The Future of "Factory Asia": the smart money is on ASEAN

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The Future of "Factory Asia": the smart manufacturing money is on ASEAN

"Factory Asia" began with facilities in China assembling products from higher-tech components manufactured elsewhere for sale to consumers in wealthier parts of the world. From this simple model has grown a manufacturing behemoth: today, China and its neighbours produce almost half the world's goods. Over the past two decades, the manufacturing industry in Asia has grown and evolved in two key ways that are of particular importance to global business.

"The region's biggest advantage over the rest of the world as production leaves China is simple: it is nearby."

The first fundamental shift is one the manufacturing community already knows well. Rising costs in China's major manufacturing centres are pushing the "Factory Asia" supply chain further into China's hinterland and into its Southeast Asian neighbours. The economic and political headwinds pushing against China's manufacturing dominance are discouraging some businesses from growing their Asia Pacific presence and in some cases are encouraging 'on-shoring' – moving production away from Asia and back home.

A closer look at what ASEAN can offer in terms of demographics, economic factors and market opportunities makes it clear that 'on-shoring' is a potentially costly knee-jerk response to rising costs in China, which is far from the only manufacturing option in the region.

The Economist notes that Southeast Asia is uniquely placed geographically to take on any manufacturing work leaking out of China. "The region's biggest advantage over the rest of the world as production leaves China is simple: it is nearby. …[G]eography matters, both to ensure quick shipment of goods and to let managers hop back and forth between factories."

The spreading supply chain is already resulting in increased capability and production quality in the countries closest to China. Continued investment and the right partnerships and trade agreements will bring to the larger region a degree of the economic advancement China is already enjoying.

"Factory Asia" is no longer just a place to manufacture goods at competitive prices for export to the West.

The other shift is one that savvy business leaders have begun to appreciate but that warrants greater consideration. "Factory Asia" is no longer just a place to manufacture goods at competitive prices for export to the West – it is also the best place to base manufacturing facilities in order to reach consumers in Asia's rapidly growing and increasingly affluent markets. Viewing Asia as the most important growth region for a business, and not simply as a place to outsource work cheaply, will require a major paradigm shift for many MNCs.

Of course, running a successful business in Asia is not without its challenges and proximity to both growing markets and low cost resources does not guarantee success.

We spoke to business leaders in the manufacturing industry across the region about how the landscape of "Factory Asia" is changing. They shared their lessons learned as well as their experiences managing manufacturing businesses in places like Indonesia, Malaysia and India.

Here, against the backdrop of relevant economic and policy developments, we share insights from leaders in the field on how to succeed in this challenging, high-potential region and why ASEAN is too important for any business to ignore.

Their insights can be categorised into the following major themes:

- Proximity to customers is key
- Consider factors beyond cost
- Two hubs in Asia are better than one
- Countries MNCs favour in the region as a manufacturing base
- Challenges remain but can be overcome

Let's consider them each in more detail.

Proximity to customers is key

ASEAN is already the world's fourth-largest exporting region. By 2025, more than half of the world's consuming class will live within a five-hour flight of Myanmar."

One of ASEAN's key strengths as a potential manufacturing base is the rapidly growing middle class being fuelled by the region's economic development. A report from the Asian Development Board points out that in the time since the "global financial crisis, demand from advanced economies has remained subdued," meanwhile, "rising wages and rapid economic growth in Asia have created a… large market with increasing purchasing power [that] remains untapped."

Investing further in manufacturing facilities in the region will put MNCs in the backyard of this growing customer base. A McKinsey report puts it bluntly: *"ASEAN is already the world's fourth-largest exporting region. By 2025, more than half of the world's consuming class will live within a five-hour flight of Myanmar."*

The experience of the executives we spoke to already reflects this economic trend:

"The main reason to set up in Asia is to be closer to our customers: faster time-to-market, lower logistical costs and freight duties, higher flexibility to adapt to local demands."

"The market requires us to be closer to the customer. Setting up a manufacturing facility in Indonesia cut our delivery time from 18 days to 3 days."

"We opt to keep manufacturing near to our customers in China and India."

Consider factors beyond cost

"You just have to 'bite the bullet' and accept rising costs and tailor the business plan accordingly"

Naturally cost is a major concern for any business, let alone a manufacturing-intensive one, but the executives we spoke to highlighted that cost should not be the only factor when deciding where to locate or grow a manufacturing footprint.

"Our main board has high, realistic expectations for our Asia businesses but it does not focus too much on rising cost issues in Asia. Instead, the drive is towards breaking into new, high-margin markets and technologies [and] remaining counter-cyclical when there is a downturn."

"Our business manufactures sophisticated, big-ticket capital equipment and so when we look for cost advantages it's not simply about the cost of manufacturing such as blue-collar wages. We have to consider the whole logistics and supply-chain piece and crucially, the quality of production and engineering available in a specific geography."

"You just have to 'bite the bullet' and accept rising costs and tailor the business plan accordingly – you need to have a business that is well positioned to provide the best quality of product and service to swelling customer numbers whilst maintaining decent margins."

"We are building an engineering hub of excellence in Vietnam, which we based on labour cost, quality of staff and other soft factors. Cost management is not the most important factor for making these decisions."

Two hubs in Asia are better than one

"It's simply not feasible or sensible to run China from another Asian hub such as Singapore."

When asked about their regional management strategy, a number of the executives we spoke to mentioned that running their business for all of Asia from one centralised hub did not make sense. They recommend maintaining a hub in China to service the massive market in Greater China and creating a second hub from which to manage the business for ASEAN.

"A sensible approach sees organisations having a 'foot in both camps'; establishing a China HQ and a 'Rest of Asia' HQ, typically in Singapore or HK. The two regions face different challenges and a one-size-fits-all business plan simply doesn't work."

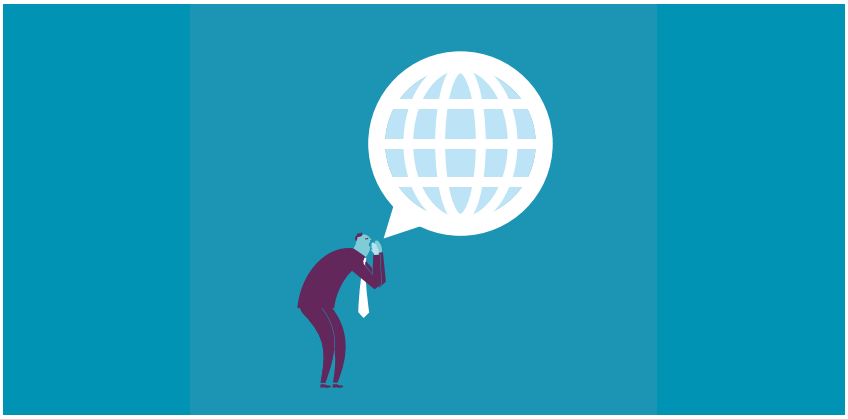
"Increasingly, MNCs are viewing China as a stand-alone region, and then setting up their 'rest of Asia' headquarters in Singapore. Singapore is an expensive place to live but their government has made it an attractive and easy place to set up and run a fully compliant Asia business."

"A business cannot simply view Asia as one region, nor can it over emphasise China's contribution in an Asia strategy. We have developed and executed a business plan that allows us to penetrate new emerging, untapped markets in China and position our business for growth in other newer Asian economies such as India, which are effectively around 15 years behind China in terms of market and economic development."

"We set up our Global HQ for several of our business units in Singapore a few years ago because of the growing importance and continuous potential of Asia. This was a major decision for our European head office, as it required a fundamental change in the way we operate. In the few years we have been operating in Singapore we have seen massive improvements in not just our sales but also our processes and internal quality standards."

"It's simply not feasible or sensible to run China from another Asian hub such as Singapore. The lines of communication are stretched, cultures are different and it sends the wrong signal to the customer base and stakeholders. It's more advisable to have two 'hubs' in Asia: China, including perhaps North Asia, and then The Rest of Asia."

Countries MNCs favour in the region as a manufacturing base



We asked the executives we interviewed to share their experiences working in key markets in the region. Some of their observations may surprise you.

Global manufacturing businesses are not surprisingly recognising the appeal of the Indonesian archipelago.

Indonesia

Indonesia has a large, young population and a new president, Joko Widodo, who is keen to attract foreign investment and higher-tech manufacturing capability. The Economist writes, "Widodo has made no secret of his desire to see his country capture higher-value activities. He has vowed to use money freed by subsidy cuts for infrastructure improvements, and has been wooing investors for his country's port system." Global manufacturing businesses are not surprisingly recognising the appeal of the Indonesian archipelago.

"If we were to set up a factory in ASEAN, I would most likely choose Indonesia. It might be easier to set something up in Thailand, which I believe is politically stable enough, but Indonesia has much more potential. It has the biggest population and is set for many years of growth."

"If we were to set up another plant to act on the growing markets in ASEAN, we would likely choose Indonesia over Malaysia or Thailand. Besides having the biggest population in the region, we have growing concerns about the political insecurities of Malaysia and Thailand, and believe that Indonesia has more long-term potential."

"We might move our factories to Malaysia because of better longevity of employees and the availability of highly educated personnel."

Thailand

Thailand has become the automobile-manufacturing centre of the region. As The Economist writes, "Thailand's strength in vehicle production, which followed the scrapping of restrictions on foreign components, shows how the right policies can weld South-East Asian countries into China's manufacturing machine."

One of the executives we spoke to shared:

"Thailand shows great promise as an emerging, dynamic market despite recent political turmoil"

Singapore

For companies at the higher end of the manufacturing value chain, Singapore may be an attractive choice. Companies in need of less complex manufacturing capability may find it more cost effective to keep a lean management team in Singapore and outsource the manufacturing work to another ASEAN country.

"The Singaporean government has put in very smart plans to allow foreign companies to set up manufacturing in its country. The government-funded Economic Development Board made sure to give us attractive tax incentives for a long-term commitment. The Jurong Town Corporation, another government-sponsored organization, introduced us to prime greenfield locations for our factory, while other government agencies helped us free-of-charge with recruitment, accounting and legal matters in our early days in the country."

"With considerations such as IP, tax and manpower, we ended up making an easy choice to invest in a Singapore factory over other possible locations like Taiwan and Korea."

"The Singapore government is encouraging us to move our manufacturing out of Singapore. Our products are a lower technology than Singapore ideally wants manufactured in its country, and our required engineers are at the lower end of the salary scale. Singapore wants us to keep only the high-end technology manufacturing in the country."

Malaysia

Malaysia was attractive to some of the manufacturing executives we spoke to for providing a more cost-effective alternative to Singapore.

We are fighting a continuous battle with our customers and distributors to convince them of the premium quality products made by our India factory.

"We considered more than ten locations across Asia-Pacific for our first factory in the region. Philippines, Thailand and Vietnam were all rejected because of their political situations. Singapore was rejected because of expensive labour and facilities and Batam [Indonesian island close to Singapore] was rejected because of supply chain issues and political insecurity. Johor Bahru [Malaysian city at the border with Singapore] proved the best choice due to 1) proximity to our Singapore regional headquarters, 2) easier access to our regional supply chain, 3) room for expansion at low cost and 4) availability of highly educated personnel."

"We might move our factories to Malaysia because of better longevity of employees and the availability of highly educated personnel."

India

While not part of ASEAN, India is a giant player in the region that is growing too quickly to be ignored. Interestingly, quite a few of the executives we spoke to provided glowing reviews of their manufacturing facilities in India.

"India became our centre of gravity, our centre of excellence, in the Asian market. We set up our largest global factory in India and source all products locally. It's the best location in Asia considering costs and local suppliers."

"Twenty years ago, our India factory used to only make products for the local market. Nowadays the factory is responsible for 80% of products for South-East Asia and increasingly also for products sold worldwide. The quality standards have gone up tremendously and it's at par with our best factories back in the UK. Our India factory has facilitated new growth for the company worldwide. We are fighting a continuous battle with our customers and distributors to convince them of the premium quality products made by our India factory. Even though the common perception is changing, we will have to continue to influence buyers to believe in our India factory."

"We have been in India since the late 90s when trade barriers were very strong in the country and we were more or less forced to establish a factory there if we wanted to be competitive in the local market. Since then, this factory is posting record results and quality standards, and it's an exemplary factory for the rest of the world.

"Our India site used to only produce for the local market but has quickly developed into producing for regional customers, with global customers to follow in 2015."

Challenges remain but can be overcome

Despite the clear demographic and economic incentives, some global manufacturers are still reluctant to build up their Asia businesses. Challenges such as political instability, natural disasters and undeveloped infrastructure will not be resolved overnight. However, ASEAN nations are working to address some of the costs of doing business in the region and investing in skills training for the growing labour pool.

On the cost front, the expense required to ensure ethical compliance and safeguard information and intellectual property remain a concern for MNCs in the region. However, some cost-related challenges are slowly being addressed through the creation of the ASEAN Economic Community. According to the regional association, the AEC will "transform ASEAN into a region with free movement of goods, services, investment, skilled labour, and freer flow of capital" by the end of 2015.

However, the AEC zero tax zone may only enable marginal cost savings for global businesses. One executive we spoke to noted:

"The AEC will have a positive but negligible influence on our business, since most of our products come from India and China."

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A broader regional economic agreement could prove more useful. The Economist writes that talks have begun about "a broader pact that would tie all countries in the region together, including India."

In addition, some MNCs worry about the ability of manufacturing facilities in Asia to match the quality and efficiency achieved by those in the West. The leaders we spoke to in the field strongly believe that this concern is out dated and tell us that the quality of manufacturing in the region already matches that achieved in the West in many cases and is improving further all the time.

One executive for a global manufacturing concern we spoke to noted his factories in Asia are already outperforming their Western counterparts in terms of quality when judged on the same KPIs. He shared:

"I believe that the main reason for this is the underlying eagerness of our Asian employees to learn, their pride in continuously improving themselves, and their overall positive attitude to work."

Conclusions

"We're finally running Asia from Asia – the next step is running the world from Asia."

Given ASEAN's demographic advantages and rapidly expanding market opportunities alongside its ever-improving quality of talent and manufacturing capability, the region is a more attractive manufacturing base than ever.

The importance of having a footprint in ASEAN becomes undeniable when the region is viewed, not just as a manufacturing centre for the developed world, but also as ground zero for capitalising on the region's inevitable, dramatic growth.

Several executives we spoke to highlighted the paradigm shift in thinking that will be crucial for the success of manufacturing businesses in the years to come:

"Several years ago most companies ran their Asia operations from foreign headquarters. The next step was to run Asia operations from an Asia office. The future step in this process, which is happening as we speak, is to run global operations from Asia, increasingly with Asian nationals running the show."

"We're finally running Asia from Asia – the next step is running the world from Asia."

Given ASEAN's market potential, favourable manufacturing environment and advances in regional economic cooperation, it's no surprise that, as the Wall Street Journal points out, the smart money is moving to manufacturing "in the region, for the region." Admittedly, challenges remain but the smart money is playing a long game in Asia and investing the time and resources needed to succeed here.

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