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China Plus One

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For the last 20 years, many Western companies have invested in China, drawn by its low production costs and enormous domestic consumer market. But in recent years, the cost advantage has diminished, while other business challenges have emerged. As a result, many companies are looking to exploit opportunities in other growing Asian markets both to hold down costs and to reduce overdependence on China.

THE PROBLEM — A MATURING ECONOMY, RISING WAGES AND DISAPPEARING TAX INCENTIVES

Over the past few decades, global corporations have been entering China to open factories and launch businesses in the services industries. This was motivated by an eagerness to access a booming Chinese market while taking advantage of relatively low production costs and wages.

Initially, Western companies had their doubts about doing business in what they saw as a risky operating environment. But over the years, China has taken action to address many of the issues that concerned Western companies the most. High-profile arrests have been made by Chinese authorities to show they are serious about cracking down on corruption and intellectual property theft. They also have stepped up monitoring of exports in certain sectors to discourage counterfeiting and to improve the quality of exported toys, clothing, footwear, accessories, appliances and furniture.

These actions helped the Chinese economy expand to become the second-largest economy in the world (smaller only than the U.S. economy). But as the Chinese economy has matured, some of the advantages that proved so alluring to Western companies have diminished. For instance, China no longer ranks as one of the cheapest labor markets in Asia. A shortage of qualified workers has led to wage inflation; 10% in 2012 according to Standard Chartered. During the coming years, forecasts suggest that Chinese labor shortages could grow, in part, as a result of China's policy permitting families to have no more than one child each.

In addition, some of the most meaningful tax incentives for Western companies have been eliminated. Since 2009, most of the tax privileges that foreign invested enterprises formerly enjoyed have expired. Although it still is possible to obtain tax incentives in certain industries (e.g., the high tech sector) and regions, the process of obtaining these incentives has become more difficult to navigate. Meanwhile, despite some progress, there remain concerns about other areas. Enforcement of intellectual property rights is inconsistent; there is growing fear of reprisals for business decisions against Chinese interests; there are occasional public protests such as the recent flare-up of anti-Japan sentiment that caused widespread disruption to Japanese businesses; and there is an increased frequency of labor disputes.

THE SOLUTION — DIVE DEEPER AND/OR BRANCH OUT

To hold the line on the cost of doing business in China, some multinational companies are opening new facilities in China's interior, where wages continue to be lower than those on the coast. For example, consumer packaged goods giant Unilever has moved some of its manufacturing facilities for products such as laundry powder and tea to Anhui, a traditionally agricultural province located 270 miles up the Yangtze River from Shanghai. Computer maker Hewlett-Packard (HP) has taken the same approach, spending $3 billion on a laptop factory in Chongqing, a city in the southwest part of the country. And HP announced in April 2012 that it would add a printer factory in Chongqing. Still, while moving to the Chinese interior may help alleviate wage pressures, there is a tradeoff. It takes longer and costs more to ship products from the Chinese heartland to overseas markets. For companies such as Unilever selling to the domestic Chinese market, that may not be a concern. And firms like HP that make relatively small, high-value products may continue to find that the benefits of moving inland outweigh the costs. But there are many companies in other industries that will find it hard to justify a move away from the coastline.

For those companies, it may make more sense to branch out by opening production facilities in other Asian countries, including Vietnam, Indonesia, Thailand or Myanmar. This China plus One strategy has several benefits:

COST CONTROL — Workers in these Southeast Asian countries generally are less expensive to hire than Chinese employees. By 2010, China already had become the third-most-expensive labor market in Asia, and labor costs have continued their upward trajectory. A March 2012 survey by Standard Chartered shows annual wage inflation running at 10 percent.

RISK DIVERSIFICATION — Spreading production across several markets hedges future investment in China by leaving producers less vulnerable to supply chain disruptions, currency fluctuations and tariff risks in any individual market.

NEW MARKET ACCESS — For an economy such as Myanmar, the world's newest frontier market that seems poised for rapid growth, it can be an advantage to become established in the country early.

One of the companies that has adopted this strategy is Intel, which made a big bet on China plus One in 2010, when the organization opened a $1 billion chip plant in Vietnam. As it becomes more expensive to do business in China, these Southeast Asian nations are actively wooing outside investors. Included among the most aggressive self-promoters has been Indonesia, which touts generous tax incentives for Western companies and has launched a marketing campaign that boasts of the country's low wages and growing workforce.

Plus Which One? Deciding Where to Diversify

For companies choosing to diversify away from China, the choice of where else to go is not a simple one, with each country presenting its own challenges. There are several key considerations when selecting an additional regional outpost, including:

LABOR COSTS — Average labor costs are similar in China and Thailand but are significantly lower in countries such as Vietnam, Indonesia and Myanmar. But these rates can be misleading since they can fluctuate widely within countries. In China, costs vary from as little as $2,000/year in western provinces to $6,000/year in Shenzen, a port city and manufacturing center on the east coast.

INFRASTRUCTURE — An Indian think tank published a ranking of East Asian countries by infrastructure in 2011. While it put China and Thailand in the middle group for infrastructure attainment, Vietnam, Indonesia and Myanmar were among the bottom six counties in East Asia. In Myanmar, for instance, mobile phones and Internet penetration rates are both below 5 percent, rolling blackouts occur on a daily basis and many streets regularly flood to knee-high levels during the rainy season.

COUNTRY RISK — Country risk encompasses a wide range of social and institutional challenges that vary from one country to the next. In Vietnam, for instance, the main operational risks include corruption, lack of accountability, low transparency and the challenges of dealing with a burdensome bureaucracy. Meanwhile in Thailand, the most acute country risk is the social instability caused by a deep division between rural poor "red shirts" and the mostly urban middle class "yellow shirts." Companies operating in Indonesia face a different challenge — the relatively high risk of terrorism and kidnapping that exists in certain parts of that country. A recent cross-border risk analysis showed that all the Asian alternatives are riskier than China, but that some of them (including

Thailand, Indonesia and Vietnam) are not significantly so.

MARKET SIZE — If companies plan to sell domestically, it makes sense to consider the size and attractiveness of local markets, as well as how those markets likely will change over the next decade. China has the highest per capita wealth and, by far, the largest population (see Table 2), but some markets (such as Thailand) have comparable per capita wealth, and other markets also have large populations.

MAJOR CUSTOMERS — Sometimes the decision of a single manufacturer has ripple effects. When Ford Motor Company announced in mid-2010 that it was spending $450 million to open a major plant in Thailand, a number of the automaker's suppliers soon began making plans for Thai operations, while banks and other services companies started looking for ways to serve what could become a major auto export base.

Table 1

WAGE OVERHEADS IN EMERGING ASIA

Country	Average minimum annual salary (worker, Intl. $)	Average mandatory welfare (% against salary)	Total labor cost (Intl. $)
Bangladesh	798	n/a	798
Cambodia	672	n/a	672
China	1,500	50	2,250
India	857	10	943
Indonesia	1,027	6	1,089
Laos	1,057	9.5	1,157
Malaysia	4,735	23	5,824
Mongolia	2,004	n/a	2,004
Myanmar	401	n/a	401
Nepal	1,889	n/a	1,889
Pakistan	984	7	1,052
Philippines	2,053	9.4	2,246
Sri Lanka	1,619	n/a	1,619
Thailand	2,293	6.9	2,451
Vietnam	1,002	15	1,152

SOURCE: IMF WORLD ECONOMIC OUTLOOK DATABASE, OCTOBER 2010

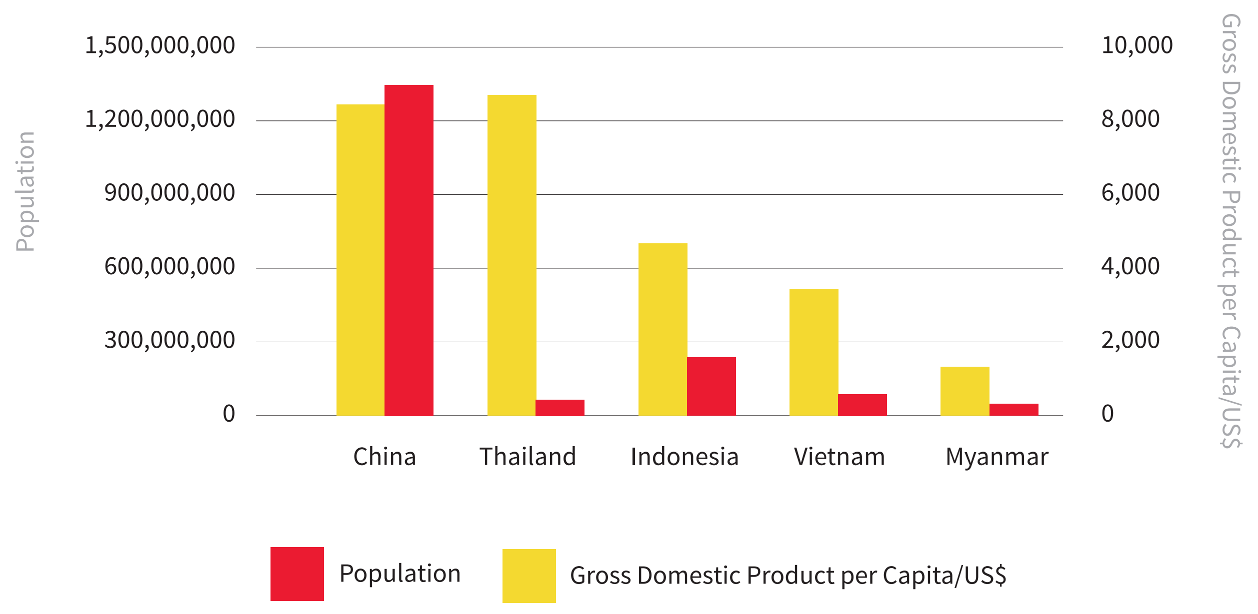
MANAGING THE RISKS — FINDING A RELIABLE PARTNER, AVOIDING CORRUPTION AND SMOOTHING THE TRANSITION

In most cases, a reliable local partner is invaluable for local investors looking to enter a new Southeast Asian market. Clearly, investors should take care to perform thorough due diligence on any prospective partner, not only probing the company's current and past financial performance but also track record and reputation in both the domestic marketplace and abroad.

Geographical considerations are important as well, as illustrated by one multinational firm that recently entered Vietnam with the intention of expanding throughout the country. The company's partner had business relationships in Ho Chi Minh City but not in Hanoi, Vietnam's other key business center.

Table 2

PER CAPITA GROSS DOMESTIC PRODUCT AND POPULATION



SOURCES: CENSUS FIGURES, OFFICIAL AND UNITED NATIONS ESTIMATES, WORLD BANK AND IMF

As the multinational discovered, the two cities have very different business cultures. To complete the expansion, the company had to join forces with a second partner already well-established in Hanoi.

Business norms in the country should be understood, especially in light of anti-corruption regulations in the United States and elsewhere that may prohibit common local practices, including the giving of bribes. Bribery is a major problem in many developing nations, as noted by their relatively low ranking on Transparency International's Corruption Perception Index. Third-party middlemen may be engaged to advise on transactions, including as go-betweens for companies and officials, related to activities that are less transparent. A survey by the University of the Thai Chamber of Commerce and the Anti-Corruption Network, for instance, finds that companies in Thailand typically must spend up to 35 percent of a project's budget on bribes to win government contracts.

Tolerance for local customs that might be considered bribery can expose multinationals to Foreign Corrupt Practices Act (FCPA) compliance risks. Offenses against the FCPA (or the UK Bribery Act, for instance), even by low-level employees, can result in substantial fines and damage to a company's reputation.
In 2011, global insurance broker Aon announced settlements with the U.S. Department of Justice, the U.S. Securities and Exchange Commission (SEC), and the UK Financial Services Authority (FSA) for paying bribes in Bangladesh, Indonesia, Myanmar, Vietnam and other countries to government officials responsible for awarding insurance contracts. Aon agreed to pay a $1.76 million fine and simultaneously settled with the SEC for more than $14.5 million in disgorgement and pre-judgment interest. The FSA imposed its own fine of £5.25 million.

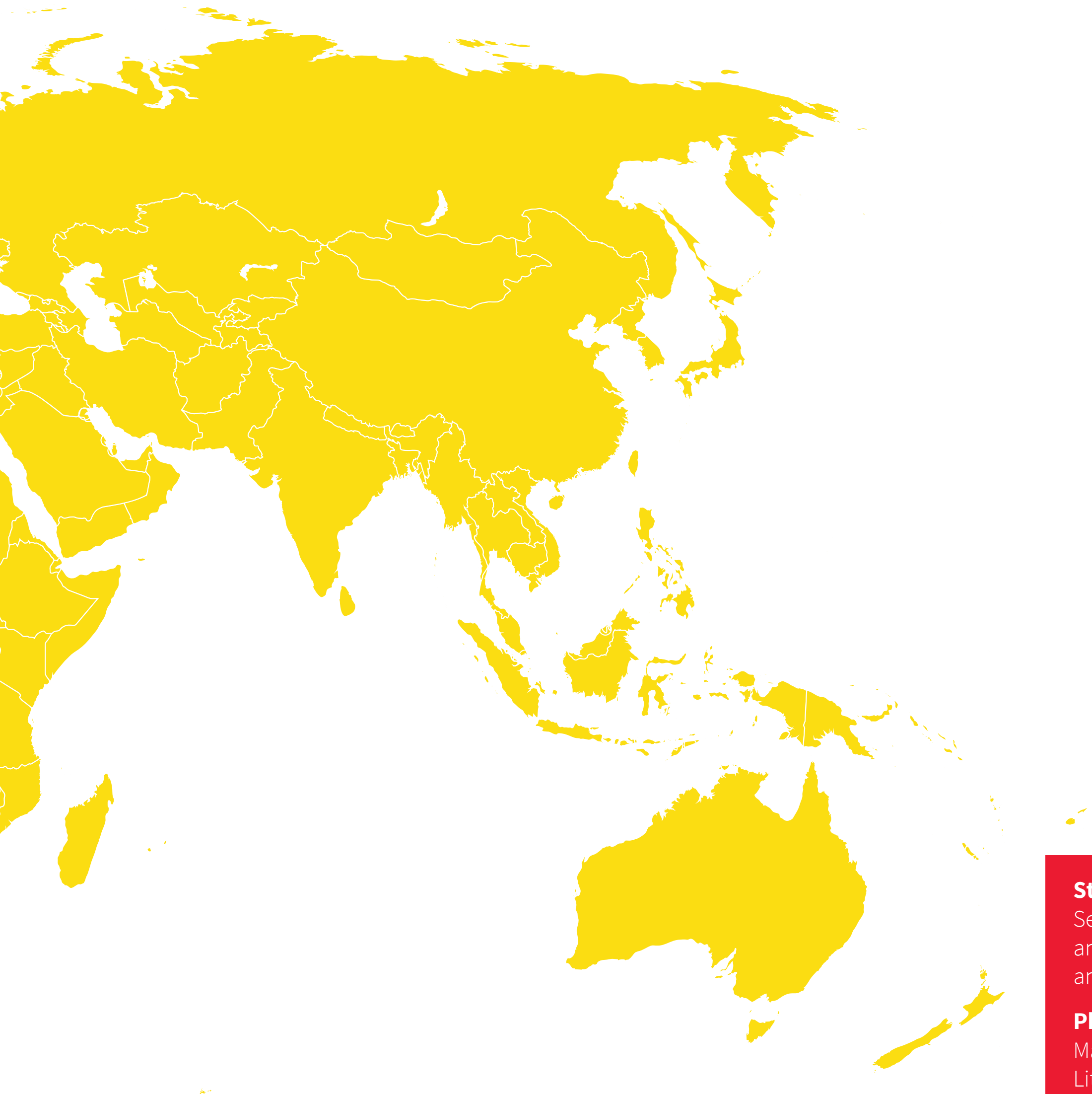
If a move into another Asian country involves scaling back on Chinese operations, there are further risks to manage. Sales from remaining Chinese facilities may plummet if customers or employees have negative reactions to the move. For example, more than 100 workers blockaded a Tesco grocery store in the eastern Chinese city of Jinhua last year, occupying entrances and exits around the clock to prevent shoppers from entering. The market was slated to close at the end of the year, and the workers were up in arms over wages and redundancy terms, according to local news media.
From time to time, dismissed Chinese workers have been known to become violent: stealing equipment, damaging property and even engaging in "bossnapping" — seizing executives and demanding significant compensation for

workers. After news of a major company layoff at the Tonghua Iron and Steel Group in Jilin province in July 2009, for example, angry workers rioted and beat to death a corporate executive.

To contain the risk of such disturbances, any shift away from Chinese production must be carefully planned and executed. It is essential for companies to negotiate with labor unions and relevant government officials to ensure a smooth transition and avoid bad publicity.

Despite the challenges of operating in China, foreign companies still will be investing there for some time to come. China has a massive population, remains the world's second-largest economy and continues to be an attractive market. Inward investment to China for the first six months of 2012 was $59 billion, down only 3 percent from the previous year, and many foreign companies are prospering there.

But as doing business in China becomes a more expensive proposition, multinationals are relying less on China alone as an Asian foothold. They are increasingly spreading their bets by investing in other regional markets to gain cost advantages, access new markets and diversify their exposure to various risks. Many of these Southeast Asian investments promise to deliver attractive returns but only for those companies that have done their homework.



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