The Weakest Links in the Global Supply Chain: Part II

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Anu Rajakumar: In the previous episode of Disruptive Forces, we began a conversation about the global supply chain. Today we're going to dig in a little deeper, focusing on how the crisis has evolved in emerging markets specifically. While some of us have been purchasing comfortable sweatpants for the prolonged work-from-home environment, the apparel companies producing them have been trying their best to mitigate the issues brought on from the crisis. How should investors think about the challenges that are faced by companies operating on the production side of the supply chain, and where are the opportunities? My name is Anu Rajakumar, and to answer those questions and more, I am joined today by Marco Spinar, portfolio manager for our Emerging Market Equities team here at Neuberger Berman, who's going to shed light on how the supply-chain issues have affected companies operating in emerging markets. Marco, thanks for joining me.

Marco Spinar: Thank you. Thanks for having me.

Anu: So Marco, last week I had Michael Barr on the show, giving his perspectives on supply-chain issues; um, and during that episode, he had mentioned that the supply chains were slowing down before COVID started. Given your role as an emerging-market portfolio manager, I would love for you to share some of your background about, how the supply chains, had some issues before COVID; and maybe even if you could share some insight on the trade wars?

Marco: Yes. So, you know, it's important to note that, you know, first of all, these supply chains are, are never static, right? Companies are constantly changing their own supply chains. They're always trying to bring efficiencies to them. They're, adjusting to political risk; both in the destination country at home, for example, as well as the origin country. And, obviously during Trump's presidency, there was a lot of attention paid to exports from China. And naturally, companies were responding to what was an obvious change in the sentiment around where goods were coming from, and a desire to diversify out of China.

Anu: Perfect. Thank you very much. And so maybe just from your perspective, do you feel like that change in sentiment, was that the catalyst for companies to really seek, overseas labor in other countries than China, or do you think that was actually also starting before these conversations were happening?

Marco: Yes. I think that's a good point. It was happening even before those issues came up. There were big cost pressures in a lot of the, the kind of lower-end manufacturing supply chain in China, that were leading companies to look elsewhere. Vietnam, Cambodia, were natural places to look. You know, they're on the same trade routes. They've been very open to kind of those lower-end manufacturing. And so you had already seen companies moving out of China for that reason. China itself was trying to move up the value chain and basically tried to further develop away from those lower-end manufacturing. So, so yes, we had already seen that happening, before the kind of political tensions developed between the U.S. and China over trade.

Anu: When you say that China was moving up the supply chain, what do you mean by that?

Marco: Just trying to do, higher value-add work, create more of a domestic, consumer-oriented economy. You know, those jobs are tough, and they don't have the greatest wages. Prices are, very sensitive to wages. And one goal of the whole Chinese growth project was to raise wages, which it did. but that in turn, can only bring so much efficiency to a manufacturing facility that has a lot of labor in it. And you kind of had that tension that drove a lot of that manufacturing to other locations. I mean, interestingly, if you were to look at the growth in textile exports from China to the U.S., from 2012 to 2019, China didn't grow at all. There was no increase in those exports basically supporting the apparel industry here in the U.S. But in Vietnam, it grew by nine percent. So you can, clearly, kind of see the evidence of that shift, long before the politics. And that was driven by a combination of higher wages in China and the desire to diversify.

Anu: Sure, absolutely. Maybe just touch on, you know, how COVID spread through China, and then other countries, and how those countries reacted. Have those problems and closures, have they abated now? Or are they still problematic in the emerging markets?

Marco: Yeah. Well, I think, to your earlier point, in the introduction, there were significant disruptions that occurred, throughout China to begin with, obviously. They were the kind of strictest, and you had a very big drop, in activity. Facilities closed. And you kind of saw that the virus itself move to other parts of the region. And so you almost had this domino effect, where the impact on economic activity, on manufacturing, kind of moved from one country to the next. A lot of that was driven by problems with labor and local government regulations to address COVID in Asia. They were very strict. There were zero-tolerance policies, not just in China but in other areas. There were lots of forced closures in Vietnam, and there were significant, labor shortages because people were sick, and they had to stay home, and they couldn't show up to those manufacturing plants.

Anu: And so another issue, of course, has been, the one around the ports. maybe you can just quickly touch upon that, and how you see those issues, at the moment.

Marco: Yeah, and they were very similar to, in many ways driven by the same issue, which is just labor shortages. you definitely have some labor component at the port. you're going to also have an important labor component when you think of the trucks that bring, the goods to, to the port or from the port. And so those issues that we heard about in California that were well flagged, were also occurring – maybe to a lesser extent – in Asia. And I think maybe, just to kind of address your question about where we are in this cycle, it looks like, as we talk to our companies on the ground, in Asia, that many of them, especially in Vietnam, in the apparel supply chain, they're returning largely to normal from a labor perspective. So they are seeing, you know, factories running at 90 percent, of utilization. But they're still having trouble with getting goods out of the port. And, most importantly, through the port here in the U.S. That's their biggest challenge right now, is getting goods, from the ship, actually through the U.S. ports and to their final destination.

Anu: Yeah, for sure. So with those challenges in mind, let's talk a little bit about onshoring or reshoring, i.e. relocating a business' production operations within its domestic borders. As an investor in emerging markets, how do you think about that as a risk for that particular – for the region that you're focused on?

Marco: Yeah. Well, I think it is a risk. And if you look historically, globalization has been very good for emerging markets. They really benefitted from the ability to do a lot more value add; to add a lot of productivity to their labor force. And they did that through exports, manufacturing-oriented exports. And so the reshoring or the onshoring that's occurring does kind of prove a threat to that economic model. Now, that being said, I think it's really important to recall that these supply chains are so well entrenched. It's not going to change in a dramatic way anytime in the near future. What we've seen in the data is that, on the margin, growth and global trade had been slowing, especially during Trump's presidency. There was a huge drop-off in global trade during COVID, but we've actually now returned to kind of the pre-COVID levels of trade, just when you look at the data. Where the whole world goes from here, I imagine it'll continue to be a somewhat challenged, top-line growth perspective in that there is this desire to re-shore and onshore. That being said, those supply chains are so important. There are still lots of opportunities to find good companies, that are growing with their, clients, whether it's Nike or Apple, and responding to them. And the partnerships that they've already formed, and the integration those companies have into a lot of our U.S. companies, are definitely going to mean those companies will continue to grow, going forward.

One thing that has also happened, that I think's important to note is that there has been a lot of wealth created domestically. And while, these economies still would love to export more and rely on that as an avenue of growth, there is an important growth in the domestic consumer, domestic markets, that provides a driver of growth in these economies. And that's – you know, when you step away from just this, the kind of narrowminded investment perspective, there's also just the broad development goals of seeing these countries improve. And you have seen the benefits of that. When you really step away from the short-term hiccups, it's important to remember how much things have really improved, for the lives of people in Asia.

Anu: Great, thanks. Now, I just wanted to dig deeper on the E, environmental, of ESG, in regard to supply chain. How do companies with production centers in emerging countries adjust their supply-chain management in order to lower carbon emissions? This is, of course, a, a big issue for so many around the world, particularly following COP26. Perhaps you can share your insights there?

Marco: Oh, yeah, it's really important. I mean, it's important to the companies here in America. As you mentioned, it's important to companies around the world. It's important to all of us as people. It's important to us on the Emerging Market team as investors. We have sustainable funds. We have an ESG orientation. And so it's, really an important issue. And those supply chains are definitely an integral part of addressing carbon. When you talk to a lot of companies here in the U.S., that have these deep supply chains into Asia or Mexico, they recognize that most of the carbon that goes into the manufacturing of their products comes from that supply chain. And to really address their goals, they're going to have to address carbon emissions in those countries.

And, one thing that happened, for example, when companies moved from say Taiwan, take Eclat, which is a Taiwanese-based fabric player, it's a higher-end textile supplier who had moved some of their operations to Vietnam. Nike is an important client for them. They went to a country that is basically dominated by coal-based electricity, and to some extent, that impacted all of the apparel supply chains, because there was that move, not just by Nike but by everybody, to more carbon-intensive electricity sources. and I think when the ideas were originally set, it was part of the equation; but it's become a much more important part of the equation. And so what we're seeing now is, companies are working with their local suppliers, to improve. And what that really means is, just look for opportunities to connect to local, renewable energy sources; look for opportunities to replace your own coal-based electricity or boilers and replace those with gas-fired boilers.

For example, this company I mentioned, Eclat, for their own reasons, I think they genuinely agree with the carbon goals; but they also have some pressure from their clients. They replaced all of their diesel-fired boilers in Taiwan in their fabric division, and now have gas-based ones, which is obviously, a big improvement in carbon. Additionally, I think it's important to note that, companies are working with the governments and encouraging them to support renewable centers, to support concessions around renewables, to make it economically effective. And to the extent that you have an important demand for electricity from these manufacturing centers, they can kind of give you that guaranteed offtake, which allows for investments in renewables. And it definitely adds to what is admittedly already a really complex equation, right? Managing these supply chains is difficult. They're complex. There are so many different nodes in that supply chain, and so you are adding a level of complexity. And, obviously, working with higher-end, more flexible companies on our end in emerging markets puts you in a better position, to make sure you continue to grow with your clients that have those demands.

Anu: No, that's terrific. Thank you. Now maybe shifting to the S of ESG, the social component, as it regards the supply chains, you know, Marco, as companies try to ramp their production capacity to pre-pandemic levels or above, there are some potential human rights issues, that have been raised. What are companies doing about that particular issue?

Marco: Yeah, that's a very fair point; and the hours can be very long. And the truth is, is that these workers, they're often migrant workers, whether they're migrating withing a country or even from other countries, to get this work. They don't have a lot of choices, and there is, a lot of potential for exploitation. And to your point, given that you've got a lot of people out sick, it's natural to expect other people to step up, much less, you know, what you saw here in the U.S. We've heard all about, what happened in the healthcare industry and the exhaustion that set in. An element of that, naturally happened, in any industry that was stressed, like what happened with the apparel business. All that said, these companies that we work with are committed to, fair treatment of their employees, as investors we're members, of an organization called KnowTheChain. We've agreed, along with a lot of other investment managers, to look at and make sure, that these employees are being treated fairly; things such as, you know, the hours they work; their ability to keep their passports; the fact that they don't have to pay fees to get jobs. These are all examples of the kind of things, that happen, and can be pretty devastating, for families migrant workers, [and] vulnerable populations, so that's also an important part, of analyzing the supply chain.

The good news, I think, around this issue is, it has gotten a lot more attention. I think there is genuine concern, here by U.S. companies. Companies, you know, they, really don't want the bad press that comes along with this stuff; and they genuinely work closely with their suppliers. We also work with them. We put pressure on them. We bring this issue to them. Generally they're responsive. It's – you know, no one that we work with would knowingly do this; but I think awareness and really being able to dig deep, not just to the first layer of that supply chain, but the second and third layer, down the supply chain, to make sure these events aren't happening.

And I think maybe I'd just point out that, examples of where we work with companies, we've actually gotten our companies to add the kind of language to their supplier contracts that supports, one, commitment from their suppliers, to be in line with human rights; and also to allow for, the inspections of these facilities, both announced and unannounced. It was interesting talking to Nike recently. They talked about examples of where they had done unannounced visits, and largely, they didn't find, examples, of bad behavior; but there were some, and that's naturally going to happen, unfortunately; and it just needs to be addressed. The compensation needs to happen, and that's really the model that's taking place.

Anu: Thank you very much. And now, I imagine that the disclosure, on these topics is, is challenging, or sparse. Could you speak a little bit about kind of how – what you're seeing in terms of the, the data particularly on human rights or other, similar issues, and what you foresee in the future? Or do you see that that is involving, you're seeing more disclosure, and are engagement efforts helping push that initiative along?

Marco: Yes. I think generally engagement – that's the first thing that needs to happen, is to get companies to disclose on these issues; preferably, in an audited manner. it's much easier for a company just to say they're doing something if they can get a third party to audit it and make sure it's happening and verify it's happening. That's what you want to see. And there are examples where that is happening. We're probably at the early stage of seeing that kind of disclosure in emerging markets. You see a lot of it already in the U.S. and in Europe, Australia, Japan. And that will be the model that eventually gets adopted in emerging markets; but it will take time.

Anu: Terrific. Thank you. So starting to wrap up here, Marco, would love to hear about your outlook for emerging-market companies, as well as just supply chains overall. What are some of your key takeaways for our listeners?

Marco: Well, I think, – I would just repeat what I said earlier – that, in spite of, evolving political needs and changes, both for domestic political reasons here in the U.S. but also just kind of the, the complications, maybe went a little too far in certain industries in terms of the supply chain. So the need to reshore, that will all happen; but there are still lots of really great opportunities, again, to find companies that are an integral partner and growing with those companies here in the U.S. or in Europe. And also, you are seeing really important improvement in the quality of the companies in these countries. Taiwan Semiconductor is just an amazing example of a company who's just gotten so good at doing this, right? They are the global leader without a doubt, as a fab. And you know that's a Taiwanese company. And a similar thing you could say about Samsung. So there's been real improvement and amazing investment opportunities, not just in that kind of lower end, component, but also way up the value chain.

Anu: Excellent. Now, Marco, before we wrap up today, I do have a bonus question for you. You know, we talked about Eclat and Nike kind of going up and down the supply chain from, you know, the fabrics to the, to the branding. So my question for you, Marco, is, during this pandemic era that we've been in, what has been your favorite, apparel purchase that you have made?

Marco: My favorite apparel purchase, um, oh God. You know, they have these, On Running shoes. I don't know, those, you know, those – Roger Federer, I think, brought this, this brand to fame. And I kind of seen people kind of running around with them, and I thought they looked kind of cool. And then my wife bought them, not knowing how hip they were, and then I went out and bought the same exact pair; and they fit my feet perfectly and they're so comfortable, and I bought literally four pair of those – mainly because the one I bought and liked, they've discontinued it. [Laughs] So I wanted to make sure I got as many as I could, as crazy as that sounds.

Anu: [Laughs] That is terrific. I will have to check those out myself. Marco, thanks so much. This has been a great conversation, you know, particularly appreciate your thoughts on how, how these supply-chain issues have impacted labor shortages globally which, we know, have been felt, here in, in the Western world, as well as emerging markets alike. So, um, hopefully – you know, you made comments on ESG issues, which I appreciate as well. It sounds like companies are increasingly taking, you know, these issues seriously and implementing improved and robust ESG practices. So thanks again, really looking forward to, uh, seeing much more of this in the future, and we'll be summing up our series of these conversations in our next episode. Marco, thanks for joining me again.

Marco: Thank you, Anu, great talking to you. Thanks.

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