

CHINA FOCUS

Issue II / 2019

Sourcing: ASEAN vs China?

In this issue:

- **China Plus One in Practice**
- **From “Buy Cheap” to “Buy Well”**
- **Zalando: Sourcing in the E-Commerce Era**

The Sino-US trade war has reignited discussions about China’s future as the world’s factory. After years of cost rises, **should you replace China** as your primary sourcing market?

Two stances usually dominate the debate. One camp tends to inflate the urgency of moving out of China due to its rising costs, while the

opposing side doubts that it’s profitable, or even feasible, to find a substitute for the country’s massive and mature supply chains.

In this China Focus, we try to add nuance and depth to this conversation. We take a closer look at the advantages and bottlenecks that alternative sourcing markets in Asia offer for specific industries, and **we analyse China’s competitiveness** as a sourcing market in a world where **“buying well”** is becoming just as important as **“buying cheap”**.

It’s impossible to reach a simple verdict about China’s future dominance as a sourcing destination. A company’s specific product focus, end markets, business goals, and resources must be factored in.

But, among the brand owners, traders, and buying offices whom we work with, those who

are doing well have three things in common:

1. They actively explore a **“China plus one”** strategy, even if they have decided not to pursue it in the short to mid-term.
2. They know that sourcing from China does not mean **“business as usual”**, so they’re making their supply chains more **flexible**.
3. They prioritise **sustainability**, and see it as a value driver rather than just a cost burden.

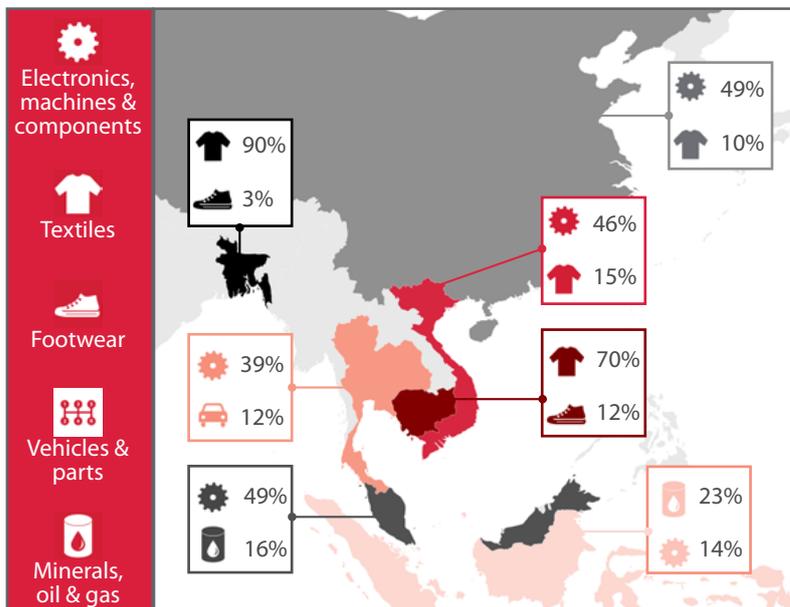
We hope that, through our insights and support, we can help you figure out not just *whether* to continue sourcing from China, but also *how* to do so in a more profitable, future-ready way. 🌱



CHINA PLUS ONE IN PRACTICE

The **cost advantage** that turned China into the world’s factory has declined over the last decade. Labour costs, which were one-tenth of those in the US in 2005, are now about one-third. This, combined with rising indirect costs, environmental regulations and, more recently, the Sino-US trade war, has prompted global companies and their suppliers to **look for cheaper alternatives**. The shift has helped lower-wage Asian countries to grow their manufacturing capacity and exports, **especially in labour-intensive sectors** such as textile, footwear and electronics (see below). Between 2010-17, for instance, China’s share of US apparel imports fell steadily from 40% to 33%, while Vietnam’s share more than doubled. *(Continued on next page.)*

TOP EXPORTS BY COUNTRY (2017)



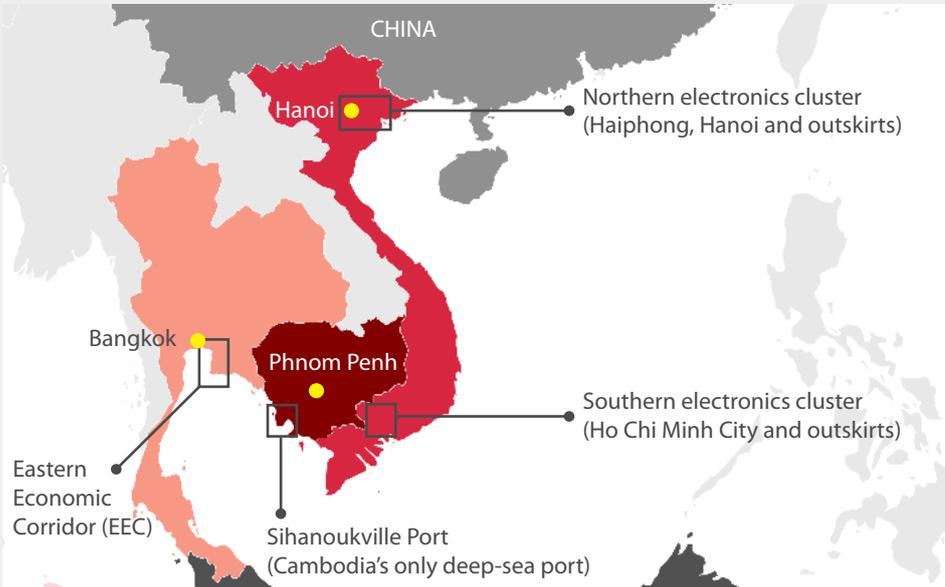
MONTHLY MINIMUM WAGES BY COUNTRY

Country	Local Currency	USD
China	CNY 1,000 - 2,420	149 - 361
Indonesia	IDR 1,571,000 - 3,940,973	112 - 280
Thailand	THB 8,008 - 8,580	252 - 270
Malaysia	RM 1,100	264
Cambodia	(set in USD)	182
Vietnam	VND 2,920,000 - 4,180,000	125 - 179
Bangladesh	BDT 8,000	95

Notes: - April 18th, 2019 FX rates
 - China, Indonesia, Thailand, Vietnam: min. wages vary by region
 - Thailand: monthly min. wage calculated based on statutory daily min. wage
 - Cambodia: statutory min. wage applies for textile and footwear workers only
Sources: Observatory of Economic Complexity (UN COMTRADE), Fiducia analysis

CONTINUED ON NEXT PAGE ▶▶▶

But rather than a large-scale, cross-industry migration of global supply chains out of China, what we're seeing are small-scale, industry-specific shifts. Most companies are looking to **complement, rather than replace**, their China sourcing. Beyond cheaper labour, decision-makers must consider the broader **competitive advantages** of each location, how they match their industry focus and business goals, and whether there are **bottlenecks** that could offset those opportunities. Below, we zoom in on three countries: Cambodia, a popular alternative for apparel and footwear, Thailand, a strong player in the automotive sector, and Vietnam, which has the most diverse manufacturing base in South-East Asia (SEA).



Labour costs are rising most rapidly in smaller, lower cost countries, so the gap with China is narrowing.

- Ben Simpfendorfer, Founder and CEO, Silk Roads Associates

THAILAND

CAMBODIA

VIETNAM

Key Exports

- ▶ **Machinery including computers and chips:** complex manufactured goods make up almost half of Thai exports
- ▶ **Vehicles and car parts:** self-nicknamed the "Detroit of Asia", Thailand is the largest automotive manufacturer in SEA
- ▶ **Apparel:** textile products make up 70% of exports. Over 60% of garment factories are located around Phnom Penh
- ▶ **Footwear and leather accessories:** footwear exports rose 25% in 2017, while apparel exports grew just 8%
- ▶ **Electronics:** Vietnam is the world's second largest exporter of smartphones
- ▶ **Apparel:** Vietnam is the #2 source country for garment imports in the US, but the EU imports more from China, Bangladesh, Turkey, India, and Cambodia

Examples



- ▶ Both **BMW** and **Mercedes-Benz** produce cars in Thailand and will start producing EV batteries for local demand and export
- ▶ In 2018, **Adidas Group** sourced 1/4 of its apparel from Cambodia, replacing China as its top source country for garments
- ▶ Since 2009, **Samsung** has shifted most of its production to Vietnam, taking key suppliers with it. The company accounts for 1/4 of Vietnam's exports

Advantages

- ▶ **Consistent economic policy:** e.g., "Thailand 4.0", a well-defined industrial upgrading plan, and a US\$45b project to boost infrastructure in the EEC
- ▶ **Good logistics networks:** ranks highest among SEA nations (except Singapore) in the World Bank's logistics index
- ▶ **Low labour costs:** average labour costs are 1/4 of China's, according to Oxford Economics
- ▶ **Special trade status:** duty-free status applies to all Cambodian imports to the EU (except weapons) and certain imports to the US (e.g. handbags and wallets)
- ▶ **Proximity to China:** land and sea connectivity to neighbouring China facilitates integration with your existing Chinese supply chain
- ▶ **Trade agreements:** a free trade agreement with the EU is expected to become effective this year

Bottlenecks

- ▶ **Labour market:** Thailand has relatively high labour costs, the fastest ageing population in SEA, and 45% of its workforce is unskilled
- ▶ **Political instability:** uncertainty continues even after the country held its first elections since the 2014 military coup
- ▶ **Ease of doing business:** it takes 99 days to start a business in Cambodia according to the World Bank, only slower than in Laos and Venezuela
- ▶ **Threat of trade sanctions:** after the country's flawed 2018 elections, the EU is reviewing to revoke its duty-free status
- ▶ **Reliance on imported inputs:** 70-80% of fabrics used to make clothing are imported, mainly from China, and the case is similar for electronic products
- ▶ **Fast-rising costs:** the cost of land, labour, electricity, and building materials are rising quickly as capacity improvements are failing to keep pace with growth 🚫

CHINA'S SOURCING ADVANTAGES

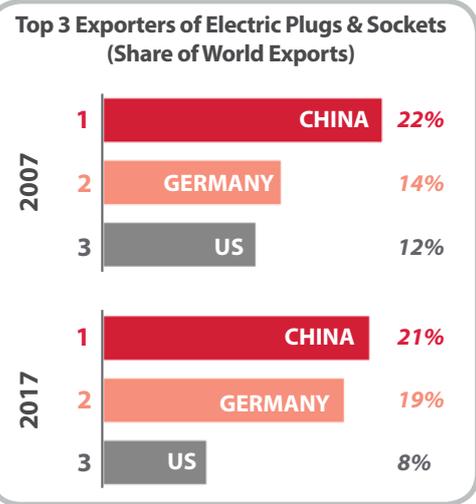
From "Buy Cheap" to "Buy Well"

That China remains a manufacturing powerhouse despite its rising costs shouldn't be surprising. Sourcing is more than just chasing cheap costs, and this statement is only becoming truer. Competitiveness is increasingly driven by other considerations. While China may not be the cheap sourcing paradise it once was, it has gained an edge by enabling faster, better supply chains.

SPEED

E-commerce and the internet have accelerated the pace at which trends spread and vanish, and the rate at which products are copied, turning speed-to-market into a rising priority. China's **integrated supply chains** are a key advantage when it comes to fast-tracking your supply chain. Its production ecosystems offer a hard-to-match concentration of input suppliers, assembly factories, skilled workers, and service providers — all at a massive scale and for a broad range of low-tech, mid-tech, and even high-tech products.

According to a European Commission report, China adds 76% of the value of the goods it exports on average (close to the EU's 87%) which shows how little it depends on imported inputs. This explains why the production of goods requiring several components, such as electrical ones, has largely remained in China.



REACTIVITY

Speed alone is not desirable if you're just getting faster at sourcing the wrong goods. To unlock profitability, what counts is reacting quickly to consumers' preferences, e.g., making your purchasing and production more demand-led to minimise inventory problems and maximise your return on investment. Thanks to its manufacturing maturity, it's easier



to find suppliers who offer **agile production setups** and smaller batch-sizes in China than in other low-cost countries (see page 4).

Another option for unlocking agility is near-shoring: bringing production geographically closer to end-consumers. Until now, this has meant moving out of China and closer to Europe or the US. But the world's consumption epicentre is shifting to the East. By 2025, 40% of apparel sales will take place in Asia, according to McKinsey. More and more companies will thus see **China as a near-shoring, rather than an off-shoring, location.**

SUSTAINABILITY

Consumers' growing demands for ethically made goods, and the internet's power to make or break a brand's reputation overnight, are turning social and environmental responsibility into an imperative for sourcing teams.

China's mature exports industry makes it relatively easy to find inspection agencies and suppliers **experienced in meeting international compliance standards.** However, corruption among inspectors and factories is still a widespread challenge, and when it comes to social responsibility, improvements in China have been limited. Unlike in Vietnam, Indonesia and other countries, Chinese workers don't have the right to strike to demand better labour conditions.

But on the environmental front, China is making headway. Since 2017, the **government's anti-pollution crackdown** has boosted investment in green tech and has driven out thousands of highly polluting players. Beijing alone has shut down or relocated close to 2,500 manufacturers. This green shift has, of course, caused supply chain disruptions. But it is also turning China into a competitive destination for sustainable production and sourcing.

COST-VALUE

Even as other considerations gain relevance, finding good value at a reasonable cost remains a sourcing priority. China is at a stage

where rising productivity and quality gains are high enough to partly offset the effects of its rising labour, property, and compliance costs.

Fast-paced automation is a key driver behind China's rising productivity. In 2011, US carmakers deployed three times as many industrial robots as Chinese factories, but China reached parity in just five years, according to a Boston Consulting Group report.

Government-led investment in skills, infrastructure, and industrial upgrading has also contributed to China's efficiency gains. Improvements have concentrated in China's coastal regions, but this is changing. Since 2012, the government has pumped US\$550b into transportation and utilities in western provinces, and boosted incentives for factories to "go west". Sichuan already produces 1/5 of Chinese-made computers and Chongqing is becoming an important tech and automotive hub. **China's interior** is emerging as a lower cost, efficient alternative for manufacturing.

Until a decade ago, China was the place to be for sourcing teams eager to "buy cheap"; now, it offers growing opportunities to those looking to "buy well".

3 KEY QUESTIONS FOR LEADERS

1. Do you have a differentiated sourcing strategy for assortments where speed is more/less crucial?
2. Are you leveraging your sales data to drive demand-led planning and buying?
3. Are you collaborating effectively with your suppliers to drive agility and sustainability improvements?

Fiducia supports sourcing teams with strategy advice, supplier management, tailored ERP solutions, and other outsourced services to help take their China-based supply chain to the next level.

CHINA SOURCING IN THE E-COMMERCE ERA



What better way of testing the future-readiness of China as a sourcing market than through the eyes of a forward-looking online retailer? **Zalando**, Europe's leading e-commerce platform for fashion, sources private label products from factories in the Far East through a team of merchandisers, quality control, testing, and ethical trade professionals located in Hong Kong, Dongguan, and Hangzhou. **Matthias Hurler, Sourcing Director Far East**, explains why sourcing from China will continue to make sense in the foreseeable future, particularly in his main area of expertise: footwear.

Is China still the go-to sourcing market for fashion?

It all depends on the product. For **synthetic shoes**, I believe China will still be a **relevant** player in the next 10 years. If you produce in Cambodia or Myanmar, of course labour costs will be cheaper but you would have to import most materials, especially PU, from China. So your margin per unit might seem more attractive at first, but you sacrifice flexibility and speed to produce a smaller amount because it takes time to get the materials and shoe components in.

Is speed becoming a more important consideration than cost?

Nowadays, you need to react to fast-changing trends and refresh your stores on a regular basis, so yes flexibility and speed are more important than ever. The **traditional approach** of buying seasonal and focusing on buying larger quantities to achieve higher input margins **doesn't work anymore**.

At Zalando, we're focusing a lot on lowering our stock risk. Instead of buying 1,000 pairs of shoes, you buy 500, test them, and if they sell you react quickly. This enables **better sell-through rates**, so even if your initial cost-price calculation didn't look so bright, you end up with **less waste and better profitability**.

Zalando is an online-first player. Does this give you a speed advantage?

Having access to massive amounts of data definitely helps. 26 million active customers shop daily on our platform, and we get to see how they're reacting to the products of 2,000-3,000 brands.

But essentially, it's about a **mindset shift**. The concept of lowering your stock risk by improving your demand forecasting, and feeding this into your supply chain, is just as relevant for a traditional brick and mortar store. And they have the necessary sales data too; you don't need the fanciest systems.

What about technology on the production side - what improvements are you driving?

We're looking into **3D design** to reduce our reliance on making physical samples, which is time-consuming for shoes. Traditionally you create a design, then based on it you make flat paper patterns, which you then cut to make a prototype. With 3D design, you can create the model in the system, which "flattens" the design for you automatically so that you can send it to the cutting machine and go straight into production.

We also work constantly with our suppliers to help them adopt new ways of production.

Within our factory base, many are investing in **automation** and I would say 10% are switching from traditional, long production lines to faster and more **flexible setups**. Suppliers are realising that order quantities are not as big as they used to be so it makes sense to scale down on the number of workers and keep production flexible.

Finding suppliers with fast, flexible approaches in countries like Vietnam and Cambodia is harder. Factories there often have higher minimum quantities, or higher prices than China for lower quantities.

Besides agility, is sustainability becoming more of a priority?

Certainly, especially in Europe. It's a strong topic and consumers are often willing to pay a premium for it. Rather than having certain eco-friendly brands in our assortment, we are shifting our focus towards improving sustainability across all labels.

The challenge is not just how to manage the **cost of sustainability**, but also how you define it. For apparel it's somewhat easier: you focus on more eco-friendly fabrics such as organic cotton. For shoes, you have more components to consider, so it's more complex. We're working on defining sustainability and investigating how we can work together with suppliers to drive improvements.

Amid all this disruption in the retail world, is the purpose of sourcing teams changing?

Sourcing teams nowadays have the crucial **role of steering changes on the factory side** through effective relationships. For instance, the initiative to invest in flexible approaches rarely comes from suppliers themselves. We often have to drive this process, making them aware of market changes and connecting them with key stakeholders, such as technology providers. We also play an active role in enhancing environmental and social responsibility. Your supplier needs to trust you and know that your business is stable, before you can ask them to improve how they feed their workers, for example. ☘

Beijing

Room 10, 11/F,
The Exchange Beijing,
118B Jianguo Road,
Beijing 100022, China
Tel: +86 8523 6308

Hong Kong

15/F OTB Building,
160 Gloucester Road,
Wanchai, Hong Kong
China
Tel: +852 2523 2171

Shanghai

Unit 604-605, Central Plaza,
227 Huangpi North Road,
Shanghai 200003
China
Tel: +86 21 6389 8288

Shenzhen

1308 Di Wang Commercial Centre
5002 Shen Nan Dong Road
Shenzhen 518008
China
Tel: +86 755 8329 2303