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Global Sourcing in the Postdownturn Era

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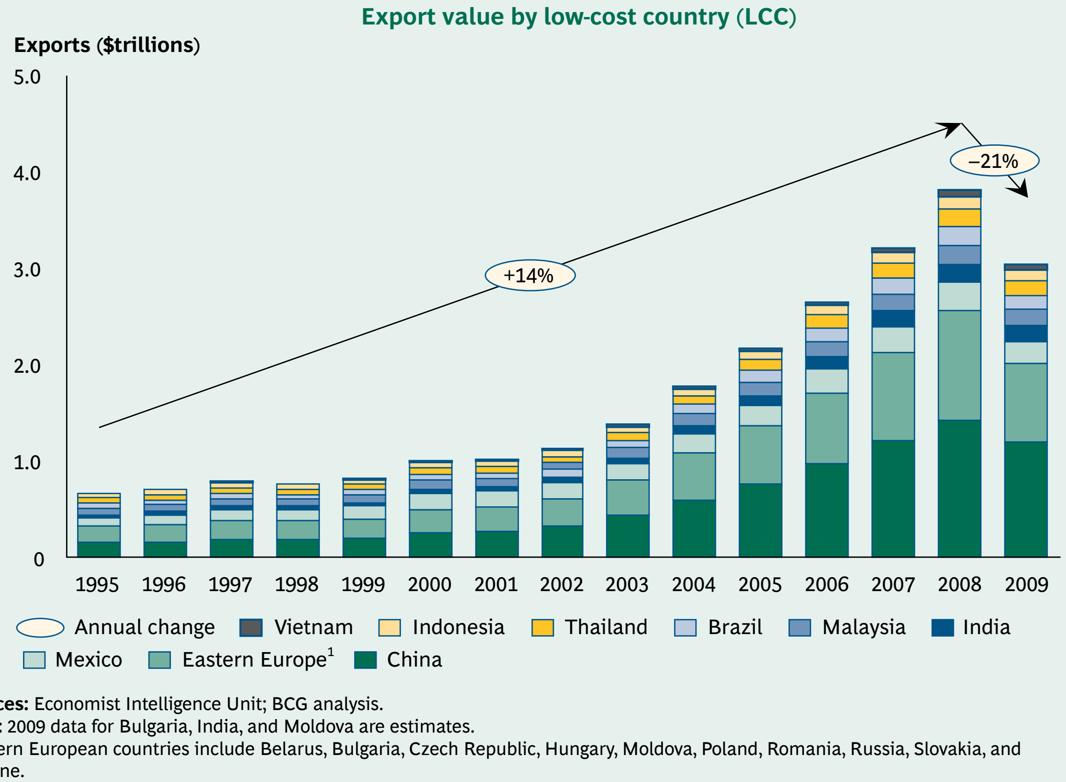
The worldwide economic downturn and its aftermath have had a significant effect on how companies view and approach global sourcing. Exports from low-cost countries (LCCs) dropped sharply during the crisis—from $3.8 trillion in 2008 to $3.0 trillion in 2009—and have yet to recover to their predownturn levels. (See Exhibit 1.) Depressed demand was a key reason for the pullback, of course, but companies are rethinking their LCC-based sourcing strategies because of other challenges as well, such as quality concerns, product recalls, growing labor costs, volatile commodity prices, and the inherent risks of longer supply chains. Recent headlines seem to suggest a shifting landscape and a migration back to "near shore" countries such as Mexico for the United States and Eastern Europe for the European Union.

According to a recent BCG survey, however, global sourcing is here to stay, although the focus continues to move away from labor cost savings alone to total cost or "best cost" country sourcing.

Rising Labor and Input Costs

Although low-cost labor drove the massive migration of production from the West to the East that began in the 1990s, global sourcing is no longer restricted to high-labor-content products such as garments, toys, and shoes. Increasingly, multinationals are sourcing a wider range of products from low-cost countries to

Exhibit 1. Exports from LCCs Dropped Sharply During the Downturn



Sources: Economist Intelligence Unit; BCG analysis.
Note: 2009 data for Bulgaria, India, and Moldova are estimates.
[1]Eastern European countries include Belarus, Bulgaria, Czech Republic, Hungary, Moldova, Poland, Romania, Russia, Slovakia, and Ukraine.

capitalize on the lower cost of overhead, inputs, and capital—or for strategic reasons such as better access to supplier clusters or to consumers in emerging markets. And as the labor content of imported products decreases, the savings from labor cost arbitrage also decrease.

Moreover, labor shortages have inevitably led to higher wages. The post-WWII rise of Japan as a low-cost producer did not last long, nor did Korea's ascendancy in the 1970s and 1980s. The large populations of China, India, and Southeast Asia postponed the inevitable, but labor shortages had become an issue by the second half of the last decade. This labor shortage, combined with ongoing demand from the export sector, has forced labor costs to rise in many of these countries. Recently, double-digit wage inflation has become common in places such as China and Vietnam.

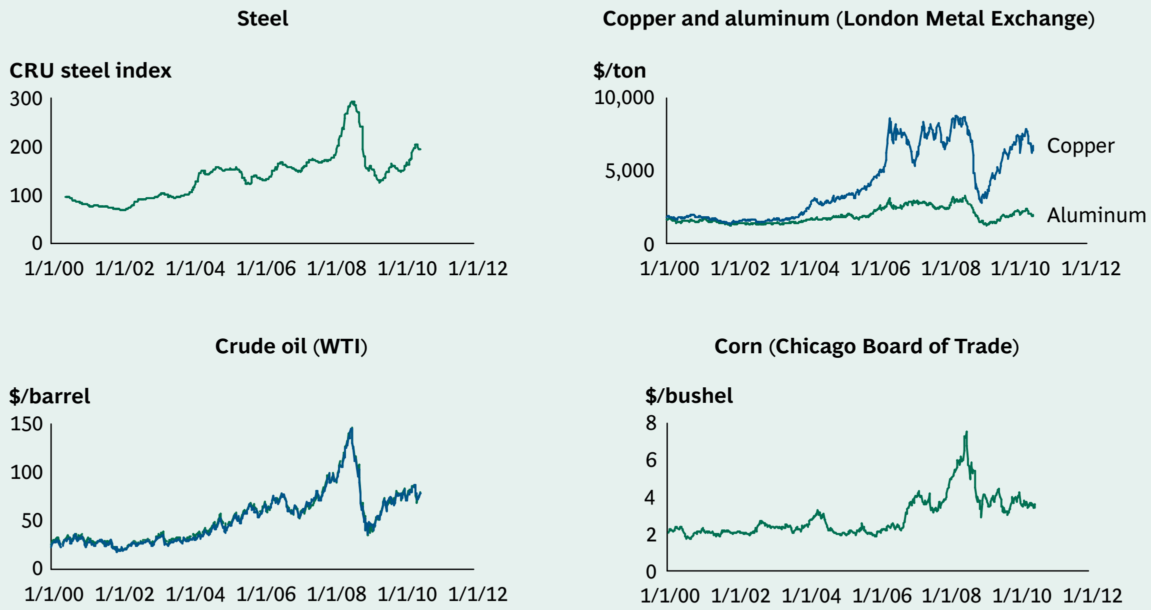
The skill level of workers in low-cost countries is also rising because of increasing demand for greater quality, better processes, and the higher level of automation required for large-scale production. And skilled workers cost more, especially because they are often in short supply.

Input costs have also changed significantly over time. (See Exhibit 2.) The manufacturing and building booms in China and other low-cost countries over the past decade led to an insatiable appetite for resources and drove up the cost of raw materials. For example, crude oil peaked at $147 per barrel right before the financial crisis. Besides boosting costs related to transportation and to petroleum-based raw materials such as plastics, the increase in oil prices affected the price of other energy sources and pushed up the cost of other inputs. These growing costs offset any labor savings and decreased the overall cost advantage of low-cost countries.

Other Cost Pressures

In addition to rising labor and input costs, companies sourcing from low-cost countries must also consider the cost of addressing environmental, health, and safety concerns; the impact of longer supply chains on inventory carrying costs and on shipping and reaction times; and potential quality problems, which can lead to costly claims, returns, and production downtime. In 2007, for instance, the lead-tainted paint on

Exhibit 2. Supply-and-Demand Imbalances Have Led to Greater Commodity Price Fluctuation



Sources: Bloomberg; CRU Group; BCG analysis.

toys made in China led to added safety requirements. Companies sourcing toys from that country have had to absorb the costs of extra quality controls or find ways to pass them on to their customers.

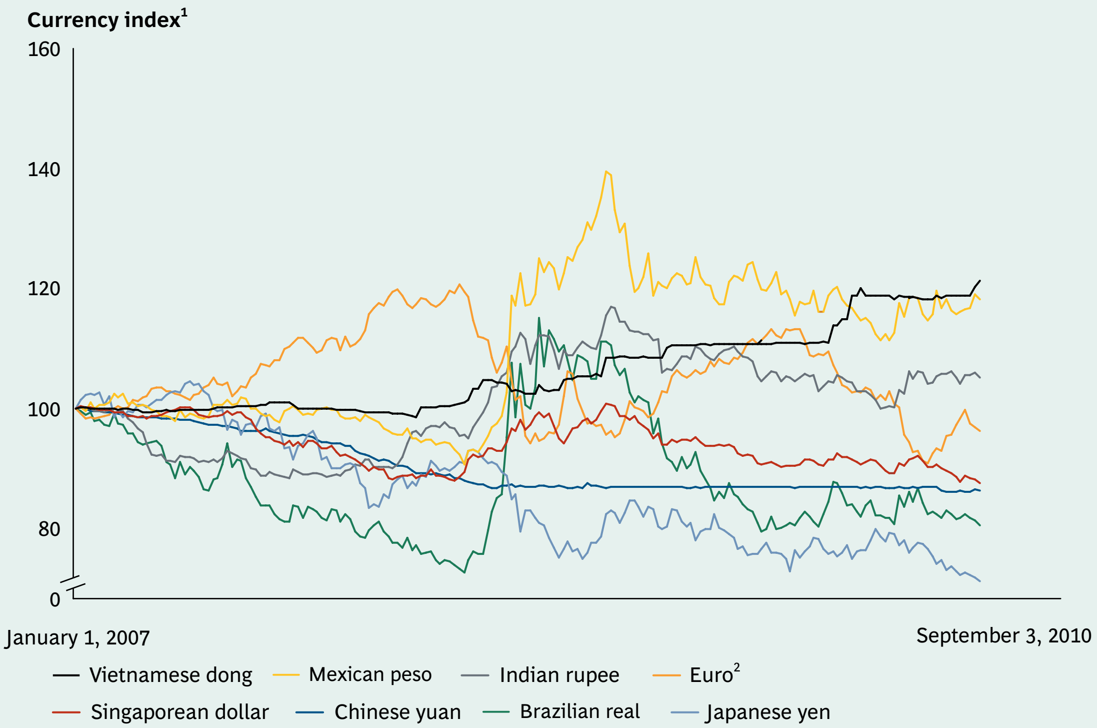
Moreover, massive currency swings have made potential savings from LCC sourcing increasingly unpredictable. Ever since the financial crisis, currency exchange markets have been highly volatile. (See Exhibit 3.) Companies that were sourcing from a single region found themselves particularly vulnerable to unfavorable currency swings that could wipe out all of their expected savings.

Growing protectionism is also increasing the uncertainty of global sourcing. After years of falling trade barriers, developed and developing countries alike are retrenching as they struggle to recover from the economic downturn. Sino-American trade friction, in particular, has increased. In addition to its ongoing concerns about China's undervalued yuan, the U.S. government has raised tariffs for many Chinese imports to protect domestic industries. In the first nine months of 2009 alone, the United States launched 14 probes into Chinese exported goods valued at $5.8 billion in total, compared with less than $1 billion the year before.

In 2009, the U.S. government imposed tariffs on all car and light-truck tires imported from China. The 27-member EU joined in the movement against low-cost-country exporters and imposed tariffs on steel imported from China. Similarly, footwear companies shipping Chinese and Vietnamese products to Europe are facing significant tariffs from the EU. Companies relying heavily on a single supply base can easily be devastated by government decisions such as these.

Protectionism is not the only legislative uncertainty faced by multinationals sourcing from low-cost countries. Many countries use export tariffs and VAT rebates to boost the competitiveness of local industries in the global export market. In China, the government has been encouraging exports through a more supportive export tariff and VAT rebate structure. However, with export growth having surged 33 percent

Exhibit 3. Currency Swings Make Potential Savings from LCC Sourcing Increasingly Unpredictable



Sources: Factiva; BCG analysis.
[1]Calculated as the ratio of local currency to U.S. dollars, indexed to 100 at January 1, 2007.
[2]Weekly open price.

in the first five months of 2010 compared with 2009, and with the impact of the 2008 financial crisis having largely subsided, the Chinese government scrapped the tax rebates for 406 export products in July 2010 to reduce incentives to export energy-intensive products such as steel, rubber, and glass. Besides having immediate financial ramifications for companies sourcing from China, the reversal also underscores an ongoing risk of global sourcing: that the cost savings from any country can be jeopardized overnight if trade laws are changed. An overreliance on a single supply source increases this risk.

A Growing Focus on Total Cost

These growing costs and changing dynamics pose new challenges for global sourcing. To succeed in the new environment requires moving away from traditional sourcing models toward a more holistic approach that considers the total cost of sourcing from various countries. As a result, many companies have shifted their focus from low-cost-country sourcing to “best cost” country sourcing (BCCS), an approach that evaluates a range of factors besides just labor costs.

To learn more about current best practices in global sourcing and how BCCS is evolving, BCG surveyed 30 multinational companies representing a wide range of industries and countries of origin. According to our findings, BCCS is here to stay. In fact, we found broader participation overall—and companies are also taking a more strategic approach, building portfolios of supply sources and seeking to achieve competitive advantages rather than just pure cost reduction. Let’s look at each of these trends more closely.

Broader Participation

Participation in BCCS is expanding beyond the major multinationals and *Fortune* 500 companies to include small to midsize companies in North America and Europe. This is partly because it has simply gotten easier to buy from overseas suppliers. Greater market transparency has helped smaller companies to set up direct sourcing arrangements from best-cost countries. But the primary reason for increased participation is the growing sophistication of LCC-based suppliers, which are proving to be credible substitutes for Western suppliers on the world stage.

In addition, the categories of goods being sourced are expanding from traditional high-labor-content products such as garments and toys to more technology- and capital-intensive products. This is generally true across all major low-cost supply bases around the world. For example, companies are sourcing more capital equipment from these regions to reduce overall capital expenditures. From pumps to chemical plant equipment, from storage tanks to blast furnaces, companies are finding a growing number of suppliers with extensive product-development and manufacturing experience—often the result of serving their fast-growing local economies. Many multinationals involved in mining, oil exploration, and chemicals are actively sourcing big-ticket capital equipment from low-cost countries for use in locations in the East and the West.

Participation in BCCS is not limited to manufacturing companies, however. Even private-equity firms are setting up sourcing offices in best-cost countries to bring cost-saving opportunities to their portfolio companies by leveraging their consolidated scale.

A Portfolio Approach

All survey participants indicated that their companies will continue to maintain or increase their sourcing activities from best-cost countries, especially from Asia, given that their savings are still significant. Many participants noted that although the financial crisis had a negative impact in some areas, it also brought opportunities for BCCS. For instance, currency devaluation has made some relatively high-cost regions such as South Korea newly viable best-cost supply bases. Other historically low-cost countries such as Mexico and Vietnam are becoming even more attractive owing to currency changes. Many participants observed that the global downturn brought the topic of cost reduction to the attention of top management. This attention generated pressure and incentives for procurement teams to explore other countries and supply sources as cost-saving alternatives.

However, the risks and uncertainty surrounding labor shortages, currency volatility, and protectionism have raised concerns among the survey participants. Many are aggressively migrating to a more diversified approach to global sourcing and are maintaining a portfolio of supply sources in different regions to mitigate risk.

Achieving Global Advantage

The survey participants also noted that the benefits of BCCS go beyond cost savings to include strategic advantages that come from competing both locally and globally. Many companies are transferring other steps of the value chain besides sourcing—such as R&D and manufacturing—to best-cost countries to further develop their design capabilities and manufacturing networks. Advances such as these can create a sustainable competitive advantage. This theme of global leverage embodies the evolving BCCS initiatives.

Apart from creating competitiveness on a global scale, companies are also leveraging their sourcing offices in emerging regions to help penetration in local markets. By providing access to local markets, establishing relationships with government officials, and demonstrating innovation throughout the supply chain, BCCS can generate significant top- and bottom-line advantages even in emerging-market businesses.

Adapting to Current Challenges: The Building Blocks

The financial crisis has clearly changed the dynamics of the global economy. To complicate matters further, a two-speed world is emerging, characterized by slower growth in the developed economies of the United States, Europe, and Japan and more rapid growth in Southeast Asia and the BRIC countries (Brazil, Russia, India, and China).[1] Satisfying the very different demands of these high-growth and low-growth regions will surely put stress on existing procurement models.

Moreover, the global business environment will be marked by uncertainty in the near to medium term. As noted earlier, the unpredictability of factors such as currency swings, input and logistics costs, and trade barriers means that companies with global supply chains must be adaptive and flexible to compete successfully. Risk management has come to the fore as companies reevaluate their operating models in light of an uncertain future.

Our survey participants are pursuing a range of activities to address these issues. For many companies, short-term changes in the structures of their global supply chains will be difficult if not impossible to implement, given the challenge of finding qualified new suppliers or shifting volume among existing ones that face capacity constraints. As a result, most short-term initiatives—such as government lobbying and currency hedging—focus on minimizing the impact of uncertainty. These activities can effectively buy time for companies to restructure their supply bases in order to better manage the new challenges.

Other companies are seeking ways to make their supply chains more flexible and agile in the face of variability and disruptions. Companies are "stress testing" their supply chains to evaluate the likely impact of scenarios such as supplier quality problems in one country that require finding an alternative supply base; port congestion or other logistics problems that lead to shipping delays and increased lead-time variability; or a major increase in the landed cost of globally sourced products owing to currency appreciation, wage inflation, logistics costs, or tariffs. Many believe that a periodic review of this sort can flag vulnerabilities.

Over the medium term, our survey participants realize that an overreliance on one region or on a single low-cost supply base will be risky and unsustainable. Companies are actively working to diversify their supply bases and reduce risk exposure. Many are developing new suppliers in Southeast Asia, Indochina, and North Africa in addition to the traditional supply bases in India and China. But the dominance of China as the world's factory over the last decade can sometimes make sourcing from elsewhere difficult. For some products, such as cigarette lighters, China's dominance is so complete that alternative sources of supply can hardly be found, let alone with the capacity to absorb significant new volume. Companies will need to invest in developing alternative suppliers before any diversification of volume can be initiated. But

1. See *Collateral Damage: Preparing for a Two-Speed World; Accelerating Out of the Great Recession,* BCG White Paper, January 2010.

a more holistic view of global supply sources is becoming the norm.

Some companies are even going so far as to question their existing global value chains, which served them well in the past but may be less viable in the future. They're asking questions that get at the heart of their current operating models, such as, Should we change our global footprint? Should we redesign our global value chain and rethink where we buy inputs and assemble products? Should manufacturing or fabrication be outsourced to increase flexibility and reduce legacy issues?

Regardless of how companies ultimately redesign their long-term operating models, procurement organizations are working hard to optimize their sourcing practices. Because of the rapid evolution of BCCS, best practices from the past are fast becoming today's norm. Companies must continually upgrade their capabilities in order to maintain an even playing field with the competition—or risk falling behind. Our survey revealed that BCCS leaders exhibit many or all of the following seven building blocks that lead to BCCS excellence:

- A comprehensive *strategic vision* and management philosophy
- A well-defined *organization structure* with formal reporting lines tailored to the nature and stage of development of the business to drive BCCS efforts
- Strong *governance* with cross-functional collaboration and coordination mechanisms that allow for efficient interactions between global buyers or procurement engineers and best-cost suppliers
- Well-defined *sourcing processes* with BCCS best practices in supplier and quote management
- A user-friendly *data system* for all relevant functions centered on appropriate metrics and support systems with flexible KPIs that can adapt to market changes
- Well-planned *talent development* to maintain a strong BCCS team with global career paths
- Strong *change-management capabilities* to mobilize and engage people at all levels of the organization

Lessons from the Leaders: Four Stages of BCCS Development

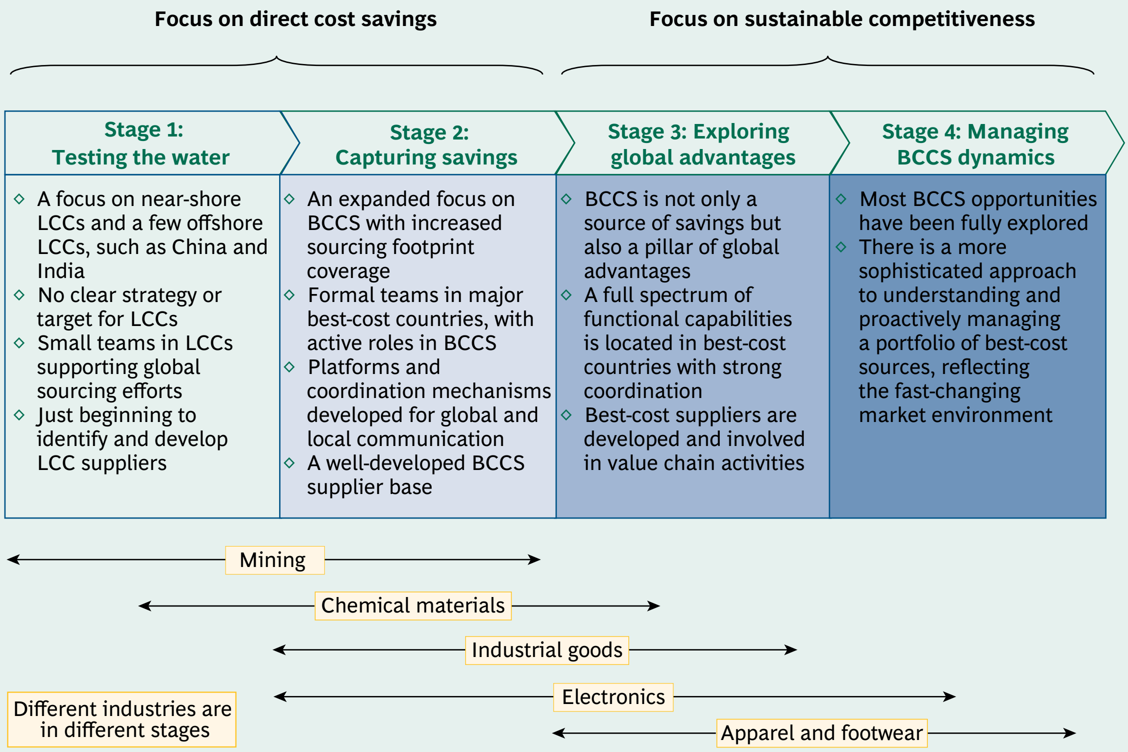
As companies accumulate experience and advance their expertise, they encounter different challenges and must develop new best practices to succeed. BCG has identified four stages of development that companies go through as they improve their BCCS capabilities. (See Exhibit 4.)

Stage 1: Testing the Water

Companies often start exploring BCCS with limited experience or knowledge and an infrastructure not yet adapted to global sourcing. Organization structure and processes are tested and refined during this first stage. To succeed, companies often deploy small project teams overseas to pilot selected product categories in multiple waves to establish the protocol for everything from supplier identification to order management. Small project teams make the process transparent and manageable and are better able to deliver tangible results. These positive early results can build momentum and mobilize the rest of the organization to change. Moreover, savings can be reinvested to fund further BCCS activities.

The key to success in this first stage is engaged and committed senior sponsors who can remove any roadblocks from the process so that a solid foundation for future stages can be built. Since BCCS represents a new way of doing business and requires a different mindset, the changes must often be driven by the chief procurement officer (CPO) or another senior-level executive. Without a strong executive champion, global sourcing initiatives can lose steam. For example, an industrial goods company had a very successful BCCS ramp-up in Asia and achieved substantial savings, which helped fund further expansion of the program. But this early success faded when the program's sponsor—a key board member—moved on and management attention was diverted to other matters. The BCCS program was never able to regain momentum within the organization.

Exhibit 4. Companies Go Through Four Stages of BCCS Development



Source: BCG analysis.

Stage 2: Capturing Savings

As companies mature along the development curve, they initiate additional sourcing waves until BCCS eventually becomes a normal part of the procurement function. To facilitate full integration, a significant effort is made to ensure that cross-functional and cross-regional coordination is in place. Some companies set up a rotation program for high-potential staff to ensure that informal networks develop among future leaders across regions and functions. In Stage 2, procurement organizations often develop a clear strategy for how to incorporate BCCS into the global operations strategy. Often, sourcing volume or savings targets are established and tracked to ensure BCCS progress and development.

To build on and sustain the effort, the organization structure and processes that were tested and refined in Stage 1 are formalized. By this time, the teams in "satellite" locations are no longer only in supporting roles. They, along with headquarters staff, are becoming an integral part of the procurement function. Companies with a "lead buyers" model may have these buyers reside in the satellite teams—rather than at company headquarters—in order to drive purchasing categories and operating strategy, because they're closer to key suppliers. The human resources organization may take an active role in developing employees in these satellite offices to ensure a pipeline of talent that can support future growth.[2]

Stage 3: Exploring Global Advantages

To compete against low-cost challengers from developing countries, companies must seek advantages other than cost. In Stage 3, leading companies shift their focus from cost reduction and look for ways to leverage the innovation, product-development, and manufacturing skills of best-cost countries. Procurement teams work with local suppliers to develop parts from scratch instead of just re-sourcing Western-designed parts from local suppliers. To this end, many companies have begun shifting other parts of their value chain overseas. For instance, many multinationals are setting up research and development centers

2. See *Creating People Advantage 2010: How Companies Can Adapt Their HR Practices for Volatile Times,* BCG report, September 2010.

in India and China. A global industrial-goods company is using engineering capabilities in China and India to develop products for both emerging and developed markets. Besides costing less to develop, these new products are also designed to be produced economically by leveraging low-cost local materials and standard parts that are readily available in the region.

Stage 4: Managing BCCS Dynamics

By this stage, companies are well advanced in developing and leveraging global advantages to gain a competitive edge. Many—such as those involved in retail, electronics, apparel, footwear, and other consumer products—already spend a large portion of their procurement dollars outside of their home base. Their main challenge now is to manage the inherent risks of operating in a very dynamic global environment with an extended supply chain. Overexposure to any single country or region can raise those risks to an unacceptable level. Many choose to limit the risk by having a balanced and diversified sourcing footprint—for example, by moving sourcing volume from a traditional supply base such as China to other low-cost regions.

Other companies at this stage have set up a network of international purchasing offices around the world in order to monitor supply-base development in each region and to optimize their cost positions by using capable local suppliers. Some companies are already diverting part of their sourcing volume away from China to reduce their exposure to the yuan and to avoid possible tariffs on selected Chinese products. Other companies are actively developing alternative supply bases to facilitate future migration if necessary. Some go even further and begin to question the design of their existing supply chain, wondering whether some degree of restructuring is necessary. For instance, would taking prefabricated parts from best-cost countries and assembling them in near-shore locations provide an optimal balance of cost, flexibility, and risk?

Each of these stages presents different challenges to the seven building blocks—and to different industries as well. For example, companies sourcing toys, garments, or other products from well-developed suppliers in best-cost countries will face different issues than companies in the mining industry, which must deal with newly emerging Asian suppliers. As companies mature along the development curve, their ability to leverage best-cost-country suppliers increases, creating more opportunities to reduce overall costs and improve their competitiveness in the market. It is important to understand, however, that a company's BCCS capabilities are dictated in part by the development and readiness of the supply base.

Staying Vigilant

It is critical that companies make regular adjustments to better manage newly emerging challenges. Without the ability to evolve and expand their BCCS capabilities, many companies find that their programs stagnate—despite initial success.

The Boston Consulting Group has tracked the progress of BCCS over the past decade and has witnessed a growing level of expertise and sophistication among practitioners. But because today's best practices will become tomorrow's norm, we recommend the following three steps:

- Conduct a periodic "health check" to assess how well your company's current BCCS practices are suited to emerging risks and challenges.
- Monitor emerging trends and the BCCS best practices employed by other companies.
- Balance the risks and rewards of changing global market conditions and adapt or develop your company's BCCS practices accordingly.

Leading companies differentiate themselves by focusing on different elements of the seven building blocks and employing practices that facilitate more effective sourcing, making the migration to the next stage of development easier. As they progress through the BCCS development stages, companies gain not only cost advantages but also greater competitiveness in the global marketplace.

Going Forward

Over the last decade, BCCS has allowed many companies to reduce their procurement costs by millions of dollars and gain a competitive advantage in global markets. But the dynamics of the global economy are changing in fundamental ways. Input costs in LCCs are on the rise, changing the relative attractiveness of different regions. At the same time, global demand patterns are shifting as emerging economies flex their purchasing power. The recent global downturn accelerated many of these changes.

The days of reducing costs simply by sourcing from China are probably over. In the future, companies will rely on a more diversified base of low-cost suppliers across multiple regions. The "China + 1 strategy" that was popular only a few years ago is likely to evolve into a "BRIC + a few more" strategy. Moreover, the unidirectional model of sourcing in the East and selling in the West will likely give way to a networked model of supply hubs in different regions to quickly penetrate fast-growing emerging markets. In light of these new global business realities, some companies may need to redesign their entire production and sourcing footprint.

Globalization has opened up substantial opportunities for multinationals to capitalize on global sourcing for both market access and cost reduction. BCCS is one of the most direct ways for companies to improve their cost position by leveraging the advantages of different regions around the world. However, these potential rewards do not come without risks. The increasingly interdependent economies of the global marketplace and the lingering uncertainties of the recent downturn present substantial challenges for global sourcing. To avoid stagnation, companies must continually develop and advance their BCCS capabilities.

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