Sourcing from the Far East: Success from the Start

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Abstract. Over the past five years, a major revolution has occurred in the way US-based companies trade with the Far East. For example, pre-1997, China was still "over there" – now it is a rapidly growing part of many companies' supply portfolios. When sourcing from the Far East, the application of sound procurement practice, and a knowledge of how the system works can prevent an enormous amount of problems from ever occurring. Here then we isolate good practice and offer insight into the mechanisms for "Sourcing from the Far East: Success from the Start."

Background. If you were a buyer fifteen years ago, then you probably remember what life in purchasing was like before the telecom revolution. Just prior to the arrival of the fax machine, the telex was then state-of-the-art in data communication. Typically, however, one or two people in the entire organization were authorized (or even knew how) to operate it.

A typical day in the life of a buyer of fabricated parts back then might go something like this: He or she might obtain the day's requisitions from the Master Planner. With these, he or she might pull buy cards to verify current revision levels and purchase history, and obtain blueprint drawings for parts as necessary.

Often, he or she would make three copies of the drawing, one each for the three local suppliers that historically bid on that part. Assuming the supplier was physically located nearby, a phone call would be made to the supplier's salesperson to let them know that a quotation was needed and drawings were available. If the supplier was not close, the buyer would generate a cover sheet and mail the drawing package.

If the part was new and the supplier was not nearby, it was not uncommon for the quote process to take two weeks or longer. (Remember, the salesperson would present the inquiry to his own quote department, and the process would begin all over again!)

The fax machine streamlined this process somewhat, but blueprints didn't fax well, and anything larger than an "A"-size drawing had to be cut up into 8 ½" by 11" pieces to fit into the machine anyway.

To this buyer at a small- to medium-size US company in 1988, sourcing from suppliers in the Far East would be like sourcing from suppliers on the moon. There was simply no time. Not enough time in the buyer's day, and certainly not enough time to wait…

Fast forward to today, where over the past fifteen years information technology and telecommunications have changed supply chain management forever. Processes that fifteeen years ago took over two weeks can now be completed in just a few days. In a word, today everything is easier. It's easier to gather and analyze information, it's easier to locate and qualify offshore suppliers, it's easier to communicate with them, and it's easier to track and

manage all the data generated during the process. Break the bank budgets and teams of personnel formed as Far East sourcing teams, previously an option solely for Fortune 100 companies, are no longer required or even needed. Requirements don't even have to be in full ocean container loads.

What *is* needed, however, are the same experiences ands skills that have made today's professional purchaser successful today: a willingness to try something new, organizational, communication, and team building skills, and above all patience and diligence.

This paper is a guide through the general process of sourcing from the Far East. It points out along the way the usual pitfalls that buyers new to this part of the world fall into, and how to avoid them. It is not a primer on global sourcing, as there are a myriad of books and magazine articles that cover the basics of this subject. The mechanics of establishing a letter of credit are the same whether your supplier is in Malaysia or France. Similarly, a 40-foot container has the same volume regardless of its origin. This paper looks at some of the nuances of Far East sourcing, so that a purchaser might anticipate and avoid unexpected difficulties during the process.

The Procurement Cycle. Any procurement cycle begins with an identification of need. Let's assume you have a need, and have decided to try and source it from the Far East. Why? Maybe you are currently sourcing components from local suppliers and are experiencing both time delays and what you believe are excessive tooling costs. Perhaps you are being pushed to develop sources in the Far East by senior management who read about the incredible cost savings opportunites overseas in the WSJ. Maybe your company is currently resource constrained, and outsourcing the need will free valuable manhours. At a time of recession in the manufacturing industry, companies, especially smaller ones, need to be more competitive yet suffer from higher production costs. The uncertainty just described is not uncommon to organizations looking to the Far East as a new source of supply, and the old carpenter adage "measure twice, cut once" applies here.

Before you undertake a Far East sourcing project, you should form a team using cross-functional members of your organization, and develop a Far East sourcing strategy. The importance of the cross-functional team will become evident shortly; developing a strategy will help answer questions such as "What exactly are we hoping to gain from this?", "What are the risks?", "What information and resources do we need?", and "Who and how will this project be managed?" You're about to materially change your supply chain - you need to have a game plan in place *before* you begin.

Your strategy will ultimately guide your decision what to source. In turn, the Far East area that you should focus on will be dependent on the product, commodity, or service being sourced. For example, high tech products such as semiconductors and other electronics might be sourced in Japan or Taiwan due to technical competence, steel in Korea or aluminum in Russia due to the availability of raw material, and electro/mechanical assemblies in China due to their high labor content. For reference, seek out information such as that shown in Figure 1 to assess what region or country might be a good fit for your need. Generally speaking, heavy and large products should not be sourced from the Far East, due to the cost of transporting them to the US. Also, highly technical products using advanced materials may also prove difficult.

Figure 1: Percentage of US Imports from China (2000)

Electrical Machinery and Equipment	17%
Toys	15%
Footwear	12%
Apparel	10%
Power Generation Equipment	10%
Furniture	5%
Leather and Travel Goods	5%
Plastics	3%
Medical Instruments	3%
Iron and Steel	2%
Other	18%

Source: US Dept. of Commerce

One option might be to initially start with something fairly simple for an easy early success. This "testing the waters" would have the added benefit of contributing to your team's learning curve.

The next step in the supply chain procurement process is locating and qualifying sources. Where and how do you find sources in the Far East? Industry contacts, the Internet (try doing a Google search for "*far east sourcing*"!) and Asian trade organizations are tried and true. In addition, more and more Far Eastern manufacturers are coming *to you*. The same PC and Internet advances that allow you to obtain and view information on suppliers overseas are being used by these same suppliers to find your company. Also, there is a fast growing group of manufacturer's representatives that have Far East factories on their line card exclusively. Finding them is easy, but remember this step includes identifying *and* qualifying them to do business with you.

Qualification is key here, and is one of the most important factors that will determine your ultimate success or failure. Independently qualify the Far East source before doing business with them. Many manufacturers, especially in Taiwan and Japan, are either certified or are seeking ISO certification, in response to that requirement by their European and North American customers. You should know, however, that ISO is relatively new and unknown inside of China, especially outside the major cities. Many companies in China that are professed to be ISO certified are highly suspect, in this author's opinion. Similarly, Certificates of Conformance and the like are not often used within China. Don't rely on them when sourcing from the Far East. Instead, insist on visiting every sub and determine if the sub is capable! Assuming you have experience and knowledge on how to conduct them, you should coordinate an on-site assessment survey.

If it's not possible for your own organization to conduct the assessment, another growing industry in the Far East are independent quality auditors. These companies, often established by western principals, can perform site assessments as well as inspect first articles, tooling, production lots, packaging - almost anything in the area of quality control. If you do go yourself, arrange for your own interpreter. Ensure you leave plenty of time for travel between the factories you will visit, especially in China, where cars on roads between towns often compete for space with trucks, bicycles, motorcycles, mopeds, pedestrians, and livestock. (note: You will need a Business Visa from the PROC and Vietnam Consulate to visit these countries. Only a valid US Passport is required for most other Far Eastern countries, including Hong Kong, Taiwan, Malaysia, Singapore, Japan, and South Korea.)

Next you will need to obtain a quote from the Far East supplier. Again, modern technology has facilitated the transmittal of drawings and specifications. Electronic drawings and files can be e-mailed in seconds. However, you should always invest some time to verify drawings are current and accurate before sending. Try to also supply a digital picture and BOM of the product being sourced whenever possible. US manufacturers are much better at "interpreting" incorrect drawings than their counterparts in the Far East, especially when any language translation is involved. When reviewing drawings, have your team take the opportunity to apply value analysis techniques for additional cost savings by asking questions like "Can metric equivalent material be used?", "Can a different brand finish be substituted?", '"Can the parts be packaged so that they are 'nested' to reduce shipping volume?", and "Can product components be substituted?"

Now, let's say you're comfortable that the purchasing specifications are accurate, and the quotation that you receive back looks really good. To make any kind of sourcing decision on price alone would be unwise. Instead, determine the landed cost for the Far East supplier, and evaluate it against the domestic supplier or the in-house total cost (if considering outsourcing). Some of the factors to be included are very straightforward, such as the cost of the part, the duty rate, tooling costs, and custom clearance charges. Other factors, like freight costs, for example, seem fairly straightforward, but can be tricky – especially when the part is being imported for the first time. How many will fit in a box? How many boxes per pallet? How many pallets per container?

If purchases are made in less than container lots, what is the volumetric weight of the shipment? Sourcing from the Far East means longer lead times, which often means higher inventory levels. There is a cost associated with this. Other factors are even harder to quantify. The exchange rate risk can be significant, but how does one translate it into dollars and cents?

An aside on pallets: the US Customs Service requires that all solid wood packing materials from China must be kiln dried, fumigated, or treated with preservatives. (This requirement is intended to eliminate the threat of the Asian Long-Horned Beetle on North America's hardwood forests.) A certificate attesting to this fact must be presented with the shipment. Many Chinese companies are instructed by their customers to simply load the container with plastic or metal pallets, or eliminate pallets altogether. Without pallets, however, specialized handling equipment is required at all shipping transfers, and many products may experience greater damage rates. Also, without pallets the US customer will have to have enough manpower to unload quickly to avoid demurrage charges. Of course, there is a trade-off in that no pallets leave more valuable space for cargo.

Only when all the total cost factors are identified and quantified do you begin to have any accurate framework within to make a decision. Often companies require a threshold savings amount before they will select an Asian source over a domestic one. An absolute dollar threshold, not a percentage threshold, should be applied to total cost savings analysis. Using a percentage threshold, a company could potentially walk away from a deal that would save them thousands of dollars. For example, assume sourcing a product from the Far East would save $14,999. A savings threshold of 15% applied to this $100k purchase would mean the company would pass. Instead, it makes much more sense to set an absolute value minimum savings when evaluating.

Another challenge when considering a make/buy decision is in the area of applied overhead. When comparing the total cost of the sourced product, do you compare it against the fully burdened internal cost, the “out-of-pocket” material and labor only, or some other formula? One alternative is to simply apply the same overhead factor that your company uses for purchased parts. It is important for your finance department to recognize that outsourcing of parts could have a material impact on overhead absorption. The situation just described, while not necessarily unique to Far East sourcing, is an often overlooked aspect for parts being considered for outsourcing.

Ensure that contingency plans are part of the decision making process. Last year’s longshoreman’s strike was a good example of this need. This strike was anticipated early in 2002, so many good logistics companies were able to re-route freight to ports in Canada and Mexico. Still, thousands of containers were stuck on the west coast, costing US businesses millions of dollars. Using a “what if” brainstorming technique with your team can help uncover alternative plans should your imported products not be available at the appointed time and place for whatever reason.

Let’s assume everything is a go at this point, and your team has decided to import a container of widgets. The next step you want to take without fail is to communicate your plan internally. There are many excellent, valid reasons that were used to make the decision to source from the Far East – make sure your stakeholders know what they are. This is *especially* true when the decision has been made to outsource a part or service previously done in-house. Hopefully, the cross-functional team that participated in the decision will champion that communication effort within their own departments. The last thing a buyer wants is to see is a container of product being delivered that was previously made in his factory without anyone on the floor having prior knowledge about it. Your inventory manager may be unprepared and unable to store a newly delivered pallet of widgets from the Far East if only cartons of that product had been historically procured in the past. The same goes for domestic suppliers. If you’ve been buying the same product from a supplier and the orders suddenly dry up, they’ll know something’s up. They should hear about your sourcing decision from you and not a third party.

Where possible, the Chinese factory will typically hand load a container using a team of factory workers. Unless specified by you, assume that no pallets – metal, plastic, or otherwise, will be used. If you have the labor to unload the container before incurring demurrage charges, then there’s no problem. However, if your Receiving Department is only staffed to receive the usual four or five pallets maximum at a time, then special arrangements need to be made. Thankfully, more and more Chinese companies doing business in the US are aware of the

non-coniferous wood requirement and are asking their material handling suppliers to offer metal and plastic alternatives. Regardless, to the extent that you can, try not to use pallets, which take up valuable cargo space.

Inspecting the Far East sourced product should be done prior to containerization, for obvious reasons. As mentioned, if it's not feasible for you to perform the inspection personally, there are a number of independent agents who will perform this job for a fee. Keep in mind this is not the same as an agent who will witness the loading and sealing of the container for L/C requirements.

Last but not least, gathering, organizing, measuring, and reporting data is important for the same reasons it is important already. Now, of course, the information can be different, and might include: inventory levels, inventory days on hand, number of containers shipped / received, number of hours outsourced, cost savings, etc. This information will have obvious benefits when it comes time to report your progress to management.

Summary. A badly managed Far East sourcing project can in many instances prove to be a more expensive option. No one can foresee or prevent all undesirable events, but you do have some defenses to minimize the extent of a problem before it occurs. Form a cross-functional team and communicate progress and decisions at every step. Use due diligence and check out the newly identified source(s). Never assume that your drawings and specifications reflect actual requirements - validate them and use the opportunity to use value analysis tools to further reduce costs. Apply total cost principles when evaluating quotations. Learn and demonstrate your understanding of the importing logistics involved from getting the product from the Far Eastern supplier's factory to your dock. Managed properly, your Far East sourcing project will be successful, sustainable, and will deliver business benefits that will make your company more competitive.