN Comtrade; USITC; WEF; World Bank; World Justice Project; WTO; press; interviews; McKinsey

As you can see in Exhibit 9, the first scenario is the most conservative, assuming that East Africa will remain a niche market over the next decade. Much of the success or struggle in this scenario depends on the existence of free trade agreements with the US and the European Union. If there is continued volatility in currencies and equity markets, the prospects for the region will remain rather modest, as that volatility will impact the level of foreign domestic investment that can be made. The scenario assumes that buyers with existing relationships will continue their purchasing, and other vendors will launch pilot initiatives in the region. As a result, we calculate exports would grow to USD 500 million over the next five years, which roughly equals the growth rate of the region in the past few years, at around 5 percent per year, and roughly USD 700 million in annual exports over the next ten years. If this scenario wins out, by 2020, the region will still remain a small slice of the global sourcing market, but of course the industry's impact will still be important for the region.

The second scenario suggests that East Africa might become a new alternative for selected large players in the basics categories, and the level of investment will rise at a faster pace. Even that limited uptick could double the region's exports. That said, in this scenario the majority of the apparel industry is still doing business elsewhere, and the region's exports grow to USD 1 billion a year over the next five years, and USD 1.7 billion per annum over the next decade. In this scenario, we believe East Africa could move beyond cut, make, and trim (CMT) facilities and find itself on the path to verticalization, but we hasten to note that this process could take several years before significant numbers of vertically integrated, indigenous players appear in the region.

Exhibit 9

3 scenarios for the future of East Africa as a sourcing spot are possible

SCENARIO 1 "Niche market"	SCENARIO 2 "The new alternative"	SCENARIO 3 "Towards new mainstream"
DESCRIPTION		
Continued volatility of the markets . Buyers with existing presence extend volume, others as pilot	Darling for a few – East Africa will work out for selected large players for basics	Turbo charge – if industry up-grading happens, more players from different regions will open a sourcing office there until 2020
POTENTIAL (USD billions)		
<p>2020 ~ 0.5 2025 ~ 0.7</p>	<p>2020 ~ 1.0 2025 ~ 1.7</p>	<p>2020 ~ 1.2 2025 ~ 3</p>
EVALUATION		
While no substantial impact on the worldwide sourcing landscape, the industry's importance for East Africa still on the rise	More and more large international companies see the value from East Africa sourcing and strategically invest in partners/infrastructure	East Africa with growth rates like Bangladesh over many years. However, in total the importance of world exports stays moderate

SOURCE: McKinsey

Our third scenario assumes that East Africa attracts a great deal of attention, growing at a rate even comparable to Bangladesh's historic growth while becoming a major force in the apparel industry over the next decade. At that pace, the industry base across the region will quickly attract the funds to upgrade facilities and attract skilled workers. Over the next decade, should this scenario play out, East Africa's export volumes could approach countries such as Mexico or Pakistan on apparel industry league tables. This spectacular export growth could see the region's output rise to USD 1.2 billion a year over the next five, and approximately USD 3 billion per annum over the next ten years, which equals an average annual growth rate of around 20 percent. As with the second scenario, here also we believe East Africa could move beyond CMT facilities and find itself on the path to verticalization. Even in this more energetic scenario, it could take several years for vertically integrated, indigenous players to appear in the region. Also, this overall growth in the region might be only reachable if the countries cooperate to build regional value chains.

Now that we have sketched out possible scenarios and growth rates, we will transition to examining the two East African markets that already have achieved a certain amount of success in the apparel business, and have economies that provide stable climates for business and the rule of law.

The Kenya opportunity

In 2008 the Kenyan government added the garment industry to its list of focus industries that it expects will drive the country's industrialization, as part of its "Kenya Vision 2030" program, and implemented several measures to support the industry's development.

Historically, the growth of the Kenyan apparel industry was driven almost exclusively by the duty-free access it enjoys from the US, via the AGOA legislation that came into effect in 2001. The dependency on the US is high with 92 percent of garment exports in 2013 delivered to the US according to UN Comtrade. Suppliers we interviewed mentioned the free-trade benefits of AGOA frequently as one of the core advantages for Kenya, but see the European Partnership Advantage as less beneficial due to preferential agreements that the EU has with core low-cost Asian countries and the overall lower duty-free benefit. At the same time Kenyan manufacturers perceive European buyers as more demanding, in terms of quality, order sizes, and adherence to lead times. Only some of the existing suppliers in Kenya are considering expanding their customer base to Europe so far. That presents some risks, as AGOA in the past was on short renewal cycles only, and any loss of AGOA would immediately have detrimental impact on the industry – as the recent developments in Swaziland show. However, those risks are not the complete story for Kenya.

“We are aiming for a balance to reduce dependency on AGOA” *Manufacturer*

On the positive side of the ledger, Kenya’s garment industries’ capacity has grown markedly in recent years, thanks to foreign direct investments mainly in CMT factories⁵ by investors from the Middle East and Asia⁶ and supported by the Export Processing Zones developed by the Kenyan government. The strategic decision power as well as the customer relationships of these companies remains largely in the hands of the foreign headquarters, while the local entities focus solely on production. It has not been straight-line growth, by any means; there have been many up years and down years, due to the dependency on US buyers and the limited importance within the global sourcing market overall. However, the remaining factories have grown into more efficient entities over the last 15 years, with around 1,500 employees on average today versus only around 560 in 2000.

“All fabrics and all trims and accessories are imported – only packaging is local” *Manufacturer*

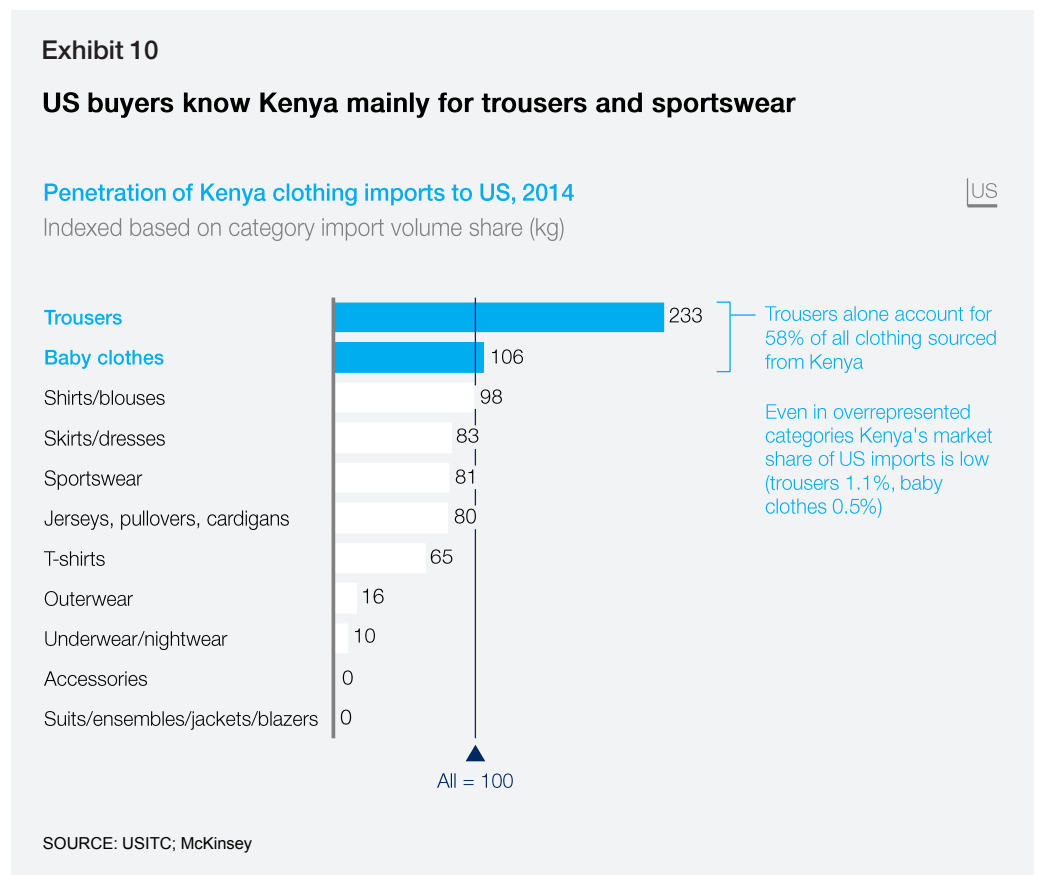
Kenya’s industry currently specializes in supplying high-volume bulk basics, and the quality level for the basic products is known to be good. However, due to the lack of a local upstream industry, fabrics have to be imported and are mainly sourced from China. Seventy percent of CPOs responding to our survey perceive this lack of upstream industry as posing a high/very high challenge. Sixty-six percent also noted the lack of raw materials in Kenya. Due to reliance on import of quality fabrics, knit and woven products from cotton and man-

⁵ CMT factories are factories working with fabrics bought or nominated by the buyers and focusing on the making of the garment.

⁶ Today, many of the top Kenyan exporters are foreign-owned. A World Bank report noted that of the 18 companies operating in the country’s Export Processing Zones in 2011, two-thirds were owned by transnational owners, whereas diaspora investors held a 28 percent share, and only one of the companies was owned by an indigenous investor (“Making foreign direct investment work for sub-Saharan Africa,” 2013).

made fibers are relatively evenly present in the Kenyan industry. To foster investments in textile mills, the Kenyan government is working to lower electricity costs and is lobbying for changes to AGOA to extend the time that the preferential trade window stays open.

Trousers alone account for 58 percent of the clothing exported from Kenya to the US. Jersey items come in second place. The typical minimum order size is 10,000 pieces, and the country's larger players are used to shipping in volumes of 25,000 to 50,000 pieces (see Exhibit 10).



If there are constraints on building additional capacity at the moment, Kenyan exporters are hindered by the limited availability of skilled employees. Manufacturers also state that the skill gap in technical roles exists even in cases where people have the educational background from local institutes, as they typically seem unfamiliar with manufacturing at mass production levels. Half of our CPOs see the lack of qualified technologists as a high/very high challenge and 58 percent of respondents in our survey see the lack of qualified managers as a high/very high challenge. As a result, the share of expatriates working in Kenyan garment factories in technical and managerial roles is high. Costs are another factor for players considering sourcing in Kenya. While AGOA offers an advantage of 16 to 32 percent, the price difference to other sourcing markets is small, as producers have relatively higher labor costs with around USD 120 to 150 monthly wages for garment workers, thanks to the level of development in the Kenyan economy. Adding to that, 60 percent of the CPOs in our survey group noted that they perceive efficiency levels to be problematic in Kenya. Energy and other infrastructure costs can also be high, and the supply of power can be spotty. Power goes out several times a week in the Export Promotion Zone, for example,

and firms there are forced to rely on generator power. But that is an expensive saving grace. According to the McKinsey report *Brighter Africa*⁷, published in February 2015, generator power in Africa works out to be four times as expensive as power from the grid. So, the high costs of power, plus the instability of current supply, can be a pain point.

“Without AGOA Kenya is not able to compete with other markets” *Manufacturer*

As in many developing countries the existing infrastructure is a hurdle for the requirements of the lead-time-focused garment industry. At the moment 42 percent of CPOs perceive inefficient hard infrastructure in Kenya as highly challenging, and 45 percent of CPOs perceive inefficient customs processes as highly challenging and another 9 percent perceive these as very highly challenging: the capacity of Mombasa port, which cannot serve mother vessels, and the prevalence of weighbridges on the roads adding waiting time to truck transport, which still accounts for 93 to 95 percent of transport. These are just two examples of the complications one can encounter in Kenya.

“Raw material imports add significant lead time to production” *Manufacturer*

The current infrastructure issue is amplified by the reliance on imported fabrics, trims, and other supplies. It can add up to 40 days in transit, for fabrics manufactured overseas to come from abroad and make their way through customs and to the factory.

However, the government and local stakeholders are working to streamline key aspects of the transport and processing of garment inputs. Initiatives include the installation of a standard gauge railway, productivity improvements of customs processes, and port efficiency improvements.

In this context, it will be key to solve the high corruption, high crime rates, and lack of security as well as to ensure social compliance, which are perceived by international CPOs as the core compliance and risk issues in Kenya.

Besides building up further capacity, we believe there are a number of process improvements and efficiency measures that could significantly benefit the apparel industry in Kenya. In Exhibit 11, our CPO respondents ranked the challenges facing Kenyan apparel companies from toughest to least challenging. With efficiency improvements and diversification of its product offerings, Kenya’s competitiveness and its global standing could be raised to a more competitive, higher-profile level. With improvement in these areas, Kenyan firms could win new buyers and expand their presence in the global apparel market.

⁷ McKinsey & Company, “Brighter Africa: The growth potential of the sub-Saharan electricity sector,” February 2015, http://www.mckinsey.com/~media/mckinsey/dotcom/client_service/EPNG/PDFs/Brighter_Africa_The_growth_potential_of_the_sub-Saharan_electricity_sector.ashx

Exhibit 11

To revive the positive trajectory and remain competitive closing the skill gap, improving efficiency and security is key

"What are the challenges for growth in apparel sourcing from Kenya?"

Average rate, 1 = no challenge to 6 = very high-impact challenge, n = 11



SOURCE: McKinsey CPO survey, January/February 2015

The Ethiopia opportunity

Though the first Ethiopian textile manufacturing mill was established back in 1939 in Dire Dawa Town, the industry remained loosely connected and growth was sluggish. While neighboring Kenya directly benefitted from AGOA, it has been less influential for Ethiopia despite the country's inclusion in the act in 2001. Things finally began accelerating after 2005 when the government formed industry and development partnerships with Turkey and Germany. The launch of a Turkish-owned spinning mill in 2007 and its subsequent expansion of its business to knitting, dyeing, and garment confectioning, as well as its delivery of products to a major German buyer, fueled additional growth. Even today this early entrant is accounting for the majority of garment exports in Ethiopia. In 2010, Ethiopia's government added the apparel industry to its Growth and Transformation Plan and launched its Textile Industry Development Institute. Since then the government has launched numerous initiatives to make the country more attractive for investors and to support the garment industry. In 2015 the second phase of the Growth and Transformation Plan started to support the industry even stronger to achieve highly ambitious plans.

Over the last two years, there has been a lot of buzz about Ethiopia, with leading European buyers starting to source from Ethiopia and large US players exploring the opportunity. At the same time a number of integrated players as well as CMT garment manufacturers from Turkey and Asia have committed to investing and starting business there, a number of enterprises from neighboring Kenya are now setting up shop in Ethiopia. From all this activity one might presume Ethiopia is an apparel powerhouse, but actually it has a modest

profile on the global stage, accounting for 0.01 percent of total apparel exports, according to the World Trade Organization. Today as much as 60 percent of those exports are sent to Germany as a result of the duty-free agreement with the European Union and the historic development of the industry. Despite AGOA, the US only accounts for less than 10 percent of Ethiopian exports. But signs of change are appearing. A number of American and European buyers are taking a closer look at Ethiopia's potential and most recently the new National AGOA Center was opened to ensure that the free trade access to the US is streamlined and more available to Ethiopian exporters.

Why, then, is Ethiopia such a hot topic for apparel buyers? To start, it has more than 3.2 million hectares of land with suitable climate for cotton cultivation, yet barely 7 percent of that land is being used today. Those low utilization rates, combined with past planning errors, low crop yields and quality problems of the local cotton, are the reasons cotton for the local textile mills currently needs to be imported. Additionally, the broader supply industry is still lacking – a fact which is only recently starting to get attention with the foundation of the Ethiopian Industrial Inputs Development Institute. Sixty-nine percent of our CPOs rated the lack of raw materials as a challenge to doing business in Ethiopia.

“The availability of workers is very high. Each day we screen workers and select the ones with the best skills” *Manufacturer*

However, the industry enjoys a relatively high degree of backward integration, with the largest garment exporters today operating from integrated factories. Though new textile mill projects, which can leverage low levels of electricity cost, are in development, the number of new investments in the less capital-intense CMT production is higher. Investors leverage the large supply of labor, as Ethiopia is the second most populous country in Africa. That said, the retention rate of workers is low and the supply of skilled workers and managers is thin. Ramping up factories, therefore, takes two or three years, and competition for labor with basic skill set could increase quickly.

“The skill level is not what we have expected” *Manufacturer*

Buyers use Ethiopia today for basic, large-volume items. An analysis of Ethiopia's exports to Europe's 15 largest economies last year bears that out. Fully 46 percent of the country's exports to the EU-15 were comprised of T-shirts, and 31 percent were trousers. Cotton knitwear alone accounts for 81 percent of exports and organic cotton is an important part of the business for the largest manufacturers. Even so, the Ethiopian products make up a modest share of overall imports into the largest EU economies (see Exhibit 12).

As existing mills focus largely on cotton with some only working with cotton blends, the increase in CMT manufacturers that rely on imported fabrics might lead to an increase in products from man-made fibers. A look at the first CMT investors at the Bole Lemi Industrial

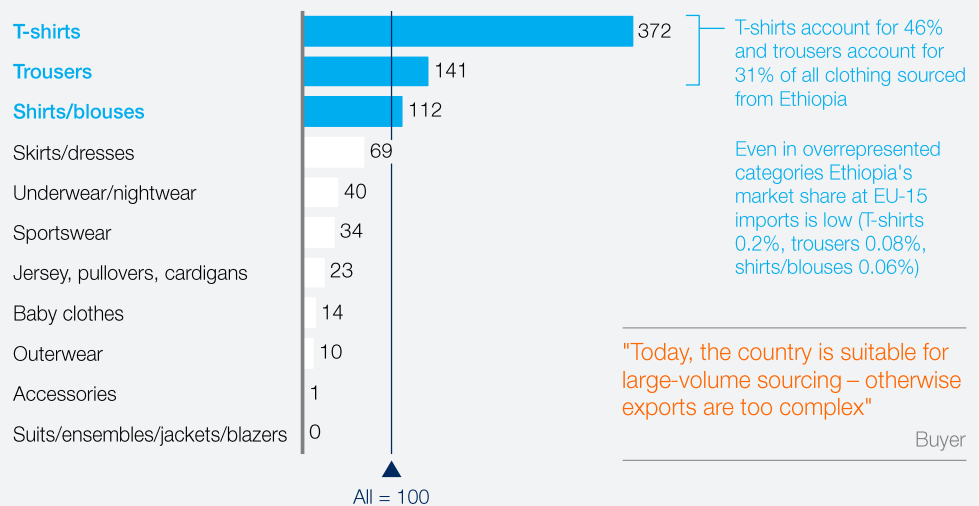
Exhibit 12

Today, Ethiopia's garment industry is mainly known for T-shirts

Penetration of Ethiopia clothing imports to EU-15, 2014

EUROPE

Indexed based on category import volume share (kg)



SOURCE: Eurostat; McKinsey

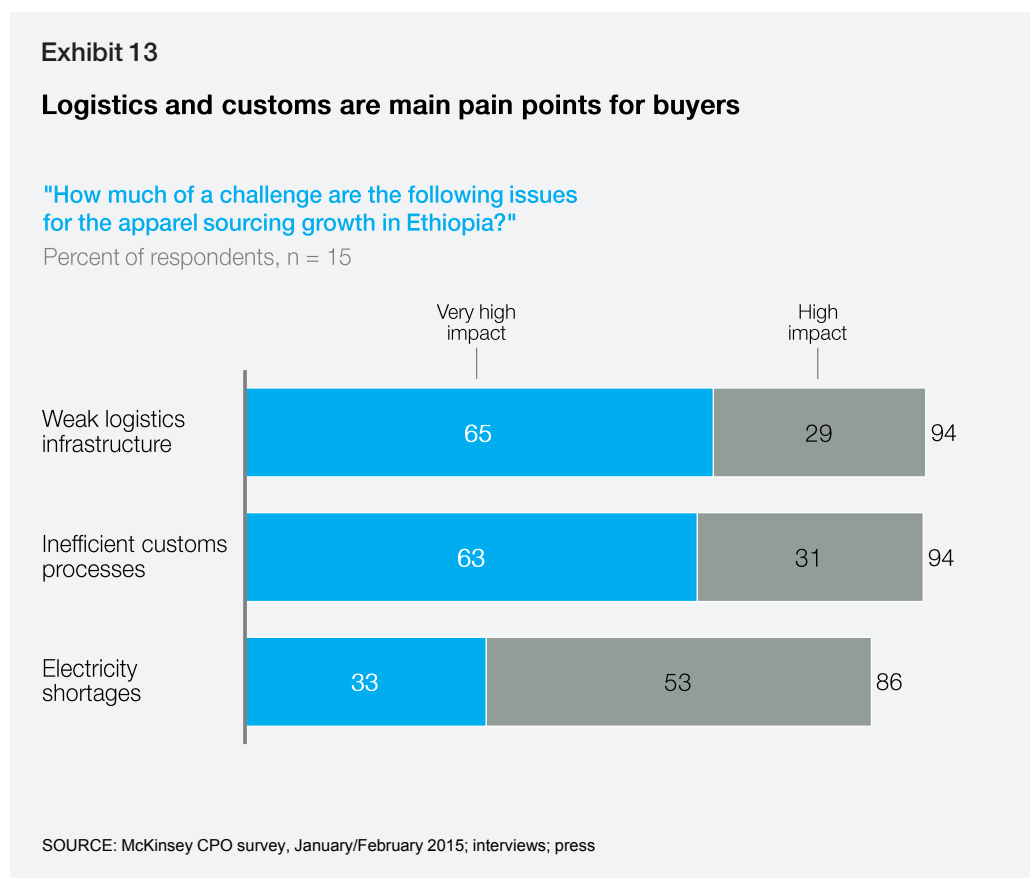
Zone shows indications of a further diversification of the garment portfolio exported from Ethiopia. From a cost perspective, Ethiopia is attractive to investors and buyers. Compared to other countries in the garment industry, Ethiopia's wages for workers are among the lowest globally at USD 60 per month, and work permit costs for foreign workers are less than 10 percent of what they would be in neighboring Kenya. Additionally, the country enjoys very competitive electricity prices, although the power grid suffers from instability. The country has a strong supply of hydroelectric plants, and while the power grid is not the most reliable, the Ethiopian government has undertaken efforts to build a separate grid for the new industrial zones under current development, and that may mitigate some of the uncertainty around power in the next few years.

"Raw material input is a lead-time challenge until the railway is finalized" *Manufacturer*

However, efficiency levels are an issue contributing to long lead times. Eighty percent of the CPOs in our survey rate production inefficiency as a challenge to the growth of apparel sourcing in Ethiopia. Today, production efficiency in Ethiopia runs between 40 and 50 percent. Besides the low skill level of workers and high churn rates, the skill gap in management and technologists is one of the drivers of this quality challenge. Fifty-seven percent of our CPO respondents characterized the lack of qualified middle management as highly or very highly challenging, and a full 65 percent of respondents noted the lack of

qualified technologists in Ethiopia. Manufacturers we interviewed, on the other hand, see the largest technical skill gap in Ethiopia as dyeing. To address the skill gap the government started several programs, including its recent cooperative program with the Indian National Institute of Fashion Technology.

From a buyer's perspective, logistics and customs processes are the two big pain points. As Ethiopia is landlocked, it relies on the port in neighboring Djibouti for all sea-going exports. It can take cargo two or three days to get from the factory to the port, and once there, it faces seven days' wait to clear customs and take care of other formalities before it can be loaded on a ship (see Exhibit 13).



“The port is THE headache for us” *Manufacturer*

At the moment, the largest ships the port in Djibouti can accommodate are 40,000 dead-weight tonnage (DWT) vessels. There are plans to extend that to 100,000 DWT vessels by 2035, but for now this route to sea will be operating at a disadvantage to those in low-cost sourcing markets across Asia, many of which have easy access to feeder systems. Overall, the port at Djibouti may be marketed as a regional hub, but freight forwarders rate the current efficiency and performance of Djibouti's port below that of Mombasa's port.

“Customs processes are unpredictable – requirements and regulations are not clear” *Manufacturer*

In customs, bureaucracy is a real challenge for manufacturers, freight forwarders, and buyers, leading to unexpected delays. One manufacturer reports, “Our fabric got stuck in customs for one month, as the data sheet was not properly prepared.” Compliance levels are rated by CPOs as a noticeable, but not particularly difficult, challenge. The most important compliance challenges on the minds of CPO respondents: social compliance issues, corruption, and lack of law enforcement. For example, organic cotton cultivation recently suffered a setback after main garment manufacturers supplying European firms became entangled in landgrabbing accusations in the Omo Valley.

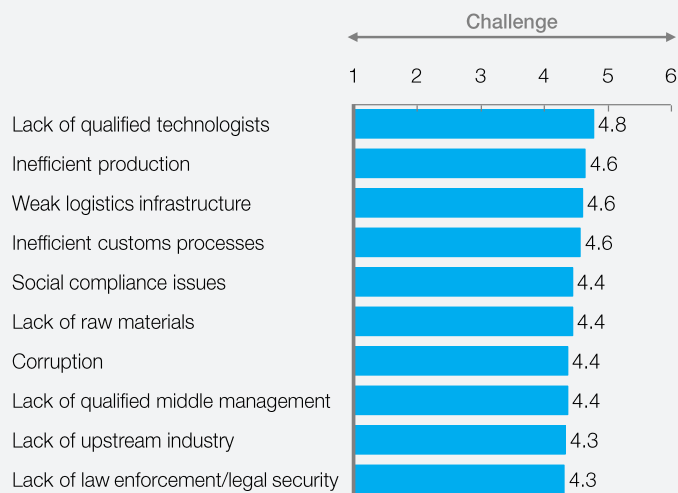
However, when asked to rank the challenges associated with doing business in Ethiopia, the CPOs still noted labor and efficiency issues as the most limiting (see Exhibit 14).

Exhibit 14

To realize its potential for growth, Ethiopia needs to overcome the skill gap, improve efficiency and infrastructure

“What are the challenges for growth in apparel sourcing from Ethiopia?”

CPO survey, average rate, 1 = no challenge to 6 = very high-impact challenge, n = 15



Growth goals and satisfaction of inflowing buyers can only be achieved while simultaneously strengthening the backbone

SOURCE: McKinsey CPO survey, January/February 2015

CREATING A SUSTAINABLE FUTURE

In order to fully tap the potential of East Africa, we believe the most important priorities for all parties are: 1) to collaborate broadly, with governments, suppliers, and buyers working together to make sustainable progress in the years ahead; and 2) to make every effort to ensure social and environment compliance. East Africa holds much promise for the apparel industry, especially as the industries in other sourcing markets around the world face rising cost, risk, or capacity issues. If all relevant stakeholders can work together to solve problems and build win-win solutions, the potential for true economic progress is great.

As part of our research effort, we wanted to step back and prioritize initiatives for all stakeholders, as joint collaboration is the surest route to success. The full list of suggestions appears in Exhibit 15, but we believe that public-sector officials and ministries in the region should focus on developing and executing their long-term development plans as well as on strengthening the regional trade structures and collaboration. The apparel industry is a good engine for improving the local economies, and any efforts to support supply industries or other backward integration should pay real dividends over the longer term. To the extent that infrastructure projects can assist the industry, officials may wish to consider supporting those efforts.

Exhibit 15

Stakeholders need to work together to tap the full potential of sub-Saharan Africa

GOVERNMENT

"Execute vision"

- Follow through with **long-term plan** for **steady growth**
- Diversify **FTAs** and support **trade marketing**
- Invest in **infrastructure**
- Foster **local entrepreneurs** and **long-term FDI**s
- Support **backward integration** and **supply industries**
- Establish market-oriented **educational institutions**

SUPPLIERS

"Think beyond"

- Improve **productivity** with new machinery and increase worker/**management training**
- Upgrade **beyond CMT** and diversify **product portfolio**
- Establish **long-term partnerships** with buyers
- Invest in **backward integration**

LARGE BUYERS

"Get real"

- Move **beyond tests or insignificant shares**
- Evaluate Africa as **strategic option** thinking beyond 2 - 3 years
- Proactively support **supplier capability building** (e.g., development, training)
- Establish optimal **local sourcing setup** to meet company objectives



Overarching recommendations

- Make every effort to ensure social and environmental compliance
- Work together to move from a short hype to a sustainable future

SOURCE: McKinsey

We believe the suppliers, themselves, should embrace performance improvements and management training. Also, we believe the time is right to move beyond CMT work and expand both product offerings and customer portfolios.

For buyers, we suggest that it might be the right time to move from conducting pilot projects to making long-term commitments to suppliers in the region. More importantly, we suggest buyers evaluate East Africa as a true strategic sourcing option, rather than a short-term experiment. Partnerships and investments in the region are needed, as the markets as they stand today are not ready to play in the global leagues.



While the challenges in East Africa must be acknowledged, we believe the potential is even greater. With the right sort of investment and knowledge sharing, the region offers rich resources, a large supply of workers looking for quality jobs, and the opportunity to diversify a concentrated sourcing strategy. If the elements of the program come together, East Africa won't overheat economically, but rather achieve a steady pace of growth with accompanying upgrades to productivity and worker skills. This is not only healthy for the governments and the local industry, but also the buyers themselves, who will build value for many years to come.

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