The Apparel Industry in Israel:

Risks and Opportunities

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This review covers two segments of the apparel industry: the manufacturing of apparel merchandise and the retail sector.

Manufacturing of Apparel Merchandise

The manufacturing sector for apparel merchandise is a traditional (low tech) industry[1] that encompasses all types of sewing methods, a wide range of input materials and all types of clothing. The manufacturing of clothing accessories, like hats for example, are also included in the industry. Over the past 20 years, globalization has resulted in a decrease in Israel's apparel manufacturing industry, as manufacturing was gradually moved to countries like China, that have significantly lower labor costs. The majority of apparel manufacturing in Israel is for the domestic market, with exports of apparel merchandise accounting for only 15% of the industry's revenue.[2]

This proportion of exports is very low relative to other manufacturing industries, indicating the particular difficulty that the industry is facing in competing with overseas production. However, it is interesting that 65% of revenues from the industry classified as "textile and leather apparel"[3], are derived from 42 factories classified as export-intensive industries.[4] Therefore, it can be inferred that most exports of apparel merchandise can be attributed to just a small number of companies.

Figure 1 illustrates that in 2013 there was a decline of 1% (annual average and seasonally adjusted) in the industrial production index for the apparel industry, relative to 2012, which indicates a moderate decrease in the volume of domestic production. A similar trend occurred in the number of employees in the apparel manufacturing industry, with the number of employees decreasing by 0.5% (seasonally adjusted average) in 2013, relative to 2012. Revenues decreased at a much higher rate in 2013, declining by 4%, relative to 2012. The decline in revenues can be partially attributed to the appreciation of the shekel relative to a basket of currencies, which hurts exporters by reducing export profitability and competitiveness.

[1] According to classifications by the Central Bureau of Statistics.
[2] Accurate to 2011.
[3] Sectors 17-19, according to classification by the Central Bureau of Statistics.
[4] An export-intensive industry must meet one of the following parameters: exports account for more than 50% of revenues or exports exceed NIS 10m and account for at least 25% of revenues.

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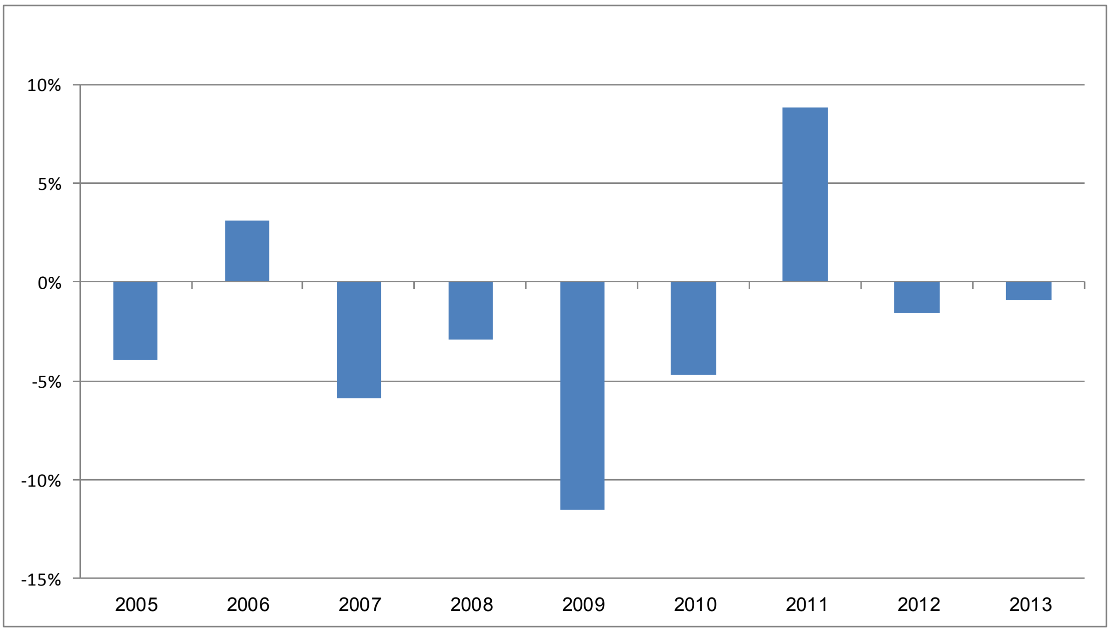
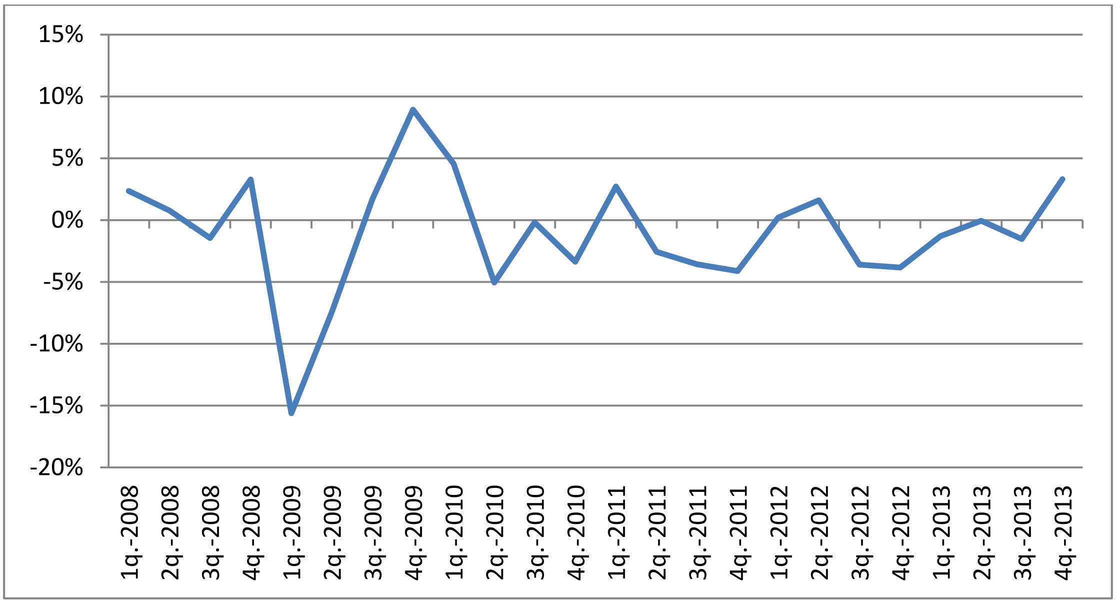
Figure 1: the industrial production index for apparel manufacturing (annual average, based on seasonally adjusted monthly data)



The volume of imports of raw materials (fabrics etc.) amounted to US$654m in 2013, which was relatively unchanged compared to 2012. However, as a result of the appreciation of the shekel during 2013, there is reason to believe that the quantity of materials imported during the period was higher than in 2012. However, using import data from the fourth quarter of 2013 as a leading indicator for the apparel manufacturing industry, we do not expect that there will be significant growth in the volume of production in the beginning of 2014.

Exports of textiles, leather and apparel merchandise amounted to US$762m in 2013, which represented a decrease of approximately 6% compared to 2012. Figure 2 illustrates that exports increased during the fourth quarter of 2013, following five consecutive quarters of declines. While the appreciation of the shekel resulted in cheaper imports of raw materials, it also contributed to the decline in exports. This is because a strong shekel decreases the ability of domestic companies to compete in the global market because their costs are measured in shekels, while export revenues are received in foreign currencies (usually Euros and Dollars). This has forced domestic exporters to raise prices for their products in order to maintain their profitability, which reduces their competitiveness.

Figure 2: **Exports of apparel merchandise, quarter-on-quarter rate of change (seasonally adjusted, US$ terms)**



Despite a continued slowdown in the apparel manufacturing industry, this trend may change as a result of increased industrial use of natural gas following significant natural gas discoveries in Israel. Manufacturing industries, including the apparel industry, have relatively high expenditures on energy (electricity usage). Research by TASC Consulting found that the integration of natural gas in a company's operations has the potential for significant cost savings for manufacturing companies in the apparel industry. These cost savings can increase the competitiveness of Israeli manufacturing companies and could translate into increased exports to international markets, and Europe in particular. An improvement in the European economy in the next few years could also lead to increased exports, while Israeli manufacturers will also benefit from a continuation in the increase in wages (labor costs) in China and other countries, which decreases the competitiveness of those countries.

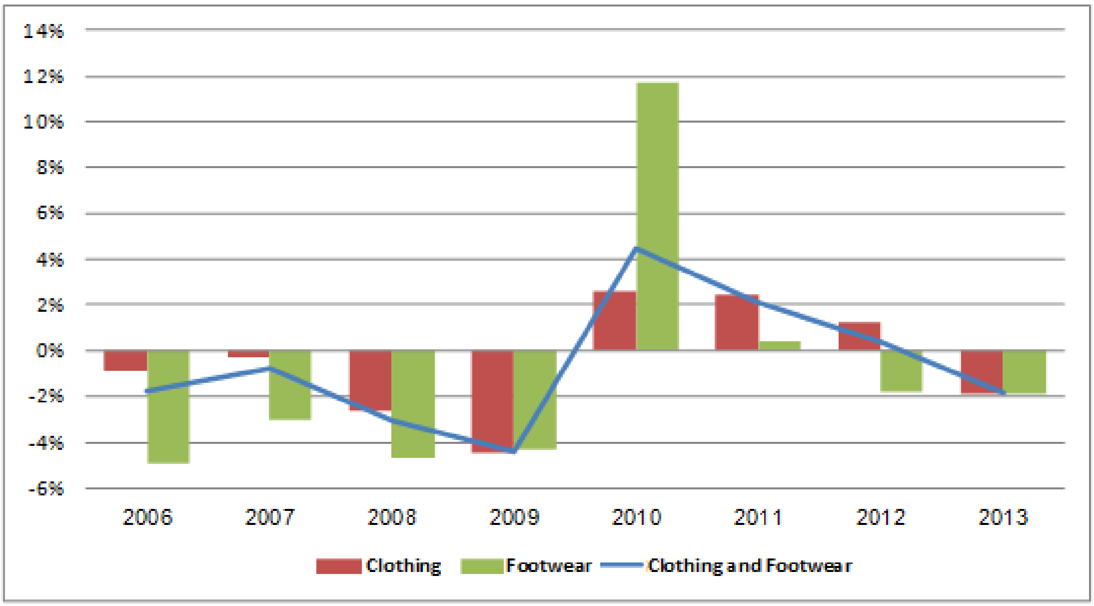
Retail Apparel Industry

The retail apparel industry is a subsector of the retail industry and includes companies engaged in the import, design and sale of apparel merchandise to consumers. The retail apparel industry is characterized by high seasonality and merchandise generally comes in seasonal collections. Summer collections are sold through the months of March-August, while winter collections are sold through the months of September-February. At the beginning of each season prices are high for new collections and as the start of the new season approaches, prices are reduced significantly as retailers implement aggressive advertising campaigns in an attempt to sell their remaining inventory.

The retail apparel industry in Israel is very diverse and comprised of both domestic and international retail chains, as well as family businesses and boutique stores. In the past few years, private stores have witnessed a decrease in their share of total industry revenues, as larger chains increased market share. This trend was particularly evident with increased market penetration of international retail chains, since most consumers have a preference for purchasing well known brands.

Household expenditure on clothing and footwear amounted to NIS 16bn (seasonally adjusted) in 2012. From data on private consumption in 2013[5], we can infer that there was an increase in expenditure of 1.6% on clothing and footwear, relative to 2012. The entry of international retail chains into Israel has resulted in increased competition and a consequential price war. Figure 3 illustrates that since 2010 there has been a decrease in the rate of price increases for clothing and footwear, as measured in the CPI, followed by a decline in prices of 2% in the past year. In addition to factors related to competition, the decline in prices in 2013 can also be attributed to the appreciation of the shekel. Currency appreciation allows retailers to import apparel merchandise at cheaper prices and sell them in the domestic market at lower prices. Imports of apparel merchandise amounted to US$1.5bn in 2013, representing an increase of 7%, relative to 2012, with products and materials from China and Europe representing a significant proportion of imports.

Figure 3: Clothing and footwear prices in the CPI, annual rate of change (December/December)



In addition to price competition, the entry of foreign retail chains had a significant impact on smaller local chains that had difficulty adjusting to the change. Large international retailers have the competitive advantage of size and an established international supply chain that provides them with more bargaining power with clothing manufactures (especially in Asia) and large commercial centers, like shopping malls. Owners of shopping malls are interested in hosting popular international retail chains, like H&M and FOREVER21, in order to attract more consumers, and therefore are willing to compromise on rent. Smaller retail chains have

[5] Based on initial estimates for fourth quarter figures.

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much less bargaining power and are usually charged higher rental rates at malls. As a result of the trend in decreasing revenue and increasing (or stable) expenses, some medium-small sized retailers, like "Jump" and "Lucci", have encountered difficulty in the past year.

The average revenue of retail chains[6] operating in the clothing and textile industry increased by 8% (seasonally adjusted, fixed prices) in 2013, relative to 2012, while revenue of footwear retailers increased by 6.5% in the same period. These growth rates are very high and exceed the natural growth rate of Israel's population, which is 1.8% annually. Based on the structure of the industry, it can be inferred that the major retail chains benefitted more from the increase in revenue than smaller retail chains.

Looking Forward

It appears that the discrepancies between large and small retailers will continue to persist. Many small retail chains will not be able to cope with the price competition that has developed in the industry. Another trend that is expected is the transition of smaller retailers from shopping malls and major commercial centers to alternative locations such as city streets, where the rent is less expensive. It is also possible that a wave of consolidation could occur with small and medium sized retail chains, as they merge together in order to benefit from economies of scale.

Another development that may have a material impact on the domestic retail industry in the medium-long term is e-commerce. Research conducted by the consulting firm TASC found that 84% of Israelis say they purchase goods through the internet, while 51% responded that they have bought apparel merchandise online. It is likely that a significant proportion of online purchases are from retailers abroad, in order to obtain lower prices or merchandise/brands that are not available in Israel. While very few Israeli apparel retailers have launched ecommerce platforms, it appears that the domestic market is evolving in that direction.

The ability to purchase apparel merchandise online poses a threat to domestic retailers and the expansion of e-commerce is expected to result in increased competition for the Israeli consumer. E-commerce is expected to widen the gap between large retailers (both international and Israeli), who can afford the costs associated with setting up an ecommerce platform and shipping merchandise, while smaller retail chains will need to find growth catalysts elsewhere. The US is an example of a developed e-commerce market, where major retail chains, like URBAN OUTFITTERS and MACY'S, sell a large proportion of their products online (more than 10%). It is possible that in the medium-term, a comparable increase in the proportion of ecommerce sales will occur in the global apparel industry, and Israel in particular. Retailers who are not able to adapt to this new trend will lose market share.

[6] A retail chain is defined as at least 3 stores.

Conclusions

Activity in the apparel manufacturing industry continued to contract in 2013. This contraction was evident in all of the following metrics: production volume, number of employees, volume of exports and revenues. However, the integration of natural gas into the operations of manufacturers, primarily through onsite electricity generation, should result in cost savings in the coming years and an increase in the competitiveness of domestic manufacturers.

The retail apparel industry experienced a continuation of intense price competition in 2013, as is evident in the decline in prices for clothing and footwear, according to the CPI. Significant gaps exist between large retail chains (both international and domestic) and small domestic retailers. The trend of increasing market share by large retailers is expected to continue as they are able to implement competitive pricing, to the detriment of smaller retailers. E-commerce is expected to widen the gap between large retailers, who can afford the costs associated with setting up an e-commerce platform and shipping merchandise.

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