

Apparel, Fashion & Luxury Practice

Bangladesh's ready-made garments landscape: The challenge of growth



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Foreword

A growing number of chief purchasing officers (CPOs) in European and US apparel companies are scrutinizing their sourcing strategies, as margin and supplier capacity pressure building over the last several years has caused them to search for the next performance improvement opportunity.

While China is starting to lose its attractiveness in this realm, the sourcing caravan is moving on to the next hot spot. With Bangladesh having developed a strong position among European and US buyers, many companies are already eager to evaluate the future potential. However, the lure of competitive prices, available capacities, and supplier capabilities offered is being cautiously weighed against a prevailing insecurity created by the challenges inherent in Bangladesh's ready-made garments (RMG) market.

McKinsey & Company has initiated a case study that sets out to review Bangladesh's RMG growth formula, which builds on the country's strong starting position and the increasing demand of international buyers. This report provides an overview of the rapid growth being seen in Bangladesh's RMG industry and then describes the main hurdles that exist for buyers when it comes to sourcing in Bangladesh. The final section of the report details what the three core stakeholders – government, suppliers, and buyers – can do to overcome the challenges of growth in Bangladesh's sourcing market.

The case study and recommendations documented in this report are based on:

- An extensive interview-based survey of CPOs from leading apparel players in Europe and the US, accounting for USD 46 billion in total apparel sourcing value and covering 66 percent of all apparel exports from Bangladesh to Europe and the US
- A telephone survey of 100+ local RMG suppliers in Bangladesh, which represents approximately 10 percent of Bangladesh's total apparel exports
- In-depth desk research using both international (e.g., World Bank, International Monetary Fund, EIU, investment banks) and local sources (e.g., Bangladesh Garment Manufacturers and Exporters Association, Centre for Policy Dialogue, Bangladesh Institute of Development Studies)
- Extensive field work, including in-depth supplier interviews, factory visits, interviews with sourcing office managers, and discussions with other local and international experts (e.g., corporate social responsibility experts and logistics experts).

McKinsey wishes to thank all participants of this study, especially the Bangladesh German Chamber of Commerce and Industry (BGCCI) President Md Saiful Islam and Executive Director Daniel Seidl, for their support in compiling this report.

Potential for rapid growth of Bangladesh's RMG industry

The sourcing of RMG is experiencing a new phase of transition, which is creating the need for companies to react accordingly in order to secure their cost positions in the apparel market. While China was once considered “the place to be” for sourcing, the light is starting to shine ever brighter on Bangladesh.

Current trends on the buying side

For decades, European and US apparel buyers were benefiting from continually decreasing purchasing prices by moving their sourcing activities to low-cost countries in the Far East and by cutting out the “middle man.” Sourcing teams could freely take their pick of the next country sourcing opportunity along the five main criteria of price, quality, capacity, speed, and risk.

Within the last several years, however, European and US buyers have been faced with a growing number of margin and capacity issues, creating an increase in sourcing strategy revisions.

Although the European and US apparel markets have regained much of their sales following the slump brought on by the most recent global financial downturn, market saturation, consumer price sensitivity, and ongoing economic insecurity continue to put pressure on top-line results.

“The story of Bangladesh has just begun” Head of sourcing office In addition, the end of a 15-year long apparel sourcing deflation is squeezing the profitability of buyers. Volatility of raw materials prices has spurred a decline in gross margins and created a general environment of insecurity among buyers. At the same time, labor costs in China and other key sourcing markets have increased significantly. This is leading buyers to question their current sourcing strategies, resulting in expansion of global direct sourcing and footprint revisions being the current key strategic focus areas.

However, the playing field is becoming increasingly limited for European and US buyers, as new, fast-growing markets develop into important customers for the traditional sourcing markets. These countries’ high growth levels and, to some extent, proximity to the markets, make them attractive. A battle for capacities is on the horizon.

For many years, China was almost always the hands-down answer to all buyers’ needs, but those times are changing.

China is losing its attractiveness for new and established buyers

In 2010, China dominated RMG imports to Europe and the US, accounting for approximately 40 percent of the import volume in each region. The macro trends of

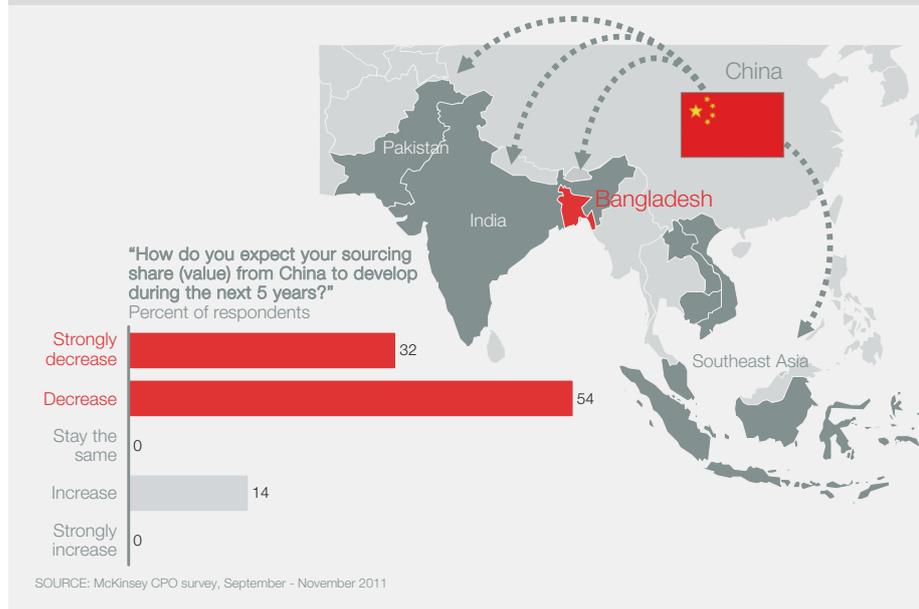
wage increases and capacity pressure, however, have proven to heavily weigh on the Chinese RMG sector. McKinsey's survey shows that CPOs of leading apparel buyers in Europe and the US almost unanimously favor moving some of their sourcing away from China. In the survey, 54 percent of CPOs shared their plans to decrease their sourcing activities in China by up to 10 percent and 32 percent stated that they sought to decrease their share of sourcing in China by more than 10 percent over the next five years (Exhibit 1).

- Labor shortages, especially in the coastal regions, are impacting the RMG industry in China, as workers continue moving on to more attractive industries and better jobs.
- Wages in Coastal China are increasing, as Chinese RMG manufacturers try to better position themselves in the tight labor supply market.
- Capacity for Western buyers is reaching its limits, as RMG players in Coastal China switch to serving the quickly growing, more profitable national market and as the Chinese government seeks to support more value-added industries in an effort to rebalance the economy. Since 2000, the share of total apparel exports has been reduced to nearly half of historical levels.

As Western RMG buyers search for the "next China," they are evaluating all options to strengthen their proximity sourcing, moving on to Northwest China, Southeast Asia, and other Far East supplier countries. Bangladesh is clearly the preferred next stop for the sourcing caravan (Exhibit 2).

CPOs plan to shift a large share of their sourcing value away from China to other countries over the next 5 years

Exhibit 1



Bangladesh has what it takes to be the next sourcing hot spot

Since the start of its garment export industry in the late 1970s, Bangladesh has seen its RMG export levels grow steadily and has become a top global exporter. With around USD 15 billion in export value in calendar year 2010, the RMG industry is currently Bangladesh's most important industry sector (13 percent share of GDP and total export share of over 75 percent). With 12 percent average annual growth rates, clothing exports are the key driving force behind GDP development (7 percent CAGR from 1995 to 2010). The attractiveness for buyers lies in Bangladesh's long-term experience and strong performance in the sourcing country selection criteria of price and capacity as well as product portfolio offered.

“There is no alternative to Bangladesh” CPO

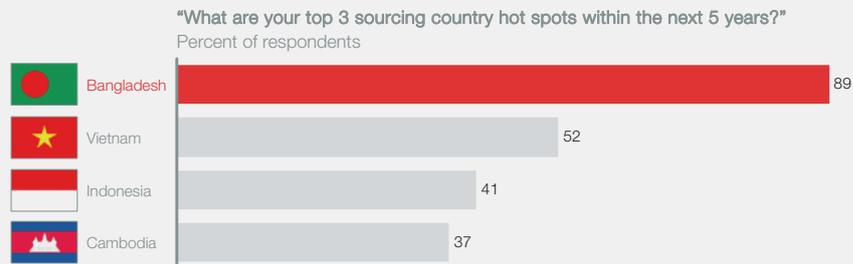
Leading international retailers, especially from the value sector, started to source in Bangladesh already in the 1980s. Over time, buyers have strengthened their

sourcing base by shifting toward direct sourcing and opening their own local offices in Dhaka and Chittagong. Of the European and US buyers McKinsey surveyed, 72 percent of those with activities in Bangladesh source directly. The high share is confirmed by the suppliers – 69 percent of the surveyed suppliers focus on working directly with international buyers.

In the last 15 years, Bangladesh's share of apparel imports to Europe and the US more than doubled, securing Bangladesh's No. 3 position among importers to the European Union 15 (EU-15) and the No. 4 position among US importers. Within just the last three years, 39 percent of the companies represented in the CPO interviews have increased

For most CPOs, Bangladesh will be the No. 1 sourcing hot spot over the next 5 years

Exhibit 2



SOURCE: McKinsey CPO survey, September - November 2011

their share of sourcing in Bangladesh by more than 30 percent, 13 percent of the companies by 20 to 30 percent, and 30 percent of the companies by 10 to 20 percent.

Bangladesh's growth has been recognized. Goldman Sachs included Bangladesh in the "Next 11" emerging countries to watch following BRIC (Brazil, Russia, India, and China) and JP Morgan lists Bangladesh among its "Frontier Five" emerging economies in which it is worth investing.

Bangladesh offers the two main "hard" advantages – price and capacity. It provides satisfactory quality levels, especially in value and entry-level mid-market products, while acceptable speed and risk levels can be achieved through careful management.

Competitive price level is clearly the prime advantage – all CPOs participating in the study named price attractiveness as the first and foremost reason for purchasing in Bangladesh. Within the next three years, both CPOs and suppliers expect a labor cost increase of about 30 percent. Not only are all stakeholders certain about increases in the future, they see it as a necessity, since minimum wages had not been adapted for a long time despite high inflation. It wasn't until November 2010 that wages were raised for the first time since 2006. And it has been announced that minimum wages will be adapted regularly in two-year rhythms. Leading suppliers already offer annual wage progression as well as profit contributions.

Respondents see the development of wages in Bangladesh being in line with that in other countries. And as they expect significant efficiency increases to offset rising costs in the future, respondents state that Bangladesh's price levels will remain highly competitive in the future.

Half of the international CPOs interviewed mentioned capacity as the second-biggest advantage of Bangladesh's RMG industry. With a current 5,000 RMG factories employing about 3.6 million workers from a total workforce of 74 million, Bangladesh is clearly ahead of Southeast Asian RMG suppliers in terms of capacity offered (e.g., Indonesia has about 2,450 factories, Vietnam 2,000, and Cambodia 260 factories). Other markets, such as India and Pakistan, would have the potential to be high-volume supply markets, but high risk or structural workforce factors prevent utilization of their capacity.

Supplier capability ranks third – mentioned by 30 percent of respondents in the survey of European and US CPOs. However, the current acknowledgment of capability is very focused: Bangladesh's suppliers are known for supplying good quality and large order sizes for the value and lower mid-market. At the same time, suppliers have started to expand into more value-added services (Exhibit 3).

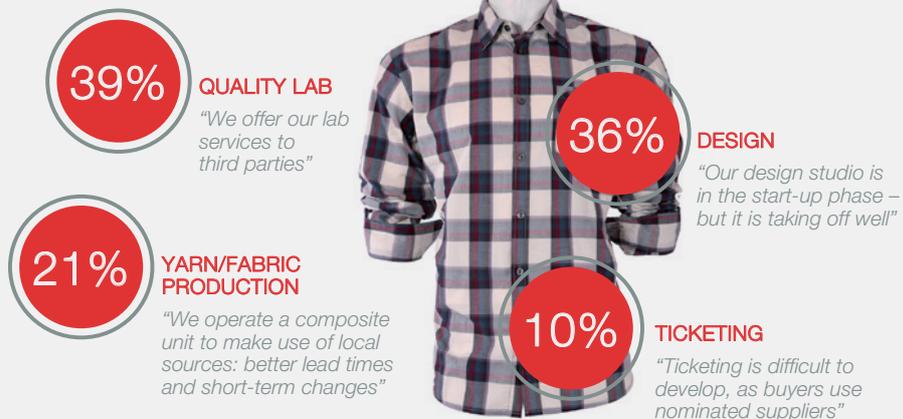
In addition to price, capacity, and capability, a high share of European CPOs strongly emphasize the advantages of sourcing in Bangladesh due to favorable trade agreements. The broadening of the EU Generalized System of Preferences (EU-GSP) rules on duty-free imports of garments from Bangladesh to include products with two-stage processing made sourcing from Bangladesh even more attractive. A shift from the currently dominant knitwear (70 percent of import value to the EU-15) to a more balanced sourcing product portfolio can be expected (e.g., the US sourced 26 percent knitwear and 74 percent wovens in 2010).

Exhibit 3

Suppliers are starting to move beyond pure CMT and to upgrade their service levels

"Which services do you offer?"

Suppliers, percent of respondents



SOURCE: McKinsey supplier survey, September 2011

This advantageous starting position in terms of price, capacity, capability, and trade regulations provides the base for positive RMG growth in Bangladesh. And the strong demand of international buyers from Europe, the US, and emerging markets will accelerate it in the future.

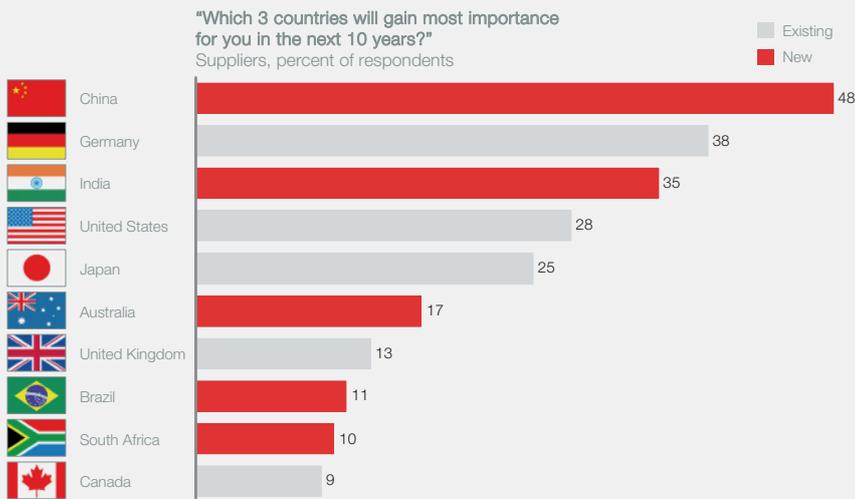
In the medium term, Bangladesh looks to be the sourcing country of choice

For the next ten years, McKinsey forecasts a continuation in the high growth of Bangladesh's RMG sector. Driven by the sourcing trends described previously and Bangladesh's current starting position, European and US buyers will continue expanding their sourcing activities in Bangladesh. Additionally, new buying markets are becoming increasingly important as sourcing customers for Bangladesh (Exhibit 4).

European and US CPOs aim to significantly grow their share of sourcing in Bangladesh. Companies focused on a value segment plan expansion from a current average 20 percent to a 25 to 30 percent sourcing share in 2020. Mid-market brands, which generate around 13 percent of their sourcing value in Bangladesh today, plan to grow their share to 20 to 25 percent in the medium term. This growth will be driven not only by an increase of volumes in current product categories but, as stated by 63 percent of CPOs interviewed, by broadening the sourcing strategy to more complex, more fashionable, or more sophisticated items (e.g., the most frequently mentioned categories are outerwear and formal wear for value markets, and an expansion of existing products as well as flat knits for mid-market players). This means that the value market will be the key volume contributor, while the mid-market will demonstrate more dynamic growth

Increased demand is expected from new buying markets in the region and international emerging markets

Exhibit 4



SOURCE: McKinsey supplier survey, September 2011

(i.e., higher CAGR). Also, many Western mid- to upmarket buyers have recently begun or have concrete plans to source from Bangladesh.

Interesting to note is that a new class of attractive customers for Bangladesh's RMG industry is growing quickly. Garment exports from Bangladesh to new buying markets – those seeking alternative options in supplying products to their fast-growing consumption-oriented middle class – showed a CAGR of 56 percent in the period 2008 to 2010. Especially regional countries want to benefit from the advantages Bangladesh has to offer. Not surprisingly, suppliers in Bangladesh see China as the country gaining most importance for them over the next ten years, with India following suit with a ranking of third. Bilateral agreements, such as the recent duty-free deal between India and Bangladesh announced in September 2011, are being established in order to foster increased trade.

Taking these drivers into account, Bangladesh's RMG industry will continue to face growing demand. McKinsey has forecast demand growth through 2020, based on its CPO survey, which covers approximately 66 percent of Bangladesh's total export value to the US and Europe. CPOs of value players want to increase the value of their sourcing in Bangladesh by about a 10 percent annual growth rate, whereas mid-market players plan an annual growth rate of around 14 percent. Looking at the demand side from existing and new markets, an annual value increase of Bangladesh's RMG industry of around 13 percent is likely. The supplier survey paints a similar picture, with some 73 percent of suppliers believing in strong growth of more than 10 percent per annum within the next ten years.

However, a number of significant challenges brought on by growth exist. Depending on how well the most severe issues can be managed, the market will realistically

develop at an annual rate of 7 to 9 percent within the next ten years, resulting in an export value of around USD 36 to 42 billion. This means the market will double by 2015 and nearly triple by 2020.

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.

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

Exhibit 5

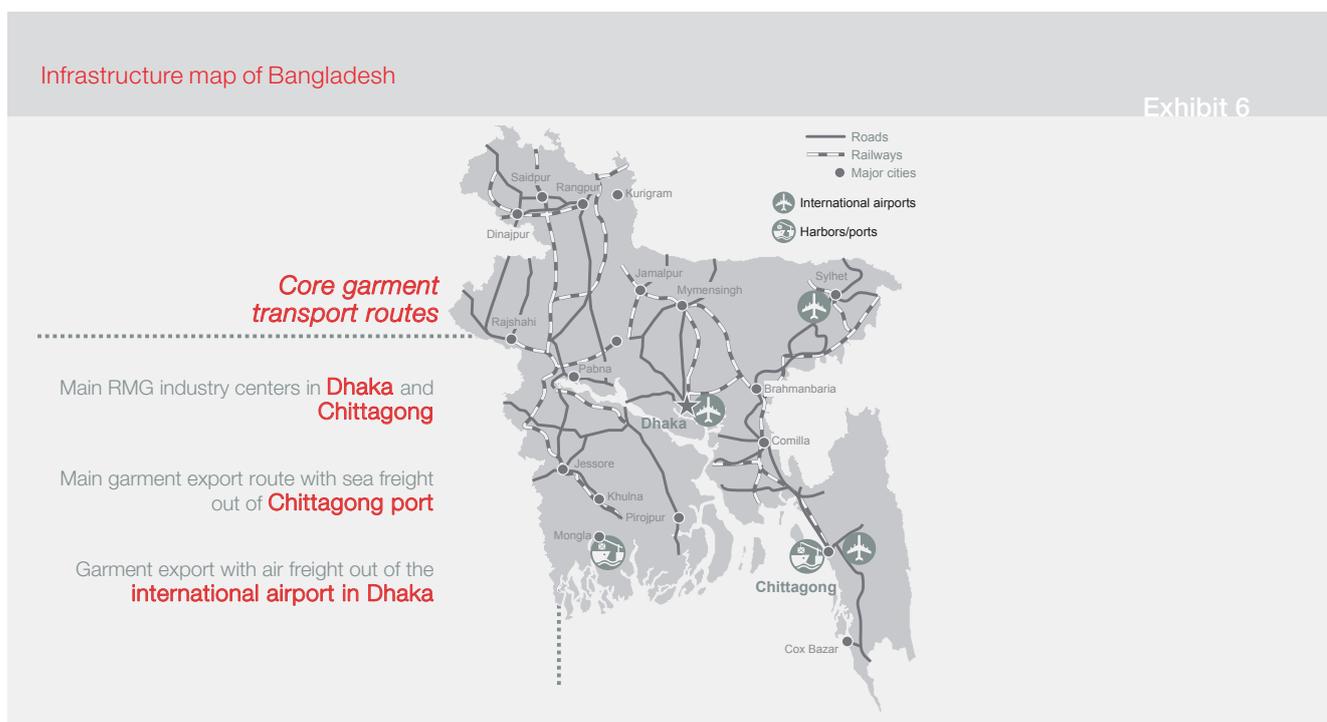


SOURCE: McKinsey CPO survey, September - November 2011; interviews

Infrastructure

For all business stakeholders, infrastructure (transport and utilities 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 harbor 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 harbor 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 harbor.
- Productivity at Chittagong port suffers from inefficient processes (e.g., manual processing), limited crane capacity, and strikes that sometimes span several days at a time.
- The Dhaka-Chittagong train connection offers limited capacity (i.e., 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 finalizing 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 licenses 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 organizations (NGOs) and corporate social responsibility (CSR) stakeholders regarding compliance. Both CSR experts and buyers report improved labor 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 labor 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 labor 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 labor 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 liters and achieved savings of USD 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

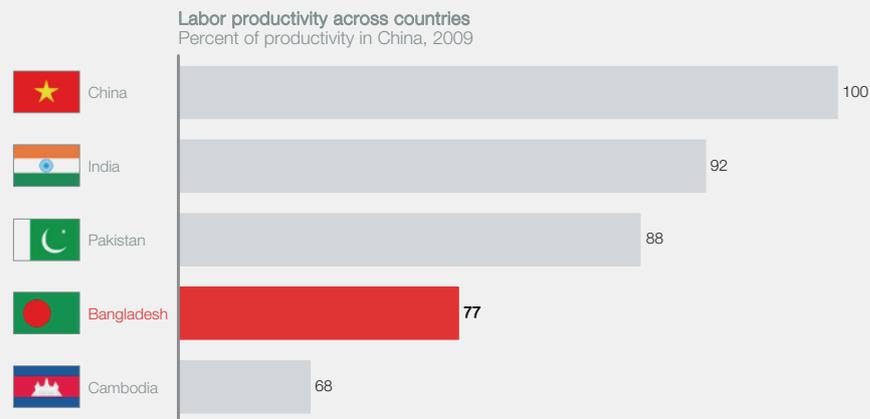
In the medium term, McKinsey expects that labor costs will continually increase, that the apparel export market will grow at between 7 to 9 percent through 2020, and that value buyers are looking to source more fashionable and sophisticated products from Bangladesh. At the same time, mid-market buyers have just entered the market and

are starting to source standard products. To realize 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.

Significant efforts are required to close the productivity gap to China and other markets

Exhibit 7



SOURCE: USAID; interviews; McKinsey

Additionally, a gap between customer requirements and supplier capabilities/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:

- 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 centers Dhaka and Chittagong – and limited employee loyalty in the low-wage jobs mean that suppliers

"I make my money from my efficiency and my quality, not low wages" Supplier

constantly face high recruitment levels of about 5 percent per year. Along with high labor 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 utilize 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 fibers 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 verti-

calization 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 (e.g., 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 characterized 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 labor-intense 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 realized 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 decentralize 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 labor 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 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 (GWG) initiative, established by the Sri Lankan apparel industry, could provide an interesting blueprint for a supplier-driven initiative in Bangladesh.

“In CSR, we need the collective will of suppliers and factories to increase” CPO

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, utilizing 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 verticalization, and diversifying into more value-added products. The final field of action would be for suppliers to optimize 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 attentive 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 programs or through compliance and environmental topics in joint programs 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.

"Buyers change suppliers each year; and each year they do postnegotiations" Supplier

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).

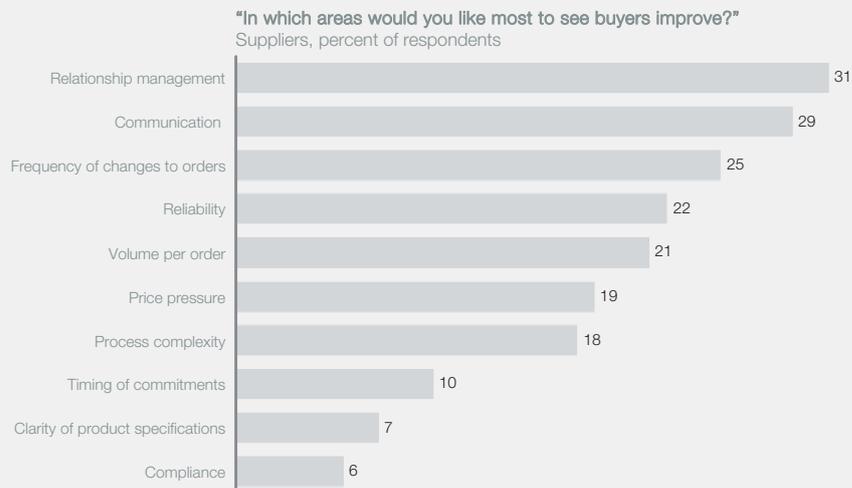
Process hygiene on the buyer side is especially important to enable efficient end-to-end processes. Often, suppliers feel that they are pressured about timekeeping. But long buyer response time, in-house process complexity among buyers between the merchandising and sourcing functions, and a high number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

Exhibit 8

Suppliers seek closer long-term relationships with buyers



SOURCE: McKinsey supplier survey, September 2011

“Do an apples-to-apples comparison: not comparing to noncompliant supplier”

Supplier

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 organizational direction (e.g., buyer versus product focus), volume, product sophistication, lead time requirements, and own capacities (global, regional HQ, etc.).

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 labor/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
- Honoring supplier efforts rather than comparing different standards in quotations
- Acknowledging development needs to ensure customer trust rather than focusing on past improvements.

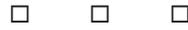
Sourcing setup "archetypes" generally cover different local sourcing activities and buyer responsibilities

	Activity	Agent	Direct sourcing from HQ	Small sourcing office	Traditional sourcing office	Full-fledged sourcing office
Preorder	R&D	↑ All activities done/coordinated by agent ↓	↑ All activities done/coordinated directly by buyers ↓	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
	Product design			<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
	Technical design			<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
	Raw materials sourcing			<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Market intelligence			<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Supplier selection	Supplier screening			<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Supplier selection			<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Supplier quotation			<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Supplier negotiation			<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Supplier decision			<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
	Supplier development			<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Order mgmt.	Order placement			<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Order follow-up			<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Quality/CSR	QA sample approval			<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	In-line inspection			<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Final sample approval	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>		
	Compliance	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		
Logistics	Warehousing	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		
	Shipping and customs	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		
Admin.	HR, Finance, IT	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		

No responsibility Full responsibility

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 professionalizing the local setup, hiring top talent, strengthening supplier relationships, and improving logistics management.

Bangladesh's RMG growth formula



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