
Case 11

Eastern Waves, Inc.¹

Mr. Paul Patton, Vice President of Purchasing for Code C, Inc., hung up the phone and shook his head. "How can Eastern Waves double prices on our fabricated steel purchases? Last summer we were celebrating a 60-percent cost reduction based on replacing our major domestic supplier with Eastern Waves, in Kuantan, Malaysia. We cannot compete if we source our angle steel products domestically." Mr. Patton phoned Jon James, the director of global sourcing. "Jon, I want you to hop on a plane to Kuantan and save our rear ends." "We have a contract." "What are our legal rights? Is our contract enforceable?" Prior to leaving, Jon requested assistance from one of the company's strategic partners in Asia. A synopsis of the situation in Malaysia follows.

BACKGROUND

Eastern Waves, Inc. is a steel manufacturing company located in Kuantan, Malaysia. The most recent balance sheet for Eastern is presented in Figure C11.1. In 2009, Eastern Waves' cash on hand was 188 ringgits (RM), which is equivalent to US\$50. In the previous year, they had an even lower cash balance of RM118. This problem is very pressing because, without cash, they are unable to purchase raw materials from the local raw material supplier. Eastern currently has a joint venture relationship with Jinan & Iron Steel Corp., which enables Eastern to buy scrap steel on credit from the Jinan plate mill operation. This scrap steel is crucial to Eastern's success given the market price of the purchased raw steel billets. However, the scrap steel is of a lower grade than the standard raw steel billet.

One of the government's most recent import policies on steel will make doing business increasingly difficult. This policy is common in many developing countries. The new policy is expected to generate more business for local and government suppliers. As an example, purchasing steel from China is significantly cheaper. Since Eastern must purchase steel at a higher price, they are at a competitive disadvantage and have decided to pass the price increase to their customers.

The Malaysian Business Environment

Malaysia is located in Southeast Asia with neighboring countries of Singapore, Thailand, and Indonesia. Since gaining its independence from Great Britain in 1963, the Malaysian government has been committed to maintaining a supportive government policy to promote opportunities for growth and profits for local businesses in order to attract investors. Recently, Malaysia has transformed itself from a producer of raw materials into an emerging multisector economy. The Malaysian economy has continued to improve and the country recorded an increase in GDP of 4.2 percent in 2008. Malaysia currently has a workforce of 9.9 million people employed in various industries.

In 1997, Malaysia was hit hard by the Asian financial crisis. The manufacturing sector, which formerly employed 27 percent of the labor force, was one of the most affected industries. In order to rescue some of the largest state-owned companies, the government imposed several strict trade barriers on certain goods. Included

¹ The author expresses appreciation to Biao Yan for his contributions to this case. Names and data have been disguised. Copyright © 2006 W. C. Benton Jr. All rights reserved.

FIGURE C11.1 Eastern Wave Balance Sheet

Balance Sheet as of 31st December, 2008

	Group		Company	
	2008 RM	2007 RM	2008 RM	2007 RM
ASSETS				
Property, plant and equipment	94,557,256	96,118,112	92,621,271	94,148,166
Subsidiary	—	—	1,585,944	931,639
Goodwill arising on consolidation	684,659	684,659	—	—
CURRENT ASSETS				
Stocks	1,199,424	—	1,199,424	—
Trade debtor	485,745	3,076	485,745	3,076
Other debtors and deposits	7,100,809	5,694,447	7,046,055	5,639,693
Cash and bank balances	381	1,221	118	938
	<u>8,786,359</u>	<u>5,698,744</u>	<u>8,731,342</u>	<u>5,643,707</u>
Less: CURRENT LIABILITIES				
Trade creditors	778,383	2,696,412	778,383	2,696,412
Other creditors and accruals	19,975,160	17,612,754	19,708,645	17,057,553
Hire purchase creditor	—	3,007	—	3,007
Amount owing to directors	582,220	96,709	495,255	9,744
Long-term loans	2,800,000	2,800,000	—	—
Bank balance overdrawn	611,089	669,282	611,089	669,282
	<u>24,746,852</u>	<u>23,878,164</u>	<u>21,593,372</u>	<u>20,435,998</u>
NET CURRENT LIABILITIES	<u>(15,960,493)</u>	<u>(18,179,420)</u>	<u>(12,862,030)</u>	<u>(14,792,291)</u>
	<u>79,281,422</u>	<u>78,623,351</u>	<u>81,345,185</u>	<u>80,287,514</u>
Financed by:				
SHARE CAPITAL	12,000,000	12,000,000	12,000,000	12,000,000
RESERVES	<u>(9,389,295)</u>	<u>(7,554,834)</u>	<u>(7,325,532)</u>	<u>(5,890,671)</u>
	2,610,705	4,445,166	4,674,468	6,109,329
LONG-TERM LOANS	<u>76,670,717</u>	<u>74,178,185</u>	<u>76,670,717</u>	<u>74,178,185</u>
	<u>79,281,422</u>	<u>78,623,351</u>	<u>81,345,185</u>	<u>80,287,514</u>

under law in these protected goods are steel billets, the raw material for use in the downstream steel industry.

The Steel Industry

The steel industry in Malaysia is divided into two subsectors, namely, the manufacture of long steel products and the manufacture of flat steel products. Long products include billets, bars, and wire rods and are widely used in the construction industry. Flat steel products include tin plates, galvanized sheets, metal sheets, and fabricated sheets. These forms of steel are used in the construction, oil,

and manufacturing sectors of the economy. Mega Steel controls the flat steel segment while the long-product segment (billets) is dominated by six large manufacturers. All six manufacturers are government-owned. The big five include Amsteel, Malayawata Steel, Perwaja Steel, Antara Steel, and Malaysian Steel Works Inc.

In 2008, the Malaysian downstream steel millers preferred to pay slightly more for domestic billets. The primary reason for the inflated price was the restrictions placed on imports to protect the local economy. However, with the price gap continuing to increase due to falling international steel prices, the local difference was beginning to eat into profitability. Domestic billets were priced at approximately RM760 per metric ton (MT), while international were priced between RM600 and RM680 per MT F.O.B. Malaysia's consumption of billets is on average about 2.7 million MT annually. The protection of the Malaysian upstream steel industry was affecting local downstream steel millers as they were forced to buy from the more expensive domestic suppliers. The raw material price variances were putting Malaysian steel millers at a competitive disadvantage with Thailand and Indonesia.

Labor Issues

The government's primary reason for a new labor policy is to ensure sustained economic growth for a favorable investment climate. They are attempting to promote cordial relationships between employers and employees and industrial harmony based on social justice and equity. The Employment Act of 1955 regulates the minimum terms and conditions of service of an employee earning less than or equal to RM1,500 per month. The labor regulations attempt to protect the domestic workers, especially the majority ethnic group of Malay, who are stereotyped by the business elites as less efficient, nondisciplined, and favored by the government. As a result, the Malaysian industries still rely heavily on cheap foreign workers from countries such as Indonesia, Thailand, Philippines, and Sri Lanka. In order to reverse the dependency on foreign workers and promote domestic workers, the government has recently imposed an annual levy of RM125–1,500 on each foreign worker and limited their work stay to only two years per permit.

Eastern Wave Manufacturing

Eastern Wave is a small steel manufacturing company in Malaysia (see Figure C11.2). It has several plants in Malaysia and China and produces various downstream steel products such as angle steel (see Figure C11.3), I-beam, and round bar. The angle steel plant is located in Kuantan, Malaysia. The production method of the angle steel is called continuous rolling, and the key raw material ingredient for angle steel production is billets. When operating at full efficiency, the annual capacity of the angle steel production is 10,000 MT.

FIGURE C11.2
The Eastern Wave
Company's
Structure

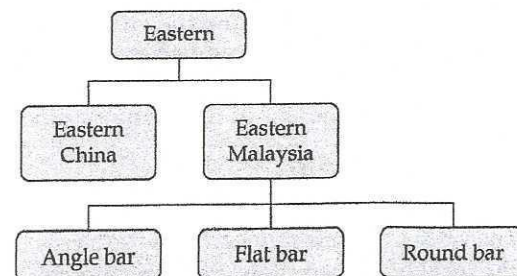
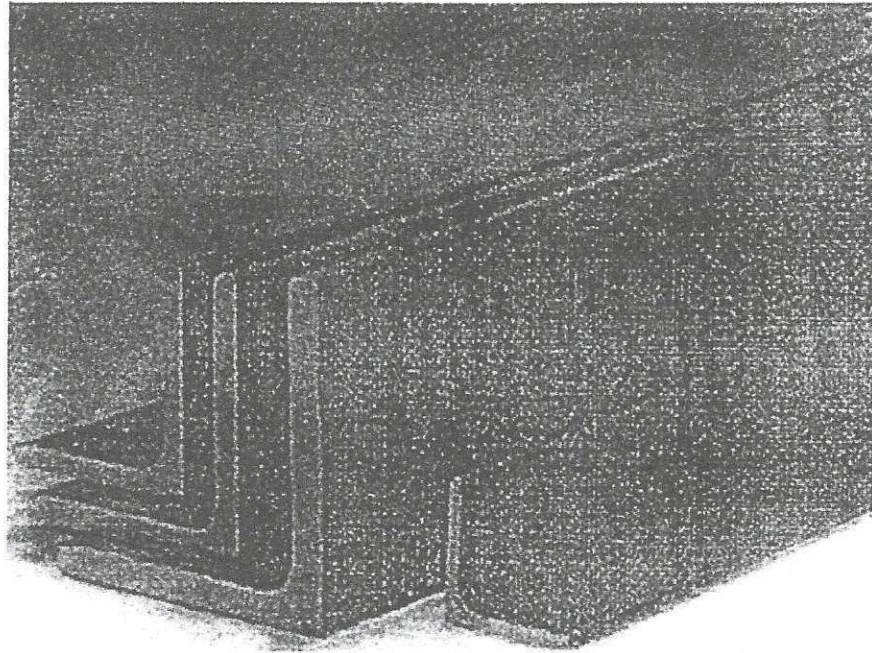


FIGURE C11.3
Angle Steel Bars



THE PROBLEM STATEMENT

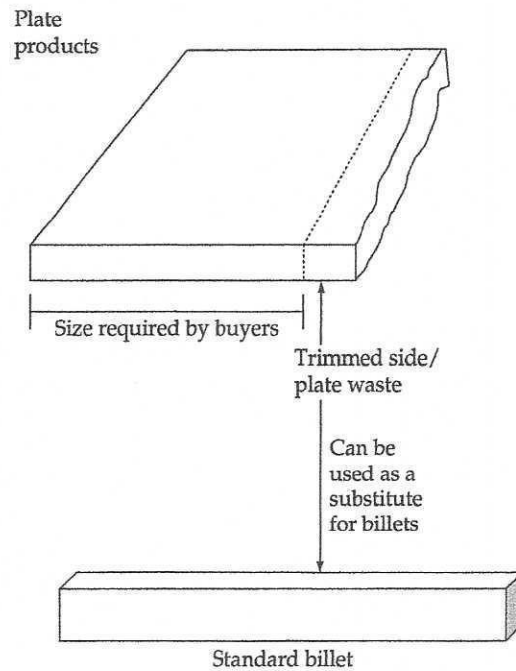
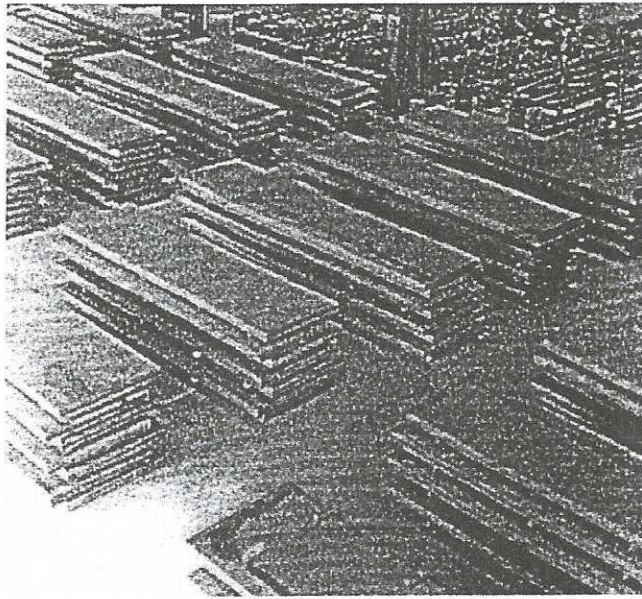
The Malaysian government's trade barrier on billets in order to protect the domestic billet producers has greatly affected the bottom lines of the downstream steel manufacturing companies. The domestic billet price is 15–25 percent higher than the international billet price. On the other hand, the government allows import of the downstream products from other countries, such as Indonesia, in order to reduce domestic supply shortage of the downstream steel products and their prices' inflation. As a result of these two policies, many of the small to medium-sized downstream steel companies were forced to cease operations. Many other steel companies are struggling to survive in this government-controlled steel industry.

The supply problem is not the only serious problem that Eastern faces. Eastern is having difficulty with the governmental labor department. The domestic workers are protected under very strict labor laws and are generally difficult to manage because of the worker-friendly laws. There is a large supply of local workers; however, it is difficult to terminate them. While there is difficulty in firing the workers, the workers are free to resign or quit at any time they feel necessary. The local workers demand to be paid in full each month whether they work or not, and if their pay is delayed at all, most of the time the workers will strike. These strikes are becoming increasingly difficult to extinguish and are becoming more prevalent with Eastern's cash-flow problem. Eastern's difficulty in controlling their labor situation makes it very difficult to adjust to the demand fluctuation of angled steel.

Direct Raw Material Problem

Due to the increase in steel prices over the past few years in Malaysia, Eastern has been searching for solutions to their raw material problems. Instead of buying standard billets from the local billet suppliers, Eastern has been researching alternative

FIGURE C11.4 Trimmed Steel Plates



sources or a billet substitute. One suitable substitute is the trimmed sides of the steel plates, which are waste by-products. These ends are not the same quality steel as the billets. The cost of this scrap steel is now increasing because it is no longer considered to be scrap and because of the billet price inflation. In 2008, Eastern China started a joint venture with Jinan Iron & Steel Corp. Jinan Iron & Steel Corp. is one of the largest steel companies in China that produces stainless composite steel. The key factor to this joint venture is that Eastern had bought the patent to the production of stainless composite steel. As one part of the joint venture agreement, Jigang Steel Plate, Jinan Iron & Steel's subsidiary in Malaysia, has agreed to provide trimmed sides of the steel plates (Figure C11.4) at a favorable price. While this seems like a great deal on the outside, there are several difficulties that remain. The first is that the scrap steel that they are purchasing from Jinan is of a lower grade. However, this is overlooked because the steel does meet all of the requirements to produce angled steel for most of their customers. The one other glaring problem is the fact that Eastern will be receiving Jinan's waste products.

This means that if Jinan is not producing at a high level, Eastern will not be receiving enough raw materials to increase their production. With this agreement, Eastern is relying heavily on the increased demand and production of steel plates. If Jinan is not producing at a high level, Eastern might be forced to buy the billets at a higher price from a government-regulated supplier.

Direct Labor Problem

In the past, Eastern has hired mostly foreign workers from either China or Thailand. Even though the workers are foreign, they are still paid at the same rate as domestic workers. However, with the hiring of foreign workers, Eastern now incurs many additional expenses. These expenses include half of the airfare that the

foreign workers demand in a year's time. They also will incur government taxes on foreign workers and immigration expenses. The company also has to provide housing for these workers while they pay for their own food. There are some advantages associated with hiring foreign laborers: They are usually under contract for two years. Not only are they under contract for two years, their working visa expires after the two years. Because the quality of life and the pay are better in Malaysia than their homeland, they usually are reluctant to quit. Another advantage is that they are not protected under the labor laws. Finally, when demand is low or the company is not producing at full capacity, the company could dismiss them without any legal problems. This also would save money and help increase profits during low demand. Although the labor cost is higher, the company believes that increases in labor control could stabilize production flow and thus reduce costs in other areas.

ASSUMPTION

The price of steel has been as unstable as the stock market during the past few years. The price is mainly determined by the market demand and supply. In order to conduct an analysis on steel prices, Eastern has assumed that the price of steel is set at RM1,300 per MT.

The strategic partner collected the data based on phone conversations with Eastern's production manager. Eastern operates on a 17-percent profit margin. The daily production output of angle steel is 15 MT, which is only half of the capacity. Currently, Eastern employs 40 workers, all of whom are foreigners earning a RM1,500 basic monthly wage. The mill operates only one eight-hour shift a day, 25 days a month.

The raw material (plate waste) currently costs RM495 per MT. The domestic standard billets cost RM760 per MT, while international billets cost RM600 per MT. Inventory holding cost is about 15 percent of the raw material price. However, around one-third of the total holding cost is spent on segregating qualified raw materials from disqualified raw materials (about 50 percent of the input) prior to production. The company has to do this because the raw material is plate waste, not the standard unit used to make angled steel. Only steel with a thickness above 120 mm is suitable for production of angle steel. The disqualified plate waste is not scrapped but sold to the market at RM525 per MT; daily sales are about 15 MT.

The output is 85 percent qualified angle steel, 10 percent semiquanlified steel, and 5 percent scrap. The prices of these three outputs are RM1,300, RM1,000, and RM380, respectively. The production manager is confident that if standard billets are used for production, the qualified products will be 95 percent of the output; 4 percent is semiquanlified while 1 percent is scrap. The supply of the plate waste is not stable and depends on the production schedule of the plate mill, which has a very irregular market demand. Sometimes, there is a shortage of the raw material supply when the plate mill has a slowdown of production. As a result, Eastern is currently operating at half of its capacity. There is no problem with the supply of standard billets in the market; however, the inflated price level makes purchase of the standard billets difficult.

THE DECISION

Jon phoned Mr. Patton immediately after the briefing. Mr. Patton responded, "Jon, please write a critique analyzing the situation in Malaysia as soon as possible." Eastern is under contract to ship 2,000 MT of steel to Code C during the next six months.