

## INSIGHTS FROM A MANUFACTURER'S PERSPECTIVE

# SOURCING FROM CHINA



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To help managers make better decisions about sourcing in China, it's useful to look at perspectives from a Chinese manufacturer. Rising manufacturing costs, strategies to improve quality, changes in manufacturers' business models and uncertainties linked to the new political leadership can all have an effect on managerial decisions.

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Over the last 30 years, China has experienced growth that has been unprecedented both in speed and scope. It has become the factory of the world, and is a favorite sourcing base for companies looking to lower their costs. With its comprehensive infrastructures and specialized industrial clusters, its abundant supply of low-cost skilled labor and its favorable government incentives, China offers competitive products and services to a broad range of industries.

However, sourcing from China is complex and full of challenges. Costs in the country are gradually nearing international levels, scandals linked to poor quality abound and long lead times make it harder to react quickly to market trends. Moreover, China is currently undergoing another round of transformations bringing operational uncertainties and risks.

### COSTS

Even with all the recent talk about China losing its competitiveness, sourcing from China still plays a major role in many companies' global sourcing activities. In Deloitte's latest Global Manufacturing Competitive Index (GMCI) – and in

line with its 2010 GMCI – China was ranked the most competitive manufacturing nation of the 38 countries evaluated by CEOs – and five-year predictions indicate that it will remain so.

However, the rising costs in China cannot be overlooked. Contributing factors include: commodity and wage inflation; the rising value of the Chinese currency; the increasing environmental, safety, health care and social costs, and the failure of many manufacturers to consistently improve their efficiency and operational systems. All of these factors are eroding competitiveness for a Chinese supplier. As such, what are Chinese manufacturers doing to maintain their competitive position?

One strategy already taken by many companies involves moving production bases inland, towards Western regions of the country. This strategy allows for taking advantage of cheaper labor, more favorable local government policies, and lower social and environmental costs. Problems arise, however, when companies fail to consider the importance of skilled and experienced workers (blue collar as well as white collar); when they underestimate the challenges of changes in the supply chain, and when they fail to address the question of how long the comparative advantages will last.



## IN COMING YEARS WE CAN EXPECT NEW POLICIES AND LAWS TO BE INTRODUCED, ALONG WITH CHANGES TO THE EXISTING FRAMEWORK

Managers are also making aggressive cost improvements. They understand the importance of scale in keeping overhead allocation low and maintaining power over suppliers. To enable the cutting of fixed costs, they are actively pushing out small customers that have no potential for future growth and are associated with operational complexities with too much product customization. Furthermore, there has also been a huge wave of investments in low-cost automation and production line re-engineering with the aim of saving on labor and increasing quality consistency.

In terms of the supply chain, decades of manufacturing have resulted in an ecosystem of suppliers that are specialized by sector, forming different clusters throughout China. Each cluster has a sustainable cost advantage due to specialization because they are able to capitalize on existing scale through a high utilization of capacity, accumulated know-how and skilled and experienced workers, as well as a business model that is based on a network of interrelated partners and, or, competitors, which allows for supply chain reconfiguration, making rapid changes possible.

### QUALITY

- When it comes to improving costs, supplier squeezing has led to tension between the parties involved. As a result, companies have found it difficult to cultivate long-term relationships with quality suppliers. All the same, most buyers still use this direct approach to cutting costs and many Chinese factories will do anything to please. When prices are famously low and production cycles are short, buyers need to wonder how factories can be so efficient and what exactly it is they are doing to achieve so much so fast, and so cheaply.

Serious buyers and manufacturers understand the challenges they face when it comes to improving quality. To start with, a significant number of quality recalls are caused by design flaws or omissions, independent

of the supply chain or manufacturing practices. In many cases, both suppliers and customers share accountability. To reduce design risks, manufacturers with R&D capabilities rely on accumulated know-how and experience by focusing on one specific industry and using independent testing centers. They also ask third-party specialists for assistance and maintain close relationships with their customers to encourage communication should problems arise during the development or production processes. Above all, both parties understand the risks and share the responsibility for maintaining their reputation in order to keep doing business in the industry.

Decades of exposure to best practices in manufacturing have trained a generation of Chinese managers to have a good understanding of continuous quality improvement, lean manufacturing philosophies and the associated tools. Be aware, though, that there are some who only scratch the surface and achieve only appearance. Serious managers understand the need for adapting theories to local circumstances in China, as opposed to strictly sticking to the books. When it comes to assessing a supplier be skeptical if all the quality management documents are complete, updated and, above all, clean. A well-used and dirty statistical process control chart is more indicative that the tool is actually being used during the production process.

### FLEXIBILITY

- For a big multinational corporation that sources huge volumes, an important criterion, though it is less explicitly mentioned by sourcing managers, is flexibility: production flexibility that allows for adapting to huge order variations at a scale that few suppliers can accommodate. Think of the launch of a product like the iPhone. The temptations are huge for companies to delay their order confirmations so as to pass on demand risks to their suppliers, requesting short lead times and avoiding inventory as much as possible.

This often implies huge costs for manufacturers – costs that manufacturers often struggle to digest.

This situation creates a strong motivation for manufacturers to change their business models. Most of them manufacture products that are commercialized by another company with its own brand name. Original design manufacturers (ODM) provide their own design, while original equipment manufacturers (OEM) use the customers' designs. ODM suppliers probably face situations involving all-or-nothing orders from big retail chain customers, especially when it comes to new products for private labels. There is often a mix of complex products in a single order for a fixed delivery date and customers are more inclined to exercise their bargaining power than to cooperate. An OEM supplier might have more room to share risks and enter into a constructive dialogue with customers, and a company dealing with its own brands will have more control over the whole operation. Companies strategies vary: for example, moving from OEM to ODM and then to an original brand manufacturer (OBM), which is a company that evolves from ODM, incorporating marketing and sales with their own brands and distribution networks. Other strategies include working with a mix of clients in order to balance capacity and utilization rates, or looking for complementary industries to offset cyclicalities.

#### **NEW POLICIES AND BUSINESS TRENDS**

● In addition to cost, quality and flexibility, there are other issues which should be taken into consideration.

With new political leadership's awareness of the need to effect profound change in the Chinese growth model, in coming years we can expect new policies and laws to be introduced, along with changes to the existing framework. In addition to the uncertainties that this may generate, a sudden insistence on complying with or executing existing policies

#### **IN SHORT:**

- \* **Manufacturing costs are rising fast in China. Having scale, good infrastructure and improving productivity will keep Chinese manufacturers competitive**
- \* **In product quality, both parties – suppliers and buyer – need to understand the risks and share the responsibility for maintaining their reputation in order to keep doing business**
- \* **As many Chinese companies move up the value chain, they are turning down opportunities with limited volume and growth and too much product customization**
- \* **With the new political leadership, China is currently going through big changes and reforms that increase operational uncertainties and risks**

could also result in unpredictable consequences at a macro-economic level, potentially even creating a direct impact on a particular industry.

It is common for serious Chinese companies to make the transition from manufacturers to service providers by developing the ability to offer customers an efficient and integrated solution for their needs. Attractive as this can be for a customer, be aware that it can also become a threat when your provider suddenly becomes your competitor.

In addition, though there have been significant improvements and in many industries you see suppliers who commit to long-term partnerships, it is still common local practice to engage in short-term actions that create advantages at the expense of a healthy long-term partnership with a customer. Issues like intellectual property infringements have made many companies skeptical when it comes to establishing long-term partnerships with suppliers in China.

Managing sourcing operations in China has its challenges, and when the stakes are high there are not many options apart from investing resources and management effort in setting up a proper strategy and building a strong local team to run daily operations and to provide information and feedback.