Business Trends & Corporate Strategies

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Made in China: Sourcing in the "New Normal"

Chinese premier Li Keqiang signaled that China has entered the era of a "new normal". This changing reality also applies to sourcing due to trends such as increasing labour costs, higher prices, and the availability of more sophisticated suppliers. For most, it still makes sense to source from China due to its mature infrastructure networks and scale of production. But the country will only remain one of the most important sourcing locations if its political, social, and economic environment remains stable.

To address this pertinent topic, we bring you this China Focus dedicated to sourcing trends in China. We interview Veit Geise of VF on his views. Next, we give you some advice on measures you can implement to make the most of this "new normal". Lastly, we provide some insight on changes in bank account opening procedures and what it means for you.

Stefan Kracht

In this Issue:

Finding the Right Balance

VF is a USD 12 billion apparel and footwear powerhouse, with an incredibly diverse, international portfolio of brands and products, including The North Face, Nautica, Timberland, Vans, and more. VF has sourcing relationships with more than 1,000 product manufacturing facilities in Asia-Pacific region countries, including China, Bangladesh, Vietnam, Indonesia, Thailand, Cambodia, Pakistan, and India.

China Focus interviews Veit Geise, VP Sourcing of VF, on his opinion of China as a sourcing destination and what trends and challenges to expect when operating there.

How important is China for you compared to other production countries?

This largely depends on the brands and whether we are looking at export or at China-for-China business. Price-sensitive brands continue to move or have already moved their activities to other countries several years ago, while very technical brands with a complicated outerwear segment, for example, still depend on China to a large extend. Growing sales & marketing activities in China continue to result in an increase of the China-for-China volume, which compensates for a loss of export volume. China, therefore, will continue to be one of the most important sourcing destinations in the future.

What factors do you consider when deciding to stay or move your production location?

This, too, depends on the brands that you are looking at. A price-sensitive business will react very fast to labour cost increases or a change in the geopolitical environment. The more technical a brand is, the less you will be inclined to move volumes to other areas for small incentives. A supplier who understands the complexity and DNA of a technically complex brand, is worth a lot more than saving a few pennies by moving countries. Nonetheless, depending on the product, a supplier's readiness to react and adapt to changes is critical.

Is price the only factor for your customers?

Definitely not, although it is clearly a driver for making sourcing decisions. Gross margin pressure will not become less in the future, and with inflation at the sourcing locations and little chances to increase retail prices in general, the price pressure will not go away. It is the right balance and mix that you need to find and manage for each brand individually.

What are the challenges you face now in China and beyond? How do you overcome them?

The sourcing business has become much more complex over the past years, and we can anticipate even more complexity in the years to come. Today we require a much greater level of transparency from our factories than we have done in the past. CSR requirements, as well as responsible sourcing, have become very important factors in a relationship. The only way to build successful alliances in the future is an even closer partnership between the buyer and the seller. We will continue to see a further decline of purely transactional business.

Chinese factories are under ever increasing price pressure, and I believe this will continue to create challenges for every buyer to find the required level of transparency within the

VF has a diversified portfolio of powerful, global brands, including Wrangler.

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- Veit Geise, VF Corporation

Profile

Veit Geise
Vice President Sourcing
VF Asia Ltd.

Veit Geise joined VF Corporation in 2007 and is responsible for the sourcing divisions of Lee, Rock & Republic and Wrangler, Workwear, Sports Licensing (MLB, Harley Davidson, NFL, Nascar), as well as the brands Nautica and Napapijri. Besides his responsibilities in VF Corporation, Geise is also actively involved in GAFTI (Global Apparel, Footwear and Textile Initiative), where he co-chairs a committee about Social Compliance Audits, Training, and Certification.

sourcing landscape. Frequent changes within your supplier matrix will result in failures and problems with regards to CSR, and factory and product safety.

What sourcing trends do you foresee for China and globally for VF?
Currency fluctuations create opportunities and risks. Obviously we are keeping a close eye on the respective currencies and react to changes or opportunities that arise from fluctuations. The current Euro weakness definitely creates opportunities for European markets to gain traction, while Asian countries will come under further increased price pressure. We have recently heard much more about Africa as a sourcing destination. While we are already sourcing from some of the East African countries, we are watching further developments there very closely.

What differences have you come across running your operations in China vs. other locations?
The largest difference when sourcing from China is the transparency of the supply chain, or lack thereof. China has, more than other markets, a very active trading and subcontracting base, which needs to be tightly controlled in order to conduct business there responsibly and successfully. With that under control, sourcing from China is much easier in many aspects, as the availability of fabrics, trims, and decorative items is vast and easily accessible. This makes the whole development and production process much faster and simpler.

How competitive is China compared to other sourcing locations?
For the more basic items, China as a sourcing location is becoming increasingly difficult to maintain. Although Chinese factories tend to run at higher efficiencies compared to other markets, the labour cost is too high to allow basic items to still be sourced from China. As mentioned earlier, if your items are more technical or complex, the know-how of Chinese factories is unsurpassed in many areas. This helps China remain competitive, although the true CM component is higher than in other markets.

What is the future of the Hong Kong buying office?
Hong Kong will remain the sourcing hub for any Asia-wide sourcing activity in the mid-term. It is centrally located and provides a wide spectrum of talent and expertise in various areas of the sourcing business.

Adjusting to the "New Normal"

The sourcing landscape in China has fundamentally changed due to recent global and domestic trends. Once considered the workshop of the world, the Chinese economy successfully managed the transition to a more advanced stage of development. Many call it the "new normal": higher wages and a strong RMB have driven up production costs, while global demand is down. But the outlook is not bad: wage increases have fuelled investment in more efficient production. While only 5 years ago some buyers' sentiments about China were rather negative, in 2015 things are not quite that bleak. On the contrary, China offers relative political and social stability and mature suppliers, especially compared to its Southeast Asian neighbours.

As everyone adjusts to the "new normal" in China, there are a number of new concerns for foreign companies sourcing from here, especially when it comes to pricing and securing timely deliveries. Nonetheless, China will remain an attractive sourcing country for many of Fiducia's clients in consumer industries due to its massive production capacities, mature supply chain of materials and technologies, and sophisticated infrastructure. Chinese manufacturers offer a wide range of quality levels and large assortment of products with several decades of experience, which cannot be taken for granted in this region. While some companies are increasingly considering a multi-country sourcing strategy, China will remain a key sourcing location, especially for those who seek a reliable and stable supply chain.

Changing Expectations

Due to the rapid depreciation of the Euro in recent months, many of our clients' European customers are asking for discounts in order to adjust to the unexpectedly more expensive prices. However, production is increasingly costly as well, leaving many companies in an awkward position. Many have adopted a wait-and-see approach, waiting for the first retailer to ultimately increase prices, triggering a reaction from others facing similar cost increases. Others have explored various ways to alleviate the cost pressures, especially as these increased costs are not equally shared among Chinese suppliers. Most of these will accept not to increase their prices or only implement smaller increases, while a select few will even accept cutting prices. In our experience, most manufacturers are aware of the cost pressures of their customers and are willing to lower their own margin expectation.

How can I cope with this?

Companies should examine various elements in their supplier relationship and collaborate with them to build trust, obtain better prices, and secure production priority. Fiducia has actively supported clients in implementing new sourcing strategies, as the ones below:

Financial measures: as the RMB grows stronger, some of our clients have protected themselves from unexpected or dramatic changes in currency exchange rates with currency hedging. Others have switched to RMB payments and reported a 3-5% price reduction. In addition, companies can help key suppliers improve their cash flow by offering shorter payment terms and higher advance payments in return for some price concessions.

Supplier partnership: companies should seek out "best-fit" suppliers who will assign a high priority for their orders. In today's China, established suppliers are equally as selective of their customers as their customers are toward them. Some of our clients have incurred losses in revenues and reputation due to ill-selected suppliers, who over-promised and gave priority to other customers during peak production seasons. In addition, companies should maintain a longer-view in the supplier relationship and gauge if the manufacturer is committed to investing further in its production capabilities. Many Chinese entrepreneurs have lost interest in manufacturing and instead pursue higher and quicker returns in real estate and other investments. For a good working partnership, companies should explore ways to help their suppliers become more efficient, for instance by collaborating with them on helping them best utilise their resources and minimise rush orders.

Strategy assessment: in the past, smaller manufacturers were inexperienced in foreign trade and many companies still purchased via trading companies. Times have changed and today most manufacturers are capable of communicating and working with foreign buyers directly. Going straight to manufacturers and cutting out middlemen who do not add distinct value could bring substantial cost savings. To provide incentives for lower prices, companies may consider consolidating their orders to a few key suppliers and renegotiating purchase contracts by offering bulk orders.

As the global sourcing landscape continues to evolve, companies are increasingly organising their sourcing activities strategically across countries. For instance, some of our clients have relocated part of their less labour-intensive, low-scale production to Eastern Europe. Other clients have moved their footwear and garment production to Vietnam, Bangladesh, and other Asian locations. However, for specific sectors a fully integrated supply chain with high capacity and lower costs only exists in China. Our clients producing toys, electronics, home improvement products, and technical textiles, for instance, have not extended their supply chain beyond China. Most Fiducia clients have used the Hong Kong platform for trading with other countries within the region.

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What is the Chinese government doing to help exporters?

As Premier Li said, "China has many tools available in its policy toolbox." One primary instrument China often uses to influence exports is the VAT-rebate policy. As the country faces downward pressure on its economy and slack export demand, the Chinese administration may yet again adjust the VAT rebate rates for some of the industries to encourage exports. The latest example was the increase of VAT rebate from 16% to 17% for selected textile products, making it a full rebate.

The internationalisation of the RMB will continue to facilitate cross-border trade with China, especially with its regional neighbours. An internationally accepted RMB offers substantial opportunities and convenience for both Chinese exporters and foreign buyers in trade and investment.

China has so far signed and implemented 12 Free Trade Agreements, with another 20 in the pipeline. The FTAs with trading partners like Switzerland and ASEAN will improve competitiveness of Chinese manufacturers in these markets. Many of our clients have also expanded within ASEAN and we have supported them by finding the right talent to run their operations.

Another policy tool to improve trade opportunities for foreign companies and facilitate customs is the nationwide setup of free trade zones. Besides the launch of the Shanghai Pilot Free Trade Zone in 2013, the government plans the establishment of three additional Free Trade Zones in Guangdong, Fujian and Tianjin.

How Fiducia Can Help

Are you looking to expand your sourcing activities in China? Fiducia's Trade Solutions is your one-stop supply chain answer:

Core Solutions:
- Supplier Management
- Order Processing
- Logistics Coordination & Documentation
- Import / Export Operations
- Trade Finance Handling
- Order-to-Cash (OTC) Electronic Platform

Value-Added Support:
- Advice on Market Entry
- E-Commerce Solutions
- Trade Fair & Showroom Support
- Sourcing and Merchandising
- Inspection and Factory Audit
- Testing & Product Registration

For questions on realising your sourcing strategy in Greater China, email us at contact@fiducia-china.com.

Update: Bank Account Opening Hong Kong

With the many recent banking scandals and tightened financial regulations put in place by international organisations such as the OECD, Hong Kong has implemented its own set of new measures in order to comply with global standards. Especially when it comes to Anti-Money Laundering (AML) legislation, the Hong Kong government has put stricter rules in place to reinforce its reputation as an international financial centre. These changes are particularly visible in corporate bank account opening procedures, which in the past were relatively hassle-free. Now, banks aim to protect themselves from potentially hefty fines by making it much more difficult to open an account. Indeed, while in previous years it was assumed that an opening application would go through, now this cannot be taken for granted any longer. Banks will conduct strict Due Diligence and Know-Your-Client investigations in order to comply with AML requirements.

Background

In 2012, HSBC and Standard Chartered Bank were fined substantial financial penalties for violations of United States laws regarding AML practices and suspicious activity reporting. As a result, the Hong Kong government imposed tightened regulatory supervision when it comes to money laundering and compliance policies. The aim is to accomplish a good rating with the Financial Action Task Force, an international body established to police money laundering on a global level, by 2016. Nowadays, for corporate bank account openings, most major banks require much more documentation and information on the company's background. HSBC, for example, has been very strict on the process, requiring clients to prove their business operations by providing invoices or contracts as supporting documents. For Standard Chartered Bank, it may not be possible to open a bank account if the company does not have a physical office space in Hong Kong.

Importance

When it comes to sourcing, Hong Kong is still a highly strategic location for many international companies. For one, its proximity to suppliers around Asia coupled with efficient logistics allow for a smooth supply chain unparalleled by other cities within the region. In addition, Hong Kong's international business environment, low and simple tax system, and large pool of skilled professionals certainly give it an edge not only for sourcing, but setting up a business in general.

These bank account regulations have also become part of the "new normal" - but don't let this stop you. With proper preparation, you can increase the likelihood of your bank account being opened. It may seem daunting but we can help you along the way and ensure as few headaches as possible.

Preparation

There have been no official guidelines or checklists that will assure the opening of a bank account. However, there are a few "rules of thumb" that you can follow that can facilitate the process. Please note, these are recommendations only and do not guarantee that your bank account application will go through.

- **Proof of business:** includes documents showing that your business is truly operational, such as contracts with suppliers or customers, sales invoices, or order confirmations, for example.
- **Proof of residential address:** can be in the form of utility bills or bank statements issued within 3 months, from the directors, owners, and any other bank signatories.
- **Transaction records:** revenue of parent company and number of orders.
- **Details of ultimate beneficiaries:** organisational charts thoroughly outlining the company's ownership structure.
- **Office space:** for certain banks, companies must rent an office space in Hong Kong.
- **Shareholder physical proof:** some banks require that owners with more than 10% shareholding in the company must appear physically in person at the bank.
- **Corporate documents:** such as your business registration and certificate of incorporation.

With over 30 years of sourcing and corporate service experience, Fiducia can help you with your bank account application. Email us at contact@fiducia-china.com.

What about China?

Opening a corporate bank account in China is an even more complex procedure. Among the many requirements are a list of 6 documents that must be signed by various people, another 9 items that relate to business activities, and finally 2-4 application forms depending on the type of account you are opening. We recommend that you find a professional advisor who can help you complete the necessary documentation.

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Editor & contact for press and article reprints:
contact@fiducia-china.com

Please contact us for a list of sources.

Hong Kong Office:
15/F OTB Building,
160 Gloucester Road,
Wanchai, Hong Kong
China

Tel: +852 2523 2171

Shanghai Office:
Unit 2107-2110, Central Plaza,
227 Huangpi North Road,
Shanghai 200003
China

Tel: +86 21 6327 9118

Shenzhen Office:
1308 Di Wang Commercial Centre
5002 Shen Nan Dong Road
Shenzhen 518008
China

Tel: +86 755 8329 2303