

Challenges that lie ahead



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

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

SOURCE: MCKINSEY CPO SURVEY, SEPTEMBER - NOVEMBER 2011; INTERVIEWS

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Challenges of growth

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 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 hours.

• 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.

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

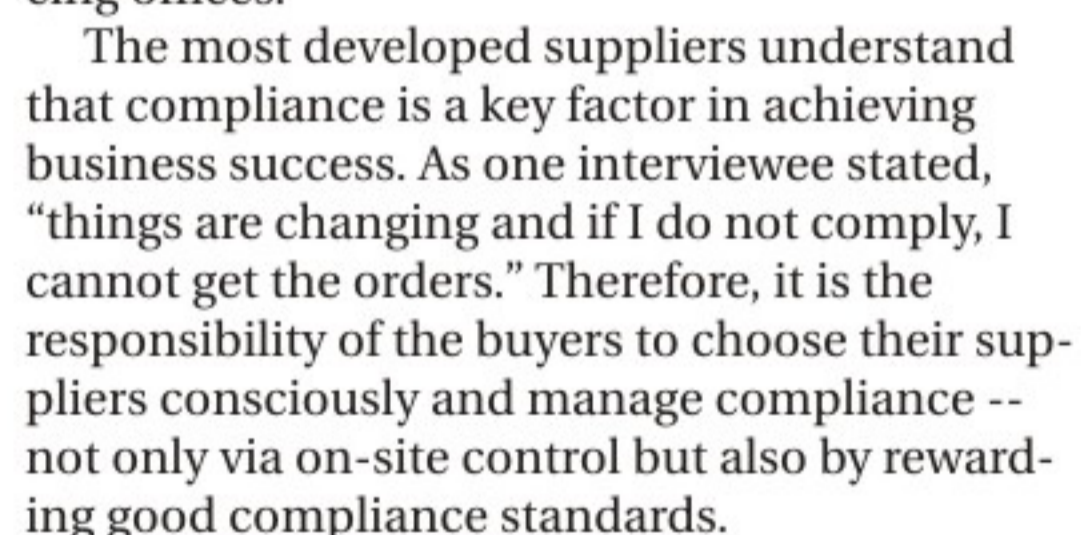
As a developing country, Bangladesh is under close scrutiny by nongovernmental organisations (NGOs) and corporate social responsibility (CSR) stakeholders regarding compliance. Both CSR experts and buyers report improved labour

relationships with suppliers remaining crucial to ensuring compliance when sourcing in Bangladesh.

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 capabilities. **Exhibit 7** Significant efforts are required to close the productivity gap to China and other markets **Labour productivity across countries** **PERCENT OF PRODUCTIVITY IN CHINA, 2009**



SOURCE: USAID; INTERVIEWS; MCKINSEY

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.

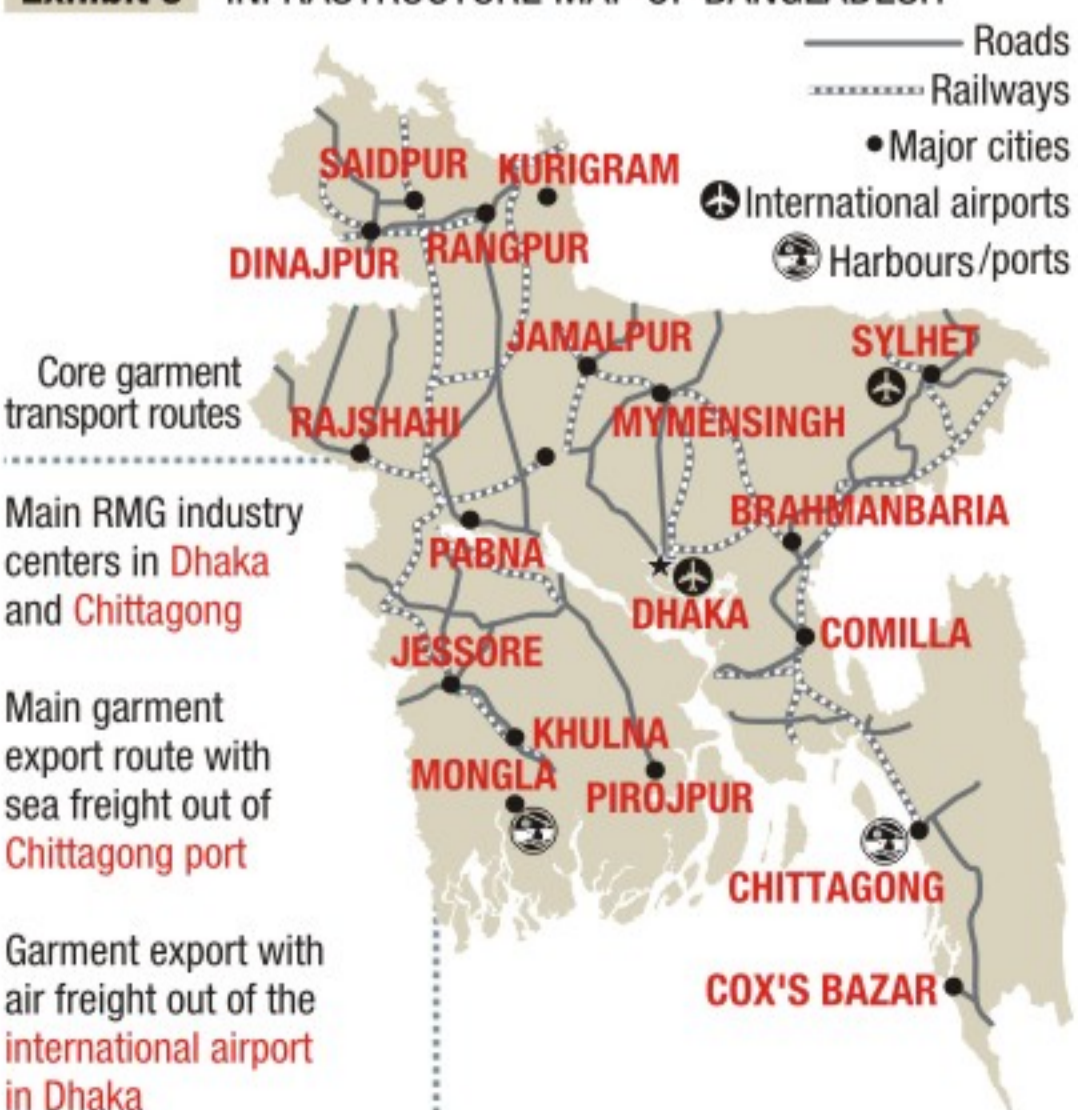
Representing 85 percent of those interviewed, the majority of CPOs are sure (41 percent)/ think it is likely (44 percent) that suppliers will be upgrading into more sophisticated products. And mid-market players are overall even more positive about the supplier upgrades than are value players. Supplier 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:

For European and US apparel players, McKinsey sees careful supplier selection, value chain transparency, a tireless effort, and close

Exhibit 6 INFRASTRUCTURE MAP OF BANGLADESH



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

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