

## Your supply chain can benefit from a practical implementation of the "China Plus One" strategy

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Due to EU-China tit-for-tat tariffs and Trump's second term, companies seek supply chain alternatives. However, many doubt viability, worry about repercussions and struggle to achieve cost-saving. Pragmatic analysis and risk mitigations with a dynamic roadmap can maximize value capture.

The China Plus One strategy is not new. It first garnered global attention around 2014 due to escalating labor costs in China. The strategy involves expanding manufacturing and sourcing beyond China, thereby mitigating risks and reducing dependence on a single market. Some companies, especially in labor-intensive production such as garment assembly, swiftly embraced the approach, but most remained skeptical due to the low availability of alternatives and cost. Many companies adopted the "In China for China" strategy, emphasizing the importance of the Chinese market while remaining unchanged in their supply chain. Geopolitical tensions and uncertainties with Trump's return to power, increased trade barriers fostered by tariffs and laws such as the Inflation Reduction Act in the US<sup>[1]</sup> and the Critical Raw Materials Act in the EU<sup>[2]</sup>, pandemics, and rising labor costs have now, almost 10 years later, driven a return to the China Plus One strategy.

### **China Plus One is simple in theory but challenging in practice**

It's no secret that many companies have heavily relied on China when it comes to supply chains. Low production costs, a vast and previously rapidly growing domestic market, highly developed infrastructure, and government incentives are all major factors contributing to this reliance. Regardless of the reasoning behind this reliance, global businesses became increasingly concerned about uncertainties and vulnerabilities around their supply chain and

operations, especially after US-China trade tensions and the pandemic. Recognizing that full decoupling is not a viable option, companies are instead focusing on de-risking and accelerating their adoption of the China Plus One strategy.

The China Plus One strategy introduces a critical layer of risk management and diversification by pivoting toward leveraging the strengths of alternative markets. This shift poses profound economic and trade implications on a global scale. It prompts companies to rethink their business models and operational setup. It also leads to increasing interest in other burgeoning markets. During this shift, Southeast Asia, benefiting from its proximity to China, economic partnership with the US and China, and relative political stability, became a preferred China Plus One destination<sup>[3]</sup>.

Although the logic behind the China Plus One strategy is relatively straightforward, designing and implementing it is incredibly challenging. Once companies begin to design the shift in practice, they encounter a multitude of issues to consider, including freight capacity, road/rail systems, workforce skill and availability, and the relative business friendliness of governments and regulating agencies.

### **Balancing a multitude of considerations for your China Plus One adoption decision**

Many different factors, such as natural disasters, political tensions, pandemics, and infrastructure failures, can cause supply chain disruptions. China Plus One strategy can mitigate some risks but does not solve all issues. A fully diversified supply chain also forfeits the benefits of scale and can incur significant costs. Thus, companies should carefully balance a range of interconnected considerations to decide if such a strategy fits the business.

- **Market access:** By selecting the "plus one" locations wisely, businesses may better engage with markets and gain a deeper comprehension of customer requests, trends, and behavior. Additionally, through global collaboration, these locations might provide a door to more expansive markets. For instance, as participants in the US-led Indo-Pacific Economic Framework for Prosperity (IPEF), ASEAN nations enjoy reduced nontariff barriers to the US. Additionally, ASEAN has started a free trade agreement with China, Japan, South Korea, Australia, and New Zealand called the Regional Comprehensive Economic Partnership (RCEP). In addition to the RCEP and IPEF, ASEAN nations are actively involved in other agreements that support market access. With his planned blanket tariffs, Trump's victory created uncertainty about the future of economic relations between ASEAN nations and the US<sup>[4]</sup>. Therefore, thoroughly evaluating the issue is more important than ever.
- **Compliance:** Legislation and compliance requirements also drive the need for diversification. Violating these standards, whether knowingly or not, can result in substantial financial and reputational harm. Relocating operations to a new country exposes companies to a new compliance landscape. Furthermore, in recent years, major countries have been introducing new laws at an unprecedented speed to ensure the competitiveness of domestic industries, especially semiconductor and green industries. For example, the European Union's Critical Raw Material Act and the Net Zero Industry Act (NZIA) set procurement targets for domestically made components such as electrolyzers<sup>[5]</sup>. The Inflation Reduction Act (IRA) from the US uses similar

leverages to foster the US supply chain and energy independence. The EU also introduces the Carbon Border Adjustment Mechanism (CBAM), which aims to level carbon emission standard between the EU and major exporters to the region<sup>[6]</sup>. All these dynamics call for evaluation and compliance management.

- **Costs:** Rising labor costs in China is one of the main reasons the China Plus One strategy emerged. While China was initially known for its cost-effective labor and production, the country finds more and more competitors emerging with similar advantages. Competitive labor costs, favorable exchange rates, and tax incentives in different countries offer cost-saving opportunities. However, a correctly implemented China Plus One strategy should lead to cost savings. Companies need to invest resources upfront to establish a supply chain in a new destination. Balancing upfront costs and saving potential is essential, as is forming a rigid implementation roadmap to safeguard saving realization.
- **Supply chain output performance:** When a supply chain spans multiple countries, production and logistics vary significantly. A careful examination of the availability and quality of a destination country's infrastructure is important. Furthermore, we should prioritize meticulous monitoring, testing, and compliance efforts to ensure consistent product quality.
- **Economic and political risks:** While the China Plus One strategy aims to derisk the supply chain, the establishment of a new operation may introduce additional risks, including currency fluctuations, labor strikes, regulatory changes, and geopolitical tensions. The need to stay ahead of dynamic economic and political environments exists regardless of supply chain locations.

### **Choosing a suitable plus requires careful evaluation of a range of factors beyond one's own production needs and risks**

When a company opts for a China Plus One strategy, it typically chooses the location based on its own production requirements and potential risks. We recommend that companies equally consider the following factors when assessing potential alternative destinations:

- **Surprise costs beyond production and logistics:** Cost-effectiveness and operational efficiency are key drivers for supply chain competitiveness. These two factors are particularly crucial in ensuring sustainable supply chain diversification. Thus, costs should be the first thing to evaluate when choosing locations. However, often companies evaluate costs following the production and logistics process, focusing on costs such as raw materials, energy, labor, and freight, underestimating the cost impact from local regulations, business laws, and policies. With one battery component manufacturer, we observe up to 15% additional production cost-saving potential when fully utilizing incentives and benefits such as rebates and tax breaks (see Figure 1).

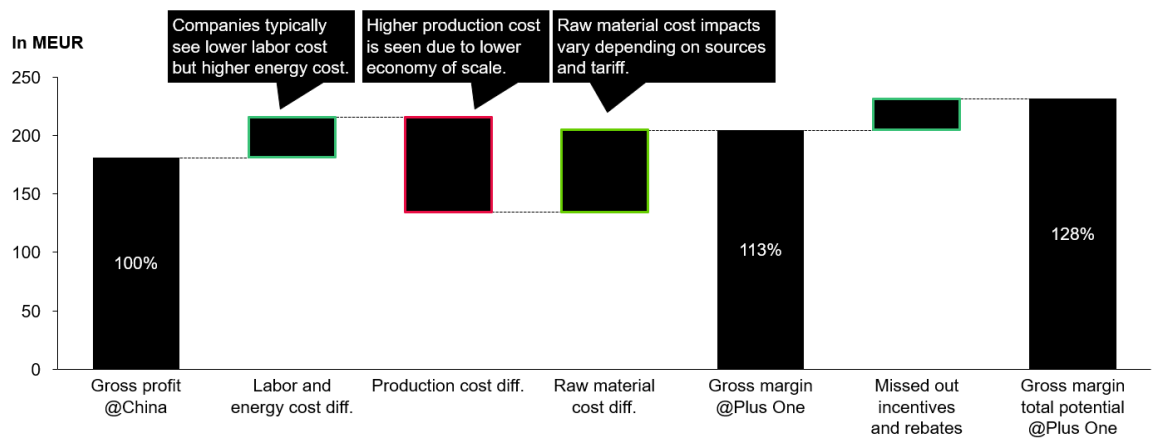


Figure 1. Production cost saving potential in one battery manufacturer case.

- Infrastructure and logistics:** One of the reasons China appeals to many companies is their highly developed and stable infrastructure. China has the largest network of high-speed rail and highways in terms of mileage, which allows efficient logistics. Fast-growing airports and port terminals also offer high freight capacity. While this is difficult to beat, it is still important that companies examine the availability and quality of a Plus One country's infrastructure and logistics. The key elements to consider include the country's proximity to key markets and connectivity to major trade routes, utility availability and stability, the performance of the transportation network (freight capacity, transit times), warehouse space and services, customs processes, and government regulations regarding the supply of inbound materials and the export of finished goods.
- Workforce:** When you look into your Plus One country candidates, workforce skill and availability are critical elements to consider against business needs. In addition to the size and availability of the labor market, companies should also consider factors such as continued education and training availability, employment stability, social welfare, and contributions, as well as expat experiences.
- Supplier availability and health:** Understanding new suppliers' accessibility, industry reputation, and financial health, as well as their history of reliability and performance, is paramount. Ensuring their capacity to navigate through disruptions and maintain operations during crises is crucial for the resilience of your company's supply chain. Furthermore, it's beneficial to understand their willingness and ability to collaborate in the long term, which usually requires strong will and the ability to invest.

## The future of supply chain and China Plus One

The China Plus One strategy will persist in significantly influencing the production landscape. We are already witnessing the shift and anticipate its acceleration. Labor-intensive production such as garment assembly made the move almost a decade ago, and now many automotive and electronics companies are expanding their operations to countries like India, Vietnam, and Mexico. And this shift goes beyond the supply chain, as many companies are relocating their production and distribution operations to reduce reliance on China even further.

Companies should always have plans A, B, and C. China Plus One strategy is an adaptable strategy to recover from supply chain disruption and production bottlenecks during the

pandemic. The strategy is straight-forward in logic but comes with its challenges. Companies, regardless of their country of origin, should continuously evaluate whether it is right for them with comprehensive criteria. Companies should also keep tabs on key candidate destinations.

## References:

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