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Managing ESG Risk when Relocating Supply Chains to Southeast Asia

By Jack Mullan and Nicole Kotsianas

In the face of China's harsh pandemic lockdowns, rising tensions between China and the West, and the implementation of sanctions covering the Xinjiang region, many companies are continuing to move their supply chains out of China - either completely, or more often, seeking diversification elsewhere. Frequently, companies that do so end up looking to Southeast Asia, lured by favorable economics and those countries' booming economies. Samsung, for example, is building a major R&D hub in Vietnam, while Apple is reported to be sourcing its Apple Watch from that country.

Shifting supply chains out of China and into neighboring nations is no panacea, however. Vietnam, Cambodia, Malaysia and other countries in this region bring their own vulnerabilities. While Southeast Asian manufacturers have quickly expanded their capabilities to keep pace with exploding demand, local regulation and enforcement regarding issues such as working conditions, child labor and forced labor has often not kept up. Western companies that source from the region are thus potentially increasing their risks regarding such issues at precisely the time when Western governments, investors, consumers and the media have been placing greater importance on ESG considerations. While Southeast Asian governments and companies are following this trend, it is unfolding more slowly and unevenly than in the United States and the EU.

When a shiny reputation hides a dark reality.

The investigations we have undertaken in the region on behalf of corporations and NGOs provide useful examples of the risks that can arise when sourcing from the region. Consider, for example, the Western company that contracted with a Malaysian latex glove supplier during the height of the pandemic, when the global shortage of latex gloves threatened to shut down the company's production facilities. Although there was no time to conduct customary due diligence before signing the contract, the glove manufacturer was well-established and had a good reputation. (Malaysia, along with Vietnam, is responsible for the majority of the world's latex glove supply.)

With the production crisis safely averted, the company asked us to investigate the supplier to ensure the terms of the contract were being fulfilled. We sent a team of local researchers to the town where the manufacturing plant was located, where they contacted workers, observed shift changes, and spoke with union representatives. We found that the supplier's reputation obscured a litany of wrongdoing, including housing workers in overcrowded dormitories, excessive overtime and confiscating workers passports. The company quickly severed ties with the supplier and found a source that conformed with global standards regarding working conditions.

The "last mile" can be far away.

Even when multinationals work with large Southeast Asian suppliers committed to best practices, supply chain risks can persist due to layers of outsourcing. Many industries in the region are highly fragmented; a large Philippine distributor distributing products locally for a Western consumer brand, for example, may rely on four or five levels of outsourcing to do so. The large distributor with which the multinational contracts may not even know the identity of the "last mile" distributors that actually get the product on the shelves in local villages, instead relying on a chain of assurances and representations that may be exceptionally difficult to monitor and verify. These vulnerabilities extend beyond ESG issues; improper product handling (such as poor refrigeration), bribery, kickbacks and theft can all take place far from the oversight of the top-level distributor.

Both ESG and non-ESG related vulnerabilities can be exacerbated when there is a lack of alignment between regulatory frameworks. First in 2009 and then in 2018, the European Union implemented regulatory directives to promote the use of sustainable biofuels like used cooking oil (which can be converted to biodiesel) and prohibit the use of palm oil, which the EU regards as unsustainable because the expansion of palm oil fields is thought to lead to deforestation.

The EU's palm oil prohibition had the effect of increasing demand for used cooking oil and driving up prices. Southeast Asia, which is a major producer of palm oil, followed the market, expanding its exportation of used cooking oil collected from food processors, restaurants and home kitchens.

In Malaysia, for example, used cooking oil exports to the EU jumped from eight million kilograms in 2015 to 118 million kilograms in 2019-a nearly 15-fold increase.

After a European multinational that was importing used cooking oil from Malaysia discovered that the used cooking oil contained as much as 30 percent unused palm oil, we were called in to investigate. By talking to well-placed industry sources in Malaysia, we uncovered an EU regulatory inconsistency being exploited by Malaysian exporters. While the EU regulations banned palm oil, "used cooking oil" could be designated as such so long as its Iodine Value - a measure of an oil's unsaturation-remained above 80. The high unsaturation of used cooking oil provided exporters with plenty of room to dilute it while staying within the EU's guidelines-which they did with the cheaper palm oil that the EU prohibited. And while the Malaysian government was aware of the practice, it did not violate Malaysian law. These inconsistencies, along with a multilayered, diffused supply chain that reached down into individual restaurants where the oil was collected, allowed exporters to circumvent EU regulations on palm oil and expose importers in the EU to regulatory compliance risks.

Sanctions introduce new risks overnight.

Finally, ESG-related supply risk can emerge suddenly due to sanctions imposed on governments, organizations and individuals as a result of geopolitical developments. In Spring 2021, for example, the United States, the UK and the EU all announced various sanctions targeting Myanmar's military regime and entities connected to it.

The links can sometimes be less than obvious: A Myanmar factory may be owned by a shell company controlled by persons on the sanctions list, or the factory may sit on land leased from Myanmar's Tatmadaw, the combined armed forces holding sway over the country since the military coup last February. Often, such risks can only be determined through extensive, on-the ground due diligence, including conducting interviews and poring over hard-copy records in local administrative offices.

More broadly, companies sourcing from the region need to do so with a renewed appreciation for rigorous due diligence. Merely following compliance procedures is not enough: Multinationals effectively need to understand the operations of their suppliers as well as they do their own. The chief procurement officer who understands that, for example, the shiny urban offices of their supplier is only the tip of a network comprised of layers of subcontractors is able to intuitively grasp-and take steps to mitigate-the supply chain risks involved.

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Jack Mullan is a Partner in the Singapore office and leads the Mintz Group's activities across Southeast Asia.

Jack has worked in Southeast Asia for the past 15 years and during this period has lived in Vietnam, Malaysia and Singapore. He has also executed hundreds of investigations across Myanmar, Indonesia, Cambodia, Laos, Brunei, Papua New Guinea, the Philippines and Sri Lanka.

Jack has led assignments on behalf of a range of government, NGO, legal and corporate clients, as well as working alongside the leading risk and security companies in Southeast Asia. He has extensive experience building teams and executing work in complex environments, including serving as a crisis responder for a response company responding to a wide range of threats in the region; and serving as an external sanctions and security risk adviser to two major NGOs following the 2021 military coup in Myanmar.

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Nicole Kotsianas is a managing director in Mintz Group's New York office and is one of the leaders of the firm's ESG practice.

Nicole manages complex asset tracing and litigation support cases to build out relevant narratives. In addition, Nicole has conducted high-profile internal investigations to determine fact patterns and identify threat actors.

Nicole is an expert in attribution research and digital investigations related to social media accounts and online artifacts and routinely liaises with law enforcement to unmask and dispense with fraudsters, impersonators and other fixated individuals. She has also identified short sellers and mapped out market manipulation networks.

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