



An executive whitepaper written by Aptium Global, Inc.

Sourcing From China: Everybody's Doing It, So Why Should We?

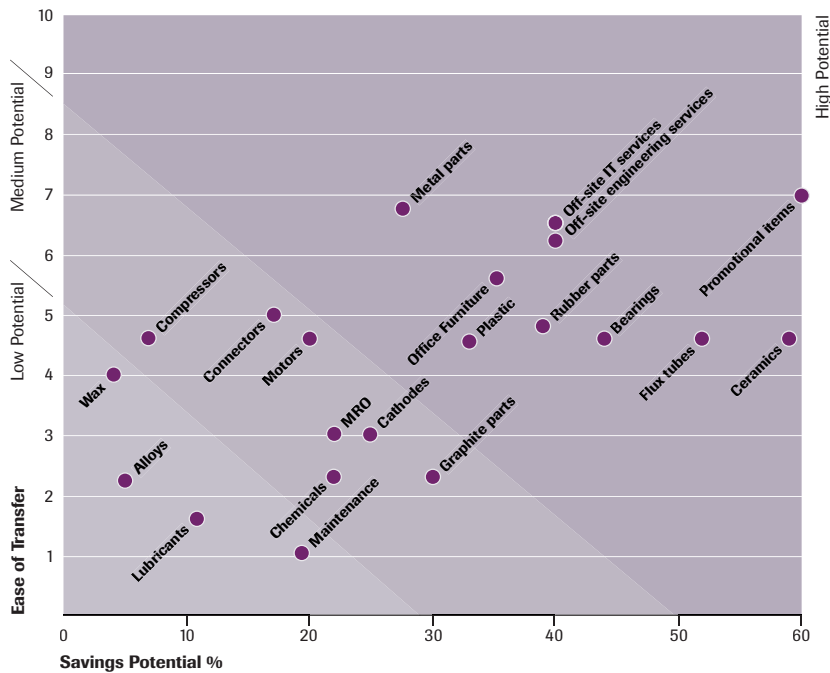
I. Executive Overview

You only have to crack open the cover of any major business magazine to realize that Low Cost Country Sourcing (LCCS) has become the current centerpiece of most cost reduction strategy discussions. But is it right for all companies, and appropriate for small to medium sized enterprises? While global sourcing, from China or elsewhere, clearly presents opportunities for companies in the manufacturing sector, many of these opportunities also bring significant risks. The good news is that we believe that small and medium size industrial product companies who deploy the right LCCS strategies can have their cake and eat it too—provided they dine with the right partner.

One of the first questions most organizations have when considering a global sourcing strategy is the potential impact LCCS can bring to their operation. While the exact savings varies by company, Figure 1 highlights the size of the potential LCCS opportunity, by spend category, for a typical industrial organization.

Figure 1
LCCS Opportunity by Category

Sources: Aptium Global, FreeMarkets



While these numbers look impressive on paper, organizations must think in terms of total cost versus unit cost in looking at actual savings opportunities (a distinction we will discuss in more detail later). It's also critical to realize that LCCS is not just about saving money through a one-time cost reduction. While the near-term benefits of basic cost savings can be huge, the commitment to operate globally also brings with it considerable benefits that overtime may even exceed initial cost savings. For example, operating globally allows an organization to access market information and develop new sales channels. It can also create a cultural awareness that encourages overseas sales and cooperative ventures that would have been unthinkable prior to the organization's exposure to LCCS. In fact, for many companies, sourcing from low cost countries is often the first step toward selling into that country. For example, Ford and GM, which once saw China as simply a market that could reduce their purchasing costs, are now actively selling cars into what has become one of the fastest growing economies in the world.

In addition to lowering costs, purchasing from emerging markets like China or countries in Eastern Europe can provide a company with access to some of the very latest manufacturing and engineering capabilities. Contrary to what critics of LCCS would have us believe, buying from overseas does not mean compromising quality. Much of the huge growth in emerging markets has come about by way of very recent investments in the latest technology and production equipment. In fact, thanks to large investments by outside countries and organizations, manufacturing capabilities in emerging markets are often more modern than those available locally. In 2003, China overtook the US as the largest recipient of Foreign Direct Investment (FDI), and continues to build its manufacturing capability through massive investment in technology and infrastructure.

These benefits—substantial cost savings, increased market knowledge, new sales channels—and the latest engineering and manufacturing processes can create competitive advantage for organizations, large and small. But LCCS can also provide other less tangible, but still important benefits. These include:

1. **Hedging supply risk**
based on changes in supply and global availability
2. **Currency hedging**
the ability to take advantage of (or mitigate against) currency fluctuation that may impact the price of sourced and finished goods
3. **Opportunistic sourcing scenarios**
when the price of a commodity or product is in a state of flux

II.

The LCCS Challenge

So far, we've explained some of the benefits that LCCS can bring. Early adopters stand to reap greater benefits than those that join later. But game changing plays also involve risk. Our experience suggests that there are many challenges that small and medium sized organizations will need to address. Deploying the right LCCS strategy is not easy. Even in the planning stages, companies need to think about some of the risks LCCS can bring. These include:

- **Selecting the right products to move offshore and selecting the right products to keep with current suppliers**
- **Qualifying overseas suppliers**
- **Maintaining supply chain flexibility**
- **Keeping inventory carrying costs down and managing stock levels with an extended supply chain**
- **Creating transparency over the suppliers' manufacturing schedules**
- **Managing logistics without acquiring additional headcount and associated costs**
- **Ensuring that suppliers produce and ship products that meet quality standards and developing a process to handle defective materials**
- **Currency risk fluctuation or local inflation in Low Cost Countries**
- **Maintaining intellectual property rights**

While this list might sound daunting, it does not have to be. To overcome these challenges, companies can work with third parties that bring relevant strategic and tactical expertise. In addition, organizations need to look at LCCS risk like a pilot viewing a flight deck. While the areas that require attention might appear overwhelming at first, with the right experience, organizations can bring the important criteria into focus, while leaving the rest to be assessed and monitored in the background.

Though all of these risks need to be addressed as part of a LCCS effort, our experience suggests that two factors often make or break the LCCS strategy. These factors include inventory/forecasting and quality:

Factor 1

Inventory and Forecasting

Prior to entering a LCCS relationship, a manufacturer should model the impact of the strategy on inventory management practices. Additional inventory in the system may eliminate any potential savings garnered from the supplier.

Inventory planning depends upon a number of factors that span from understanding the customer's demand to having a reliable raw materials supply. However, when manufacturers transition from internally manufactured items or local suppliers to low cost country sources, they typically need to adjust their inventory planning practices.

LCCS typically inhibits some of the leading inventory planning practices currently employed by manufacturers and their customers. Factors such as longer lead times and trans-ocean logistics typically work against a manufacturer's desire to reduce lot sizes and network inventory. Importing goods also reduces a manufacturer's ability to handle expedited deliveries to cover poor planning or quality issues.

Beyond the changes in lot sizes, is additional lead time needed to navigate both the bureaucracy and the ocean trip the goods will take? Lead time factors are also influenced by weather, the political climate, and current events. The most challenging aspect in projecting lead times relates to variability. How can a company plan for events like a change in the terror alert status or longshoreman strikes? While some events may be anticipated like impending contract expiration, others may not provide a level of predictability sufficient to be of use.

Factor 2

Quality risk

Low Cost Country Sourcing programs present a multitude of quality challenges a firm must manage successfully for the strategy to pay off. A container full of product at a favorable total cost of ownership is still worthless if the goods arrive damaged, corroded, or defective from the supplier.

Companies relying on low cost country suppliers must vigorously manage the products quality beyond the product's form, fit, and function to include packaging, labelling, delivery, documentation, etc. Quality products are merely the pre-requisite. Supplier quality must be measured in other terms such as customer service attributes and how effectively the supplier has executed cost reduction initiatives.

There are a number of methods companies can deploy to effectively manage total quality with their overseas vendors. Companies should go beyond specifications in a purchase order and set tangible quality standards via samples or photographs.

In addition to inventory, forecasting and quality risk, there are a number of other considerations that companies should consider in developing a LCCS strategy. These include:

The Role of Quality Agents

LCCS also may involve a single sourcing strategy. Relying upon a single supplier to deliver quality products may introduce specific risks, however. Manufacturers using a sole source strategy need to closely monitor the supplier's quality performance through verification. The current practice is to employ an agent to perform a quality assessment. While sourcing and quality agents may save money, the manufacturer needs to ascertain if the agent has the same attention to details and standards. At the onset of using a quality agent, the manufacturer should shadow the agent during the same quality assessments and in process/delivery inspections or shipment approvals. The manufacturer then may "calibrate" the agent's perception and level of acceptability to the internal standards.

Defects, Claims and Returns

Manufacturers should spell out contractually how returned and excess materials will be managed. If the materials are to be returned to the supplier for credit, identify the protocol for defect assessment and data gathering. Returned product assessments provide valuable quality information that should be incorporated into the manufacturer's product improvement and warranty plans.

Include Liability Language

Liability issues must also be well understood and managed. Liability typically emanates from a defect in design or manufacturing. Who is responsible for a manufacturing defect and how is that structured in the purchase agreement? How will claims be managed and in what jurisdiction? No one likes to talk about liability before an event occurs. Appropriate indemnity clauses need to be incorporated into the sourcing engagement and contract process. Internally, the manufacturer should understand the nuances relative to the supplier's local laws.

Other quality concerns relate to packaging for an ocean going vessel. Are the products sensitive to humidity, salinity and heat? Is the specified packaging suitable to support the product as it makes its way across the ocean?

Packaging for domestic transportation may not withstand the climates and environments the product may experience during an ocean voyage. Packaging engineers should be consulted prior to deploying the strategy. Additional costs may be incurred as a result of the additional packaging required. These need to be assessed and built into the contractual arrangements with the supplier

Avoiding Packaging Claims

In addition to the need to package for the journey, manufacturers need to work closely with their vendors to specify when goods coming off a line should be packaged. For example, if a supplier packages aluminium foil too soon after it comes off of a production line, the material would arrive with burns and holes!

III.

How Can Small Medium-Sized Enterprise Reduce LCCS Risk?

Our research suggests that small and medium sized organizations can take a number of steps to reduce and mitigate LCCS risk. These include:

- 1. Creating an integrated LCCS steering committee and team. Individuals from logistics, sourcing, and engineering should all be involved in the process.** A senior member

of the executive team should lead the process. This integration allows the company to understand all of the business issues surrounding a LCCS program.

2. **Working with third party consultants and third or fourth party logistics providers.** Third parties can offer a range of services from international trade, logistics and sourcing, tax and legal counsel as well as on-the-ground overseas resources to help facilitate introductions and minimize international travel. Fourth party logistics providers can provide tactical advice and guidance all the way through to acting as an extended logistics department for the manufacturer.
3. **Understand the Total Cost of Ownership implications of moving to a Low Cost Country.** Manufacturers that understand the balance among for example; transport costs and cycle times; or how to manage and monitor service levels; customs and duty VAT minimization strategies and processes will stand to gain the greatest benefit from LCCS initiatives.

Traditionally only larger organizations have been prepared to invest in the facilities to handle these risks and therefore it has generally only been larger corporations who have benefited from LCCS. Some like Wal-Mart have moved even beyond LCCS to become a truly global player with both major purchasing and sales operations around the world. Without the benefit of these resources, smaller organizations have watched on the side lines as the larger players have dramatically stripped costs from their operations by selectively purchasing categories of goods overseas. Now however smaller organizations are beginning to partner with third parties to achieve similar savings and manage the risk without having to add headcount to achieve it.

What to Look for in a Partner

Undoubtedly, many firms will claim they have LCCS service offerings. But to cut through the hype and marketing claims, we recommend that companies should consider the following list of criteria in evaluating potential partners:

- **The individual international trade, logistics, transportation and supply chain credentials of project team members.** For example, are team members familiar with lean supply chain concepts and/or Six Sigma? Does your partner have experience in delivering lowest enterprise cost savings vs. lowest piece-part cost savings?
- **A capability to provide on-the-ground resources in Low Cost Countries.** The professional assessment of a potential supplier's capabilities can sometimes only be handled by specialists on the ground; the right partner will have a demonstrable network of local offices that can handle this kind of work. Electronic means of identifying suppliers is only the first step
- **Knowledge of and ability to examine the tax and legal ramifications of sourcing overseas**
- **The ability to mitigate risks (as identified above)**
- **Logistics capabilities (4PL)** The partner must have extensive experience in international logistics and be able to provide 4PL services to meet the clients' logistics requirements without the client needing to increase head count.
- **The type of partnership arrangements it has with technology vendors** (e.g. can the partner provide without bias or incentives the technology enabled sourcing tools to help qualify the supply base and understand current pricing conditions?)
- **Has the partner really embedded LCCS processes to contribute to the clients long-term benefit?** Does the partner have experience with implementing a supplier score card and creating ongoing quality assessment programs to maintain supplier performance?

In conclusion, while it is true that a head long rush into LCCS can introduce considerable risks and that traditionally only larger companies have had the resources to develop and implement successful LCCS strategies, with the right partner, small and medium sized organizations can still reap huge savings from a move onto the global stage. The key is choosing a partner with the experience and breadth of services to make that journey a rewarding and game changing experience.

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