

## **Outsource Manufacturing in Today's Economic Climate**

Over the past decade, the term "Low Cost Country Sourcing" emerged as the buzzword for outsourced manufacturing with an emphasis on the cost element. There's no doubt that the economics of such a strategy will always play a prominent role in any corporate decision to move the manufacture of a particular product overseas. And it is true, or at least was, that there were plentiful opportunities to benefit from the lower cost base that factories in emerging economies could leverage off and therefore increase margins significantly. This article looks at what "Low Cost Country Sourcing" means in today's global economy and how to benefit from the opportunities that are still available.

### What is Low Cost Country Sourcing?

As mentioned above, "Low Cost Country Sourcing" was a phrase coined towards the end of the 1990's which encapsulated the rush to source products from foreign soils in order to benefit from the labour rate arbitrage. Then the reduction in costs was so significant that companies could not fail to increase margins even if every now and again they received bad quality products which were not saleable.

China has emerged from the adoption of Low Cost Country Sourcing as the "norm" in the context of outsourced supply chains. China's dominance will only continue to increase on the world stage. At the beginning of the year, all remaining clothing quotas were removed as part of World Trade Organisation Accession deals that were struck in 2005. Historically, the removal of quotas on restricted goods in both 2002 and 2005 has led to an increase in Chinese market-share and reduction in price of the restricted products of up to 20%. Unfortunately, countries such as Bangladesh, Pakistan and Indonesia have relied on the restricted goods from China for their own export industries. Moreover, Chinese Central Government also continues to increase the export rebates in order to stimulate exports which it is able to do because of its Value-Added Tax system which is similar to that used in the EU (as opposed to the US direct taxation system on Income and Property).

Even though China remains the largest exporter to the Western World, it is not as easy as it once was to capitalise on the reduction in the cost of goods from abroad. Costs for suppliers have increased across the board (wages, social security, rents and local governments have clamped down on taxes rates) which has fed through to the cost price. Whilst in the past, the general consensus was that companies could buy everything for virtually nothing, we have now learnt through painful lessons that this is not possible. Companies now have to manage their suppliers and understand what a fair target price is for any one product that they wish to source. A sense of perspective has been restored.

### Best Country Sourcing

This perspective has made the phrase "Low Cost Country Sourcing" less applicable to the modern supply chain. Although the price remains an essential factor in selecting both the jurisdiction and the supplier, companies now want the reassurance that they will receive timely shipments without any quality problems even if they are not paying the absolute minimum for the products. If you talk to people within the industry, many now refer to "Low Cost Country Sourcing" as "Best Country Sourcing" which neatly reflects the change of emphasis.

The macroeconomic climate over Q4 of 2008 and the first two quarters of 2009 has only heightened this mentality. Companies' sales have decreased and in an attempt to manage inventory levels and remove any surplus from supply chains, it is absolutely essential that there is no problem with the

quality or the timing of each shipment. We refer to this as the hidden “Cost of Quality”. Although an intangible measure of risk in the supply chain, it is essential that it is not underestimated in today’s economic climate. Suppliers that were badly managed but were able to remain cash rich because of the continual replenishment of their order books no longer exist or, if they do, they have probably been acquired by a well managed supplier. In China, the downturn in the global economy coincided with the introduction of new laws to ensure that factory workers were paid properly meaning that there was an even greater strain on poorly managed supplier cash flows.

An essential problem with sourcing in today’s climate over numerous time zones and across language and cultural barriers is how one identifies suppliers that are in fact at risk and may disappear before any particular order is shipped. An ability to monitor one’s vendors is an integral part to Best Country Sourcing.

#### How to benefit from Best Country Sourcing

Given the increased need to mitigate any risks associated with the supply chain, the only way to benefit from Best Country Sourcing is to move your procurement/buying team upstream closer to the source. This does not necessarily have to be a physical move but a company does need to have a presence on the ground in the jurisdiction from which it is sourcing. It is no longer a viable option to go direct to your suppliers from overseas (especially if you are 12-15 hours behind like buying from Asia). Not only is there greater risk of additional layers within the supply chain such as intermediary agencies, who charge commissions, but a company has no way of knowing whether the supplier is even financially viable. In this current environment it is necessary to ‘look under the hood’ and to develop strong relationships with your suppliers. In addition, a company should continually cross-quote from a wide range of suppliers to ensure that an over-reliance on any one supplier has not lead to uncompetitive pricing.

Due to the size of its export market and the restrictive nature of operating in China, we have selected it as a case study for illustrative purposes.

#### **Case Study: Taming the Dragon**

There are a number of options that a company has in order to have a presence on the ground in China. These all vary in terms of speed to market, risk, operational ability and so on. It is important, whichever country outside of the US that one is sourcing from, that a company’s strategic objectives of establishing a presence meet the capital investment and risk profile of that company.

In China, these are:

- (a) WOFE in China;
- (b) Representative Office;
- (c) Buying Office; or
- (d) Trading House or “Independent” Agent.

#### **WOFE**

A Wholly Owned Foreign Enterprise (“WOFE”) enables you to operate with the greatest flexibility as a foreign legal entity. One can select office space, retail space, select staff, sign contracts and make Chinese profits. There are, however, restrictions dependant upon the type of business license obtained. The capital investment and professional fees is likely to be in excess of \$250,000 and it can take up to 9-12 months to receive all the requisite licences. Capital investment aside, this may appear to be the most attractive way forward. However, doing business in China is not easy. The associated bureaucracy and administrative requirements can become very onerous and lead to an inefficient operation, for example the latest Transfer Pricing legislation.

## **Representative Office**

Alternatively, a Representative Office can be set up within a shorter period of time and gives you direct access to suppliers although it has no authority to enter into any contracts and there are restrictions that limit the people who can be employed and in some cases where you can operate out of.

## **Procurement Service Provider**

Although this covers a broad spectrum of companies already operating in this sector, these can be useful in terms of the expertise provided and the ability to mitigate risk within China (and other countries for that matter). Charging structures and formats can vary and you need to ensure that the solution you chose best matches your approach.

## **Trading House**

Alternatively, you can turn to a more traditional trading house, which may not be as integrated into a company's strategy (like the three above) but can still offer expertise and added value particularly in relation to risk mitigation.

## Conclusion

Buying from overseas is still an important part of most companies' sourcing strategy. However, the emphasis has now changed. The fact that the 'low costs' are not as low as they once were and the fact that the business environment has become increasingly risky, it is now important to really understand your suppliers and to develop a sound relationship that has a high level of communication. In order to achieve this, it is essential to develop a local, 'at the source' presence although how this is done will depend on your company's own circumstances and its strategic objectives going forward.

## **ET2C International Inc**

ET2C International is a British owned and managed Procurement Service Provider that is focused on adding value to our client's Asian supply chains. We provide flexible solutions including a unique Buying Office concept and an Ad-Hoc Trading service that are tailored to meet our clients' needs for their Asian supply chains.

If you want any further information or have general questions about sourcing in China or Vietnam, please do not hesitate to contact us through our website [www.et2c.com](http://www.et2c.com) or contact Jamie Archer-Perkins at our New York Office on +1 646 845 7387 or via email at [jamieap@et2cint.com](mailto:jamieap@et2cint.com).