Opportunities for Action in Consumer Markets

Aim High, Act Fast: The China Sourcing Imperative

The Boston Consulting Group
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For more than a decade, “Made in China” has been a compelling sourcing option. Today, in the consumer industry, it is becoming an imperative.

Consider some recent news stories: Ford announced plans to buy $1 billion in auto components from suppliers based in China. Wal-Mart established a sourcing division in Shenzhen to buy directly from Chinese factories. And Philips Electronics’ 23 factories in China surpassed $5 billion in goods produced, most of them for export. For those companies and many others, the story starts with cost savings on components and finished goods—but that is not where it ends. The overarching objective is cost advantage.

Of course, doing business in China, just as in other developing markets, involves significant risks and challenges. But our experience shows that they can be managed and overcome. In fact, the biggest risk may lie in moving too slowly. China is already having a fundamental impact on many industries. (See Exhibit 1.) As a result, companies that are not yet acting—or are not acting as fast as their competitors—are in danger of becoming competitively disadvantaged.

The Quest for Cost Savings

For many years, The Boston Consulting Group’s China team has worked with and studied dozens of companies operating in China, and one finding is clear: a company can now source almost anything from China. The nation has long been the world’s
leading manufacturer in categories such as air conditioners, motorcycles, and televisions. But in recent years the opportunity to source in China has expanded to include extremely high-tech products, as well as components that are part of a more complex logistics pattern, such as automobile parts. Evidence is readily seen in the huge new industrial parks outside Shanghai and Beijing. In them, Intel is making semiconductors, General Electric is producing sophisticated medical equipment, and Nokia is building next-generation mobile phones.

For almost any company, China offers three broad opportunities for savings. The first is in labor and raw materials. Manufacturers in China benefit from an enormous pool of workers, flexible working conditions, and an average hourly wage of approximately 50 cents—well below Mexico’s $2.30 and even India’s 80 cents. In addition, raw and processed materials are often cheaper in China and frequently match global standards for quality. (For example, General Motors recently awarded China’s Baosteel its global quality certificate.) Overall, procurement costs generally run 20 to 50 percent below costs for comparable goods in established markets.

The second opportunity, one that is sometimes overlooked, is “capital avoidance”—essentially, lower set-up, land, and factory expenses compared with other locations. The reasons for these lower expenses are threefold. First, to the extent that companies can outsource product manufacturing, they can save on factory costs. Second, for products that companies do manufacture themselves, they have the advantage in China of being able to use more labor and less equipment. And finally, for equipment that is necessary, tooling expenses are very low—again largely because of less expensive labor.
The third opportunity, which has emerged more recently, lies in low-cost product design and research-and-development activities. China now turns out some 2 million engineering graduates a year. That’s twice as many as in the United States, available at a small fraction of the salary. According to a recent survey, a qualified electrical engineer with six years of experience commands an annual salary of about $7,000 in China and about $83,000 in the United States.

Five Levels of Sourcing Advantage

As the savings opportunities in China have broadened, so too have the strategic options. Our experience suggests that five distinct levels of advantage are emerging in China sourcing. (See Exhibit 2.)

Level 1: Testing the Water. Many companies today still have not undertaken any formal initiatives in China, although they recognize the country’s importance. A number of them may source some basic commodities, but strictly on a trial basis.

There is little competitive advantage, however, to moving so cautiously. One small benefit may be the chance to learn from the mistakes and successes of other companies. But it certainly does not outweigh the opportunity cost.

Level 2: Purchasing Components or Complete Products. Wal-Mart bought $10.3 billion in goods from China in 2001, accounting for 4 percent of China’s total exports that year. Although Wal-Mart outsources a greater volume than almost any other multinational corporation, its efforts represent the type of sourcing activity currently pursued by most
large companies doing business in China. For example, in 2002 the French retailer Carrefour sourced $1.6 billion in China—up 27 percent from 2001. Whether it’s $10 million or $10 billion at issue, most companies are buying or manufacturing basic products and components that meet their standards at the lowest possible cost.

The advantage is a lower cost structure than that of competitors that are not moving as aggressively. In addition, the knowledge gained from working with particular suppliers, as well as a greater understanding of the overall supply base, are very valuable. However, these advantages can quickly be wiped out. Other than their own internal barriers, nothing prevents competitors from eventually achieving the same savings.

Level 3: Developing Comprehensive Sourcing.
Motorola intends to have $10 billion in accumulated purchase volume from China and to be producing $10 billion a year in goods there by 2006. It also intends by then to have made investments totaling $10 billion inside China, including building a global R&D center in Beijing and hiring almost 5,000 researchers. This type of sourcing strategy goes well beyond procuring simple commodities and components to include services and talent such as product design and engineering.

Because other companies can’t easily replicate the close relationships with key suppliers or attract the best designers and engineers, comprehensive sourcing locks in a competitive edge. Telecom equipment manufacturers, which have the most advanced China-based R&D capabilities, are finding that they can design and manufacture more higher-value-added components in China, thereby reducing their dependence on imports from high-cost countries. There are also potential
time-based advantages, such as accelerating product development cycles. One global manufacturer recently found that it could retool a plant in China not only for half the usual cost but also in half the time.

**Level 4: Adopting an Integrated China Strategy.** Until very recently, global automotive OEMs operating in China, as well as their suppliers, focused primarily on serving the country’s domestic market. Today their position is beginning to change. Increasingly, they see China not just as an important market or as a principal supply base for goods sold elsewhere, but as both. For these players and others, operating in China demands an integrated strategy. Each business line must be designed to outsource components for products that will be sold abroad as well as to produce goods that will be sold to the local market.

The advantage of an integrated strategy is additional synergies due to scale, so the potential savings are greater. Products are designed to compete both globally and domestically. Also, capacity planning is integrated: plants are sized to realize full economies of scale, not just for domestic or export demand, and they are configured to meet both local and global requirements. There may be political advantages as well to competing in both realms: some China watchers argue that it is tougher to be solely an export player because the government views such companies as less committed than players that treat China as an important market in its own right.

**Level 5: Capturing Global Advantage.** Plenty of companies talk about integrating low-cost sourcing into a business model that is truly managed across many countries, yet only a few are indeed close to achieving that goal. For example, Toyota, with its closely coordi-
Exhibit 1. China Leads the World in Making and Consuming a Wide Array of Products

Sources: China Statistics Yearbook; China Economy Statistics Yearbook; World Economy Statistics Yearbook; press search.

1By value, not volume.

Exhibit 2. Five Levels of Sourcing Advantage

Testing the water
- Recognize China’s potential
- May source some products on a trial basis
- Have no formal China initiatives
- Are not yet organized for sourcing in China

Level 1

Purchasing components or complete products
- Focus on reducing purchasing costs
- Obtain valuable understanding of the supply base
- But gain little defensible advantage

Level 2

Developing comprehensive sourcing
- Sourcing plan includes
  - parts
  - products
  - talent/R&D
- Advantage gained from
  - supplier relationships
  - product development
  - proprietary tools
  - market intelligence

Level 3

Adopting an integrated China strategy
- View China as both a market and a sourcing location
- Leverage synergies between export sourcing and domestic production
  - integrated capacity planning
  - flexible production

Level 4

Capturing global advantage
- Exploit global synergies in
  - cost structure
  - manufacturing strategy
  - supply chain
- Leverage best global capabilities
- Deploy high-cost assets

Level 5

Source: BCG analysis.
nated manufacturing and supply between regions, sources subassemblies from across Asia, enabling the company to optimize manufacturing costs and just-in-time delivery.

The economics of globalization—of cost structures and business models—will be relentless. The competitive advantage of a truly global business, which leverages the lowest costs and the best capabilities, is structural in terms of both scale and locked-in relationships. But the advantage is also based on capabilities: it is very difficult to achieve, and also very difficult for competitors to replicate. The outcome is more growth—at a local, regional, and global level.

**How to Proceed**

The five levels of sourcing advantage are not a ladder: a company doesn’t necessarily move from Level 1 to Level 2 to Level 3, and so on. Companies sometimes shift quickly from, say, a cost-focused strategy for basic components to an ambitious integrated China strategy. Similarly, many companies that have been selling in China for some time are now, in a sense, backing into sourcing, and they are also beginning to manufacture for export. Examples include Siemens, Lion Nathan beer brewers, GE Appliances, and several of the global automotive OEMs.

So how should you proceed? Whether the task is to build a China sourcing capability from scratch or to improve an existing operation, our experience points to three essential steps.

**Analyze the opportunities.** Global companies could source almost anything from China today. But what
should they source? Answering that question requires companies to get up to speed on their sourcing options. Then they should segment all the opportunities—both potential products and potential suppliers—and run all of them through a realistic feasibility screen. In addition, companies must determine the total supply-chain cost of securing the potential savings. Is the potential advantage big enough to offset the risks? Finally, companies should install a system that forces them to update their views on China frequently, because the situation will continue to change quickly.

Wal-Mart’s push to buy directly from Chinese factories is a case worth keeping in mind. With its unrivaled bargaining power, in addition to its requirements for relatively simple products, Wal-Mart can place much of the burden for screening suppliers on the suppliers themselves, asking them to provide detailed background information and samples. Nevertheless, Wal-Mart still requires a staff of more than 200 to complete site visits, verify information, and implement sourcing decisions. For other companies, the task is even more complicated. More complex products—especially those components that will go into other products—require considerably more detailed assessments and demand greater interaction with suppliers.

Establish the infrastructure. Designing and building a sourcing operation is a significant undertaking. Such an effort means creating processes and policies for everything including supplier selection and assessment, monitoring and compliance, human rights evaluation, and risk management. It also means developing databases to track price quotes from suppliers; building China-specific expertise; and acquiring and
tracking important data on benchmarks, site assessments, and supplier capabilities. Ultimately it means establishing tight links and coordination across multiple facilities and operations around the world—an amazingly tricky task. A system and a team must be in place to make the right decisions quickly and to execute them in a way that realizes savings and builds momentum.

To carry out such an ambitious project, it is essential to tap a leader who is both senior enough and capable enough to mobilize the organization. Also, because a great deal must happen outside China if a company is to be successful inside China, the importance of having the support of a strong champion at headquarters cannot be overstated. Several multinationals in China have considered following “level plus two”—a rule of thumb placing responsibility for China sourcing two levels above where it would normally reside.

**Overcome the barriers to action.** Many executives today are concerned about the risks of doing business in China. To be sure, China presents a number of serious challenges. For instance, a banking or other financial crisis could upset stability. Progress in implementing World Trade Organization concessions must be closely watched. Just as important are the substantial operational and managerial risks, such as sorting out currency swings, coordinating complex logistics, and identifying capable and trustworthy partners.

Trust is crucial when it comes to sharing intellectual property. When companies transfer expertise in product design overseas, they risk losing their proprietary technology to rivals, to employees who might defect
to rivals, and to local entrepreneurs who sometimes pirate everything from cell phones to shoes, shampoo, and software. Yet the companies that would seem to be most vulnerable, such as makers of electronics or fashion accessories, continue to expand their manufacturing operations in China, believing that it is necessary to boost their overall competitiveness. As real and as serious as these issues are, advantage comes from understanding and overcoming risks, not from avoiding them.

One of the biggest barriers of all is resistance from within your own company and even from your vendors. Time and time again we have found that companies aspiring to do business in China struggle with cultural and organizational challenges. Among them are a lack of urgency, a “business as usual” mindset, a lack of experience in China and with global sourcing in general, extreme organizational complexity, incomplete information, resistance from current suppliers, and difficulty in setting realistic targets. Before a company can move forward, it must identify and address these organizational barriers.

* * *

“Zhi xiang gao, xing dong kuai,” loosely translated, means “Aim high, act fast.” In essence, this is the imperative in China sourcing today.

Leading companies in several industries have already made big strides in China: they have begun to lock in advantages, and they are on their way toward Level 5 sourcing. However, many companies today—even those purchasing many million dollars’ worth of products from low-cost countries—are already behind key competitors in China. For them, the starting point for
any analysis of their position can no longer simply be “How much are we sourcing from China?” but rather “How do we catch up?”

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行动快

Aim High, Act Fast

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