

»» DEG evaluation results



South-South investment paves the way for the future

The Chinese garment manufacturer Texhong Renze diversifies its production in Vietnam

This report is a result of DEG's evaluation work regarding development effectiveness. DEG's monitoring and evaluating team checks at regular intervals whether the transactions it co-finances help to achieve sustainable development successes and points to ways of making further improvements for DEG and its customers. To ensure the independence of evaluation results, external consultants support the work of the team.

Significant contributions to this issue were made by:

steward redqueen

Steward Redqueen is a specialised consultancy that works across the globe advising organisations on impact and sustainability.

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DEG – Deutsche Investitions- und
Entwicklungsgesellschaft mbH
Kämmergasse 22
50676 Köln
Telefon 0221 4986-0
Telefax 0221 4986-1290
evaluation@deginvest.de
www.deginvest.de

EXECUTIVE SUMMARY

Texhong Renze, a Vietnamese subsidiary of China-based Texhong Group, is a professionally run, financially sound and responsibly-managed company. It has a strong position in the market and is well-positioned to be successful in the long run. Since 2005, when DEG provided the first of three loans to Texhong Times, a Chinese subsidiary of Texhong Group, the group and DEG have built a strong and trustful relationship, which is recognised by both parties. In 2011, DEG provided a separate long-term loan to Texhong Renze in Vietnam. Alongside this loan, DEG successfully stimulated the improvement of environmental and social (E&S) practices within the Vietnamese subsidiary and also initiated a technical assistance (TA) project in production efficiency. Especially the latter is much appreciated by Texhong Renze and is recognised as a source of value creation. However, from DEG's perspective the TA project cannot be considered fully successful so far, as the project's social target to reduce working hours has so far not been adopted by Texhong Renze.

Whereas, initially, the lack of providers of long-term finance in the local market was a reason for Texhong Group to reach out to DEG, the group is much more independent from its financiers today. It now chooses to work with DEG mostly because of the trust and strength of the relationship. Effectively, DEG has become a "back-up financier" that can further add value to the company through its specific knowledge in ESG (E&S and Governance) management and its TA programs. The only criticism regards DEG's rather long through-time of due diligence processes for loan requests.

INTRODUCTION



In 2010, DEG financed an expansion project for operations of Texhong Renze, a Texhong Group subsidiary in Vietnam. The holding company, Texhong Group, is responsible for all sourcing and sales within the group, whereas the subsidiary in Vietnam is a pure cost centre that buys and sells products from and to the holding. Therefore, this study will introduce both the holding company Texhong Group and the subsidiary Texhong Renze in order to better present their respective roles. Yet, the case study's focus is Texhong Renze and its production location near Ho Chi Minh City, as Texhong Renze is the counterparty to the loan DEG provided for the expansion.

Texhong Group

Texhong Group is China's largest manufacturer of stretch yarn, a core-spun cotton yarn with elastin filaments (spandex) and denim yarns. In the Chinese market, Texhong Group is one of the largest core-spun cotton textile manufacturers. The cotton yarn market is highly differentiated and stretch yarn comprises only a small part of the overall cotton yarn production. This market fragmentation becomes evident as, according to the company's figures, the total Chinese yarn production capacity is around 100 million spindles, and Texhong Group's – one of the biggest manufacturers – total production capacity is 2.2 million spindles.

Since Texhong Group's foundation in 1997, the group has been growing rapidly and today is successfully operating twelve production plants in mainland China - in the Yangtze Delta and Shandong Province - and three plants in Vietnam. As per the end of 2014, the Group employed more than 20,500 people, up from 13,700 people in 2010. Each of the subsidiaries is an independent legal enti-

ty and run as cost centre, whereas treasury, financing, controlling, purchasing, product R&D, sales and marketing are centralised.



The spinning process

Stretch yarn and denim yarn are sold to a variety of clients in the textile industry. The Group's current customer base is diversified with over 3,000 customers in China and overseas. Its sales network spans China, Brazil, Turkey, Bangladesh, Japan and South Korea. In 2010, 90% of the sales were generated in the Chinese domestic market while 10% came from exports. Current figures are unknown. Customers range from weaving mills, denim manufacturers, printing and dyeing factories to trading agents.

Texhong Group is in the top five of the largest cotton textile firms in China and the largest supplier of core-spun cotton textiles worldwide. While Texhong Group operates in a very competitive environment, it is still a successful niche player in the high-grade yarn segment. To avoid competitors entering this segment, Texhong Group has established a solid and close cooperation with its up- and downstream partners (e.g. exclusive cooperation agreement with Dow Chemical, an important supplier of the group). Another market entry barrier for potential competitors is the huge investment amount (around USD 100m) necessary to realise economies of scale with the spinning technology for high- grade denim yarn.

Texhong Group currently faces most competition from some of the medium and small core-spun yarn producers in Jiangsu province with production capacities of around 50,000-100,000 spindles and a few cotton yarn producers in India and Bangladesh.

Texhong Renze

Texhong Renze is a 100% subsidiary of Texhong Group. It is a pure production site of the group and focuses on the production of core-spun spandex yarns and denim yarns with a capacity of 400,000 spindles. The expansion project (Phase III), financed amongst others by DEG and completed in 2011, was the last phase of the original plan for the establishment of Texhong Renze's plant near Ho Chi Minh City. Phase I, comprising the installation of 70,000 spindles, was completed in December 2007 and Phase II, comprising 140,000 spindles, was completed in September 2008. DEG, FMO and Citibank financed Phase III, which consisted of the construction of new factory buildings on existing available land. In the newly developed facilities a total of 190,000 additional spindles were installed.



Texhong Renze Factory near Ho Chi Minh City

Texhong Renze is located approximately 60 km from Ho Chi Minh City. The company currently employs 3,959 people.

Investing in Vietnam has proven to be a strategic success for Texhong Group. Running at full capacity, the Vietnam operations are now the biggest profit generator of the whole group. This is a result of the following key success factors:

- Access to low-cost and duty-free cotton imports from the US. This is the key competitive advantage for the Vietnamese subsidiaries compared to the China-based yarn production sites, which are subject to cotton import quota mechanisms as well as higher cotton prices (regardless of whether it is sourced from domestic or offshore suppliers);
- Lower local expenses in Vietnam for land, labour and utilities and more favourable tax treatment (full tax exemption for the first 4 years of Texhong Renze generating a taxable income; 50% tax rate reduction during the subsequent 9 years);
- Zero import and export tariffs for trade between ASEAN country and China since 2009.



Cotton is processed



Cotton, ready to be processed to yarn

Currently, all final products of Texhong Renze are sold to its related parties within the Texhong Group and independent customers worldwide at a sales pricing system set on arm's-length basis. Although purchasing of raw materials is centralised in another subsidiary of Texhong Group, Sunray in Macao, inventory is held on the balance sheet of Texhong Renze. The cotton for Vietnam is sourced from a range of suppliers, with Allenberg from the USA being the biggest.

From a general point of view, Texhong Renze is purely treated as a manufacturing site as sales are all handled via Sunray Macao. Using this channel, Texhong Renze sells its products with a reasonable margin that enables to serve its obligation on DEG's loan.

THE INVESTMENT IN TEXHONG RENZE

Background

Since 2005 DEG, has been building a steady and good client relationship with Texhong Group. Before discussions started in 2010 on the Texhong Renze deal, DEG had already provided three loans to Texhong Group's Chinese subsidiary Texhong Times. In 2005, DEG provided a USD 9m long term loan (Loan I) to finance a greenfield investment. In April 2010, DEG committed another USD 15m long term loan to the same entity for capacity expansion (Loan II). Finally, in September 2013, DEG provided a third loan (20m USD) for the expansion of business .

The deal

Although Texhong Group initially negotiated only with Citibank, DEG and FMO were later approached to participate in the financing of the USD 85m Phase III capacity development of the production facilities of Texhong Renze. These USD 85m consisted of USD 60m in senior loans in a club deal by Citibank, FMO and DEG, an equipment supplier credit via Texhong Group and a small amount of additional equity from Texhong Renze (USD 2m).

In 2010, Citibank, FMO and DEG provided the USD 60m, 7-year loan (including 1 year grace period). The security package was solid and included corporate guarantees from Texhong Group, Texhong Renze Investment Ltd., Sunray International Holdings Ltd., Sunray Macau Commercial Offshore Ltd., and a first ranking pledge over moveable equipment and machinery of Texhong Renze related to the Phase III project, of which the book value was to cover at least 73% of the senior loans. Citibank was assigned the role of facility agent to coordinate the consortium of long-term lenders.



Spinning process



Overview of one of the Texhong Renze facilities

Rationale for the deal

DEG decided to provide the loan to Texhong Renze for the following reasons:

- Support expansion strategy: The expansion in Vietnam would assist Texhong Group to further expand its production capacity and market share to consolidate its position in the international market of core-spun yarns;
- Contribution to development: Texhong Renze has a considerable development impact in Vietnam by providing jobs and on-the job training;
- ESG improvement: DEG believed it was well-positioned to support Texhong Renze in improving its ESG management, particularly regarding social matters like working conditions and occupational health and safety.
- Good management: Texhong Group already was a very well-managed company, particularly in terms of risk and liquidity management;

- Strong project sponsor: Between 2005 and 2010 Texhong Group proved to be a profitable and financially sound partner and sponsor that has the necessary strength to provide DEG with a trustworthy and strong guarantee;

COMPANY PERFORMANCE

Before investment, Texhong Group had already been a stable, steadily growing and well-run company. Its listing on the stock exchange of Hong Kong in 2007 further contributed to the professionalisation and formalisation of corporate governance and internal processes.

As a result of its state-of-the-art facilities and well-trained employees Texhong Renze was able to produce high-quality yarn right from the start. It also proved to be a reliable and rapid supplier.

Financial performance

Texhong Renze increased its sales from USD 369m in 2013 to USD 388m in 2014. It is currently producing at the maximum capacity of 400.000 spindles.



Texhong Renze production

The main risk factor that influences Texhong Group's financial performance is the price of cotton. Texhong Renze is therefore important for the Texhong Group in terms of supplier risk mitigation and support, as the company buys most of its cotton from the US market, whereas Texhong Group's Chinese subsidiaries are dependent on the Chinese cotton price. In 2014, the cotton price on the Chinese market developed negatively and this influenced the Group's net profit. While the world cotton price was stable, the domestic Chinese cotton price dropped by 30% during that time. This was due to a couple of factors including a reform in the Chinese governments' cotton policy and the fall in the sales price of the Chinese cotton reserve. As the Chinese yarn price correlates with the domestic cotton price, the price drop negatively impacted all of Texhong Group's Chinese subsidiaries.

Environmental and social performance

Texhong Renze is classified as 'medium' environmental risk and 'medium to high' social risk. As there is no dyeing included in the production process, environmental impacts are limited to dust, energy consumption and waste management. The community health and safety impacts are also limited. The company is situated in a new industrial park established by the local authorities where it occupies 300,000 sqm. The higher social relevance is due to labour issues in general. At the due diligence stage and at the request of DEG, an external labour audit indicated a number of potential improvements, especially with regard to non-discrimination, overtime, occupational health and safety, working conditions of young, and pregnant workers. Over the years, significant improvements in the working conditions have been implemented in line with local and international standards. Regular internal and external audits are performed to ensure adherence to the standards as well as to identify opportunities for improving the company's systems and processes. During a short case study site visit of Texhong Renze in March 2015, **two points for improvement** could be identified in terms of occupational health and safety: First, very few machine operators used ear protection, alt-

though this is particularly important for the vortex machines due to their high noise levels. Second, some employees or suppliers loading and unloading small trucks were not wearing footwear.

Production efficiency and social improvements

Recently, specific attention has been given to the issue of overtime as this was one of the few open issues in the E&S Action Plan. DEG funded 80% of a project aimed at improving E&S management and also arranged advisory services on how to set up a production efficiency project. DEG's objectives with this project were twofold: first of all, DEG wished to ensure that the number of instances machine operators work overtime is very limited. Texhong Renze indicated that actual average daily overtime was recorded as 0.90 hours per each worker (accounted for 6 working days per week) and 291.60 hours per year per worker, which was lower than the statutory requirement imposed by the local Vietnamese government, i.e. not exceeding 4 hours per day per worker and 300 hours per year per worker. More efficient production would, theoretically, lead to a more organised way of working, fewer instances of malfunctioning machines and production targets being met more frequently. In the respective report, the consultant suggested to Texhong Renze to split the benefits of the production efficiency improvements evenly between employer and employees: 50% of the cost reduction would directly impact the company's operational profit and 50% would benefit employees by decreasing their working hours while receiving the same salary as before. The second benefit DEG hoped for was that the external mapping of the production process would also help to provide recommendations on production efficiency in general in order to streamline production, become more energy efficient and reduce costs.



Spandex yarn, the main final product of Texhong Renze

Texhong Renze showed great appreciation of DEG's idea, the efficiency results and the actual support to realise production efficiency improvements with the help of a consultant. However, the company focused solely on the efficiency gains and not on the overtime reduction effects. Although this is not clear yet, it could well be that overtime is automatically reduced through more efficient production (as explained above). But for Texhong Renze this is a side-effect and not something that management effort is given to. Also, it seems that the suggestion from the consultant to reduce the standard working hours is not being considered by Texhong Renze.

DEVELOPMENT IMPACT

DEG indicated that, despite the legally accepted tax-optimizing structure within the Group, Texhong Renze contributes strongly to development effects in Vietnam.

The investment in Texhong Renze has three main development effects:

1. **Employment effects:** in addition to the then existing staff force of approximately 3,000 employees, the expansion investment of Texhong Renze created 959 additional jobs including significant employee training. To create and secure jobs was considered to be one major development effect of this project.
2. **Social effects:** DEG supported the improvement of working conditions of about 4,000 workers in a growing sector in Vietnam. After a labour audit was carried out at due diligence

stage, it was agreed with Texhong Renze to develop a social action plan in order to support improvement measures by Texhong Renze's management and to establish an integrated E&S management system. For this project, 80% of costs were financed by DEG's TA funding. Apart from the issues regarding overtime and the number of shifts, the execution of the social action plan was largely successful. Although attribution to DEG's TA to improve E&S management is difficult to establish, the following observations during this case study underpin the fact that E&S practices of the company are good:

- Texhong Renze claims that, compared to peers, its staff retention rate is high at 94.25%;
 - On-the-job training and vocational training is well-organised and structured. For example, Texhong Renze has been carrying out a mentoring system since the start of operations, in which senior technicians from other subsidiaries of Texhong Group train Vietnamese technicians in handling routine production duties. Their expertise is also used for other aspects of the professional on-the-job training;
 - Texhong Renze claims to pay the highest wages in the core-spun cotton garn sector in Vietnam;
 - Workers are directly benefiting from the increase in productivity as a small portion of their salary is based on the production efficiency level they can realise.
3. *Technology & know-how transfer:* Texhong Group expands its production activities in Vietnam and hence transfers technology and know-how to this country. In addition, Texhong Renze's Chinese middle-management is step-by-step being replaced by Vietnamese staff: until 2014, 23 Chinese middle-management staff members had already been replaced by Vietnamese staff. All of their key job roles and obligations have been systematically shifted to those newly-trained Vietnamese managers.

DEG'S CONTRIBUTION

DEG's role at investment

DEG had an important and positive role in preparing the deal. Especially the general 'ease of doing business' that Texhong Group experienced while negotiating with DEG, helped Texhong Group to close the deal more easily compared to processes with other financiers. Texhong Group believes the long-standing and trustful relationship with DEG, which had developed over the years, was an important factor in completing the negotiation phase smoothly. The continuity and stability of DEG staff working with Texhong Group over the years played a central role in building this trust, according to the company.

Added value by DEG

At the time of investment it was still hardly possible to obtain long term financing in Vietnam. Hence, DEG and FMO ensured long term financing and therefore stabilised the company's financial structure. Nevertheless, DEG's role has become less crucial to Texhong Group as it grew bigger. DEG has effectively become a "back-up financier", who can provide long-term and reliable financing, and who especially adds value to the company through its specific knowledge in ESG management and its TA programs.

DEG added value to Texhong Renze and Texhong Group in several ways:

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- Long standing relationship and trust: Texhong Group clearly indicated that the long-standing relationship DEG has built with Texhong Group over the years and the resulting trust between the parties has been one of the main reasons for them to keep DEG as a business partner. As the company grew quickly over the years, was listed at the Hong Kong Stock Exchange and gained access to the bond markets, it has become much less dependent on particular financiers and is thus able to choose its own mix of finance providers. Still, Texhong Renze and the group continued working with DEG despite some disadvantages compared to other finance providers: “with major commercial banks we can get a loan with the same or lower interest rates, and I get it in three instead of nine months. Yet, I still choose to work with DEG because of our long-standing, trusted relationship and their advice that goes beyond mere financing”. Even though processes might be cumbersome at times, Texhong Group feels that a trustful relationship, like the one with DEG, adds value to the company, especially in case the company would be in trouble or a quick decision was needed.
 - E&S: the ESDD resulted in an action plan with clear activities and timetables, which has resulted in several improvements. Texhong Renze indicated that without DEG the company would not have approached E&S issues in the formal and thorough manner it currently applies. Texhong Renze and the whole group have learned a lot from DEG in terms of proper E&S management and in terms of E&S improvements like fire safety.
 - Technical assistance for the improvement of an integrated management of E&S matters and advisory for production efficiency improvements: DEG funded 80% of the E&S management project through a TA grant and also arranged advisory services on how to set up the production efficiency project. The production efficiency improvements were recognised by Texhong Renze as a particularly important DEG contribution.