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Greener Paddies

By Nick Carmichael, SIOR

Faced with rising labor and materials costs in China, manufacturers have little choice but to explore other options for their next investment. Vietnam is often on the short-list of alternative destinations. Since the economic reforms of the late 1980s, foreign companies have poured US$ 34 billion of FDI into Vietnam's manufacturing sector, with foreign-invested output reaching nearly half of total GDP. In the past decade, major international firms including Intel, Canon, Samsung, Hanes Brands, Nokia and Unilever have all built major plants in the areas surrounding Hanoi and Ho Chi Minh City.

Vietnam's densely-settled population, low-cost labor force, and tax holidays ensured a steady flow of FDI into the Key Economic Regions (KERs) around Hanoi and Ho Chi Minh City. Recently, however, manufacturers near the major urban areas have been suffering from high turnover rates, rising input costs and waning fiscal incentives.

Is this the end of Vietnam as a "China plus one" destination? Should foreign investors shift their gaze to the next cheap labor pool?

The answer is not that simple. Vietnam's geographic diversity and decentralized government policy necessitate an understanding of the range of available options. The haste with which investors funneled investments towards Ho Chi Minh City and Hanoi has resulted in a saturation of the top tier KERs. Yet, much of the country remains ripe for investment, and foreign manufacturers are finding that moving further afield can yield highly competitive manufacturing locations.

A Tale of Two Cities

Vietnam is a country of two capitals. In the north, Hanoi is the heart of the Red River Delta and home to the central government. Ho Chi Minh City in the south is the country's largest city and de facto economic capital. After 35 years of war and another decade of isolation, Vietnam opened its doors to foreign investment in 1986, and the two cities were natural gateways to the northern and southern regions.

When industrial land in the cities became scarce, investment spilled over to the bordering provinces. In the north, Hanoi and the six surrounding provinces form the so-called Northern Key Economic Region (NKER); Ho Chi Minh City in the south is the core of the eight-province Southern Key Economic Region (SKER). As of 2010, the two KERs accounted for 36 percent of the country's total accumulated FDI and 58 percent of GDP from only 37 percent of the population and 14 percent of the land. An area that was nearly all farmland and rubber plantations 20 years ago now employs over 11.2 million people in manufacturing.

Sustained levels of FDI dramatically altered the composition of employment in the KERs, creating a yawning gap between the share of labor employed in manufacturing versus agriculture. Tourism, real estate and hospitality now offer additional competition for labor. Following complaints by companies in the area, the Ministry of Labour, Invalids and Social Affairs reported in August 2011 that more than 1 million workers are required to meet the

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needs of manufacturers in Vietnam, including 327,000 in Dong Nai, 120,000 in Ho Chi Minh City, 95,000 in Hai Duong and 68,000 in Binh Duong. Unsurprisingly, such labor competition in those locations has allowed the Government to raise dollar-term minimum wages there 56% since 2008.

In addition to labor issues, Vietnam's concentrated FDI glut has allowed local authorities to become more selective about the projects which qualify for investment incentives. Garment and food processing investments that were once welcomed with long tax holidays have recently been shunned in favor of higher value-added electronics and R&D.

Opportunity Lies Further Afield

I'm not saying there aren't greener paddies. Just beyond the KERs lies considerable opportunity for labor intensive industries. Outside of the KERs, 63 percent of the labor force is employed in agriculture. Vietnam actually exports manpower to other Asian countries, including 63,000 to South Korea. Abundant labor does exist. It's just a matter of finding it.

Take for example the Mekong River Delta. Once a quiet backwater, tri-annual harvests and high crop yields have made the region the most densely populated rural area in the world. The Delta's main thoroughfares beep and buzz with Honda Waves and container trucks. In fact, from the shop-lined roads, Can Tho is hardly distinguishable from the outer districts of Ho Chi Minh City. The Red River Delta and certain provinces in central Vietnam also have population densities well above the country average, key in supporting labor intensive industries.

Labor costs drop sharply just beyond main urban areas. Minimum wages in Vietnam are implemented at the sub-provincial level and categorized into four Regions: Region I includes districts of Vietnam's three largest cities and the most expensive districts of the SKER; Region II covers the majority of the KERs and urban districts of other provinces; Regions III and IV cover the less developed areas of the country. While the monthly minimum wage in Region I has reached VND 2,000,000 (US$ 96) in 2011, Region IV lags behind at VND 1,400,000 (US$ 67).

Foreign investment in low value-added industries has been steered away from the areas bordering Hanoi and Ho Chi Minh City, but the Ministry of Planning and Investment offers strong incentives to commit to poorer areas. Investors can expect corporate income tax holidays of up to four years, a 5 percent rate for the following nine years, and a 10 percent rate for two more years. In KER industrial parks that would consider such an investment, companies may be subject to the standard rate of 25 percent. Local authorities in rural areas are also more willing to offer non-monetary incentives including support for recruiting, training and certain infrastructure projects. Incentives depend on a company's ability to negotiate with the local government, a much easier task in less developed provinces where a foreign company may bring wealth, infrastructure and employment in tow.

Bridging the Gap

The availability of lower-cost labor and more generous fiscal incentives appear at odds with investors' historical reluctance to base manufacturing in the outlying provinces.

For many years the missing link was infrastructure. Industrial parks radiated out from the main cities. Crumbling roads and rusty river ferries made inland transportation slow and costly. Blackouts and telecom outages kept the provinces in a state of sleepy isolation.

Now, Vietnam's industrial infrastructure presents foreign investors with considerably more options. Incentives for land developers facilitated the construction of 171 fully operational industrial parks, with plans for an additional 83. Both land prices and occupancy rates favor outlying provinces. Land-use rights average over US$ 150 per square meter in overheating Ho Chi Minh City, US$ 70 in Hanoi, and around US$ 60 in the rest of the KERs, compared with US$ 35-45 elsewhere.

Vietnam's transport network is steadily improving, and fringe areas are gaining better access to major ports and cities. In 2010, Prime Minister Nguyen Tan Dung committed US$ 18 billion of government funds for the construction of a 3,262 km north-south expressway and over 3,000 km of other roads in other less developed regions. The government is similarly making moves to stabilize the power supply. Vietnam allowed the first public-private partnership in power generation in 2009. Just a year later, a plan was approved to develop a 2,000MW nuclear power plant in cooperation with the Russian government. Additional support from the Asian Development Bank and other ODA-sponsored initiatives will help make Vietnam a much smaller place, one better powered for efficient industrial production.

No One Size Fits All Solution

There is no uniformly optimal location for manufacturers in Vietnam. Different regions—and the provinces within them—may prove the most competitive for different industries.

The Red River Delta lends itself to electronics assembly, as high-tech components can be trucked across the border from suppliers in southern China. Coffee and cashew growing in central Vietnam makes the Central Highlands region attractive for food processing. With the lowest labor costs in Vietnam, garment and footwear manufacturers are increasingly choosing the Mekong Delta. Any high tech R&D must be conducted within recruiting distance of the universities of Ho Chi Minh City, Hanoi and Da Nang.

Vietnam is comprised of six distinct regions, 63 provinces and 690 districts within them. Finding the optimal location within the country can become a dizzying endeavor. Yet, one basic principle should guide the search: look beyond the twin cities and their key economic regions to find the most competitive long-term production base.