

## Suicide Woes at Apple's Primary Chinese Manufacturer

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### So what has happened exactly?

There have been 10 suicides and 2 attempted suicides this year at Hon Hai's Foxconn factory in Longhua near Shenzhen (about an hour north of Hong Kong by car) and this has put the company's labour practice and factory working conditions into the spot light. It has been widely reported in the media with front page reports in the western press and items on CNN and BBC. Hon Hai's major customers, like Apple, HPQ and Sony, are also under considerable pressure to investigate. This has also raised questions about China's labour practices in general. For example, there have been media reports of all 4 of Honda's China plants going on strike on a pay dispute.

### So who are Hon Hai and what do they do?

Hon Hai was established in 1974 and is one of the largest EMS (Electronic Manufacturing Service) players in the world. Hon Hai provides components, modules and system assembly products to many global OEMs (Original Equipment Manufacturers) in PC, communication and consumer sectors. It is the second largest Taiwanese listed company and almost 10% of the Taiwan index. Its subsidiary, often mentioned in relation to this issue, is listed in Hong Kong and is called Foxconn International (FIH). It is 71% owned by Hon Hai. FIH makes handsets. Although headquartered in Taiwan, Hon Hai employs almost 700,000 people, of which around 85% are in China. They also have operations in Eastern Europe and Latin America. Apple, HPQ and Sony are about 60% of their revenue. Hon Hai is thought to be about 50% of Apples cost of goods sold. Although not officially published, widely circulated numbers suggest that all iPhones and iPads are made by Hon Hai (while another Taiwanese company, Quanta, make the iMac and iTouch). They also make about 70% of HPQs desktops, 40% of HPQ servers, 25% of Sony cameras, 50% of Sony notebooks, 80% of Sony game consoles... you get the picture.

Over the last few years Hon Hai have restructured their China plants and have tried to lower costs by moving some of them inland. For example, the Shenzhen plant in question used to employ over 400,000, but now employs nearer 250,000. This is also partly because they reduced their workforce by 15% in 2008, but also because they now have plants in places such as Wuhan and Langfang in Hebei province. The demand surge in 2009 as economies recovered and an increase in new products has meant they actually employed 70,000 new workers in 1Q 2010 (apparently they get 8000 job applications per day).

The company is considered to be well managed given its very successful track record, but is also thought to be secretive which can be read as 'not transparent'. However, this is partly because its major customers like HPQ, Sony and Apple do not want product information and plans divulged. Through its vertical integration model, it has a superior cost structure, quality products and is able to deliver in a time-to-market and volume-to-market fashion. As a result, the company is often ranked as the supplier of choice by its customers.

Labour costs are only 3% of Hon Hai's cost of goods sold. Materials are around 85%. However, with gross margins of 9% and operating margins of a little over 4%, every cost reduction helps. When Hon Hai's move more inland in China (i.e. away from operations in the likes of Shenzhen and Shanghai) for instance, they usually get 5 year tax or utility price reductions as well as wages approximately 15-30% lower. This plant in Shenzhen is likely to become more automated and some manufacturing moved inland. In the long term it is more likely to be an R&D centre.

## So how bad is this situation for Hon Hai in particular and China in general?

Some perspective is needed. It is worth noting that, according to WHO (World Health Organisation), the suicide rate in China was 13 for males and 14.8 for females for every 100,000 in 2009. The suicide rate at Hon Hai's factory with 300,000 workers is less than a half of that of national average. It also isn't actually that different from western country averages. This isn't to say this isn't serious. It is because the workers are relatively young that the company is concerned. Perhaps what is more significant is that this issue and other employment issues are becoming more frequent. This suggests short, medium and long term pressure on wages. This has knock-on effects for product prices and inflation pressure globally due to the huge influence China has on global manufacturing. It also has negative implications for the profitability of manufacturing operations in southern China, but more positive implications for demand for consumer goods, staple or discretionary.

## What the company has done so far

In an unprecedented move, normally considered as 'secretive', the company opened its doors and invited 5 bus loads of journalists to visit its plants this week. Journalists were free to talk to its employees during the visit. Some workers reported repetitive tasks on the production lines stressful. According to an article published by Southern Weekly, a journalist from the newspaper joined the Longhua campus for 28 days as an undercover worker. The standard shift is 8 hours however, workers can elect to do overtime at 1.5x of their base salary, and most do. Many workers are very young, in their late teens and early twenties, and are from poor and rural regions of China. Many have some responsibilities of looking after the entire family. So the pressure on them is very high. Not surprising, this situation is not unique to Hon Hai's work force, it is widely spread amongst the manufacturing industry in China.

According to a UBS report, Hon Hai has taken further measures to prevent future incidents. They include:

- (1) Proactively monitoring employees who have any signs of abnormal emotional stress. Encourage and reward all employees to trace and report colleagues that may have shown any signs of abnormal emotional stress.
- (2) Extend the existing employee complaint platform by forming a new collaborative platform specifically on emotional and psychological support with both Union and Department of Health and Welfare.
- (3) Start operation of "Foxconn Employee Care Centre" to consolidate existing resources of mental supports including complaint hot lines, emotional support hot lines and incorporate employee emotional/psychological counselling and treatment.
- (4) Further enhance on-campus facilities, including movie theatres, corporate newspapers, renovation of the sports tracks and fields.
- (5) Increase the amount of routine employee shows and performances to enrich employee life quality.
- (6) Foxconn Health division has extended the collaboration with local government agencies and national institutes to offer emotional and psychological assistance to employees. Foxconn has gained 100 psychological counsellors and they will be stationed in different business groups to provide employee emotional support.



## What the customers have done so far

Customers such as Dell and Apple are talking to Foxconn's management and are conducting their own investigations. So far, none have said they are withdrawing orders. It should also be noted that the likes of Apple conduct considerable due diligence prior to using a manufacturer and it would take some considerable time to move orders to anyone else. Hon Hai are known for being very accommodative of their customer's requirements and so it would not be that easy to replace the relationship or expertise developed over some years (for example, they worked with Apple on the iPhone for almost 3 years before the official launch). Currently we would not expect their customers to desert them, but we expect them to continue to monitor the developments closely and evaluate Hon Hai's response.

## Latest developments

The very latest news (2<sup>nd</sup> June) is that Hon Hai has raised wages 30%. Their basic wages were around the statutory minimum (900 yuan or USD130 per month) plus the overtime. This has caused the share price to fall 4% and reduces profits by approximately 10% according to analysts. However, it is the obvious wider implications of this for China which we believe will be of most interest. Apple boss Steve Jobs has also just defended Hon Hai's working conditions at the firm at a US conference according to the BBC.