

## China's Role in a Global Supply Strategy

a report by

**Tom Slaight, Tom Naramore and Guy Bouchet**

*Board Member, Institute for Supply Management (ISM), Client Executive, Acuity Brands Lighting and Vice President, A.T. Kearney, Inc.*

At first glance, the prospect of sourcing materials and goods from China may seem like a non-starter, due, in part, to the many myths that have sprung up around its suitability as a reliable source of supply. Too many people's memories are imprinted with images of the days when "Made in China" meant textiles, footwear and toys – often of dubious quality. Indeed, Chinese factories are now steadily producing export-quality machinery, electronics and appliances. While China's low labour costs are fairly common knowledge, few realise just how well educated workers there are, with the government's emphasis on education returning dividends. In addition, though the Chinese government has gained a well-deserved reputation for being highly protectionist towards its domestic markets in its business dealings, the emphasis on exports means that Chinese businesses continue to improve in their ability to accommodate the needs of foreign buyers.

Leading companies worldwide have long known the truths that debunk these myths and have used that knowledge to their competitive advantage. Globalisation and an acute strategic focus have combined to fuel interest in China, increasing its role as a significant source of supply for competitive multinational companies.

### Advantages and Disadvantages to Sourcing from China

While sourcing materials and goods from China provides many advantages, prospective purchasers need to be aware that there are also disadvantages, and these should be weighed up properly in the decision-making process.

#### Advantages

China's chief advantages revolve around one all-important factor: cost, both in terms of manufacturing and service. China will continue to offer significant labour cost advantage compared with Mexico and Eastern Europe in the foreseeable future as it taps into its huge reservoir of low-cost labour from its rural areas. At the same time, the literacy and education levels of its workers are rising rapidly. China's manufacturing capabilities are adequate for

many needs, as industry there continues to transition towards goods like machinery, electronics and appliances. Knowledge and capabilities in several specialised industries – including automotive, high technology, consumer products and apparel – add to China's advantageous position.

#### Disadvantages

China's negatives centre on logistics and the complex decision-making processes required in deciding between partnering with local companies or establishing a wholly foreign-owned business.

The combination of inadequate communication capabilities and the inferior quality of the roads, bridges and other key components of China's infrastructure often leads to logistics delays. A number of unconventional steps and stakeholders may be required to move products efficiently from China. Long supply lines and other hidden costs can inflate total logistics costs to as much as one-third of the total cost of goods sold.

While recent regulatory reform allows foreign companies to operate in China as wholly foreign-owned ventures, doing so poses unique challenges. Greenfield investments require significant capital investment and a payback period that is longer than usual, while acquiring existing assets often means taking on low-quality, overvalued facilities. For these reasons, high-profile enterprises like Anheuser-Busch, Microsoft, General Motors and DuPont have opted to partner with local Chinese companies, which brings exposure to a different set of risks, as their new partners may potentially misuse funds, fail to abide by contracts or engage in unconventional business practices.

#### Other Key Considerations

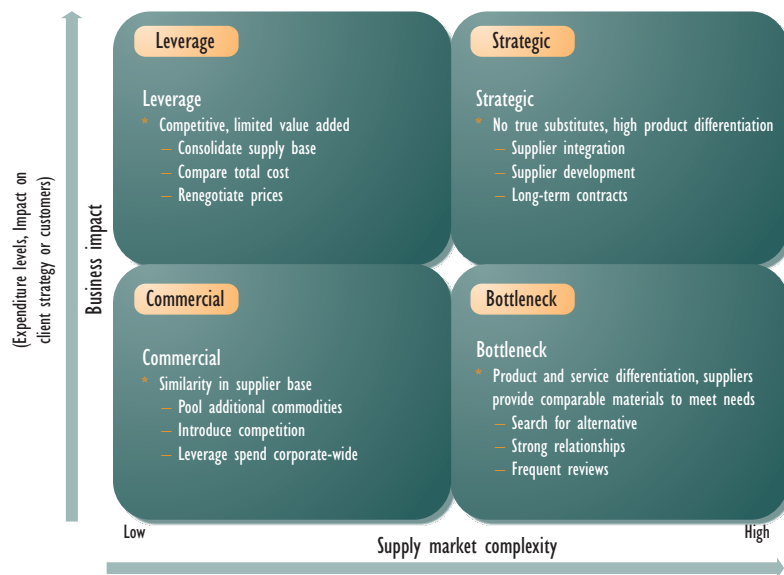
Beyond these clear-cut pros and cons, there are other factors in play that contribute to the complexity of the Chinese business environment. For instance, the current legal and regulatory systems are rather opaque, inconsistent and seemingly arbitrary, requiring that companies investigate the market thoroughly, pre-qualify potential business partners, take steps to ensure

Thomas Slaight is a board member of the Institute for Supply Management (ISM). He is also Vice President of A.T. Kearney, Inc., the management consulting firm. Mr Slaight is based in New York and is a specialist in supply strategy, helping to develop and grow strategic sourcing at A.T. Kearney until it became one of its most significant practices. He was also a co-founder of A.T. Kearney Procurement Solutions' Internet negotiations toolkit, eBreviate. Mr Slaight graduated from Hamilton College and obtained an MBA from New York University's Stern School.

Tom Naramore is a client executive of Acuity Brands Lighting – North America's largest lighting fixture company. He has been with the Atlanta-based company for more than 30 years, and his background includes assignments in sourcing, manufacturing, quality, marketing and group management. He also serves as Chair of Acuity's Sourcing Operating Committee for Strategic Sourcing, impacting operations in North America, Asia and Europe. Mr Naramore has a Bachelor's in Electrical Engineering from Georgia Institute of Technology and an MBA from Georgia State University.

Guy Bouchet is Vice President of A.T. Kearney, opening up the Shanghai office and heading the company's Operations practice in the Greater China region over the last five years. He has experienced the transition of China sourcing from beachhead providers of rudimentary products to multiple capabilities and categories of trusted materials and services. He now works out of Chicago, advising companies on how to benefit from the lessons that others have learned from doing business in China. Mr Bouchet has a Bachelor's in Economics from the University of Poitiers, France, and an MBA from Kellogg School of Management, Northwestern University.

Figure 1



that goods are delivered and payments are kept track of and craft contracts carefully so as to minimise misunderstandings. With the Chinese economy still in a state of flux, worker discontent has the potential to cause work disruptions. In addition, companies there continue to demonstrate an inconsistent mastery of certain manufacturing requirements, necessitating lengthy due diligence during the supplier selection process and the establishment of stringent cost, quality and timing metrics prior to implementation of a sourcing decision.

### Overcoming the China Sourcing Challenge

A number of companies in North America and in Europe have already created competitive advantage in their industries by overcoming China's challenges. Perhaps unsurprisingly, some are large multinationals that have the obvious resources to make the significant commitments and investments to achieve success. Many others, however, are medium-sized and even small companies that have concentrated on strategic or specialised products or components to their advantage. Large and small businesses alike are influencing their suppliers to use China and other low-cost countries to provide cost advantages for the materials and services that they need.

The experience of one particular medium-sized company provides a good example of how China's advantages can be utilised effectively as part of a balanced, three-phase supply strategy. Acuity Brands Lighting is a US\$1.5 billion manufacturer of industrial lighting products sold under several brands, including Lithonia®, Hydrel® and Peerless®, produced and distributed through a network of 24 plants, nine warehouses and seven distribution centres in the US, Europe, Canada and Mexico. Its

50 sourcing professionals purchase US\$1 billion in materials and services annually, working out of offices in North America, Europe and China.

In Phase 1 of its global sourcing programme, the company embarked on an intense strategic sourcing programme while building a centre-led sourcing organisation, supplemented by a change management programme to ensure on-going success. In the next phase, technology and programme management implementation are emphasised, while Phase 3 includes supplier relationship management and policy initiatives.

### Category Segmentation

Before the low-cost country sourcing effort was undertaken, spend category classification was performed to better ensure the viability of this approach. Typically, companies embarking on a strategic sourcing programme segment their purchases into four distinct categories: strategic, bottleneck, leverage and commercial, as shown in Figure 1.

The application of low-cost country sourcing potential varies greatly by spend category. Items that fall into the strategic categories but have limited substitutes available should be purchased from key suppliers that are capable of tight integration and are willing to collaborate on product improvements. At this time, only the most reliable and well-developed Chinese suppliers would be suitable for strategic categories, though key existing suppliers might be influenced to source some subcomponents from China. Although bottleneck items carry a lower value, the risk of a disruption in the supply of items from these categories indicates that they would also not be appropriate for Chinese supply. Because they have available substitutes, competitive pricing and straightforward product technology, leverage categories offer significant cost advantage through China sourcing. Finally, although commercial spend categories are typically too small to make China sourcing worthwhile, the suppliers in these categories must investigate China sourcing to retain competitive pricing.

### A Global Sourcing Approach

Employees throughout Acuity Brands Lighting worked under a number of time-proven tenets to guide their efforts throughout the global sourcing project:

- leverage spend and drive savings through organisation, process and tools;
- pursue low-cost country sourcing, particularly in

Asia, to drive global supplier competitiveness and build specific capabilities;

- work with suppliers to drive mutual cost reduction benefits into the supply chain;
- develop risk mitigation plans for each performance goal;
- pursue continuous innovation in product and cost with suppliers;
- develop improved logistics and systems infrastructure for the supply network;
- make sourcing organisational development a priority, blending talents and matching experience to opportunities; and
- drive initiatives and their results through a programme management structure.

With this foundation in place, the company grouped its wide-ranging initiatives into three main thrusts focused on achieving breakthrough results: strategic sourcing initiative continuation; low-cost country sourcing; and supplier relationship management.

The strategic sourcing initiative built on the momentum from previous waves of sourcing, training and strengthening the organisation through practical results and on-going communications that celebrated successes. Sourcing techniques were applied globally on a strategic, category-by-category basis, with an emphasis on managing key categories.

Due to its newness to the company, Acuity Brands Lighting made low-cost country sourcing a distinct workpiece, setting it as an on-going goal and ramping up employee knowledge in this area. An emphasis was placed on sourcing high-volume stock-keeping units from China to maximise results.

A blended model for optimum service and risk mitigation was developed, which called for back-up tooling capabilities and consigned inventories to hedge against disruptions in the China supply line. The team also crafted other contingency plans that included air freight possibilities and reserve manufacturing capacity. In addition, a landed cost model was developed for all projects to ensure that a variety of factors not normally accounted for in cost standards, including extra freight premiums, duties and tariffs, brokerage fees, currency exchange rates and lead times and volume commitments, were factored into the true costs of sourced goods.

The third workstream focuses on the complete supplier relationship management strategy,

emphasising supply base rationalisation and product complexity reduction. The rationalisation effort aims to reduce, tier and leverage the supplier base for cost and service while also selecting and developing 'preferred' suppliers committed to working together to deliver annual cost reductions and shared gains. The goal of the product complexity reduction is to reduce the number of parts by category and the overall investment in materials held in inventory at both the company and its suppliers' facilities.

### Compelling Results

The strategic sourcing initiative addressed more than 40 categories and resulted in significant annual savings. Advanced e-sourcing techniques were used for electronic requests for proposals, while Internet negotiations were also developed and embedded into the balanced sourcing approach.

Low-cost country sourcing began in 2002. Within 18 months, the development of an Asian sourcing office and a manufacturing network transformation project resulted in additional cost advantages that could not have been obtained through traditional sourcing alone.

### Lessons Learned

Acuity Brands Lighting is well on its way to achieving significant cost benefits from its China sourcing programme, with management believing that its success stems from the organised manner in which it developed a balanced programme that included sourcing, organisation, technology, supplier relations and low-cost country sourcing.

In sourcing from China, key success factors included a thorough examination of what items to source, what companies to source from and how to approach its sourcing efforts.

The company applied a tailored sourcing approach to China, with several key departures from the traditional sourcing process. Evaluating and screening suppliers was a critical step in the process, especially in terms of selecting suppliers based on their potential to develop and be the long-term lowest-cost provider. Suppliers that could potentially become competitors also had to be screened out of the selection process. Total product cost also took on a new importance in the context of sourcing from China due to the high logistics costs and associated pitfalls. ■

*This article is continued, with further discussion and final thoughts, in the Reference Section on the CD-ROM accompanying this business briefing.*