

strategic insight

GLOBAL SOURCING

fleeing China? Look before you leap

2008 gave U.S. companies many reasons to re-examine sourcing in China. But pulling up stakes may not be the answer.

By **MARK B. SOLOMON**, SENIOR EDITOR
From the **January 2009** issue

If ever there was a year for U.S. multinationals to rethink their China sourcing strategies, it might have been 2008.

The spike in oil prices and mounting labor and raw materials costs made sourcing in and shipping from China a more expensive proposition than ever before. The near two-month shuttering of factories and mines in readiness for the Summer Olympics put a crimp in supply chain flows, especially for foreign importers who failed to craft contingency plans. The financial meltdown left credit scarcer and more expensive, making it difficult for suppliers to secure financing and driving up the costs of carrying inventory that can spend 20 days or more in transit from Asia to North America. And the severe global economic downturn shut down tens of thousands of Chinese factories. By one Chinese government estimate, 67,000 Chinese businesses failed in the first half of 2008 alone. By another, half of China's 3,630 toy making plants—mostly smaller, lower-tier operators—had gone out of business by the end of August.

Then there are such chronic concerns as intellectual property infringement. In the fiscal year ending Sept. 30, 2007, China was the origin of 80 percent of counterfeit and pirated products seized by U.S. Customs and Border Protection, according to the International Anti-Counterfeiting Coalition. The seized products were valued at about \$158 billion, IACC says.

In addition, businesses still struggle with the inefficiencies of a relatively primitive Chinese logistics infrastructure and a dearth of skilled practitioners. As a result, shipping costs from China run as high as 10 percent of a product's retail value, compared with 3 percent in the United States and Europe, according to data from consultancy AMR Research. And worries linger over the quality and safety of Chinese imports in the wake of toymaker Mattel Inc.'s massive 2007 recall of Chinese-made toys after they were found to contain excessive amounts of lead.

Companies that had built much of their global sourcing platforms around China had a lot to think about during 2008. Suddenly, the idea of "reverse globalization"—or bringing supply chains closer to home—didn't seem far-fetched.

But with the new year comes a settling of the dust. The Olympics are history, along with the production hiccup that accompanied the games. The Chinese government has launched a \$586 billion stimulus program, much of it aimed at improving the nation's infrastructure. There are glimmers of hope that the turmoil in global credit markets will recede so normal lending can resume.

Most notably, oil and raw materials prices have fallen considerably from their 2008 peaks. The sharp commodity price declines have given global companies a badly needed respite from the cost pressures experienced during most of last year. It also gives them an opportunity to re-evaluate their sourcing strategies and determine if the issues that drove their supply chains to China in the first place are still valid today.

Sticking with the plan

To be sure, no one is counseling businesses to act on what could be short-term price or market fluctuations and dismantle intercontinental supply chains that took years and significant capital to build. And there are indications that, for all the heightened risks and costs, many U.S. companies now in China plan to remain there.

According to a preliminary survey of 108 manufacturers in China by the American Chamber of Commerce-Shanghai and management consultant Booz & Co. (formerly Booz Allen Hamilton), 90 percent of the respondents say they don't plan to move their production capacity out of China in the next five years. That is higher than the 87 percent positive response rate in 2007, says the chamber.

The potential of selling into China's vast and growing domestic market could be a compelling reason to keep production there. In the survey, most respondents say the opportunity to penetrate the country's domestic consumer base is the most important factor in their decision to remain.

As for competition from other low-cost Asian contenders, Steve Ganster, senior vice president, Asia, for Tompkins Associates, a Raleigh, N.C., firm that advises mostly U.S.-based Fortune 500 and mid-size companies, has analyzed the costs of sourcing in nearby Vietnam and found that with the exception of savings in the value-added tax regimes, there is no appreciable benefit. India, he says, is hampered by an inferior infrastructure and a multilayered bureaucracy that makes it virtually impossible to develop and implement projects in a timely fashion.

"China is unparalleled in its economic scale and size for both exports and domestic demand," says Ganster. "None of the countries we've looked at will be able to match China's will and ability" to continue to make offshoring an attractive sourcing option.

Ganster advises companies now in China but mulling a shift in their sourcing plans to first examine ways to optimize their existing distribution networks. He says that might include more effective consolidation practices at origin or streamlined transportation strategies such as shipping direct to customers and bypassing warehouses and distribution centers in the United States.

The risks remain

At the same time, however, the factors that led businesses to question their China sourcing strategies are still very much in play. Chinese wages are on an inexorable upward march. From 2002 to 2006, "total manufacturing wages" in China rose by

nearly 70 percent, according to consultancy IHS Global Insight. A September study by McKinsey & Co. found that Mexican workers today make only 1.15 times that of their Chinese counterparts; in 2003, Mexican wages were double that of Chinese workers.

And while a barrel of oil in early December traded in the low \$50 range, the consensus is that it's just a matter of time before oil prices return to or near historical highs. In the early fall, when oil prices were hovering around \$100 a barrel, the fuel costs embedded in shipping an ocean container equaled an 11-percent tariff on U.S. imports; in 2000, when oil prices were around \$20 a barrel, the figure was close to 3 percent.

Fuel and labor expenses can make or break an intercontinental sourcing strategy, according to McKinsey. The firm compared the costs of building a mid-priced computer server in the United States, Mexico, and China and distributing it in the U.S. market. McKinsey found it has become more profitable to make the server in Mexico than in China because of China's rising freight and labor costs. What's more, after factoring in all the elements that make up a product's "landed cost," the server manufacturer would actually spend \$16 more per unit making and shipping the product from China than building it in the United States.

In a global survey of nearly 350 senior executives conducted by the Economist Intelligence Unit and sponsored by UPS, nearly half of all respondents said low-cost sourcing had created significant problems, especially in the areas of product quality and delivery reliability. Although most companies surveyed plan to increase their low-cost sourcing, 10 percent intend to reduce it.

Findings like that are welcome news to countries like Mexico, which had hoped for a southward migration of U.S. businesses following the North American Free Trade Agreement only to watch many of them head instead to China. This time around, it's a safe bet that Mexico will aggressively tout its value as a sourcing alternative to China. "The Mexicans missed their first chance with NAFTA. They aren't going to miss it again," an executive of a major U.S. transportation company said at the recent National Industrial Transportation League meeting in Florida. The executive asked not to be identified.

Nathan Pieri, senior vice president, marketing and product management for the consultancy Management Dynamics Inc., says Mexico offers a number of advantages for companies seeking to place or move production closer to North American markets. Beyond the fuel savings and the narrowing of the wage gap with China, Pieri cites the ability for companies producing in Mexico to handle product returns faster and more effectively, and to engage in "postponement"—a strategy that allows them to delay investing in a product until the last possible moment and still get goods to all major U.S. markets in one to five days without relying on pricey airfreight services.

Pieri says the "risk factor" in doing business in China is about double the risk of trading with NAFTA countries. He adds that many businesses don't fully factor in the cost of intellectual rights infringement when developing their sourcing strategies. "It is surprising how slow the international trade community is in reacting to this issue," he says.

Ganster of Tompkins acknowledges that intellectual property violations are an important issue. "But you have to balance those risks with what might be the bigger risk of not doing business in China at all," he adds.

Song of the south

Those companies looking to source their production farther south in the Americas may find the existing infrastructure poses a significant impediment. As of year-end 2004, of Brazil's 1.75 million kilometers (about 1.1 million miles) of roadways, only 96,353 kilometers (59,871 miles) were paved, according to data from the Central Intelligence Agency's World Fact Book. In Argentina, about one-fourth of all of the country's roads were paved, according to the CIA book.

Michael B. Berzon, who spent 27 years at DuPont Co. before forming his own consultancy, which is actively involved in Latin American logistics, says there has been little change in Argentina's infrastructure since then, and at best modest improvement in Brazil's. Berzon says most of the paved roads in the two countries link their commerce centers. However, he adds that the vast majority of trucks travel over those relatively few paved roads, creating enormous congestion.

In Brazil, the problem is compounded by an inadequate rail intermodal network, says Berzon. The country's rail system is capable of handling only bulk agricultural commodities moving from Brazil's vast interior to the major cities and ports, he says. Virtually all merchandise traffic to and from the nation's ports moves by truck, Berzon says, creating an enormous bottleneck at ports and highways.

In the end, analysts contend, multinationals are best able to control their global sourcing risk by diversifying their geographic sourcing locations instead of using just one, and by increasing their IT investment to obtain clearer visibility across the supply chain. Above all, these analysts say, executives must do a better job of analyzing the total landed cost of each offshore product and understand the changing tradeoffs between the cost savings from offshoring and the rising labor and shipping expense that accompanies it.

"We don't expect to see low-cost sourcing go away," Dan Brutto, head of UPS International, said in a statement accompanying the Nov. 1 release of the joint survey with the Economist Intelligence Unit. "But it will look different in the future. The keys to successful sourcing from low-cost countries are like those of supply chain resilience in general: understand the issues, structure the supply chain appropriately, monitor performance, and work with suppliers to improve operations." Brutto added that diversified sourcing and "near-sourcing" are likely to become supply chain management best practices in the future.