

Establishing a Manufacturing Presence in Asia:

Section 1

“The Decision Process”

By: Arthur J. Yarzumbeck
Sr. V.P. & Principal, East West Associates

The Challenge

The good news is your company is expanding its manufacturing operations into Asia to take advantage of the huge market and / or lower labor costs. If executed properly, this strategy is projected to significantly enhance the profitability and growth of your firm.

Your response; ‘What an adventure! What an undertaking! Incredible planning and expertise is required. Wonder who they’ll find with the experience to head-up the project’?

Here’s the ‘bad’ news...**you’ve** been ‘chosen’ to lead this effort.

Now What?

Your firm has recently decided to establish an international manufacturing presence in Asia. Could be anywhere in Asia. But with the current push on accessing large markets and low cost labor there is a good chance it will involve China or Vietnam. Establishing a new manufacturing entity and executing a product transfer are daunting undertakings, to say the least. However, doing so 12,000 miles from home, in a foreign country with very different cultural norms, in an emerging economy with vestiges of a 3rd world mentality, under a Communist government (that still exercises varying levels of societal controls) and with a somewhat rudimentary (but evolving) legal system **really** presents some interesting leadership opportunities. Let’s take this a step further ... suppose **you** have been given the responsibility for leading this effort and let’s assume you have little to no experience in Asia. Maybe the closest you’ve been to anything remotely related to Asia is eating an occasional meal at the local Chinese restaurant (which isn’t authentic Chinese food, as you will learn) or possibly interacting with a member of your EMBA study group from Taiwan, Hong Kong or Singapore. Most likely your company has been exploring the Asian market via suppliers and/or subcontractors for a few years. You may have made some trips to Asia in support of this effort and have some experience conducting business in Asia. Your appointment probably resulted from very successful accomplishments in previous assignments, combined with some limited Asia support experience. Anyway, it’s time to settle down and do your usual professional job - given the intense top-level executive management focus that typically accompanies these efforts.

The Challenge: Now What?

So, how does one approach a China / Vietnam challenge in a manner that achieves (and exceeds) the organizational goals envisioned by your executive team? The undertaking is not simple ... nor is it impossible. One formula for success is to have experienced members on your team throughout the entire process, from *Business Case Development* to *Project Implementation*. Should this experience not be currently available within your company, it is wise to seek it elsewhere. The complexities inherent in such a venture are far too many to leave anything to chance. Successful establishment of an overseas venture requires a methodical, disciplined process to:

- develop the best *Business Case & Strategy*
- formulate a detailed *Business Plan*, and
- provide continuous, experienced on site *Project Management* to bring the project to completion.

Purpose

The purpose of the White Papers in this series is to set the stage for the overall considerations that must be addressed in the decision, planning and execution phases to successfully implement an Asian manufacturing strategy. Specifically:

- Your company's motivation for establishing an Asian presence and how do you make an enlightened 'Go-To-Asia' decision?
- Does your company have the Asian business experience to accomplish this and, if not, how will you strengthen your ability to execute an Asian strategy?
- How will you develop, in sufficient detail, the *Business Case*, *Project Strategy* and the complete *Business Plan*?
- How will you implement a *Project Management Process*, including establishing and leading a multi-disciplinary and cross-cultural Project Team?

The specific intent of this White Paper is to:

- Examine the typical process involved in deciding to initiate an Asian manufacturing presence, with a geographical focus on China and Vietnam.
- Conduct a high level "China vs. Vietnam" business environment comparison.
- Examine 3 *Critical Planning Factors* involved in developing a *Business Case / Business Plan*:
 - Tax Incentives
 - Human Resources
 - Expatriate Policy
- Review experiences of American firms operating in China (from a U.S. American Chamber of Commerce-China 2006, White Paper).

Follow-on White Papers in this series will focus on specific critical planning criteria, including the *Business Case Development / Strategy Definition* and the development of a Detailed *Business Plan* using model *Critical Planning Factors*. These factors include *Financial Planning; Manufacturing Operations; Project Management; Environmental, Health & Safety; Intellectual Property Protection; Human Resources* and 16 other key areas considered to be required to successfully implement an international business entity (see page 20 for a complete list of these factors).

The Process to Initiate Manufacturing Operations in China or Vietnam Can be Viewed as Occurring in 4 Steps:

- Decision Making*
- Insuring Organizational Readiness**
- Planning**
- Project Management **

* The Focus of this White Paper

** The Focus of Other White Papers in this Series

In this White Paper We'll Examine:

- Decision process for "Going Asian"
- A high level "China vs. Vietnam" Business Environment Comparison
- 3 Critical Planning Factors in development of the *Business Case / Plan*
- American Chamber of Commerce 2006 survey results from U.S. firms doing business in China

The “Go-To-Asia” Process

The decision to implement an international operation is a very serious move on the part of the organization. This is especially true for Asia, where the “Go International” considerations must include normal business challenges along with an understanding of the cultural and governmental influences inherent in operating in this region. While the “go international” decision is intended to have positive consequences, this type of initiative can result in **major** difficulties if not properly conceived, planned and executed. This process is depicted in Figure 1. We later discuss each facet at greater length:

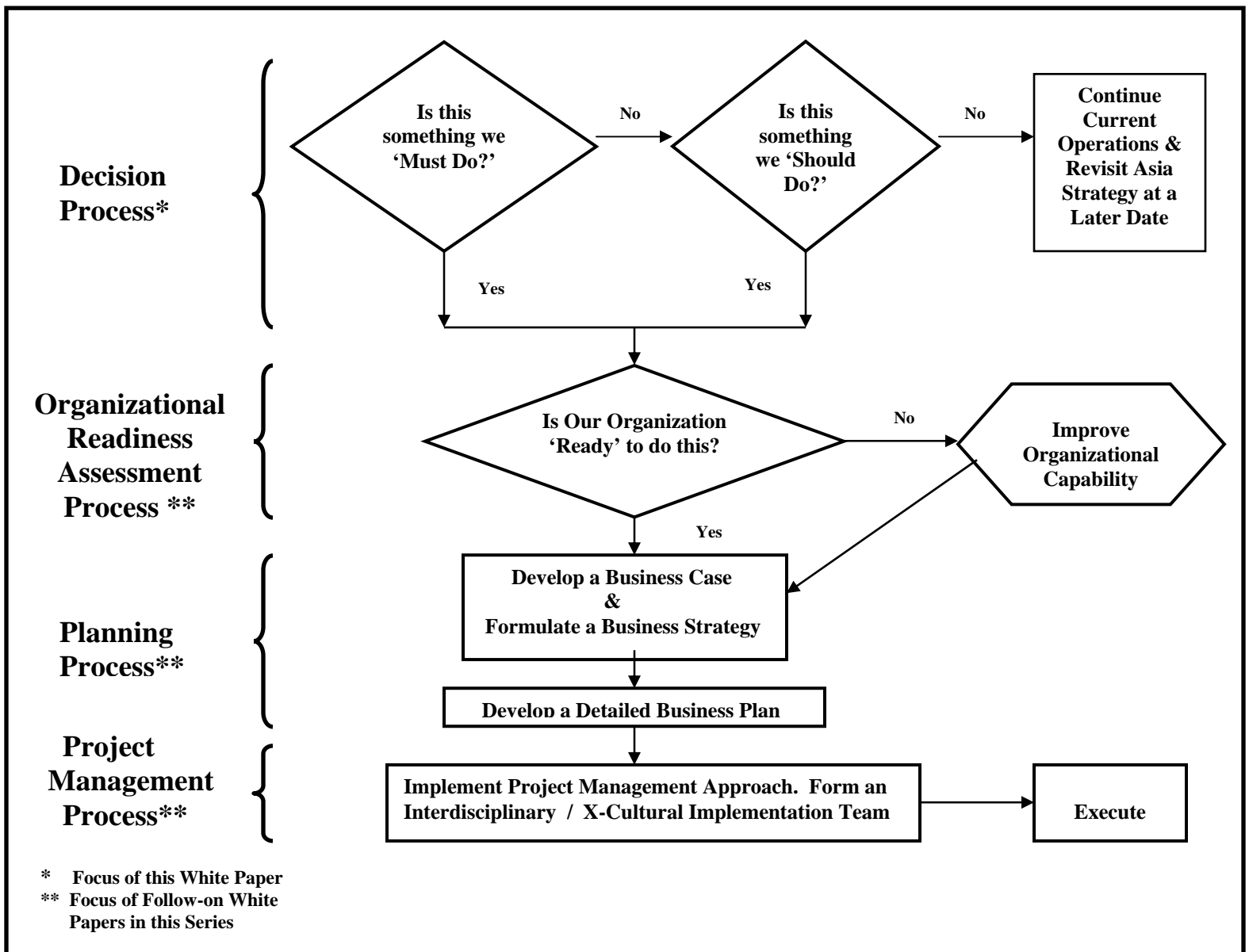


Figure 1: The Process for ‘Going International’

The Decision Process

The first obvious question that arises is **Why?** What's the motivation? Very simply, the decision to "go Asian" comes down to 2 basic questions: **Must We? ...or Should We?...** initiate an Asian manufacturing operation. If the answer to both these questions is "**No**" the organization should focus its attention on the local (U.S.) operations and possibly revisit the decision to "go Asian" at a later date.

The Decision Process: Must We?

This approach has, at its core, "survivability and sustainable growth" issues usually viewed as urgent enough to demand a more immediate decision. Let's look at the typical considerations behind a **Must We?** analysis.

- **Customer Support.** A few years ago, many automobile manufacturing companies, American, European and Japanese, initiated manufacturing operations in China- usually as some form of Joint Venture business model. The automotive manufacturing sector requires a large support structure composed of suppliers, sub-contractors, service providers and other activities. The importance of *Supply Chain* management, with the corresponding focus on inventory control and cost containment, drove a significant effort by companies in some of these support activities to initiate selected operations in China. The alternative, in many cases, would be to potentially lose the opportunity to become a supplier to the client's China operation. Since most large corporations deal with global supply contracts, the threat to these companies was potentially greater than just the incremental business associated with supporting the China operation. We have found that the loyalty of suppliers to their major clients is a **significant** consideration in the decision to initiate operations in China. This retains the very important "customer-supplier" relationship that, in some cases, has been in-place for many years. Also, once situated in China, the various support organizations were in a position to attract new customers - comprised of other manufacturing customers, especially in the rapidly emerging domestic manufacturing base. So, providing continuity of support to an important customer who has initiated operations in Asia is a fairly straightforward example of a '**Yes**' answer to the **Must We?** question.

- **Market Penetration.** This is a matter of positioning the company to facilitate access to the local (Asian) market. This might not be an immediate survivability issue but could address the sustainable growth issue. Assessing, penetrating and gaining market share are time-consuming processes requiring appropriate levels of due diligence and planning; this doesn't happen overnight. The long-term implications to the organization can be significant. Therefore, the overall process must be thorough and provide the organization with the market intelligence necessary to make a solid decision. Starting with a thorough *Market Assessment*, it is followed by a detailed analysis and market penetration strategy.

An experienced, qualified consulting organization can conduct a thorough *Market Assessment* to insure the client is armed with the best and most up-to-

- **Why Another Facility?**
- **Why Asia?**
- **What's the Motivation?**

The Decision Process

- **Must We?**
- **Should We?**

Typical Considerations in Pursuing an 'Asian Strategy'

- **Existing Customer Support**
- **Market Penetration**
- **Low Cost**

Typical Considerations in Pursuing an 'Asian Strategy'

- Existing Customer Support
- **Market Penetration**
- Low Cost

date market intelligence to support the ‘Market Penetration’ decision process. Such an organization can also advise the client on various alternatives to consider (short of an immediate full-blown manufacturing presence) should the *Market Assessment* process point to a favorable decision. In addition, this resource can then provide an assessment of the organization’s readiness, oversee the planning efforts and, in some cases, manage the entire project to completion.

- **Low Cost.** The issue of Low Cost is primarily related to the more labor intensive commodities that can be manufactured in a low-cost geography and exported back to the U.S. at less than U.S. cost. Notable examples are some categories of textiles, toys, decorations and various electronics. Many U.S. manufacturers were faced with loss of business due to competition from overseas manufacturing companies in low-cost geographies. Hence the transfer of these products to low-cost areas became a matter of survivability. Initially, China was the preferred Asian investment location, or at least a place for low-cost subcontractors. We now see a move away from China to fulfill this low-cost need. In fact, China is no longer a low-cost manufacturing location in the most popular areas like Shenzhen, Shanghai, and Beijing. The interior of China, however, still offers very favorable labor rates: however, the infrastructure in these areas is rather primitive, although the government is heavily investing in infrastructure projects in hopes of attracting business. More importantly, China is no longer courting companies in these low-cost industry segments. The Chinese government is focused on segments such as high technology and others that benefit long-term Chinese development goals. Vietnam is currently a more favored low-cost locale compared to China. Vietnam is also placing considerable emphasis on a variety of industry segments such as high technology applications, biotechnology, infrastructure development, Information technology, energy related applications and others that receive investment preferences.

Regardless of where the client might decide to deploy a low-cost strategy, the cost of shipping, landing and overland transportation must be understood and factored into the *Business Case*. *These costs can be substantial - up to \$9,000 or more per 40’ container depending on material shipped and could actually derail an otherwise good Business Case.* Also, once an organization enters the realm of import / export, a high degree of organizational expertise must be developed to insure compliance with governmental requirements (on both sides of the ocean) and to continually secure the best possible pricing and service from the freight forwarders, customs clearance agents, transportation companies, etc.

As stated above, a dependable, experienced consultant can assist the client to select the most favorable location and develop a strategy that meets the client’s objectives. This might typically be a solution involving the identification, qualification and utilization of subcontractor(s), followed by an evaluation period of a year or so. Doing so quite often achieves immediate cost savings. Later on, the client can decide if they want to pursue an equity position (either as a partner or wholly-owned). This allows continuation of the cost savings but with additional control of business operations and strategy.

Typical Considerations in Pursuing an ‘Asian Strategy’

- Existing Customer Support
- Market Penetration
- **Low Cost**

Is your Company Considering a Low Cost Solution with Export Back to the U.S.?

- Make sure you understand the nuances of import / export Laws
- Insure you have included all appropriate costs in the *Business Case*
- Insure appropriate staff has expertise in I / E operations to insure legal compliance and to continually monitor costs

EWA Can Assist You In:

- *Site Selection*
- Developing a business solution
- Identifying & engaging in-country support

The Decision Process: Should We?

The Decision Process

- Must We?
- **Should We?**

If the answer to the *Must We?* consideration is “No”, the *Should We?* scenario is the next step in the decision process. Typically, the same considerations (Customer, Market and Low Cost) are involved. The difference tends to be one of urgency for a decision. The simplest situation is where the answer to the *Should We?* scenario is also “No”. In this case, the client can proceed with their focus on current operations and possibly revisit the ‘go international’ decision at a later date.

The Decision Process

If the answer to *Should We?* is ‘No’...

Focus on your current operations model and revisit the ‘go international’ question at a later date.

A more common situation is where the answer to *Should We?* is a tentative “Yes” or “We are not sure”. How do you deal with this situation? Given that the client is not constrained for a decision (that is, not in a *Must We?-Yes* situation), there is time to craft a more deliberate approach that affords the client the time to “test the waters” in a manner that minimizes risk. A consultant typically recommends a very carefully-crafted phased approach that accomplishes this goal while setting the stage for future strategic moves. This approach employs intermediate “Go /No Go” decisions dependent on the results of each phase. Let’s look at an example (from an actual EWA proposal):

A Thoughtful ‘Phased’ Project Approach Can Benefit a Client:

- Reflects a logical flow of activities
- Simplifies the management process
- Maximizes ability for the organization to gain experience
- Minimizes initial capital requirements
- Capital injection requirements and project complexity grow along with clients’ experience
- Fosters a continual but incremental growth scenario
- Can be terminated whenever required
- Overall minimizes risk.

- **Situation:** Client manufactures a unique product using a proprietary process. Distribution is in the U.S., Europe, Canada and a few mid-eastern countries. Client is interested in penetrating the Chinese / Vietnamese market but does not fall into a *Must We? - Yes* scenario. Product is incredibly useful in its intended application but appears to be a fairly new technology in Asia.
- **Client Intent:** Establish and grow a distribution capability in China /
- **Challenges:** Given the ‘newness’ of the technology in China / Vietnam there are questions on the ability to legally import the product into these countries and about any import duties that might be levied upon arrival. There are questions regarding the actual market opportunities as well as concerns about developing ‘credible’ distribution partners in both countries. The ability to manufacture is a downstream decision that will require due consideration of location, business model, capacity, capital requirements and IP protection on the manufacturing process
- **Approach:** A phased-approach, including:
 - **Legal Assessment.** Various in-country reputable legal firms were recommended to do an analysis of the ability to import the product and advise of any duties that might be required, as well as any other customs-related issues their analysis uncovers.
 - **Market Assessment.** In-country reputable Marketing Assessment firms were recommended to do a detailed market analysis.

- **Distributor Identification & Qualification.** Contacts were notified to begin the identification of potential distributors to insure only the best firms were eventually qualified..
 - **Office Establishment:** A small in-country office was recommended to serve as focal point for management of the distribution network. Business formation laws in China and Vietnam differ as they pertain to foreign-owned “Trade & Distribution” companies, and these legal requirements must be incorporated in the business formation strategy.
 - **Initiating a Manufacturing Presence.** Recommendation also made that the client eventually establish a local (in-country) manufacturing facility. This facility can grow out of the local Business Office (above) or can be located based on the experience gained during the initial phases.
- **Benefits .** A major benefit of the above approach is that the process can stop at any time a business concern arises. The up-front costs are minimal. Decisions involving capital injection and moving to the next phase are made as the client gains valuable business experience.

Business Environment Comparison: China vs. Vietnam

Some Shared Characteristics of the Business Environments in Vietnam and China:

- Tax incentives available
- High quality workforce
- Well documented business formation policies
- Export policies very business friendly
- Varying degrees of government support
- Varying degrees of infrastructure
- WTO membership.

We’ve spent some time discussing the typical decision process involved in establishing an Asian manufacturing presence. Since we have assumed a China or Vietnam alternative, the next logical question that arises is: *which country is best given my company’s goal and objectives?* The answer to that question requires a thoughtful analysis employing a disciplined, comprehensive and prioritized list of site selection criteria. The eventual decision will be based on careful “scoring” of each visited potential location against the established site selection criteria along with financial / strategic considerations and incorporated into the *Business Case*. These evaluations can typically include upwards of 100 criteria for consideration. However, summarized here is a brief and high-level business environment comparison of Vietnam vs. China based on one of EWA partner’s 13 years’ experience working and living in Asia and conducting business in both countries. This can be considered a starting point in the location decision, but should not replace a more detailed analysis as discussed above. Figures 2a, 2b & 2c reflect a high-level business environment comparison.

**Figure 2a: Vietnam vs. China Business Environment Comparison
by
Selected Criteria**

<u>Criteria</u>	<u>Vietnam (HCM City)</u>	<u>China (overall)</u>	<u>Comments</u>
Tax incentives	✓		Up to 4 years tax holiday & 7 years at 50% nominal Not to exceed 15 years.
Ease of business formation	✓	✓	Well documented in both locations
Ease of Export	✓	✓	EPZ's available but same benefits typically apply in or out of zone.
Sell domestically	✓	✓	Equally easy. Similar provisions on VAT
Size & maturity of local market		✓	No comparison. China is far ahead
Infrastructure		✓ East & South China	Very basic in Vietnam <u>but</u> developing quickly. China Central & West interior still developing
Labor rates	✓ 48 hr/week 25% add for social programs	40 hr/week up to 60% add for social programs	Very inexpensive in Vietnam. 20-50% of China rates depending on skills & location in China. China has better trained / more experienced managers with wages that are commensurately high
Quality of workforce	✓	✓	Both have a high quality, well educated workforce
Retention	✓		Vietnamese tend to be a bit more stable. Lots of mobility in China aimed at obtaining higher salaries
English Skills		✓	Vietnam is catching up quickly
Availability of existing facilities		✓	Only small buildings immediately available in Vietnam. Clients must be to order. China typically is well supplied with existing structures.

**Figure 2b: ‘Vietnam vs. China Business Environment Comparison’
by
Selected Criteria**

<u>Criteria</u>	<u>Vietnam (HCM City)</u>	<u>China (overall)</u>	<u>Comments</u>
Availability & reliability of utilities		✓	Vietnam is catching up quickly
Land / lease price	✓	✓	Varies widely depending on locale. Typically less expensive in Vietnam in the less-developed zones but prices are increasing. Most of the available space in the preferred zones is being bought out quickly.
Utilities price	✓	✓	At first glance it is comparable. Much depends on location.
High speed internet	✓	✓	Equally capable and similarly priced
Availability of expat housing		✓	China is ahead but Vietnam is building quickly
Price of expat housing	✓		High end 300 m2 home in HCM City is approx US\$ 3500 / month. Prices in China vary widely but equivalent in Shanghai is at least US\$ 7500 / month
Availability of international schools	✓	✓	In HCM City Korean, Australian, Japanese & British schools are available. American school available in South HCM City. China has a large number of American format schools available at all levels depending on location.
Transportation	✓	✓	Local ground transportation is available in both countries. Vietnam is approx 40% less expensive (US\$ 30 vs. US\$ 50 / day).
Hotels	✓	✓	Western format hotels in both locations are available and becoming more expensive. Adequate accommodations with great service can be obtained in either country for US\$ 100-US\$ 250 / day

Figure 2c: Overall China vs. Vietnam Business Environment Comparison

Vietnam (WTO Member, 2006)

- Provides a low cost manufacturing base
- Very favorable tax advantages to all industries. Special incentives extended to ‘preferred’ industries
- Large manufacturing facilities typically not available for immediate occupancy
- Infrastructure is somewhat basic but developing quickly
- Currently, not many U.S. companies but increasing
- Incredible growth in all facets of the economy
- Government policies are ‘pro-business’ / ‘pro-growth’

China (WTO Member 2001)

- Becoming more costly
- Large and sophisticated market. Emerging ‘middle class’ is large and demanding
- Large existing base of customers / suppliers / competitors
- Great infrastructure in Eastern / Southern areas. Infrastructure in Central / West developing
- Tax incentives aimed to high technology. May be phase out in next few years
- New government policies being viewed as ‘non-business friendly’ especially in the area of labor law

Summary: Business Environment Comparison

The above discussion is intended to provide a directional feel for comparing Vietnam and China business environments. The laws in both countries can change very quickly. The infrastructure is developing at an incredibly rapid pace. Therefore, detailed *Site Selection* criteria must be established and comprehensive on-site evaluations undertaken in order to reach an enlightened decision on a preferred location.

Summary

- Laws change quickly
- Infrastructure developing rapidly
- Must conduct a detailed in-country **Site Selection** effort

Short Discussion of 3 Selected Critical Planning Criteria

Not surprisingly, there are many considerations that must be addressed in developing a *Business Case / Plan*. The *22 Critical Planning Factors* (listed on page 20) form the basis for assessing and / or developing a client's *Business Case / Plan*. Addressed here are portions of 3 of these *Critical Planning Factors* for further illustration:

- *Financial Planning-Tax Incentives*
- *Human Resources and*
- *Expatriate Policies.*

• *Financial Planning -Tax Incentives*

This factor's importance derives from the fact that it directly affects a corporation's income tax. VAT is not an incentive and tariffs should be disappearing due to WTO provisions.

Chinese Tax Policy

China has been on a '2 + 3' program for many years. In this scheme, the first 2 years of operations are given a 'tax holiday'. The 2-year clock starts ticking after (and including) the first full year of cumulative 'carried forward' profitability. Taxes for the next 3 years are levied at 50% of the nominal tax rate. Experience has shown that the different locations / zones in China may discuss alternate schemes as they compete with one another for foreign capital. This can be very confusing to the prospective investor. Caution is key here. The official government corporate tax program is '2 + 3' as described above. The 'extra incentives' should be disregarded unless the company is in a very specialized industry segment. Even then, legal validation for any scheme is advisable. The tax incentive program in China was designed to attract foreign capital. The nominal tax rate offered early on in the Special Economic Zones was 15%. Therefore, foreign investors were paying 0% for 2 years and 7.5% for 3 years, followed by a full 15% at the end of the 3-year period. Local (Chinese) companies are taxed at 30% federal + 3% local. Obviously, the tax 'breaks' given the foreign firms create an unequal tax treatment scenario. In the early days following the opening up of China, the government was focused on attracting foreign investors. At that time the local firms were not able to compete

Let's Look at 3 Examples of Planning Criteria

- **Tax Incentives**
- Human Resources
- Expatriate Policies

Corporate Income Tax Treatment-China

China's '2 + 3' program has been in-place for many years:

- 2 years tax holiday
- 3 years at 50% nominal tax rate
- Has satisfied the needs of both the foreign investor & the government
- Enabled businesses to gain momentum prior to incurring tax liabilities
- Attracted the types of business & technology sought after by the government

head-to-head with the foreign firms in terms of quality, efficiency and overall business acumen. So, differing tax scenarios were a moot point given the focus on targeting foreign investment and gaining the experience in running world-class operations.

Corporate Income Tax Treatment – China (con't)

- Local (Chinese) owned firms taxed at 33% (federal & local)
- Creates an 'uneven' playing field
- Government addressing issue

Chinese firms have gained considerable business experience, are becoming more savvy in terms of manufacturing operations and are demanding a more level playing field in terms of corporate income tax. The Chinese government will most likely take actions to eliminate the dual tax scenario. The most educated prediction is that the government will have 1 rate for all industries with an expected phase-out of tax incentives for new foreign investments. Odds are there will be industry specific tax incentives to retain the focus on attracting the industry segments believed most beneficial to the Chinese economy and overall development of the types of technology targeted by the government. So, this should be kept in mind in any discussion of tax incentives with a consultant and / or government contacts.

Vietnamese Tax Policy

In terms of economic development, Vietnam is now where China was 10-15 years ago, with the exception that they appear to have learned and applied valuable lessons from the Chinese. Vietnam offers a low-cost manufacturing regime to the more commodity-related industries. However, the government has also implemented an aggressive program of corporate income tax incentives to attract foreign investors in the higher technology segments. This program involves up to 4 years of tax holiday following (and including) the first year of 'carried forward' profitability. Thereafter, the tax rate is ½ of the nominal tax rate for a period of up to 7 years, with a total application period of up to 15 years. The nominal tax rate can be 10%, 15%, or 20% - depending on the industry sector, investment classification and location. The standard tax rate is 28% unless your entity qualifies for one of the above-mentioned 'preferential' rates. In the Vietnam *Site Selection* phase, the various zones should be visited and the tax incentives of each discussed, as well as the criteria for obtaining preferential tax treatment. The discussions on tax incentives are uniform among the various zones in Vietnam and explained in a very straightforward manner.

Corporate Income Tax Treatment-Vietnam

Vietnam Uses Programs similar to the Chinese except:

- Up to 4 years of tax holiday
- Up to 7 years of 50% of nominal tax rate
- Total application period of up to 15 years
- Still has advantages for low cost commodity industries
- Real benefits for high technology & other 'preferred' industries

Other Tax Considerations

The above discussions pertain to corporate income tax. The following taxes / duties must also be understood, and the *Business Case / Plan* must reflect, as appropriate:

- Personal Income Tax (especially for expatriates)
- Value Added tax (VAT)
- Stamp duties
- Property tax
- Consumption tax
- Capital gain tax
- Withholding tax

Human Resources

Let's Look at 3 Examples of Planning Criteria

- Tax Incentives
- **Human Resources**
- Expatriate Policies

A high-quality workforce is key to business success no matter where your company is located. In China & Vietnam, the ability to locate, hire and retain the best talent is a real management challenge. Also, there are government-mandated policies that must be followed, and social programs that must be funded / supported. The specifics of the programs vary between Vietnam and China. However, as Communist governments, many of the overall policy approaches are similar in both countries. The following considerations are highlighted as an aid in the planning process, but are by no means exhaustive.

• **Hiring**

Human Resources:

A major consideration

- Both Vietnam & China have a high quality / dedicated workforce
- Attracting & retaining workers is a key challenge
- Both countries have comprehensive labor laws
- Various mandated social programs must be supported.

Senior Management.

An H/R manager / executive and a CFO / controller should be the first hires. Both individuals should have extensive experience with western companies. It will be somewhat easier to find candidates with this background in China, although it will not be cheap. In a city like Shanghai expect to pay an experienced English-speaking H/R manager at least \$40,000-\$50,000/ year, plus incentives. An experienced CFO in the same city could cost \$70,000-\$90,000/year, plus incentives. Locating these skills is not easy. The assistance of local recruiting (“headhunter”) firms is often used for senior positions.

Since the CFO will be handling substantial amounts of money and the H/R Manager will be making staffing decisions, thorough due diligence on both individuals is essential. As stated subsequently, it is strongly recommended that the business entity begin with a strong ‘Expatriate’ manager overseeing the activities, hiring the initial group of senior managers & employees and imparting business values and ethics.

Hiring

- Initial focus should be on hiring an experienced local H/R Manager & CFO / Controller
- Staffing of other positions can then proceed
- In-country ‘headhunting’ firms can be used for the senior positions
- Local job fairs, newspaper ads and local development zones can be used to locate engineers, staff & manufacturing labor

Manufacturing Workers, Staff and Engineers.

In both countries, the local development zones and municipal governments are very helpful assisting in the search for qualified candidates for general manufacturing positions. The development zones are especially helpful in this regard. Local newspapers and job fairs can also be used as recruiting tools. It is important that resumes be screened and validated. Truthfulness about experience and education is essential; and the H/R manager oversees this screening and selection process. As more experience is gained, establishing a relationship with local universities and / trade schools becomes a good on-going recruiting tool.

Labor Costs

- The total cost of labor must be accounted for in the *Business Case*
- Typically considerable misunderstanding of labor costs during *Business Case* development
- Estimates of labor costs must be obtained from a reputable source & should be validated with other foreign firms operating in the area

General Approach to Labor Policy Similar in Both Vietnam & China

Chinese Government is Expected to Enact Increasingly Restrictive Labor Laws

Vietnam Is Clearly the Most Attractive Alternative in Terms of Low Cost Labor

• **Salary Expectations / Planning**

Salaries listed on the brochures from the local development zones should always be verified. The JV partner should be consulted about employee salaries (if looking to form a JV) but the real salary information should be obtained from salary surveys conducted by a reputable firm. Networking with other business leaders in the area is another good validation of salary data. Salary, typical salary escalation, incentive schemes, '13th month' pay and various techniques for retention need to be understood. All salary information must then be appropriately folded into the *Business Case / Plan*.

• **Employment Policies / Practices**

The general approach to labor policy is similar in both Vietnam and China. The purpose is to insure:

- fair and equitable treatment of its citizens
- support of the various mandated social programs
- everyone understands and is paying taxes according to the appropriate tax schedules.

China

It should be noted that the Chinese government has recently considered enacting H/R policy laws that are restrictive and will result in increasing the cost of labor while providing no real benefits for the employees - except possibly for those who are minimal or substandard contributors. The intent is to provide "employment for all" which has always been an objective of Communist governments. As the assets of the State-Owned Enterprises (SOE) are acquired, or entire companies sold off, the government is committed to insuring full employment for the employees of the affected SOE's. They might even go so far as to demand that the acquiring party or western JV partner agree that a certain percentage of the workforce must be transferred with the sale of the asset or establishment of the JV. Therefore, care must be exercised during the negotiation phase. Some believe these policies will work against Chinese interests, especially in the development of the central and western areas of the country.

Vietnam

Vietnam, on the other hand, has very competitive labor laws and employs labor practices / policies that are favorable to business interests but which are also fair for the employee. Undoubtedly, the costs of labor in Vietnam will increase as the country continues along its growth and development path. Laws are always subject to change and the labor laws in Vietnam most likely will change in the coming years. However, the business climate now is very favorable and most likely will continue to be so for the foreseeable future.

Let's Examine Common Elements of H/R Programs in Vietnam & China

Elements of H/R Policy / Programs in Vietnam & China

A detailed treatment of the various H/R considerations in each country is beyond the scope of this White Paper. However, listed in figure 3, below, are some of the elements of the H/R program that should be understood. As stated above, most of these considerations involve implications to the *Business Case* and must be included in the financial analysis.

Figure 3: Various Elements of H/R Policy / Practice in Vietnam & China

- | | |
|---|---|
| <ul style="list-style-type: none"> • Probationary employment period • Overtime hours & payment • '13th' month pay • Social programs <ul style="list-style-type: none"> - Medical insurance - Unemployment benefit - Pension - Housing Fund - Survivors benefits - Employment injury • Personal income tax withholdings • Housing allowance • Establishing an employment contract | <ul style="list-style-type: none"> • Terminating an employment contract • Disciplinary actions • Restraint of trade / non-compete • Non solicitation • Confidentiality • Drug / alcohol testing • Background checks • Pre-employment & routine medical screening • Retrenchment or redundancy • Leave / vacation • Unions • Collective bargaining • Others |
|---|---|

Let's Look at 3 Examples of Planning Criteria

- Tax Incentives
- Human Resources
- **Expatriate Policy**

Expatriate (Expat) Policy

The major question regarding use of expatriates usually centers on whether or not they are needed.

• **Use of Expats in the 'Early Years'**

During the early days of the China 'miracle', western companies expected to have expats included in the organizational structure. They planned for expat expense and used them extensively, not just in start-up, but also for on-going operations. The role for the expats was clear ... someone who knew the technology, could represent the interests of the U.S. partner, and who could be trusted to work through the complexities of dealing with the Chinese bureaucracy. The current prevailing thought is that China has reached a level of sophistication where an expat represents an unnecessary luxury. The belief is that many locals are available to fill this role. In the case of Vietnam, it is clear that a strong local skill base has not yet been developed and that use of expats is most likely necessary – at least for foreseeable future.

Expats Used Extensively in the 'Early Years'

- Impart technical skills
- Teach company values / business ethics
- Work through complexities of foreign business environment

Are Expats Still Relevant?

EWA Recommends an Expat Be Assigned as Senior Manager (GM or Managing Director)

- Plant start-up
- First year or two of operation

The Role of the Expat Senior Leader

- Oversee initiation of operations
- Staff Sr. Management positions
- Groom successor
- Impart company's values
- Establish & enforce western business practices
- Implement a strong business controls posture
- Establish & maintain a proactive relationship with government agencies
- Assume fiduciary and legal responsibility for the foreign business entity

• **Recommendation - Use of Expat(s)**

Based on many firms' experiences, it is strongly recommended that expats be deployed in the critical start-up phase and into the first two years of the life of the China or Vietnam business entity. Too many "mis-starts" occurred by hiring a local senior manager (Chinese or Vietnamese, if you can find them) only to have them leave for higher pay or, on a more serious note, completely fail and sometimes defraud the organization. Experience has shown that the top management position (General Manager or Managing Director) should initially be held by an expat. Ideally, this individual will be the type of person who exemplifies the company's culture and values, and hopefully, has been involved in the project from the beginning. If deliberate care is taken to do thorough due diligence in staffing the organization with strong locals in the key areas (H/R, CFO, Plant Manager, etc) the new organization can operate with one competent expat leader. The expat should also expect to have part-time "subject matter" experts from the U.S. assisting in selected areas on 2-3 week assignments, providing technical expertise and establishing a relationship with their local counterparts. After that, technical help should just be a phone call away. This allows the leader to focus on the key issues facing a fledging organization in Vietnam or China.

• **The Role of the Expat Senior Leader**

The primary role of the expat senior leader is to get the factory started, impart the parent organization's culture / standards and groom his / her successor. Establishing the manufacturing operation is, at times, considered easier than the role the expat leader must fulfill in imparting a culture of quality, establishing business transparency, insuring organizational and staff respect, driving environmental / health / safety practices, and imparting other business values often taken for granted in the west.

A successful expat senior leader must be a teacher as well as a learner, and display cultural empathy and an eagerness to learn about the culture, language - and yes, the food. He / she must be an experienced senior leader with a history of leadership successes, well grounded with a healthy sense of self, sense of purpose and a sense of humor. The leader must also be uncompromising in demanding and enforcing standards of excellence, and unflinching in setting a personal example. He / she must have frequent and proactive dialogue with various government agencies- promoting goodwill between the foreign venture, the U.S. parent company, and the host country government. Setting the organization on a solid footing, the leader will eventually leave it with a strong set of business controls to insure its continued vitality. In summary, for the above reasons it is very prudent to have an expat in the leadership position for start-up and the first critical year of operation.

Often times, Asia (manufacturing) implementation consultants have the depth of experience to provide leadership for an organization until a suitable replacement is found, and to help with the identification and selection of a general manager (GM) if candidates from

EWA Can Assist You in Filling a Senior Leadership Role

- We can assign an EWA
- consultant with previous Asian GM experience to the senior leadership position
- We can act as the GM with full legal / fiduciary responsibilities until a suitable replacement is found

Additional Considerations (Assuming Decision is Made to Use an Expat)

- Who to consider?
- How to select?
- How long?
- How much (expense)?
- How to administer?
- What happens at end of the assignment?

within the client's organization are not available. One model that has worked well entails having an experienced consultant assume a leadership position in-country, establishing the operation and serving as the first GM upon issuance of the business license. Technical support would come from a rotating U.S. team of experts from the client, with a key manufacturing representative working with the GM during the critical start-up / ramp-up period.

• **Sample Considerations Involving Expats**

Listed here are some key considerations that must be addressed once a decision is made to base an expat at the foreign entity.

- Who should be chosen (i.e. what is profile of the ideal expat)?
- What constitutes an expat 'package' & how much does it cost?
- Have these costs been included in the *Business Case / Plan*?
- How to administer an expat package?
- How to administer complex expat taxes?
- What is the re-entry plan back into the expat's home country business at the end of the assignment?

Experiences of American Firms Operating in China

Figure 4, below, contains a summary of selected data from the Mid-2006 American Chamber of Commerce in China 'White Paper' representing the views of 214 American invested companies operating in China for varying lengths of time (based on 2005 business results). Their website (www.amcham-china.com.cn) can be consulted for a continuing update of important China business information.

Whether locating in China or Vietnam, it is a good idea to join and become active in the local *AmCham*. The networking opportunities that membership provides are a great way to establish a company's presence, while also serving as a base for social activity.

**Figure 4: Amcham-China 2006 Survey of U.S. Invested Companies
Operating in China**

Number of Firms Surveyed - 214

- **Business Formation Type**
 - Wholly Foreign Owned: 55%
 - Joint Ventures: 28%
 - Other: 15%

- **Industry Sector**
 - Manufacturing: 43%
 - Services: 37%
 - IT: 7%
 - Retail / Distribution: 3%
 - Other: 10%

- **Years in Operation**
 - Less than 2 years: 14%
 - 2-5 years: 17%
 - 6-9 years: 20%
 - 10-20 years: 34%
 - Greater than 20 years: 15%

- **Number of Employees**
 - 1-50 employees: 47%
 - 51-100 employees: 12%
 - 101-500 employees: 21%
 - Greater than 500 employees: 21%

- **2005 Revenue**
 - Less than US\$ 1 M: 23%
 - US\$ 1 M – 9 M: 23%
 - US\$ 10 M – 49 M: 23%
 - US\$ 50 M – 100 M: 4%
 - Greater than US\$ 100 M: 19%
 - No revenue (Rep Offices): 8%

- **Global Revenue Derived from China**
 - Less than 2%: (revenue): 35% (respondents)
 - 2-5%: 18%
 - 6-10%: 13%
 - 11-30%: 10%
 - 31-90%: 11%
 - 91-100%: 14%

- **Profitability of China Operations**
 - Very profitable: 14%
 - Profitable: 50%
 - Break even or small loss: 32%
 - Larger loss: 4%

- **Profitability by Time in China** (for Highly Profitable or Profitable Companies)
 - 21% in China less than 2 years (of 24 total companies in China less than 2 years)
 - 45% in China 2-5 years (of 35 companies)
 - 75% in China greater than >6 years (of 143)

- **YTY Margin Growth ('04 to '05)**
 - Substantial growth: 14%
 - Some growth: 47%
 - Remained the same: 23%
 - Decreased: 16%

- **China Margins vs. Worldwide Margins (for Companies with Global Operations)**
 - Significantly higher: 5%
 - Somewhat higher: 28%
 - Comparable: 32%
 - Somewhat lower: 23%
 - Significantly Lower: 12%

Summary

➤ Review:

The purpose of this White Paper was to examine the “Go-Asian” decision process, briefly examine the business environments in Vietnam & China, address some critical planning factors, and review the experiences of a sampling of U.S. firms doing business in China. This is however, only a start in the overall process of detailed *Market Assessment, Business Case / Plan Development, Site Selection, Project Management & eventual Project Implementation.*

➤ EWA has found clients typically show 1 of 2 general schools of thought in terms of implementing an Asian presence:

- It is an impossible undertaking
or
- This is going to be easy.

➤ The Reality:

The fact of the matter is that it is neither impossible nor is it easy. It is a very complex undertaking, but can be done in a manner resulting in very successful results as evidenced in the data reflected in Figure 4. The outcome can also yield less-than-desired results, also surmised from Figure 4.

➤ The Keys to Success: EWA has found the following to be indispensable in establishing a China / Vietnam manufacturing presence:

- Organizational commitment
- A methodical & disciplined approach to decision making, planning and execution
- experience in:
 - planning for all anticipated issues
 - dealing with any unanticipated issues
 - leading the cross-cultural team in the implementation phase

EWA has the disciplined processes, the in-country experience, and the demonstrated leadership to assist you in implementing your Asian manufacturing strategy

EWA Team – Principals



Arthur Joseph Yarzumbeck - Senior Vice President

Art has more than 25 years' domestic and international manufacturing leadership experience. Art provided executive leadership in lean manufacturing operations, quality, engineering, development, P&L management, multi-site operations, strategic positioning, technology development, sales / marketing, acquisitions / divestitures and general management in his career with IBM. Art also served as an officer, U.S. Army Corps of Engineers, where he had various levels of command, staff and large project management responsibility. He is currently involved in providing consulting and project management services to manufacturing clients as a Principal in East West Associates (EWA).

Art assisted in establishing EWA and became a partner upon his retirement from IBM in 2005. He has provided various levels of consulting and project management expertise to firms in the heavy manufacturing, electronics and textile industries. Art provided due diligence support to a mid-sized mid western firm engaged in designing and manufacturing environmental vehicles (refuse and street sweeper trucks) who embarked on a China Joint Venture strategy. He then spent 6 months in China as prime project manager and as the 1st General Manager after the business entity was established. He has assisted numerous other clients with business plans in China and Vietnam.

Upon completion of military service and graduate studies, Art joined IBM as a senior associate engineer in the printed circuit board product development labs located in Endicott, NY. He worked his way through a series of management positions in a variety of engineering, quality, manufacturing, sales/customer coordination, and business unit executive roles. In 1994, Art assumed responsibility for establishing China manufacturing facilities for IBM's Microelectronics Division. As Director, Asia Operations, Art established and managed 3 high technology lean manufacturing facilities in the People's Republic of China and was also responsible for an IBM manufacturing/development facility in Japan. He lived and worked in China for 10 continuous years before returning to the USA in Dec, 2003. While in Asia, Art was an active member of the board of directors for 4 IBM China companies. He also served as primary interface between IBM Microelectronics Division and the various Chinese governmental agencies required to conduct business in China. After his return from Asia in November 2003, Art assumed a senior staff role for IBM Technology Group and was also a member of the IBM Corporate Global Resource Council responsible for planning future worldwide location strategies in support of IBM global operations.

During his IBM career, Art was responsible for manufacturing and new product introduction responsibilities for IBM facilities in the U.S.A., Singapore, Thailand, France, Hungary, Canada, Italy, Japan and China as well as similar responsibilities for a host of OEM customers. Art retired from IBM as Director, Office of OEM Microelectronics, in March 2005.

Prior to joining IBM, Art served as an officer in the US Army Corps of Engineers with 9 years' active duty and 18 years' reserve service. During his military career, Art served in a variety of command and staff assignments. Art was activated for service in the Gulf War, where he spent 10 months as an engineering officer in US Central Command in Saudi Arabia managing large-scale construction projects to support Operations Desert Shield and Desert Storm. He was awarded the Bronze Star for actions during the war. He retired from the US Army Reserve, US Army Corps of Engineers as a Lieutenant Colonel in 1997.

Art received a Master of Science degree in chemical engineering from Penn State. He speaks some Chinese (Mandarin dialect) and was previously fluent in written and spoken Spanish. Natives of Johnstown, PA, Art and his wife reside in Concord, NC. They are the proud parents of a son and 2 daughters.

EWA Critical Planning Factors

1. Financial Plan
2. Project Confidentiality
3. Site Selection
4. Human Resources
5. Expatriate Policies
6. Board of Directors Operations (JV entities only)
7. Partner & Government Relations
8. Business Formation
9. Intellectual Property (IP) Protection
10. Physical Security
11. Information Technology (IT) & Integration with Parent Co
12. Disaster Planning
13. Sales & Marketing
14. Environmental, Health and Safety
15. Supply Chain
16. Customer Fulfillment Process
17. Manufacturing Operations
18. Quality
19. Facility
20. Country Infrastructure
21. Project Management Process
22. In-Country Business Support

EWA's staff has spent over 50 years initiating manufacturing operations in many countries for major Fortune 100 companies as well as smaller, privately held firms. This experience has been primarily Asia-based but also includes Central and South America, Canada and Europe. We have obviously learned a great deal about international manufacturing operations. We have codified our experiences into what we refer to as 'Critical Planning Factors' (Fig 5). There are currently 22 of these Factors and we view them as mandatory considerations in the development of a solid *Business Case / Plan* leading to successful *Project Planning and Implementation*. Supporting the 22 *Critical Planning Factors* are over 1000 sub-factors which really form the basis of EWA's Value Chain offering especially in the area of *Business Plan Assessment / Development*. As part of an overall *Business Case / Plan Assessment or Development*, all of the 1000+ sub-factors are reviewed in great detail over a 2-4 week period by a highly skilled EWA team. This review is followed by an in-depth written report of findings with specific recommendations in areas found to be in a 'not ready' status. The linkage among the various Factors is critical especially as each influences the *Financial Planning Factor*. This linking is a natural outcome of EWA's *Business Case / Plan Assessment / Development* offering. Other White Papers in this series are designed to address each of the *Critical Planning Factors*.