GEP

White Paper

Low Cost Country Sourcing

Navigating Uncharted Opportunities Abroad

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Introduction: The Global Supply Chain

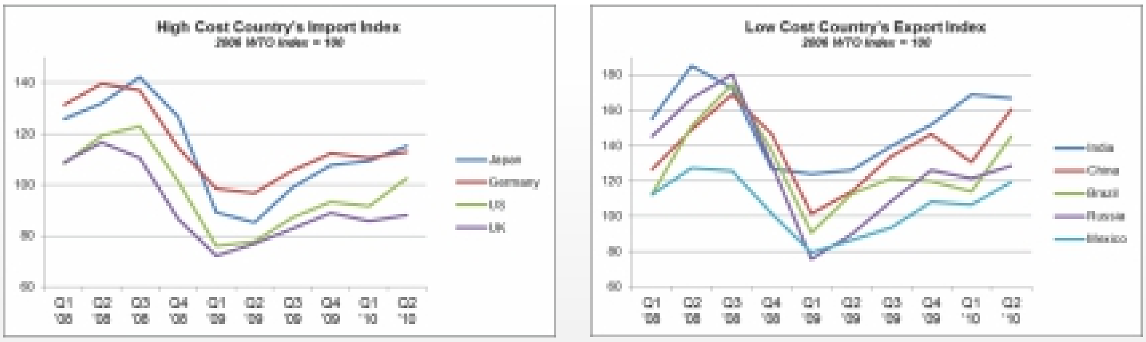
Businesses in all industries and markets have felt the impact of the recent contraction in the global economy. In the wake of the real estate market meltdown and subsequent financial fallout, spending and growth have practically evaporated from their previously bullish levels. As unemployment and uncertainty continue to linger over what continues to be a tepid recovery, demand for products and services is forecasted to remain weak over a prolonged period.

While most firms face top-line pressure due to a shrinking consumer base, exacerbated further by fierce market competition, management focus has shifted to the bottom-line with procurement being pushed to the forefront of corporate strategy. Since most supply bases have also been impacted by the recessionary environment, traditional procurement approaches are proving to be minimally effective. Hence, an increasing number of enterprises are developing newer and more innovative procurement strategies to position themselves for supply management success. One such strategy for businesses is to expand their strategic scope beyond familiar shores to capitalize on growing opportunities abroad through Low Cost Country Sourcing (LCCS).

Low Cost Country Sourcing has grown in popularity within businesses' management directives as an effective strategy to reduce costs across the supply chain. Although the slowdown in global spending had shrunk international trade, the flow of goods and services has begun to recover – supported further by unscathed free trade agreements and trade zones.

Figure 1: Definition of High & Low Cost Country

Figure 2: HCC Imports & LCC Exports Comparison



Source: World Trade Organization Statistics

Key Drivers of Low Cost Country Sourcing:

While companies may have different reasons for pursuing LCCS, some of the key drivers are:

Cost Competitiveness:
The accelerating trend toward increased sourcing from outside markets is fueled mainly by the relentless competitive pressures that are driving companies to devise ways to continually reduce costs. According to GEP's category experts, skilled manpower in low cost countries in Asia such as China and Thailand can cost between 50 to 75 percent lesser, compared to Western nations, while unskilled manpower can be as much as 95 percent lower. Moreover, significant savings go beyond labor arbitrage to reduced costs on production and manufacturing equipment. Tooling, for example, costs roughly 30 to 50 percent less in low cost Asian countries than it does in North America and Western Europe.

On an average, GEP has seen incremental savings of 25% to 30% through LCCS initiatives over sourcing projects in domestic supply bases.

Globalization:
Increased globalization has brought with it fewer trade restrictions and tariffs, lowering the costs and inherent risks of doing business with low cost countries even more. Improvements in technological infrastructure through the worldwide proliferation of internet-access and VOIP have significantly improved communication speed with reduction in the associated costs. In addition, cross-border institutions such as the WTO and IMF and their coverage have seen rapid expansion to provide protection and transparency in developing regions. Furthermore, emerging markets continue to diversify their industrial and economic footprint leading to new and increasingly advanced goods and services being made available from low cost regions.

These twin forces of global supplier competitiveness and improved accessibility have made Low Cost Country Sourcing a key part of most companies' procurement strategies.

LCCS Risk & Mitigation Strategies

As the Mattel recall of lead-painted products and the more recent Chinese manufactured drywall controversy have shown, the cost benefits from LCCS initiatives are not without their risks and pitfalls. Defective products cost companies millions and more importantly can also damage their reputation and competitiveness in the marketplace. Lacking oversight, ongoing risk mitigation and due diligence strategy, the upfront savings were grossly outweighed by the future costs of poor LCCS execution. As these example show, low cost countries may offer savings on the surface through reduced production costs yet the total cost of ownership is influenced by a gamut of monetary as well as risk factors. Overseas transportation, currency fluctuations and import duties can quickly erode the benefits of lower production costs and labor rates. Furthermore, LCCS introduces new complex risk factors which vary depending on the category and country in question.

Although LCCS cost components share similarities with domestic sourcing, the risk complexity is what makes this process unique and necessitates more robust strategies as well as expertise. Some key features that must be examined and managed are:

1. Regional Risk & Mitigation Strategy

The first risk factors that must be considered and analyzed effectively are those originating from the low cost countries and/or regions offering the product or service of interest. Unlike more industrialized nations, low cost regions tend to have more volatile economies displayed through their key macroeconomic indicators such as unemployment, inflation and industrial production. Fluctuations in these indices tend to be more pronounced during periods of business cycle growth or contraction.

Figure 3: LCCS Cost & Risk Factor Analysis

Cost Factors		
Materials	↓	Supply-demand dynamics
Labor	↓	Lower wage rates
Overhead	↓	Reduced costs of operations
Transportation	↑	International freight expenses
Foreign Exchange	↑	Exchange rate movements
Duties	↑	Import taxes
Sourcing Risks	↑	Potential unforeseen costs

Risk Factors	
Regional	• Macroeconomy • Geopolitics • Culture
Regulatory	• International Law • Local Regulation • Duties & Quotas
Firm	• Performance • Capabilities • Stability
Product	• Production • Specifications • Quality Control
Logistical	• Transportation • Management • Communication

Total Cost of Ownership	While low cost countries offer lower production costs, the net benefit is impacted by additional importing expenses and complex risk profile.

Such regions also tend to have less governmental clout and diplomatic influence causing some to suffer prolific geopolitical concerns such as disagreements with neighbor-states as well as internal instability. Tied to both the macroeconomic and government policies, a country's currency and its foreign exchange value can significantly impact a low cost country's viability and savings potential. Lastly, cultural barriers such as language, business culture and other factors play a role of success and/or potential failure of a sourcing initiative from LCC's. To mitigate such risks, it is critical to assess and understand all relevant issues presented by each potential low cost country and respective region. In light of Greece's sovereign debt fears contrasting China and India's burgeoning success, it is imperative to have knowledge capital and an understanding of every country's unique circumstances and outlook.

2. Regulatory Risk & Mitigation Strategy

The international processes which need to be in place for any LCCS initiative require an understanding of the existing regulatory frameworks and their potential impact on the target product or service. Both local and international trade regulations can limit a category's feasibility as they may dictate whether a given product or service can be traded globally. The country's multilateral trade policies and relationships such as quotas, prohibitive tariffs or other regulatory red tape must be understood completely because they play a critical role in the area of LCCS. Similarly, standard duties will add a percentage-based cost which must be factored into the total cost of ownership for any imported goods as they can significantly impact savings projections. Conversely, an absence of governmental oversight can be a source of risk and a lack of local standards control can lead to costly and damaging consequences as evidenced by the Mattel case. An understanding of international policy trends and more specifically the United States trade-related regulations will diminish risks in this particular area.

3. Firm Risk & Mitigation Strategy

In pursuing international suppliers, there is an inherent level of opacity into their company's operations and internal data in any given industry. The United States has well established mechanisms in place to verify most firms' financial and performance metrics through credit rating agencies and external auditors. Developed regions also benefit from mature debt and equity markets which provide companies with financing structures that inevitably place them under the scrutiny of a reputable third party. However, such verification tools and resources may not be readily available to verify LCCS resources, further complicating the standard due diligence procedure. As discussed, developing regions have more profound economic growth and contraction cycles – the latter of which can wreak havoc on low cost country's firms' sustainability. More troubling, some emerging markets lack efficient bankruptcy procedures which can lead to costly supply chain disruptions if the restructuring process lags significantly or the firm is shut down completely. Given the opacity that accompanies supplier relationships across borders, more in-depth resources and research must be invested from the onset of any LCCS initiative.

Through a detailed evaluation process, potential suppliers in low cost regions must be critically assessed on all necessary criteria. As the process continues and finalists are chosen, resources should be committed through in-person meetings and site visits to verify and audit the details provided.

4. Product Risk & Mitigation Strategy

The next critical risk area lies in the production process and resulting output as LCC suppliers may have unique technologies along with their own regional standards of classification. Although industries across borders may share a common end product or service, the intermediate processes may have developed along divergent paths in each individual region and/or country. For example, Latin American regions may import complex machinery from the United States while Asian nations will look to closer European sources. As such, the functionality and nuances in other areas of the world may follow separate standards affecting their viability within a LCCS context. Similarly, regional terminology and measurements must be considered as miscommunications can have dire consequences for any sourcing initiative. Such problem areas can arise from simple metric versus linear units of measurement or more complex methods of defining individual specifications. While quality control mechanisms have improved through the proliferation of the International Organization for Standardization and its ISO system, quality assurance processes tend to be less mature in emerging markets and must be evaluated vigilantly. Through a well-organized and comprehensive evaluation process, a procurement team will be able to minimize these risk factors to ensure an optimal LCCS result. By fully understanding language and definition standards complemented by effective communication, the chances for costly misunderstandings can be reduced. Additionally, through a defined and thorough sampling and audit process, any inconsistencies in international suppliers' products or services can be effectively managed.

5. Logistical Risk & Mitigation Strategy

In crossing potentially vast distances across numerous time zones, the logistical requirements also play a critical role for any LCCS category. From a transportation perspective, the majority of physical goods will be moved via ocean freight to reach one's production line, plants or other facilities. This additional layer of complexity increased risk of loss and/or lead time delays to and from the ports of departure and entrance. Given the volume of global trade, the busiest hubs can have significant off and on loading delays due to the sheer shipment volume they must accommodate and process. In addition to costs from time lags, this new level of logistical sophistication will increase the probability of transit loss or damage resulting in supply shocks. Moreover, in crossing greater territory, ocean freight exposes import goods to more diverse climates with potential natural disasters such as hurricanes or other storms depending on the route. In addition to transportation-based factors, communication, coordination and other logistical considerations will be much more complex under a LCCS process. For example, with the aforementioned time zones, the window for contacting a supplier representative directly via VOIP or phone can be narrow.

Analogous to the regional assessment, geographies of interest must be understood through various lenses to diminish the likelihood of unforeseen logistical costs. From a transportation perspective, a procurement team should have full transparency into the complete route, including the intermediate steps from plant to port to the final destination. While international tracking availability can provide this necessary oversight, a tiered supply chain with a diverse supplier pool provides the optimal risk mitigation outcome.

LCCS Strategies for Success

Given the aforementioned complex risk factors, an effectual strategy necessitates consistent due diligence and commitment of resources. As such, implementing a successful LCCS program requires upfront management commitment and a clearly outlined company vision for LCCS. Some of the preparation steps are:

Necessary Objectives for LCCS Success

- Articulating goals from LCCS with clear milestones and timelines
- Obtaining management commitment up-front
- Identifying an internal team and LCCS Key Performance Indicators (KPI's)
- Demonstrating initial success with quick-wins and building internal support
- Tapping into the right level of expertise, potential options being:
  - Establishing full-time internal positions for LCCS
  - Partnering with a local company in the low cost country
  - Establishing an Internal Procurement Office (IPO) in the low cost country
  - Partnering with a LCCS expert in the supply chain domain

Once a company-wide LCCS strategy has been defined with clear objectives and resource commitments – whether in-house or from an external partner – project-specific LCCS implementation can be initiated:

Figure 4: LCCS Process Roadmap

Category Selection: Setting the Foundation

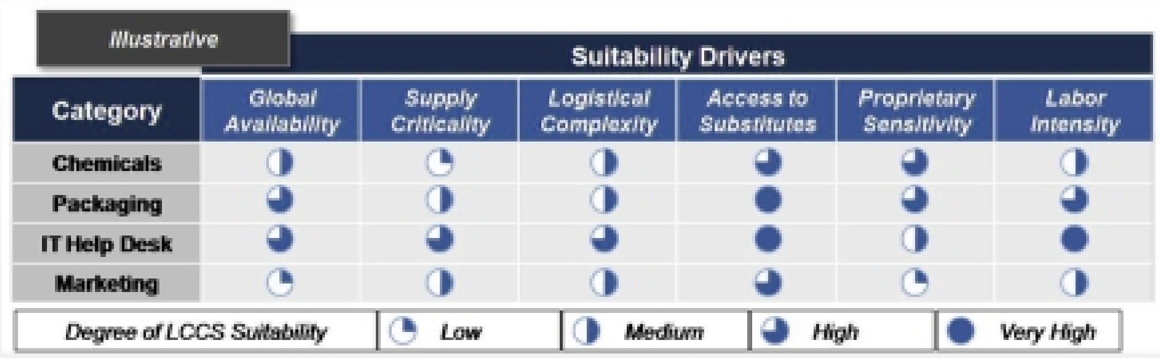
Key Strategies

- Select LCCS categories with high savings potential & low sourcing risk
- Ensure category is readily available internationally
- Cultivate and leverage in-house expertise or partner with a LCCS specialist

At the outset, it is critical to select a suitable category for a Low Cost Country Sourcing effort which will minimize the inherent risks while also maximizing the potential and sustainable cost benefits. Through comprehensive spend analysis, low to moderate spend categories that are not essential inputs in the supply chain should be found; this minimizes the likelihood of significant impact to a company's operations. Additionally, the ability to easily and quickly substitute goods through domestic suppliers is important as this will help reduce the sourcing risks significantly.

Depending on the product or service to be sourced offshore, intellectual property rights can also be a major concern and will play a critical role throughout the initiative. As such, neither non-sensitive nor proprietary goods should be considered for a fledgling LCCS function as global intellectual property protection schemes have not yet reached the standards set forth by developed nations. Lastly, preliminary research into foreign markets should be conducted to ensure that there are indeed competitive sources of international supply which can be leveraged. A sample of such an assessment is provided, highlighting some of the areas that impact a category's LCCS viability:

Figure 5: Sample LCCS Opportunity Assessment



Target Region: Navigating Uncharted Seas

Key Strategies

- Develop understanding of global market players for selected category
- Perform thorough analysis of all relevant risk and cost factors
- Assess any and all resource needs: language, legal, financial or expertise-based

After laying a firm foundation through selection of an optimal and source-able category, the next step will be the choice of low cost regions to explore comprehensive analysis. It is paramount to develop a broad understanding of the global market players and their local economy, resources and outlook in the industry of interest. Through specialization dictated by comparative advantage, both countries and whole regions have differentiated their productive capabilities and profiles, making them cost competitive in some markets. These nuances will serve as a guide to determine the focus-geographies for the LCCS initiative. With candidate areas an in-depth risk assessment on all relevant aforementioned is determined. Factors such as macroeconomy, geopolitics and culture must be conducted. Doing so will serve as an audit for the feasibility,opportunities identification as well as determining what language, legal, financial and/or knowledge resources will be needed to ensure success.

Figure 6: Top 5 Exports by Representative LCC's

Source: International Trade Center & World Trade Organization Statistics

Supplier Search: Discovering New Opportunities

Key Strategies

- Cooperate with suppliers towards mutually beneficial cost & quality objectives
- Phase in new LCCS suppliers with ongoing feedback for improvement
- Execute ongoing supplier as well as category due diligence

Once the target low cost region and countries have been decided upon, a deeper dive will need to be conducted to begin developing a potential supplier pool in each area assessing their capabilities against one another. Leveraging both English-based as well as local resources, all players in the select market should be found and included to participate in the evaluation process. Once a robust group of candidates has been found, it is imperative that one's in-house or external procurement team agrees upon the critical evaluation and scoring criteria for comparison.

By focusing on very specific metrics, it will ensure that the likely diverse supplier pool can be evaluated as objectively and efficiently as possible. Meanwhile, all communications used for this assessment procedure will require an awareness of the regional and/or local specification standards as well as terminology pertinent to the product or service. As the vetting process begins to rank the competitiveness of LCC suppliers, a tiered rather than all-or-nothing outcome will minimize risks. Primary, secondary and even tertiary layers to the supply chain will act as fail safes for any disruptions while also providing flexibility to shift volumes according to future circumstances impacting relative competitiveness.

Supplier Development: Reaping Sustainable Rewards

Key Strategies

- Cooperate with suppliers towards mutually beneficial cost & quality objectives
- Phase in new LCCS suppliers with ongoing feedback for improvement
- Execute ongoing supplier as well as category due diligence

As the supplier candidates are shortlisted through each subsequent round of appraisal, a partnership-based approach should be applied as opposed to the traditional LCCS models. Under the latter, supplier's value was limited to their immediate cost competitiveness with little effort or investment in their long-term growth in quality and capabilities. Conversely, the partnership-model assesses suppliers on more diverse metrics such as service as well as social and environmental responsibility and is complemented by a mutually beneficial commitment to the supplier's development. Applying this framework, a key feature of finalist negotiations should include a comprehensive sampling process and mutual site visits – this is particularly the case for direct and indirect materials.

By seeing the function and application of their product, the LCC suppliers can adapt and tailor their capabilities to provide the best possible results. Furthermore, if the supplier's representatives can attend the trials directly, they can fully address any potential problem areas rather than risk the loss of details through remote communication. Similarly, touring potential suppliers' facilities will serve as the best possible audit to verify all information they have provided throughout the evaluation process.

Upon selecting finalists, a step-by-step process should be communicated between organizations to ensure a phasing-in period can be conducted and supported with all necessary logistics. This should entail gradually escalating volumes through clearly demarcated trial rounds. For example, a trial procedure for plastic packaging would take the following form:

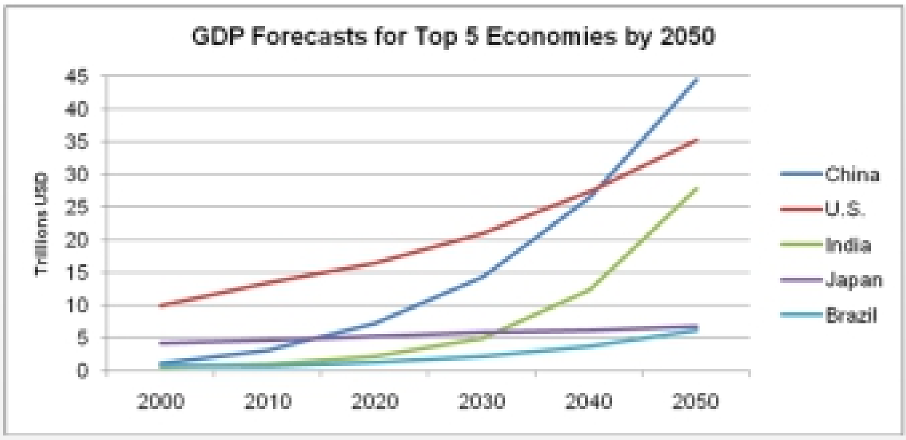
- Round 1) 100 Units
- Round 2) Single Pallet
- Round 3) 20 Foot Container
- Round 4) 40 Foot Container

This strategy will allow for bilateral, ongoing feedback to detect and resolve any pain points with the finalist supplier prior to full integration. Although a low cost country supplier may have passed all of the aforementioned steps, only ongoing due diligence and periodic audits will ensure all benefits to the bottom line are realized and sustained into the future.

Conclusions: LCCS Looking Forward

Low Cost Country Sourcing has undergone a marked transition in the recent years as its impact begins to gravitate up the value chain and goes beyond a purely cost driven directive. Traditional LCCS categories included support functions such as information technology, customer service and human resource administration as well as manufacturing. By off-shoring these capabilities, the value-add of international suppliers was generally limited to their lower labor rates and cost of operations. Presently, LCCS has expanded its scope to include a wide gamut of inputs from direct raw materials to increasingly complex and critical goods and services. LCCS today should be viewed in more holistic terms as a natural gateway to capitalize on the changing global economic balance in the decades to come. In the current recessionary environment, emerging market countries have become the first to return to growth and will be a driving force in the recovery of economic activity. In the near to intermediate term, the developed nations such as the G8 will have their growth prospects stunted as a result of their debt-burdens attributed to unprecedented fiscal stimulus programs. Therefore, the post-crisis world system will be profoundly different as the recovery process has favored and positioned emerging markets well to become future centers of both economic production and more importantly consumption. As the following forecasts predict, India and China will experience remarkable growth – with the latter expected to surpass the United States in output by 2040.

Figure 7: World GDP Forecasts through 2050



Source: Goldman Sachs BRIC Study

Such an outlook for global development makes Low Cost Country Sourcing all the more imperative as a critical resource for companies to shift future growth and market strategies globally. Firstly, the synergies are clear as the research, due diligence and regional familiarity gleaned from LCCS processes provide a firm foundation to leverage opportunities within these markets. For example, to initiate a successful, fully-fledged LCCS operation will require fundamental expertise of: international and local regulation, import and export procedures, production standards, transportation logistics, foreign exchange, language, culture, and an understanding of the overall economic system. As a business develops knowledge capital in these areas, it is only natural that they will be well-positioned to apply such expertise to venture into these proverbial "uncharted seas."

In conclusion, the Low Cost Country Sourcing process can potentially provide organizations with a cost competitive advantage in an increasingly fierce marketplace. However, to leverage these opportunities fully and to minimize present and future costs as well as risks, a comprehensive strategy will be required. Finally, given the changing balance and outlook for global economic hegemony in the coming decades, LCCS will provide a robust foundation for a company to capitalize on clear market and profit opportunities in emerging markets.

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