Heidrick & Struggles

Industrial Practice

Industry Outlook 2016 - Supply Chain Asia

Industry trends and talent implications

'Factory Asia' is the catchy name given to the concentrated manufacturing and supply chain hub in the Asia Pacific region. For years, China had the undisputed monopoly of Asia's manufacturing sector, literally putting its 'Made in China' stamp on a vast array of products. However, other players in Southeast Asia, including Vietnam, Thailand, India, Malaysia and Indonesia, are stepping up their game to become attractive alternative manufacturing centers.

Due to its low-cost labor, efficient supply chains and relatively lenient regulatory system, China earned itself the title of 'the world's factory'. However, the global financial crisis, rising labor costs and environmental concerns, have all contributed to slowing manufacturing growth in the country, with year-on-year growth of 12.1% in 2010 dropping to about 6.0% in 2015.[1] With labor and production costs on the rise, many businesses have moved their manufacturing bases out of China to Southeast Asia.

Vietnam has become a favored supply chain hub due to lower labor costs and attractive tax incentives, including numerous free-trade agreements. Although electronics have been its main export since 2013, it has been reported that over 5,000 businesses previously based in Guangdong Province have made the move to Vietnam since 2011.[2]

The new year did not seem to bring improvement for China's manufacturing sector. The Purchasing Managers' Index (PMI) is an economic indicator that measures the state of a country's manufacturing industry, where a score of over 50 indicates industry growth and below 50 shows contraction. In January 2016, China's PMI was 48.4, the 11th straight month which saw the score fall

Comparison between China Wages and Wages in other Asian Countries

Country	Annual Minimum Wage (USD)	Adjusted for Employer Social Insurance Contributions (USD)	% Difference Against China
Malaysia	3,107	3,534	106%
Thailand	3,012	3,169	95%
China	2,472	3,337	100%
Philippines	1,515	1,648	49%
Vietnam	1,296	1,581	47%
Indonesia	1,087	1,187	36%
India	689	740	22%

Source: 'China's rising manufacturing costs: Challenges and opportunities', Chris Devonshire-Ellis, Matthew Zito & Eunice Ku, Dezan Shira and Associates, China Briefing: Business Intelligence from Dezan Shira & Associates , July 8, 2014, http://www.china-briefing.com/news/2014/07/08/chinas-rising-manufacturing-costs-challenges-opportunities.html

1 'Change of industrial production in China from December 2014 to December 2015', Statista, accessed on January 30, 2016, http://www.statista.com/statistics/232771/industrial-production-change-in-china-compared-to-same-month-previous-year/; 'Development of China's industrial production from 2008 to 2014', Statista, accessed on January 30, 2016, http://www.statista.com/statistics/276443/development-of-the-industrial-production-in-china/

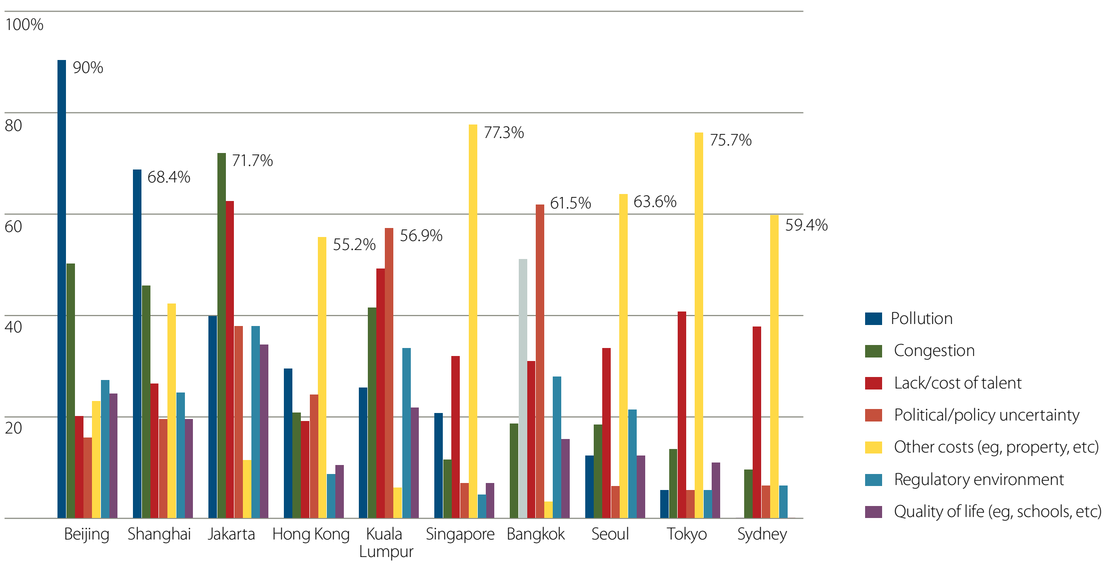
2 'Vietnam steps up its game', Jennifer Lo, China Daily Asia, September 25, 2015, http://www.chinadailyasia.com/asiaweekly/2015-09/25/content_15321840.html

below the crucial 50 mark.[3] In contrast, Vietnam's PMI was 51.5 in January 2016,[4] while it scored above 50 for 10 of the 12 months in 2015.[5]

Another factor that has affected China's dominant position in the global supply chain is the stricter regulatory environment amidst the push to ensure companies are accountable for the quality of their products, standards, and possibly most importantly, the well-being of their workers and the environment. In tandem with these increased regulations, China's President Xi Jinping started an anti-corruption campaign in 2012, with the aim of rooting out corrupt people and practices in government and business. Although foreign businesses acknowledge that this program should improve operating conditions, many feel it restricts foreign firms from competing fairly. A survey by ***The Economist*** found that 32% of respondents believe the anti-corruption policies involve a degree of bias against foreign businesses,[6] which may be discouraging some companies from doing business in China.

In this challenging business environment, there are greater demands on supply chain professionals and also increased competition for supply chain talent. The challenge is finding talent with the ability to work seamlessly across multiple geographies, as they need to have the relevant knowledge, language skills and overseas experience. Another challenge is retaining staff, as the shortage of qualified candidates can result in star players being presented with numerous attractive offers. In five major Asia Pacific hubs, talent shortages/costs were considered the second most important reason a company might choose to relocate, as seen in the chart below:

What issues might cause you to consider relocating operations or moving headcount away from any of these locations in the next two years (2016-2017)?



Source: The Economist Corporate Network
Source: 'Responding to Asia's new normal: Asia Business Outlook Survey 2016', The Economist, January 2016, http://ftp01.economist.com.hk/ECN_papers/2016ABOS

3 'Caixin China General Manufacturing PMI', Markit, February 1, 2016, https://www.markiteconomics.com/Survey/PressRelease.mvc/09185002723a4f5c9f91d7f80462b11e

4 'Nikkei Vietnam Manufacturing PMI', Markit, February 1, 2016, https://www.markiteconomics.com/Survey/PressRelease.mvc/3cca9eab9cc146d98d47a82f312ed92a

5 'Vietnam PMI – 2015 review', Andrew Harker, Markit, January 4, 2016, https://www.markit.com/Commentary/Get/04012016-Economics-Vietnam-PMI-2015-review

6 'Responding to Asia's new normal: Asia Business Outlook Survey 2016', The Economist, January 2016, http://ftp01.economist.com.hk/ECN_papers/2016ABOS

In the next section, we take a closer look at China and Vietnam's supply chain sectors and what the future may hold for them.

CHINA – THE CHALLENGE TO STAY ON TOP

Over the past three decades, company supply chains in China have evolved – from sourcing in China; to making in China; to making and selling in China; to making, selling and designing in China; to designing and developing products for the local market; to ultimately establishing global centers of excellence for innovation and advanced research and development (R&D). In addition, China has registered an increasing number of patents in recent years.

As the China operating environment has evolved and become more sophisticated, it has started to incur higher costs, with labor rates having more than tripled over the last decade. As mentioned above, this has driven some lower cost, labor-intensive, export-oriented industries such as textiles, footwear and apparel, to move to cheaper locations such as Cambodia, Indonesia, Bangladesh and parts of Africa.

For other industries, such as electronics, multinational corporations (MNCs) may seek to diversify and add capacity in lower cost locations in inland China or elsewhere in Southeast Asia such as the Philippines, Vietnam or Thailand. However, companies may find that "there is no other China out there". The combination of China's big domestic market and large, developed supply base make it hard to replicate or replace.

Within China, some multinational manufacturers may decide not to add capacity, or they may seek to downsize operations in higher cost coastal regions in favor of lower cost inland locations. However, this too has challenges in the form of higher logistics costs and learning curves for new employees. Companies with well-established R&D centers in Shenzhen, for example, may choose to maintain these, in addition to also adding manufacturing capacity inland in places such as Chengdu.

More recently, the slowdown in the China market, combined with increased costs, has put pressure on profits. MNCs in many sectors are now focusing on cost and productivity more intensely than ever. This requires best-in-class leaders across key operational functions, including manufacturing, procurement, logistics and quality. Therefore, talent with experience working in MNCs, who can function effectively both within the organization and across the region, and who can lead the local organization and operations in China, remain highly sought after.

Although MNCs in many cases are seeking to reduce overall headcount in China, they are, however, upgrading their talent, improving performance management and offering more differentiated compensation and benefit strategies that reward top performers.

Ethics and compliance challenges also continue to require constant training and vigilance. As stricter regulations continue to be implemented across many industries, staff need to be well-trained and up to date on the latest regulations, and understand the risks of non-compliance.

What can China do to take back the lead?

A growing trend is for businesses to focus on customer satisfaction metrics. Just as companies such as Taobao and TripAdvisor request real-time feedback from customers to help them address customer concerns and improve service, manufacturers are adopting this tactic too. To satisfy customers' high expectations regarding order fulfillment and management, many companies are now using big data and other technological developments to identify patterns that can help analyze the huge amounts of data available, in order to improve decision-making, optimize performance and possibly guide future decisions.

E-commerce is also creating a new type of supply chain complexity as companies are expected to have real-time visibility and order fulfillment. On the plus side, the interconnectivity that e-commerce allows can give companies greater international exposure, enable faster payments and allow better tracking of products. However, it also pits the traditional industry (manufacturing, shipping and logistics) against the booming online sector (including online shopping sites such as Amazon and Taobao).

China has recognized the need to adapt and increase its competitiveness. One way it aims to address this issue is through 'Made in China 2025[7], a 10-year plan which was introduced in 2015 and which aims "to transform China from a manufacturing giant into a world manufacturing power". The key tasks of the plan include increasing the focus on innovation, integrating technology and industry, and enforcing green technology.

It is clear that for China to compete with its emerging supply chain competitors, businesses need to be proactive, take steps to modernize, and continue innovating.

VIETNAM – THE SUPPLY CHAIN DARLING OF SOUTHEAST ASIA

The world's largest emerging economies – including Russia, Brazil and China – have been stumbling. At the same time, Vietnam's economic growth was 6.7% in 2015,[8] making it among the fastest growing markets globally. It continues to be one of the hottest markets in Southeast Asia, increasingly attractive for all sorts of businesses. One segment growing extremely quickly is its manufacturing platform – and this has created all sorts of headaches for neighboring countries.

Vietnam has a young and vibrant workforce with a strong educational footprint that will allow the country's labor force to grow by more than 1 million people per year.[8] This is in stark contrast to other Southeast Asian countries which are experiencing a shrinking labor pool. Close to 60% of Vietnam's population is under 35 years of age, with about two people of working age for every dependent.[9] "One of Vietnam's main attractions is its expanding labor force. We analyzed five different ASEAN countries, and they all exhibited labor constraints – with the only exception being Vietnam. It just made sense for us to invest in our new factory footprint in Northern Vietnam," stated one regional supply chain leader.

While worker productivity in China remains high, many supply chain executives are increasingly concerned about geopolitical turmoil and are "de-risking their supply chain platforms" by seeking other countries that can offer an attractive manufacturing base. Although

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7 '"Made in China 2025" plan unveiled to boost manufacturing', Xinhua, May 19, 2015, http://news.xinhuanet.com/english/2015-05/19/c_134252230.htm

8 'Vietnam economic outlook', Focus Economics, January 26, 2016, http://www.focus-economics.com/countries/vietnam

9 'Why Vietnam?', International Enterprise Singapore, accessed on 30 March 2016, http://www.iesingapore.gov.sg/Venture-Overseas/Browse-By-Market/Asia-Pacific/Vietnam/Country-Information

'Vietnam Demographics Profile 2014', Index Mundi, accessed on March 30, 2016, https://www.cia.gov/library/publications/the-world-factbook

Thailand and Malaysia were often seen as alternatives in Asia Pacific, Vietnam has truly become the darling of supply chain executives looking for such diversification.

In addition to having a highly motivated and educated working populace, Vietnam is part of the Trans-Pacific Partnership, a US-led trade deal which is proving quite attractive for foreign direct investment (FDI) into Vietnam. The treaty will cut some 18,000 tariffs in 12 countries,[10] helping Vietnam increase exports of locally made products and find new markets. As a leading shoe manufacturing executive pointed out, "While we like the tactical reasons to be in Vietnam – cheap labor – we are also consistently facing margin compression issues. If we can knock 5% off import duties into North America, this is a benefit that can be passed on to our consumers and investors. We believe that as well as being positioned as a top manufacturing destination, as the domestic economy grows, consumption will also allow us to address this market segment as well." In 2014, Vietnam overtook its regional counterparts to become the biggest exporter to the US, surpassing its more established manufacturing rivals, Thailand and Malaysia.

Exports of manufactured products in Vietnam will continue to expand, given that 66% of disbursed FDI in the first nine months of 2015[11] was directed into manufacturing. This trend is set to continue in 2016, with increasing amounts of supply chain capital expenditure being allocated to Vietnam and away from neighboring economies.

It is not just low-end manufacturing that is moving to build an operational presence in Vietnam – high-end, IP-focused manufacturers such as Samsung, Intel and Bayer are interested too.

Even the automotive industry is looking at the Vietnam market as a way to diversify supply chain risk. In 2015, Toyota decided against building a new factory in Thailand and decided instead to start manufacturing in Vietnam.[12] By 2020, manufacturing will likely account for about 40% of all exports, or about USD 100 billion in value.

Yet, although companies are anticipating double-digit growth for the foreseeable future, most are aware that there are still some pitfalls. "Logistics costs are one of our major concerns. We just don't get the economy of scale pricing when shipping products from our factories out of Vietnam versus China," stated a consumer supply chain executive. "We expect the cost curve to come down over time, but currently we are disadvantaged in this key logistics metric."

The Vietnam supply chain narrative looks strong going forward. However, companies are not looking at Vietnam in a singular vacuum, but rather as part of an overall ASEAN supply chain diversification strategy that is driven by their end-customers. "We have to react quicker and cannot suffer supply chain disruptions as in the past. I am being measured on end-customer satisfaction metrics so we have to be in markets that allow us the flexibility to react quickly to these," stated a Vietnamese executive. "Vietnam is one piece of the puzzle – and a very important one at that."

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10 'The Trans-Pacific Partnership', Office of the United States Trade Representative, accessed on March 30, 2016, https://ustr.gov/tpp/
11 'Vietnam on track to replace China as new manufacturing hub: experts', Anh Vu, Thanh Nien News, October 28, 2015, http://www.thanhniennews.com/business/vietnam-on-track-to-replace-china-as-new-manufacturing-hub-experts-52973.html
12 'Toyota opens new plant in Thailand to meet demand', Adrienne Selko, IndustryWeek, January 20, 2012, http://www.industryweek.com/industry-clusters/toyota-opens-new-plant-thailand-meet-demand

ENHANCING THE SUPPLY CHAIN MODEL

While it is challenging to find top executives in general, most companies specifically struggle to find the right people at the supervisor, manager and director level. One reason is that organizations often do not have a talent pipeline in place. In addition, it is a challenge to attract more experienced workers in the mature markets because they may not be willing to move to a different country, and are not always culturally adept enough to work in the Asia Pacific market.

So the question remains – where can organizations find these elusive ideal supply chain executives? These days, even at the Operations Director level, many search projects are now regional and even global. Companies have had to compromise – although they might insist on hiring someone with overseas experience, they might not require that candidates have experience in a particular country. Also, they are now willing to look outside of their industry, seeking candidates with the requisite supply chain toolkits. This means that due to the lack of available talent, employers will often sacrifice sector/product knowledge in favor of cultural fit.

What does the future hold?

The factory of the future will probably differ rather significantly from today's ideal. Factories will likely look at centralizing supply chain functions, and limiting the number of locations to areas where talent supplies are abundant, rather than having multiple supply chain points physically close to the factories. These solutions address many of today's pressing concerns, including talent, costs and risk mitigation.

Companies streamlining their businesses, with a focus on supply chain

Flex

American international supply chain solutions company, **Flex** (formerly Flextronics),[13] knows it needs to be where its customers are. Therefore, in seeking a balance between local control and centralization of its operations, the company has focused its supply chain functions in India (80%), China and Mexico over the past three years.

So far, purchasing, planning, logistics and even engineering have been centralized in four or five locations, with over 2,200 employees. Factory floor operations will, however, stay in the manufacturing hubs. By using innovative ideas, the company can better control the business; for example, by placing monitors and cameras in factories, a line supervisor who is having a quality issue with a product can immediately talk to the relevant quality manager in Mexico, China or India.

This type of solution is well-suited to India, which has the right skill sets (e.g. many engineers), language skills, multicultural mindset and population numbers to make it work.

Johnson & Johnson

Another example is American consumer packaged goods, medical device and pharmaceutical company, **Johnson & Johnson** (J&J),[14] which has adopted a Center of Excellence for Supply Chain (Supply Chain COE) or a quasi-centralized model. A Supply Chain CoE is a team consisting of experts from each critical supply chain function. Their mission is to improve collaboration

13 'Flextronics will manage global supply chain with new real-time software', Rachael King, The Wall Street Journal, July 7, 2015, http://www.wsj. com/articles/flextronics-will-manage-global-supply-chain-with-new-real-time-software-1436311241
14 '2016 New Year's Resolutions with Tony Verbeck of Johnson & Johnson', Lora Cecere, Supply Chain Insights, December 21, 2015, http://supplychaininsights.com/podcast/2016-new-years-resolutions-with-tony-verbeck-of-johnson-johnson/

and learn from each other in an effort to deliver the greatest benefit possible through a collection of best practices that can spread throughout the entire manufacturing process. As such, key supply chain experts are concentrated in one location and service all of J&J's Asia factory operations from one central point.

The organization has found this to be a suitable model for the following reasons:

- By sending homegrown supply chain talent overseas for two to three years, they are able to give their associates overseas work experience. One of the biggest issues for Asia Pacific and China talent is that they often lack the ability to work cross-culturally. Yet, after completing their overseas stints, these executives can be sent to other in-country roles.
- It encourages collaboration and engagement within the CoE and in-country operations.
- Executives have the opportunity to develop expertise in other functions beyond their core skill sets.

This approach has helped J&J create a sustainable supply chain talent pool in the Asia Pacific region. In addition, the company has also set up a supply chain academy where it provides training for specific functions. Also, by centralizing supply chain knowledge, the transition becomes much easier when executives depart for either internal or external opportunities.

Is this the solution?

This factory of the future is one possible way to address supply chain talent shortages. It is highly automated, and the majority of the back-office support is centralized rather than factory-based, meaning lower costs and higher productivity. This type of centralized supply chain can assist in the recruitment of senior talent, as well as enhance productivity and drive lower costs.

The reality is that it can be hard to find candidates with the right hard skills to run a supply chain effectively, and who also possess the soft skills to navigate business in the Asia Pacific region. However, by being innovative, organizations can address the issues and still come out on top.

Next-generation supply chains need to be agile and responsive, and must be able to compete in a VUCA (volatile, uncertain, complex and ambiguous) world. While it is easy to borrow best practices, supply chain leaders need to innovate – at the end of the day, talent is at the core. To succeed, organizations therefore need to create a new talent paradigm that is aligned with their corporate strategy.

About the author

Jeff Stryker is a partner in charge of Heidrick & Struggles' Bangkok office, serving Thailand and surrounding countries. His practice focuses on the industrial, manufacturing and supply chain & logistics sectors.

jstryker@heidrick.com

Seth Peterson is a partner serving manufacturing businesses in the region across the C-suite and main functions. He is also a member of the firm's Supply Chain and Transportation & Logistics practices. Seth is based in Hong Kong.

speterson@heidrick.com

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Asia Leaders of Supply Chain & Operations officers Practice

Guy Farrow
Partner-in-Charge, Sydney
gfarrow@heidrick.com

Linda Zhang
Partner-in-Charge, Shanghai
lzhang@heidrick.com

Arun Das Mahapatra
Partner-in-Charge, Banglore
adasmahapatra@heidrick.com

Jeffrey Greg Stryker
Partner-in-Charge, Bangkok
jstryker@heidrick.com

Klaus Heldman
Partner, Hong Kong
kheldman@heidrick.com

Charlie Liu
Partner, Hong Kong
chliu@heidrick.com

Seth Peterson
Partner, Hong Kong
speterson@heidrick.com

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