Sourcing Consumer Products in Asia
Managing Risk—and Turning Crisis to Advantage
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Even before the world’s economy plunged into recession, many companies had already begun to reexamine their low-cost country (LCC) sourcing strategies in Asia in light of currency fluctuations and rising labor and transportation costs. Now—in the face of widespread factory closings and dramatic swings in currency valuations—those reassessments have become not only more urgent but also more complex, and their conclusions will vary according to the circumstances of each company. Although some companies are cutting back on their LCC sourcing, others are taking advantage of the crisis to expand their sourcing in Asia—which is what we believe more companies should be doing.

The global downturn has both created some challenges and opened up the possibility of more effective LCC sourcing for companies that are able to take advantage of new opportunities. For example, as consumers and businesses in the West trade down, countries with production costs that are 20 to 30 percent lower than those in Western markets have become even more attractive to suppliers. Although labor rates in LCCs have risen over the past few years, they are still only a fraction of labor costs in the West, and the increases are being offset by rising productivity and falling exchange rates (especially against the dollar) in many Asian countries.

Effective and efficient sourcing from LCCs is by no means a given, however. Success will depend on how well companies understand the challenges and prepare for uncertain outcomes. Conditions that have been considered stable will inevitably change. The economic crisis and declining demand for many products will lead to the collapse of numerous suppliers, in both high- and low-cost countries. To prevent a disruption in supply, it is crucial that companies assess the risks in their supply base as well as their options for alternative sources. This step is especially important for industries served by suppliers that are concentrated in a single country. If such suppliers are forced out of business because of the downturn, buyers in these industries could have difficulty finding alternatives.

In this report, we examine the likely impact of the global economic crisis on the future of LCC sourcing in Asia, and we explain how companies can turn this crisis to advantage while limiting their exposure to risk.

Signs of Trouble in Asia
There is little doubt that the events of 2008 significantly changed the way companies view LCC sourcing, particularly in Asia. Because China has been the world’s go-to country for low-cost manufacturing—and a bellwether for other LCCs as they evolve—it provides a good example of what companies might expect as they source from low-cost countries in the wake of the downturn. The economic crisis has been relatively severe in China, considering the country’s long, uninterrupted expansion over the past three decades. The annual growth rate in China’s GDP fell from 10.1 percent in the second quarter of 2008 to 9 percent and 6.8 percent in the third and fourth quarters, respectively.

Leading indicators for the manufacturing sector—output, new orders, new export orders, and the purchase of inputs, to name just a few—all point to a slowdown. This slowdown is being driven to a large degree by tumbling year-on-year growth rates in exports, which fell from a high of 26 percent in the third quarter of 2006 to 4 percent in the fourth quarter of 2008. In November 2008, China’s exports experienced a decline
for the first time in seven years relative to the previous year’s level.

The slump in demand from the developed economies is also translating into factory closures in China. One problem is that manufacturers throughout the country—and of course the world—are having trouble securing financing at reasonable costs. For example, one Hong Kong–owned factory in southern China saw the interest rate on its short-term loan from a long-standing banking partner rise from 4.5 percent to 7 percent in October 2008. And this manufacturer was one of the lucky ones: many others found themselves without access to credit and unable to order raw materials or pay their employees.

In the city of Dongguan, a major export-manufacturing hub in southern China, 714 companies closed down in the month of October 2008 alone. According to China’s National Development and Reform Commission, 67,000 small and medium-size enterprises across the country had already stopped producing in the first half of 2008—before the global economic crisis hit. With the full effects of the crisis still taking shape, many are expecting even gloomier statistics in the months ahead. The Federation of Hong Kong Industries predicted that, in a worst-case scenario, as many as 25 percent of the estimated 70,000 Hong Kong–run factories in the Greater Pearl River Delta would close by the end of this cycle, owing to a shortage of capital and orders from the West.

The situation is not much better elsewhere in Asia. In Vietnam, labor shortages and an inflation rate that exceeded 25 percent in June 2008 led to widespread labor strikes and disputes long before the economic crisis hit. According to one study, an estimated 300 strikes took place in the first half of 2008, and 540 took place in 2007.

Yet all is not as bleak as it might appear. To be sure, the number of closures is significant, but companies should not overestimate the resulting reduction in capacity, since the closings represent a small percentage of total factory capacity. In addition, the continued decline in exports will likely outpace the capacity that is lost as factories close. Therefore, sufficient capacity still exists for most consumer products, although there will be a need for more capacity once the economy recovers.

What’s more, the slowdown has picked off the weakest players, while the larger, more efficient factories continue to operate. Consider the toy sector, for example. Although the closing of large numbers of toy factories across China has been widely reported in the media, the country’s toy exports in November and December 2008 experienced declines of only 8.6 percent and 7.6 percent, respectively, relative to the previous year’s levels—and on an annual basis they actually achieved a 1.9 percent growth rate in 2008. Furthermore, as of July 2008, 93 percent of the toy factories that had closed were small, with less than $100,000 in annual revenues. To be sure, a few larger factories have shut down as well, but the slowdown has served primarily to winnow out the most inefficient suppliers.

In sum, the recent challenges in the LCC sourcing environment should not dissuade companies from considering the significant cost advantages that Asia continues to offer. A quick survey of key consumer-goods categories such as apparel indicates that sourcing in Asia can produce an advantage of 30 to 50 percent in the so-called landed price, which is the price companies pay once the product is delivered to their home country. Given the huge price gaps between low-cost countries and developed markets, there is still a significant cost savings to be found even in the face of increased complexity, uncertainty, and costs.

Changes to Come

No one knows how the crisis will play out over the course of the next 12 months, but we can be reasonably sure that LCC sourcing will no longer be business as usual. Buyers that adapt most quickly to the new environment will not only lower their risks but also position themselves to turn some of those risks into opportunities.

One of the most critical considerations for deciding on a sourcing location is the total cost of the product being sourced. The major components of that cost are the supplier’s price in the local currency, which is driven by labor costs, raw material prices, and required operating margins; the conversion of that cost into the buyer’s home currency; and the total costs in the supply chain, in-

The slowdown has served primarily to winnow out the most inefficient suppliers.
cluding transportation costs. In this section, we will look closely at supplier prices for the short term through the long term, currency fluctuations, and transportation and supply chain costs. We will not focus on the costs of raw materials, since those costs tend to be set in a global market and do not create any relative advantage for one sourcing location over another.

**Supplier Prices for the Short to Medium Term.** The drastic decline in demand for many discretionary products that are made in low-cost countries—such as electronics, clothing, and footwear—has led to overcapacity in most manufacturing segments. As we have noted, many less efficient suppliers are being forced to shut down, leaving only the fittest to survive. The factories that continue to compete in the market will focus on remaining open until demand picks up again. As a result, weak demand and an abundance of capacity will make suppliers more willing to accept prices closer to their marginal cost.

But the decrease in demand has not been all bad for suppliers in China. For one thing, it has reversed the trend toward labor shortages. With as many as 10 million migrant workers laid off in 2008, it is unlikely that the wage increases that workers have won over the past few years will continue at a rapid pace. Furthermore, the decline in commodity prices during the second half of 2008 has also been a small boon for suppliers. With steel prices down approximately 35 percent and resin prices down approximately 35 to 40 percent from their respective peaks in 2008, the cost pressures created by rising commodity prices will be somewhat alleviated, at least for the short term.

In light of the decreases both in demand and in the cost of supplier inputs—especially labor and raw materials—consumer products companies willing to either negotiate aggressively with current suppliers or shop around for good deals are likely to meet with success throughout the duration of the downturn. As suppliers shift into survival mode, buyers will have the opportunity to build deeper relationships with them and thus to benefit from low prices for an extended period of time. For example, suppliers may be willing to offer especially low prices in exchange for a guaranteed minimum order over a specified period.

**Supplier Prices for the Long Term.** Eventually, although no one knows exactly when, global demand will pick up again. When it does, however, global buyers will find a devastated supply base. Depending on the duration of the global crisis and its impact on individual sectors, the number and capacity of suppliers could be significantly reduced, with only the most adept suppliers remaining. As a result, these survivors will likely incur capacity problems almost immediately when the global economies start to recover—and inflated prices will likely return. Even worse, consumer products companies may be unable to find the capacity they will need to fill orders at a critical time during the economic recovery. New capacity takes time to develop—even for incumbents—and new suppliers require even lengthier lead-times, largely to complete the qualification process that ensures their product quality, safety, and adherence to acceptable social practices. To minimize these disruptions, companies should act now, during the downturn, to protect and manage their future supply base.

**The High Risk of Currency Fluctuation.** The global economic crisis has led to dramatic and unprecedented swings in exchange rates. Outside of China, the currencies of most Asian LCCs have depreciated against the U.S. dollar and have fluctuated markedly against the euro. (See Exhibit 1.) So far, these currencies have not started to appreciate against the dollar, and—if the experience of 1997 is any indication—it could be a long time until they return to precrisis values. (See Exhibit 2.) In many of the countries with devalued currencies, this trend has created new sourcing opportunities for purchases denominated in dollars. However, currency swings have also occurred in developed economies. In the month of October 2008 alone, the euro depreciated more than 8 percent against the dollar, the British pound depreciated about 8 percent, and the Japanese yen appreciated about 6 percent. The considerable fluctuation in global currencies has made it difficult to assess the full potential for achieving future savings through sourcing from low-cost countries.

Although we are relatively confident that volatility will continue, it is impossible to predict currency movements precisely. Therefore, compa-
Exhibit 1. In Low-Cost Countries in Asia, Exchange Rates Have Been on a Roller Coaster

Fluctuation of key Asian LCC currencies relative to the U.S. dollar

Indexed exchange rates for local currencies, in U.S. dollars (January 1, 2007 = 100)

Sources: www.oanda.com/convert/fxhistory; BCG analysis.

Exhibit 2. Currencies in Many Asian Countries Have Been Slow to Recover from the 1997 Asian Financial Crisis

Indexed exchange rates for local currencies, in U.S. dollars (January 1996 = 100)

Source: The Economist Intelligence Unit.
nies should plan for volatility in two ways. First, they should ensure that they have the right hedging capabilities in place. Second, whenever possible, companies should diversify their supply base across currencies in order to mitigate the overall risk of volatility and enable themselves to shift orders rapidly from one country to another as currency movements alter cost advantages in individual countries.

In the near term, China’s renminbi is likely to be the least volatile of all the LCC currencies given its managed exchange rate relative to the U.S. dollar (but not the euro), and the greater relative certainty about the renminbi could be attractive to some companies. Although the appreciation of the renminbi from 2005 onward has, in some cases, hurt China’s competitiveness, especially in light of the recent devaluation of other Asian currencies, most experts—and even the Chinese government—have said that they do not expect the renminbi to continue to appreciate at the current pace.

Certainly, companies should take advantage of depreciated currencies where possible. Today, very competitive prices stemming from currency depreciation can be found throughout Asia for many types of products. Although these prices may not last forever, our experience with the last round of currency depreciation in 1997 suggests that such advantages can continue for years.

**Transportation and Supply Chain Costs.** During the summer of 2008, when oil prices were hitting a record high, some predicted that the resulting rise in shipping costs would make LCC sourcing less cost effective, especially sourcing from Asia to the United States or Europe. But the logic of that assumption is flawed. Shipping costs constitute a very small portion of the total cost of goods, in large part because ocean freight is a relatively cost- and energy-efficient option. (See Exhibit 3.) Furthermore, shipping costs are largely determined by supply and demand, and expansions in shipping capacity over the past few years have capped the ability of shipping companies to raise their rates to fully reflect increases in energy costs—even during the

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**Exhibit 3. Ocean Shipping Costs Represent a Small Share of Total Product Costs**

<table>
<thead>
<tr>
<th>Country</th>
<th>Cost per Mile (US$)</th>
<th>Typical U.S. Retail Price (US$)</th>
<th>Ocean Freight Relative to Price (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ocean freight from Shanghai to the United States</td>
<td>0.40–0.55</td>
<td>1,100–2,000</td>
<td>~0.5–1</td>
</tr>
<tr>
<td>Trucking within the United States</td>
<td>1.85–2.60</td>
<td></td>
<td></td>
</tr>
<tr>
<td>European Union</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ocean freight from Shanghai to the European Union</td>
<td>0.35–0.45</td>
<td>80–150</td>
<td>~1–3</td>
</tr>
<tr>
<td>Trucking within the European Union</td>
<td>3.70–3.80</td>
<td>100–150</td>
<td>~1–2</td>
</tr>
</tbody>
</table>

Sources: Drewry Shipping Consultants Ltd., Container Freight Rate Insight; Lloyd’s Register; ISL Shipping Statistics Yearbook (various years); www.truckloadrate.com; BCG analysis.

Note: Estimates as of September 2008.
months of peak oil prices in the summer of 2008. Now, with the crisis triggering a decline in demand, downward pressure on shipping costs and on pricing overall is even more likely.

At the same time, LCC sourcing raises other important cost considerations involving the length and variability of the supply chain when companies source from distant countries. For one thing, ports in many Western countries have not been expanding their container capacity and unloading capabilities at the same rate as ports in Asia have. This has meant rising inventory costs and stockouts for companies whose supply chains take too long to react to increasing demand.

How, then, should consumer goods companies evaluate the cost of sourcing from distant low-cost countries? Most important, the total cost of the supply chain should be considered when companies compare sourcing locations. This involves understanding the impact of transport-time variability on stockout and inventory costs. To begin, companies should estimate their total cost of carrying inventory, the cost of markdwons to move unsold inventory, and any resulting stockouts and their opportunity costs. If these costs are significant, then lengthening the supply chain to source from a distant low-cost country will only exacerbate them. (See the sidebar “Little-Known Facts About Shipping Costs.”)

A Blueprint for Action

As we have demonstrated, the global economic crisis has clearly increased the risk of relying on LCC sourcing, but it has also created additional opportunities for companies that are able to successfully manage that risk. Companies must begin now to re-align their LCC-sourcing strategies with the rapidly evolving economic environment in order to capture savings in the near term and also to limit the risk of disruption in the long term when the economy begins to recover.

Managers should begin immediately to identify their key suppliers at risk.

We have developed a matrix that serves as a quick diagnostic tool to help companies plan for managing the long-term risks of LCC sourcing. (See Exhibit 4.) Managers can use the tool to make two assessments for each of their product categories: the probability that their current supply base will collapse, and the availability of an alternative and qualified supply base. By assessing where their products rank on each axis and assigning them to quadrants, managers can use the matrix to identify high-risk categories early on and implement preemptive strategies to mitigate these risks.

Strategy 1: Support the incumbents and develop new suppliers.

If critical suppliers are likely to go out of business and alternatives are not easy to find, managers should begin immediately to identify their key suppliers at risk. They should then support these businesses by developing deep and long-term relationships with them in order to improve the suppliers’ chances of surviving the downturn.

Suppliers from many low-cost Asian countries, for example, have been accustomed to deriving their entire cost advantage from cheap labor; they therefore lack the skills, capabilities, and motivation to achieve lower costs through other means. By being introduced to tools such as lean manufacturing—which guide companies in redesigning processes, improving efficiencies, reducing work-in-progress inventory, and imple-

Little-Known Facts About Shipping Costs

Shipping has always been an economical means for transporting goods, with a cost per mile significantly lower than that incurred by trucking. For instance, even during the summer of 2008—when the price of crude oil was at its peak—the cost to ship a 20-foot container of 42-inch LCD TVs from Shanghai to Hamburg (approximately 12,000 miles) was about the same as the cost to truck the same 20-foot container from Munich to Hamburg (less than 500 miles). Of course, shipping the container from China would take a long time, and therefore would raise inventory levels.

Although some analysts criticize container shipping as environmentally unfriendly because of the carbon dioxide emissions that result, such emissions should be put into perspective. Shipping a refrigerator from China to Los Angeles releases the same amount of CO\text{2} as driving a sport-utility vehicle for approximately 12 miles.
menting continuous-improvement programs to enhance productivity—such suppliers can overcome their inexperience with cost containment and can learn to be more cost effective and reduce their working-capital requirements.

In helping our clients work with their suppliers to reduce costs, we have been able to achieve productivity improvements of up to 30 percent. These gains not only lower suppliers’ costs but also provide relief from the labor shortages facing many suppliers—in China and Vietnam. Furthermore, the experience of working together creates bonds of trust and loyalty between buyers and their suppliers. Of course, suppliers are not always fully aware of the type of results that such improvement programs can deliver, and they usually require some convincing. But once suppliers are engaged in the efforts, they quickly see the benefits.

In addition to improving the operational effectiveness of suppliers, companies can also prioritize suppliers in terms of their competitiveness, capabilities, and capacities and then allocate orders to “preferred” suppliers in order to help them weather the storm. Apart from generating goodwill with the chosen suppliers, close collaboration also creates more transparency and increases the likelihood of better pricing in a tough economic climate.

The companies that undertake this strategy will have significant influence on the future landscape of suppliers. By acting now to support their incumbent suppliers, companies not only enhance their chances of weathering this global crisis, they also forge stronger supplier relationships that will prove advantageous when the crisis is over.

Even when they are helping their current suppliers survive the global economic crisis, however, companies should resist relying too heavily on an existing supply base, especially if their suppliers are concentrated in one region. To reduce their exposure to risk, companies should develop a contingency plan for cultivating potential suppliers elsewhere in the world.

In those sectors where one country has always dominated global production—as China has in toys and cigarette lighters, for example—developing a supply base in another country or region will require substantial resources and patience, as the entire value chain will need to be built from scratch. Often, such a large commitment of time and resources deters many companies from starting to develop a new supply base until their competitors have moved first.

**Strategy 2: Get ready to migrate.**

When current suppliers are likely to collapse but alternatives are not hard to find, companies face relatively low exposure to risk. However, companies should carefully evaluate alternative suppliers to make sure that they are not also at risk of collapsing and that they could be qualified quickly, when needed. (If, upon review, all of the alternative suppliers prove to be unreliable, then companies should pursue Strategy 1.)

By working with alternative suppliers from several regions, companies can also lower their risk of encountering country-specific difficulties, such as regulatory changes or highly volatile currency prices. Since companies in this quadrant can identify alternative supply bases, they should make sure to update their cost estimates with the latest exchange rates, which can have a significant impact on prices.

**Strategy 3: Diversify to reduce risk.**

When current suppliers are not
likely to go under as a result of the economic crisis and there is widespread availability of alternative suppliers if they do, companies simply need to monitor the situation and make sure that the risk for their current suppliers remains low. In an unstable environment, even healthy suppliers can experience a reversal of fortune as a result of volatile energy costs, fluctuating exchange rates, or tight credit. Companies should continually assess their suppliers’ exposure to risk across all cost variables. And if their current suppliers are heavily concentrated in one region, companies could find it useful to diversify their supply base to lower their overall exposure to risk.

**Strategy 4: Negotiate with incumbents and develop new suppliers.**
When current suppliers are strong but alternatives are hard to find, the lack of qualified potential suppliers elsewhere can weaken bargaining power and make it difficult for companies to move quickly in the unlikely event that their current suppliers do close down. Despite such difficulties, buyers should actively engage in price renegotiation, particularly since the costs of suppliers’ inputs have been declining significantly since the peak period of mid-2008. Companies should review the prices for key inputs that drive their sourcing costs, such as labor and raw materials. A decline in prices for several inputs would indicate that many sourcing contracts could be rewritten for long-run, or nonseasonal, items.

Companies in this quadrant should also assess the possibility of developing new suppliers and introducing competition into the existing supply base. The great fluctuation of exchange rates and the currency depreciation in many LCCs in Asia will likely open up new areas that can support a competitive supply base.

The global downturn provides companies an immediate opportunity to reevaluate their LCC sourcing strategies, restructure their supply base, and leverage the advantages offered by suppliers in several regions. For Western companies, the growing tendency of consumers to trade down to less expensive products, the currency depreciation in many low-cost countries in Asia, and the rapid decrease in transportation costs make LCC sourcing an even more attractive option for reducing the cost of operations.

To exploit the full potential of cost opportunities, companies must be able to plan systematically for new developments and respond decisively as they emerge. Change always takes longer than expected, and it is sure to cause disruptions in the supply chain. That’s why the economic slowdown offers a rare chance for companies to achieve lower production costs without also risking a major decline in supplier reliability.
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Coping with the Commodities Crisis
Opportunities for Action in Consumer Markets, November 2008

Sourcing from China: Lessons from the Leaders
A Focus by The Boston Consulting Group, July 2007

Surviving the China Rip Tide: How to Profit from the Supply Chain Bottleneck
A report by The Boston Consulting Group, May 2007