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Sourcing from China

Lessons from the Leaders



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Lessons from the Leaders

As companies continue to stretch their supply chains around the globe, some are becoming adept at reaping the rewards of sourcing from rapidly developing economies (RDEs), such as China, India, and many other countries. Others, however, continue to struggle. And even among those companies that have been most successful at sourcing from RDEs, some are finding themselves stuck at lower levels of sourcing than they want to achieve. A recent study by The Boston Consulting Group reveals that companies sourcing from China, in particular, are encountering increasingly tough challenges—both internal and external—as their sourcing operations there mature.

This is frustrating, because the game is so manifestly worth winning. The rewards of sourcing from China are well known. They include not only greatly improved cost structures but also robust product and process innovation arising from increasingly sophisticated and diversified supply bases; a low-cost, highly skilled labor pool that can support production as well as research and development; low-cost plants and equipment; numerous national and local government incentives; a vast and fast-growing domestic market that can help China-based suppliers quickly reach critical mass; and, in sectors such as plastics, printing, and electronics, highly developed clusters of complementary suppliers. Little wonder that global companies have been rushing to China to set up sourcing offices.

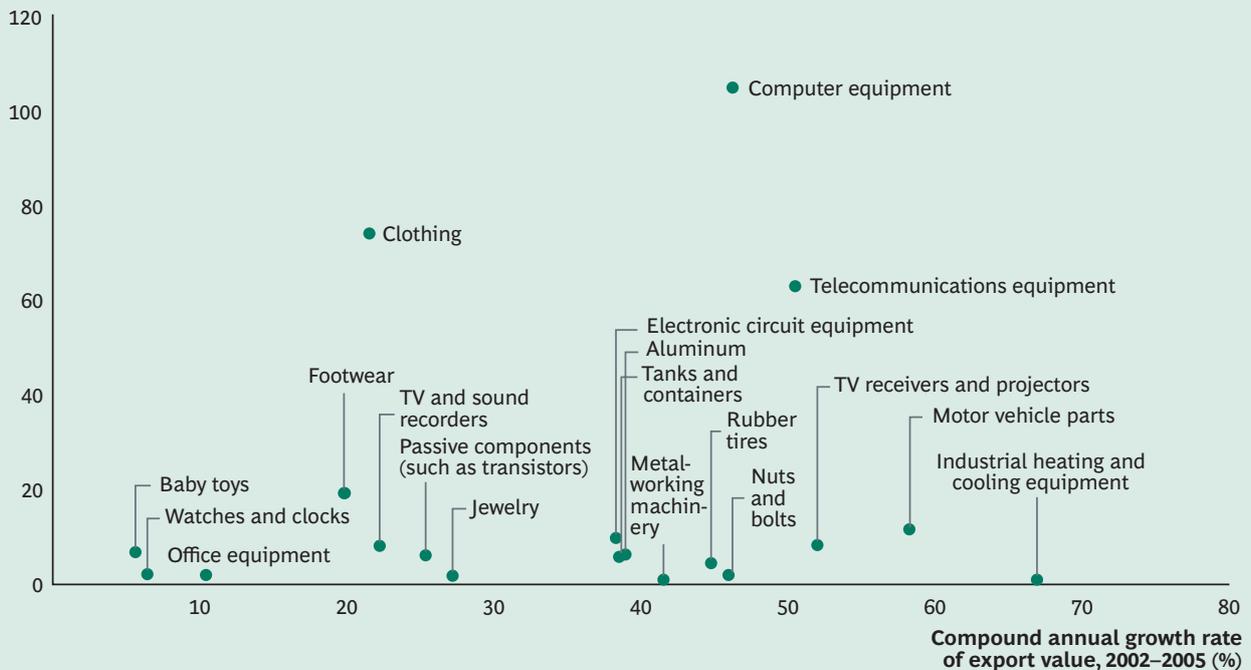
The impact on China has been huge. Fueled in part by this wave of China sourcing, the country's export volumes have soared. Between 2001, when China entered the World Trade Organization, and 2006, the country's exports more than tripled, reaching \$969 billion—and accounting for more than one-third of China's economy. China's mix of exports is also shifting toward higher-value-added products. (See Exhibit 1, page 2.)

This is not to say that China should play a central role in every company's global procurement activities. Other RDEs in Asia, Central and Eastern Europe, Latin America, and elsewhere certainly have valuable contributions to make to global supply chains. And for some companies, sourcing from RDEs may not be warranted at all. But the sheer magnitude of China's market—and the variety of competitive advantages China offers—suggest that companies should at least give serious consideration to sourcing from China.

But succeeding at it is far from simple. Our work in China, complemented by our recent study of 15 global companies in the automotive, industrial goods, and consumer durables industries that have all opened sourcing offices in China, reveals mixed results. However, those companies are also devising effective ways to address the significant challenges they are encountering. The central question we posed in our study was this: What are the practices that distinguish companies that are highly successful at China sourcing from those that aren't? The

Exhibit 1. China's Mix of Exports Includes Many Higher-Value-Added Products

Export value, 2005 (\$billions)



Sources: China Statistical Yearbook, 2006; BCG analysis.

answers to that question are contained in this Focus report. Before we discuss best practices, however, it's important to understand the four stages companies typically pass through as their China sourcing evolves.

The Evolution of China Sourcing

Companies advance through four stages when engaging in China sourcing. (See Exhibit 2.) In each stage, the sourcing environment becomes increasingly complicated, so companies must continuously renew themselves to meet the emerging challenges.

Stage 1. Testing the Waters. In the initial stage, companies tend to test the attractiveness of sourcing in China by setting up a sourcing office there and building a small sourcing team. Often the team is charged with rolling out a few pilot projects, which offer opportunities to develop and test in-

ternal and external processes (such as identifying and screening suppliers, auditing and evaluating them, and coordinating supplier quotations). Given that pilot projects are often highly visible within the company and driven by top management, they can leverage the involvement of top management to overcome internal resistance. They can also create traction within the organization, especially at headquarters. The early success of pilot projects becomes an effective internal marketing tool for drumming up support for China sourcing.

During this initial stage, companies are often preoccupied with issues related to starting up their China sourcing, such as building the necessary organization and processes and conducting comprehensive supplier evaluations. Typically, companies cite differences in cultural and business norms and the lack of transparency in the Chinese supply market as key challenges at this stage. However, most companies can successfully overcome those challenges and move on to new ones.

Stage 2. Early Engagement. At this stage, most companies have seen positive results from their pilot sourcing projects and are eager to roll out multiple sourcing waves covering increasingly broad product categories. These waves offer opportunities to build up the company's sourcing teams (both in China and around the world) and train them in how to conduct China sourcing on an ongoing basis. The China team quickly masters the basic skills of identifying and screening suppliers, as well as negotiating with them, and fine-tunes the internal process of coordinating with global buyers located halfway around the world. To prepare for the ramp-up of China sourcing, some companies also broaden the local team's capabilities at this stage to include skills such as supplier qualification and development.

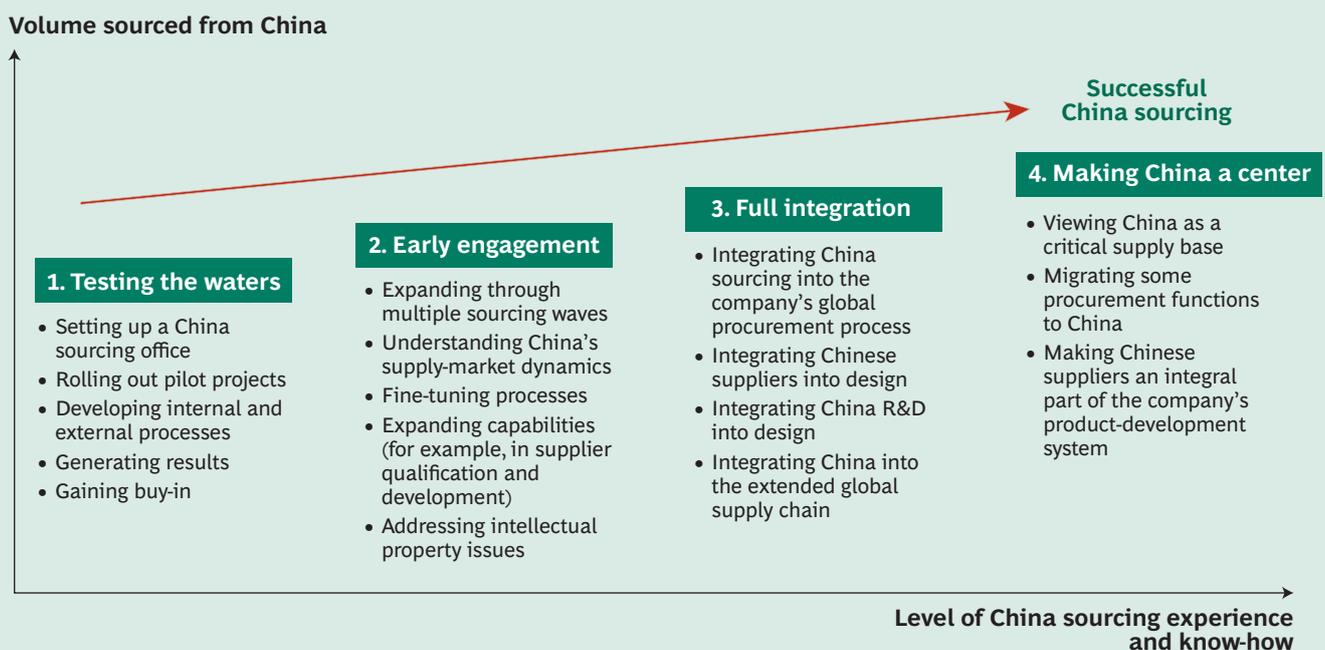
Challenges that become pressing include the protection of intellectual property rights. Many companies find themselves unprepared to deal with this issue and therefore limit the potential range of products that they can source from China. Companies that fail to explicitly address in-

tellectual property issues risk losing out to those that do.

Another challenge at this stage is that many potential Chinese suppliers need some degree of development in order to participate in Western business processes and meet Western quality standards. So supplier development becomes an important activity for sourcing teams. For some companies, particularly in industries that are still not highly developed in China, supplier development personnel can outnumber purchasing personnel by as much as three to one. Moreover, supplier development is often a cross-functional initiative involving multiple departments. Managing the complexity of cross-regional and cross-functional sourcing initiatives can be a lot for a new outpost organization in China to handle.

Finally, companies at this stage are beginning to face a common problem in China: the rapid turnover of sourcing personnel. Some participants in our study have experienced annual turnover as high as 30 percent. So an effective HR strategy to

Exhibit 2. Companies Advance Through Four Stages in China Sourcing



Source: Leading China Sourcing Practices, BCG study, 2007.

recruit, train, and retain personnel is critical to the success of any China sourcing organization.

Stage 3. Full Integration. After companies have gained traction, developed momentum, and matured through Stages 1 and 2, China sourcing progresses toward what we call “full integration.” It takes place in four areas: procurement, suppliers, R&D, and global supply chains.

Integration of Procurement. China sourcing becomes an integrated part of the global procurement organization, rather than consisting of special projects run individually in waves. Processes, systems, and coordinating mechanisms are developed to create integrating linkages. China-based sourcing teams actively participate in—or even drive—global commodity strategies.

Integration of Suppliers into Design. In Stages 1 and 2, companies often confine their China sourcing to products that have been designed elsewhere. Although this is a quick and easy way to start sourcing from China, it yields only limited cost savings because costs unrelated to China sourcing have been designed into the product. For example, a part designed to be produced in a highly automated processing environment will not garner much savings from Chinese suppliers because it cannot fully benefit from China’s labor cost advantage.

But as companies’ China sourcing becomes more mature, they learn to leverage Chinese suppliers’ capabilities by integrating them into product design—and even involving the suppliers in designing products from concept. This approach benefits both from China’s cost-effective product-development capabilities and from the fact that products designed by Chinese suppliers are often better able to leverage China’s low-cost manufacturing processes. More and more Chinese suppliers are now participating in the design of their clients’ products.

Integration of R&D into Design. To migrate in this new direction, China sourcing operations need significant engineering support in both technical areas and design. The China R&D and technology

centers set up by many global companies in China in recent years are an effective way to provide that support. When R&D centers are integrated with sourcing, they can provide supplier technical support and product localization.

Integration of Global Supply Chains. As the volume of products sourced from China increases, additional challenges emerge. By extending their supply chains, companies are putting pressure on their entire planning and management processes for sales, operations, and logistics. Clearly, companies sourcing from China—or elsewhere far from their markets—need to pay special attention to managing the risk of shipping disruptions along such extended chains. Third-party logistics providers can resolve some issues temporarily, until these companies find ways to integrate and manage the supply chains.

Stage 4. Making China a Center. At the fourth stage, companies view China as a critical supply base and are shifting some procurement functions there from their headquarters. For instance, China’s highly developed electronics supply base has prompted some companies to locate their top procurement teams in the country. IBM, for example, moved its chief procurement officer to China in 2006 in order to put him closer to the supply base. By locating some of their central functions in China, companies can better understand the dynamic supply base there and leverage their innovation to create competitive advantage in the marketplace. At this stage, companies also make their Chinese suppliers an integral part of their product-development systems.

Making the Most of China Sourcing

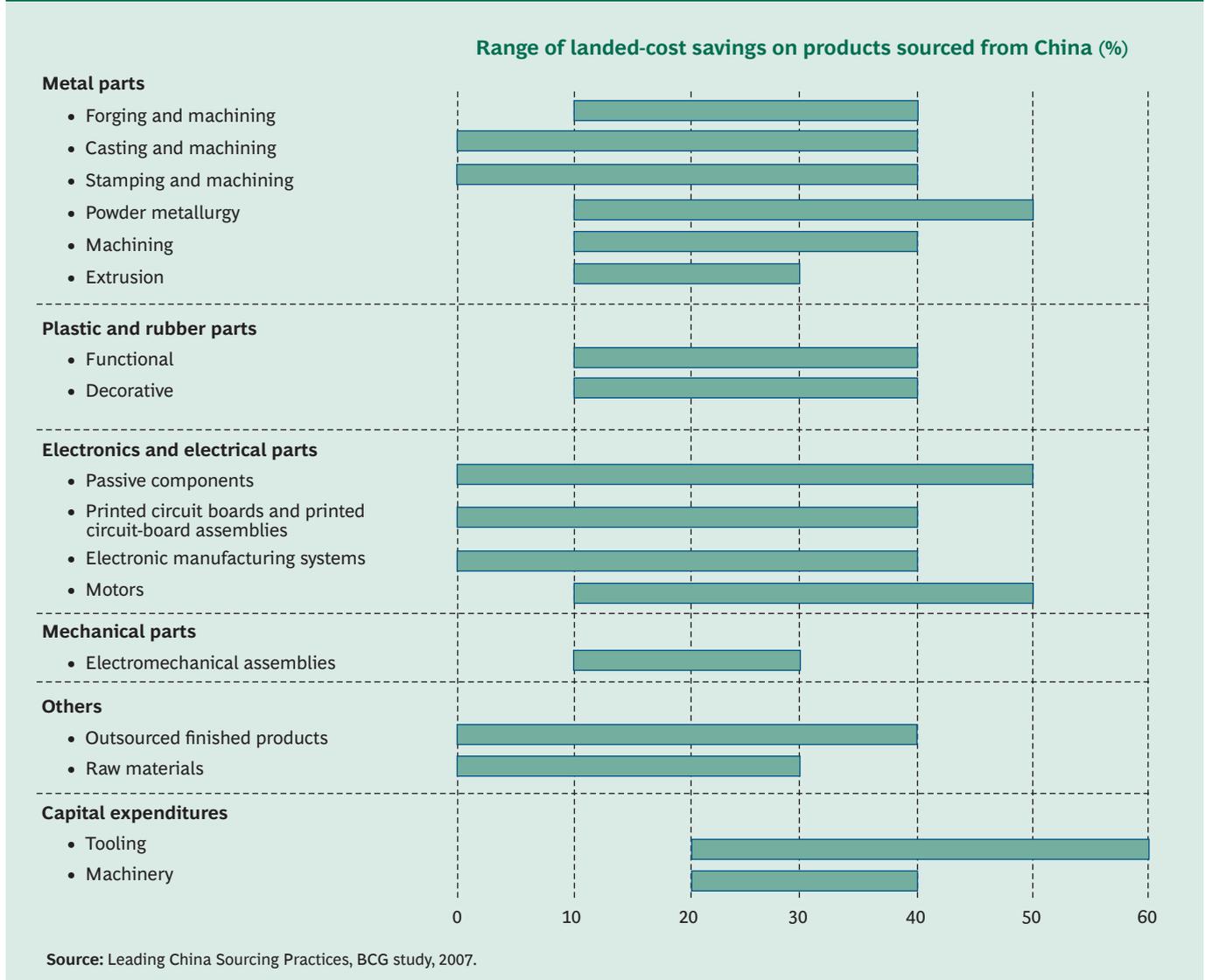
As expected, our study confirms that companies are indeed benefiting by sourcing from low-cost suppliers in China. The 15 companies in our study reported savings as high as 60 percent of landed costs for commodities and products sourced from China, with an average landed-cost savings of more than 20 percent. (See Exhibit 3.)

Nonetheless, our study reveals that companies are achieving different degrees of success in moving their global procurement spending to China. In fact, many global companies' volume of China sourcing as a percentage of their global procurement spending remains relatively low. Although it is logical to assume that companies' China sourcing volumes will increase as their China sourcing offices gain experience, our study shows that this is not always the case. Even though senior managers have publicly endorsed China sourcing and are trying to increase their sourcing volumes from China,

many companies, even with extensive sourcing experience in the country, have not been able to expand their China sourcing beyond 10 percent of their global procurement spending. (See Exhibit 4, page 6.) And even some companies that aspire to reach 10 percent have not been able to get there. A number of China sourcing offices are now asking whether they are lagging behind their peers in reaping the full operational and strategic benefits.

With just one exception, all the participants in our study pointed to internal resistance at all levels as

Exhibit 3. Study Participants Reported Savings Across Products Sourced from China



the number one issue limiting their sourcing from China. (See Exhibit 5.) In general, there are three sources of resistance: lack of understanding, lack of incentives, and perception of risk. Management must tackle each with specific actions, such as the best practices described below.

Another interesting finding is that industries are leveraging China differently, reflecting varying levels of supply base development. As expected, companies sourcing components for which the Chinese supply base is well developed can easily migrate their sourcing spending to China. For instance, the Chinese supply base in electronics has been well established for years, thanks to extensive development in the 1980s and 1990s in the consumer electronics and IT industries. This strongly developed supply base has created an advantage for global companies because many local suppliers' production processes now meet global standards for efficiency and quality. As a consequence, some electronics and high-tech companies are able to source up to 50 percent of their global spending from China. In contrast, China's automotive supply base is still at an early stage of development. Despite global automakers' strong interest in enjoying the benefits of China sourcing, they are currently sourcing from China only limited amounts—often less than 10 percent of their annual procurement volumes.

While differences among industries in their adoption of China sourcing can reflect varying degrees of supply base readiness, variances in companies' sourcing performance within the same industry are more difficult to explain. Our study suggests that different levels of performance can be attributed

primarily to companies' varying success at implementing a set of best practices.

Best Practices in China Sourcing

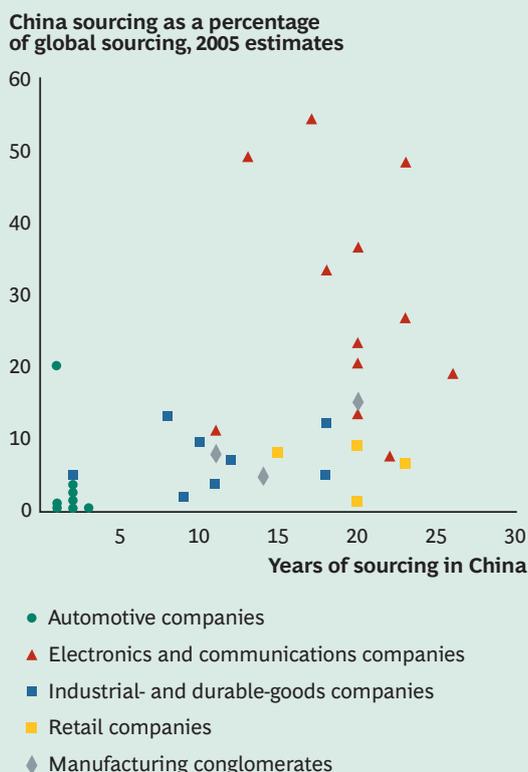
Our investigation into the practices of China sourcing offices revealed ten best practices that differentiate the most effective offices from their peers.

1. Defining a Clear Sourcing Strategy with Specific Targets and Plans. In leading companies, top management typically defines the RDE sourcing strategy and then communicates its importance

through the ranks. To be effective, such strategies need to go far beyond simple public announcements of target sourcing volumes. More than a dozen of the 15 companies in our study reported that they had developed sourcing targets, but only one-third of them had created specific plans that spelled out how they would realize those targets. To be implementable, plans need to specify what will be sourced where, when, from whom, with what resources, with what expected savings—and who will be held accountable.

As the supply base in China has developed, it has also become increasingly heterogeneous, with significant variation by region and type of ownership. In the 1980s, when sourcing began to develop, most factories were owned by foreign companies and located in special economic zones in the Pearl River Delta. Today the suppliers involved in exports cover a much broader geographic area, and wage rates vary by a factor of two or more. Best-practice strategies go well

Exhibit 4. The Extent of China Sourcing Varies Among Industries and Companies



Sources: Analysts' reports; company Web sites; press search; BCG database; BCG interviews and analysis.

Note: The symbols represent individual companies in various industries. Sourcing volumes include both domestic and export. The sourcing history begins with the first plant setup.

beyond deciding what will be sourced from China; savvy companies specify what will be sourced from which type of supplier, in which region, and with what expected savings.

Given the increasing complexity in the Chinese supply base, it is important to involve experienced, knowledgeable sourcing experts in strategic planning as well as buying. Only slightly more than half of the companies in our study have been involved in commodity strategy development. Even fewer, about a quarter, have participated in make-or-buy decisions. In contrast, best-practice companies fully leverage their China-based expertise, not just for execution but also for strategic planning and decision making.

2. Aligning the China Sourcing Organization with Global Procurement. The optimal structure

for a China sourcing organization is typically determined by the structure of the company’s global procurement function and the stage of development of its China sourcing activity. For companies with centralized global procurement organizations, the China sourcing office often functions as a direct solid-line extension of the global organization. For example, automotive OEMs typically organize their China sourcing this way. In contrast, for decentralized companies with multiple business units, the positioning of the China sourcing office can be more complicated. The key question is whether there should be a single China sourcing office serving the company as a whole or multiple sourcing offices—one for each business unit.

For decentralized companies, using a single sourcing office for all business units seems to make sense, especially during the start-up phase, when

Exhibit 5. Internal Resistance Is the Biggest Constraint Limiting the Growth of China Sourcing



Source: Leading China Sourcing Practices, BCG study, 2007.

the company is testing the waters and learning about China sourcing. However, as the office gains traction and critical mass, issues such as allocating costs and resources among business units can become contentious. Companies that choose to deploy multiple sourcing offices need strong coordination across business units to create effective leverage.

3. Enabling Collaboration Across Regional and Functional Boundaries. Leading companies are developing strong cross-regional and cross-functional coordination in order to succeed in China sourcing. Often, companies set up dedicated program-management teams on both the sending and receiving ends to ensure proper coordination. On the personnel side, many companies are strategically positioning expatriates who have strong networks within global headquarters to run their China sourcing offices. By leveraging these long-established personal networks, expatriate managers can enhance cooperation across geographic and departmental boundaries.

An interesting question that often arises is whether China sourcing for local production and for export should be conducted by the same organization. The proponents of separation argue that the two functions require different skills and often buy different products, so there is limited benefit in putting them together. However, an increasing number of companies are moving to consolidate the two functions in order to leverage scale. In fact, more than two-thirds of the participants in our study have merged the two functions within one organization. By consolidating volume, companies are gaining leverage and attention from the supply base.

4. Integrating Suppliers and R&D into Design. Companies that have reached Stage 3 (full integration) have found that sourcing products designed elsewhere limits the benefits of China sourcing. The key is to leverage Chinese suppliers' capabilities by integrating the suppliers into product design and involving them in designing products from concept. Integrating China R&D and technology centers into the design process can contribute to great progress in this area.

5. Systematically Developing Suppliers. Many companies that have succeeded in their initial forays into China sourcing find it difficult to ramp up to significant volumes because of the limited availability of qualified suppliers. Many qualified Chinese suppliers are already operating at full capacity, despite having launched aggressive plans for rapid expansion. Therefore, leading companies are increasingly employing rigorous supplier-development and management systems to groom preferred suppliers for global sourcing. Companies are offering their suppliers extensive technical support as well as support in process and quality control. Such support is becoming increasingly important as sourcing offices migrate from "build to design" to "build from concept," taking advantage of Chinese suppliers' product-development capabilities.

It is not uncommon for supplier development teams to be deployed at potential suppliers' facilities for months, to help them improve both quality and processes. The suppliers, for their part, generally welcome this kind of support, which increases their loyalty to the companies that provide it. In addition to supplier development systems, it is important to have a robust supplier-feedback system.

The development of potential suppliers in China can convey other benefits as well. For example, an industrial goods company has used the emergence of Chinese suppliers of basic products to pose a credible competitive threat to its oligopolistic Western supply structure—thus creating significant leverage and boosting its bargaining power in negotiations.

6. Recruiting, Developing, and Retaining the Best People. One characteristic that distinguishes leading sourcing companies from others is the quality and quantity of the people they have working in China and dedicated to global sourcing. There is just no substitute for having capable people on the ground in China. Directly related to this practice is the need to develop local teams. Leading companies have been quite successful in localizing their China sourcing teams. Of the staff members in the China sourcing offices that participated in

our study, only 7 percent were expatriates. Most of them held management positions or provided technical expertise.

It is no easy task to assemble and retain such localized sourcing teams. Qualifying and developing suppliers and integrating them into product development require specific technical skills and experience. China has a limited supply of sourcing specialists because the field of strategic sourcing did not attract much attention there until the late 1990s. This limited pool is often insufficient to meet the ever-increasing demand of China sourcing offices and local companies. So foreign companies typically recruit new sourcing staff members by poaching one another's sourcing offices. As a consequence, turnover rates in sourcing office "hot spots" such as Shanghai can be as high as 30 percent.

However, as sourcing volumes expand and China sourcing offices multiply, poaching alone will no longer satisfy the increasing demand for talent. Leading companies are setting up robust training programs for their sourcing staff, covering both technical and sourcing-related topics. They are also paying more attention to employee retention, offering increasingly attractive compensation packages as well as nonmonetary rewards such as personal recognition, overseas training opportunities, and clear career paths.

7. Gaining 100 Percent Transparency into Sourcing Volumes and Savings. As discussed above, China sourcing requires significant changes in the way an organization operates. Leading companies have developed robust RDE sourcing scorecards and data collection systems to enhance transparency. By showing on a scorecard how much sourcing is being conducted by different business units or product lines, companies can identify gaps and set goals for improvement. Transparency can also create healthy pressure from within because it allows the company to compare the performance of various business units.

Transparency requires the sharing of a tremendous amount of data by multiple functions at many levels in several regions, which must often act on those data simultaneously. Types of data

involved include information on suppliers, specifications, RFQs, commercial terms, and order status. Facilitation of this exchange requires fairly sophisticated and robust data-sharing systems—global e-rooms—that provide timely access to accurate information.

8. Providing Internal Education to Increase Awareness and Understanding. Changing suppliers can easily disrupt production. Therefore, procurement professionals tend not to change suppliers unless it is absolutely necessary. If global procurement teams lack a clear understanding of what is available in China, they are often reluctant to choose a China sourcing solution. The key to convincing them that Chinese suppliers offer viable alternatives to incumbents is internal education that puts procurement teams and suppliers in direct contact. Many companies are conducting internal marketing programs to increase the visibility of Chinese suppliers' capabilities by bringing global buyers to China for supplier conferences, sending Chinese suppliers to headquarters, or both.

9. Tying Incentives to Sourcing Targets. Many companies do not have incentive programs that tie individuals' performance measurements to success in sourcing from China. Some companies actually impose disincentives, such as penalizing logistics personnel for the higher freight and inventory costs of China sourcing. Without incentives to change people's behavior, China sourcing will not gain traction in any organization.

To ensure global buyers' support for China sourcing, some leading companies establish China sourcing targets on the commodity level and tie buyers' individual performance assessments to China sourcing volumes and the savings thus generated. Some companies are also setting up "dashboards"—that is, tools that provide snapshots of progress in projects or programs—to monitor China sourcing and tie its success to procurement teams' performance measures, key performance indicators, and compensation. To ensure alignment, companies should tie incentives directly to the performance of buyers and engineers based both in China and at the company's center.

In tying incentives to sourcing targets—as in promoting China sourcing generally—senior managers must visibly support and drive China sourcing programs. Many companies set up centralized program offices, run by senior managers, for this purpose alone. The executives in these offices push the agenda internally and help to overcome resistance at all levels, ensuring the transparency of China sourcing activities so that top management can track—and reward—progress where merited.

10. Addressing Real and Perceived Risks. Sourcing from RDEs raises a number of real and perceived risks, including—but not limited to—fluctuations in exchange rates, changes in the costs of labor and materials, power outages, quality problems, transportation delays, intellectual property theft, human rights violations, worker safety issues, environmental damage, and increased obsolescence. Leading companies systematically identify these risks, develop solutions, and ensure that they are broadly communicated within the organization.

Senior managers need to think strategically about the current and potential value of their China sourcing activities. Critical questions to answer include the following:

- Is our China sourcing achieving our company’s strategic objectives?
- Are we ahead of or behind our competitors in leveraging China sourcing?
- Are internal or external constraints preventing our China sourcing from achieving its full potential?
- What actions do we need to take to improve our China sourcing practices?
- How will we address the supply chain risks related to sourcing from China?
- How should the role of our China sourcing evolve over the next five to ten years?

China sourcing itself is evolving. Approaches that were best practices just a few years ago are now

standard operating procedure in most China sourcing offices. No doubt today’s best practices will become tomorrow’s norms. Whether your company is currently engaged in setting up a China sourcing office or moving to gain additional scale and traction in established China sourcing activities, the goalposts will be constantly moving away from you. To stay ahead in this arena, companies need to continuously reinvent themselves. Nonetheless, many companies are finding that the rewards to be won through effective China sourcing are well worth the concerted effort they require.



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