Changing Trends in China
USDA Outlook Conference 2006
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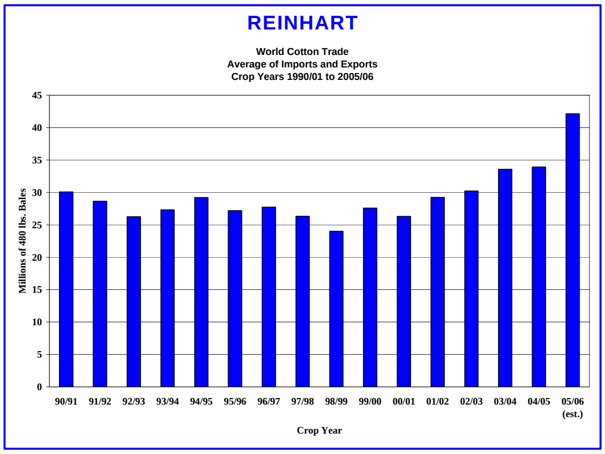
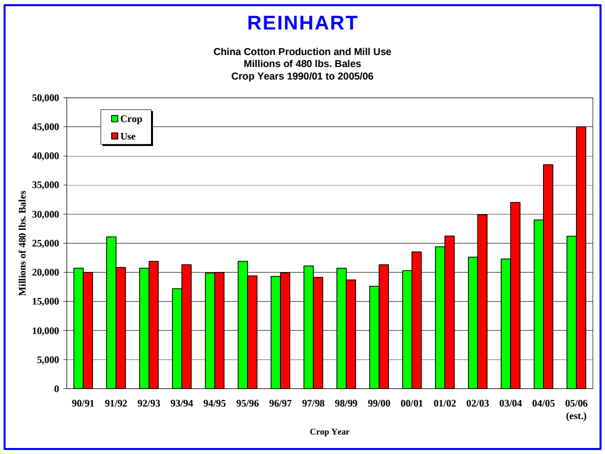
Introduction
Good morning. It is a pleasure to speak to such a distinguished group. Before I start I would like to preface my speech by relaying a comment that was given to me when I first joined Reinhart and went through Paul Ruh's cotton class. He told me it takes 100 lessons to understand the cotton market and you can only learn one a year; he noted he had only 45 under his belt and he was not even halfway. Even though I only have 5, luckily I have access to seasoned professionals in Paul Reinhart, a company that is over 220 years old. My first lesson was that China is the biggest player in the world cotton market, with some of the most astute traders and no one knows the precise Chinese data.

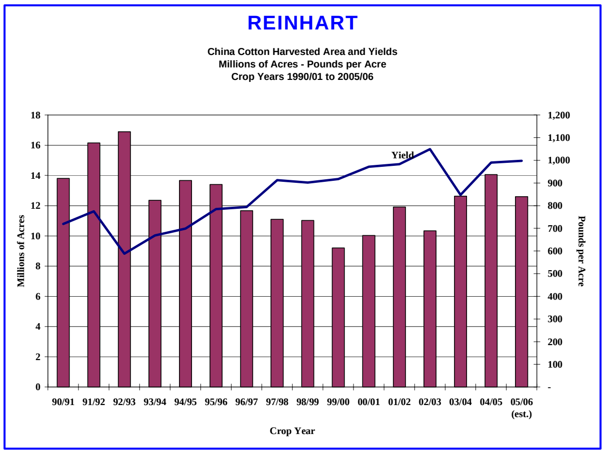
Synopsis
Rapid growth in China's textile industry and growing demand for cotton imports has resulted in innovative trading arrangements affecting the timing of sales, financing, quality standards, storage and delivery. This paper will address the changing needs of China's textile mills, the development of new marketing strategies, the advancement of stronger relationships through tighter contracts, and the effects of the new strategies on international merchants as it relates to the exports of U.S. cotton.



Quick overview of the current Situation
Before I address the changing textile industry let me first lay the groundwork using the USDA's latest figures, which are all quoted in 480 lb. bales.



World Cotton Trade and China Net Trade
A key point to remember when reviewing the world balance sheet for an international merchant is not the world consumption; it is not the global production or even the ending stocks. Our focus is on world trade, implying movement of cotton across international borders. Global trade had been stagnating at about 30 million 480 lb. bales through the nineties; then China became a major importer. Since 2000/01 over 15 million bales have been added to world trade annually. Multiple factors played a role in this transition, but most are related to the preparation for the removal of the textile import quotas in January 2005.

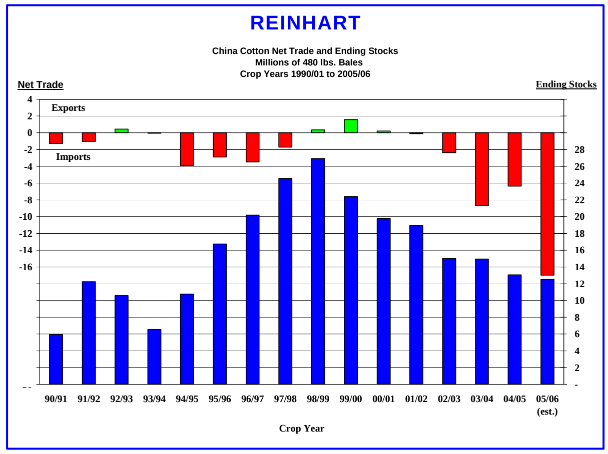


China Cotton Consumption
Throughout the nineties China's cotton consumption was stable, around 20 million bales, but since 2000/01 it has steadily advanced from 23.5 million to 45.0 in 2005/06. From another perspective, China represented about 25% of the world consumption, but is now over 39%. During this same period China was in the process of privatizing

parts of its state owned businesses. Foreign and local asset investments started supporting the whole gamut of the textile industry. Growth potential was eminent with a highly educated and low income workforce coupled with improving efficiencies throughout the industry. And now they have money for new capital investments and more importantly working capital to purchase cotton.

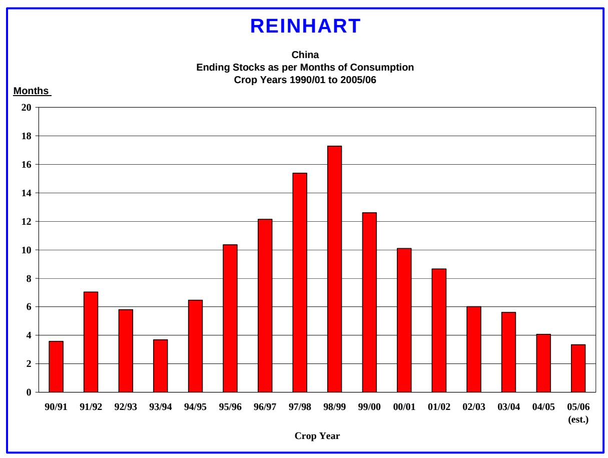
Cotton Production

To supply this growing market we must now look at China's supply. Yields in China are some of the highest in the world as it peaked at about 1,100 lbs per acre in 2002/03 before experiencing declines the last three years due to inferior weather. China has invested in new seed varieties, with some showing the potential of increasing yields by about 25%. Their yields already almost double the world average at 635 lbs. per acre. Production had been relatively stable ranging around 20 million bales during the nineties, slightly above consumption. Over the last 5 years it has risen to an average of 24.9 million bales, with recent trends moving towards the 30 million bale level. Planted and harvested acres started a steady decline as yields started to rise. 1999/00 was a turning point; China actually started the year exporting some of their stocks and then experienced bad weather which caused farmers to abandon acreage to the lowest harvest area in over a decade. Harvested acres were back on the rise until last year when a government policy to promote feed grains diverted acreage. Early indications are that planted acres in 2006/07 should be up slightly, but still below the burgeoning demand.



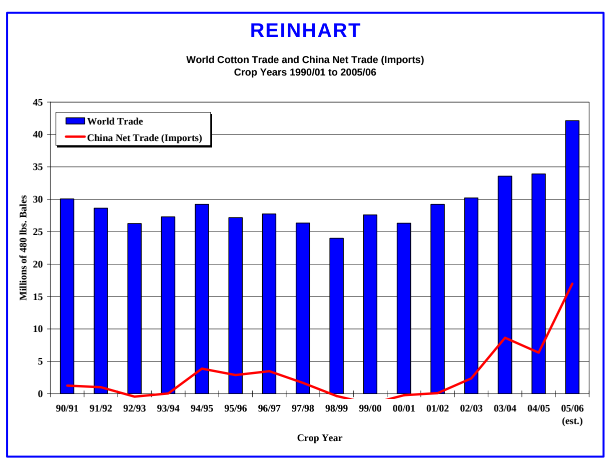
Cotton Net Trade and Ending Stocks

In a process to stabilize prices for farmers, the strategic reserves began to build and maxed out at 26.3 million in 1998/99. During this same time net international trade in any one given year did not swing more than 4 million bales until 2003/04. Production and the drawdown of strategic stocks were still not enough to meet the fast pace demand which now required substantial imports. Also, China was in the process of WTO negotiations to gain access to the textile import quotas. Trading partners seeing the potential demand required China to open its borders to a set minimum import quota of 894,000 bales annually. This number seems small today, but negotiators are forced to use past trends to set limits and not future potential.



Stocks as per Months of Consumption

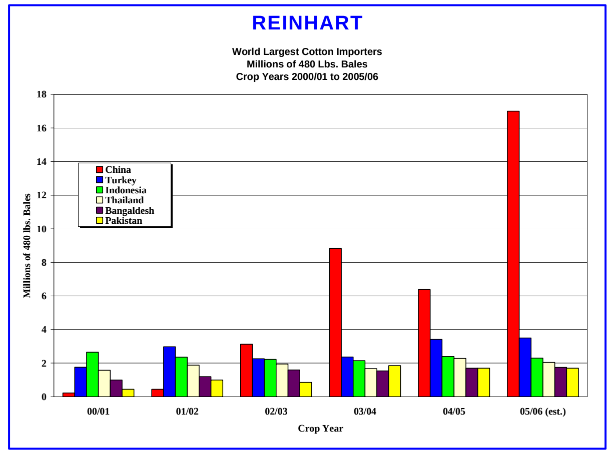
In the last decade we have watched China stocks grow to over sixteen months of consumption to the last two years where it has settled in the range of two to three months. Mills were use to carrying stocks of three to four months of consumption to ensure consistent spinning due to quality or

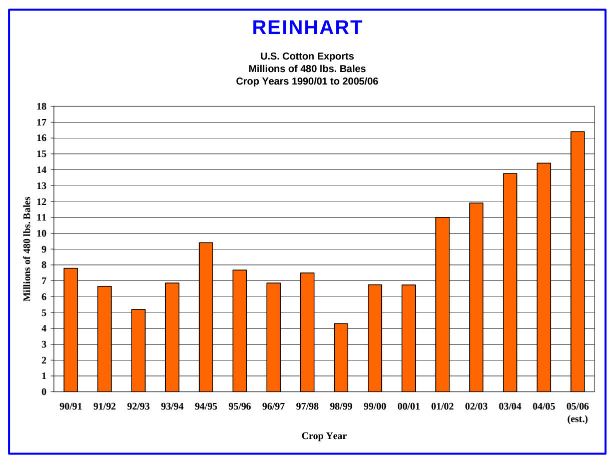


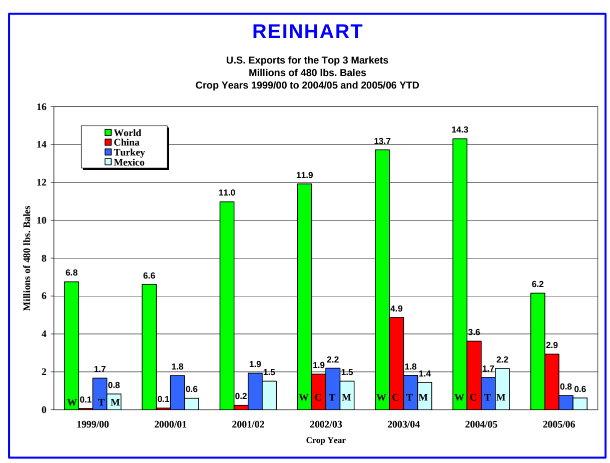
transportation issues during various seasons. It is estimated that some mill stocks may be as low as two to three weeks.

Chinese Imports

Once the reserves reached critically low levels, imports were required. However, they are done through a quota allotment process. Buyers in China come in all forms: from the state reserves, state owned mills, private mills and a growing local merchant community. At 17 million bales, China is estimated to absorb 40% of world trade. This will provide opportunities for international merchants to supply an array of cotton from around the world.







U.S. Exports

A weak U.S. dollar (relative to the Chinese Yuan) coupled with a growing U.S. supply has been a formula for China importing U.S. cotton. Exporters of U.S. cotton have retained their principal share of the market in calendar 2005 at 47%, although it is slipping from 55% last year. In the future it may loose further ground to Central Asia and West Africa growths.

Textile industry in general

Just the virtual size of the Chinese textile industry makes it non-comparable to most markets. This is especially true in regards to the U.S. where we have 10 large to midsize spinners at most, where in China it is estimated they have over 5,000 spinners comprised of 70 million spindles.

A large portion of the mills are fully integrated. They focus on each part of the textile business and manage them like separate profit centers.

When investments started pouring into China, a bulk of them went first to the spinning industry to help fill the growing yarn demand. However, investments soon shifted down the processing chain as the demand for finished products started to grow with the approach of January 2005 and the elimination of global textile import quotas.

As a result, inventory of finished products began building to fill the potential growing world demand. However, a small "bump in the road" occurred when two of the top importing markets, the U.S. and European Union implemented safeguard actions on finished cotton products as negotiated under the WTO. This had the effect of putting new import quotas based on a set rate for the next couple of years.

A little side note that has big implications -- with opportunity and risk comes the potential for higher profit margins. With a large under-utilized polyester production capacity, it did not matter that the raw commodity prices were rising. Chinese polyester remained relatively low compared to world prices and competitive with cotton prices. It was able to hold its share in the yarn market and estimates are that over 25 million bales equivalent of polyester production were added in the last 6 years. Chemical fiber output in calendar year 2005 amounted to 74.8 million bale equivalents, about three times the cotton production. During the spinning process, chemical fibers are more efficient than natural grown cotton, implying more yarn per pound.

Demand for yarn continued to grow, but could be imported from other sources at a lower price rather than trying to expand their own spinning. First, they turned to Southeast Asia who had large yarn surpluses at the time. Then India and Pakistan became viable suppliers. They both had access to inexpensive local cotton, low wages, and growing investments in their spinning industry. These two markets should be on everyone's radar, but that is for another discussion.

Misconceptions about the Chinese Textile Market

China leaped into the world textile market in a very short time period with many people drawing their own conclusions. It can be pointed out that there are numerous misconceptions about the Chinese industry. Here are only a select few, but I am sure there are many more.

First myth: China is only an export machine of finished textile products. The actual truth is that the local domestic consumer market is strong and growing. Just a few years ago it was estimated that 50% of the products made in China were consumed locally; that number is now estimated at over 70%.

Second myth: Chinese industry is state controlled and private firms are told how to buy. In reality, most mills are private or being privatized with estimates of only about 30% still state owned. Even municipally controlled mills are acting like private firms.

Third myth: Chinese farmers only do what they are told by the government. False, they are acting on price incentives like all other producers around the world. This decision-making revolves around local seed cotton prices, international prices, input costs, government support for various commodities, etc.

Fourth myth: Chinese industry pays "dirt cheap" wages. Well, this is relative; the Chinese workforce is one of the most highly educated and wages are comparable or higher than many countries and rising. Even in some regions of China there are labor shortages for certain jobs.

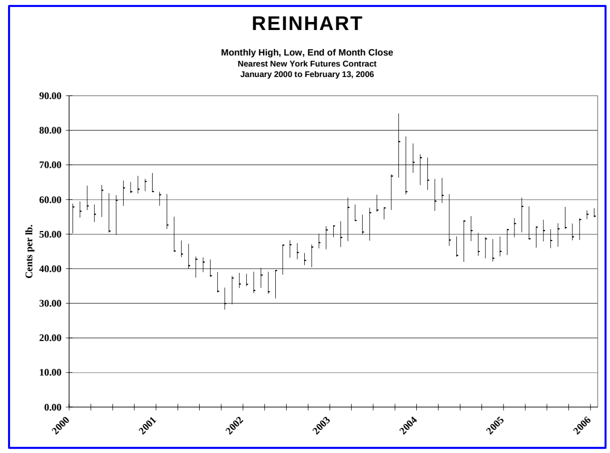
Fifth myth: China is such a powerhouse in the textile market there are no competitors. Economics teaches us that trade will move to those entities who have the best comparative advantage. In this case, we have seen India and Pakistan become major yarn suppliers to the world market and to China. They both have access to lower wages and their own large local production.

Changing Textile Industry

Rapid growth in China's textile industry has come at a time when the country is transitioning from completely state owned and operated to privately held businesses ranging from family farms to textile manufacturers. Also, the service industry is growing from trucking, warehousing, local commodity merchants and large private banks. A mentor once told me, capitalism is hard to teach, but can be learned quickly if there is a profit to be made.

Growing pains were felt in 2005 when the Central Bank tightened credit and terms to slow the fast growth in various industries. This had a direct impact on the textile mills and forced them to better mange their work capital and stocks. One executive in my office always stresses that mills can carry cotton as bales or yarn and both of them have to be financed if there is no yarn contract in place. This in turn limits his ability to purchase additional cotton. So when we hear that a mill is only carrying limited stocks in cotton bales, the next question should be what level are their yarn stocks.

Purchasing decisions which had been mainly through state reserves have now been passed to individual mills. Mill owners and buyers are quickly learning the way international growths of cotton are priced and what may affect their pricing. Most of the aggressive mills in China have someone who works throughout the cotton trading hours of the New York Board of Trade.



Managers of the textile mills that were growing and needed to import cotton had to become very knowledgeable of the international market very quickly. In the process, they learned some quick lessons, which turned them to buying hand-to-mouth. First hard lesson: prices can continue to fall even further after dropping 10 cents, 20 cents, 30 cents and more as they went from 84.80 in October 2003 to 42.00 in August 2004. Many mills kept thinking they were buying at a great level at 65.00 cents, then at 55.00 and as the market kept falling they kept buying, averaging down prices buying out 6 months then expanding to a over a year, only to watch the market fall lower. It was also a lesson the international merchants had to work through as they were thinking that these mills had great potential; however, walking away from high priced contracts was a large issue and hurt many U.S. merchants who were trying to build their international business in China. So the current hand-to-mouth buying is driven by both sides, as buyers are limited on credit and scared prices could drop, while international merchants want to limit their exposure and risk as well.

Buying techniques by mills are changing as international merchants are teaching strategies to reduce their risk over time. However, mills need to make sure they know and trust the merchant they are doing business with to ensure that they are creating strategies that truly reduce price risk. One buying practice that is starting to advance and has a lot of potential is that cotton is being sold "On-call" NYK versus fixed price. This allows the mills to lock all aspects of the contract, including the basis, except for the final price. Then mill buyers can place "Good Till Cancelled" (GTC) orders to try to better mange NYK or may give a buy order for a fixed price contract using a GTC. This is only scratching the surface of simple price strategies.

Testing multiple growths seemed to be the aim of many Chinese spinners this past year to ensure they were not tied to one growth. A sign of experience as they have seen large quality shifts in their local production. At the same time, this will give them more options to gain a better price in their mixes, but they have also learned an old lesson, "you get what you pay for." Buyers have changed their mind from being very quality minded to widening their view to a more balance approach of fair price and quality.

Consignments have always been used around the world by international merchants and U.S. merchants to provide a quick response to a potential demand. In the U.S. we refer to it as a consolidating warehouse, but a consignment is just taking that one step further down the international logistical channel. Recently, we have seen this grow in China with estimates of half of the consignments at ports being of non-U.S. origin. Buyers like to be able to see the cotton, have a guaranteed delivery in a short period and have cotton at the mills shortly after paying for it or opening a Letter Credit. It also allows the international merchant to deliver consistently smaller amounts as the cotton is paid and has reduced quality claims. However, it is not all roses. You have additional charges which large mills do not like to pay and an international merchant has to make sure he consigns the right quality as the local supply or demand can change quite rapidly.

Stronger relationships through tighter contracts

An international merchant must look at every contract as the beginning/ongoing of a long-term relationship. This lesson is not new to the well established merchant community, but there are some merchants who take advantage of a new market as they learn to negotiate contracts. We have seen great results out of the U.S. cotton industry in teaching mills how to negotiate a well defined contract in other countries and I look forward to seeing these same principles taught to Chinese mills. Some objectives should include: 1) clearly defined quality, 2) standard arbitration rules, 3) payment terms, 4) delivery, 5) shipping instructions, etc.

Identifying and Initiating strategies to benefit U.S. exports

1) All mills struggle with financing of cotton until it is sold as yarn and it is no different in China.
2) Identify the specification of yarn needed to produce and make sure they are not over-engineering their cotton. This sometimes is an issue where the engineer is requesting higher quality cotton to cut back on his responsibilities.
3) Quality factors differ annually across the cotton belt. Promote the testing of various U.S. growths so mills would look to other sources in the U.S. first, versus other exotic growths.
4) Cut the confusion on quality concerns and educate mills on the value of High Volume Instrument data (HVI) by USDA which has become very reliable to a point that almost the entire U.S. crop is classed by USDA.
5) Location of stocks will be critical to maintain a competitive edge into the Chinese market. I would recommend that merchants look at doing this in small bits, as there are many risks with moving cotton to a bonded warehouse at a distant port.
6) The U.S. cotton industry should strive to improve every aspect of the logistical nature of how cotton is moved from the gin to a U.S. port. Everyone involved must be aware that this cotton is being delivered to a viable client, which happens to be overseas. We, the merchants, will always take the first hit if for some reason a shipment has country damage, but in the long run the U.S. farmer is the one that will loose out as mills have long memories and will shift their sourcing patterns overtime until they feel comfortable returning. This can take years, sometimes decades.
7) Chinese warehouses need to be taught how to handle cotton as imports are relatively new and the difference in handling U.S. versus block lots of other growths.
8) More research should be undertaken to better understand the growing demand for finished cotton goods for local consumption.

In closing, I would like to stress two points. First, all of those involved, from the farmer up until when the finished product is bought at the retail store are in the cotton service industry. We should be striving to ensure that a high quality product is passed through the marketing channel in an efficient way if we want U.S. cotton to be a competitive product in the future. Second, I would like to quote our Senior Vice-President for Exports who has traveled quite extensively throughout the world, including China, and has negotiated many contracts, “Always listen to what they are saying, but more importantly pay attention to what they are doing.” This holds true for all markets.

Thank you for your time and at this point I will be happy to take your questions.