Cotton crisis: A grave challenge for commercial linen users

In this white paper

Report commissioned by the Textile Services Association, November/December 2010. Written and researched by Phil Cain, an economics researcher and journalist who regularly contributes to The Economist, Scotsman, Telegraph, Wall Street Journal, Guardian, FT, Herald and World Politics Review.

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The massive rise in cotton prices is a huge problem for sectors such as hospitality, which rely on a supply of cotton-rich essentials like bed sheets, towels and tablecloths. The issues are arguably greater than those of the fashion industry, which can use many other textiles.

"Hoteliers, restaurants, hospitals and other sectors dependent on cotton-rich textiles should be ready to work creatively with their crisis-hit suppliers to help ensure their needs are served over the coming months," says Murray Simpson, Chief Executive Officer of the Textile Services Association (TSA). "Not only are thousands of skilled jobs at stake, but a failure to recognise the challenges may lead to serious supply and quality issues. It is a matter of exercising enlightened self-interest."

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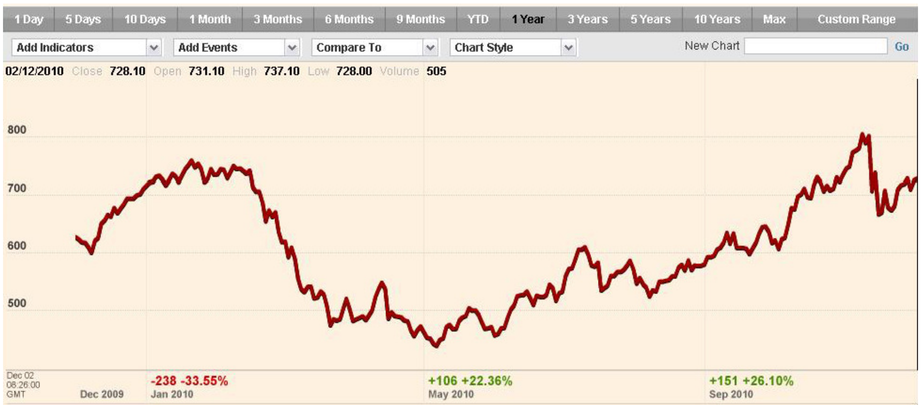
Among the underlying causes of the cotton crisis are: this summer's flooding in Pakistan, among the biggest cotton growing nations; a drought in China, the largest cotton producer and the world's most veracious cotton consumer; and, less intuitively, economists are suggesting that liquidity measures taken by the US are filtering through to boost the price of cotton as well as those of other commodities (see the chart below for cotton prices and corn and sugar overleaf).

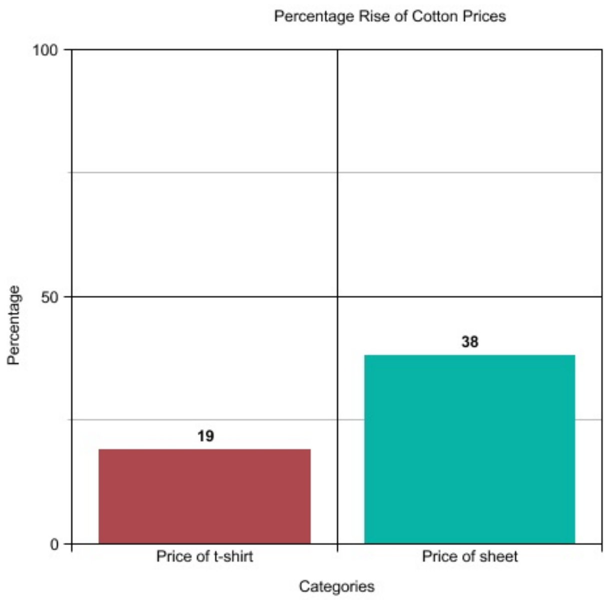


Being part of this broader trend of booming commodity prices has secondary effects. The historic highs in cotton prices offer little or no extra incentive to switch over to the crop, because sugar, corn and other food items currently also appear to offer farmers similarly attractive profit potential. There is little reason therefore, for those acting in the market to think the current elevated prices are sufficient to provide the remedy to the cotton shortage in the near term.

> ***The 76 per cent rise in the price of cotton over the year to the end of November translated into a 38 per cent rise in the cost of a sheet twice the rise one might expect in the cost of even the high street t-shirt***

The effect each of the unforeseen factors has had, and how they are likely to evolve is hard to determine. This uncertainty is itself having the effect of destabilising the cotton supply chain, a phenomenon which finds its expression in unprecedented levels of price volatility. With a fast buck to be made, contracts are more frequently broken as suppliers of cotton at its various stages of processing scramble to maximise profits by settling deals at the best price available at the expense of long term arrangements.

Cotton which entered the supply chain at highly-inflated prices several months ago is now emerging as finished products, presenting a serious challenge to large, commercial scale buyers in the UK. The problem this poses to high street clothing manufacturers and retailers are widely recognised, but the problems facing less glamorous cotton-dependent businesses have so far been largely ignored. This lack of attention comes despite the fact that the consequences are set to be more severe than in the clothing business because of the far larger contribution cotton makes to the final cost of the product. Bed, bath and table linen is typically made of around 80 per cent cotton and, in normal times, accounts for around half its cost compared to, perhaps, a quarter of the cost of a basic t-shirt.



The 76 per cent rise in the price of cotton over the year to the end of November translated into a 38 per cent rise in the cost of a sheet. Twice the rise one might expect in the cost of even the high street t-shirt (see chart). Somewhere along the line this extra cost has to be paid for. The question is, by whom?

An acute problem for a long term pricing system

Commercial linen, as well as being more sensitive to price fluctuations than clothing, also has a supply chain which is less accommodating to them. To reduce costs and ensure quality control, hotels, hospitals, residential care providers and others rent as much as 90% of their textiles from specialist commercial laundries on long term contracts, rather than buying them themselves.

The turnover of the UK textile rental business is close to £1 billion, according to TSA estimates, with half a dozen large players (see table) and scores of smaller ones. The UK's largest laundry plant in the UK is one run by the market leader, Sunlight, in Merton, London, which processes nearly 2.5 million pieces of linen a week.

The UK's largest laundries

Company	**Market segment**
Sunlight Textile Services	The market leader in hotel linen, healthcare and joint leader in work wear
Brilliant Laundry Group	A trading name for around 15 independent laundries including Paragon Laundry, Clean Linen, County Linen and Fresh Linen.
National Laundry Group	A trading name for around 35 independents
Fishers Services	Second largest in hotel linen, based in four Scottish plants and in Newcastle. Market leader in Scotland.
Bourne Group	Based in Lincoln
Johnson Textile Services	Mainly a work wear specialist through Johnsons Apparelmaster division. Provider to hotel industry through its Stalbridge brand.

Source: Textile Services Association estimates

In normal times this business model provides hoteliers and others who take advantage of it with access to valuable economies of scale which they simply could not hope to achieve in-house. According to the TSA, outsourcing laundry generates significant savings for customers. "It is a 'pooled stock' system," explains David Stevens, joint Managing Director of Cheltenham-based Paragon Laundry. "The hundred sheets you get back from the laundry are not the ones which you sent me," Stevens says.

But all this shared stock needs to be regularly renewed or it will soon become scrappy and unusable, a cost laundry companies providing the textile rental services must meet as part of the terms of their contract. This is problematic because rental rates are typically agreed years in advance - typically three - which mean textile rental companies now face a severe problem in covering the enormous, unexpected rise in stock replacement costs seen this year because of the leap in the cotton price. "As a laundry you could possibly be lucky and find other suppliers of linen, but you would be experimenting in real time with unproven suppliers," says Simpson of the TSA. Even if a supplier can be found that offers cheaper rates, it can ultimately prove more expensive.

> ***The cotton price rise is so enormous the extra cost textile rental companies face can run into several millions of pounds***

Laundry companies typically replace around a third of their rented textile stock every year to make sure it meets the quality standards set out by their clients. "If you get three years out of a sheet you have done well. A sheet rarely dies of old age: they get stained, lost, ripped or stolen," says Stevens. The cotton price rise is so enormous the extra cost textile rental companies face can run into several millions of pounds, a burden many simply cannot afford from already tight cash flows.

To make the situation worse, UK banks, still reeling from the collapse that followed their catastrophic consumer lending spree, are still offering businesses precious little credit to tide them over. "It is very cash flow intensive and you need to find the money at a time when the banks will not lend you very much," says Simpson. Cotton price's 50 per cent contribution to the cost of a sheet is reflected by the TSA's Laundry Cost Index (LCI), which brings together a typical basket of a laundry's costs into one figure.

"Laundry businesses are not really very interested in the retail price index (RPI) or consumer price index (CPI) because our basket of costs is totally different. We, therefore, track our industry's principle costs in a robust manner using government statistics where possible," says Simpson. In doing so the LCI demonstrates how much cotton price rises have so far been the largest factor in an 8% rise in the cost base of a typical laundry engaged in textile rental in October 2010 alone. This is almost 148% more than the rise in the consumer prices over the same period (see table).

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A "typical" annual laundry cost inflation

Cost Centre	Increase	Weighting	Total
Labour	2.2%	40%	0.88%
Textiles	34.1%	15%	5.11%
Energy	0.45%	10%	0.05%
Diesel	11.01%	4.2%	0.46%
Other Transport	4.8%	7.8%	0.36%
Other 7	4.6%	23%	1.06%
TOTAL		100%	7.92%
RPI			4.50%
CPI			3.20%

Source: Textile Services Association, Office for National Statistics

The LCI's current rapid growth began at the end of 2009 (see chart). Already, by this point, cotton prices were the main contributor to the annual increase in costs, having risen 19 per cent compared to the previous year. The impact of this rise was counterbalanced by an 18 per cent fall in energy prices, which was finally falling from their all-time highs. In July 2010, however, the 10 per cent fall in energy prices was not enough to compensate for the 18 percent rise in cotton, which boosted the LCI growth to a level 44 per cent higher than CPI. With even larger rises in textile prices in the subsequent months the upward trend in LCI growth accelerated thanks again to booming cotton prices. In October the fall in energy prices had ended, meaning the effect of the 34% cotton price rise was felt in full.

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Annual laundry cost's route to outstripping inflation

	LCI	CPI	RPI
December 2009	2.69%	2.9%	2.4%
July 2010	4.48%	3.1%	4.8%
October 2010	7.92%	3.2%	4.5%

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The impact on UK laundries

The situation facing UK laundries is stark. "Last year I spent £2.5 million buying new stock. This year I expect to spend around £3.5 million," says Stevens of Paragon. "That is £1 million more I am going to be spending this year—that's the same as the company's profit for last year."

Julian Carr, Managing Director of Sunlight Textile Services, the UK's largest supplier of linen services to hotels and hospitals agrees:
"We estimate the cotton crisis has added nearly £8 million to our costs, at the same time as the company and the industry is bracing itself for price hikes on gas, electricity and diesel."

The impact will be felt by the bigger players, particularly those specialising in linen where cotton costs make up a relatively large proportion of the cost base. But taken across the UK as a whole, the figures are even more staggering. The UK textile rental industry purchases one million sheets a year to renew stock on around one million hotel beds made with linen on rental contracts, so many in fact that it is difficult for the TSA to estimate the precise cost. For bed sheets alone rental companies will need to spend millions of £s not including the extra costs they will face for table cloths and towels. The TSA estimate that total cost of the cotton crisis might be close to £25 million.

> ***All sides will need to realise that the common interest will be in recognising and overcoming the extraordinary challenge the textile rental business is facing***

Many textile rental companies could face bankruptcy unless customers agree to workable pricing solutions. The cost of replacing rented stock amounts to around 15 per cent of a textile rental business's cost base according to the TSA's Laundry Cost Index, which means at the current levels all hope of turning a profit are gone. This potentially puts 25,000 jobs at risk and could wipe out large sections of a £1 billion industry.

But where is this money going to come from? "Clothing retailers have a straight forward price-increase mechanism through their retail stores. They can simply put a t-shirt up from £4 to £5," says Stevens. But there is no such simple solution for textile rental businesses. The forward commitments they offer, though extremely helpful to all parties when markets behave normally, do not accommodate radical and unpredictable price fluctuations like the ones currently seen in the price of cotton. "All sides will need to realise that the common interest will be in recognising and overcoming the extraordinary challenge the textile rental business is facing," says Simpson.

Rises in volume and turnover can often hide the fact that expansion can often hurt profitability

Even those who manage to pick up new business in the current climate may be simply facing themselves with an unsustainable burden. Taking on a new textile rental customer puts greater pressure on cash flow because large quantities of stock need to be bought to serve them. And it is far more stock than one might think. "If you take on a new customer with one hundred bedrooms then you need to buy enough linen for 500 bedrooms: you need one set on the bed, one in the cupboard, one set in the laundry, one set in distribution and one set just in case," explains Simpson. "Rises in volume and turnover can often hide the fact that expansion can often hurt profitability. Companies which perhaps treble in turnover terms will often end up making less money."

Textile rental businesses have very little room to manoeuvre on prices, in any case, with most operating on profit margins of less than 10 per cent. And price is still the key determining factor for many buyers. "It is a case of hitting the deadline or being on the breadline," says Simpson.

Textile rental is a complex business requiring the sophisticated co-ordination of transport, production, washing drying and finishing. If one element in this package goes outside normal parameters it knocks all of your calculations for six

And meeting these high expectations is no easy matter. "Textile rental is a complex business requiring the sophisticated co-ordination of transport, production, washing drying and finishing," says Simpson. "If one element in this package goes outside normal parameters it knocks all of your calculations for six." And the figures look unlikely to stack up for some time to come. Stocks of cotton bought before the hike in prices have so far helped keep prices down, but these stocks are nigh-on exhausted and suppliers are in no position to sell at a loss.

The strict quality control criteria under which textile rental contracts operate mean there is no option but to face up to the extra cost, other than to go out of business. "You could choose not to invest in fabric, but that would be very short-sighted because textiles will become very tired and not come up to clients' brand standards," explains Simpson."The problem is with national rental contracts, often negotiated by central procurement teams or third-party purchasing organisations. They often have no interest in anything but price."

> *Some could afford to accept a price rise, but they would be giving away a short term advantage against their competitors*

The case for more accommodation

The hotel sector, with its own severe financial problems to wrestle with, is likely to find it difficult to raise its sights from the bottom line. "The problem we have is that many hotels are also going bust. There has been a huge spike in hotels going into administration and, as such, they are all desperate to rein in costs wherever possible, to counteract the decline in revenue from fewer customers, and lower room rates," says David Harper of Leisure Property Services, a hospitality industry consultancy.

The cost of laundry is normally accounted for by hotel groups as a fixed cost per room in what is known in the trade as the "rooms department", Harper explains, "This rooms department is, or should be, the key driver of a hotel's profits. If laundry costs go up it could jeopardise the whole hotel operation."

Some market theorists would argue that business failures in textile rental would be part of the natural evolution of an efficient market. But sticking too strictly to this principle in times of exceptional circumstances could rebound on the dogmatist. It might mean, for example, that a hotel had to begin afresh with a new, untested textile supplier or, if no alternative supplier existed, it might be forced to take laundry in-house — a costly business. And since the problem posed by high cotton prices is industry-wide, hotels taking evasive measures would simply be delaying the impact of high cotton prices rather than avoiding it, and potentially making matters worse in the long run.

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There is, therefore, a case for hotels which are not simply struggling to survive to engage in longer-term thinking, guided by enlightened self-interest. "A good supplier allows the hotel to offer a superior service at a lower cost, thereby making itself more attractive to potential customers," says Harper. "Sometimes it is sensible to take a little short term pain on behalf of your customer [the hotel guest] to retain your business relationship with a good and reliable supplier. The key, though, is that the service the supplier provides is good and reliable," says Harper. "If a supplier fails on either of these counts then it may not be a financial advantage."

Sometimes it is sensible to take a little short term pain on behalf of your customer

Harper suggests one possible solution which hotels and their textile rental companies might adopt, "Perhaps there could be one rate for a certain level of business, with a higher rate when the hotel gets above a certain level of business." This goes contrary to how prices are structured at the moment, where discounts are offered for bulk orders. Nevertheless: "It might be a way to help laundry suppliers stay in business when the hotel can afford to, so making the hotel's business more sustainable," says Harper.

Rentokil Initial shut its laundry division having been unable to find a buyer, putting 2,000 people out of work

Energy's ill omens

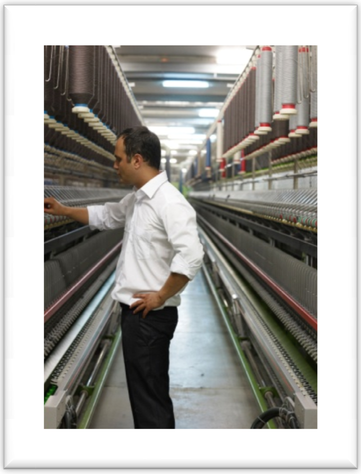
With a 10 per cent weighting, energy makes a large contribution to a laundry's cost base, according to the TSA's Laundry Cost Index, yet it is still less than the 15 per cent weighting of the price of cotton. The outcome of steep energy price rises which started in 2003 and peaked in 2008 are not encouraging, being a key reason for the disappearance of many well-respected laundry businesses. The most high-profile casualty of the energy crisis was Brooks, which closed down in February 2007, at the cost of 880 jobs. In April 2006 Rentokil Initial shut its laundry division having been unable to find a buyer, putting 2,000 people out of work.

A series of acute and unexpected events, coupled with the often erratic nature of the markets' reaction to these events, have sent cotton prices spiralling

"The fact is that energy is a smaller contributor to laundries' costs but caused the failure of two iconic businesses," says Simpson. "This would suggest similar things will happen as the result of the cotton crisis." And even if the cotton price falls as dramatically as it rose - something few currently predict - the extra cost of purchasing new stock at inflated prices will still have to be paid for somehow. "Customers have to understand that what is happening to cotton prices now will have an effect on textile rental business models for many years to come," says

Heavy rains in major cotton-producing areas like Punjab and Andhra Pradesh have delayed the scheduled lifting of the ban

Simpson. "All textile rental businesses will have to find some way to amortise the extra cost of restocking."



Trouble at t' market

Much of the world's cotton is grown and processed in some of the most politically, economically and environmentally unpredictable countries, notably China and Pakistan. A series of acute and unexpected events, coupled with the often erratic nature of the markets' reaction to these events, have sent cotton prices spiralling.

On October 11th the Cotlook A Index, a measure of global cotton prices, broke the previous record of 119.4 cents per pound, established in April 1995, before climbing to 147 cents per pound on October 27th 2010. Over the month the index was 89% higher than in October 2009, while price volatility (a measure of how much price it goes up and down) averaged 57% from August to October 2010, compared to 11% in the same period last year.

“The size and quality of China's 2010 cotton crop is also smaller and of poorer quality than usual”

As with any market, cotton's price is fundamentally determined by supply and demand. The price has dramatically risen because supply from Pakistan and China has suddenly fallen while global demand has continued to increase. India, meanwhile, reacted to the crisis by squeezing world supplies further, banning raw cotton exports from April to protect the supplies to domestic spinners and weavers. It imposed a limit on monthly exports even on pre-arranged deals. Heavy rains in major cotton-producing areas like Punjab and Andhra Pradesh have delayed the scheduled lifting of the ban.

Some also see sharp cotton price rises, together with those of other commodity prices, as a consequence of America's $600 billion liquidity creation measures. This extra liquidity, some economists argue, has been transmitted into emerging market economies that are over heating because of currency pegs to keep the exchange rates of these export-driven economies artificially low. China's currency peg is a notable example.

July's floods in Pakistan hit the nation's cotton crop hardest, with some estimating that 15 per cent was wiped out by the raging waters. There was also severe damage to the power and transport infrastructure needed to irrigate and distribute the crop properly. In financial terms the damage is put at around $1 billion. The subsequent monsoon crop was expected to be down over 20 per cent to 11 million bales, compared to the target of 14 million. As a consequence thousands of local textile workers have been laid off and scores of factories closed.

The size and quality of China's 2010 cotton crop is also smaller and of poorer quality than usual, this time primarily because of drought. In late 2010 Chinese cotton futures hit $3.74 a kilogram ($8.23 a pound). This record high came on the back of analysts' projections that China's cotton production for the 2010-11 season would be 7.7 per cent down on last year, 6.45 million tonnes compared to 6.98 million last year. The US Department of Agriculture had expected this year's crop to match that of last year.

Chinese spinners are hungry for imported cotton, particularly that of high quality. Market watchers, such as Spinwell International, say this demand will keep prices high. Already the high prices have forced many Chinese cotton mills to stop or suspend production, while the government has closed down state-owned mills in an attempt to ensure more cotton is available to private sector producers.

> ***"Already the high prices have forced many Chinese cotton mills to stop or suspend production"***

To some, stepping back for a second the crisis would appear somewhat overblown, with the US Department of Agriculture expecting world production to fall just 1.2 per cent to 115.25 million bales this year. But market instability and uncertainly alone is thought to be a factor in driving up prices. "The steep rise and high volatility of cotton prices over the first three months of the current season reflect primarily a combination of low global cotton stocks and continued demand by spinning mills, but has also been affected by panic induced by fear of defaults on contracts," admitted the International

Cotton Advisory Committee, a group of cotton producing countries, in November.

Economic fundamentals are a key factor in determining a market's long term behaviour, but irrational panic and short term speculation at all levels is playing at least as large a part in precipitating this price boom as any that have gone before. But knowing this does not point to a predictable resolution.

"In Egypt, the price of cotton has more than doubled"

Beyond the behemoths

The cotton crisis is having knock-on effects outside the big producers. In Egypt, which is known less for its volume than for its high quality cotton production, the price of cotton has more than doubled.

"We thought the cotton price rises might just be a short term thing, but it turned out to be long term," says Ashraf Said, Managing Director of Nile Linen Group, Egypt's largest exporter of bed and table linen. Nile's mills can produce 35 million metres of linen a year, and generate turnover of over $70 million. "We first started to change our price lists and then we realised we had to change everything from the middle of 2010," Said says. "We used to accept a year's worth of orders, but we now only accept three months. We will commit to volumes but we will not commit to prices." He is currently obliged to charge some 50 per cent more than last year for his products to cover the extra cost and cannot see the situation changing within the coming year.

Even in the UK, where the cotton industry has been in decline for a century or more, the effect is being felt. "Some of the mills we deal with won't even quote us a price let alone quote us one we are happy with," says Raj Ruia, managing director of Bolton-based Richard Haworth, a cotton business founded in 1876 which buys in textiles, mainly from Pakistan, and makes them into bed, bath and table linen bought by hotel and rental companies.

"They are just worried they cannot get hold of the cotton," Said says. One step down the supply chain, cotton spinners supplying yarn to the weaving mills supplying Richard Haworth are more prone to reneging on contracts while the market price is shooting up, he explains. "It makes it very difficult to plan."

Careful planning and mutual understanding will be needed to ensure this crisis does not lead to sleepless nights for hotel managers and, ultimately, compromises in the service offered to their paying guests.