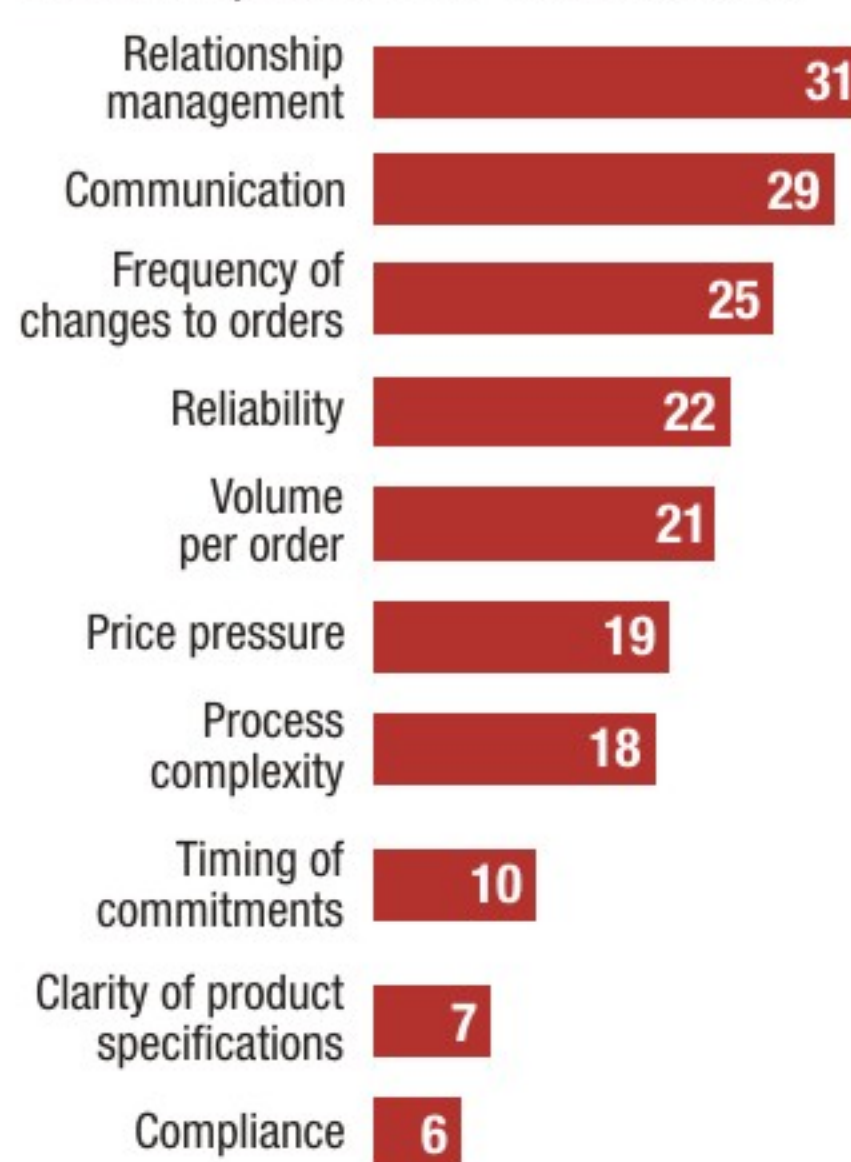


# Future growth requires 3.5m more workers

**Exhibit 8** Suppliers seek closer long-term relationships with buyers

"In which areas would you like most to see buyers improve?"

**SUPPLIERS, PERCENT OF RESPONDENTS**



SOURCE: MCKINSEY SUPPLIER SURVEY, SEPTEMBER 2011

**FROM B5**

➤ Educational institutions for technical skills are few or nonexistent.  
➤ The RMG industry's image is not attractive enough to interest young top employees and graduates.  
➤ "Importing" middle management creates several problems, such as cultural issues and the lack of incentives for local workers to pursue internal training or development as well as increased costs.

Consequently, the low educational level of workers contributes to more inefficiency in the garment factories. Experts estimate that there is currently a 25 percent shortage of skilled workers in Bangladesh's RMG industry. The majority of workers receive training only at a basic level on the job in the factories or in regional basic sewing schools, as vocational training institutions currently don't exist.

Also, the migration backgrounds of workers -- coming from poor remote regions to the garment centres Dhaka and Chittagong -- and limited employee loyalty in the low-wage jobs mean that suppliers constantly face high recruitment levels of about 5 percent per year. Along with high labour turnover, the future growth of RMG exports weighing above productivity increases will require up to 6 million workers by 2020. With most of the industry being focused on Dhaka, healthy and sustainable expansion -- from a business as well as a social responsibility point of view -- will necessitate geographic diversification into rural areas in order to more effectively utilise the availability of Bangladesh's workforce. A key enabler for diversification into the less developed western part of the country will be the development and improvement of infrastructure.

**Raw materials**

The high volatility of raw materials prices seen within the last few years has increased buyers' sensitivity to raw materials prices and ease of access in sourcing countries. Considering this context, the current lack of any noteworthy own raw materials supply of natural or man-made fibres in Bangladesh weighs even stronger, beyond the immediate issue of lead time increase.

Bangladesh's dependency on imports creates sourcing risks and longer lead times. Whereas the average fabric lead time for wovens in Bangladesh is seven days, it increased to up to 15 days when sourced from India and up to 30 days when sourced from China. However, many fabrics produced in Bangladesh typically are at quality levels mainly suited for the value markets. Improvement in local capabilities and verticalisation would improve lead times. However, integration is likely to be seen more in knitwear due to the high capital investments needed for wovens.

Also, recent changes to trade agreements (EU-GSP rules of origin, India duty-free deal) provide incentives for Bangladesh's RMG industry to import fabrics, thus offering a chance for CMT (cut, make & trim) suppliers to upgrade and venture into more fashionable, more sophisticated products.

However, the overall development of Bangladesh's RMG industry leads to continued dependency, risk, and value chain inefficiencies. So it is not surprising that the average lead time for 45 percent of the local suppliers interviewed is still at around 90 days and for 25 percent, at 120 days. It should be noted, however, that 21 percent of suppliers manage to bring down their shortest lead times to less than 30 days.

**Economy and political stability**

In the opinion of European and US CPOs, economy and political stability

are the fifth area of risk when sourcing in Bangladesh. About half of the CPOs interviewed stated that they would reduce the value of their sourcing in Bangladesh if political stability were to decrease. Planning security, political unrest and strikes, corruption, and ease of doing business are the topics mentioned most often.

Bangladesh's multiparty democracy is characterised by two large opposing parties and a five-year election cycle. The dynamics of the country's government has partially contributed to interruptions in short-term planning and implementation of longer-term projects.

Although mass strikes (known locally as "hartal") have less frequently directly affected the RMG industry in recent times, political unrest and strikes in the supply chain can lead to significant delays. In McKinsey's survey, Bangladesh's RMG suppliers cited political unrest (50 percent of respondents) and strikes (21 percent of respondents) as the highest risks in sourcing from Bangladesh, right after infrastructure. The "hartal phenomenon," as the local media call it, is not only a signpost for the continued social changes required, but a risk of which buyers need to be aware.

The majority of CPOs see corruption as a major hurdle for doing business in Bangladesh. Some 57 percent of respondents are aware of corruption being present but manageable with experience, whereas 30 percent have seen limitations in their business dealings because of it. Though Bangladesh's position in the Transparency Corruption Index has improved over the last few years, measures against corruption need to become more effective. In the view of CPOs and suppliers as well as international NGOs, the enforcement of law and order is inefficient -- or as one CPO put it: "Laws exist, but the government does not enforce application."

Approximately 5 percent of suppliers mentioned high interest rates as a hurdle to capital investment in the RMG sector. In the past, the International Monetary Fund (IMF) had requested a reduction in lending interest rates to foster investment. Though the rates have dropped from an average of 16.4 percent in 2008, lending interest rates in Bangladesh in 2010 were still at an average 13 percent according to the IMF -- more than double the level of China's average lending interest rate at 5.4 percent.

New industry and service sectors are starting to gain importance for the economy in Bangladesh (e.g., pharmaceuticals, shipbuilding, IT). Today and in the medium term, the labour-intensive RMG industry still takes precedence, but in the longer term, a shift in the government's focus will likely emerge.

The potential for Bangladesh's RMG growth can be realised only if the challenges in the five areas of infrastructure, compliance, supplier performance and workforce supply, raw materials, and economy and political stability are tackled. It will be paramount that stakeholders work jointly to achieve this goal.

**Making it work: Overcoming the challenges of growth**

Despite all the challenges that exist in Bangladesh, companies can still highly benefit from its sourcing offering. There are a number of areas in which the three main stakeholders -- government, suppliers, and buyers -- can work to overcome various hurdles to success.

**Government: Plan ahead**

From the RMG industry perspective, longer-term plans and investments to accommodate the foreseen future growth are most important. The government's top 3 priorities for investment are infrastructure, education, and trade support.

As previously noted, the current infrastructure investments are a start, but are far from enough to either provide the capacity needed today or come close to what is required for the future. Increased investments, diligent planning, and project management, as well as overcoming unnecessary bureaucracy and corruption are required. If the infrastructure is provided, additional incentives to decentralise the industry could support its healthy growth.

Investment in education requires broad initiatives. On the one hand, middle management education should be combined with an effort to improve the image of the garment industry. And on the other, vocational training needs to be developed and the appropriate institutions must be established either by the government or via public-

private partnerships.

Continued trade support for Bangladesh's RMG industry, especially with regard to bilateral agreements, is the third core priority. For the latter, the focus shouldn't be on export markets only, but a long-term strategy needs to be developed in order to secure the required raw materials supply as well. Further support in increasing the country's attractiveness and enabling national backwards integration in Bangladesh would help further reduce dependencies.

These are the areas in which suppliers most strongly desire government investment, with 97 percent of suppliers asking for investment in infrastructure, 79 percent in education, and 50 percent in trade support. Additional focus areas for the government from an RMG industry perspective should be social/health, environment, and law and order.

**Suppliers: Think beyond**

McKinsey's work has identified five "action fields" -- productivity, compliance, partnerships, supply chain management, and funding -- that suppliers should play upon to overcome the barriers to growth in Bangladesh's garment export business.

First, suppliers need to increase their professional standards and make their own efforts to improve productivity and education instead of waiting for the government to do so. Concrete steps that suppliers can take, for example, include:

- Improve the management skills of top and middle management.
- Provide structured in-house training for both workers and middle management.
- Ensure fair wages and incentive schemes.
- Pursue lean workshops, certification, and automation of production.
- Incorporate enterprise resource planning systems, production planning systems, and continuous productivity monitoring.

The second field of action suppliers should affect is establishing clear standards for labour and environmental compliance. Here, a step change is required from simply reacting to buyer and NGO demands, to proactively developing a comprehensive CSR strategy with dedicated compliance

**Bangladesh's RMG growth formula**  
**STRONG STARTING POSITION**



teams, "clean production" initiatives, worker satisfaction and loyalty monitoring, and best practice sharing within the industry and among NGOs and buyers. The industry-wide Garments Without Guilt (GWW) initiative, established by the Sri Lankan apparel industry, could provide an interesting blueprint for a supplier-driven initiative in Bangladesh.

Creating long-term partnerships with buyers and leveraging buyer know-how in capability building is the third field on which suppliers should focus. This can include, for example, utilising buyer know-how for capability building, long-term capacity planning/blocking, co-development of products, electronic data exchange, and balancing minimum order sizes.

The fourth action field should involve suppliers managing their supply chains more strategically, focusing on core topics such as local versus foreign raw materials footprint, developing approved local sources (e.g., for accessories), evaluating the potential for verticalisation, and diversifying into more value-added products. The final field of action would be for suppliers to optimise their funding for capital investments, considering, for example, retained earnings and equity funding, co-investments with buyers, and joint ventures.

McKinsey's research shows that some manufacturers have already set out on a path toward making improvements, but broader efforts along all five action fields are required and more suppliers need to join this improvement effort.

**Buyers: Take care**

What can European and US buyers do to secure Bangladesh as a sourcing powerhouse? Clearly, they should think about how to help overcome the hurdles to growth and improve efficiency from a full value chain perspective. Additionally, buyers need to be atten-

Sourcing setup "archetypes" generally cover different local sourcing activities and buyer responsibilities

Activity	Agent	Direct sourcing from HQ	Small sourcing office	Traditional sourcing office	Full-fledged sourcing office
Preorder	R&D				
	Product design				
	Technical design				
	Raw materials sourcing				
Supplier selection	Market intelligence				
	Supplier screening				
	Supplier selection				
	Supplier quotation				
	Supplier negotiation				
	Supplier decision				
Order mgmt.	Supplier development				
	Order placement				
Quality/CSR	Order follow-up				
	QA sample approval				
	In-line inspection				
Logistics	Final sample approval				
	Compliance				
Admin.	Warehousing				
	Shipping and customs				

tive to the shift from a buyers' to a suppliers' market, as the sourcing landscape in Bangladesh becomes more populated with Western buyers and new buying countries (e.g., China, India, and Brazil). At the same time, compliance efforts should never slow down, but should be pursued actively and continually.

Selectively, buyers have invested in supplier development in the past, whether via preferred supplier programmes or through compliance and environmental topics in joint programmes with NGOs. To further increase efficiency and transparency in the supply chain, buyers should expand their support for lean operations and electronic data exchange. Furthermore, buyers can evaluate their involvement in efforts regarding middle management development or building up vocational training institutions.

Another important lever suppliers can pursue in overcoming the challenges of growth is to build up close supplier relationships in order to position themselves in the emerging supplier market. As one sourcing office representative put it, what is needed is "a move from being directive, to being charming." Already today, 84 percent of CPOs in companies buying from Bangladesh describe their type of supplier relationship as long-term. However, suppliers still see clear areas for improvement (Exhibit 8).

Process hygiene on the buyer side is especially important to enable efficient end-to-end processes. Often, suppliers feel that they are pressured about timekeeping. But long buyer response time, in-house process complexity among buyers between the merchandising and sourcing functions, and a high number of last-minute changes contribute to slowing down the overall process. As McKinsey experiences in its work with clients, buyers recognise this issue and have started to work on reducing their inhouse process complexity and improving the interface with suppliers.

Additionally, the past price negotiation focus of buyers is being met with increasingly more resistance from suppliers. The most developed suppliers in Bangladesh have even begun choosing their customers very carefully at times, even breaking off ties with long-established buying partners in order to upgrade their customer base. The greater demand for mid-market products and higher absolute margins require a new pricing model. Suppliers are requesting a fair price model. As one supplier puts it: "An FOB price increase is needed there's a large gap between FOB price and buyers' sales price, but still buyers are bargaining for 5 and 10 cents and using FOB price negotiation across different standards of suppliers."

To enable closer supplier relationships, having an own local sourcing setup is becoming increasingly important. In order to choose the right archetype (see table on following page), buyers will need to more seriously consider supplier relationships and development in addition to the following five typical strategic decision making criteria regarding sourcing setup: strategic and organisational direction (e.g., buyer versus product focus), volume, product sophistication, lead time requirements, and own capacities (global, regional HQ).

Buyers are urged to continue pursuing their ongoing significant efforts and address compliance along the following dimensions, which are based on McKinsey's work with clients and the survey results:

- Their own capacities and standards to ensure labour/social compliance of suppliers

- Their own capacities and standards to ensure suppliers' environmental compliance.

- Governance schemes and monitoring to ensure compliance within their own sourcing setup/office.

- Cooperation with different NGOs and initiatives to ensure industry-wide improvement.

- Honouring supplier efforts rather than comparing different standards in quotations.

- Acknowledging development needs to ensure customer trust rather than focusing on past improvements.

Together, the three main stakeholders -- government, suppliers, and buyers -- can accomplish the development potential and solve Bangladesh's RMG growth formula. Most importantly, they need to work hand in hand on their continued efforts regarding all of the various measures involved in improving the image of Bangladesh's RMG industry.

McKinsey sees a need for a new level of collaboration with regard to compliance, in which forces join across government, suppliers, buyers, and other stakeholders to anchor ethical and sustainable business practices along the value chain. The future development of Bangladesh depends on addressing these critical issues now. Only if wholehearted efforts are led by all stakeholders together, will the stage be set to support a future "rebranding" of Bangladesh.

Bangladesh should be on the radar screen of all European and US apparel buyers. This is especially true as Bangladesh's RMG exports will strengthen the country's position and are likely to grow -- double by 2015 and nearly triple by 2020. Other markets in Southeast Asia will increase their exports too, but won't be able to replace -- at least in the near future -- Bangladesh as a viable RMG sourcing hub. But Bangladesh's sourcing market will get crowded, as incumbents plan to significantly increase and new players enter.

In order to leverage the best of what Bangladesh has to offer in the way of sourcing opportunities, apparel companies will need to prepare themselves accordingly. They should plan to revisit their sourcing and country strategies to secure the benefits, upgrade supplier management, move quickly, and not ignore the importance of managing the risks. This will of course also involve upgrading and further professionalising the local setup, hiring top talent, strengthening supplier relationships, and improving logistics management.

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