It’s been over a year since the collapse of the Rana Plaza building in Bangladesh where over 1,100 garment workers perished. What has happened since then? What are the key challenges facing retailers and what does this mean for investors? We travelled to Bangladesh and met with retailers, factory owners and a number of other key stakeholders.

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KEY POINTS

> Good supply chain practices are important for investors for a number of reasons: brand risk, sustainability of supply chains and the financial risk/reward ratio related to sourcing from low-cost countries.

> Since the Rana Plaza disaster, a number of commitments for improved factory standards have been made. However, while systemic reform is taking place in Bangladesh, the improvements are from a low base and significant challenges remain, including funding of factory remediation, labour standards, poor infrastructure and various challenges to the sustainability of doing business in Bangladesh.

> Investors benefit from a deep understanding of the supply chains of companies they have invested in. The brand risk is arguably higher today than before the Rana Plaza disaster and this particular ESG theme will likely play out over time – we see further necessary cost increases and the key question will be how this will be absorbed between consumers, retailers and factories.

WHY THE INTEREST IN SUPPLY CHAIN MANAGEMENT?

On 24 April 2013 Bangladesh experienced its worst ever industrial disaster when the Rana Plaza building collapsed, leading to over 1,100 fatalities. Since then, there has been significant interest in supply chain management not only within the garment sector but also among consumers, media and investors.

During our factory visits to China in 2011 and 2012, AMP Capital identified two key trends in the supply chain resulting from structural challenges in the retail industry: increased direct sourcing and a gradual move out of China where labour costs are increasing to Bangladesh where the minimum wage is lower.

As discussed in our 2012 paper How sustainable are Australian retailers’ new sourcing strategies? investor interest in supply chain management relates to a number of factors, including:

> ‘Ethical’ concerns
  Reputational risk, potential brand damage and consumer backlash

> Financial risk/reward ratio
  Potential cost savings from cheaper labour in Bangladesh need to be balanced against incremental business risks such as impact on lead times, product quality and a wide range of other risks

> Sustainability of a minimum wage
  The minimum wage is insufficient to meet the basic costs of living.
As investors, AMP Capital focuses on future risks. In the garment industry, history tends to repeat itself and sadly, there were early warning signals before the Rana Plaza tragedy, including hundreds of other fatalities in Bangladeshi garment factories, such as the Tazreen factory fire in November 2012 which resulted in over 110 fatalities. The latter resulted in a proposed multi-stakeholder risk management framework which enabled investors to have more focused dialogues with retailers about sourcing from Bangladesh. That framework did not attract the required number of retail signatories to proceed further.

So, why did it take the Rana Plaza disaster for broad investor engagement? Potential reasons include the previous lack of media coverage, lack of interaction between investors and NGOs and, perhaps, labour rights in the supply chain were not seen as financially material issues?

A key lesson for investors is to deepen their understanding of the supply chains of companies, in which they have invested. This requires in-depth research into companies’ risk exposure and their risk management practices, not just the policy framework but how risk is managed in practice.

**WHAT ARE THE KEY CHANGES IN BANGLADESH?**

Although China remains the number one manufacturer in the market, labour cost increases, driven by minimum wage increases and labour shortages, are resulting in companies sourcing from countries such as Vietnam, Cambodia and Bangladesh.

Bangladesh’s ready-made garment industry has grown fast as it offers cheap garment manufacturing with a large unskilled workforce and low minimum wage. Today, Bangladesh’s garment industry comprises approximately 5,000 factories, employs over 4 million workers and accounts for nearly 80% of the country’s exports, which makes it a politically powerful organisation.

There are signs of an emerging industry of domestic sub suppliers of accessories and capabilities within the cotton milling and spinning industry. As this develops, this could have a positive impact on lead times. However, cotton, which is the key cost driver in the garment sector, is not grown in Bangladesh and needs to be imported. While China has a vertically integrated supply chain, Bangladesh continues to compete primarily on labour costs.

**THE POSITIVES**

Since the Rana Plaza collapse and subsequent social unrest, a number of key improvements have occurred. These include a 77% increase in minimum wage (now equivalent to US$ 68 per month), new labour laws, a doubling in factories with union representation and national standards for fire and building safety. A key development has been the emergence of the multi-stakeholder and legally binding Bangladesh Accord on Fire and Building Safety (‘the Accord’), the retail-driven Alliance on Bangladesh Worker Safety (‘the Alliance’) and the complementing ‘Better Work Programme’.

At the time of writing, the Accord has expanded to over 160 retail signatories from 20 countries and the Alliance has 26 members. Between them, over 1,000 factories have been inspected.

**THE CHALLENGES**

Despite improvements, significant business challenges remain for retailers sourcing from Bangladesh.

First, the Accord and the Alliance are major undertakings and the implementation and verification of recommended corrective actions to factories will be a challenge. Some factories have been temporarily shut down while remediation takes place. In some cases, there are significant practical complexities to overcome, particularly when factories are located in multi-purpose buildings. Also, the source of funding of the remediation (estimated to be approximately US$200,000 per factory on average) remains murky. Access to capital in Bangladesh might become a major issue.

Second, as a study by the Alliance found, there is an acute need for worker training on fire and electrical safety. This has led to significant training programmes being rolled out. However, high staff attrition rates in several factories might undermine the benefits of some of these programmes. The structural building concerns in Bangladesh also put new demands on engineering expertise for internal and external factory auditors.

Third, while the initiatives in Bangladesh aim to reduce the risks of new Rana Plaza-type incidents, a number of other risks remain fairly unchanged. These include:

> Widespread cases of poor working conditions

There is significant anecdotal evidence of failure to pay the new minimum wage and harsh treatment (verbal, physical and sexual abuse). As workers are becoming increasingly aware of their rights, including the right to refuse to work in unsafe conditions, retailers that treat supply chain management at an arm’s length are at risk of supply chain disruption. Factories we visited gave clear evidence of how better working conditions have resulted in better productivity and lower staff attrition.

**Garment workers outside a factory in Dhaka**

*Source: AMP Capital, 2014.*

> The ‘living wage’ issue

Official statistics are difficult to find, but analysis and overwhelming anecdotal evidence show that the current minimum wage, even after the 77% increase, appears to be insufficient for the basic costs of living, due to high inflation. This means a risk of social unrest, productivity issues and supply chain disruption.
Lack of unionisation
While the number of factories with union representation has doubled since 2013, only around 250 factories out of 5,000 have union representation. This reinforces the risk of supply chain disruption.

Poor infrastructure
Investment in infrastructure is crucially needed but there is little evidence of government intent to improve the situation. Bangladesh continues to suffer from an unreliable electricity supply, which means garment factories often operate with back-up generators. The roads network is poor and, combined with high capacity utilisation in the main port in Chittagong, there is a risk of delays and longer lead times.

Road between Dhaka and Chittagong

Doing business in Bangladesh is also subject to a number of other risks, including political instability, corruption and fraud. The industry, on the whole, is also characterised by poor loyalty among workers and brands, which results in high staff attrition rates that can undermine efficiency, productivity and training efforts. This also makes it difficult for factories to plan ahead and make the capital investments required for factory improvements. In turn, this means a continued risk of factories making short cuts on safety.

Some of the challenges might be particularly high for Australian retailers, which arrived relatively late in Bangladesh and are relatively small players compared to major international retailers. Bangladeshi factories are typically geared towards large production volumes. To make sourcing work in Bangladesh a retailer needs to have effective risk management systems in place and focus on building close relationships with appropriate suppliers.

QUESTIONS FOR INVESTORS
How financially material are the developments that have taken place in Bangladesh over the last 18 months for investors?
First, it is clear that efforts on ‘ethical sourcing’ can lead to real business benefits, including fewer quality issues, better productivity, shorter lead times and more room for a living wage. This, in turn, means more sustainable supply chains.

Second, the brand risk is arguably higher today than before the Rana Plaza incident. Brands, which are equivalent to a high proportion of retailers’ market capitalisation are sensitive and can be costly to restore. The industry has had more than 12 months to sort out the main issues and there is increased scrutiny by media and NGOs and higher consumer awareness.

Third, Environmental, Social and Governance (ESG), including supply chain management, can be a proxy for management quality. The majority of a typical company’s value comes from intangible factors. Hard assets alone don’t generate return. Rather, it is how those assets are managed, financed, developed and protected that impact the long-term sustainability of operations. Management of supply chains can be seen as a proxy for management’s ability to deal with complexity. For AMP Capital, supply chain management is more than a ‘social’ issue, it is a strategic issue.

ESG themes play out over time. In our experience, companies with poor supply chain standards often have poor overall ESG profiles, and companies with poor ESG profiles tend to underperform over time. In addition, AMP Capital believes further minimum wage hikes are likely and the jury is still out on factory standards and remediation costs.

The retail industry has seen significant price deflation in the last decade, but achieving sustainable supply chains require higher costs for someone: consumers and / or retailers and / or factories. The relative cost absorption will determine the impact on retailers’ gross margins. It will also depend on what efficiency and productivity measures can be introduced at factory level.

Rather than stopping research efforts short on companies’ policy frameworks, investors need to understand how supply chain risk management is carried out in practice.
COMPANIES: LEADERS VERSUS LAGGARDS

AMP Capital visited four factories in Bangladesh, which are generally regarded as being in the upper range of factory standards. These typically pay above-minimum wage, offer medical facilities at factory level and some paid leave. Notable differences between Bangladeshi and Chinese factories visited on previous field trips include lower productivity per worker and more supervisors / helpers per garment worker. In other words, there is significant scope for productivity and efficiency improvements. Capitalising on these opportunities could create win-win situations for retailers, factory owners and workers.

Among retailers, leaders in supply chain management set high standards and participate in multi-stakeholder frameworks. Typically, such companies have also moved away from an over-reliance on factory ‘audits’ to see long-term supplier relationships as strategic and competitive advantages where factories are improved over time and are rewarded with better business. By establishing trust and by driving non-exploitative efficiency improvements, there is more room for a living wage. It can also have positive impacts on product quality and lead times. Leaders also realise that on-the-ground presence and frequent factory visits are required and they proactively engage with NGOs and other stakeholders, including peers, to avoid business risks.

Finally, they see lack of freedom of association and unsustainable minimum wages as long-term risks for sustainable supply chains and engage with authorities on these issues.

In contrast, laggards, set low or no standards, effectively outsource brand risk management to third parties and regard themselves as too small to influence factory standards without making an effort to collaborate with other buyers on the issues.

CONCLUSION

The Rana Plaza disaster in 2013 set the wheels in motion for systemic improvement in Bangladesh, including significant projects to reduce fire and electrical safety risks and poor building standards. Factory inspections are under way but the implementation and funding of corrective actions might be a major challenge. Also, Bangladesh continues to suffer from a number of other key business risks that threaten the sustainability of retailers’ supply chains.

As a result, retailers sourcing from Bangladesh need to have strong risk management systems in place and investors need to understand the complexities of the supply chains in companies they have invested in.

From an investment perspective, AMP Capital sees continued high brand risk for retailers with poor ethical sourcing standards and we also believe the financial materiality of the sustainability issues in Bangladesh will play out over time. AMP Capital foresees increased sourcing costs and questions how these cost increases will be absorbed.

CONTACT US

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