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Analysis of value chain and performance of leather companies in Kenya.

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ANALYSIS OF VALUE CHAIN AND PERFORMANCE OF LEATHER COMPANIES IN KENYA

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DECLARATION

I declare that this work has not been previously submitted and approved for the award of a degree by this or any other university. To the best of my knowledge and belief, the dissertation contains no material previously published or written by another person except where due reference is made in the thesis itself.

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Signature Date

This dissertation has been submitted for examination with my approval as university supervisor.

S. Wagura Ndiritu

……. ……

Signature Date

ABSTRACT

The performance of a company is the core aspect for management and shareholders as it is a measure of success or failure and usually guides decision making within that business. Value chain analysis is a fundamental approach to conducting internal analysis of a company since it is a systematic examination and analysis of the specific activities or functions through which a firm can create value and realize growth in margins. Analysis of the value chain has significant impact on decisions regarding performance of the company or industry as the activities of the value chain have a bearing on costs. This study's objective was to analyze the value chain and performance of the leather companies in Kenya.

The study used a descriptive research design and a census was conducted on five leather processing companies in Kenya. The study collected primary data gathered using structured questionnaires through interviews and analyzed using descriptive statistics. The research yielded both qualitative and quantitative data. The study found that the leather value chain in Kenya has three main levels of participation i.e. the raw hides and skins level, tannery level and finished leather products level. Additionally, the study concluded that the highest average gross and net margins were realized at finished leather product level, followed by the tannery level and the raw material level had the lowest gross and net margins in the value chain. Combined activity analysis of the value chain indicated that the combination would result in the lowest margins on gross margins and net margins across all value chain levels. The leather value chain in Kenya can be profitable for the investor who specializes at particular levels of activity. Cost control is invaluably critical in production planning and processing resulting in maximization of margins.

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This research study and process would have been impossible without the love and support of family; your continuous encouragement and unfailing support was amazing.

DEDICATION

I dedicate this work to the various participants across the Leather Industry in Kenya and my hope is that the content, findings and recommendations therein will add value during their decision making deliberations, production efficiencies and enhance their firm's performance to scale greater heights in business, access global markets and earn a premium price for their effort in value addition.

LIST OF ABBREVIATIONS AND ACRONYMS

AGOA: Africa Opportunity Growth Act

COMESA: Commonwealth East and Southern Africa

GDP: Gross Domestic Product

RBV: Resource-Based View

VCA: Value Chain Analysis

CHAPTER ONE: INTRODUCTION

Introduction

This chapter discusses background of study, problem statement, objectives of the study, research questions, scope of the study and significance of study.

1.1 Background to the Study

The value chain can be described as the full range of activities that firms and workers perform to bring a product from its conception to end use and beyond (Gereffi, 1995). These activities within the value chain include the design, production, marketing, distribution and support to the final consumer of the goods or services. These activities that comprise a value chain can be contained within a single firm or divided among different firms. The concept of value chains was introduced by Michael Porter in 1985 and consist a generic value chain model comprising a sequence of activities found to be common to a wide range of firms. These activities are supported by the infrastructure of the firm, human resource management, technology development and procurement (Porter, 1998).

Following the sequences of tangible and intangible value-adding activities, Value Chain Analysis (VCA) provides a holistic view of the industries. For example, they can analyze the supplier relationships and analyze the impact of a managerial business decision on the business process and effects to the customer at the end of the chain. VCA methodology as proposed by Gereffi (1995) explores the following aspects of the business: an input-output structure, which describes the process of transforming raw materials into final products; governance structure, which explains how the value chain is controlled; an institutional context in which the industry value chain is embedded and a geographical consideration where the business operates.

Humphrey and Schmidt (2002) developed an additional element of analysis referred to as industrial upgrading. Industrial upgrading describes the dynamic movement or shift of raw material or goods from one level of the value chain to another. Initially, global value chain methodology focused mainly on economic and competitiveness issues but more recently it has also incorporated social and environmental dimensions such as labor regulation issues, appreciation of green of value chains, workforce development, gender parity and disability inclusion among others elements.

Porter (1998) advanced that a value chain would consist of the primary activities such as inbound logistics, operations, outbound logistics, marketing and sales and after sales services to achieve customer satisfaction. These primary activities are supported by secondary functions such as the infrastructure of the firm, human resource management, technology development and procurement

Inbound logistics is part of business logistics corresponding to the set of operations that are associated with the flow of materials and information, from the source of raw materials to the entrance at the factory. The acquisition of materials has long been an important aspect of materials management and will most probably continue to be so in the future (Hannon, 2013). Material management is directly responsible for the product flow into the company. The materials manager's customer is the manufacturing or the production department rather than the intermediate or final customer in the marketplace.

Operations consist of value creating activities meant to transform inputs into the final product or service. Distinct activities here include machining, packaging, assembly, equipment maintenance, testing, printing and facility operations. According to Bartol (2011) in service organizations, operations involve transforming inputs into intangible outcomes. Such outcomes, when produced, are simultaneously consumed, cannot be stored and involved customer participation. Competitive advantages result from the firm’s ability to either perform the required activities, at lower costs, or in ways able to create value for the client and that allow the firm to ask for a higher price.

Outbound logistics refers to the leg between the production facilities and the customers. Transportation is the physical movement of products from where they are produced to where they are needed during which time value is added to the product i.e. place utility. Transportation is also a factor in time utility of goods as determines how fast and consistently a product moves from one point to another (Lambert et al, 2016).

Marketing activities are geared towards informing buyers about products or services, inducing buyers to purchase them and facilitating their purchase. Under marketing, activities include: channel selection, channel relations, advertising, promotion, and selling, pricing/quoting and retail management.

Service activities relate to the after sale of a product or service and they are meant to maintain and enhance the value of that product or service once the customer takes possession of it. Examples include customer support, installation, repair, training, spare parts supply and management, complaints handling and product upgrading (Zeberga, 2010).

Porter (2010), asserts that the value creation process is a series of several distinct activities and identifies these distinct activities to include designing, producing, marketing, delivering and product or service support after sale. These activities have both cost and value implications.

Hofer (1986), describes performance as a contextual concept associated with the phenomenon being studied, for example, for financial performance; performance being a measure of the change of the financial state of an organization. Organizational performance is therefore firm specific since the strategic choices a firm makes dictates which performance measures it will implement. Critical factors to consider when analyzing performance of a value-chain include inputs, production, marketing, transportation and sale of the product.

There are four performance measures used to assess the success of value chains in a firm. These are efficiency, degree of responsiveness flexibility and quality. Efficiency is the utilization of resources in the value chain. It is measured in terms of production costs, profit, return on investment and level of inventory; Degree of responsiveness is the time spent in the fulfillment of a request. It is measured through fill rate, product lateness, customer response time, lead-time, shipping errors and customer complaints Flexibility is the degree of responsiveness of the value chain to a changing environment. It is measured through customer satisfaction and the flexibility in volume and lost sales. Quality consists of product and process quality. Product quality includes product safety and health, shelf-life, product reliability and convenience while process quality consists of the characteristics of production and marketing systems (Lusine et al. 2007).

Organizations have to create value by analyzing their value chains and then exploring ways of adding value to the activities in the chains by improving performance to meet the needs of customers. The overall goal is to provide customers with superior value products and services which in turn translate to better financial performance of the

firm. It is therefore important to understand how firms create value and then look for ways to add more value to it (Kaplinsky and Morris, 2001).

1.1.1 Leather Industry in Kenya

Kenya's leather industry has been on a steady growth trajectory in recent decades. An abundance of livestock population in Kenya has created an industry for meat export as well as export of hides and skins for decades. Hides and skins have traditionally been perceived as by-products of the meat industry. Leather export predominantly took place in the form of raw hides and skins (Tradecraft, 2010). Today, Kenya's leather industry comprises of suppliers of raw hides and skins from the abattoirs, tanneries and producers of finished leather product. Broadly, the sector is divided into the formal and informal sector (Mwinyihija, 2014). Total employment in the leather industry is estimated to be around 14,000 people during peak times. According to official trade statistics, the total value of leather and leather products exports were US$122 million in 2012 and US$147 million in 2013 (Mwinyihija, 2014). Almost all leather goods manufacturers that operate in Kenya today are considered small and micro enterprises. Only a few constitute medium enterprises. Among small and micro scale producers, the majority prefer to be in the informal sector in order to avoid the tax burden (Mwinyihija, 2012).

Although the leather sector in Kenya, has many natural strengths, it risks missing out on opportunities in the global market and especially the African Growth and Opportunity Act (AGOA) trade opportunity that offers free access to leather products manufactured in Kenya to the US market. According to statistics, African countries account for only 4% of world leather production and 3.3% of value addition in leather despite owning a fifth of the global livestock population (AGOA, 2013). Kenya is currently exporting leather products worth US$140 million; this is significantly low compared to global leaders in leather such as China, Italy, and Vietnam. However, these countries are lacking in availability of and access to raw materials.

Kenya is a low-cost producer of undifferentiated, low-end shoes and boots mostly for the domestic market. The production is estimated at 3.3 million pairs of leather footwear per year. Most of Kenyan leather is produced and sold as a commodity with little quality or design differentiation in the form of semi-processed tanned "wet blue" leather (89%), raw hides and skins (5%), finished leather (2%) and leather footwear

and handbags, travel ware, and other leather products (4%) according to the Kenya Leather Industry - Diagnosis, Strategy and Action Plan (2015).

In 2006, the government raised the export tax payable on the export of raw hides and skins to 20% and in June 2007, doubled it to 40%. The impact of this new legislation resulted in commitment to free trade. A report by Traidcraft Exchange and Oxfam (2010) shows that it increased the number of tanneries in the country from 6 to 9 tanneries. Currently there are 11 tanneries mostly concentrated around Nairobi and this has increased leather exports by 54% and boosted sector earnings by almost $10M resulting in creation of 7,000 new jobs thereby having a multiplier effect on 40,000 people.

The leather value chain is Kenya consists of few players depicted as follows: the abattoir where the hides and skins are collected after slaughter of cattle. The tanning companies will have mechanisms for collection of hides and skins to deliver them to their premises after minimal processing called salting. The raw hides and skins are delivered to the tannery for curing and processing the hide into usable leather. Lastly, the production of leather products into finished products that are released in the market.

In leather industry in Kenya, value chains and margin analysis has not been researched yet the industry promises to create more value in the future for investors and holds promise for the economy at large as envisioned in Kenya's Vision 2030. This study seeks to analyze the value chain and evaluate the performance in terms of profit margins at the different levels of participants in the leather value chain in Kenya.

1.2 Problem Statement

The leather and leather products sector offers an important opportunity for industrialization and diversification of exports to improve on trade imbalances. The leather sector can contribute to economic growth through expanding exports of both semi-processed and finished leather goods (Mwangangi, 2016). However, value addition in the leather sector has been minimal and most of Kenya's exports have been in the form of unprocessed, raw hides and skins (Mwinyihija, 2012). His study however did not indicate whether there was a relationship between the value chain activities and performance of players across the value chain.

The export opportunities available for Kenyan Leather products would be channeled through the African Growth and Opportunity Act, an export initiative that opens the United States market to Kenyan products and the opening up of the COMESA market with a population of 390 Million people with almost similar purchasing power and buying characteristics to Kenyan consumers. However, Kenya is yet to take a share of this market opportunity and pursue exports vigorously (AGOA, 2013).

Akanbi et al. (2016) in their study of value chain analysis and the performance of fish farmers in Nigeria found a direct relationship between value chain analysis and performance of participants in the value chain through enhanced cost and returns.

From the above studies, there appears to be limited in-depth analysis of value chain in the leather industry in Kenya and especially in relation to performance. The leather value chain therefore becomes critical for this study in order to bridge the inherent knowledge gap. This study aimed to identify specific functional levels for investment within the value chain to maximize profit margins and determine the main challenges that limit the ability of the Kenyan leather industry to compete aggressively with other global markets.

1.3 Research Objectives

i) To analyze the value chains used within the leather industry in Kenya.
ii) To evaluate the performance in terms of profit margins at the different levels of participants in the leather value chain in Kenya.
iii) To identify the core challenges experienced across the leather value chains in Kenya and possible solutions.

1.4 Research Questions

i) Who are the players within the leather value chain in Kenya? What are their characteristics?
ii) What is the performance in terms profit margins in the different levels of leather value chain in Kenya?
iii) What are the main challenges faced by players in the leather industry value chain in Kenya?

1.5 Scope of the Study

The study aimed at determining the value chain participants in leather processing in Kenya and evaluate the financial performance of the leather companies in Kenya. The study focused on five operating leather companies in Kenya in the year 2019. These companies were located around Nairobi.

1.6 Significance of the Study

The study will provide the managers and other decision makers of leather companies in Kenya with insights into the benefits of proper adoption of the value chain model in maximizing profits. The study will indicate the level of value chain and the performance of such levels thereby informing decision making on investment in future.

Scholars could therefore use the findings as a foundation for further research. Researchers will also be able to borrow from the findings of this study. The study will bring much contribution to the current literature in the field of leather industry in Kenya. It should also act as an incentive for further research to improve and extend the present research in the area especially in Kenya.

This study would be beneficial to policy makers in government, as it would inform government spending and resource allocation together with capacity building to strengthen the leather value chain in Kenya.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter provides a discussion of the reviewed literature on value chains and margin analysis. It covers a theoretical framework for the study that gives a discussion of theories, general literature review, empirical literature, conceptual framework, and summary of literature review.

2.2 Theoretical Framework

This section presents theories related to value chain analysis and margin analysis. The following section will discuss relevant theories concerning this topic. The theories attempt to explain the role of each study variable which includes value chain participants, value chain practices and the impact on financial performance of the leather companies in Kenya. The theories described will be: Resource-Based View theory, Porter's five forces theory and Systems theory.

2.2.1 Resource-Based View Theory

Penrose (1959) and later Wernerfelt (1984) propagated the Resource-based View Theory (RBV). It proposes that competitiveness can only be attained by innovatively giving high value to consumers. RBV refers to the contention that all organizations are a collection of unique capabilities and resources. The exclusivity of any organization capabilities and resources is the foundation of an organization's strategy and its capability to get above average returns.

Penrose (1959), offered durable principles governing the growth of firms and the rate at which firms can grow efficiently. Specifically, Penrose (1959) provided an explanatory logic to unravel causal links among resources, capabilities, and competitive advantage, which contributes to a resource-based theory of competitive advantage. Penrose (1959) provides at least three key arguments concerning linkages among firm's resources, productive opportunities, and profitable firm growth. She maintained that firms could create economic value not due to mere possession of resources, but due to effective and innovative management of resources. The RBV theory advances that the resources must fulfill the criteria of being: An enabler of the

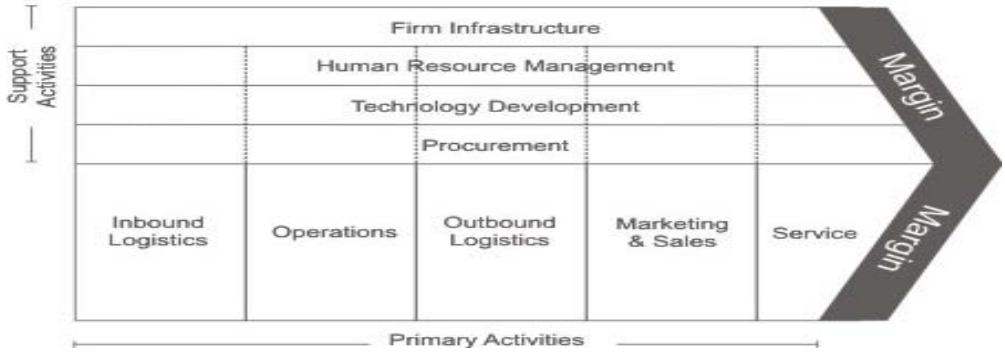
firm to employ a value-creating strategy, by either outperforming its competitors or reduce its own weaknesses. The resource must be rare by definition and this could be measured by the price of the resource, which will be a reflection of the expected discounted future above-average returns. The advantage of the resource is only sustainable if competitors are not able to duplicate it perfectly. The resource must be non-substitutable i.e. if competitors are able to counter the firm's value-creating strategy with a substitute, prices are driven down to the point that the price equals the discounted future earnings resulting in zero economic profits.

The theory is pertinent to the study because it identifies economic resources that are likely to be important in margin analysis in value chains. Resource-based theory predicts resources availability and employment of these resources will be more important determinants of the performance than the sector effects by comparing outcomes across multiple levels of analysis.

2.2.2 Porter's Theory of Value Chain Analysis

Porter (1985) analyzed the value chain and arrived at the Porter's Theory of Competitive Advantage, which focuses upon individual industries and extends VCA analysis by bringing in the performance angle (Porter, 1990). He advanced that the behavior of costs and the potential sources of differentiation affect the margins of the firm and came up with a model that includes primary activities and support activities as shown below. The activities across the value chain are meant to create additional value that exceeds the cost of conducting that activity, therefore generating a higher profit.

Figure 2.1 Porters Value Chain



Source: Andrew, Benjamin and Claudine 2012.

The primary activities include; inbound logistics, operations, outbound logistics, marketing and sales, service in the core value chain creating direct value. The support activities are procurement, technology development, human resource management and firm infrastructure supporting the value creation in the core value chain (Porter, 1985) as indicated in Fig. 1 on the previous page.

This theory is relevant in the study in determining the value chain in the leather industry in Kenya as well as evaluation of performance as a measure in this value chain. Porter offered five undeniable forces that can be used by businesses and play an important role shaping the market or even the industry. The forces are used broadly in the process of measuring profitability, attractiveness, and intensity of competition (Porter, 2008).

2.2.3 Systems Theory

Von (1950) made pivotal contribution to the development of systems theory specifically during the 1950s. Systems theory argues that a phenomenon is seen as a whole and not simply the sum of its elementary parts (Martinelli, 2013). A system comprises of subsystems whose interrelationship and inter-dependence move towards equilibrium of a larger system (Steele, 2014), the focus is on the relationship between parts in order to understand an entity's organization, functioning and outcomes. It also views the organization as constantly interacting with its environment which is comprised of a set of relationships between agents, shareholders and other factors beyond the organizations control (Mason, 2007).

In value chain context, systems theory brings together various components of complex supply chain (that is human, capital, information, materials and financial resources) to form a subsystem which is then a larger system of supply chain networks (Fowler, 2013). It can further help to identify interdependencies between constitutes of the system and better understanding of the dynamics of the supply chain hence improve planning, execution, and coordination of leather industry supply chain. The theory is relevant to the study because it simplifies the relations among the components of the systems, in order to gain better understanding and analysis of values generated by value chain.

2.3 Empirical Review

According to Barney et al. (2004), Value Chain Analysis (VCA) is a three-step process that comprises of the following:

Activity Analysis of the value chain involves the identification of the activities that contribute to the delivery of the service or the product that make up part of the customer experience. The input-output structure is typically represented as a set of value chain boxes connected by arrows that show the flows of tangible and intangible goods and services, which are critical to mapping the value added at different stages in the chain and to layering in information of particular interest to the researcher.

Secondly, for each identified activity, there is continuous and intense thought to identify the value factors i.e. factors valued most by the customer as regards how each activity is conducted. Such could include a fast, correct and knowledgeable response to the customer queries made on the telephone.

Thirdly, it is necessary to evaluate whether it is worth making changes, and then plan for action. This will involve putting the ideas generated above into action. Customer feedback while implementing these changes would be critical to determine and confirm whether the plan is right or the business is able to capture correctly what they really want. The mitigation of environmental impacts also offers commercial opportunities, such as product differentiation, efficient use of inputs, creation of new income streams and improved stakeholder relationships. Thus, some firms have become proactive at the chain level in communicating and collaborating in projects to reduce their environmental impact.

Brennan and Rakhmatullin (2015), in the United Kingdom, found that the value chain describes the full range of activities that firms engage into bring a product from its conception to its end use and beyond. This includes design, production, marketing, distribution and support to the final consumer. The activities that comprise a value chain can be contained within a single firm or divided among different firms. Value chain activities can produce goods or services and can be contained within a single geographical location or spread over wider areas. This study aims to determine the value chain within the leather industry in Kenya and the levels of participants.

In Nigeria, Akenbor and Okoye (2011), noted that that the value chain analysis enables companies' executives to control cost drivers better than competitors and thus

creating above-average performance in operational efficiency, profitability, market share, customers' satisfaction, innovation, and quality and assets utilization. The study indicated that the value-chain does not only reveal cost advantages but also brings attention to several sources of differentiation advantage relative to competitors.

Urbig (2003) conducted a pilot study to investigate "The implications of the value chain for firm and industry analysis" among selected companies in Berlin. The study revealed that the value chain analysis enables company's executives to control cost drivers better than the competitors and thus creating above average performance in operational efficiency, profitability, market share, customers' satisfaction, innovations, quality, and assets utilization. There is the need to conduct a similar study in other countries as ours to validate whether environmental differences and respondent characteristics could cause a major difference in the researcher findings.

Cooper and Lybrand (1996) conducted a study on 213 companies in Pakistan to examine "The impact of value chain analysis on the profit margin of firms". The findings indicated a correlation co-efficient of 0.74 i.e. 74% relationship between value-chain analysis and profit margin of the firm. This implies that increases in the adoption of value chain analysis by companies could bring about 74% increases in profit. The study equally shows that 57% of the respondents agreed that the value chain analysis is a useful technique in minimizing the operational cost of a business. This gives the firm the opportunity of cost-leadership position in the industry thereby resulting to superior performance.

In Nigeria, Akenbor and Okoye (2011), noted that that the value chain analysis enables companies' executives to control cost drivers better than competitors and thus creating above-average performance in operational efficiency, profitability, market share, customers' satisfaction, innovation, and quality and assets utilization.

Brennan and Rakhmatullin (2015), in the United Kingdom, found that the value chain describes the full range of activities that firms engage into bring a product from its conception to its end use and beyond. Van Galen, and Hoste (2016), did an assessment of profit analysis in animal product supply chains in Netherlands. The study concluded that comparison of profit margins between different supply chains or products.

2.4 Margin Analysis

Before deciding whether to enter a new market or businessperson must first determine which business is most profitable for them. After mapping out the value chain, the next step is to analyze the chain in depth. Costs and margin analysis provides an avenue for this analysis and enable the producer to lower the cost per production unit sustainably. Cost is the money contributed by a player in the value chain and the margin is the net of revenues generated less costs. Knowledge of these costs and margins enable decisions to be made on costs of entry, distribution of costs and margins along the value chain, change in costs and margins over time to predict future growth or decline of the value chain, value chain comparison and performance benchmarking of value chains across the globe.

This value that is created within the value chain and captured by a company is the profit margin and can be summed up as:

Margin = Value Created and Captured less Cost of Creating that Value

In the leather industry, the margins could be affected by the following factors:

a) Costs of entry with regards to investment and operating costs for different players
b) Cost distribution across the players in the value chain to determine possible interventions to upscale efficiency and minimize costs
c) Change in costs and margins over time to determine future growth or decline of the chain.

Van Galen and Hoste, (2016), did an assessment of profit analysis in animal product supply chains in Netherlands. The study applied regression to analyze average operating and pre-tax profit margin per industry. It concluded that comparison of profit margins between different supply chains or products and/or product groups, between parts of a supply chain, between countries, and between companies was not clear and ambiguous without a thorough value chain analysis.

Umar et al. (2015), established the value chain analysis of hides and skin in Daura area of Katsina State, Nigeria. The socio-economic characteristics of traders, organization of flow of hides and skin and profitability along the value chain were analyzed. Data elicited was analyzed using descriptive statistics, gross margin, and

flow chart analysis. The study found that the organization of flow of the commodity was fairly simple, the research also made it clear that marketing of hides and skins was a profitable business and recommended that various stakeholders should be involved in the value chain to support in the area of funding/institutional credit facilities specially to hides and skins traders.

Akanbi et al. (2016) in their study of value chain analysis and the performance of Small Scale Agri-business fish farmers in Kwara State examined the influence of value chain analysis on the performance of small scale cultured fish farmers in Kwara state. The objective of the study was to determine the influence of value chain on the performance (i.e. cost and returns and marketing efficiency) of small scale agri-business farmers. It was recommended that there should be policy thrust that will enlighten cultured fish farmers that value chain analysis leads to improvement in firms' performance through enhanced cost and returns and marketing efficiency.

Challenges of Value Chain Implementation

Some of the challenges faced during through the value chain include; access to quality raw material inputs for production. Where the raw material is available and of high quality, the acquisition costs are also high hence affect the overall profit margin of the chain. Production infrastructure is expensive to install and maintain. Once they depreciate and become unusable, they can only be disposed as waste junk and cannot be used by any other industry as recycled material. Growing environmental concerns have led to stringent pollution control norms and the costs of compliance have an effect on the margins of the companies. Non-compliance with environmental standards is also a factor hindering access to some of the international markets (UNCTAD 2018). The scale and scope of a value chain analysis can be overwhelming and it can be time consuming. The identification of key participants within the value chain, challenges and possible solutions within that value chain can be equally daunting (Simister, 2011).

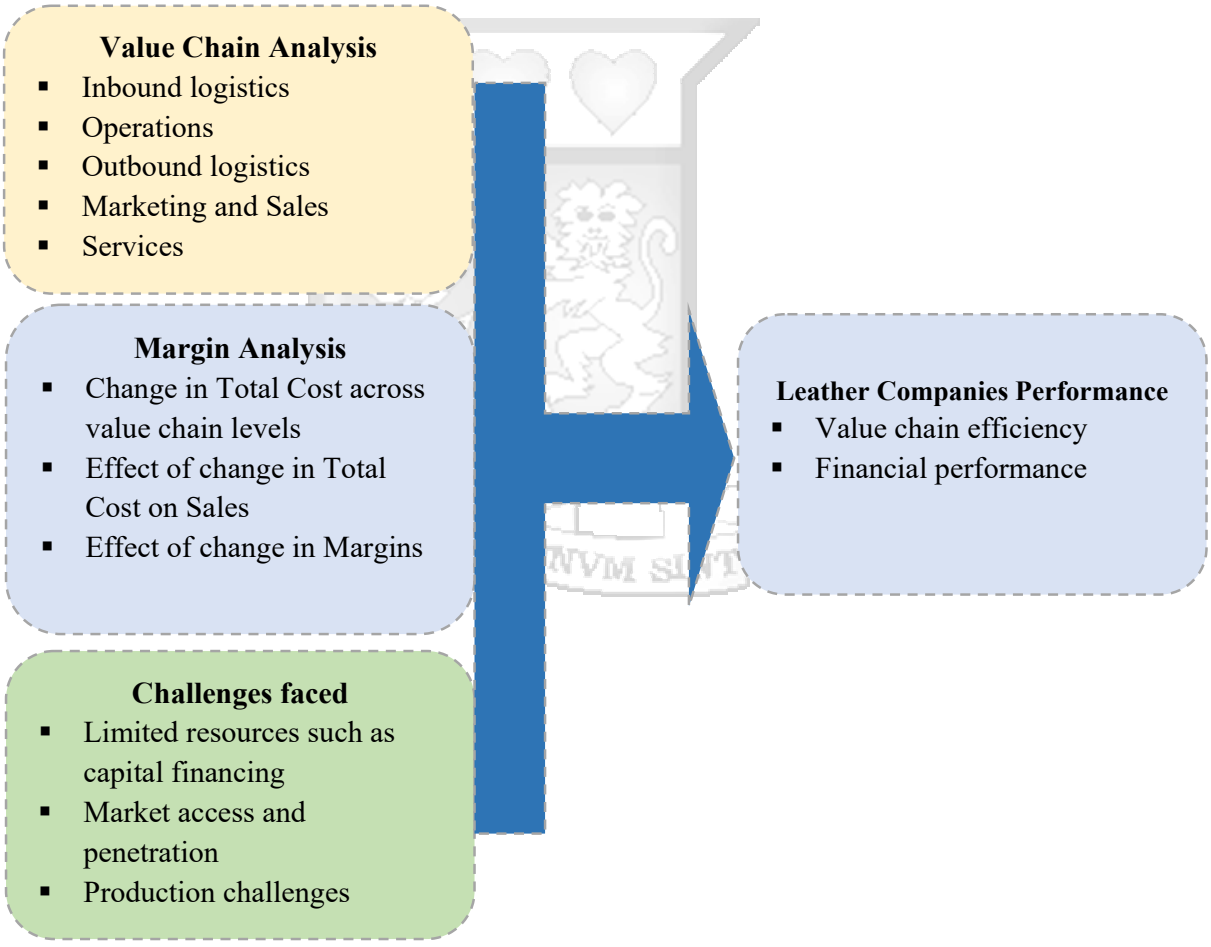
An analysis of the studies available identified gaps in empirical data in research context of leather value chains in Kenya. There is limited information available on the mapping of the leather value chains in Kenya, the margin analysis and also core challenges that affect this value chain. Information available is generic in government

policy and there is no supporting documentation to support the policy. This study sought to fill some of these gaps by mapping the value chain and evaluating performance on margins for the players in the leather value chain.

2.5 Conceptual Framework

A conceptual framework is a diagrammatical presentation of variables in a research and developed by the researcher. The relationship between the variables could either be positive or negative.

Figure 2.2 Conceptual Framework



2.5 Chapter Summary

This chapter presents the literature review on value chains and margin analysis as discussed by various authors. The major rule of the RBV is that the reason for an aggressive favorable position of a company lies fundamentally in the utilization of the bundle of profitable resources available to the firm. The Porter's Theory of value chain analysis focuses upon individual industries and extends VCA analysis by bringing in the performance angle. The behavior of costs and the potential sources of differentiation affect the margins of the firm. The activities across the value chain are meant to create additional value that exceeds the cost of conducting that activity, therefore generating a higher profit.

On the systems theory, in value chain context, systems theory brings together various components of complex supply chain (that is human, capital, information, materials and financial resources) to form a subsystem which is then a larger system of supply chain networks.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter provides a discussion of the outline of the research methodology that was used in this study. It focuses on the research design, population, sample and sampling techniques, instruments for data collection and procedures, pilot tests and data processing as well as data analysis methods used in this study.

3.2 Research Design

Research design is an important aspect to ensure that information gained in the process of collection of data is adequate in responding to the question(s) satisfactorily as possible (Creswell and Clark, 2007). Kothari (2004), argued that a good research design yields high volume of information and offers a chance to consider different features of a problem.

Research designs can be classified into two major categories, qualitative and quantitative research design. Based on the research variables, we used qualitative approaches to analyze the value chain with reference to profit margins. The study was descriptive as it provided a description of the elements within the leather value chain in Kenya in more detail. Qualitative research design was used to give the respondents an opportunity to describe what has been quantified and generalized.

3.3 Population and Sampling

Target population in research is the exact population about which data is required. According to Sekaran (2005), a population is a distinct set of individuals, services, events, and elements, households or group of things that are being studied. The study involved a census of the five (5) operating leather industries in Kenya. Currently, 14 tanneries are licensed to operate in Kenya. However, only five companies were operational and in production of leather products at the time of the study. The unit of analysis for the study was the company itself that was engaged in leather processing.

3.4 Data Collection Methods

The study utilized primary data gathered using structured questionnaires and interviews. The questionnaires were selected to promote uniformity on the way questions were asked. As indicated by Brotherton (2008), the utilization of structured questionnaires considers consistency of reactions to questions while unstructured questionnaires are open for the respondents to give reactions which the researcher has to infer using his/her own words. The questionnaire was divided into two main sections: a profile and the survey questions. The profile contained socio-demographic characteristics of the respondent while the survey questions included questions that explored each objective of the study in detail. The structured questions were in the form of open ended questions and multiple choice answers in some instances.

3.5 Data Analysis

Data analysis includes activities which are performed with the reason for outlining the gathered information and uniting them in such a way, to the point that they answer the research questions (Sekaran, 2005). The data gathered was analysed using descriptive statistics. The research also yielded quantitative data.

The filled questionnaires were checked for completeness and data analysis began once all the data had been captured by classifying, tabulating and summarizing. The quantitative data gathered from close ended questions was analysed utilizing descriptive statistics with the help of Statistical Package for Social Sciences (SPSS) version 21. The results were presented utilizing tables, frequencies and percentages. Open ended questions were analyzed using the content analysis method. Analysis involved the production and interpretation of frequencies counts and tables that describe and summarized the data. The study also applied mean and standard deviation to provide conclusions and comparisons on the variables.

Specific variables within the conceptual framework were measured as follows:

a) Analysis of value chains: Measured using the structured scale where the respondents were classified according to their function in the leather value chain. Ordinal scales were also used to provide a rank order based on their volumes of transactions along the value chain.

b) The margins at each level were calculated as follows:

1. GM = (TR – TVC)/TR*100
   Where;
   GM = Gross Profit Margin
   TR = Total Revenue
   TVC = Total Variable Cost
   TR is calculated as: TR = Q * P
   Where;
   Q = Total production in kg
   P = Price (Kshs/kg).

2. NM = (TR – TC)/TR*100
   Where;
   NM = Net Profit Margin
   TR = Total Revenue
   TC = Total Cost

It is assumed that other things held constant, members within the value chain will be in business only when they can achieve positive gross/ net margins.

According to Shiferaw et al, (2007), the variable costs include costs of premises (if leased), transport costs, chemicals for tanning, labor costs, electricity etc. The total variable costs of producing and marketing the leather products include standard production costs, marketing costs, and transaction costs. Transaction costs include costs of identifying, negotiating and concluding an exchange and may be decomposed into three types: information costs, which are the costs encountered prior to the transaction and include costs related to searching for and screening potential trading partners; negotiation costs, which include the costs of arranging the trade, drawing the terms of exchange, and reaching an agreement on exchange (including the costs of bargaining); and enforcement costs, which include the ex-post costs of monitoring and enforcing compliance with the terms of exchange, including the costs of conflict prevention, dispute settlement and mal-adaptation (Shiferaw et al, 2007)

Transactions costs could arise at the production level in the case of finding input suppliers, negotiating the terms of purchase, and verifying the quality of input and the sale price. They can also arise from asymmetric information in the process of acquiring credit and hiring labor, which requires monitoring and supervision of hired

workers. At the marketing level, transaction costs arise in the process of finding a buyer, negotiating the sale price, and verifying the quality of product and reliability of weights. These production- and market-level transaction costs are exacerbated by incomplete information, geographical spread of the abattoirs, frequency with which exchange takes place, and the degree to which the assets needed to complete the exchange are specific to the transaction. The marketing of commodities typically involves many intermediaries within the value chain: assemblers, wholesalers, retailers, and the ultimate end users (i.e., consumers). The performance of the marketing system of any commodity depends on the organization of its marketing channels. In particular, the number of players involved and the degree of coordination and information sharing within the value chain determined the marketing costs and margins (Shiferaw et al, 2007).

c) Challenges faced in the leather chain and possible solutions:

   The challenges and innovative solution platforms in the leather value chain were measured using open ended questions where the respondents were required to indicate what they feel are the most pressing challenges.

3.6 Validity and Reliability

3.6.1 Validity

Validity is used to show whether items measured what they were required to measure (Brotherton, 2008). Mugenda and Mugenda (2011) defined content validity as a measure of the extent to which data gathered using a particular instrument represent a particular domain of indicators or content of a certain subject. Content validity refers to whether an instrument provides adequate coverage of a topic. Additions and adjustments to the research instruments discussions and consultations with the administrator were done to find content validity. In this study, the researcher used content validity to find out whether the instruments responded to research questions.

The content validity of the instrument was determined in two ways. First the researcher discussed the items in the instrument with the supervisor and proceeded to interview the CEOs and senior management staff of the 5 companies dealing in leather processing in Kenya. These staff were expected to indicate a response for

every item in the questionnaire if it measures what is supposed to measure or not. The advice will include suggestions, clarifications and other inputs which will be used in making necessary changes. The average content validity Index (CVI) formula used to capture adequate and representative sets of items which will be used to tap the content will be;

Content Validity Index = Number of items declared valid

Total number of items

3.6.2 Reliability

Cooper and Schindler (2006), defined reliability as assessment of the extent to which a research instrument gives consistent findings after recurrent study trials. Other scholars define reliability as the research consistency and the extent to which a certain study may be replicated. To ensure there was a high degree of reliability, the researcher collected data personally. The researcher pre-tested the questionnaire using a sample of respondents not included in the sample to evaluate the relevance of the questions and the ease with which participants can respond to them. Reliability offers a measure of the internal homogeneity and consistency of the items encompassing the scale. The study used Cronbach's alpha formula to test reliability, with value of 0.7.

3.7 Ethical Issues in Research

The researcher exercised utmost caution while administering the data collection instruments to the respondents and ensured their rights and privacy was upheld. Prior to actual administration of the instruments, an introduction on the aim and the purpose of the study was made to the respondents in the language they best understood. The researcher sought approval from the Strathmore University Ethics Committee before the data collection exercise began and sought for NACOSTI permit before data collection.

The respondents consented to the interview before the study began. In order to maintain confidentiality, the respondents did not indicate their names on the questionnaire. The study did not use force or coercion, and a respondent was at liberty

to exit the interview at any stage. The study findings as presented are without any manipulation or influence by the researcher in any way.

CHAPTER FOUR: PRESENTATION OF RESEARCH FINDINGS

4.1 Introduction

The primary objective of this study was to analyze the value chain system in leather processing in Kenya and evaluate the profit margins within the different levels of participants in the value chain. This chapter presents the findings of the data as described in chapter three. In presenting the research data, descriptive statistics was used to establish the characteristics of the population and the data was interpreted in descriptive tables indicating frequency, percentages, mean and standard deviation.

Being that the population was made up of five companies and they all participated in the study, a census was conducted. The response rate was adequate for the study and the following findings can be considered representative of leather companies in Kenya.

4.2 Demographic Characteristics of the leather companies in Kenya

The study first sought to evaluate the demographic characteristics of the established and operational leather companies in Kenya. The variables selected were the length of time the respondents have been in the leather business, frequency of raw material purchase, type of specialty product they produce, customer base for their finished leather product their average annual revenue and expenditure.

60% of the companies have been in the leather business for between 6 years and 9 years. 40% of the companies are more than 10 years in leather business. As such, they would be considered mature business to be engaged in this study as they have gone through the cycles of challenges and successes in this business.

Table 4.2 Length of time in the leather business

	Frequency	Percentage
Less Than 1 year	0	0.0
2 - 5 years	0	0.0
6 - 9 years	3	60.0
Over 10 years	2	40.0
Total	5	100.0

Raw material purchases are done on a daily basis 30% and weekly basis 30%. This could be attributed to the delicate nature of raw hides and skins that late delivery for processing could lead to loss of quality. 12.5% raw material purchases could be done outside the common purchase window in case of demand surge from the market.

Table 4.3 Frequency of Raw Material Purchase

	Frequency	Percentage
Daily	5	31.3
Weekly	5	31.3
Fortnightly	2	12.5
Monthly	2	12.5
Other	2	12.5

As indicated in Table 4.4 below, after the raw hides and skins are processed and tanned, they can be sold off as unfinished tanned leather by 33.3% of the respondents or converted to leather bags and shoes (44.4%) or processed into clothes and leather accessories (22.2%).

Table 4.4 Specialty product lines

	Frequency	Percentage
Bags and shoes	4	44.4
Clothes and accessories	2	22.2
Unfinished tanned leather	3	33.3

The market for tanned leather varies across the different companies with 45% of the leather products being sold in Kenya. 27% of the companies exported their product to African countries while 27% of the unfinished tanned leather is sold to Europe and Asia block. None of the companies was exporting their products to the Americas as indicated in Table 4.5.

Table 4.5 Markets for Leather Products

	Percentage
Within Kenya	45.4
Africa	27.3
Americas	0.0
Europe & Asia	27.3

Majority of the companies (60%) indicated that their average annual revenues were above KES 50,000,000 confirming that they have been able to build a sound business in the years of operation. One company indicated their revenue as between KES 35,000,000 – 50,000,000. As indicated in Table 4.6, one company declined to indicate their annual revenue as shown below.

Table 4.6 Annual Revenue

	Frequency	Percentage
Less than KES 5,000,000	0	0.0
KES 5,000,000 - 20,000,000	0	0.0
KES 20,000,000 - 35,000,000	0	0.0
KES 35,000,000 - 50,000,000	1	20.0
Over KES 50,000,000	3	60.0
Did not Answer	1	20.0
Total	5	100.0

Majority of the companies have annual expenses in the range of KES 5,000,000 – 20,000,000 as per Table 4.7. Once company averages between KES 35,000,000 – 50,000,000. Similarly, one company has annual expenses above KES 50,000,000. Once company declined to indicate their annual revenue as shown below.

Table 4.7 Annual Expenses

	Frequency	Percentage
Less than KES 5,000,000	0	0.0
KES 5,000,000 - 20,000,000	2	40.0
KES 20,000,000 - 35,000,000	0	0.0
KES 35,000,000 - 50,000,000	1	20.0
Over KES 50,000,000	1	20.0
Did not Answer	1	20.0
Total	5	100.0

4.3 Analysis of the Leather Value Chain in Kenya

The first objective of the study was to analyze the leather value chains in Kenya so as to identify the participants within the value chain and their role in the industry. The variables measured were: to determine the major value chain activities, participants influencing the value chain, types of businesses, firm infrastructure, sources of credit finance, employment terms for employees, distribution systems and customer engagement.

According to data from the study, the major activities in the value chain are Tanning (26%), Leather product processing (26%) and marketing of the end products (26%). 11% of the respondents are engaged in raw hide collection directly and 11% are also involved in Storage and transport of these hides to the tanneries as shown below in Table 4.8.

Table 4.8 Leather Value Chain Activities

Activity	Frequency	Percentage
Animal rearing	0	0.0
Slaughter House	0	0.0
Raw Hide Collection Agent	2	10.5
Storage/Transport/Freight	2	10.5
Tanning	5	26.3
Leather product manufacture	5	26.3
Marketing and Sales	5	26.3
Others	0	0.0

Some value chain activities are carried out in combination. Such combined activities such as tanning, processing marketing and sales were being undertaken by 71% of the companies. From Table 4.9 below, 29% of the companies are engaged in rawhide collection and transportation. None of the respondents is in animal rearing activities or involved in slaughter house activities. None of the respondents conducts all the activities in the value chain.

Table 4.9 Cross analysis - Combination of value chain activities of participants

Activity	Frequency	Percentage
Animal rearing & slaughter	0	0.0
Raw Hide Collection Agent, Storage & Freight	2	28.6
Tanning & leather product manufacture, marketing & sales	5	71.4
All activities	0	0.0

On the question of ownership of the trading business space where these companies operate from, 60% of the participants own the premises. 40% of the participants have leased out the space from the table 4.10 below. None of the respondents owns premises affiliated to an institution or organization.

Table 4.10 Type of Ownership

Type of ownership	Frequency	Percentage
Self-owned	3	60.0
Rented/Leased	2	40.0
Organizational/institutional owned (e.g. Sacco)	0	0.0

With regard to the type of business organization of the leather industry, 63% were trading as limited liability companies and 37% were trading as sole proprietorships. The sole proprietorships were also registered as limited liability companies. None of the participants was working under partnership.

Table 4.11 Type of Business Organization

	Frequency	Percentage
Sole proprietorship	3	37.5
Partnership	0	0.0
Limited Company	5	62.5

Firm infrastructure was a varied topic as they have equipment assembled locally and some that is imported. 63% of respondents use locally assembled equipment and 37% use imported equipment as shown in Table 4.12.

Table 4.12 Sources of Firm Infrastructure

	Frequency	Percentage
Locally assembled	5	62.5
Imported equipment	3	37.5

Majorly, finance and credit in the leather industry is funded by commercial banks 50% and 50% from own sources mostly as retained earnings and ploughed back profits as per Table 4.13

Table 4.13 Sources of Finance

	Frequency	Percentage
Self-financing	5	50.0
Financial Credit Lines	5	50.0
SACCO/Chama	0	0.0
Government grants	0	0.0
Other	0	0.0

Half of the workforce (50%) worked on casual employment terms, 40% worked on permanent basis and 10% were outsourced from employment firms in rare occasions as shown in Table 4.14 below.

Table 4.14 Employment terms

	Frequency	Percentage
Full time employees	4	40.0
Casual employees	5	50.0
Outsourced from employee recruitment firms	1	10.0

Leather companies are importing 50% of their raw materials for processing raw hides and skins and using 50% locally prepared raw material as well. No raw material is issued by the government as per the Table 4.15 below.

Table 4.15 Sources of Raw material

	Frequency	Percentage
Imported Raw Materials	5	50.0
Locally prepared	5	50.0
Government distributed	0	0.0

46% of participants are directly involved in self transport and distribution of the end product. 46% of customers collect the product from these companies directly. Table 4.16 also shows that 9% of participants have outsourced transport and distribution activities.

Table 4.16 Transport and distribution of products

	Frequency	Percentage
Self-Transportation and distribution	5	45.5
Client/customer collects	5	45.5
Outsourced transportation and distribution	1	9.1

Identification of customer needs is primarily the function of the individual participant company at 56%. 22% of the participants have outsourced this function and 22% of participants do not carry out this function.

Table 4.17 Identification of customer needs and market demands

	Frequency	Percentage
Self	5	55.6
Outsourced	2	22.2
None	2	22.2

100% of the participants are involved in generating sales and processing orders from customers. This function has not been outsourced by any participant.

Table 4.18 Order generation and processing

	Frequency	Percentage
Self	5	100.0
Outsourced	0	0.0

Table 4.18 below, indicates that participants maintain 80% role in customer relations and after sales services. The function has not been outsourced. 20% participants done not carry out this activity.

Table 4.19 Customer relations and after sales service

	Frequency	Percentage
Self	4	80.0
Outsourced	0	0.0
None	1	20.0
Total	5	100

The respondents were asked to comment on whether the current participants of the value chain system in leather have improved their business through their interactions. 80% of participants indicated that their businesses had improved while another 20% did not respond to this query.

Table 4.20: Have participants in the value chain improved your business?

	Frequency	Percentage
Yes	4	80.0
No	0	0.0
Did not Respond	1	20.0

Interaction of one level with another across the value chain was regarded as an important aspect of business survival since it allows for shared platforms to compare notes, lobby government for services and policy change, share expertise, determine quality assurance standards and increase the bargaining power within the industry in light of stiff competition from external markets and substitute product imports.

4.4 Evaluation of financial performance at different levels of the Leather value chain.

The second objective of this study was to evaluate the financial performance at the different levels of the leather value chain in Kenya. This was achieved by computing Gross margins and Net margins at different levels in the value chain.

To achieve the objective, the following variables were measured using the questionnaire: Average weight and price per kilogram of raw hide purchased per month, Average weight and price per kilogram of raw hide delivered to tanneries, Monthly running costs incurred in procuring the raw material up to delivery to tannery, Percentage weight of raw hide converted to leather after tanning processes, Average price per kilogram of processed leather, Monthly costs incurred during

tanning hides into leather, Percentage conversion of tanned leather to leather products, Average price per kilogram of processed leather products and Monthly costs (incurred in producing the final leather product up to delivery to the customer).

To maintain confidentiality and protect the identity of the company participants in this study, we shall adopt a code for these companies as follows:

COMPANY	**CODE**
Company A	PP1
Company B	PP2
Company C	PP3
Company D	PP4
Company E	PP5

An analysis of the results is as below.

From Table 4.21 below, company owned brokers stationed at the slaughterhouse deliver the raw material at lower cost than not having direct brokers under the tanner's value chain. PP1, PP2 and PP5 did not have direct brokers and would buy direct from any supplier at a higher cost than PP3 and PP4.

The average price for raw material at the slaughterhouse is KES26.5 per kilogram. Average broker costs for storage and freight of raw material to the tannery is KES22.0 per kilogram. Average weight of raw material delivered to tanneries per month is 73,300.00 kilograms and average price is KES60.2 per kilogram. Average Gross Margin at this level is 83% and Net margin is 63%. 10% loss in weight of the raw hide and skins between the collection point at the slaughter house and the tannery.

Table 4.21 Margins for Brokers delivering Raw Hide to the Tannery

	Raw Material at Slaughter House		Costs for Raw Material Brokers		Delivered Raw Material to tannery			
Company	Avg Weight purchased per month	Avg Price	Avg Weight handled per month	Avg Price	Avg Weight delivered per month	Avg Price	Gross Margin	Net Margin
PP1	100,000.00	26.50	100,000.00	22.00	90,000.00	65.00	66%	25%
PP2	120,000.00	26.50	120,000.00	22.00	108,000.00	62.00	65%	22%
PP3	65,000.00	25.00	65,000.00	21.00	58,500.00	51.00	59%	10%
PP4	40,000.00	28.00	40,000.00	23.00	38,000.00	53.00	57%	4%
PP5	50,000.00	26.50	50,000.00	22.00	50,000.00	70.00	69%	31%
Mean	52,500.00	26.50	52,500.00	22.00	68,900.00	60.20	63%	18%
SD	17,677.67	2.12	17,677.67	1.41	29,129.88	8.04	0.05	0.11

After the raw material is delivered to the Tannery, it is processed to unfinished leather also called wet blue or tanned leather. The average variable cost for tanning leather is KES47.2 per kilogram. PP5 had the highest tanning variable costs at KES60.0 per kilogram. PP4 had the lowest variable costs at KES35.0 per kilogram. However, PP4 tanned the lowest weight of leather at 38,000 kilograms. PP2 had the highest weight of raw material received for tanning at 120,000 kilograms according to Table 4.21 below.

During tanning, on average 72% of the raw material is converted to tanned leather. PP3 and PP4 had a conversion rate of 60%, meaning they lost 40% of the raw material during tanning processes. The rest of the participants had a conversion rate of 80%. Tanned leather on average sells at KES162.0 per kilogram. PP5 sold at the highest price of KES205.0, PP2 at KES180.0, PP1 at KES170.0, PP3 at KES130.0 and the lowest price was in PP4 at KES125.0.

The average gross margin is 71% and net margin 33%. While gross margins were almost the same. Net margin for PP5 and PP2 were highest at 37%. PP4 had the lowest net margin of 30%.

Table 4.22 Margins for Tanned Leather

	Variable Costs for Tanning Leather			Tanned Leather			
Company	Avg Weight	Avg Price	% Weight converted to leather	Avg Weight	Avg Price	Gross Margin	Net Margin
PP1	90,000.00	51.00	80%	72,000.00	170.00	70%	32%
PP2	108,000.00	51.00	80%	86,400.00	180.00	72%	37%
PP3	58,500.00	39.00	60%	35,100.00	130.00	70%	31%
PP4	38,000.00	35.00	60%	22,800.00	125.00	72%	30%
PP5	50,000.00	60.00	80%	40,000.00	205.00	71%	37%
Mean	68,900.00	47.20	72%	51,260.00	162.00	71%	33%
SD	29,129.88	10.11	11	26,752.91	34.02	0.009	0.035

Table 4.22 above indicates the conversion of tanned leather to finished leather products. Finished leather products are the epitome of leather production process but some participants have limited function of this level. PP4 converted only 10% of tanned leather to finished product while the average was 64%. This means they prefer to sell tanned leather to other processors mostly exports. PP5 had the highest conversion rate of 95% of tanned leather.

The variable costs for finished products average KES28.4 per kilogram. PP2 had the highest variable cost price at KES45.0 and PP4 had the lowest at KES10.0.

Finished leather products fetch a premium price and the average price per kilogram was KES337.0. PP5 sold their finished products at highest cost of KES480.0 per kilogram. PP4 had the lowest price at KES225.0 per kilogram.

The average gross margin was 92% on finished products. Net margins were on average 43% with PP5 having the highest net margin at 50%.

Table 4.23 Margins for converting tanned leather to finished leather product

	Variable costs for finished leather product			Finished Leather product			
Company	Avg Weight	Avg Price	% Weight converted to finished leather product	Avg Weight	Avg Price	Gross Margin	Net Margin
PP1	80,000.00	40.00	90%	72,000.00	350.00	89%	40%
PP2	96,000.00	45.00	85%	81,600.00	380.00	88%	41%
PP3	35,100.00	12.00	40%	14,040.00	250.00	95%	43%
PP4	22,800.00	10.00	10%	2,280.00	225.00	96%	40%
PP5	40,000.00	35.00	95%	38,000.00	480.00	93%	50%
Mean	54,780.00	28.40	64%	41,584.00	337.00	92%	43%
SD	31,478.60	16.29	0.37	34,794.88	103.17	0.035	0.042

Comparatively as shown in Table 4.24, the combined activity level margins indicate that the average gross margin is 32% for combined activity. PP5 had the highest gross margin at 43%. PP4 had the lowest gross margin at 21%. The average net margin is 10% for combined activity level. PP5 returned highest net margin of 23% while PP4 retuned the lowest Net margin at 1%, a low volume processor with high costs of production.

Gross and Net Margins reduced as the value chain progressed with the participants at raw material level making the highest gross margins at 63% and 18% respectively on average. At the Tannery Level, the average gross margin and net margin was 71% and 33% respectively. The average Gross and Net margins at finished level product were higher than tannery level margins returning 92% and 43% respectively. The combined activity level analysis indicated 32% for gross margins and 10% net margins.

The finished leather product level had the highest margins and this level involves processing of the tanned leather to finished products consumed by the market such as shoes, bags and accessories. The tannery level had the second best margins and this level involves tanning of raw material skins and hides to unfished leather or wet blue leather. The raw material level had the lowest returns on margins. This level includes

brokers stationed at the slaughterhouses and collect the hides on behalf of the tanneries.

Table 4.24 Analysis of Margins at participant level

	Raw Material Level		Tannery Level		Finished Product Level		Combined Activity Level	
Company	**Gross Margin**	**Net Margin**	**Gross Margin**	**Net Margin**	**Gross Margin**	**Net Margin**	**Gross Margin**	**Net Margin**
PP1	66%	25%	70%	32%	89%	40%	33%	7%
PP2	65%	22%	72%	37%	88%	41%	36%	11%
PP3	59%	10%	70%	31%	95%	43%	28%	7%
PP4	57%	4%	72%	30%	96%	40%	21%	1%
PP5	69%	31%	71%	37%	93%	50%	43%	23%
Mean	63%	18%	71%	33%	92%	43%	32%	10%
SD	0.05	0.11	0.01	0.03	0.035	0.042	0.08	0.08

4.5 Challenges facing the Leather Value Chain in Kenya

The final objective of the study was to identify the challenges experienced by the participants in the leather value chains in Kenya and the responses could be summarized as per Table 4.24 below.

Table 4.25 Analysis of challenges facing the value chain

Challenges faced	Frequency	Percentage
Low quality raw hide & skins	5	100.0
High cost of tanning equipment and leather product manufacturing	4	80.0
Lack of trained manpower	5	100.0
Limited access to credit finance	4	80.0
Storage and transport challenges	4	80.0
Barriers to export trade	4	80.0
Competition from second hand imports	4	80.0
Access to local and export markets	5	100.0

The quality of raw hides and skins received at the tannery was considered to be of low standards across the companies with all the companies returning a positive response. Availability of trained manpower was a significant challenge within the leather value chain to be able to increase the value offering and product development for all the

participants. When asked about the ease of access to local and export markets for finished products was cited by all the participants as a major challenge for the business. The response on the high cost of equipment for tanning and leather products manufacturing was cited by 80% of the participants. 80% of the participants in the study responded regarding limited access to finance, storage and transport challenges, barriers to export markets and competition from second hand imports were observed as challenges affecting their business performance.

CHAPTER FIVE: CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter gives a summary of the study and provides insights that form the basis of conclusions and recommendations. It highlights the key findings and presents the summary of the findings of the study. The main objectives of the study were: To identify and analyze the leather value chain in Kenya; To evaluate the performance at the different levels of participants in the leather value chain in Kenya; To identify the challenges experienced across the leather value chains approach in Kenya. Cross sectional data was collected using a structured questionnaire and the target population was five participants involved in leather processing in Kenya. The summary of the findings is as presented below.

5.2 Summary and Discussion of Findings

5.2.1 Response rate and demographic data

A census was conducted and questionnaires distributed during study and the findings considered representative of leather companies in Kenya. Brotherton (2008) indicated that the utilization of structured questionnaires considers consistency of reactions to questions. The researcher indicated that unstructured questionnaires were open for the respondents to give reactions which the researcher had to infer in their own words.

Majority of the companies would be considered mature business that have gone through the cycles of challenges and successes in this business. The barriers to entry are high and this could be affecting new companies entering the space and bring in innovation and design shift. The Ministry of Industrialization and trade (Ministry of Industrialization and Enterprise Development, Republic of Kenya, 2015) has realized this as a challenge and has offered to provide the Kenya leather park to act as an incubator for the new businesses and ease the setting up of businesses.

The leather products manufactured in Kenya are not being exported to the Americas despite the AGOA window export quota being available to Kenyan manufacturers. The AGOA market is strict on quality and high volumes and as such could be the challenge for the manufacturers. Chemonics (2012) had observed that the AGOA

initiative is a major market for selected African products and Kenya is approved for Export Quota for the next 10years to America.

According to Mwinyikione and Quiesenberry (2013), a major challenge of leather processing is negative environmental impact especially for untreated industrial waste. This according to their study, was already a challenge in Chinese manufacturing and the Chinese government has taken measures to safeguard the environment in China from pollution by leather companies. To circumvent the strict policies and reduce cost of doing business, Chinese manufacturers are tapping the market in Africa for wet blue tanned leather for finished product processing only. African tanneries would still make margins from the sale of tanned leather and

Gereffi (1999) proposed industrial upgrading as a process of improving the ability of a firm to be more profitable, more technologically sophisticated and to serve more capital- and technology intensive market niches. This study found that there was a weak Government driven agenda and initiative to create a thriving leather products industry that would generate substantial spillovers to the rural economy, both in terms of direct income effects and in terms of technological learning especially to farmers and slaughter house personnel. Industrial upgrading such as training courses for tanneries and footwear producers or quality assurance labs could be a big addition especially for quality sensitive markets such as Europe and America.

5.2.2 Analysis of the Leather Value Chain in Kenya

This study found that interaction with other participants in the value chain allows for shared platforms to lobby government for services, shared expertise which is a challenge in the industry, quality assurance standards and increase the bargaining power of these companies within their industry for customers. Porter (1985) identified Policies and decisions, Linkages among activities, Interrelationships, Learning, Integration, Scale and Institutional factors as cost drivers within the value chain. The study therefore confirms that interaction across the value chain is important and would result in a managed ecosystem where costs are shared and are predictable.

The World Bank proposed that countries with manufacturing capacity should encourage Foreign Direct Investment (FDI) programs to help reduce dependence on credit finance and plough back of profits for expansion so as to reach economies of

scale faster (World Bank, 2013). This study found that leather companies operate from own premises while others have leased out the space for operations. This could mean that they are investing money in infrastructure other than improving production systems, innovation and customer engagement that could tilt the scales of profitability more significantly than brick and mortar investments would. FDI programs could potentially push technological advancement, a limiting factor within the industry as indicated from the findings of the study.

This study found that value chain players are directly involved in self transport and distribution of the finished products to the market. Outsourcing of transport and distribution activities are highly reduced in the value chain therefore, companies are incurring variable costs in performing these functions. Kokemuller (2007) observed that outsourced distribution and delivery of orders could lead to reduced delivery times, optimize inventory, improve customer relationships and thereby result in higher revenues and profit margins.

5.2.3 Financial performance at different levels of the Leather value chain

Gross and Net Margins increased as the value chain progressed with the companies involved at raw material level making the lowest gross and net margins.

The highest average gross and net margins were realized at finished product level and also had the second highest variable costs. The tannery level had the second highest margins across the value chain and this level also recorded the highest variable costs. The raw material level had the lower returns on both gross and net margins than the tannery level but had the lowest variable costs.

Combined activity analysis indicated that the combination would result in the lowest margins on gross and new margins across all value chain levels. This study differs from the study on value chain performance in the floricultural business in Kenya (Githere 2017) where the highest margins were made by participants performing all activities in the value chain as they had lowest variable costs compared to other levels of the floriculture value chain.

5.2.4 Challenges of the Leather Value Chain

The final objective of the study was to identify the challenges experienced by the participants in the leather value chains in Kenya.

The major challenge was the low quality of raw hides and skins received at the tannery due to external injuries caused on the animal during growth. Damage to the skins reflects significantly after tanning the hides resulting in rejects in the market. Slaughter houses are mostly manually operated and there is a chance of flaying of skins at the point of skinning of the animal and causing lacerations on the raw hide. Mwinyikione and Quiesenberry (2013) identified the same challenge on the quality of raw material in their study on challenges of value addition in the leather industry and proposed that farmer training should be incorporated as part of the improvements on the value chain.

Muthee (2015), in the study on integrated value chain analysis of the leather sector in Kenya, found a challenge on trained labor availability. This study found availability of trained manpower was a significant challenge for all the respondents since there is no specialized institution to learn about leather work in Kenya. The companies have to train their staff from scratch and since they are on casual employment, the training could end up being a waste of resources and time. This also comes with inferior product designs and less than average standards compared to other value chains with trained labor force.

Ease of access to local and export market was cited as a challenge by the participants and their argument was that more established leather industries in the world have significant government backing in opening up new markets abroad and protection from competition in their local markets. In the same line, Muthee (2015) observed that the integration of value chains in government policy would foster faster decision making and focused investment for governments to negotiate for markets on behalf of the value chain players was significant.

High cost of equipment required for tanning and leather products manufacturing, limited access to finance, storage and transport challenges, barriers to export markets and competition from second hand imports were raised as challenges by the respondents. On the same breath of protecting local industries from second hand imports, the Ministry of Industrialization and Enterprise Development Plan (2015)

had proposed a phased ban of second hand importation of shoes in Kenya by 2018 so as to support the local leather industry and create a market locally. This ban is yet to be implemented and second hand shoes easily find their way into Kenya.

Lambert et al (2016) observed that place utility of products drives customer satisfaction and encourages consumption which in turn drives productivity and higher margins for the manufacturer. If the activities of distribution and transport of final products could be outsourced and the real impact of such an action could improve customer satisfaction from ease of access to their product needs.

5.3 Conclusions and Recommendations

From the findings above, we could make the following conclusions:

5.3.1 Conclusions and recommendations on the Analysis of leather value chain

The leather value chain was analyzed and some of the conclusions and recommendations would include:

The value chain can be said to begin at the slaughter house where the raw skins and hides are collected for tanning. However, hides and skins are regarded as byproducts of the meat industry and as such not much emphasis is placed on the raw hides and skins as compared to meat. There would be need to pursue post slaughter processes that would enhance preservation of quality before the raw material reaches the tannery.

Being that it is a bulky product, there could be enhanced access to transport solutions that are economically viable to the industry. Such could include outsourcing of the functions to professional transport solution providers for delivery efficiency and realized cost savings.

Ownership of the business is in the form of limited companies though some are still sole proprietorships. Registered businesses should be encouraged through incentives to increase level of investment and declaration of earnings for tax purposes; a critical element in revenue generation for service provision by the government.

Employment, mostly on casual basis affects productivity as the employees are not sure they would still be engaged for work in the future. Casual labor sometimes could

be more expensive than permanent employed labor, a factor that is significant in the variable costs matrix especially at the tannery level of the value chain.

Identification of customer needs is primarily the function of the company. Participants indicated that they maintain an active role in customer relations and after sales services. These functions however were not regarded as critical for success the by manufacturers yet they could be tipping point for the value proposition in this value chain. Customer driven production, innovation and design can help capture new markets and encourage repeat purchase from existing customers.

The leather value chain lacks specialization of participants for activities involved and they are carrying out all the functions across the value chain. To improve output and maximizes on returns due to efficiencies and value proposition, specialization should be encouraged.

Incentives for export-oriented production could be encouraged with a focus on export market product orientation and placement. This would earn premium prices on the product and the new niche market and its stability would guarantee workers longer engagement for work, better remuneration and possibly improve their employment terms to permanent employment instead of casual labor.

The production of low cost value added leather that will include low-cost men's shoes, boots and school shoes for the growing population would be a good move in this value chain. This action would lower production and distribution costs while maintaining quality to compete favorably with second hand imports targeting the domestic and regional market.

5.3.2 Conclusions and Recommendations on the financial performance at different levels of the leather value chain.

The findings from the margin analysis indicate the following:

Raw material level of the value chain players had the lowest returns on margins. This level includes brokers who are stationed at the slaughterhouses and collect the hides on behalf of the tanneries.

The finished leather product level had the best margins and this included participants that processed the tanned leather to finished products consumed by the market such as shoes, bags and leather accessories.

The tannery level had the second lowest margins across the value chain as it's a cost intense production level. As such, we can conclude that finished leather products had high margins when the product was of very high quality, branded and packaged attractively and positioned for the market as a high value product. This is because that product could fetch a premium price and cover the production costs compared to a product that looks ordinary and cannot compete with a substitute product or imported second hand products.

Costing is an inevitable function across the value chain that directly impacts productivity, competitiveness and margins of profit. The costing aspect of this value chain is significant especially at the tannery level due to high labor costs, input costs, electricity costs etc. As such, companies will need to reevaluate their production costs and innovate new solutions to this element that significantly impacts their profitability.

Cost of production affects the volume of product processed. Some of the costs would be consistently high irrespective of the volume of raw material processed. Therefore, to reduce the unit cost per kilogram of processed raw material, the industry should encourage high volume processing.

5.3.3 Conclusions and recommendations on the challenges experienced across the leather value chain in Kenya

The final objective of the study was to identify the challenges experienced by the participants in the leather value chains in Kenya. We can conclude as follows:

The quality of hide depends on livestock management practices at the farm level and slaughter house level. Interventions must be put in place as this quality affects the end product pricing and customer satisfaction.

There is a big opportunity for growth in this market if the business is able to address the weaknesses and capitalize on the opportunities. Trained manpower challenges can only be resolved with investment into training colleges by the government at tertiary level.

Financing should be made available through innovative banking products for leather chain players especially on entry stage and modernization of existing equipment.

Variable costs can be financed on short term basis to promote production volumes that can compete globally.

Restricted entry of second hand leather products should be the norm. The import duty of second hand shoes is a fixed rate and not based on weight unlike for locally processed leather whose tax rate is computed based on volumetric weight, thereby becoming uncompetitive in price comparison.

Finally, an aggregator function could be introduced in the leather value chain to manage aggregation of finished products, marketing, distribution and customer engagement on behalf of the leather manufacturers. This would ease the burden of functions on the manufacturer so that they concentrate on their core mandate of leather processing.

5.3.4 Recommendation for further studies

Based on the summary of the findings, conclusions and recommendations above, there would be need for further empirical study as follows:

This study focused on leather companies registered and trading within the leather value chain around Nairobi and involved in the value chain up to the finished product level. A review and analysis should be done especially on small-scale finished leather product traders who could be part of the value chain but have not been captured.

A review of the preparedness of the Kenya Export Commodities to access new market opportunities such as market openings under the AGOA initiative as well as other favorable global markets that Kenyan products are yet to access.

It would be necessary to conduct a comparative study between Kenya and Africa leather industry players would enable the country position itself among its peers for future market growth as well as reveal weaknesses in production systems, value chain designs and investment that could be valuable to spur industry improvement.

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APPENDICES

Appendix I: Application Letter

2nd May 2019

The CEO

ABC leather Industries Ltd

Nairobi.

Dear Sir/Madam,

RE: Request to conduct interviews towards partial fulfilment of Master's Degree at Strathmore University

My name is Kennedy Karinga, a Post Graduate (Masters) student of Strathmore University and conducting a study among Leather Industry players in Kenya.

At the moment, I am conducting a study to familiarize myself with the value chains within the leather industry in Kenya and also to evaluate the profit margins realized at the different levels of the value chain.

I highly encourage that you participate in this study but the decision is voluntary. I pledge to treat whatever information you provide with a lot of confidentiality. The information you provide will not be used for any other purpose other than the objectives of this study. Please provide the information frankly and honestly.

Thank you.

Yours Sincerely

Kennedy Karinga

Appendix II: Questionnaire

SECTION A: GENERAL INFORMATION

DEMOGRAPHIC INFORMATION

1. Select the number of years the company has been dealing in leather processing?

   Less than 1 year [ ] 6 to 9 years [ ]

   2 to 5 years [ ] 10 years and above [ ]

2. What is the raw hide and skins receiving frequency?

   Daily [ ] Weekly [ ] Fortnightly [ ]

   Monthly [ ] Other_____

3. What is your specialty product?

   Bags & Shoes [ ] Clothes & Accessories [ ] Unfinished tanned leather [ ]

4. Where do you sell the finished leather product?

   Within Kenya [ ] Africa [ ] Americas ( ) Europe & Asia [ ]

5. What is the company annual revenue? _____

6. What is the company annual total expenses? _____

Section B: Value Chain analysis of leather companies in Kenya

A value chain can be defined as a set of activities that a firm operating in a specific industry performs in order to deliver a valuable product or service for the market These activities include: Inbound Logistics which involves the receiving and warehousing of raw materials plus distribution to manufacturing units as required; Operations, the processes of transforming inputs into finished products and services; Outbound Logistics involving the warehousing and distribution of finished goods; and Marketing & Sales involving identification of customer needs and order generation; and Service where the support of customers after the products and services are sold to them are provided (Porter, 1998).

7. Which activities in the leather value chain do you perform? (Tick all appropriate)

Animal rearing [ ] Slaughter House [ ] Raw Hide Collection Agent [ ]

Storage/Transport/Freight [ ] Tanning [ ] Leather Product

Manufacture [ ]Marketing and Sales [ ] Others _____

8. Have other participants in the value chain improved your trade?

Yes [ ] No [ ]

9. If yes, how? If No, why?

_____

_____

_____

_____

Answer Questions that are relevant to your role in the leather value chain

10. What is the type of ownership status of the premises where you conduct the leather trade?
    Self-owned [ ] Rented/Leased [ ] Organizational/institutional owned (e.g. SACCO) [ ]

11. What form of business organization is your leather trade?
    Sole proprietorship [ ] Partnership [ ] Limited Company [ ]

12. What type of equipment do you use in abattoirs/tanning/final production?
    Locally built and assembled [ ] Imported equipment [ ]

13. What is your major Sources of Financing for your business?
    Self-financing [ ] Financial Credit Lines [ ]
    SACCO/Chama [ ] Government grants [ ] Other _____

14. What is the source of your raw materials (hides, chemicals etc)?
    Imported materials [ ] Government distributed [ ] Locally prepared and procured [ ]

15. What is the type of employment status for employees that you work with?
    Full time employees [ ] Casual employees [ ]
    Outsourced from employee recruitment firms [ ]

16. What is the transport and distribution system for your products?
    Self-Transportation and distribution [ ] Client/customer collects [ ]
    Outsourced transportation and distribution [ ]

17. Who identifies customer needs and demand of your customer markets?
    Self [ ] Outsourced [ ]

18. Who processes sales orders and delivers the product to the customer?

Self [ ] Outsourced [ ]

19. Who takes care of customer relations and after sales services to customers?
Self [ ] Outsourced [ ]

Section C: Marginal Analysis in the Leather Value Chain

This section requires general financial information questions on your operations in the value chain. The purpose is to estimate the margins at each level in the value chain. Please indicate monthly figures to the best of your knowledge

1. Average monthly units of raw hide and skins purchased at slaughter house?

Less than 500 [ ] 501 to 1000 [ ]

1,001 to 5,000 [ ] Over 10,000 [ ]

2. What is the weight (kilograms) of raw hide purchased per month? _____
3. What is the price per kilogram of raw hide purchased? _____
4. What is the price per kilogram of raw hide delivered to tanneries? _____
5. What is the monthly cost (Labor, Packaging, Transport, Marketing) incurred in procuring the raw material up to delivery to tannery? _____
6. What percentage of raw hide is converted to leather after tanning processes?

Less than Kshs 20% [ ] 20% to 40% [ ] 40% to 60% [ ]

60% to 80% [ ] Over 80% [ ]

7. What is the average price per kilogram of processed leather? _____
8. What is the monthly cost (Labor, processing, storage, Marketing) incurred during tanning of hides into leather? _____
9. Conversion of tanned leather to leather products?

Less than Kshs 20% [ ] 20% to 40% [ ] 40% to 60% [ ]

60% to 80% [ ] Over 80% [ ]

10. Average price per kilogram of processed leather products? _____
11. What is the monthly cost (Labor, Packaging, Transport, Marketing) incurred in producing the final leather product up to delivery to the customer? _____

Section G: Challenges faced within the leather industry

a) Briefly describe some of the challenges you face in the industry that affect your overall success.

_____

_____

_____

_____

_____

b) In your opinion, what needs to be done in order of priority to resolve some of the challenges mentioned above?

_____

_____

_____

_____

_____