ELEVATE Webinar

New Countries, New Risks: How to anticipate and minimize regional risks in new sourcing markets

Slide 1:

Hi everyone, good morning, good afternoon, good evening to those of you joining from different parts of the world. Thanks for joining us. We are very excited to share this webinar: New Countries, New Risks: How to anticipate and minimize regional risks in new sourcing markets.

Now before we start, we want to do some quick housekeeping. We want you to be participatory - you can raise your hands and ask us questions in the Q&A box. We will try to answer all the questions. If we don't because of limited time, we will get back to you via email. If anything is interesting to you or if you want to learn more, do email us – the email address is in the deck. We will get back to you with answers / additional information, etc.

Slide 2:

I am Filippo Sebastio. I am Senior Analyst for Analytics and Sustainability. I have been part of ELEVATE for close to one year and I have been leading the work on new countries and new risk.

I am joined by my colleague Vignesh Venkataraman. Over to you Vignesh.

I am Vignesh. I am a Consultant for Analytics and Sustainability. I have been part of ELEVATE for close to two years now and been involved in the development and consultation of our analytics products which includes our risk intelligence platform, EiQ. And I am very excited to present this webinar and to share our thoughts on this topic.

Slide 3:

Vignesh: Going to the next slide, you can see our overarching theme for this year. That is Program Effectiveness which places a focus on how to run a complaint and resilient program by optimizing resources. This is key for responsible sourcing especially right now because of the changes we are witnessing in the global supply chain landscape: I am talking about trade wars, changes in business patterns, increasing global regulations. Every year we build our content around our theme through webinars, the ELEVATE Leadership Series events for industry and see if we can move the needle a little bit. And now without any further delay let's jump right into it.

Slide 4:

Vignesh: Here's a snapshot of what we want to share today. We would like to start with providing some context on why companies are looking to move away from China. We are going to talk about trade wars, production costs, etc.

And then we are going to talk about the use of data to measure risk. We would like to run through a couple of simulations to see how will risk change if you move out of China. And finally, we will share some of our thoughts on how we can leverage data to drive continuous improvement in your program.

Slide 5:

Filippo: We have seen an increase in the escalation of the trade war in the last year: In July 2018, Trump imposed 25% tariffs on Chinese goods worth US$34 billion dollars.

China responded by doing the same and now we are in this trade war between these two countries which is at US$550 billion worth on Chinese goods and US$100 billion on US goods. And this is expected to keep on rising.

Vignesh: What sectors are affected the most because of this trade war?

Filippo: A lot actually. But to name some of the key / impacted goods that the US has imposed tariffs on are electrical equipment, footwear, dishwashers, flat panel TVs etc. On the other hand, China has put tariffs on electric/hybrid vehicles and agricultural goods such as soybeans.

Together with tariff trade barriers, we are expecting China to impose non-tariff trade barriers such as complicating bureaucracy for foreign companies and the harassment of US companies doing business in China.

Trade wars are already taking quite a toll on both the US and Chinese economies. These tariffs are having significant impact on US consumers - about US$460 over a year for the average US family, according to an analysis from economists at the University College London and the London School of Economics.

They are also having significant impact on Chinese suppliers:

- In August 2019, Chinese exports to the US fell 1% from a year earlier. That is despite two factors:
    - Analysts' expectations that a falling yuan would offset some cost pressure
    - and that tariffs may have prompted some brands and Chinese exporters to bring forward shipment to the US to anticipate the imposition of new tariffs.
- Finally, it is just recent news that the retail giant Target has told both its American and Chinese suppliers that it will not accept any increased costs from tariffs on Chinese goods, so they don't have to pass price increases to the consumers.

Vignesh: As we mentioned before, tariffs are not the only challenge to the Chinese supply chain, right?

Filippo: Yes, while this is a big issue, it is not the only issue. The increasing production costs as a result of labor shortages is also making companies wonder whether to look at alternative sourcing destinations.

For example, if you look at the graph on the right-hand side you can see that China's labor cost in the electronics/hard goods sector increased by 12% over the last three years and is 240% higher than in

competing countries such as Malaysia and Vietnam. At the same time, the apparel sector wages have increased over 20% in the last two years in China. And this is 300% more than its regional counterparts.

Slide 6:

Filippo: Vignesh, together with new sourcing strategy we also see new responsibilities, right?

Vignesh: Absolutely. With the increasing involvement of civil society organizations, companies have a responsibility to monitor and disclose their performance. For example, the California Transparency in Supply Chains Act was introduced in 2012 followed by the UK Modern Slavery Act in 2015 and the Australian Modern Slavery Act in 2017. Even in a country like UK, where you have strong regulatory frameworks, it was found that hundreds of people were forced to work for almost nothing with sub-par living conditions. A majority of these people were vulnerable. They were either from a poor economic background locally or migrants coming in from the other parts of Europe such as Poland and Romania. In the last 12 months, there were a multitude of arrests made in the UK following this investigation cracking down on human trafficking rings which exploited hundreds of vulnerable victims.

This requires companies to (1) engage in verification of product supply chains to evaluate and address risks of human trafficking and slavery; (2) conduct audits to disclose supplier performance which should include statistics regarding the timeline, frequency, and number of audits; (3) require direct supplies to certify that materials incorporated into the product comply with the laws regarding slavery and human trafficking of the countries in which they are doing business; (4) maintain accountability standards and procedures for employees or contractors that fail to meet company standards regarding slavery and human trafficking; and (5) provide employees and management training on slavery and human trafficking.

There is the Trade Facilitation and Trade Enforcement Act which came into effect in 2016 which prohibits imports of goods into the U.S. produced using forced labor / child labor. And this is just to name a few, besides these there is an increasing pressure from NGOs, industry initiatives to disclose supply chain performance.

I would say now there is more need than ever to have a closer look at your supply chain and adopt an evidence-based, metrics-driven assessment to be more responsible as a business by not only mitigating these issues but also creating impactful work where you are present.

Slide 7:

Filippo: Vignesh, what do you mean by risk and how can companies assess risk?

Vignesh: Well, at ELEVATE our focus is on supply chain risks. We are more interested in that. Our supply chain risk covers five key pillars which are:
Labor - Looking into child labor, forced labor, wages, working hours, discrimination and harassment related violations.
Health and safety that looks into building safety, machine safety and occupational safety in sites
Environment focusing on emissions and management associated with air, water and waste
Business ethics measuring policies and bribery related risks, and

Management systems which zoom into the bookkeeping practices, permits, unauthorized sub-contracting, etc.

Now how do we measure this and use this in our day to day analysis. I'm going to switch to our EiQ platform to show the way we assess and manage risk. This is a country risk landscape which is very material if you are looking for new countries or even if you're looking to manage your existing operations in terms of what kind of risk you should be addressing. A country like China is traditionally viewed as a high-risk country overall. But what we see here is different levels of risks for different issues and different sectors and industries, right? For example, I can see the electronics sector and the footwear sector being medium risk countries. And what if I draw down a level deeper into a specific province in China for example, Guangdong and the risk profile changes for a province like Guangdong.

Here I see the electronics sector being a high risk in a province like Guangdong, whereas overall in China it's considered to be a medium risk. And not only that, but when you go down to an issue level, you can see what are the issues that are prevalent in the sectors. We see some improvement in the labor issues, environmental issues, bit of decrease in trend. And then you have business ethics, which is still a high-risk issue, but we are seeing considerable improvements when it comes to transparency and also documentation etc. However, I moved to a different province for example Zhejiang and the risk profile changes again with poor labor conditions, and still huge issues when it comes to wages and working hours. Transparency is again, very low with an extreme risk. So, I think it is time for us to start viewing risks from a broader scope and start understanding it at a granular level or an industry and province level for more actionable insights.

Filippo: This is interesting because it is showing us how risk changes in a country like China. We have to realize how risk changes across industries and across geographical location.

Slide 9:

Now, to give some context, if we had to compare China to its local competitors in the Asia supply chain, what would that look like?

We have run a statistical analysis called Principal Component Analysis to plot on a 3D graph the Asian key supply chain countries and see which ones are closer to each other and see where China is. By the results, we can see that China, the black dot, is significantly similar in terms of risk to those countries it competes with for electronics and hard goods: Malaysia, Thailand, Indonesia, Philippines. These are both medium and high-risk countries that share similar violations:

- Environmental violations
- H&S risks in the factory

And some of these countries (Thailand and Malaysia) also share significant migrant labor risk – all those violations that are related to the exploitation of migrant workers. These two countries that have advanced economically and now they are attracting workers from higher risk countries eg Nepalese workers in Malaysia and also Vietnamese workers in Taiwan in electronics or footwear and garment industries. We are seeing in an increase in violations related to accepting migrant workers – wage compliance, working hours, withholding passports.

On the other hand, China is further away from countries (red dots) that compete for garment and footwear companies – these are Cambodia, Myanmar, Bangladesh, Vietnam. They are all countries that are higher risk than Thailand and Malaysia and show significant risk in:

- corruption and poor business ethics
- zero-tolerance violations (Forced and Child Labor)
- Underdeveloped management systems that do not allow documenting business process in the workplace.

Finally, we have the advanced supply chain, all those countries (blue dots) that are medium-low risk countries such as Japan, Taiwan, South Korea. These are countries that share labor violations.

Slide 10

Vignesh: What if you were an Apparel & Footwear brand with a substantial portfolio of suppliers in China – say 50% - and the remaining in medium risk countries, and you wanted to move some of your orders from China to Vietnam, Myanmar, Cambodia, and Bangladesh? How will your risk change?

Filippo: Well, apparel companies moving from China to Myanmar, Cambodia, Vietnam and Bangladesh are going to experience significantly lower production costs but at the same time increasing production risk. Plotting the supplier portfolio risk on a bar graph where in dark blue we depicted the exposure to risk before the transition and in light blue after the transition from China, we see that risk increases from medium to high, especially because of labor risk and H&S risk.

Myanmar and Cambodia present a significant risk of child and forced labor, while workers in Bangladesh run significant overtime.

In terms of environment, we do not see a radical change in the exposure to risk but when it comes to business ethics we see that suppliers in Cambodia, Myanmar and Vietnam expose brands to significant risk of corruption of auditors and other poor business practices.

Companies in Cambodia and Myanmar have not adopted the necessary management systems.

In terms of Health and Safety - Building Safety is still significant issue in Bangladesh.

Vignesh: What if you were an Electronics supplier with 60% of your supply chain in China and you're looking to move part of your operations to Taiwan, Malaysia and India? What happens then?

Filippo: Well, again, repeating the same exercise as before of plotting risk before the transition in dark blue and risk after the transition in light blue, we see how risk does not necessarily increase in intensity, but varies in type. First of all, we see more risk in labor – especially because Malaysia and Taiwan present significant migrant worker related risk due to immigration from risky countries.

In terms of environment, Suppliers in India present significant environmental challenges on air emission and wastewater…so similar challenges you would have found in China.

Indian suppliers present a larger risk in terms of corruption of auditors; however, transparency rates during audits is higher than in China.

When we look at management systems we do not see significant change in the way suppliers document their business practices in these new emerging countries as compared to China.

In terms of H&S, India and Malaysia present more challenges related to building and fire safety than in China.

So overall, intensity of risk does not change significantly, but type of risk does.

Slide 12

Vignesh: We have been talking a lot about compliance risk, but what about production? At the end, it is key for brands to get their products with the right quality and on time.

Filippo: Great point...allow me to take a step back. In the graph on the left we have plotted risk against production costs (here proxied by salary level) in the electronics, toy and hard good sectors across key supply chain countries.

What we see is a strong correlation between the two: the lower the production costs, the higher the risk. If we fit a line in the data cloud, we see that those countries north of the line present a positive trade-off for brands: lower sourcing risk given the production cost they charge. On the other hand, countries south of the fitting line present too high of production costs given the risk they provide factories.

Vignesh: How come China – a pivot country in the global supply chain - is south of the line?

Filippo: Because China presents significant production advantages compared to the other Asian supply chain countries – access to raw material and components, know-how and productivity levels currently unmet in Asia. And here back to your question. Companies that move away from China into emerging markets will be increasing production pressure on local suppliers – and in the medium term, lower production capacity in emerging markets will put brands at risk of those production-related violations: suppliers relying on unauthorized subcontracting, running excessive overtime or neglecting H&S compliance in the workplace. As more brands shift their supply chain, we foresee risk changing in type and intensity.

Slide 13:

Filippo: We have been talking about risk. Let’s see how data can help brands in this journey outside China into new emerging markets.

Vignesh:

Well the first step is to understand risk. And when you take that first step, you answer to questions like,

1. What is your risk appetite, what are your priorities as business (e.g. Is it eradicating modern slavery in supply chain, providing living wage to all your workforce?) and how much risk are you willing to accept in your supply chain?
2. Understand what the risks are in countries you want to enter. E.g. What kind of regulatory risk are you exposed to? For example, in a country like Malaysia, they have their own regulation on hiring policies / practices. How do you respond to that when you set up a new business in Malaysia?
3. Seek expert support where you have limited influence / knowledge

The second step is to assess your risk.

1. Build a solid intelligence based on audit and public domain data.
2. Conduct segmentation exercise to view suppliers from not only a risk perspective but also based on business information like how much you spend with a supplier, what the order volume is, how material your supplier is to your supply chain, and relationship with the supplier – is it strategic or transactional.
3. Rank supplier based on risk priorities and production leverage

What this does is help you design the most effective program suited to your needs and priorities. For example:

1. Looking into your order volume and spend data will help you in deciding whether to set up an office in a location that you are doing business with or whether to rely on local vendors with the necessary expertise.
2. Prioritize audits based on risk exposure. Whether you want to do a full audit or a specialized audit focusing on specific issue for example foreign migrant worker survey in Malaysia or Taiwan.
3. and also where do you invest on improvement activities such as CAP Management, eLearning.

Those are the three steps. However, this journey not end after step 3. There's a lot of moving parts in our industry and the risk landscape changes at a faster rate than we can imagine. There're always new, emerging issues that we were not exposed to historically. So, I see this as a continuous and iterative process to keep up with all the changes and stay ahead of the curve if the focus to run an effective program.

Slide 14

Filippo: To conclude – today we discussed how macro trends are shifting the supply chain from China to new emerging markets and how global regulatory trends are making brands more accountable for operation and compliance in their supply chain. We have shown a couple of simulations and hopefully we managed to pass some key points: risk is going to increase for those brands moving from China to Bangladesh, Vietnam, Cambodia, Myanmar - -- while companies moving from China to countries competing for the electronics market are not going to see a change in intensity of risk, but rather a change in type of risk.

Finally, we showed how companies need to be aware that risk is constantly changing as production patterns shift and we expect risk to increase and change in the emerging markets.

Finally, we show how companies need to be aware that the risk is constantly changing as production partners

Vignesh
Looking at questions: You only talk about risk at country level, but what about risk at a factory level? I am starting business with factories, not countries.

Filippo: Interesting point: individual supplier risk can be significantly different from country risk and we do recommend companies that move to emerging markets to be very wary – visiting suppliers and making sure that sourcing is in order. Yet, we believe that when you move to a new country you need to be aware of what the common issues are and what risks you are more likely to face. Often you will not have full visibility/transparency down in your supply chain and you will need to know whether to run specific strategies such as deep auditing/worker voice technology to identify sensitive risk, say illegal recruitment fees or passport withholding.

The point of the intelligence is not to prove the risk at the factory level but to have a good understanding of the risk at the country level. I want to reiterate one thing. The way we calculate risk is based on the local suppliers so there is truth; it is not just a calculation of risk based on data in the public domain. This is research based on actual audit data that ELEVATE has been collecting for more than 10 years.

Vignesh: It is important to always be aware of unknown issues that exist in the country but not in your supply chain.

Filippo: Another important point is the way you analyze this type of data. It's also very important to discern good data from bad data. We at ELEVATE are very careful in rating assessments and audits as transparent because good data is so significant.

Vignesh: Another question is how is risk changing in China as trade wars escalates?

This is interesting because we talk quite a bit about how risk changes in emerging markets, but we haven't really talked about how risk is going to change in China. Well, this is more anecdotal than data-based evidence, but in the escalation of trade wars we are seeing a lot of brands neglecting compliance in their supply chain. Now brands are very concerned about procuring goods and anticipating shipping in fear of new or increasing tariffs targeted at their products. This means that many brands are less stringent with their code of conduct and as a result we expect an increase in violations in China.

This is also quite in line with what we are seeing for transparency rates in audits.

At ELEVATE, we mark audits transparent or non-transparent based on the documentation provided and cross validation of data during the audit – China's transparency rate was increasing significantly during the 2015-2018 – yet – starting in 2018 we have been seeing a significant reduction in the growth of the transparency rate. We believe that this trend is partially explained by the escalation of trade wars in 2018 as suppliers are more prone to hide violations in the supply chain. They want to appear compliant because they are competing for fewer customers.

Vignesh: Now we know we are getting to the close to the hour, if you have any more questions, keep sending them to us. We will respond to them via email today or tomorrow. If you want to get in touch with us in person, we would like to see you at the ELEVATE Leadership Series conferences. We have one in London on the 22nd of October, one in Hamburg on the 11th of November.

We have one more webinar coming towards the end of the year which will be the last for the year 2019. It is on disclosure and transparency that meets reporting and investor expectations.

For more information, contact our webinar presenters:

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