

The China Syndrome

By C. Richard Panico

There is probably no topic receiving greater attention today within the manufacturing world than outsourcing manufacturing to China.

Circumstances are making outsourcing off-shore an essential strategy consideration for many companies. For some, it may be critical for survival; for others, it may be necessary to sustain and grow profit margins.

There is probably no topic receiving greater attention today within the manufacturing world than outsourcing manufacturing to China. In some cases, the discussions center on how to efficiently outsource without compromising quality, customer service, propriety property and other critical supply chain elements. Other conversations center on how to compete directly with Chinese manufacturers or domestic competitors who are sourcing products or product components out of China.

I recently attended a conference on this subject specifically designed for CEOs, presidents and owners of companies dealing with the increasing challenges of global markets and competition. Of course, based on the nature of the subject, you can guess that most of the discussion centered on doing business in China and India. However, similar correlations can be made in reference to doing business in other places around the globe. I was not surprised to learn that most companies' experiences were very similar to ours and our clients'.

Before identifying typical challenges, suggesting solutions and approaches, and sharing perspectives related to doing business in China, I'd like to present the circumstances that are making outsourcing off-shore an essential strategy consideration for many companies.

Competitive Challenges Require More Weapons

I'd like to limit our reference to small and mid-sized companies, those with revenues of a

few million dollars to a couple hundred million dollars. I believe that there is great value in focusing on this segment for several reasons. First of all, the greatest percentages of these businesses are privately owned. Also, these businesses have the maximum impact on our economy and account for the largest contribution to employment in the United States.

Because these businesses don't have the sophisticated infrastructures and underwriting capabilities of larger companies, it is very difficult for them to consider off-shore manufacturing as an alternative. Another challenge is that they also tend to be most loyal to employees, domestic suppliers and the philosophy that "made in the USA" is the only way to ensure quality.

While many of these companies have honorable and worthy attributes, competitive challenges require more and different weapons in the arsenal. Market forces, including customer buying motives, are less frequently influenced by philosophies than by pricing, delivery and quality. For many years, sourcing in China, India, Russia, Indonesia, Korea, Mexico and other low-cost economies was synonymous with poor delivery and quality, and the lower price differential was insufficient to overcome the negative perceptions and realities. However, with the rapid assimilation of these countries into a global capitalistic market, accelerated learning fueled by greater collaboration and intervention on the part of large companies and universities, and the integration of more sophisticated technology, the quality and delivery issues gap is steadily and quickly narrowing.

A fact that you may find interesting is that the number of U.S. universities participating in, sponsoring or establishing a presence in these developing countries is also increasing. They have also recognized the opportunities present in

these new markets. I happen to believe that this factor, which tends to receive very little attention in the media and business world, will have a huge impact in the industrialization and modernization of underdeveloped countries and economies.

When the labor component of cost begins to stabilize, which may happen more quickly than some realize, the competitive advantage will shift to those countries that have educated resources as well as an abundance of resources. Individuals on the factory floor will have to be better educated to manage evolving technologies. Ultimately, the greatest competitive advantage will rest with those who possess educated resources, technology and, most important, cultures characterized by extraordinary leadership, cooperation, focus, discipline and inspiration.

If you haven't figured it out, many of these attributes cannot be bought, are difficult to replicate and require years (not fiscal quarters) to accomplish. Creating business cultures that possess these attributes is our supreme challenge.

Outsource Strategies

Let's refocus to the challenges faced by our small to mid-sized companies that have decided, in order to compete, some or all of its manufactured products (or components thereof) need to be outsourced to meet cost targets. In some cases, the strategy may be to outsource for a period of time sufficient to generate and accumulate profits so that technology investments can be made to increase productivity, flexibility and quality. One company in the Midwest employed this strategy and was successful in returning most of its manufacturing operations to the United States after several years.

In other cases, the strategy may be to outsource commodity, non-critical components of a product, while retaining manufacturing responsibility for the complex components and assemblies. Yet others may decide that their strength does not lie within manufacturing but rather in R&D, or sales and marketing, or some other facet of the business and decide to partner with an outsourced low-cost manufacturer.

In any case, the decision to outsource, specifically outside the United States, should be fact-based, not assumption-based. As obvious as this may seem, there are too many examples of companies that regretted their decision to outsource manufacturing and later realized that baseline information related to current standard cost and other essential metrics

were not accurate. Assumptions and facts regarding costs, business processes, foreign tariffs and duties, cultural tendencies, and other factors were wrongly (partially or completely) misinterpreted or otherwise misapplied.

I am familiar with a well-known company with operations in the United States that decided to move its manufacturing operations to Mexico. The decision was made on an unqualified assumption and a strong desire by the CEO, who was influenced by peers who had successfully moved their operation to Mexico. The move was crippling to the company, as major issues were encountered with quality and throughput. Customer service performance degraded from an industry high standard to one that was characterized by major backlogs and missed deadlines. Two years after startup, the throughput and efficiency had not reached former levels. The company had grossly underestimated several factors, including high labor turnover, which taxed its ability to train resources and overcome the learning curve. Today the company is seeking to sell off this division to a competitor. This point is not to discourage outsourcing, but rather to encourage due diligence and the consideration of all factors that will ultimately influence success or failure.

The Steps

So, you haven't done business in China but you know that your labor costs are high, your margins are eroding, competitors are becoming more aggressive, and it is more difficult to differentiate your product and company based on the other buyer considerations. After thoroughly analyzing your costs and being convinced that the information being used is current and accurate, a strategic decision is made to evaluate outsourcing to China.

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What's next? Although there is much to consider, here are some essential steps:

- Determine whether the specific manufacturing capability is available and well-developed in China. Unless you are willing to invest huge sums of money, time and resource, it may not be worthwhile. Some industries are much more developed than others.
- Don't assume that accurate drawings, specifications and instructions will produce the desired results - you will likely be disappointed.
- Plan on a great deal of hands-on facilitation to guide the manufacturer through the process steps and describe the product through physical examples that can be seen and touched. The Chinese manufacturers are very good at duplicating/copying a sample.
- Assume that your product will be copied and marketed by "pirates". Although agreements and contracts are advisable and gradually becoming more effective, compliance is difficult to enforce.
- If possible and efficient, utilize different vendors to manufacture component pieces. This will make it more difficult for your product to be replicated.
- Understand the impact of currency value difference. Exchange rates can make or break the deal.
- Determine the impact of transportation, time, cost and U.S. Customs requirements. Products that are heavy and bulky may require shipment by water; this will have a major impact on delivery lead times, inventory considerations and more important, customer service. Some of these costs and risks may eliminate the actual manufacturing cost savings.
- Understand the payment procedures. Be prepared to pay for your goods before they leave the factory. Also, become familiar with establishing a secured letter of credit (LOC) and drawing on the established line to pay the vendor once the product has been inspected and is ready to be shipped. This is customary.
- Learn business customs. "I understand" here means that you'll probably get what you expect. In China, it most likely will mean "I'll keep trying." Wasted labor and time receives little attention.

However, there is an abundance of cooperation and willingness to do it again.

- Stay involved until the process is repeated over and over and consistently produces the quality you expect.
- Expect the transition (outsourcing) to take longer than you planned - it will.
- Maintain rigorous files of lessons learned and evolve processes and procedures so that with time, internal expertise in managing work in China is developed and easily transferable to others.
- Utilize a broker who is familiar with doing business in China and familiar with your industry. As in the U.S, relationships are key.

Almost all of the companies that attended the session I referred to earlier were using intermediaries to broker their Chinese business deals. Some companies evolved to the point of hiring local personnel to oversee the manufacturing process and ensure the quality and consistency of their products. For smaller companies, this is difficult so the broker should be capable of serving in the owner's representative role.

As intimidating as it may be to enter the global arena, it will be inevitable for many businesses that expect to succeed. We are all challenged to evolve or die. In this case, you have the opportunity to capitalize on a path others have cleared, the lessons they have learned and the intelligence that has been gathered - *use it wisely!* **GCI**

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