

Sizing Up China

Effective China Sourcing from Overseas

[By Dezan Shira & Associates]

The decision to go...

In business today we are all seeking the best design technology, the lowest cost producer, the fastest delivery time, and the most effective marketing techniques. All these ingredients factor into one main enterprise, providing the market place with the most competitive product at the best available price, before the competition does. As most of us have experienced, when the weekly management meeting rolls around, the team ends up sitting around a large table in a board room hashing and rehashing cost saving ideas. While it is a great mental exercise, it only goes so far without commitment and execution, and unless someone comes in with fresh ideas and the drive to see them through, the same dialogue occurs the next week. "If we send Joe to Mexico or Germany to meet with the OEM people again, maybe he can reach an agreement this time. Let's explore China to see if we can find a reliable factory to manufacture the components..." The list goes on and on.

Inevitably, the discussion will leave the starting block and when thoughts of cost savings turn to China, a new level of dialogue commences. Typically, before management teams can be confident enough to execute their decision, they must answer three basic questions:

- 1) What are the main threats (internal and external) when entering China?
- 2) How much can we save by sourcing in China?
- 3) How do we reduce our exposure to those threats while remaining competitive?

To start out, let's address the most common external threats that people typically worry about, being those of political/economic duress and potential currency fluctuation. China has addressed both of these issues with an economic agenda that underlines "the general principle of comprehensive, coordinated and sustainable development."

Here are some of the main priorities for the Chinese government:

- Consolidate and strengthen the fundamental role of agriculture in the national economy, and increase farmers' income by all possible means
- Readjust and optimize the industrial structure for the promotion of coordinated development of regional economies
- Work hard to boost employment and the reemployment of laid-off workers, and improve the social security network
- Expand consumer demand and upgrade the living standards of both urban and rural residents
- Continue to implement a proactive financial policy and prudent monetary policy, and do fiscal and financial work well
- Accelerate the pace of economic restructuring, and continue the efforts to rectify and standardize the market order
- Open wider to the outside world for the promotion of foreign trade and the utilization of foreign investment
- Take the overall situation into consideration for the advancement of social undertakings

If you take anything away from these pointers, the two items to remember are that China has committed itself to "the promotion of foreign trade and utilization of foreign investment," and to provide a "proactive financial policy and a prudent monetary policy."

Threats: discounted

At some point, the people analyzing the impact of the market in China ask the question of politics and sustainable growth expectations. In 2009, China received approximately US\$90 billion in foreign direct investment. With this large amount of invested capital, Chinese manufacturing practices have been able to increase their overall efficiency and a higher quality of output is now available. Noting these improvements, the fastest growing sectors have been listed as automotive, food processing, and machine building. Not far behind are the pharmaceutical industry, building materials, and the textile and garment sectors. If you were to develop a broader industry chart, you'd find that almost every industry has been improved upon to some extent.

Beijing's level of commitment isn't just due to the immediate benefits received from FDI in China. If you trace the collateral benefits, you'll notice Beijing is able to attack two other priorities on its list. First, there is an automatic and obvious boost in employment. Second, as more citizens are employed there is an increase in demand for consumer goods. Foreign investment has been able to fuel the growth of foreign-invested enterprises, thus decreasing unemployment count and increasing the per capita income. More so, the products needed to operate the facilities are often purchased locally adding an exponential amount of jobs into the economy. As for consumer demand, FIEs have introduced their products into the local market, sparking an increase in local consumer spending and demand. The general idea being dictated is that, if you strip away the hype and look at the raw facts, the Chinese government has a reasonably balanced approach to economic growth. This applies to purchasing in China and

increasingly so to supplying an increasingly affluent domestic market.

Opportunity: cost savings

China remains a cost competitive staging ground for all types of industries. An example of this lies with Xerox, which has been taking advantage of the China discount for years, and may very well be the reason that they are still around today. When they began sourcing in Asia during the late 1990s, it was purchasing around US\$40 million to US\$50 million dollars worth of components, today it is expected to purchase roughly ten times that amount. One thing they found was, “the most productive companies, the most cost-effective and capable companies, were those that were foreign-owned. We tried initially [to work] with the local, state-owned companies (in China), and that turned out to be an education in itself. So we decided to drop that activity... Every one of our competitors is there (on Mainland China)....” The cost savings recognized by Xerox are astounding. Depending on the component, when priced against a U.S. benchmark its saving is anywhere from 35 percent to 56 percent. If you were to break out tooling, the difference is at 70 percent.

Also, Valence Technology, a leader in the development of Lithium-ion battery technology, cites a substantial cost savings due to its facility located in China. Previously, the company’s manufacturing operations were located in Northern Ireland. By moving it to China, the company was able to recognize more than a 50 percent reduction in per unit manufacturing costs. This money proved invaluable by reducing its quarterly cash burn and working capital requirements.

Exposure: risk reduction

Assuming you’re familiar with forming a representative office, joint venture, or wholly foreign invested enterprise, you should also be aware of the initial capital outlay. Some companies are confident of their market and making this investment will have no effect on the overall budget, however if you’re not ready to make the capital commitment or want to test the waters there is a safe alternative.

A new trend that’s developing is office outsourcing, and it’s typically used either as a bridge during the “setup” to “launch” time gap, or as a hedge tactic before making a 100 percent commitment in business in China.

Outsourcing an office and staff essentially gives you an instant office and an instant presence in China. Most companies offering this product can provide a package that includes everything from a suitable staff, physical infrastructure, IT support, all the way down to the coffee machine and the other amenities that go into an office. The costs usually involve a set up fee and a monthly charge that’s varied with staff costs, desk space, and the length of your contract. Just as anything in life, your costs will vary with the options you need and how fast you need to be established.

Finally, an instant office provides you with an option for the unthinkable, an exit strategy. If, after spending a few months in China, you realize that it isn’t the market that you initially thought it was, you’ve got to decide how to get out. Depending on the initial method of entry, exiting may include winding up operations, displacing personnel, selling or moving equipment, and a myriad of other chores. If you chose to enter China via an instant office, your exit strategy would be reduced to minimal costs and exercises.

Summary

At the end of the day, we’re all forced to live with the decisions that we’ve made and the decision to enter the market in China comes down to comfort, confidence, and tolerance for the ambiguity. The best that a company can do is to collect all information that is relevant to its industry, sort out what is important and what isn’t, and make an informed decision on the facts. After witnessing the growth and dynamic culture in China, it’s obvious that the government policy makers in Beijing have a solid commitment to sustainable growth in the country. The questions that you’ll be forced to ask may not be, “Can we save money in China?” and “Should we consider entering the market there?”, but “How much more competitive can we be by sourcing/manufacturing/staffing in China?” and “What’s the best way to enter?”.

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