Textiles and Apparel in Honduras

Source: New Cloth Market

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In many respects, Honduras is a very successful exporter of textiles and apparel, and has developed quite a competitive and complete cluster of companies in that industry. With Honduran exports accounting for 3.4 percent of the total U.S. import market by value, the country is the seventh largest provider textiles and apparel to the U.S., after China, Mexico, Vietnam, Indonesia, India, and Bangladesh, all of which have much larger populations and total output by volume. Honduran exports reached $2.6 billion in 2008, placing the count fourth by volume of apparel, with 6 percent of the Square Meter Equivalents (SME), and the main regional provider of materials within DR-CAFTA. Market share, on the other hand, has fallen in recent years, largely due to the expiration of the Textile Agreement in WTO in 2006 and increasing Chinese competition. Such a large volume of trade for such a small country makes Honduras very important player in the world apparel market, and at the same time ma exports of these products a key component of the country's economy, Textiles and apparel are by far the biggest line items of Honduran exports, and 89 percent of these products go to the U.S. market.

Clearly, the overall performance and development of production in Honduras is quite weak, so the specific strengths, efforts, and initiatives that have made these remarkable achievements possible in the case of the textile and apparel industries deserve much analysis, and should be a standard against bench-marks are set. Furthermore, because so much rides on this sector for Honduras, it is essential to identify the challenges and critical steps for the industry the future.

Textiles and apparel have a very simple (i.e., close to linear) value chain. The first steps - the acquisition and production of raw materials (natural, based on cotton, silk, and wool, or synthetic, usually petroleum-based), fiber processing, and production of threads and cloth - are capital intensive and produce increasingly significant returns to scale. Furthermore, due to a low value/volume ratio, shipping costs can be very relevant in these upstream components of the process. The market in thread and cloth is highly competitive, with many p pants and very low margins.

The parallel design process takes place outside the main chain as it typically has little-to-no material content. It is, however, critical for the next two stages, which are confection (sewing, or assembly) and finishing. Both of these are very labor intensive and subject to extremely cut-throat competition world-wide. Because of the low human capital requirements to enter this industry and the importance of low-cost labor and the feasibility of small-scale operation, literally hundreds of nations take part in the confection stage, whether they are integrated backwards (like the dominant players) or not.

The end of the process, commercialization, comprises logistics, distribution and retail. Although the bulk of that stage occurs in the main destination markets, and not where production takes place, the quality of logistics and the timeliness and preparedness with which output can link to the distribution process are very relevant characteristics that significantly differentiate the producers and become fiercely guarded competitive traits.

Despite the fact that the final product is not perishable, time to market-and not only shipping costs - is a key aspect of a country's ability to compete, since sales opportunities are tied to seasons, especially in temperate climates.

In the CAFTA+NAFTA region, the headquarters of the main brands and distributors are generally located in the U.S. These firms establish contracts throughout the region with maquiladoras, as well as with more integrated producers, to prepare orders according to their specified design, cut, and assembly. In the Honduran case, many maquiladoras are subcontractors to more integrated producers, and are not in direct contact with the distributors and retailers. Also, 90 percent of the maquilas' output ends up in the U.S., including some product that is then globally distributed from there. In this industry, proximity (cultural and physical) to the hub of the market is a key competitive strength.

Honduran textile companies import the bulk of their natural raw materials, since the country produces insufficient quantities of cotton thread and no silk and wool. It also imports dyes and the petrochemicals and resins for the synthetic raw materials (as well as these finished materials directly). That is not surprising given the fact that these processes are very capital intensive and the comparative advantage in those processes lies elsewhere. Other imports include accessories, whose production is increasingly specialized and displays massive scale economies. As a result, some of the very early stages in the value chain take place abroad, which is not a problem in itself provided that those inputs can be acquired by Honduran producers in a timely and cost competitive manner. Many distributors and providers of these imported materials have physical presence and even production facilities in Honduras, so their sourcing is not complex.

With a per capita income of roughly US$1,300, Honduras is one of the poorest and least productive countries in the hemisphere. This is reflected in the overall levels of remuneration as well as in the quality of the business climate. Problems, both economic and political, are abundant.

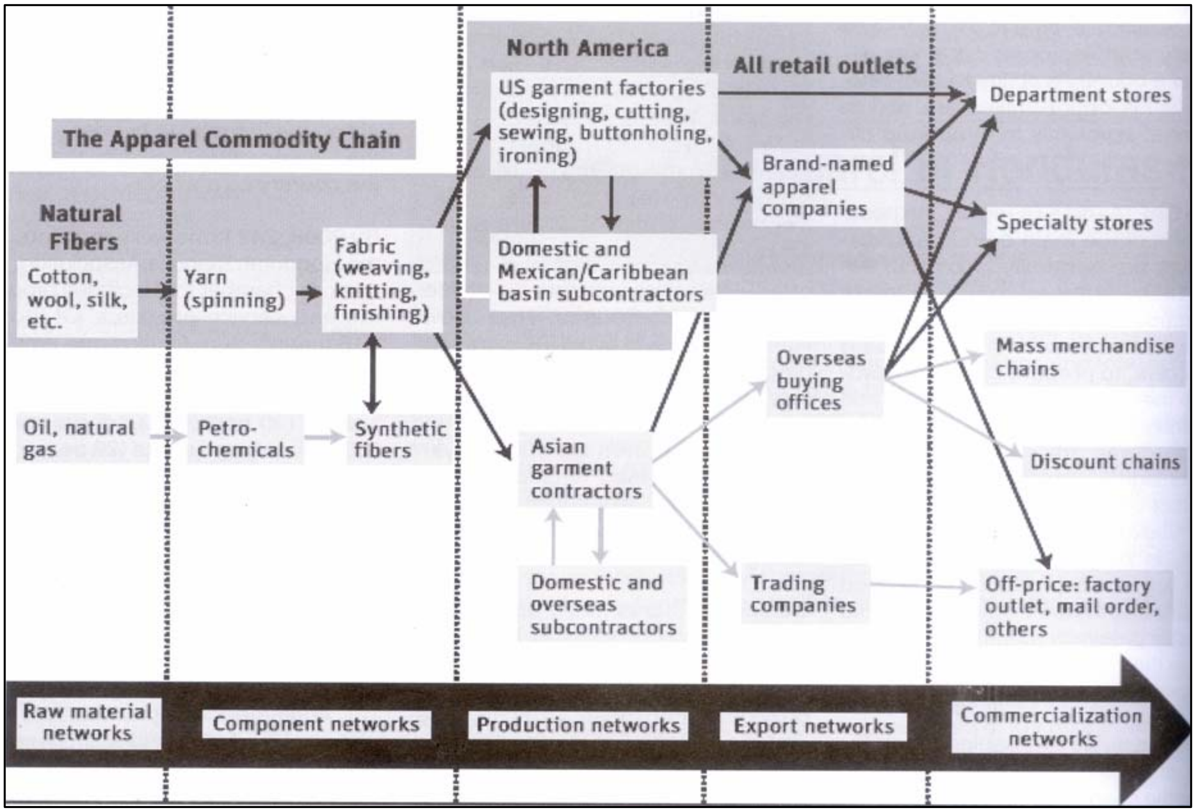
Nevertheless, most of the remainder of the process occurs in Honduras, often within single companies or interrelated conglomerates. That allows Honduran firms to avoid the extra shipping delays and costs that competitors commonly face.

The main imported input is the yarn that is transformed in cloth and knit fabric flat weave, which then undergoes confection, full package, and other finishing processes.

Confection plants make up the main concentration of firms in Honduras. Fewer in number, but larger in size, are the accessory, full package, and knit providers. For these vertically integrated companies, thread and packaging materials are the critical inputs in terms of cost and quality, as reported in a recent poll. More than half of respondents reported that they need quality over the mean of the global industry, and 45 percent report that they can make most of their purchases from local producers.

The Honduran textile and apparel sector exhibits many of the characteristics of a successful industrial cluster. The overwhelming majority of industry participants in Honduras are concentrated around the city of San Pedro Sula and the harbor at Puerto Cortes, in the departments of Cortes, Atlantida, and Santa Barbara.

The geographical concentration in San Pedro/Santa Barbara/Cortes is not necessarily a weakness. In many countries, notably in Europe and North America, the most successful industries tend to agglomerate in relatively small geographical areas to take the fullest advantage of the clustering effect. The situation in Northern coastal Honduras with textiles follows this pattern. Furthermore, geographical concentration and the proximity to Puerto Cortes have been essential for enabling the industry to bypass some of the infrastructure problems that affect the country as a whole.



By 2008,242 firms were registered in the Honduran Maquila Association, the sector's chamber that includes producers and service providers. Of those, 116 manufacture textiles and employ roughly 110,000 workers. Their principal output consists of casual shirts and t-shirts (30 percent), undergarments (30 percent) and socks (26 percent).

Most of the 116 firms involved in confection, plus all of the 18 firms that produce textiles and flat weave, are located in 17 industrial parks, generally in very close proximity to each other. They are the target (or link to the chain) for a large number of service providers, including energy companies (2), equipment companies (10); and chemical producers and distributors (6). Other firms include producers of accessories such as zippers, buttons, and other detailing (12), label makers (4), packaging companies (6), and prints and brocades (10). Other services include specialized laundry operators (6) and cutters (2).

Finally, there are logistics and transport operators (12) that provide specialized services of shipping, distribution, and storage, and dealing with the port authorities. In that regard, the volume and cost competitiveness of the port at Puerto Cortes is of essence, as only a handful of these companies, and typically not the main ones, also serve the local and Central American markets.

Honduras is on a par with, or not too far behind, considerably wealthier and more productive nations such as Peru, Colombia, the Dominican Republic, and EI Salvador. While far behind Mexico and Costa Rica, those other nations have been pricing themselves out of the competition in the apparel sector in the last few years due to the emergence of other industries. Furthermore, weaknesses in the areas of higher education, innovation, and technological readiness, are less relevant in the apparel sector. Honduras' main concern is not competition with other Latin American countries, but with China and other Asian producers, which combine low cost with a better business climate.

One area of concern is the availability of basic human capital. Success in meeting the needs of global buyers inevitably requires a greater use of capital equipment and an increase in skills, not only in operating the capital equipment but also in communicating with other links in the value chain that produce the finished product. This is particularly important in textiles and apparel, where global buyers are looking to their suppliers to provide a complete package, forcing the Honduran firms to manage all materials costs and costs associated with inventory.

Not all of this is bad. Honduras ranks 20th in the world in low bureaucratic costs, and 36th in seaport facilities. The tax treatment for foreign investors, the associated regulations, and the number of days spent creating a new business are all comparatively favorable (41 to 54). Taxes on labor are relatively low, and it is easy to hire and fire workers (although firing costs are high, with Honduras ranking 94 among 134 nations). The textiles and apparel industry, which is characterized by intense competition among many providers of inputs, is situated close to the ports, has little need for land transportation, and maintains separate electricity services. The key strengths that have fostered the competitiveness of the Honduran industry have been the ability to perform "complete package" and multi-style production, the capacity to deliver quickly, and the certification of labor standards that PR-min retailers demand.

The development of full package-that is, vertical integration that enables foreign purchaser to acquire integrated processes ranging from the thread and cloth through the cutting and sewing to the labeling and shipping, from a single local entity - has enabled Honduran firms to remain competitive despite having higher labor costs than China, Bangladesh, and other Asian competitors. It allows higher margins and simplifies the sourcing operations of the foreign buyer. According to Honduran Maquiladora Association (AHM), 45 percent of the participants in the industry are vertically integrated and 30 percent offer complete package.

Multi-style production, in which a number of small to medium volumes of similar but slightly differentiated lots are batched together, is another specialty of the more nimble producers in Central America, and especially in Honduras. The bulkier Asian competitors have difficulty emulating this ability. Because this process is often the mechanism used to replenish inventories in response to demand for each of the different styles within a single season, multi-style production is one reason why time-to-market is critical.

Thus, proximity to the main markets in the Eastern U.S. is an important advantage for Honduras in the apparel market. It takes three days for a ship leaving Puerto Cortes to arrive at Houston, 19 days reach Southampton, and 21 days to Rotterdam. Travel time from Asia to these locations is more than 10 weeks. The shipping time advantages largely explain how Central American producers, and Honduras in particular, successfully meet competition from Asian providers with their lower wage costs and similar industrial productivity.

Features like capabilities for quick delivery or full package are valuable, of course, if and only if costs are also competitive, which is a challenge in Honduras. Costs are far more concentrated in textile and apparel than in other industries, with the key drivers being labor, energy and logistics.

Labor and Energy Costs

In a country with a weak record in creating human capital and in forming an established and mature industry, slow growth in labor productivity is to be expected. As apparel is a very labor-intensive process - perhaps the most in all of manufacturing - one cannot exaggerate the importance of this subject. Not only it is difficult for Honduras to compete in wages with many Asian countries, but the pressure is mounting due to currency overvaluation and rigidities in the labor market. For several years, inflation of the Honduran lempira has exceeded by several percentage points that of the U.S. dollar, yet the nominal exchange rate has been kept roughly constant over a long period. This means that, measured in dollars; the cost of living for Honduran apparel workers is rising, which is eventually reflected in the costs of production. The problem is worsened by the rigidities caused by the fact that very few workers earn more than the minimum wage, and that the policy regarding the minimum wage has been erratic during the last couple of years.

Textile Wages, Turnaround Time to the Eastern U.S., and Shipping Costs of a 40 ft. Container (US$)

	Wages	**Turnaround time**	**Shipping costs**
Mexico	2.20	3 weeks	1,750
Dominican Republic	1.70	4 weeks	1,600
Haiti	1.40	5 weeks	1,550
Honduras	1.70	4 weeks	1,400
Guatemala	1.80	4 weeks	1,950
Nicaragua	1.50	4 weeks	2,050
EI Salvador	1.85	4 weeks	2,100
Costa Rica	2.10	4 weeks	1,450
China	1.12	10 weeks	4,300
United States	5.00	2 weeks	-

Honduras: Minimum Wage Structure 2007

Wage and benefits	**US$**
Minimum wage/direct payment to worker (2288 hrs *0.7379)	1,688.42
Benefits to worker (vacations, paid holidays, bonuses)	763.52
Taxes (health, social security, national training institute, etc.)	469.30
Total Direct Labor Cost	2,921.24

Producers are in a difficult labor-cost position due to the real appreciation of the lempira relative to the USD and the significantly lower wages of Asian competitors than the US$1.28/hr that Hondurans are paid, with little difference in productivity. The apparel maquiladoras were exempted by presidential decree, late last year, which ordered a 60% hike in the minimum wage. The exemption implies that the industry is now facing upward pressure on wages from unions & increased turnover, while national competitiveness has eroded. The other big cost driver is electricity.

Cost increases in the last few years have been significant, especially if measured in U.S. dollars, as the government has chosen not to adjust the lempira/dollar exchange rate in response to the accumulated and large differences in inflation rates. Part of the problem, of course, is dependence on foreign oil for electricity generation.

Honduras relies on fossil fuels for 61 percent of its energy, as opposed to, for instance, Costa Rica, which generates 97 percent of its electricity from renewable resources whose prices have not risen. As shown in the following chart, Honduras has higher electricity rates than several of its regional competitors, as well as China and the Dominican Republic. These costs create serious pressures on firms, which must rely on a very favorable business climate and a very fluid relationship among players in the value chain to remain viable. These costs vary throughout the country. Starting in March 2006, through Decree 027STSS-06, the Secretary of Commerce can designate specific underdeveloped regions as Investment and Employment Zones (ZIE) where it can reduce the energy costs and minimum wage levels and allocate additional public resources to training the local labor force. As a result, the minimum wage in the departments of Santa Barbara, Choluteca, EI Paraíso, Olancho, and Valle has been cut by $0.12 per hour. Perhaps not surprisingly, Santa Barbara, located near the apparel hub of San Pedro Sula and the shipping port of Cortes, has become a full participant in the industry and home to 34 percent of the number of apparel firms. It was expected that investment would also result from the ZIE incentives in other beneficiary departments, although that has not happened yet due to serious logistical difficulties.

Of course, how much a company can afford to pay in wages and energy costs in a particular location depends on the productivity that it can achieve there. In a very inhospitable business climate, firms can grow and make profits only when their costs are very low, while in a location with highly productive resources, high unit cost will simply reflect value and demand.

Logistics

The shipping process for the Honduras textile industry is quite streamlined. According to operators moving consolidated cargo between ship and factory door, in either direction, takes 2-4 days, with relatively low policy-related (i.e., tariffs, corruption, or irregularity) expenses. However processing paper work for shipping and unloading can take between 14 and 15 days. But large producers, with carefully planned shipments and orders, can do a good part of this paper work beforehand, even in a couple of hours, especially if they have internal departments charged with logistics. These large producers depend on no other firms to conduct their logistics, and have at their disposal very high specialized customs agents who are familiar with the sector, understand the requirements of the business, and have the capability to fill some of the gaps left by government, thus facilitating the compliance of import and export prerequisites.

On the other hand, smaller producers or cargo consolidators that must wait for a container to be filled by different clients before it is shipped typically cannot carry out the bureaucratic procedures beforehand. The first producer to bring in his cargo must wait for other producers to arrive, and only then will the two weeks of paperwork get underway. Even though the very competitive logistics companies can provide them with a tailor-made process, their costs are higher, and the wait is particularly onerous.

Most operators operate in a free trade zone, or maquila, in which customs procedures are expedited, imported inputs are never "internalized" into the local economy, and most duties are exempted. Puerto Cortes is a high-volume port, arguably the most efficient in Central America. Its location is also ideal, as average transit between San Pedro and Miami is about three days; an order from the U.S. can be met within one week. There is no way Asian competitors can even begin to match this, since not only is their production time longer, but also their shipping time is over 10 weeks.

Puerto Cortes is security certified by the Department of Homeland Security of the United States, and this facilitates the docking, transfer, receipt, dispatch, storage, and reloading of merchandise. It was the third "mega port" in the world to achieve this status.

Honduras' overall export process in general requires less than 20 days, even including companies outside the textile sector. These include 14 days in pre-shipping paperwork (more for perishables, and less for textiles), ranging from a bill of lading, origin certification, order forms and receipts, customs declaration, exchange rate authorization, packing list, and preshipping inspection. The system is automatically 'synchronized with the U.S. port authorities, so the turnaround time is indeed kept under one week, and at relatively low cost.

The same source estimates that imports take 23 days to be processed, again with most time devoted to preshipping document preparation. The same list of documents is required as in the case of exports, plus a tax certificate, a release authorization, and request for unloading at port. Once ship arrives, the whole process may take less than 3 days, especially fir textile companies in Free Trade Zones.

The Honduran Tax Authority is undef taking a project of technological grade and modernization in all of country's customs offices, and implementing a new system of customs information, the Automated Customs Collection System of Honduras (SARAH for its Spanish initials). It may result in a significant improvement, judging from the success of similar initiatives in neighboring countries such as Costa Rica. Nevertheless, it is also a source of tension with customs agents, who feel that SARAH is coopting some of their roles. The agents also fear the punitive fees that the system will levy for mistakes in its use.

The steps ahead

The competitive advantage of textile and apparel companies in Honduras is cost competition, not product differentiation. The industry is what the country needs right now, but it still has to demonstrate its ability to further improve quality and value added and achieve higher levels of productivity and wages.

The industry in Honduras so far has developed the mechanisms to adapt successfully to the changing world market and the challenges of the local business environment. Products flow very easily along the different links of the value chain, activities are highly integrated (and, when they are not, the immediate availability of local providers allows for smooth sourcing), and the port infrastructure and logistics operations are first rate. Competitive firms can interact efficiently with each other and with the world, both as providers and as costumers. These firms find in Honduras what they need, offered by a sufficient number of competing suppliers. Honduras' strength in this business is the manner by which companies link efficiently to the global value chain; its weakness is the quality and availability of the inputs they need. There are a number of needs that require priority action:

- An electricity supply that is untrustworthy, irregular, or expensive will place a cap on the growth of the textile industry, in addition to other export-oriented manufacturing sectors. The backlog of investments in electricity generation, and the dependence on fossil fuels are too large, and will become even more onerous as the price of oil recovers in the coming years.
- The supply of qualified workers is too limited in Honduras. The installed capacity of INFOP, the national training institute, is insufficient, and although the textile industry

currently employs mainly low-skilled workers, there are activities where quality and complexity demand a more highly qualified workforce. In Costa Rica, for example, where small apparel plants have been supplanted by other, more complex, forms of manufactures, textile firms still operate in more specialized areas, such as men's suits, lingerie, baby clothes, clothes for therapeutic or medical needs, or higher fashion, regardless of the fact that wages in that country are twice those of Honduras. If Honduras is to enter those more specialized apparel areas, it must increase its pool of more highly qualified labor.

- The barriers a small, local operator in the textile industry must overcome to-'enter the market-especially the slow and costly paperwork for shipping consolidated cargo - are too great. In a majority of the processes in this industry scale economies are large and the viability of small-scale companies is still limited. Yet, there are exceptions in some auxiliary services as well as in the confection of higher quality, targeted apparel and fashions.
- The heavy concentration in the U.S. market also needs to be addressed. OJ course, in a way the advantages that Honduras enjoys in the U.S. are quite unique: proximity, high integration into the U.S. marketing end of the value chain, a culture of co-production, and important preferential market access. There is no way that the European market, for example, could offer some of those features. On the other hand, the EU is now negotiating a bilateral Free Trade Agreement with the Central American Common Market, and this presents a unique opportunity.
- Shipping distances are great, but they are even greater for other key competitors. Market access to the EU is quite limited, and outside of Central America no key player in the textile and apparel industry has sufficient preferential access to the European market. The agreements are very important. Rules of origin are of particular importance, since usage of European fibers (analog to the yarn-forward rule in CAFTA) would be prohibitive, and better access would have to be secured.
- It is difficult for other industries to emerge, grow, and succeed as competitive exporters in Honduras because so many of the solutions to domestic competitiveness problems relating to the textile and apparel industry, and to the separation between people and markets, are so specific to that particular industry.

How can Honduras replicate the good parts of this story in other manufacturing sectors, or in agriculture and services? Finding answers to this question is important if development is to reach other regions of the country and segments of the population, and also if diversification is to realize its potential for providing more stable and sustainable roots for economic growth.

It is very telling that there is such a contrast between strengths in the business climate reported to us directly from the textile and apparel sector (bureaucracy, shipping delays, international trade logistics, competition among suppliers, etc.) and the weaknesses reported to WEF in the very same areas by a sample of businesspeople from different industries. The special status that Puerto Cortes enjoys regarding the Homeland Security restrictions in the U.S. is, of course, very valuable in the case of the textile industry, but it would also provide an enormous advantage in other areas like foodstuffs, where non tariff barriers are more prevalent.

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