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Sourcing Goods from China:

The Mass Migration

Everyone is doing it, but is it right for you?

Isaac Cheng

IF you work for a manufacturing or retail company and have not yet moved operations beyond domestic borders, someone in your boardroom has likely asked in the past year, Should we source from China?

Most larger US companies, which profit more from cost-cutting moves because of their scale, have already made the move, with many giants such as Wal-Mart Stores, Inc. and General Electric Co. setting up purchasing centers in China to feed their global supply chains. Even companies that have decided that their existing manufacturing operations are best left untouched for now are reexamining their upstream supply chains and confronting their suppliers with price quotes from Chinese producers. If your company has never looked at the option before, now may be the time to look. And if you have looked before, it may be time to look again, since the manufacturing dynamics in China change quickly.

The big question

The first question for the uninitiated, of course, is: Should we go to China? The answer depends in part on your company's products (see p.21). Most analysts note that China excels at sourcing components or goods made on templates, such as furniture, toys, and consumer electronics and appliances. Telecom, biotechology, and electronics are also emerging new strengths, and General Electric Co., Microsoft Corp., and Motorola, Inc., among others, have set up global research and development centers in China to capitalize on them.

The answer also depends on the level of PRC exposure your company seeks. For companies entering China only for procurement, cost advantage is still China's primary draw, but companies considering more permanent stakes may find better product quality and manufacturing flexibility, as well as growing domestic demand, to be more important. Depending on these factors, here's what sourcing from China can offer your company:

- **Lower labor costs**

According to a Boston Consulting Group (BCG) outsourcing report, the average hourly pay (including benefits) of production workers in China is $0.80 versus $21.86 in the United States; given the same equipment, American workers need to be 25 times more productive than their Chinese counterparts to remain competitive. Furthermore, if PRC government reforms on labor mobility succeed, huge labor surpluses in the rural areas and underemployed workers at state-owned enterprises waiting in the wings may keep manufacturing wages competitive for some time.

- **Long-term flexibility in production**

Companies often overlook the fact that, once Chinese workers have been well trained, substituting human hands for expensive, specialized machines can actually improve the flexibility of production lines.

- **Proximity to downstream manufacturers**

For companies that churn out intermediate goods such as auto parts, refined chemicals, and machine tools, customers—other factories—are increasingly located in China. Paradoxically, moving operations to China nowadays can lower shipping costs in addition to lowering labor costs.

- **Familiarity with the PRC operating environment**

Companies with longer-term plans to supply the

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Chinese market can start with a sourcing operation, which enables them to explore their options and lay the groundwork for a move toward local production.

● **Lower capital costs**
For companies that plan to set up PRC manufacturing operations, land and setup costs can be a fraction of US costs, at least in the interior provinces and outside of major cities. Companies also find that using local components often minimizes input costs.

● **Favorable tax structures**
Foreign-invested manufacturers enjoy a tax rate of 15 percent, as opposed to 33 percent for domestic enterprises, and the government rebates up to 15 percent of value-added taxes (VAT) on exports (see the *CBR*, January–February 2004, p.32). Though the government has plans to unify the business tax structure and phase out some of these incentives, localities are likely to continue to offer incentives to lure investors.

China is equally well known as a tough environment for logistics and intellectual property rights (IPR) protection and as a lackluster enforcer of legal contracts. Specific difficulties in sourcing include:

● **Initial start-up time**
Getting a sourcing operation up and running may take longer than you anticipate, depending on the complexity of your product and your supplier's abilities. Finding a new supplier almost always requires new molds or new lines and plenty of quality control.

● **A weak intellectual property regime**
Foreign companies will find IPR protection a major concern for the foreseeable future, despite promising Chinese commitments on IPR made at April's Joint Commission on Commerce and Trade meeting between senior US and PRC trade officials.

● **Increased management complexity**
Adding an overseas branch or supply relationship requires stronger communication, stringent quality control monitoring, and a redesign of operations to adjust for different comparative advantages. The sheer geographical and cultural distance between the United States and China causes some small US companies to hesitate; even the 12-to 15-hour time difference can make teleconferencing a headache.

● **Longer and more complex supply chains**
Delayed delivery of consumer goods to US and European consumers is a risk unless companies manage their supply chains properly.

● **Energy shortages and other operational hiccups**
This summer, factories across China were crippled by power shortages, which are likely to persist through 2005. PRC producers have borne the brunt of the power outages; some have been forced to operate only on the graveyard shift.

● **Decommissioning of local assets** Companies may find that closing US factories and laying off workers at home are necessary if sourcing adds excess capacity and returns to local assets are low. The penalties are unique to individual companies but usually entail financial, social, and sometimes political costs.

The 1-2-3 of Sourcing

1. Pick product to source
2. Define supplier and product criteria
3. Search for suppliers
4. Research supplier qualifications
5. Evaluate samples
6. Audit factories
7. Test order
8. Choose supplier
9. Establish reliable quality control
10. Establish communications
11. Establish supply chains
12. Monitor patent protection
13. Enforce long-term cost reductions
14. Repeat as needed

As more foreign companies move to China, they are creating nuclei of high-quality production and are challenging local factories to compete not only on price but on quality and service.

Other trends have added to the appeal of China as a sourcing destination. First, as more foreign companies move to China, they are creating nuclei of high-quality production and are challenging local factories to compete not only on price but on quality and service. Second, as the Chinese consumer market grows enough to support major industries, companies are establishing their presence in hitherto unexplored categories, not only across product lines but also vertically along the supply chain. Retailers and product assemblers are joining component makers in China, meaning that, for some companies, all their partners have already made the move. Finally, the PRC government seems to have convinced the business community that it is serious about building an investment-friendly institutional regime. For instance, the new PRC Administrative Licensing Law greatly increases transparency in licensing and registration. And China's strenuous efforts to be recognized as a market economy, and the Chinese Communist

Should My Product Go?

A check-heavy left side argues against sourcing from China; more checks on the right signal a move may be appropriate.

LABOR CONTENT		
❑ Blend of automation and highly skilled labor	❑ Automated processes	❑ Labor-intensive manufacture
IPR DANGER		
❑ Intellectual property integral to product	❑ Proprietary parts easily segregated	❑ Public domain
CHINA MARKET POTENTIAL		
❑ No perceived PRC demand	❑ PRC demand is rising but not yet robust	❑ China is the main growth market
PRC SUPPLIER ENVIRONMENT		
❑ No PRC producers	❑ Some PRC producers	❑ PRC is leading global producer
LOGISTICS CONSTRAINTS		
❑ Customized orders for time-sensitive clients	❑ Faraway clients but uniform shipments	❑ Strong international distribution chains
DEMAND STRUCTURE		
❑ Unpredictable fluctuations	❑ Predictable fluctuations	❑ Stable
STANDARDIZATION OF GOODS		
❑ Customized	❑ Partially customized	❑ Standardized

Party's new embrace of private entrepreneurs, offer some comfort for foreign investors uncertain of China's long-term commitment to a more open economy.

Assessing the costs

Each company must make its own decision to move to China, and a careful cost analysis is a critical part of this decision. A China-based competitor's price, adjusted for quality and market position differentials, can serve as an initial guide. Total cost analysis will incorporate cost savings (the largest portion of which is usually cheaper labor and components) and additional costs incurred, such as the initial setup costs and higher freight costs and duty payments. A more complex model will include sensitivity analysis to anticipate different scenarios, such as a government-forced slowdown or widespread power shortages.

Choosing the right path

Perhaps the easiest way for a company to source in China is to link up with an existing supplier's operations there or to encourage an existing supplier to also make the move. This allows for Chinese production prices at a familiar level of quality control and delivery.

Five Options

Think strategically and consider long-term plans before you pick your path.

Structure	Pros & Cons
1. Source selective components using sourcing agent	PROS: Easy to set up CONS: Low cost savings; little awareness of China markets
2. Source products through representative office in China	PROS: Hands-on approach and development of local expertise lets you sleep easier at night CONS: Increased management demands
3. Establish global procurement center	PROS: Maximize savings internationally; build deep relationships with PRC suppliers CONS: Requires good enterprise and communication systems within the company
4. Set up joint venture or wholly foreign-owned manufacturing enterprise in China	PROS: Production with rapid response; better positioned to capitalize on growing PRC strengths CONS: Large fixed investment
5. Create full manufacturing, distribution, and sales network	PROS: In some industries, China is the major growth market CONS: CEO or board decision; must have long-term investment and exit plans

Sourcing Help

Companies that otherwise would go to China often delay because of the initial capital and management outlay required, and the complex operational and regulatory environment in China. One solution to these problems is to retain a sourcing firm.

Some firms cover the entire process, from finding suppliers to transferring design specifications to setting up the supply chain and conducting quality control. This is a good choice for small companies or companies with limited management resources; all communication is with the US-based office of the sourcing firm. These firms generally charge between 3 and 12 percent commission on invoiced goods, depending on the complexity of the process and the scale of the order. Examples include ThreeSixty Sourcing Inc. and International Smart Sourcing Inc.

Other sourcing agents operate more as matchmakers. One example, Shanghaimart, gathers providers of high-value manufactures in a trade center in Shanghai according to client specifications and offers order coordination, trade financing, and limited delivery services. Such firms should be used if companies are comfortable handling their own supply management and are willing to take a more hands-on approach.

For companies that plan on setting up their own sourcing operations but need advice on PRC regulations and commercial realities, a consultant expert in Chinese commercial law can be invaluable. These consultants, which include China-focused consultants like NCO Ltd. in Shanghai or China branches of international firms such as Accenture Ltd. and Monitor Group, offer advice on corporate structures and different partners and locations to consider.

Regardless of specialty and size, the most important qualification of a sourcing firm is operational experience and a strong presence in China, preferably in more than one location. Sourcing agents should be able to present their search process and their track record in your industry up front and, ideally, come with referrals from your partners. Before entering the relationship, your company should be clear on how the sourcing agent matches suppliers and clients and should define the degree of involvement that will be required of your company.

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Another way to find partners is through industry trade fairs in China; referrals from officials in the relevant ministry or local government; discussions with the American Chamber of Commerce, the US-China Business Council (publisher of this magazine), the US Commercial Service, or other trade organizations. Firms can also ask existing Chinese partners about potential partners or suppliers in other product areas, keeping in mind possible biases they may have.

Companies that are understaffed or on a tight budget can turn to sourcing agents (see above). Outside help on sourcing ranges from matchmaking to consulting on logistics and quality control. According to *McKinsey Quarterly*, procurement agents' fees range from 3 to 12 percent of the purchase price, depending on the level of service. Of course, careful vetting of sourcing firms is crucial.

Do due diligence

The next step is to conduct due diligence on PRC factories—examine their financial health, production capacity, quality of goods, client references, export history, IPR performance, and level of experience with Western or US companies. It is important to compile as broad a list of potential factories as possible. According to BCG's report, Carrier Corp., an air-conditioner manufacturing subsidiary of United Technologies Corp., obtained 1,600 quotes before making its first order. Product samples are the first bar—shoddy quality or unreliable delivery should eliminate candidates.

After narrowing down the field to three to five suppliers that look good on paper and produce good-quality products at a satisfactory price, a detailed factory audit in China should follow. During the inspection, it is important to bring a good translator and to take the time to understand each candidate's production process and ensure that it meets international product and labor standards.

US companies will want to ask questions such as: Does the Chinese vendor run its own compliance checks on quality control and have sufficient oversight? Is the PRC supplier likely to outsource the order? Second-degree outsourcing makes it more difficult for companies to monitor supplier quality and ensure that there are no environmental, health, safety, or child labor violations in the manufacture of its goods.

The next step is for your company to make a detailed, second-level assessment that integrates buyer requirements into the evaluation; this process usually rates the candidate as a whole, including all business practices, with a specific grading scale for each set of criteria. Your company can then either choose one candidate or start a bidding process between the potential suppliers on your shortlist.

It's all about execution

Once your company finds a Chinese partner, how do you structure the relationship? Some companies make frequent buying and audit trips to China or use a full-service sourcing agent. Though this is an easy way to test the waters, it fails to capture many of the long-term advantages of sourcing from China. Setting up a PRC representative office to manage sourcing operations may be a better choice (see p.28). The representative office is relatively simple to establish, although it cannot export goods on its own account. Another similar option is to set up a sourcing coordination center in Hong Kong, which allows control of shipping and more security over transactions (at the expense of higher operating costs and greater distance from the manufacturing plant). Companies with longer planning horizons, more management heft, and a commitment to the Chinese market may choose to set up a wholly foreign-owned enterprise (WFOE), a more popular means of entry than the joint venture (see p.6). Some companies acquire a PRC firm to jumpstart their WFOE formation.

No matter what route you take, maintaining high product quality will be challenging. For critical components with a low tolerance for error, having an employee on the ground to monitor the manufacturing process is indispensable. For other goods, regular onsite inspections, random product sampling, and periodic holistic evaluation of supplier operations generally suffice. One US company holds monthly online performance reviews with each vendor. These reviews are public to competing suppliers, creating a unique info-sharing and peer pressure environment. The company also conducts direct performance reviews two to four times per year, depending on the sensitivity of the product. Quality maintenance, delivery performance, inventory, and cost savings should all be reviewed, with the supplier submitting specific evidence to show that it is verifying process control and implementing agreed-upon standards (local and otherwise). If there are breaches, the PRC supplier must have a non-negotiable timeline for returning to the standards.

The rules for quality control hold equally true for social responsibility standards. In many cases, the PRC vendor is aware of the local environmental, health, and safety standards but is uncertain what action to take to meet these requirements. If forced by local content requirements to choose vendors less savvy about regulatory compliance, a company may need to invest resources to educate and upgrade the supplier. One of the benefits of this approach is the usually favorable relationship that develops between the vendor and the buyer.

Strong communications systems are critical to supply chain management. According to sourcing firms, the order-to-delivery lag can be as short as 12 days but can run up to 8 weeks. If demand changes unpredictably or there is no capacity for excess inventory, good communication between China suppliers and US clients becomes crucial. One US company uses an online supplier databank to allow Chinese suppliers to submit all documents, including invoices, online and also to enable buyers to track purchase orders.

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Communication is also necessary between the head office and the office responsible for China management. For multinationals or companies with multiple business lines, good online technology also encourages local operations to coordinate buying efforts and thus maximize the cost savings that Chinese procurement brings.

Don't rest on your laurels (or your cost savings)

Finally, companies already in China cannot afford to be complacent. It is no secret that the PRC manufacturing environment is changing quickly, especially in terms of diversification. Companies should plan annual or biannual reviews of their product lines to see if sourcing or logistics operations need to be modified. Sourcing consultant ThreeSixty Sourcing Inc. estimates that even their clients with operations already in China often achieve cost savings of 25 percent. Other sourcing firms cite inability to keep track of regulatory and operational developments as a primary reason that companies retain them.

The standing lesson from the failed wave of foreign investment in China in the 1990s is that companies that refuse to adjust to changing local conditions put themselves at a disadvantage. As the Chinese say, "it is the flowing water that stays fresh" (*liushui bu fu*). This is true not only in the PRC consumer market, but also in the manufactures market. 完