## Challenges that lie ahead







AMRAN HOSSA

CPOs have 5 major issues on their minds when it comes to sourcing from Bangladesh

High Low CPOs' PERSPECTIVES IMPORTANCE Utilities, road network, and port facilities Infrastructure are seen as major limiting factors Situation has improved over the last few years; Compliance however, significant continued efforts required Labour costs are expected Supplier to increase; in addition, performance and workforce skill/capability/capacity gap needs to be closed supply Dependency on imports are considered a major source of risk regarding materials lead times Risk of political instability Economy and threatens sourcing political stability

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Exhibit 5

Challenges of growth
While Bangladesh represents

While Bangladesh represents some very promising advantages in certain dimensions, a number of challenges could create hurdles for companies seeking to source there (Exhibit 5). Only if these challenges can be overcome, will Bangladesh's RMG industry continue to prosper?

*Infrastructure* For all business stak

For all business stakeholders, infrastructure (transport and utility supply) is the single largest issue hampering Bangladesh's RMG industry. Buyers today are forced to carefully select the

type of products to source from Bangladesh, since congested roads, limited inland transport alternatives, and the lack of a deep-sea harbour add inefficiencies to garment lead time. With the aim to move toward sourcing more fashionable, shorter lead time items in Bangladesh, reliable and fast transport is becoming extremely important. The transport issues need to be solved quickly in order to avoid a collapse in the transport network as volumes continue to grow (Exhibit 6).

As the RMG industry is highly dependent on the Dhaka-Chittagong highway and Chittagong harbour as the only main transport routes, the following examples of current issues are already limiting the efficiency of Bangladesh's garment industry:

The highway is often congested as capacity planning falls behind demand, increasing transport time from Dhaka to Chittagong up to 20

Lead time for sea freight is increased by about ten days due to the lack of a deep-sea harbour.

Productivity at Chittagong port suffers from inefficient processes (manual processing), limited crane capacity, and strikes that sometimes span several days at a time.

The Dhaka-Chittagong train connection offers limited capacity (only for about 120 containers per day) although logistics experts estimate a tenfold capacity need.

At the moment, suppliers are making adjustments and "manage" around these issues by incorporating additional transport days into planning, building very close relationships with transport companies, making drivers more accountable, and by using tracking systems to achieve full transparency of their products' movements at all times.

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Discussions with government representatives validated a number of projects addressing the different transport routes that are being

pursued to help ease the situation. For example, the government plans to expand the Dhaka-Chittagong highway to four lanes, prepare long-term efforts to establish a deep-sea port in Chittagong, improve efficiency at Dhaka airport, and double the train container transport capacity.

It remains to be seen if the improvements planned by the government can be financed, implemented quickly enough, and are sufficient in their current form to avoid a possible transport network collapse. The country's past success rate in finalising projects on time raises some doubt about a quick solution for the infrastructure issue. For example, only about 17 percent of the work on the highway project has been completed to date, making the December 2012 deadline obsolete.

The power supply issue seems more likely solvable within the next two or three years, although 90 percent of local suppliers rate the current energy supply as very poor or poor. Today, many factories are investing to ensure having a constant power supply and are using their own generators in order to remain independent of the public energy supply. However, the issuing of gas licences has been limited, leading to delays in manufacturers' expansion plans.

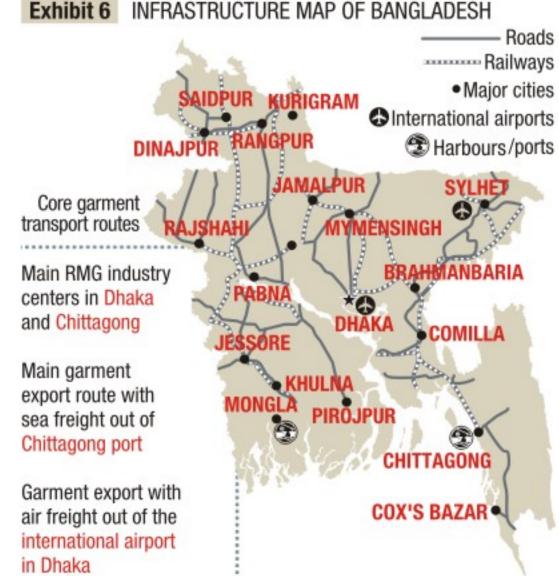
Additionally, conserving energy is becoming a more prominent topic. Some 12 suppliers have started to move toward "greener" production and are improving their energy efficiency within the "Cleaner Production Initiative," coordinated by the World Bank's International Finance Corporation (IFC) in cooperation with six leading garment buyers, including large buyers such as Walmart, H&M, and Marks & Spencer. For example, one vertically integrated supplier recently demonstrated 10 to 12 percent in energy savings in a report on preliminary results of the initiative.

Improving the country's energy supply is a core topic for the current government. Within the last two years, more than 2,000 megawatts of power have been added to Bangladesh's network, new contracts for 34 power plants have been awarded, and negotiations for a joint electricity grid to enable power trade in the region are under way.

## Compliance

As a developing country, Bangladesh is under close scrutiny by nongovernmental organisations (NGOs) and corporate social responsibility (CSR) stakeholders regarding compliance. Both CSR experts and buyers report improved labour

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and social compliance standards, but there is still a broad range of compliance seen across suppliers and, as described in the following, many unsolved topics still exist. Solving these issues and achieving ethical labour standards and sourcing practices are key prerequisites in Bangladesh's apparel industry from a McKinsey perspective.

Regional concentration of Bangladesh's RMG industry provides a relatively high visibility of the compliance situation. CSR stakeholders can visit a significant amount of suppliers within a relatively short time. This situation offers more opportunity to create transparency regarding supplier conduct than would be possible in countries such as China and India, as their industry locations are much more spread out. International buyers should also make active use of unannounced visits to achieve transparency.

Some 93 percent of the European and US CPOs interviewed agreed that the compliance standard in Bangladesh has somewhat improved (67 percent) or strongly improved (26 percent) within the last five years. However, they reported that the spread among suppliers remains high.

As one buyer of a mid-market brand puts it, you would be "impressed by how good the compliance is in the good factories." Some of the best factories have even started to increase transparency by implementing CSR reporting. However, only 50 to 100 manufacturers of around 5,000 that are active are mentioned as having achieved very high standards. McKinsey suggests that buyers should continually push efforts to increase and maintain compliance standards by educating workers, implementing standards at suppliers, and fostering full transparency in the supply chain via their local sourcing offices.

The most developed suppliers understand that compliance is a key factor in achieving business success. As one interviewee stated, "things are changing and if I do not comply, I cannot get the orders." Therefore, it is the responsibility of the buyers to choose their suppliers consciously and manage compliance -- not only via on-site control but also by rewarding good compliance standards.

Despite the progress of the last few years, gaps exist and new risks may be emerging. Issues in social compliance mentioned by some of the top buyers in Bangladesh are the lack of worker education, a remaining risk of subcontracting, lack of law enforcement, and a continued need for developing fair practices and compensation. For example, Bangladesh enacted child labour regulation in 2006, but UNICEF has reported a lack of enforcement. In 2010, a new legal framework was developed in conjunction with the input of UNICEF as well as other stakeholders. This most recent effort by the government of Bangladesh aims to eradicate child labour by 2015.

Environmental compliance is just starting to get the required attention in the market. The previously mentioned "Cleaner Production Initiative," coordinated by the World Bank's International Finance Corporation, is the first big effort in this area. In October 2011, the IFC reported that the 12 factories involved in the pilot project have lowered water consumption by 75 million litres and achieved savings of \$1 million in operating costs.

Past improvements can be attributed to the strong push of critical Western stakeholders as well as European and US buyers. However, the new customer base of Bangladesh's RMG industry might have a different idea of what standards need to be followed. Interviews conducted with CSR experts revealed that they expect implementation of and adherence to stricter standards to become more difficult as customers from regional markets increase their share of sourcing in Bangladesh.

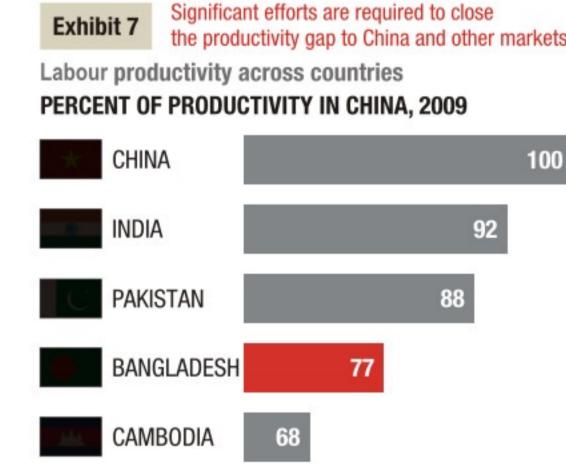
For European and US apparel players, McKinsey sees careful supplier selection, value chain transparency, a tireless effort, and close relationships with suppliers remaining crucial to ensuring compliance when sourcing in Bangladesh.

## Supplier performance and workforce supply

In the medium term, McKinsey expects that labour costs will continually increase, that the apparel export market will grow at between 7 to 9 percent through 2020, and that value buyers are looking to source more fashionable and sophisticated products from Bangladesh. At the same time, mid-market buyers have just entered the market and are starting to source standard products. To realise the growth potential, garment manufacturers will need to make performance improvements and ensure the supply of skilled workers.

Productivity at suppliers needs to improve, not only to mitigate rising wages, but also to close the existing productivity gap in comparison to other sourcing countries (Exhibit 7). Productivity in Bangladesh's RMG factories needs to catch up to the levels seen in India if Bangladesh's suppliers are going to be able to deliver on the unit demand growth that McKinsey forecasts, now expected to be 2x to 2.5x through 2020.

Additionally, a gap between customer requirements and supplier capabili-



ties/investment plans is emerging. Buyers want to expand their sourcing product mix into more sophisticated categories, such as outerwear, tailored products, ladies intimates, and functional clothing. Currently, however, only 50 to 100 local garment manufacturers are able to produce at an advanced level in terms of product categories, productivity, services, and compliance.

SOURCE: USAID; INTERVIEWS; MCKINSEY

Representing 85 percent of those interviewed, the majority of CPOs are sure (41 percent) / think it is likely (44 percent) that suppliers will be upgrading into more sophisticated products. And mid-market players are overall even more positive about the supplier upgrades than are value players. Supplier investment plans show mostly only minor developments within existing product categories. Just a few suppliers are starting to invest in new technologies in order to make any kind of notable upgrades.

Besides a lack of investment in new machinery and technologies, the current insufficient size of skilled workforce also impedes an increase in productivity and a move toward more sophisticated products. Also, existing challenges will multiply if suppliers aren't able to fill higher-skill middle management positions and if the amount of skilled workers needed in Bangladesh's RMG industry is not secured.

When they were interviewed, all types of stakeholders mentioned the lack of skilled middle management as a key factor limiting productivity improvement at suppliers:

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