Purspective

LCC Sourcing under Uncertainty of Economy

Purchasing Club Meeting

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The escalated competitive pressures have set the expectations that companies need to continuously reduce their total costs, at the same time delivering faster and providing more diverse product portfolio. Over the past decade, low cost country sourcing has moved up its position on the agenda of purchasing executives. Increasingly, companies are taking advantages of opportunity to source from low cost countries, no matter from China, Brazil, India, Mexico and etc. in order to respond to the competitive pressures and sustain their business performance.

Low cost country sourcing has been adapted as an important sourcing strategy in different intensity, however, across almost all industrial sectors. Five years ago, the spending in low cost countries was 8-15% on average of the total expenditure of a western multinational. Today, it has grown to 20-25% on average. In some extreme cases, companies set ambitious goals that more than 50% of their expenditure will be in low cost countries by 2010.

Low cost country sourcing is not a "pancake falling from the sky" in Chinese saying. Apart from benefits such as cost savings, different low cost countries represent different concerns to purchasing executives. These differences are not only reflected in what can be exactly sourced from the low cost countries, ranging from raw materials, to components, to semi-finished products, to different level of technology embedded products, to customer services; but also in performances such as quality, delivery reliability, level of total costs, lead time, and capability in innovation. Furthermore, geopolitical and economic policies in different low cost countries have a lot to say to sourcing decisions and related day-to-day management. And their evolvement along the time can have a big impact on the net benefits that companies can enjoy from low cost country sourcing. "Low cost does not equal to low concerns."

2008 is a special year. China as one of the biggest beneficiary from low cost country sourcing successfully hosted the Beijing Olympic Games in August. Two months after the event, the country with the biggest population in the world has to face an unprecedented challenge from the change of global economy climate. One of the world's biggest toy makers, Smart Union, a key supplier to Mattel and Disney went into serious financial turmoil. More than 50% of its business went out in just 7 months.

This is not the end, and this is not only about China.

Three weeks later, the Michigan "Big Three" announced their heavy loss in Q3 of 2008. General Motors and Ford burned out more than US$14 billion in cash, which is almost the GDP of a small country. Last week Thursday (Nov 20th), the German chemical giant, BASF announced that it would close 80 plants due to slumping demand, and cut production capacity of 100 more. In consequence, it would affect the job of some 20,000 workers globally. The stock price of BASF was dropped by 9%.

At the same time, governments across the world were in actions. US government promised a rescue package of US$700 billion to the market. Early this month, Chinese central government decided to throw a stimulus package of US$588 billion (RMB 4,000 billion) to boost domestic demand, and approved the raise of export tax rebates for 3,486 items, which was ¼ of the total products covered by the country's custom office.

Market demand starts to shrink, suppliers are struggling with increased financial difficulties, and governments are taking proactive stance in rescuing the economy. This is the big picture of the world we are in today, and this is the background of the purchasing club meeting.

The question is: As purchasing executives deeply engaged in low cost country sourcing for the business, how do we look at these challenges and what do we see can be our opportunities? With these in mind, four sets of questions have been raised under the title of "Low cost country sourcing under uncertainty of economy". They cover "emerging risks deserved for our special attention", "impact on sourcing policy and guidance", "power balance between buyers and suppliers", and "critical success factors".

Purchasing executives from 15 businesses join the 4 hours meeting and heated discussions. Companies are across different industrial sectors e.g. retailing, high-tech, electronics, consumer durables, manufacturing, software development, cosmetics, medical devices, and private equity.

"If the risks have already existed, they may get worse under today's economy."

Currency fluctuation has always been one of the major concerns of purchasing executives in low cost country sourcing business. Under today's uncertainty of economy, it has been given more attention. Two months ago, the exchange rate between Euro and RMB was still around 10, today it is below 9. Considering that suppliers have fought hard through the past 18 months on inflation, 10% difference on exchange rate can have an additional negative impact to supplier's profitability if they are contracted in Euro.

"Cash is king." It is critical if supplier is able to leverage their fixed costs and installed manufacturing capacity in this difficult time. It is very much dependent on the customer portfolio that the supplier has currently. Drop of demand is a general phenomenon though; the intensity can be different from different customers. We may not be the one who introduce the biggest decrease of demand. However influences from other customers of our supplier can have impacts on the commercial offerings by the supplier. This raises the attention that when we now analyze supplier's financial health, we also need to give a more careful look at its customer base and the evolvement of capacity allocation/utilization.

"Bull whip" effect is a big enemy to inventory management when economy is good. It can have more impact on working capital when the climate turns bad. Often suppliers at upstream of supply chain are hit the most, which can quickly turn into financial turmoil and consequently cause supply disruption or even change of business ownership. It is important that we do not only look at our first tier suppliers but also extend our attention to second tier suppliers, in particular for those critical products and parts suppliers.

If we look at the economic development of the low cost countries that we are in, most of them have enjoyed double digits growth over decades. This also tells that quite a number of our suppliers in low cost countries do not have rich experiences in facing today's kind of economic climate. The lack of experience poses a very important risk.

Development of the economy climate this time is very fast. It is not only about how fast we need to respond, but also how fast we can take our suppliers to respond TOGETHER. If not, even the risks have already existed can get worse.

"Political environment dominates the debates on globalization vs. localization."

The impact of today's economy climate is around the globe. Governments across the continents are taking proactive actions to rescue countries' economy. These actions are in directions of re-collecting the confidence from public, boosting domestic consumer demand, creating more job opportunities, reducing burdens of tax payers, and adjusting import/export tariffs and rebates. Uncontrolled inflation and shortage of supply are the last things that any government wants to see today, as it can ruin the efforts they have put into these directions. On these aspects, low cost countries still have a lot to offer.

Being sourcing executives in low cost countries, our sourcing policy shall lead to a more cost effective and reliable supply chain management. Questions that we need to bear in mind to challenge ourselves are:

- Are there any more that we can source from low cost countries? --- *Portfolio analysis;*
- Are there any more opportunities that we can take to re-engineer our supply base for lower costs? --- *Supply base re-engineering;*
- Are there any more approaches that we can take to further reduce total cost of ownership e.g. reduction of unnecessary packaging? --- *Innovative cost reduction;*
- Do we have a solid and implementable contingency plan with our key suppliers? --- *Back-up scenario planning;*
- Are there any other areas/regions/countries that we can source from to enjoy fiscal benefits? --- *Fiscal rule analysis;*

Environment protection and social responsibility has increasingly raised the attention, in both developed and developing world. Under today's economy, it has an important role to play in terms of generating new businesses, reducing costs for consumers, and providing a sustainable growth path for economy. However at same time, it also means new investment, transformation of business/economy, and closure of environment unfriendly plants. Governments need to absorb and digest the costs and social issues related to such changes. The questions remain are how fast and how capable different governments can act on, and how will be the balance between benefits and costs in short-, medium-term. Nevertheless, it is the trend in a longer term, and we need to prepare ourselves and our supply base depending on different businesses.

"It is difficult to be a smart buyer."

With the combination of continuously expanded supply market capacity over the past decade and the quick shrink of overall demand under today's economy climate, clearly the power balance is converted to buyer's side in general sense. Buyers will be aggressively trying to "win back" the battle that they have struggled with in the past few years.

It is a good time to build a healthier relationship with suppliers at equilibrium. The kind of supplier relationship built over the previous years will be important and has its influence in the turbulence times of today. This also applies that the relationship defined today will have its impact tomorrow when economy walks out of its down turn.

Buyers need to be educated that under extreme pressures from empowered buyers, suppliers may behave irrationally in order to survive. They may create short term opportunities but in a longer term there will be risks for buyers. Irrational behaviors can be agreeing with tough terms and conditions imposed by buyers, but can also be a "forced" cartel between suppliers. Buyers with relatively stable volume will be more attractive to suppliers today.

Changing suppliers may not always be possible even with choices available in supply market. In some cases, with certain constraints e.g. technology, exclusivity, investment requirement, it is not straightforward for buying organizations to change suppliers. This turbulent time will provide a good opportunity to further strengthen the relationship if the organizations can really work side-by-side collaboratively. It will pave the road when economy picks up, and will become an important driving factor in future relationship and business. As multinationals, we have learned our lessons from previous recessions, and it's time to remind us on these learning.

Supplier relationship management is not only based on individual's intelligence. It is also and can be more influenced by organizations. It is critical to have good internal stakeholder management and alliance. Lack of organizational support, it is difficult to be a smart buyer.

"Communicate with suppliers quickly and effectively."

In an unfavorable economy climate, one of the biggest worries, if not the biggest, of a company, is losing its market share. This also applies for our suppliers. It is critical for buyers to communicate quickly with these suppliers the reasons behind lower forecasts to prevent harmful irrational behavior. Normal way of communication such as e-mail, letter, fax, and telephone may not be effective enough to remove suspicions. Face to face meeting is recommended.

Supplier development is another critical success factor. Under today's economic situation, our most concerns are not to the suppliers that we can find a dozen of alternatives in the market or we can switch quickly with low costs. Rather concerned are those strategic level suppliers. Supplier development is key to help suppliers overcome their difficulties in this turbulent time. And don't forget that if we do not do these, our competitors may do. Through our development efforts, these strategic level suppliers will improve their productivity, consolidate their market share, and strengthen their financial positions. In return they reward us with more competitiveness of their core competency which is our non-core competency. This requires a long term perspective thinking from the buying organization, and a better stakeholder management by purchasing team.

Supplier development and a healthier relationship with suppliers are based on a certain risk level that buying organization can accommodate. A structured supplier risk assessment needs to be installed as a key enabler. At this moment of time, financial risk overrides others as disruption of cash flow can trigger other risks to take place and immediately disturb the business. This naturally links back to the importance of contingency planning. Dual sourcing is recommended as an approach to be taken, if there are equivalent suppliers available in the market.

Summary

Development of economy today does bring a number of challenges to low cost country sourcing, particularly considering that not every supplier including ourselves has rich experiences in dealing with such climate. However we stay positive as low cost country sourcing still has a lot to offer to support governments' actions to boost countries' economy, in terms of providing more cost effective goods and their availability in market supply.

With the combination of continuously expanded supply market capacity over the past decade and the quick shrink of overall demand under today's economy climate, clearly the power balance is converted to buyer's side in general sense. However we need to stay cautious about the intensity of pressures we are going to apply to different suppliers (supplier segmentation).

Our most concerns today are not to the suppliers that we can find a dozen of alternatives in the market or we can switch quickly with low costs, but rather to our strategic level suppliers. Quick and effective communication with these suppliers on the change of our business is critical to prevent harmful irrational behavior. Supplier development represents an opportunity to help both suppliers and ourselves walk out of the difficult time together. It however needs to be justified by the amount and level of risks that we might be exposed to, particularly those triggered by financial risks. A structured risk assessment coupled with an implementable contingency plan is crucial.