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by Ronald Haddock, Michael Pfitzmann, and Reid Wilk

10/14/2008

a strategy+business exclusive

booz&co.

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Structural shifts in the Asian giant's economy are forcing companies to adopt deeper and more personal strategies for supplier relationships.

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The experience of a top U.S. retailer tells a lot about what it is like to do business in China now. Over the years, this company had built a broad supply base in China involving hundreds of firms — and inch by inch its rivals were doing the same. To seize an advantage over its competitors, the retailer decided to significantly narrow this supply base and create deeper relationships with a relative handful of trusted suppliers. It was a wise move: Benefiting from supplier expertise and collaborative partnerships, the retailer gained a 33 to 50 percent advantage over its competitors in terms of the time needed to introduce new products to the American market.

Although the retailer can claim success, few companies have followed its lead. The myth still persists in some quarters that smart analysts in a back room can understand bids from Chinese suppliers a continent away, despite having little contact with the companies that are being asked to produce and ship critical components and products. Indeed, many U.S. and European manufacturers send an RFP (a Request for Proposal, asking suppliers to bid on a job) to Chinese companies without ever setting foot on the mainland.

Such practices will no longer work, partly because of important structural shifts under way in China's economy, including commodity and wage inflation, the rising value of the Chinese currency, high real costs of talent due to low employee retention, and the failure of many manufacturers to implement efficient and lean operational systems in their plants. Because of these factors, some 50 percent of multinational companies doing business in China think the nation's competitiveness in low-cost manufacturing is eroding, according to a new survey by Booz & Company and the American Chamber of Commerce in Shanghai. Almost a fifth, or 17 percent, are considering — and in some cases already pursuing — a shift of operations to even lower-cost countries such as India, Vietnam, and Thailand. Nonetheless, the vast majority of these companies find China to be highly attractive as a growth market, thanks to its expanding economy and a middle class that continues to grow by tens of millions of people every year.

Faced with these conditions, companies will find it increasingly necessary to pursue a dual strategy of using the Chinese platform to make more sophisticated product components for export and simultaneously seeking to penetrate the domestic market. This means taking a more holistic view of how sourcing fits into a company's overall activities in China, and it requires a deeper level of management engagement. Consequently, we believe that multinationals should consider adopting

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the new approach to working with Chinese suppliers that we call knowledge-based sourcing, which significantly increases insight into the supply base through a deeper understanding of — and two-way discussions about — production costs, manufacturing and transportation economics, lead-time requirements, schedule stability, the likely degree of product design changes, and the technical skills of the suppliers.

The use of knowledge-based sourcing in China is a controversial idea for some Western executives. In their minds, an investment of this magnitude, which can require maintaining a staff of dozens or hundreds of people in the country, could offset any possible gains from sourcing there. Wal-Mart seems to adhere to this view. It requires its suppliers to participate in an annual bidding process that consistently awards contracts to the lowest bidder (even as, critics allege, the quality of its products declines). This process serves the purpose of driving the price down with each passing year, which is Wal-Mart's primary motivation. But it does little to develop strategic supplier relationships, decidedly a low priority for the retailer.

It's a different game entirely for companies interested in long-term, innovation-based relationships and for retailers seeking to improve product design and quality or to secure access to unique capabilities. If top Western executives need to change their product designs in response to new tastes or market demands anywhere in the world, to what extent can they count on Chinese suppliers to understand those realities and to accommodate them if they do not have a close partnership?

Moreover, consider the costs that companies can incur if they fail to pay close attention to their suppliers. Mattel Inc., for instance, was forced to recall more than 20 million toys — mostly because of lead paint — that had been sold from November 2006 through August 2007. What Mattel and other companies learned from this experience was the importance of having the right people and processes in place from the outset. In other words, a greater up-front investment in supplier relationships reduces the risk of having to pay far more to clear up a problem after it has erupted.

Putting Theory into Practice

When companies decide that a knowledge-based sourcing approach in China (or another low-cost country) is right for them, three imperatives are essential to successful implementation:

1. Know your suppliers inside out. This includes understanding the true cost positions of current and potential suppliers. We have heard of many cases in which a supplier in China did not understand its own costs. It won work from major manufacturers and retailers only to discover that it was losing money by fulfilling its contracts. Not surprisingly, these relationships fell into crisis. Visit suppliers and see their technical capabilities and capacity with your own eyes — their machinery and equipment, their process technologies, the number and qualifications of their employees, and the like. A bid is no guarantee of a supplier's willingness and ability to meet current volume and quality requirements or its future competitiveness.

Assess supplier performance against major cost drivers (including wages and benefits, productivity, facility and process/equipment scale and utilization, logistics, and access to raw materials). Low labor costs and the ability to obtain cheap raw materials and components are just two possible elements of cost structure. To gain a true advantage, it is important to establish the ideal combination of world-class performance with location, scale, process technologies and automation, and success in execution. It will then be possible to rate potential suppliers against that ideal and determine how close a supplier from a low-cost country can come to meeting it. In some cases, it might be more advantageous to select a supplier closer to home.

2. Develop strong relationships with a small number of suppliers. Identify the suppliers that are willing to commit to a long-term relationship and to jointly creating a competitive advantage. Offer an enduring and profitable business relationship to each supplier and, in turn, demand its commitment to meeting cost, delivery, quality, and, if applicable, innovation targets. This will likely require local resources dedicated to supplier development, which means working with the supplier to achieve ambitious jointly established targets.

To avoid fragmentation of the supply base, stop bidding out each part and dropping suppliers any time another company offers a better deal. It is difficult for suppliers to develop the right capabilities, make customer-specific investments, and work together well if they're not confident of continuity.

Beware of the risks of a large supply base into which you have little insight and over which you have little control. The dangers include divisive conflicts within the supplier's leadership team, financial problems, shifts in the supplier's strategy or customer base, and deteriorating performance. These problems could go unnoticed until crucial shipments are missed, costs mysteriously escalate, or quality suddenly nose-dives.

Finally, avoid the transactional costs associated with managing many suppliers. Each supplier, particularly one far away from a customer's locations, requires valuable and often expensive resources in purchasing, engineering, and other functions to manage purchase orders and financial transactions, to review and discuss quality and delivery performance, and to work on innovation and product design changes. The larger the supply base, the more resources are required to manage transactions, control supplier performance, and address issues in the relationships. These resources could be better spent on valuable activities such as working on an innovative or lower-cost product design.

3. Work jointly with your suppliers on continuous improvement. Focus on developing suppliers' capabilities and advancing their competitiveness over time. Set ambitious but realistic targets for better performance in cost, quality, delivery, or innovation, and work with your suppliers, not against them, in achieving those goals. Successful continuous improvement requires agreed-on objectives, clear communication about current and anticipated costs and processes, and an open exchange of ideas about how to improve.

Large customers often have internal knowledge about advanced concepts such as lean manufacturing that many low-cost suppliers have not yet developed. Improving low-cost suppliers' capabilities in that regard can pay off for both parties. If you have a smaller, more dedicated supply base, you can afford to invest in relationships and ensure a higher level of coordination in the entire supply chain.

The GM Advantage

General Motors Corporation's sourcing program in China reflects both the demands and the benefits of knowledge-based sourcing. GM is very active in China: The company has a joint venture in Shanghai with SAIC Motor Corporation and sells a million vehicles a year in China, making it the number one player in the market. GM also purchases US$2 billion worth of parts each year from Chinese manufacturers to ship to its plants in Asia and North America. In addition to staff assigned to the joint venture with SAIC, Bo Andersson, GM's group vice president of global purchasing and supply chain, has put in place a veritable knowledge-based sourcing blitz: Two hundred and fifty GM purchasing professionals in China work with suppliers to monitor and upgrade their capabilities, as well as to build strong relationships that can redound to GM's advantage.

GM's goal is to find local entrepreneurs and take an active hand in the evolution of their businesses. "It may take us 10 years to develop them, but we'd rather do that and have loyal suppliers forever," Andersson explains. "Our strategy is based on the fact that we are willing to do a lot of work with people who have the right mind-set and the right culture and the right cost structure, versus just sourcing from China."

The ability to adopt and use a knowledge-based sourcing approach takes on particular urgency in view of the rising currency and changing cost structure in China. Companies that want to hold their margins and maintain access to that fast-growing economy must increase the efficiency of their Chinese supply base. Even those manufacturers and retailers that choose to simply shift their supply base to a lower-cost country, such as India, Vietnam, or Thailand, would do well to observe the essential truths of knowledge-based sourcing. As these emerging economies prosper, it is very likely that they will go through the same evolution that China is going through now. When that happens, the winning multinationals in those countries will be those that learned from their experiences in China and implemented best practices in sourcing from the start. +

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