Specialty Retail and Department Stores

China Tariffs: production shift means margin headwind not as bad as before

Industry Overview

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Equity
United States
Retailing

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A look at the impact of tariffs in election year

We view escalating China apparel tariffs as a risk, but one that has been significantly mitigated by sourcing shifts out of China. Over the last decade, many retailers moved their apparel sourcing from China to Vietnam, Bangladesh and India to cut costs. Since 2010, China as a percentage of US apparel imports has dropped from 39% to 20%, while Vietnam grew from 8% to 16%. Public retailers have moved even faster after the initiation of modest tariffs in 2019 and the threat of larger ones; we estimate that our coverage imports less than 10% of apparel from China.

Margin implications of a tariff

We estimate that a 10% total tariff equates to 25bp of headwind to GM, a 25% tariff results in over 60bp of headwind, and a hypothetical 60% a 150bp headwind. Compared to the current case (7.5% tariff & our estimate of 10% China imports), a hike in the tariff rate to 15% would be a 20bp incremental headwind to GM; however, the headwind could be completely offset by reducing China imports from 10% to 5%, based on our analysis.

Price increases will not be easy in this environment

Apparel CPI was largely deflationary for a decade pre-COVID. CPI turned positive in 2021 as retailers raised prices during the supply-constrained reopening boom, but is now decelerating. We do not see a consumer appetite or ability to pay higher prices this year.

Production has shifted, marginal savings more constrained

Most of the supply chain shift out of China is already behind us. China is more expensive (minimum wages in China remains 114% above Vietnam) but retailers still source there because of its proximity to the fabric manufacturing process, skilled labor force, and more efficient factories. This is particularly important for intricate garments or quick turn chase orders. As Vietnam continues to train its workforce, we could see the final portion of imports move away from China.

Where are the risks?

If the tariff discussion moves beyond China and into all imports, this poses a much greater risk to our coverage. While many industries are responding with onshoring or nearshoring, the labor intensity of apparel manufacturing makes it difficult to move. The manufacturing of Home products tend to be more China-oriented and production is more difficult to move, so a broader tariff on this category could result in increased risk.

2019 was a scramble around tariffs

Most companies saw very little impact from the 2019 tariffs (see Exhibit 3). But, the mitigating factors used in 2019 (shifting production and price increases) are less impactful today. In 2019, Trump tweeted about imposing 10% tariffs on goods including apparel beginning 9/1. The rate was boosted to 15% on 8/23, and cut to 7.5% as China agreed to some concessions. Almost 80% of apparel & textile imported from China were on list 4A (7.5%) while 13% are on list 4B (later suspended).

CPI: Consumer Price Index

SE: Southeast

ST: short term

LT: long term

GM: gross margin

USTR: United States Trade Representative

IIE: Institute of International Economics

AUC: Average unit cost

SE: Southeast

SC: supply chain

2024 Tariff Deep Dive

Margin implications of a tariff hike

The impact of incremental tariffs on China imports is less material now than it would have been five years ago as most apparel retailers have lowered the percentage sourced from China to under 20%. Netting out products made in China to sell in China, we estimate China imports at approximately 10% across our apparel coverage (Exhibit 1).

Exhibit 1: China sourcing exposure has come down over the last few years; netting some of the made in China for China sales with the percentage of China sourcing, we estimate that the average % imported is about 10% across the apparel retailers under our coverage
China as % of Sourcing and sales by retailer

Company	Ticker	Sales (China or Asia)	F2022 % China/SE Asia sourcing	Sourcing changes in last few years
Nike	NKE	14% Greater China (LTM)	18% apparel, 18% footwear, China	Down from 23% apparel, 22% footwear China in F2020
Lululemon	LULU	12% China (YTD)	<7% manufacturing	Down from 9% manufactured in China in F2020
Ralph Lauren	RL	5-6% (China)	19% China	Down from 25% in F2020
VF Corp	VFC	8%	15% from China	Down from 17% in F2020
Victoria's Secret	VSCO	11% international (F23E)	<20% since 2020, target single-digit	Down from 20% + prior to F2020
Abercrombie	ANF	3.4% (APAC)	13% China	
American Eagle	AEO	immaterial	330 vendors, no single one >10%	-
Urban Outfitters	URBN	n/a	5k vendors, no single one >10%	-
Gap Inc	GPS	2.5% (Asia)	30% Vietnam, 17% Indonesia (China not given)	Down from 16% China in F2020
Bath & Body Works	BBWI	immaterial	5-10% from China (componentry)	-
Levi Strauss	LEVI	2-3% China	<1% imports from China into US	Down from 8% a few years ago

Source: Company filings, BofA Global Research estimates

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To assess the incremental margin impact of higher section 301 tariffs and changes in the percentage of China sourcing, we compare the implied gross margins to a current base case of 7.5% Section 301 tariff rates and 10% of China imports (Exhibit 2). We estimate that compared to the current base case, increasing the tariff rate to 15% would equate to a (20)bp GM headwind; however, if retailers continue to reduce China sourcing from 10% to 5%, the headwind could be completely offset. Using the same basis of analysis, a bear case scenario of 60% tariffs on China imports would be a (130)bp incremental headwind at the current estimated 10% of China imports.

Exhibit 2: Scenario analysis: Incremental margin impact of higher Section 301 tariff rates vs various rates of % China sourcing
We estimate that compared to the current base case of 10% China sourcing and a 7.5% Section 301 tariff rate, a raise in the tariff rate to 15% would be a (20)bp headwind to GM; however, if retailers continue to reduce China sourcing to 5%, the headwind could be offset

		% China Sourcing					
		2.5%	5%	10%	15%	20%	25%
	7.50%	14	9	0	(9)	(19)	(28)
Section 301	10%	12	6	(6)	(19)	(31)	(44)
Tariff rate	15%	9	0	(19)	(38)	(56)	(75)
(China imports)	20%	6	(6)	(31)	(56)	(81)	(106)
	25%	3	(13)	(44)	(75)	(106)	(138)
	60%	(19)	(56)	(131)	(206)	(281)	(356)

Source: BofA Global Research estimates

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2019 – a quick reminder

In 2019, retailers were forced to scramble when Trump tweeted about imposing 10% tariff on List 4 goods (including apparel) starting 9/1. The rate was boosted to 15% on 8/23, and cut to 7.5% by the implementation of Phase 1 as China agreed to some concessions. 77% of apparel & textile imported from China were on list 4A (9/1 implementation at 7.5%), 13% are on list 4B (12/15 implementation, later suspended), while the other 10% were already included in the first round of 2018 tariffs, according to the Institute of International Economics (IIE). Most of the Section 301 tariffs have stuck.

Retailers reacted largely by negotiating with suppliers in the short-term, and shifting sourcing out of China to other South-east (SE) Asia countries longer term. Other strategies to mitigate the impact included tariff engineering (designing apparel to fit in lower rate categories) and tariff exclusion process (rarely granted), but both require substantial human resources and are thus less utilized.

China is more expensive but retailers still source from China because of its proximity to the fabric manufacturing process (still heavily China-skewed), its skilled labor force, and more efficient factories. In addition, substantial investment is still required in most countries order to reach a level of manufacturing efficiency comparable to that in China.

Exhibit 3: Retailer commentaries on tariff in 2019 surrounding Trump tweets

In 2019, retailers were forced to scramble when Trump tweeted about imposing 10% tariff on List 4 goods (including apparel) starting 9/1. The rate was boosted to 15% on 8/23, and cut to 7.5% by the implementation of Phase 1

Reported earnings post-8/1 Trump tweet	
AEO	"Based on recently enforced tariffs, unless core, we do not expect a material impact this year. At present, we expect the impact to be manageable in 2020"
BURL	"We do not expect a material financial net impact from these new tariffs as we have deployed strategies to offset these costs." "...we're really looking to offset some of the tariffs by increasing our levels of pack and hold and close-out to because those are obviously some of our more productive categories as we mentioned many times before. We're working with our partners with our direct imports to see if there's any offsets that we can have there, overall." "Yeah, I think that any disruption in the marketplace produces product for the off-price market as we've said."
FL	"As we work with our suppliers and while private label has become a smaller piece of our apparel business, we're obviously working with our suppliers to understand the implications of the tariffs. We're looking for different sourcing and we'll figure out from a pricing perspective what we have to do to cover the gap, again because...the tariffs are ultimately a tax on the end consumer."
GPS	"The unmitigated impacts of list for tariffs would be an incremental $0.06 impact to our guidance based on current estimates. So through our mitigation and contingency plans, we would expect this impact to be much lower."
JWN	--
KSS	"We will approach our path forward thoughtfully with a focus on doing what's right not only for our business, but also what's right for our customers over the long term. We know that our customers are driven by our value proposition, so we will ensure that our customers continue to receive the value they expect from Kohl's."
LULU	"...[our direct exposure to China is] down considerably given how we have diversified our vendor base. We've never had more flexibility than we do today in our supply chain. So going forward, we do not expect it to be a big impact to the business."
M	"We know from the earlier tranche of tariffs, though, that today's customer doesn't have much appetite for price increases." "...I think that 10% is manageable in the short and long-term. I think when it goes to 25%, you're dealing with...other series of dynamics that I would not say we wouldn't have to raise prices."
PVH	"I just don't think this is an environment that will withstand price increases in apparel as we move forward."
ROST	"A good portion of our apparel and footwear comes from China. So with that said, in terms of the mitigation, we think it was a prudent approach to make our best estimate of the potential impact, separating out what goes into effect in September and December. And for us, our best estimate at this point is we took $0.03 from EPS in the back half."
SIG	"As we have mentioned previously, the three tranches of tariffs that were enacted in 2018 have no meaningful impact on our business. However, our jewelry merchandise is subject to the recently announced List four tariffs...We believe that the actions we've taken to leverage the flexibility in our multinational supply chain will enable us to cover the current 15% List four tariffs impact within our fiscal 2020 operating profit guidance range. In fiscal 2020, we do not expect to pass along price increases to our customers as a result of tariffs."
TJX	"Based on what we know today, we have included a small negative tariff impact in our full year guidance only for the merchandise that we've already committed to. We're planning to offset this impact primarily through opportunities in the favorable buying environment and expense savings."
TPR	"Our gross margin forecast also incorporates the impact of US tariffs on imports from China, including the 25% tariffs on handbags and small leather goods, currently in place, as well as the recently announced 10% tariff on the list of $300B of goods expected to go into effect on September 1 for categories such as footwear and ready-to-wear."
URBN	"If the 10% tariffs go in to effect as they are threatened to, I think we could see anywhere from $2.5mn to $3mn charge in the back half of the year. Now, we are making up on some of the money is being refunded to us by the -- in terms of better prices and some of the money is coming to us via a depreciation. So I think that we are reasonably confident that the affect will not be too great and then we also have some pricing power in any assortment, I think that our teams could go in and probably cherry-pick 10% of the items, and say that if it were very a few dollars more probably, no one would notice and so we may do that. We haven't decided yet."
Reported earnings pre-8/1 Trump tweet	
CRI	"I had one supplier from China, call me recently said Mike, I've got 10,000 families relying on our business with Carter's and a lot of times, these suppliers build their factories in remote areas and build housing for those families and highly dependent on Carter's."

Exhibit 3: Retailer commentaries on tariff in 2019 surrounding Trump tweets
In 2019, retailers were forced to scramble when Trump tweeted about imposing 10% tariff on List 4 goods (including apparel) starting 9/1. The rate was boosted to 15% on 8/23, and cut to 7.5% by the implementation of Phase 1

Reported earnings post-8/1 Trump tweet	
	"...pricing would be the least desirable change that we would make...But if we have to raise prices, we'll do it, and I would say the price increases would be modest, in the context of the value in our product offering." "The silver lining in this threatened disruption may be more abundant capacity in China at our cost objectives, than would have otherwise been possible. Since our last call with you, we have negotiated lower product costs for spring 2020."
NKE	"Our exposure in terms of product produced in China to North America is relatively modest. At the same time, we see great opportunity to continue and potentially expand the production of product in China, for China and for other markets."
RL	"We continue to increase the flexibility and efficiency of our global supply chain as we keep a close eye on tariffs and other trade developments. The tariffs enacted to date have a limited impact on our business, but we are continuing to diversify our supply chain to mitigate the long-term impact of potential tariff scenarios."
UAA	"We also know just how complicated the current tariff and global trade situation can potentially be. And so, understanding and thinking about how do we de-risk our supply chain but also manage the tariffs and the duty challenges that exist something we've spent a lot of time thinking about"
VFC	"The impact of tariffs to date has been the de minimis. We continue to monitor the situation closely and are developing contingency plans for potential outcomes."

Source: BofA Global Research, company reports, company conference calls

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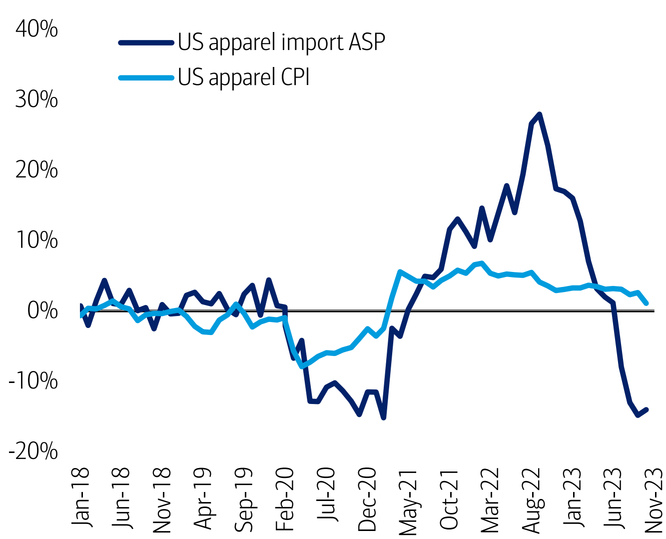
Apparel sourcing costs have come down

Apparel sourcing costs have come down since a post-pandemic surge, and continue to decline as raw material costs normalize after peaking in mid-2022. However, the rate of decline in costs has inflected in October (Exhibit 4). While some retailers still have remaining raw material costs to recoup within GM (see our GM note), we expect the benefits to normalize from here. We expect costs to rise over the next several years in the event that another trade war comes to pass, depending on this year's election results. We see risk that even a modest annual increase in sourcing costs could pressure margins for many brands as apparel CPI growth has been on a downward trend over the past year.

Exhibit 4: US apparel import average unit costs have come down, but the rate of decline hit an inflection point in October 2023; meanwhile, apparel pricing growth has been on a downward trend over the past year
US apparel import average selling price (ASP) vs US apparel CPI



Source: U.S. Bureau of Labor Statistics, US Department of Commerce Office of Textiles and Apparel (OTEXA)

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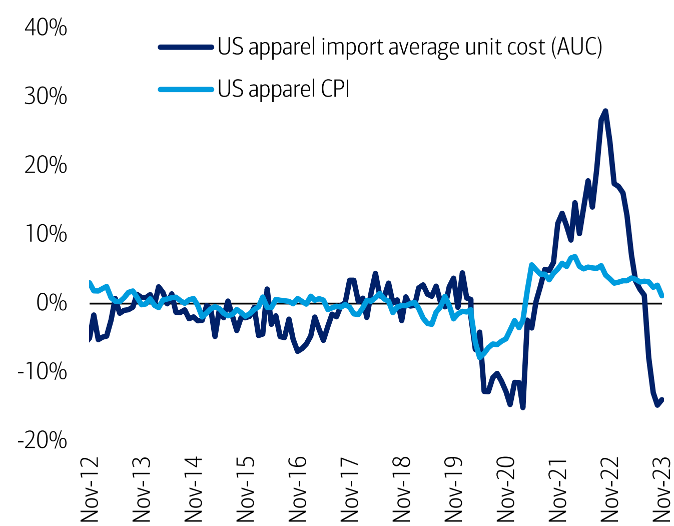
Exhibit 5: Apparel sourcing costs had been largely favorable from 2012 through pre-pandemic, spiked during COVID, and has come down throughout 2023
US apparel import average selling price (ASP) vs US apparel CPI



Source: U.S. Bureau of Labor Statistics, US Department of Commerce Office of Textiles and Apparel (OTEXA)

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Price increases could be hard to avoid if tariffs >15%

Retailers raised prices during the aftermath of COVID and apparel CPI has been positive the last three years (since April 2021), after three years of declines pre-pandemic. We don't expect the consumer to have an appetite for higher prices this year. Most retailers increased prices during the post-pandemic reopening boom and tight inventory conditions in 2021, but had to discount by 2022 to get rid of excess inventory. 2023 was largely a year of normalization, during which most retailers tried to hold prices steady.

Alternate countries already at tighter capacity

Wages in alternative manufacturing countries have been growing steadily since pre-trade war days, and continued to grow at a healthy pace during and post pandemic (Exhibit 6). Minimum manufacturing wages in Vietnam, the second largest apparel exporter to the US, are up 26% since pre-trade war in 2017; wages are up 10% from 2019-2022. Minimum wages in China remain 114% above Vietnam, so continued shifting of the supply chain should result in cost savings (Exhibit 7). However, we believe apparel manufacturers are facing capacity constraints and rising wages in Vietnam as they increasingly compete for land and labor. Multiple companies have been shifting supply chains to Vietnam in recent years, across apparel, tech hardware, and semiconductors. In addition, Vietnam apparel manufacturing wages are also rising more quickly than minimum wages (Exhibit 8).

Exhibit 6: Minimum manufacturing wages grew the most compared to pre-trade war in Indonesia and Cambodia (+31%/27%/26% respectively), and are up the most in Indonesia, China, and Vietnam since 2019 (+13%/10%/10% respectively)

Minimum Wage by country (US$/Month)

	2017	2018	2019	2020	2021	2022	Growth y/y	Growth since 2017	Growth since 2019
Indonesia	$113 - $248	$123 - $270	$131 - $288	$142 - $313	$146 - $322	$147 - $325	1.0%	31%	13%
Cambodia	$153	$170	$182	$192	$193	$195	1.0%	27%	7%
Vietnam	$127 - $165	$136 - $175	$146 - $189	$159 - $206	$159 - $206	$160 -$208	1.0%	26%	10%
China	$170 - $330	$179 - $347	$184 - $357	$367	$378	$393	4.0%	19%	10%
Philippines	$193	$201	$207	$215	$215	$226	5.0%	17%	9%

Source: Makalot, BofA Global Research

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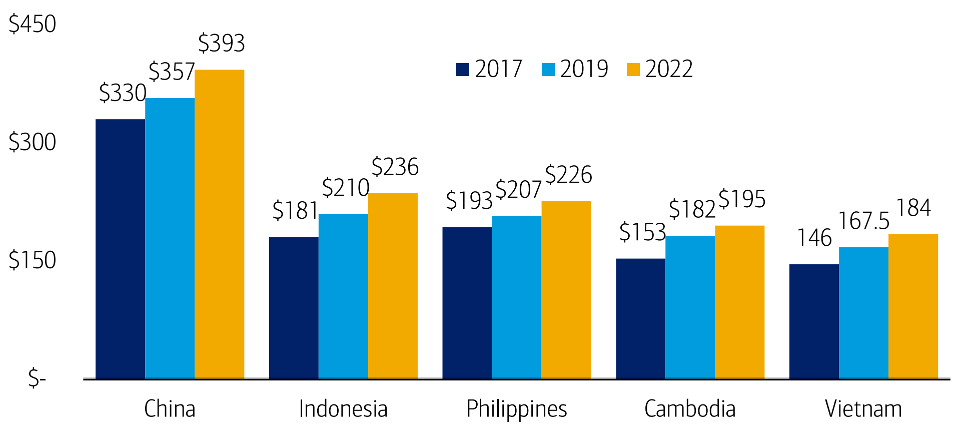
Exhibit 7: China still maintains a substantial lead in minimum wages amongst the most popular manufacturing countries, being 114% above Vietnam in 2022; continued shift out of China should still result in cost efficiencies

Minimum Wage by country (US$/Month), 2022 data



Source: Makalot, BofA Global Research

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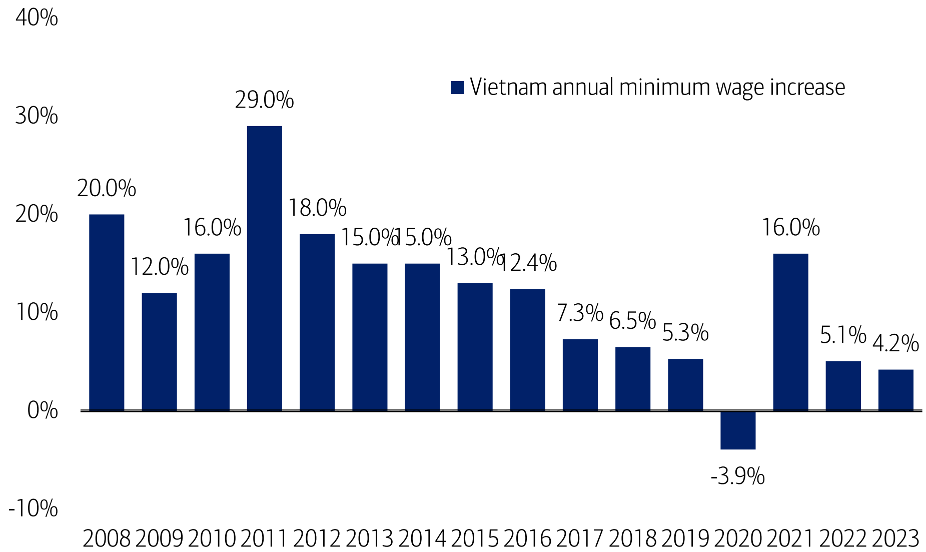
Exhibit 8: Vietnam apparel manufacturing wages are rising more quickly than minimum wages
Vietnam apparel factory employee wage growth y/y



Source: General Statistics Office of Vietnam

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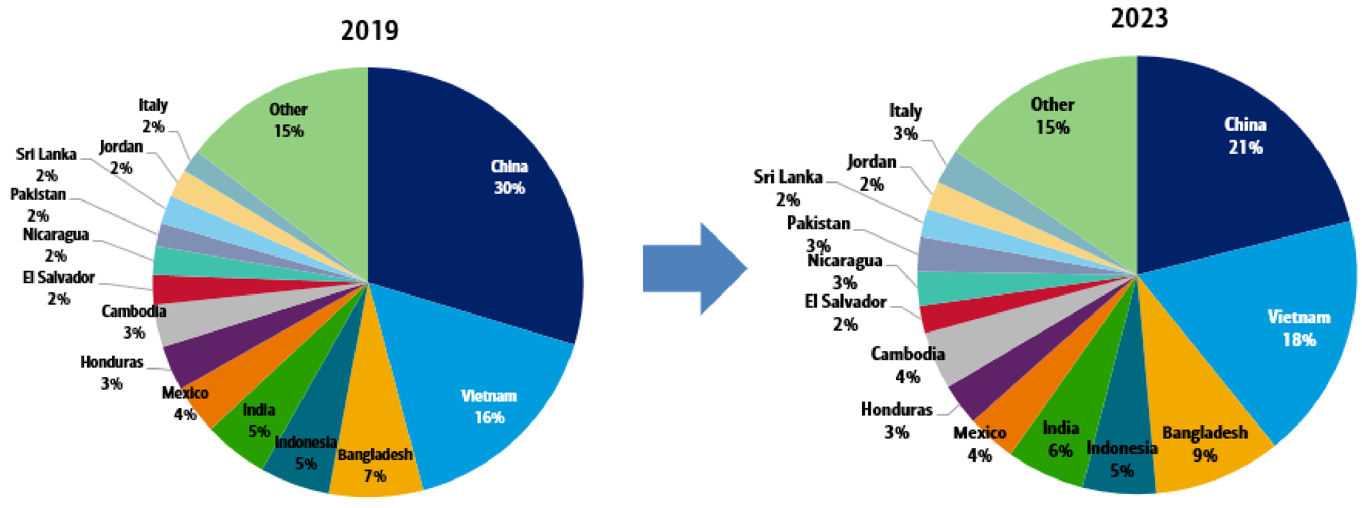
Apparel supply chain shift to Vietnam is in late stages

Should higher tariffs be on the horizon, shorter term we expect brands and retailers to ship inventory earlier ahead of incremental tariff implementation. This could increase the risk of port congestion and margin pressure due to higher air freight, and also increases the fashion risk retailers take to make trend predictions further out before the selling season. Longer term, the shift out of China manufacturing should continue, as it has for the past decade. Since 2010, China as a percentage of total US imports has gone from 39% to 20%, while Vietnam grew from 8% to 16% (Exhibits 9-11).

However, we expect the shift at a slower pace going forward; whereas the shift was accelerating in the three years pre-pandemic, by 2023 imports from both countries are down a similar amount (Exhibit 12). Bangladesh, India, and Indonesia have also all seen share of exports rise over the last three years since the pandemic; Bangladesh grew from 7% to 9% during this time, while India grew slightly more than one percent to 5% (Exhibit 11). We expect more shifts into these alternative countries in the coming years as Vietnam also becomes saturated, but at a slower pace.

Exhibit 9: US apparel imports have shifted out of China significantly over the last three years

US Apparel imports by country (% of total value)



Source: Office of Textiles and Apparel (OTEXA), BofA Global Research

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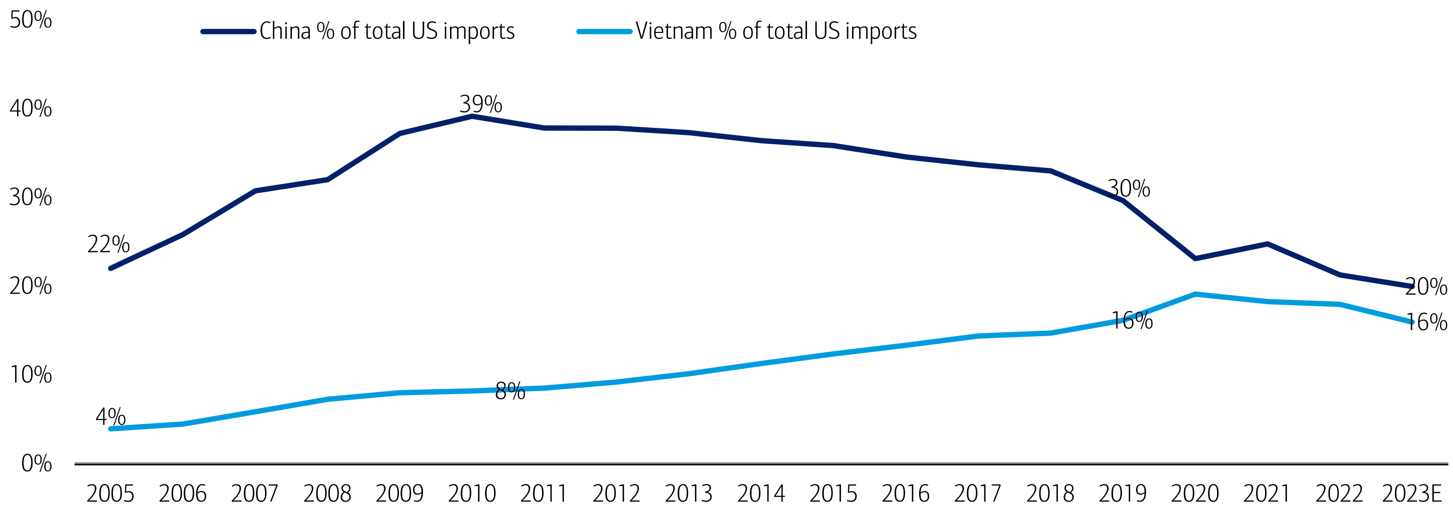
Exhibit 10: Apparel supply chain has been shifting out of China to Vietnam over the last two decades. The shift briefly paused amid supply chain disruption in 2021, but continued on post. As of 2023, there is only a 4% difference between % exported between the two countries

% of US imports from China and from Vietnam over the last two decades (2005-2023E*)



Source: Office of Textiles and Apparel (OTEXA), BofA Global Research estimates

*2023E includes first 11months of actualized data for 2023

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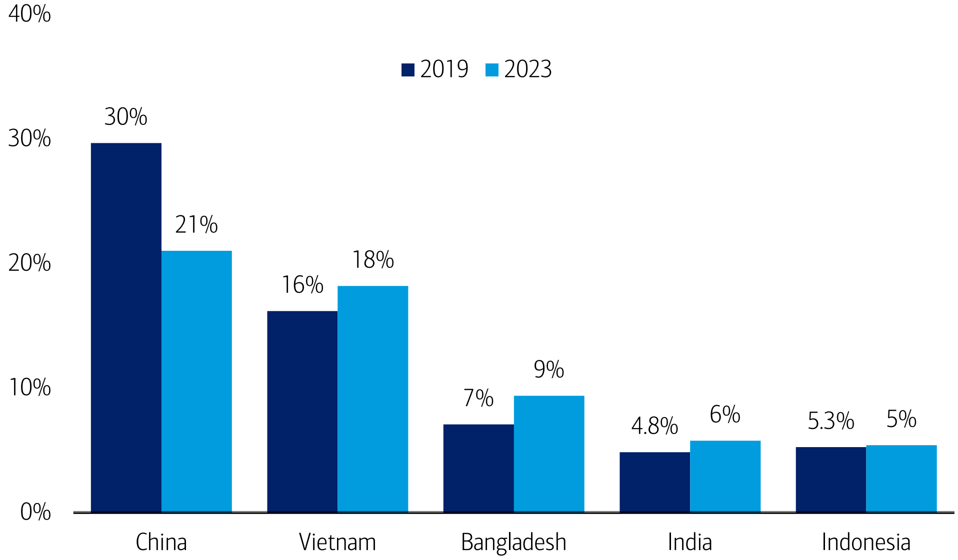
Exhibit 11: China imports have declined as a % of world imports from 30% to 21% by 2023 compared to 2019, while Vietnam imports climbed from 16% to 18% and Bangladesh imports also grew from 7% to 9% during this time

US apparel imports by region as % of world imports, top five importing countries



Source: Office of Textiles and Apparel (OTEXA), BofA Global Research estimates

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Exhibit 12: We expect the shift from China to Vietnam to continue at a slower pace going forward; whereas shift was accelerating in the three years pre pandemic, by 2023 imports from both countries are down a similar amount

US Apparel imports from China % growth vs apparel imports from Vietnam % growth

Source: US Department of Commerce Office of Textiles and Apparel (OTEXA)

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Exhibit 13: US apparel imports has continued to shift out of China to alternative Southeast Asian countries in the last few years
US apparel imports by country - % of total

Year	2017	2018	2019	2020	2021	2022	2023E*
China	33.7%	33.0%	29.7%	23.7%	24.0%	21.8%	21.0%
Vietnam	14.4%	14.7%	16.2%	19.6%	17.6%	18.3%	18.2%
Bangladesh	6.3%	6.5%	7.1%	8.2%	8.8%	9.7%	9.4%
Indonesia	5.7%	5.4%	5.3%	5.5%	5.1%	5.6%	5.4%
India	4.6%	4.6%	4.8%	4.7%	5.1%	5.7%	5.8%
Mexico	4.5%	4.0%	3.7%	3.4%	3.5%	3.2%	3.6%
Honduras	3.1%	3.1%	3.4%	2.8%	3.3%	3.2%	3.1%
Cambodia	2.7%	2.9%	3.2%	4.4%	4.2%	4.4%	4.3%
El Salvador	2.4%	2.3%	2.2%	2.0%	2.2%	1.9%	2.0%
Nicaragua	1.8%	2.0%	2.2%	2.2%	2.4%	2.8%	2.5%
Pakistan	1.6%	1.6%	1.7%	2.2%	2.7%	2.8%	2.6%
Sri Lanka	2.4%	2.1%	2.1%	2.3%	2.1%	2.1%	2.1%
Jordan	1.7%	1.8%	2.1%	2.4%	2.1%	1.9%	2.1%
Italy	1.5%	1.6%	1.7%	1.7%	1.9%	2.0%	2.6%
Other	13.6%	14.2%	14.6%	14.9%	15.1%	14.7%	15.4%

Source: Office of Textiles and Apparel (OTEXA)
*Data includes first 11 months of 2023A

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Exhibit 14: US apparel imports growth has normalized in 2023 after two years of post pandemic boom
US apparel imports by country – y/y% growth

Annual - % y/y	2017	2018	2019	2020	2021	2022	11M23 (vs 11M22)
World	-1%	3%	1%	-24%	27%	23%	-22%
China	-3%	1%	-9%	-39%	29%	11%	-26%
Vietnam	7%	6%	11%	-7%	14%	27%	-23%
Bangladesh	-4%	7%	10%	-12%	37%	36%	-25%
Indonesia	-3%	-2%	-2%	-20%	18%	35%	-26%
India	1%	3%	7%	-26%	39%	36%	-22%
Mexico	5%	-6%	-7%	-30%	28%	12%	-10%
Honduras	-3%	4%	10%	-35%	45%	20%	-24%
Cambodia	0%	12%	11%	5%	20%	28%	-25%
El Salvador	-1%	0%	-2%	-30%	36%	7%	-18%
Nicaragua	1%	10%	11%	-23%	42%	43%	-31%
Pakistan	1%	7%	7%	-4%	58%	24%	-28%
Sri Lanka	-1%	-11%	4%	-19%	18%	23%	-24%
Jordan	8%	9%	20%	-14%	10%	16%	-16%
Italy	3%	14%	4%	-23%	39%	29%	4%
Other	71%	8%	4%	-22%	29%	19%	-18%

Source: Office of Textiles and Apparel (OTEXA)

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Disclosures

Important Disclosures

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R1]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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