Non-Equity Modes of Operation in ASEAN

Promoting new forms of trade between Japan and ASEAN

PAPER 7

MARCH 2018

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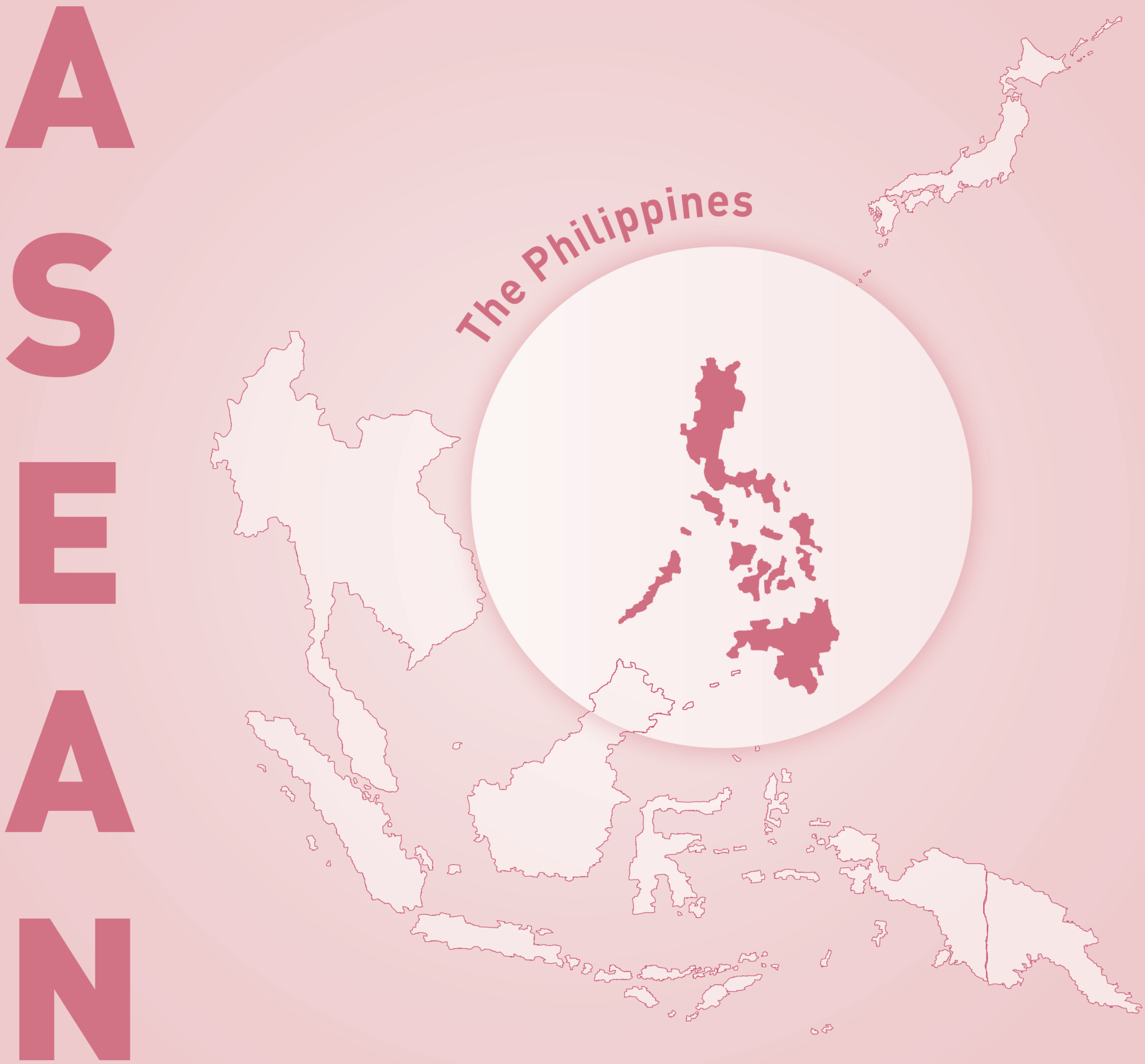

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NOTES

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The following symbols have been used in the tables:

- Two dots (..) indicate that data are not available or are not separately reported.
- A dash (-) indicates that the item is equal to zero or its value is negligible.
- Use of a dash (-) between dates representing years, e.g., 2015–2016, signifies the full period involved, including the beginning and end years.

Reference to "dollars" ($) means United States dollars, unless otherwise indicated.

There are 10 papers in total. The other nine papers will be produced subsequently.

Paper 1. Brunei Darussalam
Paper 2. Cambodia
Paper 3. Indonesia
Paper 4. Lao People's Democratic Republic
Paper 5. Malaysia
Paper 6. Myanmar
Paper 7. Philippines
Paper 8. Singapore
Paper 9. Thailand
Paper 10. Viet Nam

Prepared by Chie Iguchi (Keio University, Japan) and the trade staff members of the ASEAN–Japan Centre (AJC) under the direction of Masataka Fujita (AJC). Errors and omissions are only those of the authors and should not be attributed to the respective organizations.

CONTENTS

KEY MESSAGES

- The volume of non-equity mode (NEM) production and exports has been increasing in the Philippines, reaching an estimated $40 billion and $32 billion, respectively, in 2016. NEMs were estimated to account for 43 per cent of total exports.
- Philippine firms are involved in various types of NEMs, including subcontracting, management contracts, and franchising. The use of NEMs varies by industry.
- Information technology and business process outsourcing (IT-BPO) is a good example of outsourcing (subcontracting) and is one of the best-performing and best employment-generating activities in the Philippines. It is also the top growth industry in the Philippines, with $25 billion sales in 2016 and an 8 per cent share of GDP. As it is hard to forecast demand, IT-BPO firms tend to be required to build their capacity without exact knowledge of the size of NEM operations with future customers.
- The Philippine furniture-making industry, which boasts world-famous designers and has more than 5.4 million people in the supply chain, is another example of subcontracting and an export-led growth industry. Furniture exports grew from $218 million in 2012 to $354 million in 2016. Although various support programs make Philippine products even more competitive in the international market, local furniture firms build part of their competitiveness from NEM customers outside the country.
- About 30 per cent of total retail sales are contributed by franchisee retail from foreign transnational corporations (TNCs). Among others, convenience stores are an expanding franchise business. In 2016, leading convenience store operator Philippine Seven Corp. reached total revenues of $652 million and had total assets of $248 million.
- International hotels operate in the Philippines through either management contracts or franchise agreements, or on long-term leased land on which hotels are built with equity investments. The inward FDI policy does not allow foreigners to own private land.
- Foreign TNCs outsource a part or the whole of any goods or services or even part of their global value chains (GVCs) to the country when localization is a low priority.
- As TNCs can easily terminate contracts, a long-term relationship is not established, particularly when the quality of services or goods does not meet TNCs' standards and local firms in other countries are more competitive.
- NEMs may play a role in alleviating the potential risks associated with the externally dependent economic characteristics of the Philippines, and are critical for further economic development.
- When selecting NEMs as an economic growth strategy, consideration of the development of the local community, including NEM local firms and NEM local employees, is important.
- There are two directions of policy implications associated with NEMs. One direction is to create local employment through NEMs and the other is to promote NEM policies. These two directions should be pursued through an appropriate institutional framework. NEM-oriented policies also help break overdependence on overseas remittances.

1. INTRODUCTION

Trade is not always undertaken between independent firms. Both arm's-length and non-arm's-length trade exist, and in the latter trade may also take place between foreign companies and local firms without an equity relationship, with the local firms controlled by the foreign ones. In the Philippines, this non-equity mode (NEM) of trade is spreading in the form of international subcontracting in manufacturing industries for automobiles, electronics and garments, among others; contract farming in agriculture, as in banana plantations and food processing; international franchising in fast food and retail (including convenience) stores; variations of build-own-operate-transfer arrangements and other concessions in infrastructure projects; and management contracts (e.g. in international hotel chains).[1] Recently, information technology and business process outsourcing (IT-BPO) and information technology and business process management (IT-BPM) have become top exporting businesses, typically undertaken through contractual agreements with foreign entities. This paper examines the case of the Philippines within the overall framework of the ASEAN-Japan Centre (AJC) NEM project (box 1).

In the Philippines, the 36th largest economy in the world and the 3rd largest in ASEAN (after Indonesia and Thailand), NEMs in all three sectors – primary, manufacturing and services – have been contributing significantly to economic development. In manufacturing, for example, the electronics industry plays a pivotal role, accounting for 47 per cent of exports, with 258 companies exporting over $1 million each in 2014. This industry comprises semiconductor manufacturing services[2] (73 per cent) and electronics manufacturing services[3] (27 per cent). Major global semiconductor players such as Samsung (Republic of Korea), Texas Instruments (United States), Toshiba (Japan), NXP (Netherlands), and STMicroelectronics (Switzerland), have production bases in the Philippines, and their foreign affiliates are engaged in transactions not only with their parent firms but also with NEM partners in and out of the country. Integrated Microelectronics Inc. (IMI), based in the Philippines, is the 6th largest global provider of electronics manufacturing services to the automotive industry, and a major NEM supplier for Bosch (Germany), the world's largest supplier of automotive components. IMI provides Bosch with automotive, industrial and consumer electronic products.

As an example of services, which has become the strongest and fastest-growing sector of the Philippine economy,[4] IT-BPO/BPM is one of the best-performing and best-employment-generating industries in the country, generating $25 billion in revenues. The Philippines attracts not only foreign direct investment (FDI) by major IT-BPO/BPM transnational companies (TNCs), including call centres,[5] but also NEMs for international production. Another example is that in matching with consumer lifestyles, with the growth in convenience stores and restaurant chains, foreign companies enter through franchising: for example, 7-Eleven, the largest convenience store in the world, as well as in the Philippines, plans to have 10,000 stores in the country by 2023.[6] These industry examples show that NEMs are integrated into economic development and daily life in the Philippines (table 1).

1 There are also many types of NEMs of business activities among local companies. As this paper highlights NEMs in the context of international trade, it does not address the case of NEMs among local companies.
2 Semiconductor manufacturing services include companies manufacturing integrated circuits, transistors, diodes, resistors, capacitors, coils, transformers, printed circuit boards and other components.
3 Source: SEIPI (Semiconductor and Electronics Industries in the Philippines Foundation, Inc.).
4 Its gross value added contribution share reached 57 per cent in 2014 (www.industry.gov.ph/category/services).
5 According to the Central Bank of the Philippines, the export share of call centres in the IT-BPO industry reached over 53 per cent in 2013.
6 *Business Mirror*, 30 July 2015. As of 2016, there are 1,995 7-Eleven outlets in the Philippines (7-Eleven 2016 annual report).

This study is structured as follows. The next section explains the characteristics and scope of NEMs by type and introduces particular types that have distinguishing characteristics in the Philippines. Section 3 provides a picture of opportunities and challenges in the selected industries and analyzes the implications of NEMs for the economy. The last section makes suggestions about policy implications.

Box 1. **The NEM project of the ASEAN-Japan Centre**

Arm's-length relationships and equity holding are not the only means of exerting control over global value chains (GVCs). Companies also enter into contractual relationships with other independent firms. Such trade is gaining importance as the system of global production becomes more integrated and value chains form. This is an area in which lack of knowledge and a huge gap in research exist in ASEAN. An overall analytical framework is needed in order to assess development impacts and make it possible to propose a policy framework for dealing with these transactions.

The fundamental difference from normal trade is that non-equity forms of operations relate to a contractual partnership between private parties. The role of the state in relation to this partnership is limited to setting the framework conditions within which the private parties can freely negotiate the terms of their cooperation. By understanding this phenomenon better, including its scale and scope, and filling in a policy analysis gap, the AJC can provide each ASEAN country government with policies to consider in order to fully benefit from these new forms of trade, as well as from investment.

In order to understand better the scale and scope of non-equity involvement in major industrial sectors, a case study approach is also employed whenever appropriate. The reasons for taking this approach are two-fold: (1) balance-of-payments and supplementary statistics do not provide the details necessary to accurately measure cross-border non-equity participation; and (2) the relevant microdata are fragmented and disconnected. As much as possible, each case study builds on existing research and statistics.

New opportunities are opening up for ASEAN countries through the international innovation networks of transnational corporations (TNCs). Although attracting foreign direct investment (FDI) and encouraging foreign TNCs to establish affiliates remain important options for ASEAN countries, governments also need to review current regulatory regimes in the context of these international innovation networks. A key objective of this study is to make recommendations on which policies (investment and industrial) governments need to consider in order to fully benefit from emerging opportunities in NEMs.

Table 1. **Description of selected non-equity modalities, including examples of typical industries, in the Philippines**

Modality	Description (in the international context)	Typical industries	Company examples
Subcontracting	Agreement whereby a TNC contracts out to a host-country firm one or more aspects of product design, processing or manufacturing; includes contract manufacturing and design, and outsourcing in the case of services or business processes	Electronics	IMI
		Garments	LHK Creation
		Automotive	Yazaki Torres
		BPO	Accenture, JPMorgan Chase
Contract farming/ contract mining	Agreement between a TNC buyer and host-country farmers or miners (including government representatives) that establishes conditions for the production and marketing of farm and mining products	Agriculture	Dole, Del Monte, Chiquita, Sumifru
Licensing	Contractual relationship in which a TNC (licensor) grants to a host-country firm (licensee) the right to use intellectual property (e.g. copyrights, trademarks, patents, industrial design rights, trade secrets) in exchange for a payment (royalty); includes brand licensing, product licensing and process licensing (cross-licensing, intra-firm licensing)	Pharmaceuticals	Cathay Drug
		Consumer goods	Click! Licensing Asia
		Electronics	Dae Kyung Philippines
Franchising	Contractual relationship in which a TNC (franchisor) permits a host-country firm (franchisee) to run a specified business modelled on a system developed by the franchisor in exchange for a fee	Retail	7-11, McDonalds
		Education	Canadian Tourism & Hospitality Institute
Management contracts	Agreement under which operational control of an asset in a host country is vested in a TNC contractor that manages the asset in return for a fee	Tourism and hospitality	S&P, SM Hotels
Other	Concessions, lease agreements, build-operate-transfer arrangements and the like, in the context of public-private partnerships	Infrastructure	GMR Infrastructure

Source: AJC.

2. CHARACTERISTICS OF NON-EQUITY MODALITIES

2.1 Scale and scope

According to the central bank, Bangko Sentral ng Pilipinas (BSP), in 2016 the country's total external trade in goods and in services reached some $121 billion and $55 billion, respectively.[7] Although the balance on goods has had deficits throughout the recent past, the service trade balance has registered a growing surplus. In particular, the contribution of the IT-BPO/BPM industry has been forecast to overtake even the income remittances from overseas Filipino workers (OFWs) in the next few years.[8] In this respect, the first research question is the extent of the sales volume of NEMs as well as the trade they generate and how significant NEMs are in total exports.

UNCTAD estimated global NEM production at over $2 trillion of sales in 2010 (UNCTAD 2011).[9] However, it noted that the analysis of NEMs is complex as "the web of directly owned, partially owned, contract-based and arm's-length forms of international operation of TNCs is tangled, and some of the distinctions between the different modes are blurred" (p. 130). Thus, the analysis is limited to a number of industries in which NEMs are especially important. Looking at various trade data, it can be seen that the growth of world trade has stagnated since 2008. In 2016, trade in goods declined by 0.2 per cent from the previous year to $15.9 trillion, only a $0.8 trillion increase from 2010 at current prices.[10] In this context, NEM export activity in the Philippines in 2016 was estimated at $19.4 billion in the goods sector alone, whereas total exports of goods reached $42.7 billion. The amount of NEM activity jumps if services trade is considered. For example, IT-BPO, the top growth industry in the Philippines, had $25 billion sales in 2016 and an 8 per cent share of GDP. Total NEM exports of goods and services reached at least $32 billion in 2016, and NEMs accounted for 43 per cent of total exports. Table 2 summarizes NEM operations in selected main industries.

In each sector, NEM exports are substantial. In the primary sector, banana production and export is a good example of contract farming and growing[11] that is operated and managed by cooperatives and banana exporters affiliated with major food companies such as Dole, Chiquita, Del Monte and Sumifru. Fresh banana is a major agricultural export of the country; Japan is the largest export destination, receiving products worth $231 million or 37 per cent of all banana exports in 2016.[12] Coconut oil is another major agricultural export.

In the secondary sector, the electronics and electrical industry has been playing a major role in driving Philippine exports and FDI. A top dollar earner of the country, the industry accounted for more than 30 per cent of all FDI and for 51 per cent of total exports from the Philippines, at $29 billion in 2016. As of March 2014, there were 447 registered electronics companies, the majority of which are foreign companies from Japan, the Republic of Korea, and the United States. Those companies, plus the Philippine global player IMI, are providers of either electronics manufacturing

7 Goods exports: $42.7 billion; goods imports: $78.2 billion; services exports: $31.2 billion; services imports: $24.2 (BSP 2016).

8 Comment by an executive officer of the Information Technology and Business Process Association of the Philippines (IBPAP).

9 Contract manufacturing and services outsourcing accounted for $1.1–1.3 trillion, franchising $330–350 billion, licensing $340–360 billion, and management contracts about $100 billion (UNCTAD 2011).

10 IMF, "Trade of Goods, Selected Indicators" (source: International Financial Statistics).

11 Contract growing is a contract between a plantation company and a cooperative, typically called a "Banana Production and Purchase Agreement".

12 ITC Trade Map.

services or original design manufacturing (ODM). Whereas electronics manufacturing services companies produce electronic parts or devices to order and do not make products under their own brand, ODM companies design, manufacture and supply clients' products under the clients' brands. Both types of companies are in NEMs as long as they have orders from other companies with which they do not have equity relations.

The furniture industry, another in the secondary sector, churns out products by world-famous designers and is also an export-led growth industry. Exports accounted for 26 per cent of furniture production in 2012 and grew at an annual rate of 15 per cent from 2009 to 2013.[13] The majority of exporting furniture manufacturers are able to comply with individual orders and inquiries from foreign companies and supply products to them through original equipment manufacturing (OEM).

As for the tertiary sector, various services are growing rapidly. The share in GDP of this sector alone reached 57 per cent in 2014, with an average growth rate of 6.3 per cent from 2000 to 2014. Among convenience stores that are growing rapidly in urban areas, replacing local shops and stores, Sari-sari is a well-developed example of store franchising. 7-Eleven, the largest international chain of convenience stores, has 1,995 stores in the Philippines: 985, or 49 per cent of them, are franchised stores whose owners pay franchise fees and marketing fees to the Philippine Seven Corporation, which in turn makes payments to the parent company in Japan.

IT-BPO is one of the most dynamic industries in terms of revenues and employment. The industry has attracted TNCs such as Accenture, JPMorgan Chase, IBM and HSBC to operate in the country and has helped create 1.146 million jobs, equivalent to 5 per cent of all service jobs in the Philippines. The IT and Business Process Association of the Philippines (IBPAP) estimates that the value of sales in this industry will overtake that of remittances from OFWs in 2018 and become a top revenue generator for the economy by 2022.

According to a World Travel & Tourism Council report, the direct contribution of travel and tourism to GDP was $12 billion, or 4.2 per cent of the total in 2014. The industry also generated 11.1 per cent of total employment, or $4.232 million in that year. Within the industry's contribution, hotels – and international hotel chains in particular – can best contribute to NEM operations through contract management.

[13] Department of Trade and Industry (DTI) Philippines, "Directory of Philippine Exporters" (2014).

Table 2. **NEM operations in major sectors, 2016**

Sector	Primary	Secondary	
Industry (representative example)	Banana	Electronics	Furniture
Product or services	Cavendish Cultivars	Semiconductor manufacturing services; electronics manufacturing services	Rattan and wicker furniture; wood, metal, bamboo, etc.
Number of companies [NEM-related, estimation]	166 (2013 business census) [40]	447 (2014 business census: Japanese, Korean, and U.S. firms are majority) [312]	2,600 registered manufacturers (2014 Export Marketing Bureau, Department of Trade and Industry) [100]
Major companies (local partner/ main franchisee)	Dole (Stanfilco), Chiquita (TADECO), Del Monte (Delinanas Development Corp), Sumifru AgriNurture	IMI, Ionics SIIX, Tsukiden Fujitsu Ten	Most companies are small and medium enterprises
Estimated export volume, total (Estimated volume by NEMs)	$618.8 million ($433.2 million)	$29.41 billion ($18.23 billion)	$354 million for furniture ($247 million)
NEM	Contract farming/growing (cooperatives)	Subcontracting	Subcontracting
Estimated NEM employment	32,500 (Total Cavendish banana cultivation with 45,255 workers in 2013 census)	280,636 (direct employment in 2014 census)	1,900,000 (direct and indirect employment)
Average export growth	28.5% for fresh bananas from 2009 to 2013	5.80% from 2009 to 2013	14.88% for furniture and furnishing from 2009 to 2013
Market and/or trade scale	95% of total banana demand from the Asian market	Japan (19%) United States (14%) 41% of total exports	United States (62%) Japan (6%) United Kingdom (4%) Italy (2%) Australia (2%)
Product or service scope	Bananas generated value added estimated at $347 million, corresponding to 40.6% of the entire agriculture sector in 2013	Anticipated gains driven by components, electronic data processing, telecommunications, cybersecurity, and self-driving cars	Local OEM and ODM companies can do business with TNCs

Source: AJC.
Note: 2016 data unless otherwise noted. Selected industries only.
[a] 7-Eleven Philippines 2016 Annual Report: does not include non-branded CVS, generic CVS, and 24-hour hybrid grocery CVS.
[b] Euromonitor 2016.

Tertiary		
Convenience stores	IT-BPO	Hotels
Small retail groceries; snack foods; confectionery; soft drinks; tobacco	Contact centre; transcription animation software development; other BPOs	Welcome, comfort, quality, trust and safety services
3,152[a] [1,150]	1,456 (2012 Census) [800]	3577 (2014 Census) (12.7% of hotel and restaurant establishments) [120]
Six big names: 7-Eleven (Philippines Seven Co), Mercury Drug, Ministop, FamilyMart, San Miguel Food, Alfamart	Accenture Convergys PHL JPMorgan Chase 24/7 Customer PHN	Novotel (S&P Inc.) Conrad (SM Hotel) Radisson (SM Hotel) Raffles (Ayala Land)
($9.2 million for license fees to TNCs)	$25 billion revenue ($12 billion)	$3.8 billion market size[b] ($554 million)
Franchising, licensing	Sub-contracting	Licensing, management contract
30,000	1,146,000 (5% of total service employment)	90,000
13.0% for convenience stores from 2014 to 2015	14.7% for IT-BPO from 2014 to 2016	20% for internal tourism expenditure from 2012 to 2016
United States (50%) Japan (20%) Indonesia (2%) Rest owned by Philippine firms	IT: global sourcing 60% BPM: global sourcing 50%	25% growth in market size from 2012 to 2016
More convenience stores to open: 7-Eleven plans 2,000 in 2017; Lawson had 26 outlets as of 2017 and plans 500 by 2020	Rapid shift to higher-value work Locational expansion outside Metro Manila	More international hotel chains have room to enter local resorts

2.2 NEMs by modality

Many foreign firms and TNCs do business with local partners through NEMs in various industries. Their type of involvement in NEMs and their contribution to the Philippine economy vary by modality and industry. In this section, modalities such as outsourcing, subcontracting, franchising and management contracts are examined by highlighting particular industries that rely on them.

(1) Outsourcing: IT-BPO

The Philippine IT-BPO/BPM industry (box 2) has become one of the best-performing and best-employment-generating activities in recent years. Industrial developments in voice-based services (call centres) as well as continuing improvements in non-voice and complex, knowledge-based process outsourcing show the promising growth trajectory of the industry.

Box 2. **Definition of segmentation of the IT-BPO/BPM industry**

According to statistics from Bangko Sentral Ng Pilipinas, the IT-BPO/BPM industry includes contact centres, transcription, animation and software development, among other activities. The Philippines Software Industry Association (PSIA) also categorizes this industry into production segments. Each segment has its related business association to help in the development of the whole industry:

- Voice BPO, including customer services and customer care services (Call Center Association of the Philippines, Global In-House Centre Council)
- Software development (IT outsourcing) including software development and design and related services (PSIA)
- Knowledge process outsourcing (non-voice BPO) including human resource management, financial and accounting services, and procurement purchasing (IBPAP and Global In-House Centre Council)
- Health care information management services (Healthcare Information Management Association of the Philippines)
- Creative process including animation (Animation Council of the Philippines, Inc.)
- Game development (Game Developers Association of the Philippines)
- Engineering services (Institute of Computer Engineers of the Philippines)

The industry employs 1.146 million people, accounting for 5 per cent of all service jobs and 2.8 per cent of total employment in 2016 (table 3). In 2016, it had sales revenues of $25 billion, equivalent to 14 per cent of services sector GDP and 8 per cent of total GDP (table 4).

In this industry in 2013, contact centres (voice centres) made up 53 per cent of the industry's exports, although other segments have been growing. Total exports of the industry in 2013 accounted for 61 per cent of total services exports and 21 per cent of total exports of goods and services from the country (table 5). The annual growth rate of the industry from 2005 to 2013 was 37 per cent, more than double that of service exports, at 15 per cent. During the same period, export propensity (exports divided by sales) rose from 70 per cent to 93 per cent. More and more foreign customers purchase IT-BPO/BPM services from the Philippines, and today most customers are foreigners.

Table 3. **IT-BPO/BPM employment by job category, 2005–2016**

Year	Total employment by industry			Employment in IT-BPO						Share of IT-BPO in total employment (%)	Share of IT-BPO in services employment (%)
	People employed (thousands)	Total manufacturing (thousands)	Total services (thousands)	Contact centres	Transcription	Animation	Software development	Other BPOs	Total IT-BPO industry		
2005	32,313	5,024	15,660	96,246	1,785	1,864	17,829	20,278	138,002	0.4	0.8
2006	32,636	4,997	15,957	153,683	4,956	4,482	42,657	42,267	248,045	0.7	1.5
2007	33,560	5,121	16,654	169,748	6,621	4,323	44,870	45,994	271,556	0.8	1.6
2008	34,089	5,047	17,010	212,372	4,321	5,656	49,893	82,893	355,135	1.0	2.0
2009	35,061	5,090	17,928	255,765	7,060	3,732	46,987	131,267	444,811	1.2	2.4
2010	36,035	5,399	18,682	329,597	9,131	3,908	49,516	143,975	536,128	1.4	2.8
2011	37,192	5,530	19,394	433,183	11,084	3,973	55,464	175,761	679,464	1.8	3.5
2012	37,600	5,743	19,764	487,757	16,997	4,164	64,922	196,092	769,932	2.0	3.9
2013	36,286	5,750	19,508	530,882	20,172	4,206	82,583	213,939	851,782	2.3	4.3
2014	37,310	5,987	20,112	..	..	..	..	..	958,000	2.5	4.7
2015	39,775	6,364	21,677	..	..	..	..	..	1,044,000	2.6	4.8
2016	40,664	7,400	22,893	..	..	..	..	..	1,146,000	2.8	5.0

Source: Bangko Sentral Ng Pilipinas (http://www.bsp.gov.ph/statistics/efs_ext2.asp#ITBPO).

Table 4. **IT-BPO/BPM sales by job category, 2005–2015**

Year	Contact centres	Transcription	Animation	Software development	Other BPOs	Total IT-BPO industry	GDP ($ million)	GDP, services sector ($ million)	Share of IT-BPO in total GDP (%)	Share of IT-BPO in services sector (%)
2005	986	8	17	399	585	1,996	103,072	55,144	1.9	3.6
2006	1,455	20	26	707	697	2,906	122,211	66,163	2.3	4.3
2007	2,051	33	29	1,098	1,157	4,368	149,360	81,327	2.9	5.3
2008	2,839	34	36	1,413	2,004	6,325	173,603	93,535	3.6	6.7
2009	4,207	57	52	1,672	2,270	8,258	168,485	93,019	4.9	8.8
2010	5,260	84	63	2,198	2,452	10,058	199,591	110,009	5.0	9.1
2011	6,817	122	72	2,469	2,594	12,074	224,143	125,367	5.3	9.6
2012	7,587	198	80	2,848	2,736	13,450	250,092	142,352	5.3	9.4
2013	8,394	423	88	3,429	2,971	15,305	271,836	156,664	5.6	9.7
2014	..	..	..	..	..	18,000	284,834	163,424	6.3	11.0
2015	..	..	..	..	..	20,500	292.449	172,434	7.0	11.8
2016	..	..	..	..	..	25,000	304.900	181,415	8.1	13.7

Source: Calculated on the basis of data from the Philippine Statistics Authority (PSA) and Bangko Sentral Ng Pilipinas.

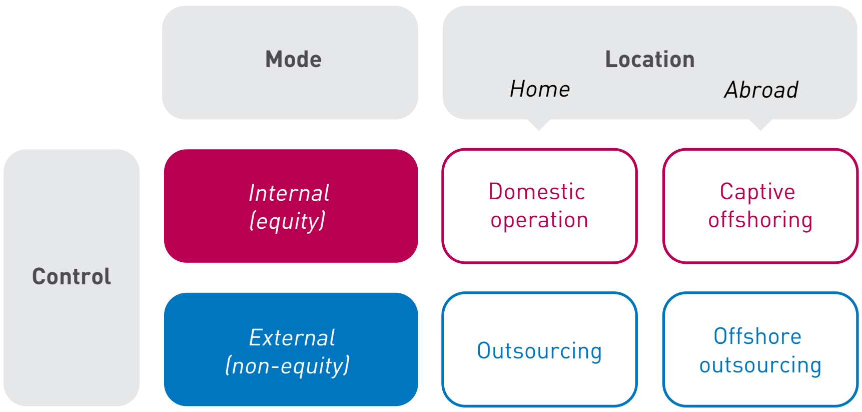
Table 5. **IT-BPO/BPM exports by job category, 2004–2013** ($ million and per cent)

Year	Total exports		IT-BPO category exports							
	Exports of goods and services	Exports of services	Contact centres	Transcription	Animation	Software development	Other BPOs	Total industry	Share of IT-BPO exports to total services exports (%)	Share of IT-BPO exports to total exports of goods and services (%)
2004	32,562	6,743	561	4	7	98	216	888	13.1%	2.7%
2005	33,772	8,610	949	8	11	159	258	1,387	16.1%	4.1%
2006	41,798	11,064	1,329	18	22	454	461	2,288	20.6%	5.4%
2007	46,304	13,501	1,732	25	26	851	854	3,489	25.8%	7.5%
2008	47,733	13,054	2,489	23	34	1,148	1,592	5,288	40.5%	11.0%
2009	43,227	14,084	3,938	54	45	1,552	2,126	7,717	54.7%	17.8%
2010	54,553	17,782	5,125	74	53	1,927	2,287	9,469	53.2%	17.3%
2011	57,154	18,878	6,165	121	59	2,380	2,431	11,159	59.1%	19.5%
2012	66,823	20,439	7,061	198	69	2,612	2,561	12,503	61.1%	18.7%
2013	67,847	23,335	7,578	421	74	3,221	2,878	14,174	60.7%	20.8%

Source: Bangko Sentral Ng Pilipinas (http://www.bsp.gov.ph/statistics/efs_ext2.asp#ITBPO), Euromonitor International from national statistics, Organization for Economic Co-operation and Development, International Monetary Fund and International Financial Statistics (IFS).

IT-BPO/BPM businesses are undertaken through outsourcing. Outsourcing refers to the contracting out of a business function to an external provider. It involves an exchange of goods or services for payment. It is different from offshoring, particularly when it is used abroad. Captive offshoring refers to the relocation of a business function from one country to another within a TNC, typically from the parent company to a foreign affiliate. Client firms or user firms offshore a variety of businesses, such as call centres, data entry, engineering, software development, game application development and research and development (R&D) to local firms (offshore outsourcing) or foreign subsidiaries in a host country (captive offshoring) (figure 1).

Figure 1. **Outsourcing and offshoring by type**



Source: AJC.

In order to gain direct insight into strategic operations by outsourcing to the IT-BPO/BPM industry in the Philippines, seven firms were interviewed in Manila in November 2016 (box 3).

Each segment of the IT-BPO/BPM industry has grown over time. Call (contact) centres are by far the largest segment in this industry and contribute the most to the economy in terms of sales, employment and exports (tables 2–4). Working for call centres does not require high educational levels: jobs are offered to applicants who are at least 18 years old (box 3) and have typing skills, the required level of English grammar skills, and communications and listening skills, depending on the jobs. Types of jobs include voice services and chat services, in which the entry barrier for unskilled young workers is very low. Some of these workers, however, have moved up the value chain from voice to non-voice centres through the receipt of technical assistance from client firms. In the non-voice centres, some firms have moved up the ladder that requires higher knowledge and skills.

The IT-BPO/BPM industry faces two inter-related problems: one related to standardized services and the other related to technological upgrading. Traditionally, Philippine IT-BPO customers – particularly in voice, non-voice, and management process outsourcing – have trained their employees because standardized skills are required. In-house training provided good results for employees; however, employees who have acquired higher skills as a result of in-house training have tended to leave for other firms. At a United States IT-BPO company that was interviewed for this study, the non-voice centre segment has a rather high turnover ratio (40 to 45 per cent every year, some years even 70 per cent). Thus, even though companies have been significantly investing in training, the return on the investment is limited.

Box 3. **Main findings of seven case studies of IT-BPO firms in the Philippines**

The case studies looked at two firms in game development, one in animation and game development, two in voice BPO, one in non-voice and knowledge BPO, and one in logistics.

Game development firms:

Dynamic segment attracting younger generation

Two Filipino companies that develop games for smartphones, social media and games linking with some TNCs' products sold in customers' countries (United States, Singapore, Hong Kong (China), Malaysia, and the United Kingdom). They are small and medium enterprises (SMEs) employing fewer than 60 people (firm A has 55 staff members, 80 per cent of them male, and firm B has 30 staff members, 90 per cent of them male) and work on a project basis, depending on customer's requests.

Animation and game development firm:

Capability of locally embedded design skills

A Filipino company that has 200 employees and contracts for producing animation and developing games from animation series. The firm undertakes offshore outsourcing work from the United States, Japan, Canada and Poland.

Voice BPO firms:

Technology transfer and capability of locally embedded communication skills

Owned by TNCs – one from the United States and the other from Japan – with customers located mainly in the home countries. On recruiting their staff at call centres, neither firm requires any minimum education level if the applicant is at least 18 years old. The United States subsidiary company has more than 5,000 employees in eight call centres, and the Japanese subsidiary company has 200 employees, with 30 per cent of the staff engaged in software development.

Non-voice and knowledge BPO firm:

Upgraded its functioning to higher level

A Filipino-owned company, started from a voice call centre in 1996, which has shifted to providing software suites, core software modules, software libraries and knowledge process outsourcing, and to developing systems for health solutions and for reducing carbon emissions. Its clients are in the United States and Australia for health solutions and in Hong Kong (China), Africa and Europe for software development.

Logistics operation support firm:

Technology transfer from headquarters

A German subsidiary logistics company that has played a key role in the central operation system of logistics in the Philippines since 2013, with 120 employees. The firm acts as a regional centre in the Asia Pacific, supporting the work of customer support, R&D, custom reporting and data management in North America and Europe.

The IT-BPO/BPM industry faces two inter-related problems: one related to standardized services and the other related to technological upgrading. Traditionally, Philippine IT-BPO customers – particularly in voice, non-voice, and management process outsourcing – have trained their employees because standardized skills are required. In-house training provided good results for employees; however, employees who have acquired higher skills as a result of in-house training have tended to leave for other firms. At a United States IT-BPO company that was interviewed for this study, the non-voice centre segment has a rather high turnover ratio (40 to 45 per cent every year, some years even 70 per cent). Thus, even though companies have been significantly investing in training, the return on the investment is limited.

From a technological point of view, this industry requires continuous investment. Companies in the Philippines try to differentiate themselves by providing advanced IT technologies to attract overseas customers. For example, in order to develop software or animation, massive amounts of data need to be synchronized with customers outside the Philippines. In order to have a strong IT infrastructure, further investment is required. Some companies in the Philippines meet these needs so that they can differentiate themselves from their competitors, even outside the Philippines (e.g. India and Viet Nam).

IT-BPO/BPM firms have voice or non-voice centres in different large cities. This is partially because customers outside the Philippines want to minimize the risks associated with concentrated locations and partially because firms in the IT-BPO/BPM industry want to secure employees, as turnover ratios for some segments are relatively high. As a result, about 70 per cent of firms in the IT-BPO/BPM industry are located in the Metro Manila area, including Makati, Ortigas and Bonifacio Global City; 11 per cent in Metro Cebu; and 19 per cent in other cities, such as Metro Clark and Metro Bacolod. Consequently, employment in the IT-BPO/BPM industry is growing in these locations and IT infrastructure is improving, through the establishment of voice or non-voice centres.

Since locational distribution tends to be beneficial for rural areas, the Department of Science and Technology – Information and Communications Technology Office (DOST-ICTO) and the IBPAP initiated a partnership project with 10 cities[14] in 2015–2016, to secure the telecommunication facilities and infrastructure needed to set up voice and non-voice centres. This project will benefit both IT-BPO/BPM companies and these provincial towns and cities through the lower cost of doing business outside Metro Manila and through the creation of jobs and investment opportunities.

(2) Subcontracting: Furniture industry

Subcontracting is spread throughout various industries, in particular in the manufacturing of clothing, electrical and electronic devices, and furniture. Unlike in other countries, in the Philippines, furniture stands out as the industry most reliant on subcontracting when dealing with international businesses. The furniture industry is known for its global design innovations. Production of furniture through contract agreements is also growing in the Philippines and abroad; products are used for hotels, resorts and entertainment facilities (Board of Investment 2015). In the furniture industry, a local operation or activity is not usually owned by a foreign TNC. Their operations or activities are owned and managed by local firms, including micro, small and medium-sized enterprises (MSMEs). They are typically bound by NEMs.

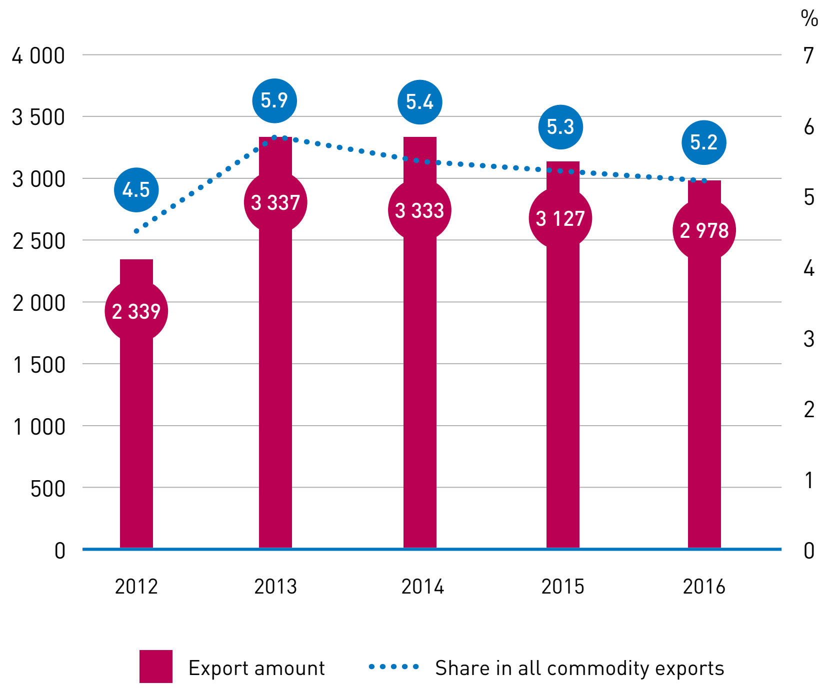
In the furniture industry, MSMEs account for about 98 per cent of all firms, providing 123,000 direct workers and 2.1 million indirect workers nationwide and 5.4 million persons in the supply chains in 2013 (Board of Investment 2015). The three major furniture production areas are in Metro Manila, Pampanga and Cebu. Metro Manila and nearby peripheral cities in Calabarzon specialize in furniture made from wood and from mixed materials. Pampanga is associated with hand-carved wood, wicker and iron products, whereas Cebu, which once was the heart of rattan furniture making in the country, is known today for its fine wood furniture work (Board of Investment 2015).

Woodcraft and furniture is ranked the fourth largest export industry in the Philippines, accounting for about 5 per cent of total exports; the industry's overall exports in 2016 were $3 billion (figure 2). The industry aims to grow its business overseas through a niche marketing strategy to boost sales at least 10 per cent every year, by sustainably producing sophisticated, sturdy and environmentally friendly products.[15]

[14] Namely Baguio City, Cagayan de Oro City, Dagupan City, Dasmarinas City, Dumaguete City, Lipa City, Malolos City, Naga City, Sta. Rosa City, Taytay and Rizal.

[15] In the Philippine Exporters Confederation Inc. (PHILEXPORT) News and Features, March 24, 2017.

Figure 2. **Philippines woodcrafts and furniture exports, 2012–2016**
(F.O.B. $ million and per cent)



Source: AJC based on PSA data, 2012–2017.

For this industry, three firms were interviewed, dealing with home decoration, lighting and furniture accessories; Christmas decorations; and ethnic Moroccan lighting, abaca lighting and baskets, respectively.[16]

Since firms in the industry are MSMEs and have many contracting workers outside the company, potential backward linkages with these contracting workers contribute to employment creation and to capacity building in the industry through learning from OEM or ODM manufacturing.

As for job creation, as a result of having OEM and/or ODM agreements with customers outside the country, the number of new jobs, particularly through contracting with local MSMEs, has been increasing, judging from the interview data. Given that the industry comprises essentially MSMEs, having OEM or ODM contracts with customers outside the country will contribute to employment in MSMEs in the Philippines.

MSMEs in the furniture industry are often located in rural areas. Priority sectors are selected on the basis of the localization of industry road maps and consultation with the Department of Trade and Industry – Board of Investment (DTI-BOI) in each region. As a result, furniture was selected as one of the priority sectors in the regions of Cagayan Valley, Central Luzon and Central Visayas. Developing the furniture industry will help in the development of these rural regions.

From the interviews, it appears that local furniture firms have learned a lot from NEM customers outside the country. Local firms started by receiving orders from customers and have developed

16 All firms are Philippine-owned local companies that have customers outside the country, including in Japan.

to become ODM so that they can present new designs or new products to customers on the basis of the capacity of local firms. Local firms agreed that they learned different stages of design, manufacturing and finishing processes of production through having contracts with customers. NEMs in the furniture industry can help local firms build their capabilities.

The NEM in the furniture industry is governed by foreign customers, in particular for design and manufacturing processes. As local firms have been upgrading their quality of design over the years, the relationship between local firms and foreign customers has been shifting upward in the value chain. As a result, local firms can become ODM firms, a step up from OEM firms.

Operations in the furniture industry are integrated with TNCs' activities since local firms' customers tend to be TNCs that export the finished products to customers in other countries. Thus, critical factors for TNCs engaged in NEMs with local firms are the availability of wood materials, flexible workers in MSMEs under contracting arrangements with local firms, and engineers and designers in local firms.

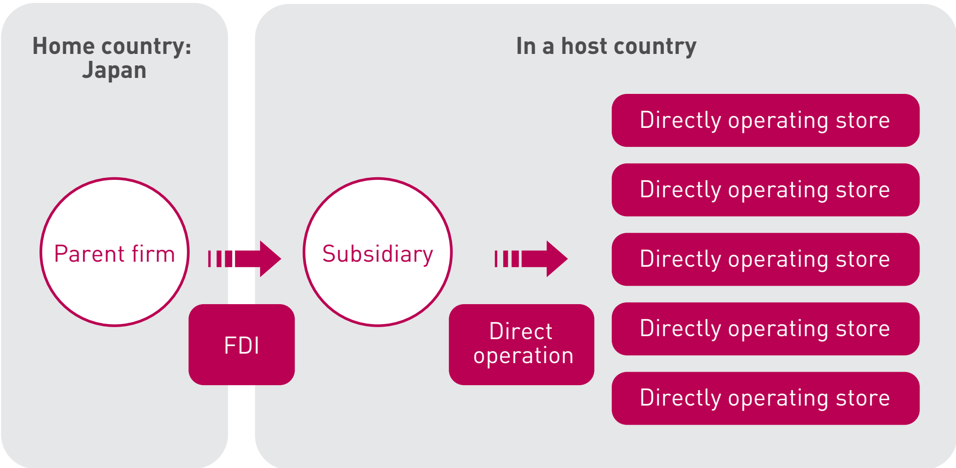
TNCs have already been utilizing NEMs with local firms in the industry. Since local firms' design capabilities and the flexible arrangement of local value chains have developed as a result of linkages with foreign TNCs, TNCs will continue to utilize the current modalities. This reinforcing relationship between foreign NEM firms and local subcontractors will further strengthen export capabilities and contribute to the growth of the country's exports.

(3) Franchising: Convenience stores

There are a number of types of franchising agreements between foreign firms or TNCs and local firms, depending on the TNC's strategy or TNC-specific decisions. The Philippine Franchise Association (PFA), which represents most franchising firms in the Philippine market, has categorized its member firms into three areas: foods, services and retail. Since operations in the retail industry typically occur under franchising agreements, many fashion brands and convenience stores are members of the association. Those in the foods category include restaurants, fast foods and bakeries (about 40 per cent); those in the services category include wellness centres, beauty salons, spas, hotels and senior care (in the aging population) (about 30 per cent); and those in retail include clothes (fashion) stores and convenience stores (about 30 per cent). Member firms have 1,500 brands: in the foods category there are 675, in services 375, and in retail 450. By national origin, 1,020 brands are Filipino and 480 are foreign, with United States franchises accounting for 60 per cent of foreign brands and 40 per cent of foreign food franchises.

TNCs do not always use franchising agreements to run stores or shops in foreign markets. They enter the Philippines to control management and operation of stores through equity holdings. Japan's Fast Retailing (UNIQLO) is one example: it owns 75 per cent of UNIQLO jointly with SM Retail Inc., which owns the remaining 25 per cent. As of 2016, UNIQLO directly operates 35 stores in the country with 1,400 employees. All stores are directly operated, so this arrangement is not considered to be a NEM (figure 3).

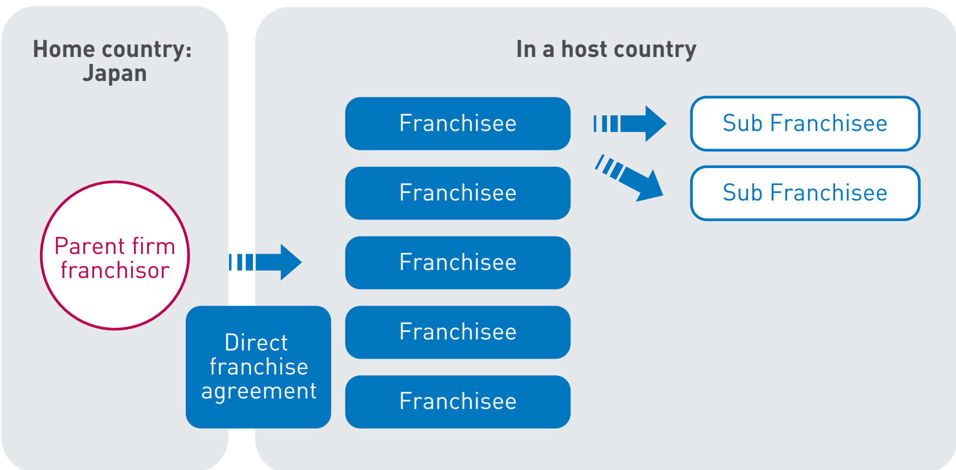
Figure 3. **Direct operation by TNC through equity modality**
(Case of UNIQLO)



Source: AJC.
Note: Red colour indicates an equity relationship.

TNCs may have direct franchise agreements with local firms (figure 4). However, as it is hard to control management and operation, it is rare to see this type of agreement.

Figure 4. **Direct franchise agreement**
(Case of Beard Papa's)

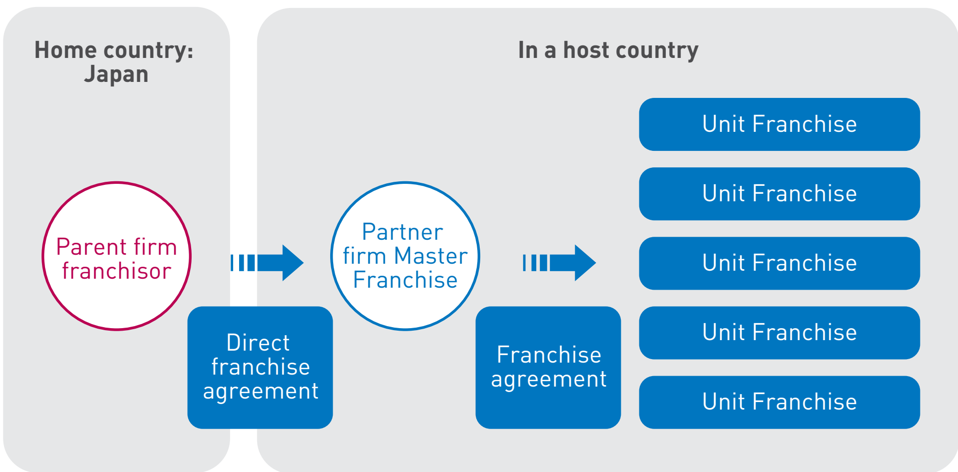


Source: AJC.
Note: Blue colour indicates a NEM relationship.

In many countries as well as in the Philippines, a hybrid type of franchising is used most often. In such cases, franchise agreements entail the establishment of a master franchise firm in a host country. This master franchise firm can be a local partner with no equity relationship (thus, a NEM partner) with foreign TNCs (figure 5) or a local partner with an equity relationship with foreign TNCs (either a joint venture with a local partner firm (see box 4 for the case of Family Mart) or a subsidiary that is 100 per cent owned by a TNC (figure 6)).

When foreign TNCs have direct franchise agreements with a local firm, this firm becomes a master franchise (figure 5). A master franchisee takes care of franchise agreements with unit franchisees in the country. Karada Factory, a Japanese chiropractic clinic chain, is an example of this case. It has a franchise agreement with CWC (Createch Wellness Corporation, which is owned by Technolax HD), which operates 14 franchise stores with 150 employees as of March 2017. This TNC does not have to invest at all, and the quality of operation or control depends on the local partner (master franchisee). Nevertheless, the parent firm in Japan usually supports the master franchisee fully until the opening of the first store. Once the first store is opened, support tends to become limited. Thus, with this type of arrangement, it might be difficult for TNCs to control and operate franchises as they wish. As the master franchisee is not an affiliate of the TNC, it is not easy to send expatriates to a host country.

Figure 5. **Master franchise agreement with direct franchisees**
(Case of KARADA factory)



Source: AJC.
Note: Blue colour indicates to NEM relationship.

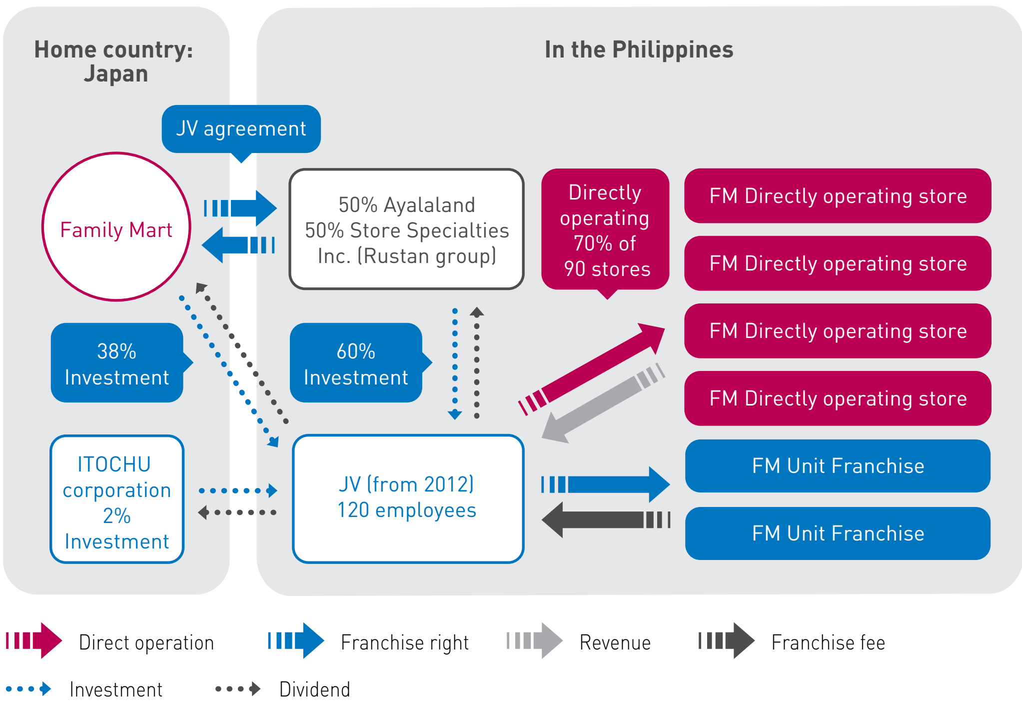
Another hybrid of NEMs and FDI is the case in which a master franchisee is a joint venture with a TNC and a local partner firm. In this case, the foreign TNCs can have influences on local operation and management, though there are always risks associated with operations since the master franchise is jointly owned. When TNCs and local partners jointly manage their local franchising agreement, TNCs typically send expatriates to the joint venture firm. Family Mart in the Philippines is an example (box 4).

Box 4. **Family Mart's franchising system** (continued)

A Japanese convenience store chain, Family Mart established Family Mart Philippines in November 2012. As of March 2017, it has 90 stores, of which 30 per cent are under franchise agreement and 70 per cent are owned by a joint venture. Box figure 4.1 illustrates Family Mart's franchise agreements in the Philippines.

In the Philippines, Family Mart has a joint venture with a local firm called SIAL (50 per cent owned by Ayala Land and 50 per cent owned by Stores Specialties, Inc.), which acts as the master franchisee. Its business model started from FDI, followed by operating directly owned stores and franchise stores. This franchising style is in contrast to the one in Malaysia, in which a local firm has an area franchising agreement directly with Family Mart Japan and acts as a master franchisee so that it can create or find local franchisees (box figure 4.2). This Malaysian model is operated as a pure franchising agreement with no equity involved, as opposed to the Philippine case, in which NEM arrangements come into play only after the main joint venture is established through investment.

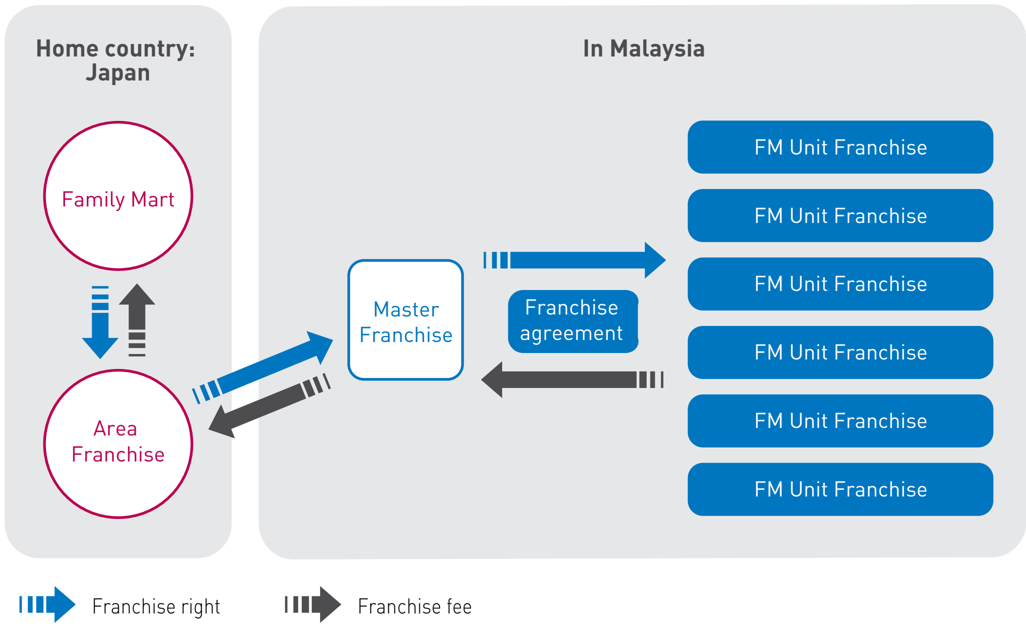
Box figure 4.1. **Franchising agreements of Family Mart in the Philippines**



Source: Based on interviews with a manager of Family Mart in the Philippines.
Note: Red colour indicates an equity relationship, and blue indicates a NEM relationship.

Box 4. **Family Mart's franchising system** (concluded)

Box figure 4.2. **Franchising agreements of Family Mart in Malaysia**



Source: AJC, based on interviews with a manager of Family Mart in the Malaysia.

In a host country, foreign TNCs establish a 100 per cent owned master franchisee that in turn has a franchise agreement with local unit franchisees, as in the case of KUMON (figure 6). In this situation, foreign TNCs can control management and operation over the entire franchise system. Access to local tacit knowledge or the local network is different whether the master franchise is wholly owned or jointly owned: the wholly foreign-owned master franchisee can directly support unit franchisees and can also have sub-franchise agreements under the unit franchisee agreement.

Whatever the franchise agreement is, local franchisees have to pay franchise fees to use the franchisor's brand name. In addition, they have to pay marketing fees for promotion and advertisement in the Philippines. In order for franchisees to operate under the brand name, they need to pay both fees, called "loyalty fees", once they receive revenues. It is estimated that the lowest fees are 2 to 3 per cent but that usually fees are much higher, in most sectors. For the food and retail industries, loyalty fees of 3 per cent to 8 per cent are the norm, whereas in services industries including wellness centres, beauty salons, spas, hotels and senior care, loyalty fees run between 5 per cent and 20 per cent. In 2015, franchisees in the Philippines paid $613 million and received $11 million in royalty and licensing fees.[17]

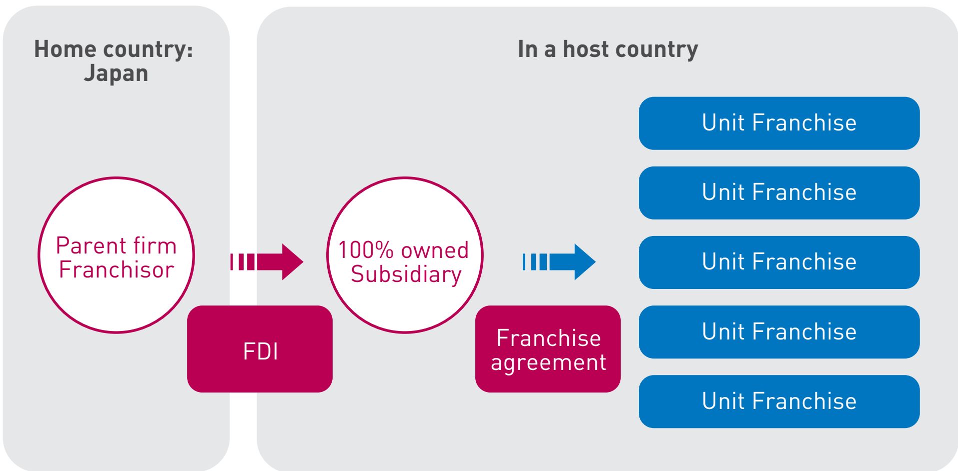
With 450 brands, the retail industry is not only one of the main categories of the PFA but also an important part of the Philippines services industry, which accounts for about 33 per cent of exports

[17] Data on royalty and licensing fees were obtained from AJC, "Promoting Services Trade in ASEAN – Paper 2: Trade in Research and Development Services", February 2017, pp. 34–35.

from the services sector. Sales of retail industries were $36.3 billion in 2016, equivalent to 13 per cent of GDP. According to the BOI's data, about half of total retail sales are concentrated in the Manila Metropolitan Area. Employment in the industry is more than 5 million. About 30 per cent of total retail sales come from franchisee retail from foreign TNCs, and more than 124,000 franchisees employ about 1.1 million people (Philippines Retailers Association). In the retail industry, the dominant four players are SM Group, Ayala Corporation, Robinson's and Rustan's Group.

Although the industry is growing rapidly thanks to the advent of franchisee retailers, in rural areas, where about 51 per cent of the population lives, traditional retail outlets are still preferred. With modern retailing now making up about 30 per cent of the industry (Li 2016), the dominant retailers, such as SM Retail, Puregold and Robinson's, have made extraordinary progress in transforming the country's retail style.[18]

Figure 6. **Master franchise agreement with a fully owned foreign subsidiary**
(Case of KUMON Philippines)



Source: AJC.
Note: Red colour indicates an equity relationship, and blue indicates a NEM relationship.

Within the grocery sector, the convenience store style has become popular, with more than 3,100 stores in the country (table 6). SM Investments Corporations owns 100 per cent of SM Retail Inc., which has 100 per cent of Save More (grocery stores). JG Summit Holdings, Inc., has 100 per cent of Robinson's Retail. As mentioned earlier, 7-Eleven is the largest convenience store chain (box 5). Mini Stop, the second largest, which is owned by AEON and Mitsubishi Corporation, had 499 stores in 2016. Ayala Corporation owns Philippine Family Mart CVS Inc., which has been invested in by Itochu Corporation (2.55 per cent), Family Mart in Japan (37.45 per cent) and Ayala Holding companies (which is owned 50 per cent by Rustan's and 50 per cent by Ayala Land) for 60 per cent. It had 100 stores as of December 2016.

[18] SM Retail, for instance, opened 99 stores in various formats in 2015, with grocery retail sales of $2.7 billion, while Puregold generated $2.1 billion in sales and Robinson's Retail generated $1 billion.

Table 6. **Convenience stores and their market shares in the Philippines, as of 31 December 2016**

Store name	Number of stores	Market share (%)
7-Eleven	1,995	63.29
Ministop	499	15.83
Alfamart	130	4.12
Mercury Drug (operating 24 hours)	111	3.52
Davao Central Convenience Store	107	3.39
FamilyMart	100	3.17
San Miguel Food Avenue	58	1.84
i-Mart	39	1.24
HB1	29	0.92
Lawson	27	0.86
Munsterific	25	0.79
Quixmart	24	0.76
Circle K	8	0.25
Total	3,152	Approximately 100

Source: 7-Eleven Annual Report 2016.
Note: Does not include data on non-branded or generic CVS and 24-hour hybrid grocery-CVS.

Banks in the Philippines can finance up to 60 per cent of capital for franchising operations in the retail industry. Therefore, it is relatively easy for the retailing industry to set up franchising agreements with foreign TNCs. However, if TNC retailers establish stores in the country, they need to have paid-up capital of $2.5 million or more, or if the parent company has a net worth of more than $200 million, a minimum investment of $830,000 per store is required. As a result, the country has experienced growth in organized and large retailers, namely, the growth of franchisee retail (30 per cent of total retail sales) and thus the entry of many foreign brands in the market (e.g. Forever 21, Uniqlo, Apple & Bee). The development of the retail industry is also helped by the growth in awareness of global brands among all young employees and OFWs.

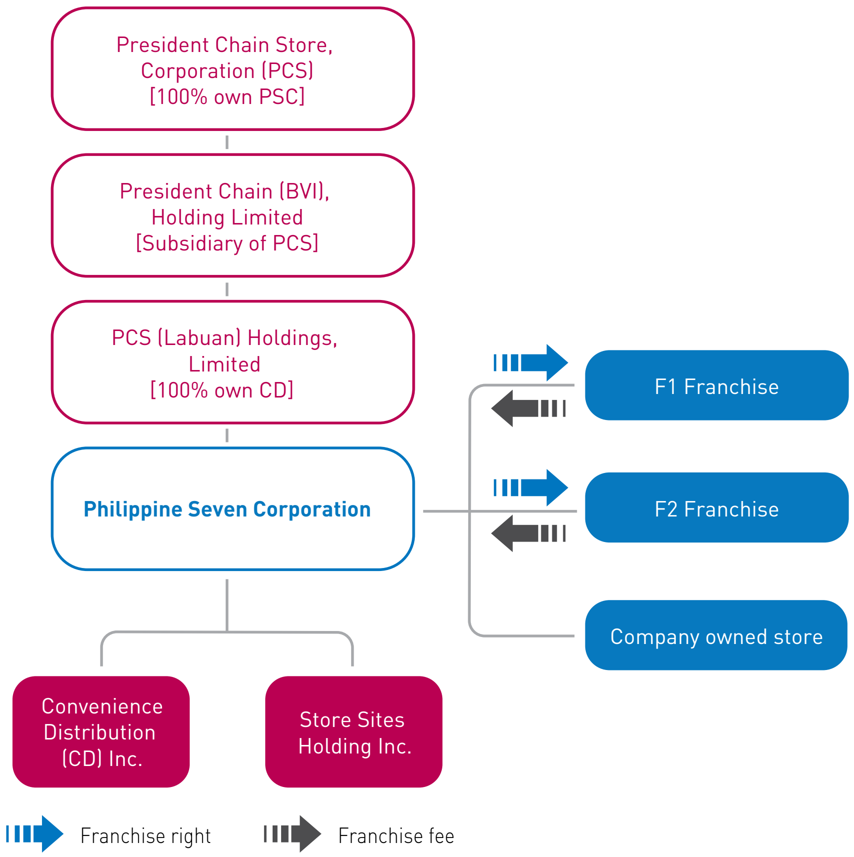
As one of the drivers of industrial development, franchising offers some benefits for both local firms that can be franchisees and TNCs that can be franchisors. In developing countries such as the Philippines, income gaps[19] between rich and poor are huge, as are knowledge gaps. Once a local firm becomes a franchisee, it can obtain benefits such as gaining know-how from foreign TNCs through a master franchisee, receiving support from a master franchisee, paying taxes, using international accounting standards and getting access to the market. As a result, MSMEs can grow faster. In the Philippines, there are many different types of franchise businesses, down to very small businesses such as sugarcane juice stands or ice cream stands in shopping malls. These small franchise businesses can be accessed by lower-income businesspeople. As for the TNC side, it is much faster and costs less to expand foreign brands in a host country.

[19] According to the PSA, the average annual income of a Filipino family in 2012 was $5,727. The income of the families in the richest decile is 10 times that of those in the poorest decile.

Box 5. **The largest convenience store in the Philippines: 7-Eleven**

Philippine Seven Corporation, with a total revenue of $652 million and total assets of $248 million as of 31 December 2016,[a] is headquartered in Mandaluyong City, Philippines. It is an affiliate of President Chain Store (Labuan) Holdings Ltd. (Malaysia), which is owned 100 per cent by President Chain Store Corporation (Taiwan Province of China). President Chain Store (Labuan) Holdings Ltd. owns 56.59 per cent of Philippine Seven Corporation in the Philippines and 100 per cent of Convenience Distribution Inc. in the Philippines (box figure 5.1). This company's case clearly demonstrates its good brand image, which results in more unit franchises or even sub-franchises in the country.

Box figure 5.1. **Conglomerate map and structure of Philippine 7-Eleven**



Source: 7-Eleven Philippines.
Note: [Equity ratio].

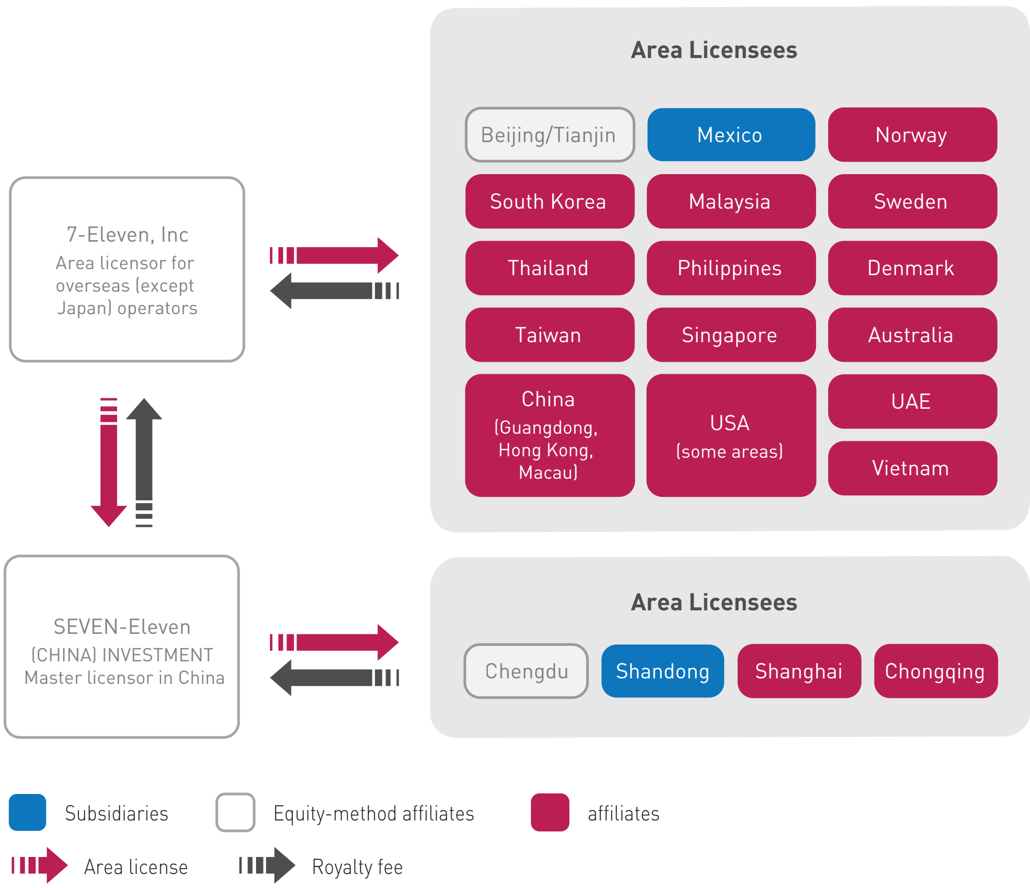
The company engages in retailing, merchandising, buying, selling, marketing, importing, exporting, franchising, acquiring, holding, distributing, warehousing, trading, exchanging and dealing in various grocery items, dry goods, food or foodstuff, beverages, drinks and other consumer products and services for residents, commuters, students and other urban shoppers. It also offers bill payment services; phone and call cards; and 7-Connect, a service that enables customers to pay utility bills and pay for selected online purchases with cash through 7-Eleven stores.

Box 5. **The largest convenience store in the Philippines: 7-Eleven** (continued)

Philippine Seven Corporation started business in the Philippines in 1982. The company was allowed to have units through franchising agreements with 7-Eleven, Inc. (United States) in 1998. As of December 31, 2016, it operated 1,995 stores comprising 869 franchise stores under FC1, in which the shopkeeper owns the store or a lessee or the store property; 235 franchise stores under FC2, in which the shopkeeper is an employee of 7-Eleven or some other company; and 891 company-owned stores. As of the end of 2016, there were 238 stores in the Visayas, consisting of 137 in Cebu, 50 in Negros, 38 in Iloilo, 8 in Aklan, 3 in Capiz and 2 in Antique. There were 101 stores in Mindanao, consisting of 74 in Davao, 19 in Cagayan de Oro, 3 in Bukidnon and 5 in General Santos City.

In 1991, 7-Eleven, Inc. became a wholly owned company of 7-Eleven Japan, under Seven & i Holdings (box figure 5.3).

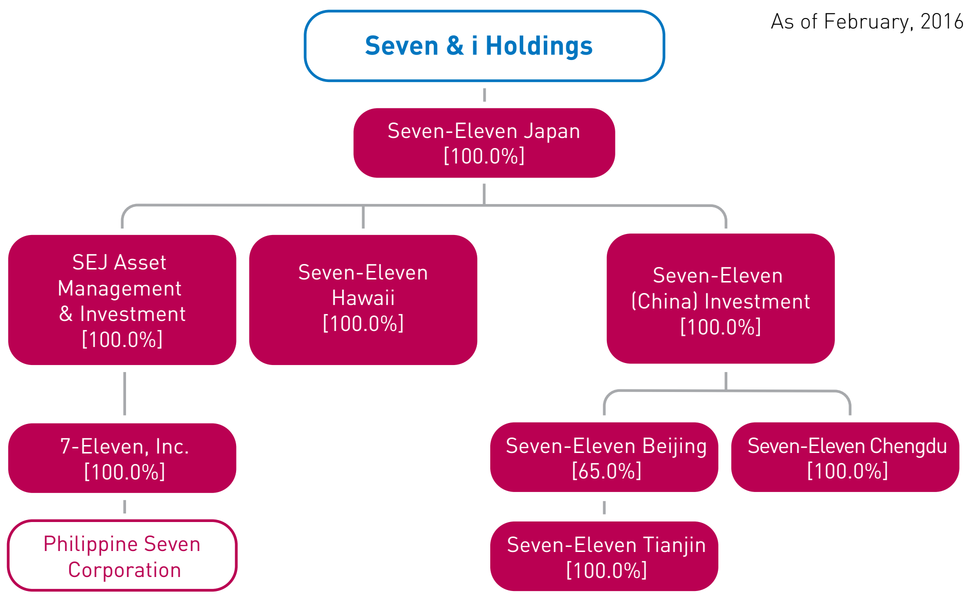
Box figure 5.2. **The company structure of 7-Eleven, Inc.**



Source: 7&I Holdings Company Profile.

Box 5. **The largest convenience store in the Philippines: 7-Eleven** (concluded)

Box figure 5.3. **The company structure of Seven & i Holdings**



Source: 7&I Holdings Company Profile.
Note: [Equity ratio].
[a] Full foreign participation is allowed for foreign retail trade enterprises (a) if they have paid-up capital of $2.5 million or more, provided that the investment for establishing a store is not less than $830,000; or (b) if they specialize in high-end or luxury products, provided that the paid-up capital per store is not less than $250,000 (Tenth Regular Foreign Investment Negative List).

In terms of job creation, employment in the industry is more than 5 million (BOI data). Each new unit of a convenience store chain employs four or five people. Franchising agreements in the retail industry can contribute to capacity building in MSMEs and in employees.

Since unit franchise stores usually learn the know-how from master franchisees or parent TNCs, NEMs occur at all stages of a GVC. The 7-Eleven case (see box 5) shows that the master franchise has to have all elements in its value chains that are needed for the retail stores' business model. In the retail industry, know-how about the business model or store operation, inventory management or brand image, and management are transferred from the TNC through franchising agreements (or a wholly foreign-owned subsidiary or a joint venture as the master franchisee). This transfer can be considered part of the investment. Once a store is opened, as a result of daily operations and activities within a store, flows of goods and services become trade activities. When they are directed abroad, they are exports. International payments and receipts of royalty fees and transfer of productive resources all relate to trade.

According to the PFA, franchising businesses have a long history in the country. For Filipinos who would like to have some kind of business (e.g. sugarcane juice stands), it is easier to start a business with a franchise agreement than to invest in a new business model. TNCs can choose NEMs to enter the country without having equity investments or can choose to enter a joint venture on a master franchise, if TNCs can find good local partners.

(4) Management contract: Hotels

International hotels operate in many countries including the Philippines, and these are operated by different types of contracts and different types of entry modes (table 7). As the inward FDI policy in the Philippines does not allow foreigners to own private land, international hotels operate either through NEMs – in other words, a management contract or franchise agreement – or on long-term leased land on which hotels can be built with equity investments.

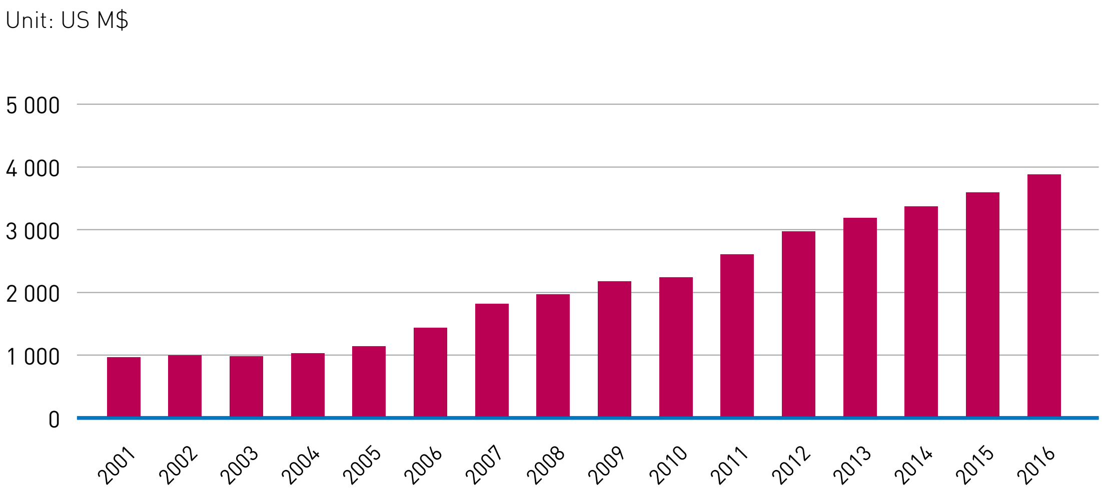
Table 7. **Hotel operations in the Philippines, by type**

	FDI	Management contract	Franchise agreement
Ownership of the land and hotel	Owns hotels	Without ownership	Without ownership
Management control	Direct control	Direct leadership by expatriates from the headquarters	Management training by the manuals
Contract fees	Not applicable	Higher (10% or more of profit)	Lower (below 10% of profit)
Scale and speed of the hotel chain	Slow, smaller-scale	Faster, medium-scale	Very fast, larger-scale
Hotel categories	first stage of hotel chain, 5 star hotel, independent type hotel	4 star class	3 star class

Source: Shinomiya (2016).

The Philippines is one of the ASEAN member countries that attracts tourists from all over the world. Market demand for hotels has been increasing continuously in the past decades (figure 7).

Figure 7. **Market size of hotel industry in the Philippines, 2001–2016**



Source: Euromonitor, from trade sources and national statistics.

Table 8 shows the number of accredited hotels and the number of employees in the different regions.

Table 8. Number of accommodation establishments by region in 2014 and number of accredited hotels and employees by region in 2016

2014		2016	
Accomodation Establishments		Accredited Hotels	
Region	Number	Number	No. of Employees
Cordillia Administrative Region (CAR)	349	45	751
National Capital Region (NCR)	405	92	18 084
Region I (Ilocos Region)	656	25	657
Region II (Cagayan Valley)	322	19	504
Region III (Central Luzon)	672	27	1 585
Region IV - A (Calabarzon)	424	23	1 174
Region IV - B (Mimaropa)	898	17	773
Zegion V (Bicol Region)	518	8	477
Region VI (Western Visayas)	892	30	1 288
Region VII (Central Visayas)	1 291	45	4 844
Region VIII (Eastern Visayas)	480	1	59
Region IX (Zamboanga Peninsula)	347	19	1 062
Region X (Northern Mindanao)	554	17	1 108
Region XI (Davao Region)	477	25	1 328
Region XII (Soccsksargen)	386	12	633
Region XIII (Caraga)	13 359	8	370

Source: Philippine Franchise Association.

Most of the top-ranked hotels in the country are known for operating world-wide. Table 9 lists the hotel brands with the top market shares in the Philippines. For example, Shangri-la Hotels, operating four hotels and resorts, had a 6.6 per cent share of the Phillipine market in 2014. Four hotel groups with top market shares in the Philippines, namely Shangri-La, Marriott, Mandarin Oriental, and New World, are owned by foreign investors (table 10).

The Hyatt Group operates NEM hotels. In June 2014, Hyatt Hotels Corporation and Melco Crown Resorts Corporation in the Philippines announced an agreement to build a Hyatt hotel, and Melco Crown Resorts Corporation has entered into a management agreement for the operation of Hyatt City of Dreams Manila. For this agreement, the foreign investor side (Hyatt Hotels Corporation) wants the hotel to represent an important milestone in their effort to build brand loyalty in locations where their guests travel frequently. As for the local firm (Melco Crown Resorts Corporation), the strong Hyatt brand name and the hotel's ideal location will attract both business and leisure travellers as well as meeting and incentive groups from across the region.[20]

[20] "Hyatt Announces Plan for Hyatt City of Dreams Manila in the Philippines" (http://newsroom.hyatt.com).

Table 9. **Market share of hotels by brand in the Philippines, 2006–2014** (Per cent)

Hotel Brand	Company name	2006	2007	2008	2009	2010	2011	2012	2013	2014
Shangri-La	Shangri-La Hotel & Resort Inc	5.1	5.2	5.0	5.3	6.2	6.2	6.2	6.3	6.6
Waterfront	Waterfront Philippines Inc	1.7	1.6	1.6	1.5	1.7	1.7	1.7	1.6	1.4
Peninsula	Hong Kong & Shanghai Hotels Ltd	1.2	1.2	1.2	1.0	1.1	1.0	1.0	1.0	0.9
Marriott	Marriott International Inc	0.9	0.8	0.8	0.8	0.9	0.8	0.7	0.7	0.7
Mandarin Oriental	Mandarin Oriental Hotel Group	1.0	0.9	0.8	0.6	0.7	0.6	0.6	0.6	0.4
Hyatt	Hyatt Hotels Corp	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Herald Suites	Nipad Inc	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Sofitel	AccorHotels Group	1.6	1.5	1.5	1.3	1.4	1.3	1.2	1.2	1.1
Others	Others	87.8	88.0	88.5	88.9	87.4	87.7	87.8	88.1	88.3

Source: Euromonitor, from trade sources and national statistics.

Two conglomerates in the Philippines, SM Group and Ayala Group, have several international hotels that, like Hyatt, use local companies for NEM operations of international hotels, although those hotels are not ranked at the top of the market. SM Prime Holdings[21] owns and operates four hotels: Radisson Blu Hotel, Park Inn Clark, Park Inn Davao and Conrad Manila. Radisson Blu Hotel is operated and owned by Carlson Rezidor Hotel Group, which does not have any subsidiaries in the Philippines. SM Investment Corporation has a management (franchising) agreement to operate the hotel. Ayala Land operates two hotels which are also from international hotel groups: Raffles Makati and Marriott Cebu.

The hotel industry links with many other industries such as online booking services, restaurant services, food and beverage services, linen services and furniture and decoration industries, as well as transport services and tourism businesses. These linkages will contribute to employment creation and the development of related industries in the country.[22] The tourism industry is one of the priority sectors in many regions: Ilocos, Mimaropa, Western Visayas, Central Visayas, Northern Mindanao, the Davao region, and the Soccsksargen and Cordillera administrative regions. The locations of hotels are partially concentrated in the central Manila area, but they are also dispersed in the different tourism regions. Thanks to the development of tourism, the hotel industry is contributing to employment and rural development because of the industry's labour intensiveness and community-based activities.

21 SM Prime Holdings, owned 49.6 per cent by SM Investments Corporation and 4.4 per cent by Hanry Sy.

22 According to the PSC (2014), 416,942 people were engaged in "Accommodation and Food Service Activities" and total income reached $8.9 billion. The breakdown of the employment is as follows: accommodation activities (91,843); restaurants and mobile food service (290,535); event catering and other food service (7,791); and beverage-serving activities (26,773).

Table 10. **Foreign investors that own hotels in the Philippines**

Hotel Brand	Company that owns the brand in the Philippines	Share (%)	Foreign investors
Shangri-La	Makati Shangri-La Hotel & Resort, Inc.	100	Shangri-La Asia Ltd. (NBB: SHAL Y)
	Edsa Shangri-La Hotel & Resort, Inc.	100	Shangri-La Asia Ltd. (NBB: SHAL Y)
	Mactan Shangri-La Hotel & Resort, Inc.	100	Shangri-La Asia Ltd. (NBB: SHAL Y)
	Boracay Shangri-La Hotel & Resort, Inc.	100	Shangri-La Asia Ltd. (NBB: SHAL Y)
Waterfront	Waterfront Mactan Casino Hotel, Incorporated	100	Waterfront Philippines Inc
	Waterfront Cebu City Casino Hotel, Incorporated	100	Waterfront Philippines Inc
Peninsula	..	..	..
Marriott	Marriott International Hotels, Inc. (Philippines Branch)	100	Marriott International, Inc. (NMS: MAR)
	Porto Bello Cove Hotel Corporation	100	Marriott International, Inc. (NMS: MAR)
	Renaissance Hotels International Corporation Limited (Philippines Branch)	100	Marriott International, Inc. (NMS: MAR)
Mandarin Oriental	Manila Mandarin Hotel Incorporated	96.20	Mandarin Oriental International Ltd. (LON: MDO)
Hyatt	Hyatt of Philippines Limited	100	Hyatt Hotels Corp (NYS: H) Hong Kong
Herald Suites	..	..	..
Sofitel	..	..	..
New World	CTF Hotel & Entertainment, Inc.	51	International Entertainment Corp
	CTF Properties (Philippines), Inc.	51	International Entertainment Corp
	Marina Square Properties, Inc.	51	International Entertainment Corp
	NCHI	51	International Entertainment Corp

Source: Euromonitor, from trade sources and national statistics.

One of the most critical factors influencing TNCs to choose NEMs in the Philippines is local regulation, which favours NEMs over FDI. Hotel management or operations are prime cases as they relate to land and estate development. In the global hotel industry, the Philippines ranked 20th in market size in 2016, while Thailand and Malaysia ranked 12th and 16th, respectively (Euromonitor). Thus, TNCs are interested in expanding into the country as a tourist destination. Since the hotel industry in the Philippines has the potential to grow further, TNCs will continue to utilize NEM operations.

3. OPPORTUNITIES AND CHALLENGES

This section provides an analysis of opportunities and challenges faced by the Philippines in promoting and utilizing NEMs. By establishing NEM agreements with TNCs, each industry can benefit from a number of opportunities. However, there are also challenges for local firms, particularly because of the characteristics of NEMs.

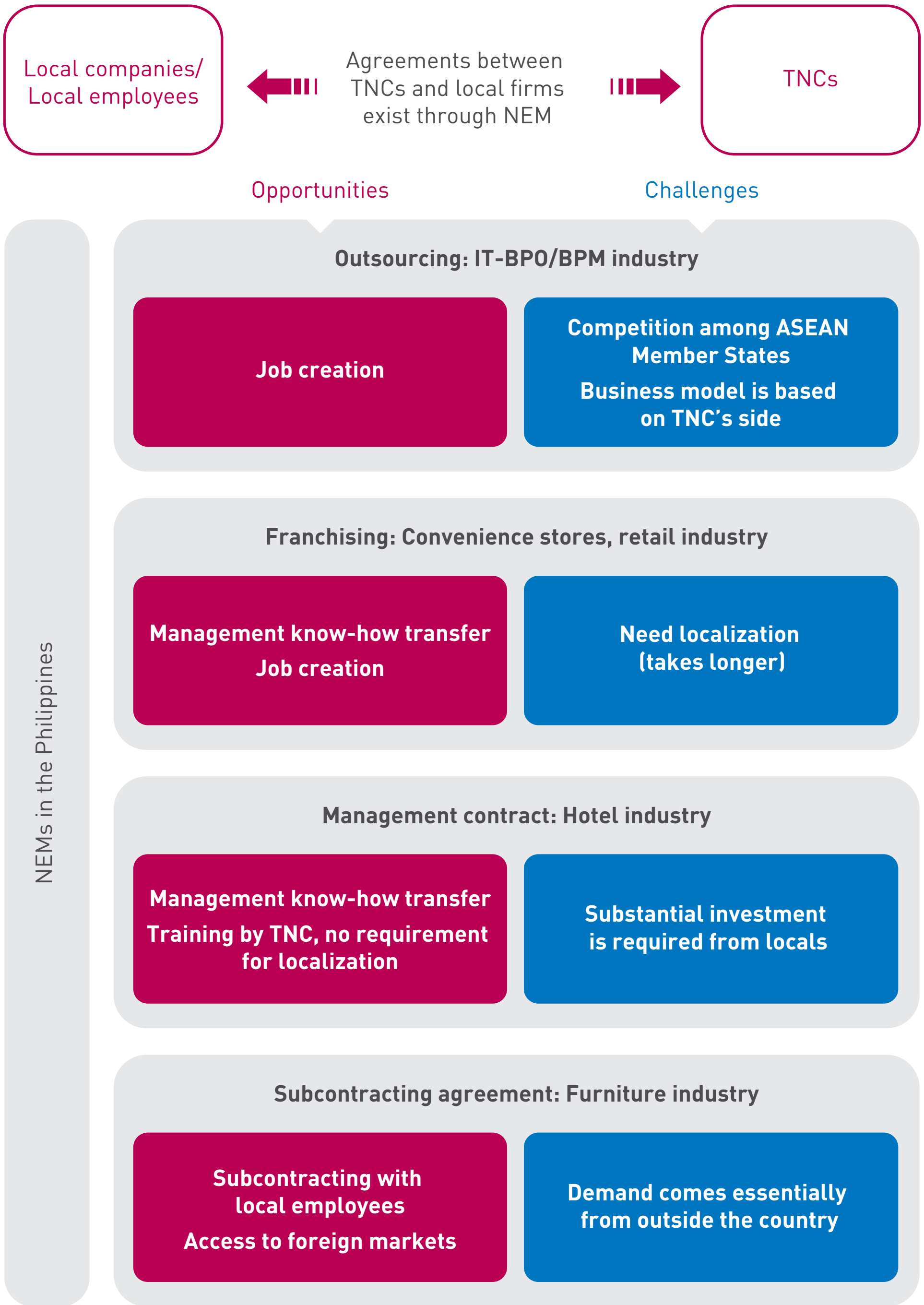
Ownership/non-ownership. If business activities are not owned by TNCs, it is easier for TNCs to enter the market through NEMs. If TNCs can find local firms that can offer services instead of their own affiliates, TNCs can contract with local firms without owning an affiliate in a host country. This is one of the advantages of having a NEM for TNCs in a host country. Therefore, there are potential opportunities for local firms in the IT-BPO/BPM, furniture, hotel and retail industries as well as other industries to have contract agreements with TNCs. Although such opportunities can be viewed as attractive by local firms, local firms need to have a minimum level of management skills, including autonomy and initiative, technological skills and capacity, as TNC support is limited. In addition, TNCs' decision making for selecting local partners and terminating contracts with them is volatile, as the contract agreements are not guaranteed for long terms and can be terminated anytime. One of the characteristics of NEMs is that demand for the particular products or services comes from outside the country and is not predictable. Since demand cannot be controlled, local firms are required to build capacity without exact knowledge of the size of NEM operations with potential customers.

Relationships between NEMs and industries. Particular modalities are in fact linked to particular industries in the Philippines. For the IT-BPO/BPM industry there is a range of modalities. There are TNC-owned subsidiaries in the Philippines that have contract agreements with customer firms outside the country. These subsidiaries create offshore outsourcing with the TNC's vendors. This type of modality creates opportunities for local employees to be integrated into the subsidiaries' business activities; however, it does not provide opportunities for capacity building for local firms. If local IT-BPO firms have contract agreements with TNCs, that creates offshore outsourcing (figure 1). Through this modality, local firms have potential opportunities to receive orders from customer TNCs located outside the country. TNC affiliates also have a modality through captive offshoring, which is done through FDI (non-NEM). Clearly, in the IT-BPO/BPM industry, particular modalities are linked to TNCs' strategies in their home countries.

Different types of modalities are also linked to the hotel industry and retail industry. For the retail industry, one case is that TNCs implement FDI, followed by NEMs. The other case is that local firms (master franchisees) make franchise agreements directly with a TNC in its home country. The activities of the unit franchise look very similar in both cases, but there are significant differences in terms of impact on local franchisees. The degree of direct participation by the foreign parent in local franchisees is minimal for NEMs. As in the hotel industry, management contracts or franchise agreements are the typical modalities engaged in by TNCs in the Philippines, though there are also hotels that are owned and managed directly by foreign hoteliers.

Ownership and control. One of the salient features of a NEM is that foreign firms and TNCs do not directly own the business activities of local firms but have indirect control of them. Local firms are not controlled through TNCs' equity. There are a number of challenges for local firms, as the contracts between local firms and TNCs can easily be jeopardized. For instance, when local firms do not meet the quality of goods or services required by TNCs, TNCs can easily terminate their contract. If the demand of the TNC shifts to a new position, and local firms do not have the capacity to meet the new demands, then TNCs can easily terminate their contracts and move to another country.

Figure 8. **Opportunities for NEM in the Philippines**



Source: AJC.
Note: Major industries only.

In the cases above, if TNCs own firms (or affiliates) in the country, TNCs directly control their activities. TNCs will make efforts to control quality by, for example, further investing in human resources or equipment for improving quality. TNCs will change their overall strategies so that the positioning of the activities in the Philippines can meet possible new demand, if there is a shift. This is related to the fact that TNCs are utilizing the local firms via NEM for their strategy – and that choice of modality reflects in part the stages of GVCs in which TNCs operate.

Under NEMs, local firms will have many opportunities for new businesses, sales growth, job creation and income growth. In order to sustain local firms' operations or activities without direct support from TNCs, local firms should create their own business activities. Whether local firms can strategically utilize TNCs by linking with them or build the capacity to do so remain the challenges for local firms.

Localization strategies. TNCs operate globally and local firms' operations or activities constitute part of their GVCs, whether they are undertaken by captive offshoring (i.e. FDI) or offshore outsourcing (i.e. NEMs). If local firms need to implement localization strategies to meet TNCs' demands, local firms will have initiatives for the operation, which in turn will create more opportunities. In the IT-BPO/BPM industry, firm operations or activities in the Philippines do not need to implement a localization strategy. What local firms do is to meet the requirements of or order from TNCs, which is one of the characteristics of outsourcing. However, the initiatives that local firms can take are limited, and they will face challenges if any negative factors arise on the TNCs' side.

In industries with franchising agreements, operations or activities – for example, in the retail industry – require a localization strategy, whereas that is not necessarily required in the hotel industry. In the retail industry, the final customers are mainly in the Philippines and demand is also within the country. Therefore, TNCs need a localization strategy to meet local customers' demand. In the hotel industry, TNCs' operations and activities in the Philippines are standardized and basically the same as other countries. In the furniture industry, as in the IT-BPO/BPM industry, firms with operations or activities in the Philippines do not need to implement a localization strategy. In any case,, in order to avoid any negative effects from the foreign client firms, local firms should make efforts to build their production capacity.

Foreign TNCs can outsource a part or the whole of any goods or services, or even part of their GVCs to the country since localization is a low priority as they are not physically present in the local economy. However, it is also true that TNCs may terminate their agreement with contracting firms, which results in costs to them as well as the local economy. Local firms' operations or activities require a localization strategy, but TNCs also need their own localization strategies, even in NEM operations. Local NEM firms are equally as important as their own affiliates in the formation of GVCs. Local firms should take initiatives independently from TNCs to integrate their operations and activities into TNCs' overall production networks and into GVCs.

Opportunities and challenges for local firms through NEMs. The issues faced by Philippine firms range from those related to agreement of the NEM to those related to industry characteristics and TNC strategies. Both opportunities and challenges can be found in each category of the issues, which are grouped into (1) continuity issues, (2) NEMs' typical issues, (3) capacity-building issues and (4) local firms' initiatives and local embeddedness issues (table 11). If local firms can strategically utilize TNCs' know-how and technological skills by linking with them, they can build capacities to deal with the challenges and even expand their businesses by using the TNCs' networks.

Table 11. **Opportunities and challenges for local firms engaged in NEM**

Opportunities	Typical industries concerned	Challenges
Continuity (footlooseness) problems		
Easier to find TNC partners both in and outside the country through, for example, matching events (since TNCs do not directly invest in the business).	IT-BPO/BPM Furniture	Easy for TNC to terminate the contract and long-term relationship is not guaranteed, if quality of services or goods do not meet TNC's standard and if local firms in other countries are more competitive (e.g. competitors in the IT-BPO/BPM industry exist in India and Viet Nam).
NEM's characteristic issues		
Easier to enter a new market or new area even when demand is not present in the country. Skills, talents or resources that are available but not required in the country can be usefully utilized outside the country.	IT-BPO/BPM Furniture Hotel	Demand and markets are outside the country (e.g. customers of the IT-BPO/BPM industry, hotel industry and industries that use subcontracting to produce products such as furniture). Demand by TNCs may change depending on the interest and taste of their clients (e.g. changes in trends for tourism destinations, furniture and home decoration tastes.)
Capacity-building issues		
Easier for local employees to work in business activities in the IT-BPO/BPM industry and the furniture industry because of their low skill requirements at the entry level.	IT-BPO/BPM Furniture Hotel Retail	Not easy for local firms to build further capacity apart from receiving orders from customers as they receive only relevant know-how at best (e.g. upgrading value chain activities through their own efforts is not easy).
Initiatives and local embeddedness issues		
Local firms adapt to foreign design and management and do not need to think about local values and a localization strategy (that is, it is quicker for local firms to make a profit by using a TNC's business model).	IT/BPO Furniture Hotel	Local firms may lose their initiative, creativity and traditional values, apart from designing for limited products in the furniture industry (e.g. local firms may follow TNCs' business models in the IT-BPO/BPM industry and hotel industry, as they do not need to implement a localization strategy).
Initiatives and local embeddedness issues		
Local firms and franchisees need to be localized, so it takes a longer time for local firms to make profits. Therefore, they need initiatives for their operations or activities leading to the embeddedness.	Retail Fast food Convenience stores	In the short term, franchisees or local firms may face difficulties in adopting TNCs' original strategies to localize taste and need to learn through experience before they become part of the community (e.g. in the retail industry, franchisees need to localize the strategy to meet local customers' demand, of which TNCs are not aware).

Source: AJC.

4. POLICY IMPLICATIONS

ASEAN countries as a whole have been attracting FDI inflows for the past decade, though FDI to ASEAN countries has slowed for the past few years, as it has in other countries.[23] In order to deal with the risks associated with inter-ASEAN relationships the Philippine government needs to aim at developing the economy, to enhance opportunities at the local level rather than developing an externally dependent economy. The government has already implemented tremendous efforts to further develop industries such as IT-BPO/BPM, hotel and retail through strengthening knowledge and industry-specific business associations. In addition to current policies that focus on developing potential employees through education and training, the challenges that local firms will face in the medium to long run centre on developing local firms' overall capabilities and mainstreaming sustainable development in NEM operations, which might be helpful in becoming an economy in which people see opportunities at the local level.

4.1 Enhancing capacities of local firms

Local firms' capabilities in both technological and management skills should be enhanced so that they can meet TNCs' current and potential demand. Once these necessary capabilities have been attained, firms can have more initiative or autonomy in their operations; they can find potential customers through networks; and independently from TNCs in terms of autonomy or initiatives, they can then create their own business activities in the long run.

In order to enhance local firms' overall capabilities, the government needs to provide support at two levels – the individual firm level and the industry level.

At the individual firm level, the government needs to support the following efforts:

- Implementing continuous internal training for employees within local firms. Local firms need to train employees for higher job skills. Judging from the results of the interviews done for this study, not all local firms implement continuous or regular training because of the costs incurred. Direct or indirect financial supports for training would help local firms focus on internal training tailored to the needs of the firms themselves or focused on demand from their client TNCs.
- Establishing a learning centre where local firms can learn about NEM operations or activities. Local firms need to be aware of the changes and future demand in their industries rather than focusing only on current operations. The government can support this learning by being a facilitator that connects individual firms with potential customers. The centre would cover all aspects of NEM in forming, executing and evaluating contracts, as well as operating.
- Creating a conducive environment for local firms, to facilitate their globalization and localization strategies. To meet current and potential demand by TNCs and to integrate with TNCs' current and potential GVCs, local firms need to be familiar with TNCs' changing strategies. Each firm needs to learn about their customers' strategies. The government can offer support for different

[23] BRIC countries (Brazil, Russian Federation, India, China) experienced a 4.16 per cent decline (2015) following 2.61 per cent growth (2014). Mercosur countries experienced a 1.47 per cent decline (2015), following 15.96 per cent growth (2014) after a 30.78 per cent decline (2013). Middle Eastern and North African countries experienced a 0.61 per cent growth (2015) following a 16.24 per cent decline (2014). Sub-Saharan African countries experienced a 12.92 per cent decline (2015), following 20.04 per cent growth (2014), and a previous 0.19 per cent decline (2013) (UNCTAD STAT).

types of strategies, introducing good practices in different industries at the individual level, rather than simply offering support for an industry as a whole.

At the industry level, industrial or business associations and the government can work toward the following goals:

- Creating an environment for competition and cooperation between local firms. Local firms need to ensure continuity in their operations or activities by enhancing their capabilities, as they compete among themselves. Local competition implies that a number of firms will become competitive enough to become TNCs' partners or vendors. The government could help create a better environment for firms to compete against each other and cooperate with each other so that NEM industries as a whole become more competitive.
- Promoting local firms to a higher position in GVCs. Shifts in demand by TNCs and changes in TNCs' GVCs in the Philippines derive mostly from TNCs' requests for cost reduction. If each local firm can upgrade its value added activity, they can attain higher levels of value chains, both horizontally and vertically. The government can promote local firms' capabilities explicitly by supporting innovation and technical upgrading. Only then may such firms partner with foreign TNCs in NEM operations.
- Putting an innovation policy in place for local firms to encourage and protect technologies they need in order to operate under NEMs. Competition to become a TNCs' NEM partner is high. For example, in the IT-BPO/BPM industry there are competitors in India or Vietnam that offer services with lower prices. Particularly if the services offered by local firms are standardized and are not required to be localized, competition will be much more severe. An innovation policy is required in any event as the Philippines will eventually face a middle-income trap like those that other advanced ASEAN member states have faced or are facing. Innovations flourish only when they are protected by proper intellectual property rights. Such protection is still at a premature stage in this respect, as the country is classified as "transition from stage 1 to stage 2" level (the second lowest in terms of development stage), according to the World Economic Forum's Global Competitiveness Index 2016–2017. In addition, on the innovation and sophistication factors the country is ranked 53rd with a score of 3.76.[24]
- Protecting local employees from unreasonable conditions. There are some benefits to being employed by NEM firms. For example, among the IT-BPO/BPM firms surveyed for this study there is no minimum educational level and educational background is not assessed, as long as employees are over 18 years old and willing to take the firms' internal training. There are opportunities for those who did not finish their school or college to work for the industry. It is an attractive industry to work for; however, it is also important to note that the turnover ratio can be high.[25] IT-BPO-BPM employees have to work for different markets, which are usually in different time zones. For example, the first shift starts at 9 pm for the United States market, takes a break at 1 am, and continues working for another four hours. Because firms in the IT-BPO/BPM industry in the Philippines are open 24 hours a day, to meet demand from different regions, employees may need to work very different hours from their family members. In addition, the industry is dynamic; employees need to learn new things for new products or services by attending regular internal training. Although firms make efforts to offer various engagement activities for employees,[26] the turnover ratio remains

24 Singapore is ranked 12th and has a score of 5.25. Malaysia is ranked 20th with a score of 4.94. Thailand is ranked 47th and has a score of 3.85. Viet Nam is ranked 84th and has a score of 3.47 (World Competitiveness Report).

25 Firms in the survey responded that the turnover ratio is low for game developers, but high for workers in animation and call centres (voice). The average turnover ratio was 40–45 per cent and the highest was 70 per cent.

26 At a corporate level, there are sports festivals, some parties and a summer event for all employees. One firm also hosts various activities such as a Halloween party at the team level. To keep employees motivated, firms offer incentive programs for attendance or performance. They also offer incentive programs for periods when many employees do not come to work, e.g. after a longer holiday.

notable. In addition, local employees need to be protected by some labour policy for the industry, as current working environments or conditions do not necessarily meet global standards.

4.2 Mainstreaming sustainable development

As local NEM firms and their foreign clients have no equity relationship, the normal TNC governance of foreign affiliates in host countries is sometimes almost absent. In the IT-BPO/BPM industry, firms surveyed for this study mentioned that they follow their customers' compliance level and guidance, and not their local firm's standard. Clients from the United States and Europe, and recently from Japan, have increased the monitoring of human rights in suppliers outside their own countries and presented their own guidance, based on international guidelines. In the furniture industry, subcontracted workers of local NEM firms are a part of foreign clients' supplier networks; however, clients have no direct contact with these subcontracting workers. Even though some foreign clients have implemented corporate social responsibility principles at local NEM firms, these principles are not necessarily conveyed to subcontractors. The Philippine government does not have its own compliance standards, but it cannot rely only on foreign clients' home-country compliance level and guidance. The foreign clients of NEM firms have their own compliance standards. The business community needs to have guiding principles such as the UN guiding principles on business and human rights. According to the UN's guidance,[27] human rights due diligence "should cover adverse human rights impacts that the business enterprise may cause or contribute to through its own activities, or which may be directly linked to its operations, products or services by its business relationship" (p. 17).

4.3 Improving institutional setting

In the Philippines, unlike other ASEAN member countries, total imports exceed total exports, and this trade deficit has been increasing continuously.[28] However, the current account balance of the Philippines has been continuously in surplus for the last 10 years,[29] as the trade deficit has been offset by overseas remittance inflows[30] – a unique characteristic of the Philippines. Lower FDI levels is another characteristic: FDI flows into the Philippines in 2016 were one half to one third of the FDI stock in neighbouring countries such as Malaysia, Thailand and Viet Nam. Since sources of FDI inflows for these neighbouring countries are from manufacturing industries, there is a positive relationship between FDI inflows and the percentage of GDP contributed by the manufacturing sector.[31] Although the manufacturing sector (industrial sector) accounted for a share of 31 per cent of GDP in 2015, only 16 per cent of total employment is in this sector. This also shows that overall growth in the manufacturing sector has continued to be limited. Most of the decline in agriculture

27 United Nations (2011), "Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework", by the United Nations Human Rights Office of the High Commissioner. New York and Geneva.

28 In 2016, the Philippines recorded a trade deficit of $28.5 billion, while Thailand had a trade surplus of $61.3 billion and Malaysia $17.5 billion (IMF).

29 In 2016, the current account balance of the Philippines rose to $3.1 billion, while Thailand reduced the balance to $45.9 billion and Malaysia to $4.7 billion (IMF).

30 In 2016, the Philippines recorded remittance inflows of $29.1 billion, while Thailand had $5.3 billion and Malaysia $1.7 billion (World Bank, Migration and Remittances Statistics).

31 For instance, manufacturing industries in the Philippines accounts for 31 per cent of total GDP whereas Malaysia (36 per cent), Thailand (36 per cent), Indonesia (40 per cent) and Vietnam (33 per cent) have higher ratios (World Bank, 2015).

and manufacturing as a share of GDP and of employment has been absorbed by the expansion of the services sector, such as in the IT-BPO/BPM, hotel and tourism, and retail industries.

Two directions of policy implications emerge from these characteristics. The first is the creation of local employment. Continuous growth of remittance inflows from OFWs is one of the government's strategies, partly to alleviate a high unemployment rate. Recent trends show that industries such as the IT-BPO/BPM industry may be able to absorb current OFWs. If OFWs could work locally, the economy would not have to rely on remittance inflows to offset the trade deficit. However, in order to achieve this shift, the government needs to help respond to the industry's dynamic changes, including replacement of some low value added tasks in call centres by machines or by suppliers outside the country. It seems that although having NEM foreign clients is beneficial for society and the economy for a while, having contracts is not enough to ensure economic and social improvement over time. Developing human capital is crucial to moving into higher value added activities in NEM operations. Policies in areas such as education, training, workforce development and capacity development of local NEM firms are therefore important. The IT-BOP/BPM industry is dynamically evolving as the business environment has been changing so rapidly. NEM firms should be agile, niche-specific and capable of handling tasks under this environment.

The second direction is promoting NEM policy as well as FDI policy. In addition to the current industrial policy encouraging FDI in manufacturing, the government could pursue industrial policy to encourage NEM agreements with foreign NEM clients. The country's current FDI is lower than that of neighbouring ASEAN countries. However, some service industries under NEMs are more attractive for foreign NEM clients than for neighbouring countries. Competitive advantages can be found in the areas of good design, communication in English and a business culture in which the franchising business has a long history in diversified industries. TNC clients look for opportunities to have NEM agreements in the country. NEMs offer the potential of contributing to economic and industrial development, improving the trade balance with smaller remittance inflows, and creating employment. To realize this potential, policies are important in areas such as implementing human rights guidelines, compliance and governance guidelines in all suppliers (including subcontracting MSMEs with local NEM firms) under NEM agreements. These two directions can be considered as the main government strategies for the sustainable development of the Philippines.

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Within the overall policy framework of NEMs articulated above, the government may want to evaluate the state of NEM or NEM-like operations in the country. Assuming that there is no such evaluation methodology currently, the AJC proposes the following checklist (table 12). This proposal is based on the corporate code of conduct of the Tokyo Chamber of Commerce and Industry. It provides some hints for the government to use to check on whether NEM agreements and operations comply with a certain level of international standards from the viewpoints of foreign NEM clients, local NEM firms, local NEM firms' sub-contracting firms and local employment standards.

Table 12. **Checklist for NEM agreements and operations to maximize benefits from and minimize costs with NEM** (continued)

NEM policy of the Philippine government	Compliance with laws	Whether there is an agreement on contract performance
		Whether there is an agreement on contract terms (duration)
		Whether there is an agreement on contract termination and its process
		Whether there is an agreement on contract arrangement (additional contracts) and its process
	Respect for human rights	Whether there are rules on non-discrimination
		Whether there are rules on basic human rights
		Whether there are rules on harassment (power balance between NEM local firms and TNC)
	Environmental consideration	Whether there are guidelines on air pollution by local NEM firms
		Whether there are guidelines on water contamination by local NEM firms
		Whether there are guidelines on environmental friendly goods or services by local NEM firms
	Work environment	Whether there are employment rules (laws) on age under the NEM agreement
		Whether there are employment rules (laws) on gender under the NEM agreement
		Whether there are guidelines on a safe and pleasant work environment for local NEM firms
		Whether there are employment rules (laws) on working environments under the NEM agreement
		Whether there are employment rules (laws) on working conditions under the NEM agreement
		Whether there are employment rules (laws) on working hours under the NEM agreement
		Whether there are employment rules (laws) on taking holidays under the NEM agreement
		Whether there are employment rules (laws) on treatment of absence under the NEM agreement
		Whether there are employment rules (laws) on maternity-related leave under the NEM agreement
		Whether there are guidelines on provision of support system of childcare and nursing care
		Whether there are employment rules (laws) on terminating employment contracts under the NEM agreement
	For local firms' development	Whether there is a program through local NEM firms can improve their technology/capacity
		Whether there is a program through which local NEM firms' employees can learn
		Whether there is a program through which local NEM firms can gain an understanding of NEM policy
		Whether there is a program through which local NEM firms can gain an understanding of the business environment of the industry
	Subcontractors/ suppliers	Whether there are guidelines for similar NEM policy for local sub-contractors and suppliers

Table 12. **Checklist for NEM agreements and operations to maximize benefits from and minimize costs with NEM** (concluded)

For TNCs, required by the Philippine government	Earning the trust of customers and consumers	Whether there are guidelines for TNCs to provide correct information on their products or services
	Mutual growth with partner companies	Whether there are guidelines for TNCs to respect free and fair trading rules
		Whether there are guidelines for TNCs to provide relevant information required for trading
		Whether there are guidelines for TNCs to develop relationships based on trust with local NEM firms
	Coexistence with local communities	Whether there are guidelines for TNCs to establish and maintain a good relationship with local communities where local NEM firms are located

Source: Adopted from "Corporate Code of Conduct, the Third edition" by the Tokyo Chamber of Commerce and Industry (2013).

5. POSTSCRIPT

Dialogue at the 2017 seminar, "Changing Trade and Investment Landscape in ASEAN and the Philippines", between the Secretary General of the AJC, commenters, and presenters[32] confirmed (1) the positioning of NEM in the Philippines and (2) the importance of NEM as well as FDI. Following our policy recommendation in this country report, we would like to summarize our concluding remarks at the seminar.

5.1 Positioning of NEM in the Philippines

In the Philippines, the use of NEMs is a phenomenon widely seen in the country but usually classified as global strategic partnerships (GSP) or global strategic alliances (GSA). The volume of NEM production and exports in the Philippines has been increasing, to reach an estimated $40 billion and $32 billion, respectively, in 2016. NEMs were estimated to account for 42 per cent of exports in 2016.

We have looked at four major industries that use NEMs, namely, the IT-BPO/BPM industry, furniture industry, retail industry and hotel industry. However, from the Philippines' perspective, the agriculture sector is also considered very important for NEMs. Some agricultural products are exported to be sold in supermarkets such as Tesco (United Kingdom) as a private brand, which are also examples of NEM. In the ASEAN Economic Community, ASEAN countries have a characteristic "single market and single production" base, of which the seaweed, tuna and coconut industries are considered as clear examples in the Philippines. These industries are very important because the participants are from SMEs and MSMEs. For example, a conglomerate company requires 2,000 ha to organize 2,000 farmers. This is the challenge for the Philippines, as in order to have more employment impact

[32] The Secretary General of ASEAN-Japan Centre is Masataka Fujita. Commenters were Senen M. Perlada, Director, Export Marketing Bureau, DTI, and Dr. Ramon L. Clarete, Professor, University of the Philippines. Presenters were Dr. Chie Iguchi, Associate Professor, Keio University, and Penny S. Bongato, Executive Director for Talent Development, IBPAP. The seminar was held at Makati Diamond Residences in Makati City, Metro Manila, on 29 September 2017.

through the use of NEMs for exporting agricultural products, government supports for facilitating and organizing cooperatives are necessary.

Philippine exports of goods and services account for about 38 per cent of GDP. Services are particularly important, driven by the IT-BPO industry. That industry is a key export sector and considered a champion for NEMs in the Philippine Export Development Plan 2018 to 2022. In the case of franchising and licensing, industries such as furniture, retail and hotel are considered under-achievers. The Philippines is particularly promoting franchising in ASEAN, since the country is the one of the best resources for franchising and can be a platform for ASEAN if TNCs come to the Philippines.

The current situation in the Philippines can be described as a hybrid. Before 1996, the functioning of the entire value chain of a firm was taken care of and organized by the firm, from the first step to the final product. Due to cost reductions in trade and through the use of information and communication technology, various stages of the value chain are now handled by various firms, in GVCs. The industries in the Philippines that are involved in GVCs are human resource driven or resource cost driven, rather than technology driven.

In the case of the IT-BPO industry, the Philippines' comparative advantage is in human resources as well. The IT-BPO industry has slightly different characteristics than the other three industries since the industry uses both NEMs and FDI. Through FDI, TNCs have generated a lot of innovation and brought artificial intelligence to the Philippines. The limitation on growth in the Philippines is the ability to hire qualified people, which foreign clients need. Therefore, if local NEM partners can improve skills in technologies, that would generate more NEM clients in the country. So, the Philippines needs to improve its skills, its human resources, and its abilities to address the needs of the future now.

In this report, hotel management was included as an example of NEM operations. Hotels are usually assets of TNCs, and Filipino partners do not own them. The Philippines can provide well-trained human resources; however, hotel management services, which is the core of the business, is protected by certain brand-name TNCs that have hotel management know-how. The industry is important for the Philippines, and the government should continue to promote this particular group of activities.

5.2 Importance of FDI as well as NEM

The executive director for talent development of the IBPAP stressed that NEM contracts between SMEs and TNCs are significant in the IT-BPO industry. However, they also are highly volatile and could move to another country tomorrow, as discussed in the report. A professor from the University of the Philippines also stressed that the country still needs FDI, which can be expected to generate external spillovers into the country, since the Philippines does not have basic capabilities as an industrial country. As a development strategy, the Philippines cannot focus only on NEMs as an industrial development policy since they are more risky for sustaining long-term development of the economy. To really grow the economy, the Philippines needs continuous FDI in the manufacturing sector and other industrial sectors in addition to NEMs.

As Philippine firms move up the value chain, they require technology and capital. The more FDI there is, the more relaxed will be the country's capital constraints. NEMs are not a substitute for FDI, but it is important to consider NEM as a complement FDI.

5.3 Concluding remarks

According to the professor's comments, there are 1.5 million Filipinos looking for jobs each year. Among them, 250,000 people will go abroad as OFWs. Another 250,000 go into formal sectors including the IT-BPO/BPM industry. The rest either remain unemployed or enter formal but low-value sectors. The Philippines need to develop a structure for more long-term employment. One source could be subcontracting employment in the furniture industry, and potentially in agriculture as well, but the most developed source is the IT-BPO/BPM industry. NEMs can help with the current employment problem, but more industries and sectors need to be involved in these arrangements.

The DTI sees NEM as very important, and considers that the government cannot attract only foreign investors for FDI. There are risks for companies as well as many opportunities. This is a reality the government has to be aware of and has to monitor. In the report, there are many ways in which Philippines companies can get involved in NEM. The DTI appreciates policy recommendations and will look at the recommendations for how they can improve participation in GVCs.

Although NEMs are similar to GSP or GSA, they do not replicate GSP or GSA. They go beyond what the Department has learned about strategic alliances in the sense that the companies are more involved, and at the same time NEMs provide local companies, including SMEs and MSMEs, more opportunities. TNCs are moving toward that particular mode. Thus, TNCs can provide a lot of opportunities, yet also brings costs or challenges.

As mentioned during the dialogue, some agricultural producers operate under NEM arrangements and they are very important for SMEs and MSMEs, as the influence of NEMs in the production process can extend to the household level. Some agricultural production does not need equity, just a contract for exporting. The Philippines has been playing an expanding role in global trade and has learned how to be part of global trade, and has a coordination role in several production activities in several countries. It is important to consider whether there are policies in areas such as human rights, compliance and governance for all suppliers (including subcontracting MSMEs with local NEM firms) like those in table 12 for SMEs and MSMEs that are involved with GVCs through NEMs.

From the dialogue at the seminar, it is clear that the Philippine government recognizes the importance of NEMs and looks for measures to facilitate or promote NEMs, particularly in franchise licensing (the "under achiever") as well as in IT-BPO (a champion).

Upgrading levels of technologies and skills is equally important for moving up in GVCs. Local capacity building is critical for all industries, whether human resource driven or technology driven. For NEMs, rather than receiving orders from TNCs, local NEM firms need to build their own capacity and technologies, to make their own learning systems. This can apply to all NEMs. However, it is not easy to achieve in isolation – or by local MSMEs or SMEs. Learning systems supported by the government are necessary in all the sectors involving NEMs, including agriculture. As a result of such support, local firms would have more initiative to move up the ladder of GVCs in the services sector.

It was also mentioned during the dialogue that there is no doubt that for the next five to ten years, the Philippines will see progress as a result of this phenomena of NEMs and that the Philippines is promoting participation in GVCs through NEMs. Participants noted that they were impressed to see how industries in the Philippines are involved in NEM.

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ANNEX

Changing Trade and Investment Landscape in ASEAN and the Philippines

Makati City, Philippines 29 September 2017

TIME	ACTIVITY
08:30 – 09:00	**Registration**
09:00 – 09:10	**OPENING REMARKS** **Undersecretary Nora K. Terrado** Department of Trade and Industry

Part I: Non-Equity Mode of International Trade

TIME	ACTIVITY
09:10 – 09:30	**INTRODUCTORY REMARKS ON NON-EQUITY MODE OF INTERNATIONAL TRADE** **Secretary General Masataka Fujita** ASEAN-Japan Centre
09:30 – 09:50	**CURRENT SITUATION OF NEM IN THE PHILIPPINES** **Ms. Penny S. Bongato** Executive Director for Talent Development IT and Business Process Association of the Philippines
09:50 – 10:20	**REPORT OF THE PHILIPPINE COUNTRY PAPER** **Dr. Chie Iguchi** Associate Professor of International Business Keio University
10:20 – 10:40	**Open Forum**
10:40 – 10:55	**Coffee Break**
10:55 – 12:00	**INTERACTIVE DIALOGUE** **Facilitator:** **Secretary General Masataka Fujita** ASEAN-Japan Centre **Commentors:** **Mr. Senen M. Perlada** Director, Export Marketing Bureau Department of Trade and Industry **Dr. Ramon L. Clarete** Professor, School of Economics University of the Philippines **Dr. Chie Iguchi** Associate Professor of International Business Keio University

			Ms. Penny S. Bongato Executive Director for Talent Development IT and Business Process Association of the Philippines
			Mr. Yasushi Ishida Master of Ceremonies
12:00 – 13:30	**Lunch**		

Part II: Global Value Chains in ASEAN

13:30 – 14:10	**GLOBAL VALUE CHAINS IN ASEAN: A REGIONAL PERSPECTIVE**		
	Secretary General Masataka Fujita ASEAN-Japan Centre		
14:10 – 14:30	**COMMENTS**		
	Dr. Josef T. Yap Professor, School of Economics University of the Philippines		
14:30 – 14:40	**Coffee Break**		
14:40 – 15:20	**GLOBAL VALUE CHAINS IN ASEAN: THE PHILIPPINES**		
	Secretary General Masataka Fujita ASEAN-Japan Centre		
15:20 – 15:40	**COMMENTS**		
	Dr. Francis Mark A. Quimba Research Fellow Philippine Institute of Development Studies		
15:40 – 16:00	**INTERACTIVE DIALOGUE AND OPEN FORUM**		
	Facilitator:	**Secretary General Masataka Fujita** ASEAN-Japan Centre	
	Commentors:	**H.E. WIN NAING**	
		Ambassador Extraordinary and Plenipotentiary Embassy of the Republic of the Union of Myanmar	
		Ms. Jenni McEwin First Secretary, Economic Section Australian Embassy in the Philippines	
		Dr. Josef T. Yap Professor, School of Economics University of the Philippines	
		Dr. Francis Mark A. Quimba Research Fellow Philippine Institute of Development Studies	
16:10 – 16:30	**SUMMARY AND CLOSING REMARKS**		
	Secretary General Masataka Fujita ASEAN-Japan Centre		
	Dr. Yuka Kubota Master of Ceremonies		

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