

Beating Your Competition on China Sourcing

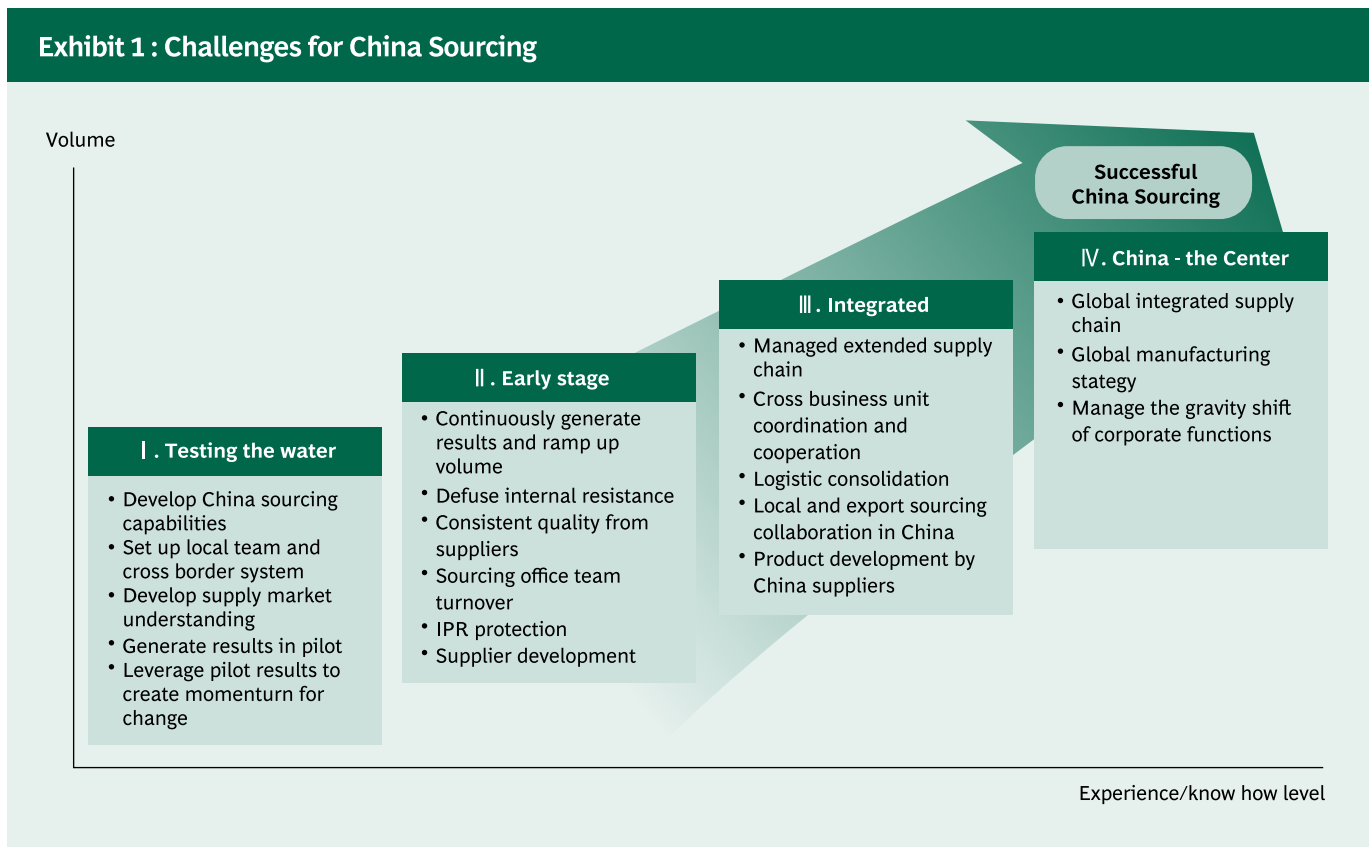
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Sourcing from China is nothing new. China has been a trading partner with the west through the Silk Road for centuries. However, it was the economic development of the new industrialized China that is changing the global economic landscape. China has been the supply base for many low cost finished products, such as wrist watches and toys, since China began its economic reform in late 70s. Within the last decade, however, a new wave of China sourcing, focusing on buying components from China or outsourcing produc-

tion altogether to Chinese companies, is catching the corporate attention. As a result, global companies were rushing to China to set up sourcing offices in order to take advantage of this low cost supply base.

This phenomenon is not only changing the corporate world, it is having a lasting impact in China. The recent Chinese economic boom is in part driven by this wave of China sourcing. Ever since China's entry into the WTO in 2001, Chinese export volume grew about 3 times in 4 years to US\$

Exhibit 1 : Challenges for China Sourcing



762 billion in 2005, accounting for over 30% of China's economy.

The Evolution of China Sourcing

From the early days when pioneers were “testing the water” and engaging China sourcing as a novel concept through pilot projects, China sourcing has proven to be challenging. However, these challenges can vary over time as companies grow along the learning curve (Exhibit 1). In the initial stage, companies are often concerned about implementing China sourcing and building the facilitating process and organization. Typical problems such as cultural and business norm difference, lack of transparency in the Chinese supply market, etc. are topics that are often cited as the key challenges for China sourcing. However, most companies have passed this initial stage and have been able to address those issues effectively.

As companies move beyond this initial entry stage and start ramping up their sourcing activities in China, as we found in our 2007 Leading China Sourcing Practices Study, additional challenges begin to emerge and companies often find ramping up China sourcing much more difficult than expected. While challenges are many, most participating China sourcing office leaders point to their inability to overcome internal resistance as the critical constraint limiting their ability to increase China sourcing. In the words of one sourcing office director of a global industrial goods company “To use the baseball terminology, we are having a pitcher-catch system; if the pitcher does not throw the ball out, it does not matter how good it is of your catcher”.

Though many of the participants stated that they have top management commitment and support on the initiative, many find that such support have not cascaded down to the working level team where cooperation is critical in making the initiative work.

Sourcing professionals are also finding out that though there are ample suppliers in the market,

few are capable of delivering the quality and quantity multinational companies are looking for. To counter this shortage, companies are putting more emphasis on supplier development in order to build up the qualified supply base in China. Often, this is a cross functional initiatives that involve multiple departments. The complication of having a cross-regional and cross-functional sourcing initiatives handled by a new outpost organization in China can be too much to handle.

Moreover, order fulfillment and extended supply chain management are also becoming critical as more volume being sourced from China. With the increase volume being sourced from China, the risk of the initiative is also increasing. As a result, risk management in many areas (e.g. intellectual property rights (IPR) infringement, currency exposure) is also becoming more challenging.

Some companies are moving even further to relocate part of their corporate procurement functions to China. IBM relocated its CPO to China in 2006 in order to have the procurement head closer to its key supply base. Others are moving their lead buyers to China so that China will be an integrated part in setting and driving the global commodity strategy. As companies progress along the stages of maturity, new challenges will emerge.

How to Maximize Leverage from China Sourcing?

But is China sourcing living up to the promise of delivering savings to global companies? Are western companies generating the savings they expected from China sourcing? As more and more companies are sourcing from China, how can companies meet and beat competition in China sourcing and gain better cost positioning?

In BCG 2007 Leading China Sourcing Practices Study, we set out to answer these questions and to assess the impact of China sourcing on global companies. We studied and interviewed a num-

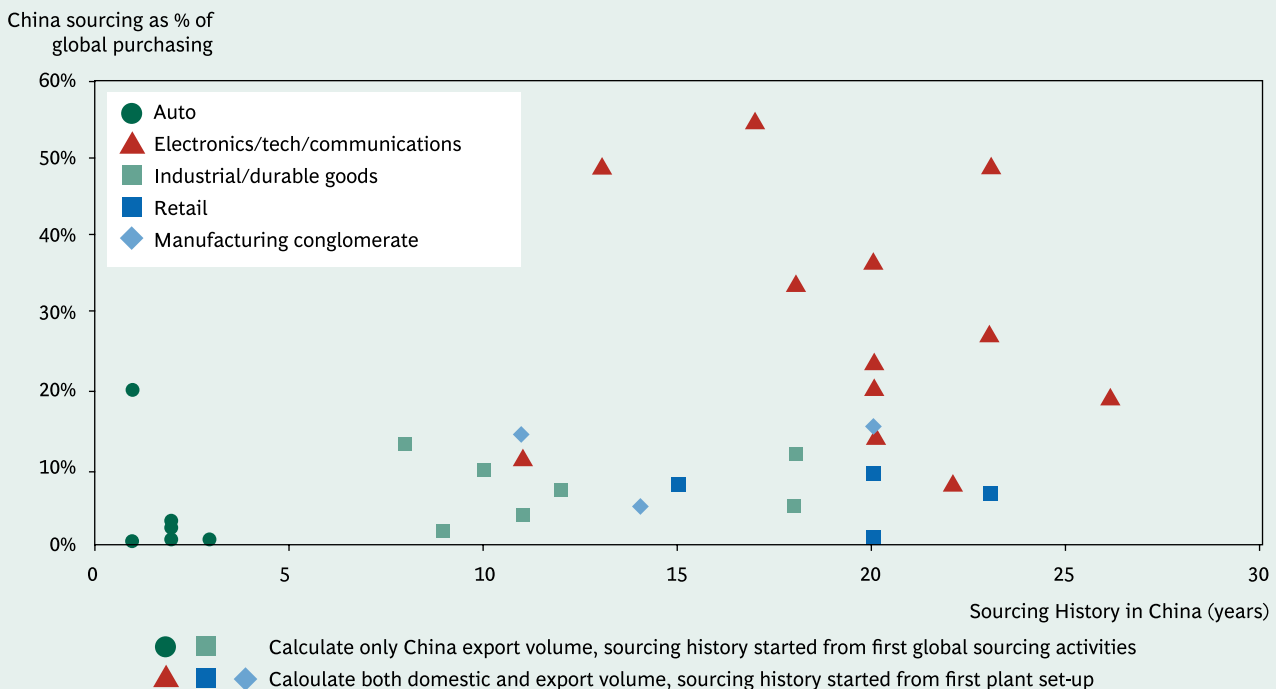
ber of global companies across different industries that have established sourcing offices in China. As expected, our findings confirm one key fact - companies are benefiting by sourcing from low cost suppliers in China. Participants in our study have been experiencing on average over 20% of landed cost savings in the commodities and products they sourced from China.

Results like these are driving global companies to outsource more of their procurement spend and production to China in order to increase their leverage of China as a low cost supply base. Companies after companies are announcing aggressive China sourcing targets to the investment community. Despite such senior management support, our study reveals that companies are achieving different degrees of success moving global procurement spend to China, actual China sourcing volume as a percentage of global procurement spend for many global companies remains relatively low.

Exhibit 2 shows that many companies with extensive China sourcing experience were not able to extend their sourcing from China to beyond 15% of their global procurement spend. While one would expect a company's China sourcing volume will increase as experience accumulated over the years, our study shows that many are not benefiting from their years of experience sourcing from China. As a result, they are lagging behind their peers in ramping up their China sourcing volume, and thus not able to leverage Chinese low cost base to the full extent.

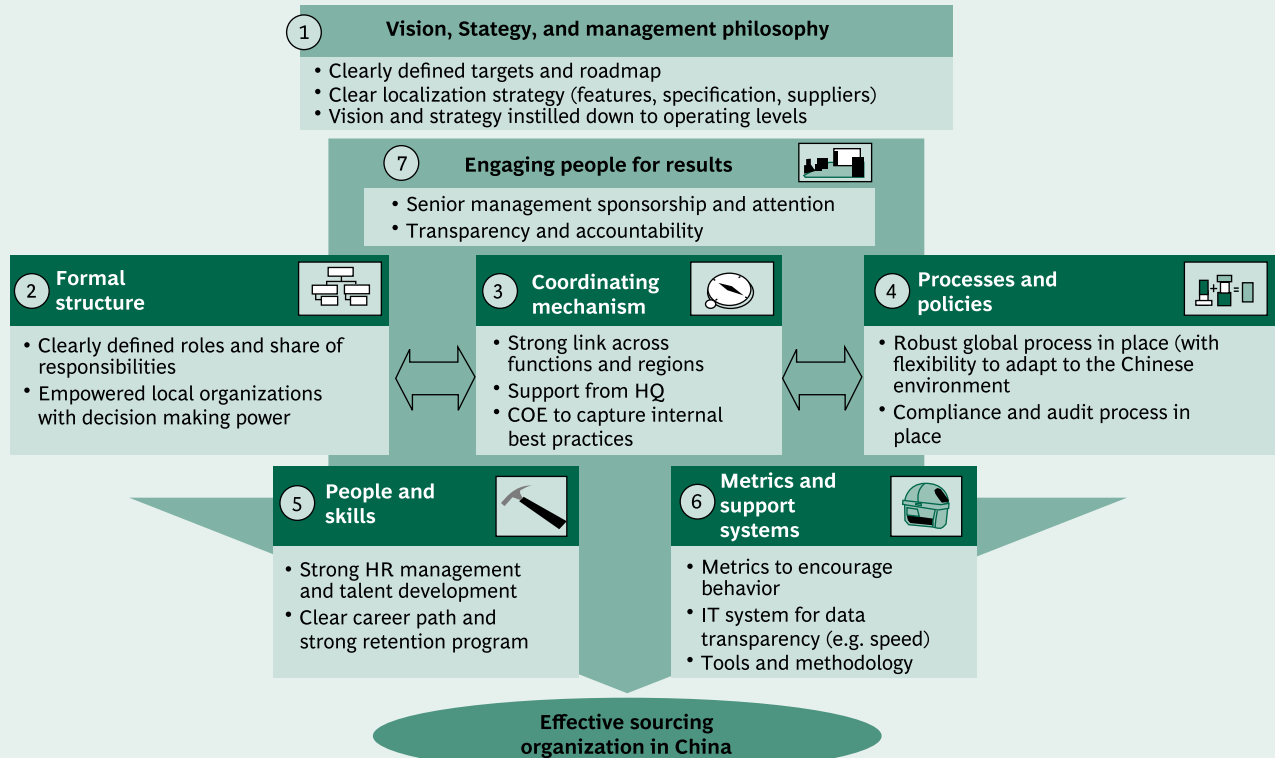
Another interesting finding is that different industries are leveraging China differently depending on the level of supply base development in the sector. As expected, companies sourcing components with a well developed supply base in China can easily migrate their procurement spend to China. For instance, Chinese supply base in the electronics industry has been well established over the years and so electronics companies are

Exhibit 2 : Sourcing in China Relative to Global Purchasing— 005 Estimates



Sources: Analyst Report, Company Websites, Press Search, BCG database, BCG interviews and estimates.

Exhibit 3 : The Study Reveals that Leading China Sourcing Organizations Share Common Traits



Note: COE-Center of Excellence.

able to source more portion of their global spend from China. On the contrary, the automotive supply base in China is still at its early stage of development. Despite strong commitment from global auto companies, only limited amount of their global spend are being sourced in China.

While inter-industry difference can be resulting from supply base readiness, variances in companies' performance within the same industry are more difficult to explain. Our study reveals that the different performance can mainly be attributed to varying ability to overcome challenges from within to ensure proper ramp up of China sourcing.

As mentioned, different challenges emerge as companies mature through the various stages of China sourcing. While companies can usually be successful in overcoming initial challenges link-

ing up with qualified suppliers in China, veteran companies are finding it more difficult to overcome other challenges as they gain more experience and traction on China sourcing. Challenges are not only from external, internal challenges can be overwhelming.

However, with new challenges come emerging best practices. In our discussions with leaders of China sourcing offices, over forty best practices along seven key dimensions have been identified as effective means to enhance China sourcing. Many leading China sourcing offices are able to differentiate themselves from their peers by successfully deploying these practices in their day-to-day operations and achieved sustainable ramp up on China sourcing volume. Interestingly, these leading companies share many common traits in these seven dimensions (Exhibit 3).

1. Vision, strategy, and management philosophy

Leading companies often have low cost country (LCC) and China sourcing strategies clearly defined by top management and instilled through the ranks. The strategy goes beyond only a sourcing volume target announced to the public, but often accompanied with concrete plan on implementation and infrastructure development.

Often supplier strategy plays an important role in this overall strategy. While companies have been successful initially in China sourcing, significant volume ramp up can be challenging due to limited qualified suppliers available. With the expected increase of China sourcing volume, many qualified Chinese suppliers are up to capacity even with aggressive expansion plan. As a result, leading companies are increasingly paying more attention to develop potential Chinese suppliers. Supplier development from technical support to process and quality control are often offered by companies who are eager to expand their supply base in China.

Another interesting shift in recent years is that after Chinese suppliers have proven that they are qualified in manufacturing according to design, western companies are increasingly open to leverage Chinese suppliers' product development capabilities. On one hand, this can leverage the cost effective product development capabilities. On the other hand, developments done by Chinese suppliers are often better able to leverage the low cost manufacturing processes in China. This has led to more and more Chinese suppliers are participating in design works for global companies in future product launches.

2. Formal structure

China sourcing office is adding complexity to global procurement system. For companies with centralized global procurement organization, China sourcing office is often functioned as an extension of the global organization. However, for multi-business units (BU) companies with decentralized organization, China sourcing office's

positioning can be more complicated. The key question is whether there should be a single China sourcing office or multiple sourcing offices for each BU.

For some, using a single sourcing office for all BUs seems to make sense especially during the initial start when the company is testing the water and learning about China sourcing. However, as the office gains traction and critical mass, problems such as cost allocation and directing the resources can be contentious across BUs. For companies chose to use multiple sourcing offices, strong cross-BU coordination can often be seen to maintain strong leverage among each other. To this day, many companies are still struggling with designing the optimal structure for their procurement organization in China.

3. Coordinating mechanism

Besides having an appropriate organization structure, leading companies are placing heavy emphases on developing strong cross-regional and cross-functional coordination to ensure success China sourcing. Often, companies set up specific program management teams on both the sending and receiving ends to ensure proper coordination. On the personnel side, many companies are strategically positioning expatriates with strong network from the headquarters to run their China sourcing offices. Leveraging these long established personal networks, they are able to enhance cooperation across geographical and departmental boundaries

An interesting question often raised is whether China sourcing for local production and for export should be conducted under the same organization? The proponents of separation often cite that the two functions require different skills and are often buying different products, so there is limited benefit of putting the two together. However, increasing number of companies is moving to consolidate the functions in order to leverage scale. In fact, 78% of the participants in our study have merged these two functions under one organization to increase leverage.

4. Processes and policies

As mentioned before, supplier development is critical to the success of China sourcing. Leading companies are employing systematic supplier management systems to groom and developed preferred suppliers for global use. Communications among Chinese suppliers, global buyers and China sourcing offices are often regular and open.

Global sourcing can be risky and China is not different. China sourcing has its fair share of risks ranging from intellectual property rights (IPR) infringement to RMB appreciation and disruption of extended supply chain. Leading China sourcing offices are proactively managing risk to minimize risk exposure and potential disruptions.

5. People and skills

Companies have been successful in localizing their China sourcing team. Only 7% of the participating China sourcing office staff in our study are expatriates, majority of them are in management role or provide technical expertise to support the offices. To achieve such a localized sourcing team is no easy task. To begin with, China has a limited supply of sourcing specialists as the field of strategic sourcing did not gain much attention until late 90s. The limited pool of sourcing professionals in China has difficulty meeting the ever increasing demand of China sourcing offices and local companies. Poaching other sourcing offices becomes the typical approach for China sourcing offices to obtain new talents.

However, as sourcing volume continues to increase and increasing number of China sourcing offices being set up in China, poaching alone can no longer satisfy the increasing demand of talents. Leading companies are setting up robust training for their sourcing staff covering technical topics and sourcing related topics. With a trained team in house, poaching by others can now become a highly possible drain of internal talents. Double digit turnover rate for sourcing staff, some even as high as 30-40%, can be

expected in sourcing office “hot spots” such as Shanghai. This has pushed companies to pay more attention to the problem of employee retention. For some, offering increasingly attractive compensation package may seem to be the right answer. Many find that non-monetary rewards, such as personal recognition, overseas training opportunities and clear career path, can be as effective.

6. Metrics and support systems

Leading companies create a metrics system to align the right behavior among its staff both at the sending and receiving ends. To ensure support for China sourcing by global buyers, some leading companies set up China sourcing targets on the commodity level and tie individual performance to China sourcing volume and savings generated.

7. Engaging people for change

While the above six dimensions are important, none is more important than engaging people for change. Over 90% of the participants in our study are pointing to internal resistance (at all levels) as the main reason why they cannot increase China sourcing volume as fast as they would like. Indeed, many companies can be performing well in the first six dimensions, but are not successful in China sourcing because internal staff is reluctant to change and engage in China sourcing.

To engage people for change, leading companies employ both a top-down and bottom-up approach. China sourcing can only be successful if it is supported and driven by the top management, so senior management’s vision setting and active participation on China sourcing initiatives are critical. Many companies set up centralized program offices run by senior management to drive China sourcing, push the agenda through internally and help to overcome resistance at all levels. The program management creates transparency of China sourcing activities within the organization and top management can track progress in the area.

To go along with the pressure by top management, leading companies often set up bottom-up approach to ensure changes in the mindset of mid management. One effective measure being used is to set up an internal education system to ensure global buyers are aware of the full potential Chinese suppliers can bring. From simply putting supplier profile online to make it accessible globally to setting up sourcing fair in China or supplier day at headquarters, companies are placing significant resources to ensure global buyers are equipped with the knowledge to make the right decision about engaging in China sourcing.

Implications for Global Companies

China sourcing has been proven as an effective means of generating procurement savings for multi-national corporations. However, how much impact China sourcing can generate depends on how this initiative is embraced by all within the organization. While many companies have openly stated that they view China sourcing as an important strategic initiative and are committed to it, the actual impact generated by China sourcing in these companies vary significantly. How to maximize the impact and beat the competition in China sourcing is the strategic question for senior executive to ponder. 5 key questions needed to be asked by companies themselves.

1. Is China sourcing achieving my company's strategic objectives?
2. Are we ahead or behind competition in leveraging China sourcing?
3. Are internal and external constraints preventing China sourcing from achieving its full potential?
4. Can we improve the current China sourcing practices?
5. How should the role of China sourcing evolved in the medium term (next 5-10 years)?

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