KPMG

South East Asia Manufacturing

"China plus One" considerations for new investments

June 2019

With rising trade tensions between the People's Republic of China ("China") and the United States of America ("U.S."), many enterprises are now wondering how to manage emerging geopolitical risk and its likely impact on their regional manufacturing strategy. KPMG has prepared this publication as an introductory overview of potential alternative manufacturing locations in South East Asia.

What is at stake?

According to recent trade data, the U.S. imported USD540bn worth of goods from China, whereas China imported only USD120bn from the U.S. in 2018. This escalating trade imbalance resulted in growing trade tensions and ultimately resulted in the imposition of trade sanctions by the U.S. in 2018. Currently, nearly half of all imports into the U.S. from China are subject to levies of up to 25%. The Trump administration is also now threatening to apply tariffs on all remaining imported Chinese goods. China has been quick to retaliate with tariffs on USD110 billion of U.S. imported goods into China. This tit for tat application of levies and sanctions by both parties is not likely to be resolved quickly, if at all. Accordingly, this rise in tariffs may have a significant impact on global economic activity and for U.S. enterprises who rely on imports from China in particular.

As uncertainty grows, many enterprises with manufacturing capacity in China are now exploring a manufacturing diversification strategy commonly referred to as a "China plus One" strategy. The basis of this strategy is retaining a foothold in China, but expanding into a new jurisdiction for cost reduction or other reasons.

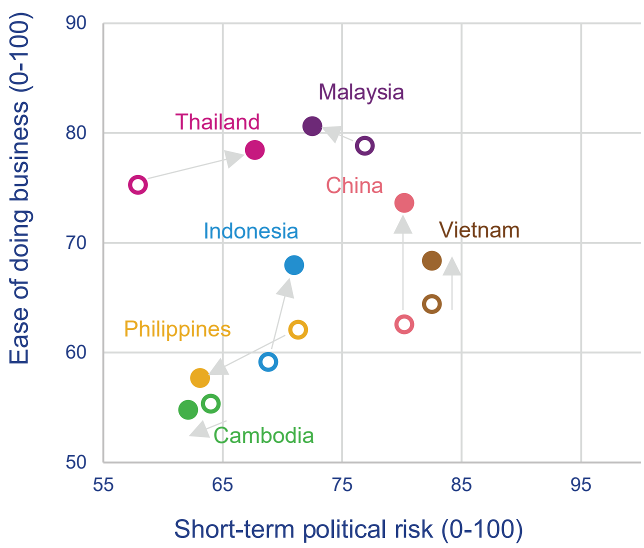
Major ASEAN countries are getting more attraction and foreign direct investments ("FDIs")

Many manufacturing enterprises are now turning their attention and foreign direct investment ("FDI") to some of the countries that comprise the Association of Southeast Asian Nations ("ASEAN") as an alternative to China, especially emerging markets, as wage costs are a factor. Each country has its strengths and weaknesses, but a few locations stand out. According to the Financial Times FDI Report 2019, Indonesia and Vietnam ranked third and fourth in attracting the most inbound greenfield FDI by value in 2018 in the Asia Pacific region, after China and India. Thailand experienced the highest growth in new FDI projects by number with a 55% increase over the prior year.

Ease of doing business

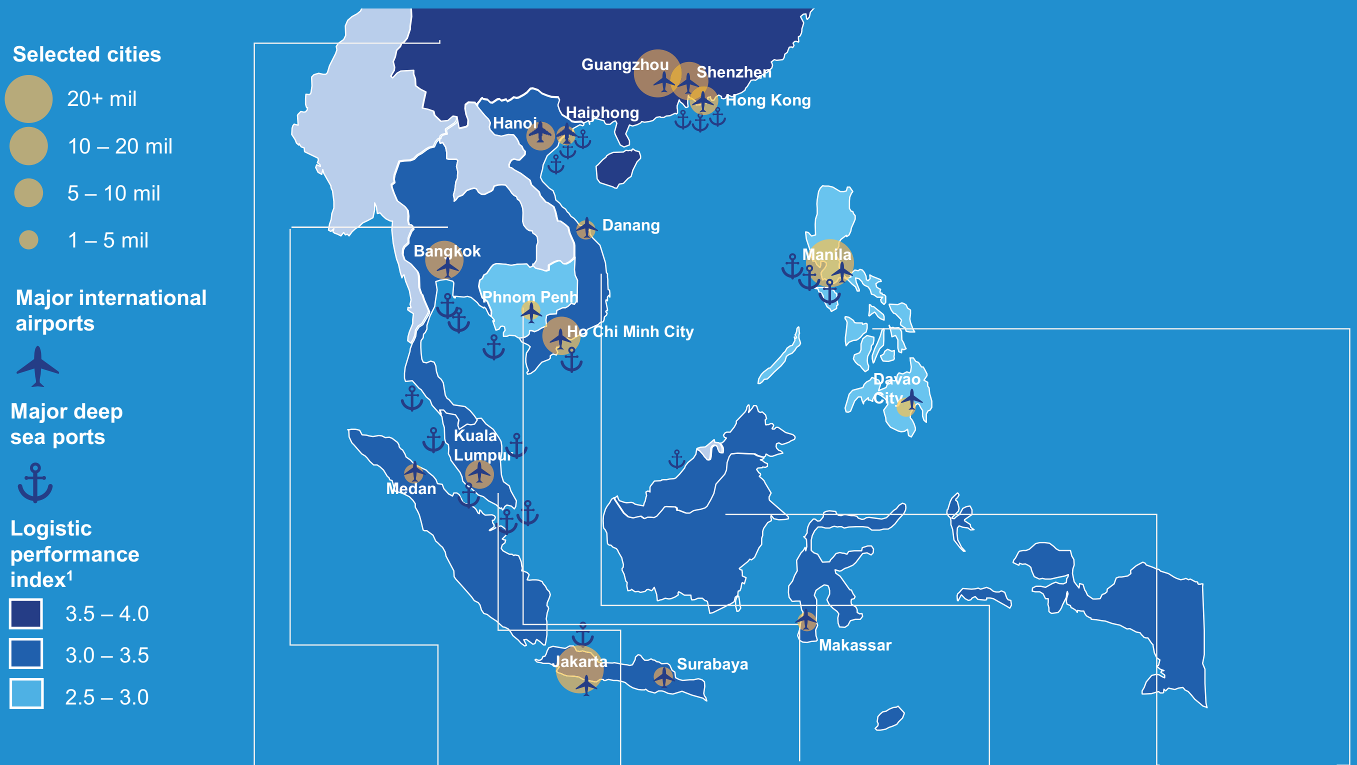
According to the latest annual World Bank survey on the Ease of Doing Business (2019), many ASEAN countries have improved their overall rankings, but more work is needed on digital transformation to reduce the administration burden of doing business in those jurisdictions. Countries that have implemented automated compliance processes have achieved higher overall rankings. As two of the more developed countries in the region, Malaysia and Thailand scored well (see table 1). On a different metric (political risk), Vietnam ranked highest among comparable countries and has benefited from a stable political system.

Table 1: Non-cost factors among selected ASEAN countries compared to China



Source: World Bank, BMI (2018, 2019)

Economic and logistics comparison of selected countries



Country/ Population	China (CN) 1,386 m	Thailand (TH) 69 m	Malaysia (MY) 32 m	Cambodia (KH) 16 m	Vietnam (VN) 96 m	Indonesia (ID) 264 m	Philippines (PH) 105 m
GDP/ Growth[2]	12,238 bn (+6.95%)	455 bn (+2.79%)	315 bn (+5.30%)	22 bn (+7.04%)	224 bn (+6.42%)	1,016 bn (+5.00%)	314 bn (+6.44%)
FDI/ growth[2]	168.2 bn (-12.8%)	8.0 bn (-15,7%)	9.5 bn (-4.2%)	2.8 bn (+7.7%)	14.1 bn (+12.2%)	21.5 bn (-2.0%)	10.1 bn (+28.1%)
Currency/ Volatility[3]	Renminbi (1.15%)	Thai Baht (1.53%)	Malay. Ringgit (2.47%)	Cam. Riel (0.69%)	Viet. Dong (1.15%)	Indo. Rupiah (1.15%)	Phil. Peso (1.35%)
Top exports	Electronics, Machinery/ instruments	Electronics, Automotive	Electronics, Oil and gas	Garment, Footwear	Electronics, Garment	Palm oil, Coal	Electronics, Machinery/ instruments

Source: World Bank (2017), OEC (2017), Fitch Solutions (2018), Investing.com (2019)
Notes: [1]The Logistics Performance Index is scored on the scale of 0 – 5 based on the combination of the following sub indicators: customs, infrastructure, international shipments, logistics competence, tracking & tracing, timeliness; [2]Total in USD, growth: CAGR 2013-2017; [3]Volatility from 01/2013 to 04/2019

Global trade integration

Free trade agreements ("FTAs") have a direct impact on the movements of goods across international borders. China has a higher total number of FTAs, while Malaysia and Vietnam on the other hand have more multilateral trade agreements in place. This multilateral trade approach arguably provides access to more countries with larger markets (see table 2). The Comprehensive and Progressive Agreement for Trans-Pacific Partnership ("CPTPP") is also a key consideration. Malaysia and Vietnam have signed the CPTPP, whereas Thailand, Indonesia and the Philippines have not. Vietnam has also signed a multilateral free trade agreement with the European Union.

Table 2: Overview of relevant FTAs

FTAs	VN	MY	TH	PH	ID	KH	CN
AFTA	✓	✓	✓	✓	✓	✓	x
AFTA-China	✓	✓	✓	✓	✓	✓	✓
India	✓	✓	✓	✓	✓	✓	x
Korea	✓	✓	✓	✓	✓	✓	✓
Japan	✓	✓	✓	✓	✓	✓	x
CPTPP	✓	✓	x	x	x	x	x
EU	○	○	○	○	x	x	x
US	x	○	○	x	x	x	x

Legend: ○ To be ratified ○ In negotiations

Source: WTO (2019)

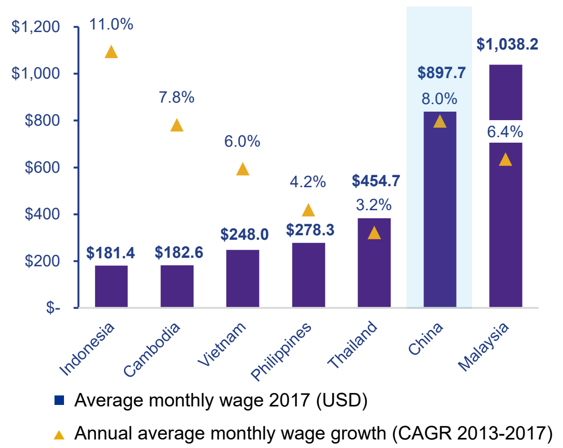
Cost considerations

A key consideration for manufacturing is cost and a primary component of the cost is labor. Malaysia and China have significantly higher wage costs compared to say Indonesia and Cambodia. Vietnam and the Philippines have similar wage costs (see table 3) which are significantly lower than China. However while Indonesia's wage cost is the lowest, it has the fastest rate of increase. It is also worth noting that its lower wage cost is usually associated with less developed infrastructure or is driven by the fact it is located in more remote places.

KPMG Observation: Wage costs in China are expensive by regional standards. Leaving aside U.S. trade tarriffs, rising costs in China are already driving FDI into other regional locations.

Utilities, taxes, and land rental costs are other key cost considerations. Some of these cost elements are country driven, while others are driven by geographic and strategic locations. While this is another key cost consideration, a detailed analysis of this matter is beyond the scope of this publication.

Table 3: Relevant cost factors – wage



Source: Fitch solutions, BMI, 2017

KPMG Observation: Cost factors are always impacted by location and so generalizations can be misleading.

Taxation considerations

The annual World Bank survey on paying taxes provides a useful jurisdiction by jurisdiction benchmarking exercise on taxation, because the hypothetical taxpayer is a manufacturing enterprise. The overall ranking is based on time to comply with tax laws plus the total tax cost. Thailand and Malaysia achieved a good overall ranking in 2018 due to the automation of tax compliance processes, while Vietnam and Cambodia scored poorly overall for the same reasons. The introduction of electronic invoicing in Vietnam will likely improve its overall ranking going forward. However when the total tax metric (i.e., overall tax cost) is reviewed, China has a very high total tax cost which is more than double Thailand or Indonesia. Vietnam and Malaysia also have a low total tax cost when compared against China (see table 4).

Table 4: Ease of paying taxes

Global ranking	Country	Rate (% of profit)	Rate trend	Hours per year spent	Number of payments
59th	TH	29.5	Slightly increased	229	21
72nd	MY	39.2	Unchanged	188	8
94th	PH	42.9	Unchanged	181	14
112th	ID	30.1	Noticeably decreased	207.5	43
114th	CN	64.9	Slightly decreased	142	7
131st	VN	37.8	Noticeably decreased	498	10
137th	KH	21.7	Slightly increased	173	40

Source: WTO (2019)

KPMG Observation: The World Bank survey does not provide a clear picture, because it does not capture all relevant tax considerations. Tax incentives, withholding taxes and customs duties are not included. A country-by-country analysis of tax incentives for new investment may result in significantly lower overall tax costs.

Supply chain considerations

China has significant competitive advantage when it comes to supply chain management. Most inputs can be sourced locally which may reduce transportation costs and result in fewer supply chain disruptions. However, cost escalations, regulation, and recent trade levies imposed on exports into the U.S. raise concerns with respect to ongoing manufacturing in China.

KPMG Observation: Vietnam's shared land border with China (with direct road connections) enhances its interconnectivity with China and arguably reduces supply chain disruption risks arising from a "China plus One" manufacturing strategy.

Industry considerations

When looking at specific industry sectors like textiles, clothing, automotive, chemical, equipment, electronics and white goods, each jurisdiction will have its own advantages and disadvantages.

Philippines has had some success with heavy industries like ship building. Thailand is the largest automotive manufacturer in the region and second largest exporter of computer hard drives in the world. Vietnam is also a rising electronics manufacturer and is the largest exporter of Samsung phones globally. It also has a very significant garment manufacturing sector. Malaysia has attracted attention for its higher value added industries and hi-tech manufacturing.

Conclusion

A “China plus One” strategy opens a range of considerations that will require a detailed analysis of cost and non-cost factors based on individual commercial and economic drivers. For example, Vietnam’s low cost factors, developing infrastructure and favorable geographical location have made it an attractive choice for labor intensive manufacturing processes. Recently, Vietnam has positioned itself for hi-tech manufacturing as well. Malaysia and Thailand are ideal for automotive and technologically complex manufacturing processes, but at substantially higher costs.

Naturally, investment decision making requires inputs based on significant local knowledge and experience. Based on our extensive knowledge and experience in the region, KPMG can provide advice and analysis on regional manufacturing options as well as market entry strategy.

Why is Market Entry advice important?

Market entry provides many opportunities, but brings unknown risk. Our experts can support and advise you on a range of issues including:

- Which location is the right choice for you?
- What are the potential risks arising from the local tax,
- legal, and commercial environment?
- Where in the country should you invest? What are
- relevant economic and cost considerations?
- How should you invest? What are the most suitable tax, legal, and operational structures for your business?
- Introductions and fact checking.

Why KPMG

KPMG is the largest professional services firm in Vietnam today, with 34 partners and around 1,500 people working across three offices. Combined with our international network, we are ideally placed to provide unparalleled local knowledge combined with international experience. We offer a dedicated team focused on market entry who are alert to the issues, opportunities and challenges arising from investment decision making.

Link to other publications:

Make in Vietnam (2019)

Investing in ASEAN (2018)

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