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Sourcing in China: Behind the Media Frenzy, There Is Much to Explore

The saga surrounding recalls of products made in China continues to attract headlines. On October 25th, the U.S. Consumer Product Safety Commission (CPSC) announced the recall of around 665,000 items, including 38,000 toys made by Mattel's Fisher-Price unit that were recalled due to excessive levels of lead.

Mattel has been at the center of the storm raging over the quality of Chinese products: This is the fourth recall of toys made by the company in the past few months. Mattel's troubles began on August 2 with the recall of 1.5 million toys which had been coated in potentially hazardous lead paint. The paint had been applied by Lee Der, a Chinese manufacturer that has since had its export license suspended. Days after the recall, a Lee Der co-owner, Zhang Shuhong, committed suicide. Following criticism that it had not carried out proper quality checks, Mattel says it has stepped up its quality testing. But this comes only after the recall of more than 20 million China-made Mattel toys. The recalls have been expensive, caused damage to the company's reputation and, most importantly, have raised questions about possible health risks associated with the toys.

In recent months, China-made quality has been the subject of attention -- and criticism -- from the rest of the world. Behind the media frenzy, what is the state of sourcing in China these days and how has it changed in recent years? In this article, China Knowledge@Wharton interviews sourcing experts for their views on where the potential risks lie in dealing with Chinese suppliers, and what purchasers can do to minimize them.

Sharing the Blame

In newspaper reports, Chinese suppliers have received significant negative exposure, with attention being drawn to suppliers that have used lesser quality materials in order to cut costs. In the U.S., for instance, much media attention on Mattel's problems has focused on the lead paint health hazard. Yet Thomas Debrowski, Mattel's executive vice president for worldwide operations, has acknowledged that the "vast majority" of toys have been recalled due to faulty design by Mattel, not problems traceable to suppliers.

According to many Chinese suppliers, foreign purchasers and sourcing experts, purchasers must also shoulder some of the blame for quality problems affecting China-sourced items.

Indeed, Fiducia Management Consultants, a management consultancy firm based in Hong Kong, estimates that only 5% of Chinese suppliers cut corners on quality. Juergen Kracht, managing director of Fiducia, believes that the driving force behind suppliers' use of low-quality materials is, in fact, multinationals that have been "aggressively" pushing down prices. Kracht, who has been involved in the Chinese trade and investment scene for more than 30 years, cites reports that U.S. discount retail chains have pushed down the price of clothing imports by 25% since 1995. Suppliers may not be able to absorb extra costs. "Many suppliers in China have razor-thin margins," says Kracht, citing a survey by Kurt Salmon Associates which found that a Chinese shoe manufacturer might expect to earn profits worth a mere 1% of the U.S. retail price.

Zhong Hai, general manager of Beijing firm Tianheng Electron-Machinery, presents the suppliers' case. Zhong, whose company makes and supplies digital refractometers and other devices, says that foreign companies deserve their fair share of responsibility for ensuring the quality of the parts they procure in China. "Chinese manufacturers neither understand nor care about other countries' laws and regulations relating to quality," says Zhong. "They simply produce goods according to clients' requirements." Zhong argues that buyers are free to choose from a range of suppliers and qualities of materials. In the end, they will get the quality of work they are willing to pay for.

To compound matters, changes in China's VAT refund policy that became effective on July 1,

2007, may heighten the temptation for foreign buyers to pressure local suppliers into cutting costs. The move abolished refunds on exports -- including cement, fertilizer and some industrial chemicals -- and reduced rebates on items ranging from clothing and glassware to toys, bags, furniture and electronic machinery. This comes on top of rising raw materials prices. "Buyers may be tempted to try to pass these costs on to suppliers," warns Kracht.

Speaking from the purchasing side of the fence, Frank Fang, director of supply management for the China operations of Swedish boat engine and power plant giant Wartsila, confirms the importance of cutting costs. Fang says that his department's goal is to expand its sourcing operations in China while at the same time achieving cost reductions. After all, he points out, the company's manufacturing costs in China need to compete with those in Europe.

Fang also attests to difficulties with suppliers. He says his greatest supply chain problem is poor punctuality of delivery. Fang estimates that just 70% to 80% of goods arrive on time. He says his second biggest headache is achieving a consistent quality of supplies.

Nevertheless, Fang, who has been in charge of boat engine sourcing operations in China since 1995, advocates taking a balanced view. "On the whole, you have to be fair when you talk about complaints regarding Chinese quality," he says. On the Chinese side, it's necessary to improve the quality control process. But purchasers also have to consider the Chinese reality and ensure that purchase and design is geared to capabilities on the ground. Additionally, Chinese suppliers may be cheaper than those in Europe, but Fang cautions that companies looking at the Chinese market need to factor in other costs, such as management and logistics.

If European manufacturers, for instance, want to have European standards, they cannot necessarily have "Chinese" prices, adds Wartsila China's general sourcing manager Marcus Sollberger. In Wartsila's industry, he notes, component prices are "not so far away any more from the prices outside of China." Meanwhile, suppliers from other countries are striving to compete with Chinese prices.

Adding Value to the Relationship

The problems with variable quality reported by Fang are common, says a foreign sourcing expert who asked not to be named. He describes a typical scenario whereby a supplier's first batch of goods is of good quality, but by the second batch of goods, the buyer will be confronted with eroding quality (the so-called "quality fade" phenomenon) and demands for higher prices. "You have to expect this and be aware of it," the consultant says.

Nevertheless, in contrast to much recent media coverage, the expert paints an optimistic picture of sourcing in China. Following good processes brings success over 90% of the time, he states. "Sourcing is not rocket science. Quality sourcing is possible in China for almost all parts. But it takes time. You must be patient, and you have to set up trust."

The initial supplier search is especially important, he advises, and China reps should ask for twice the time that headquarters expects a supplier search to take. A thorough search usually lasts at least six weeks, or possibly two to three months, depending on the complexity of the commodity, the expert says. Hagglng over the price alone may take several weeks and might seem like a laborious process. "But it's worth it: The more time you spend looking for a supplier, the higher is the chance that you will have the right quality at the end and that you will be happy with the supplier" for the whole length of the relationship.

The expert recommends that prospective purchasers try to ascertain the strategy of the supply firm's top management and get a feeling for the capabilities of the middle management. They should also be on the look-out for tricks -- such as bringing in other companies' staff for the duration of the visit to give an impression of competence. The supplier's certification also needs to be checked at this stage.

Soft factors should not be underestimated, the expert adds. "Usually, projects will fail due to communication [issues]," he warns, stressing the importance of overcoming language barriers. Zhong Hai, the Chinese supplier, confirms that one of his greatest problems in his relationship with foreign clients is communication: "Sometimes you don't know what they

[the client] want, and they don't know what you are capable of doing," he says.

The Carrot and the Stick

The final deal has to be a win-win situation for both parties. "You must know when you have to stop the negotiations," the expert says. This means making sure the supplier has a reasonable profit margin. Otherwise, suppliers may accept an initially low price to win the contract – and then try to renegotiate after the first production batch.

Frank Fang, meanwhile, advises that foreign companies take control of their relationship with suppliers, and stresses the importance of building a relationship based on mutual investment and development. In some industries, he adds, it may not be necessary to have such a good relationship with suppliers: supermarket buyers, for instance, chop and change suppliers in pursuit of the lowest price. For its part, Wartsila employs supplier development engineers, and helps suppliers to improve by organizing visits to other European companies. Fang believes that a sourcing manager must also provide value for both supplier and client.

The expert says that finding first-class suppliers is not a problem in China. But they come with first-class price tags. The trick, rather, is to find a medium-quality supplier who can be supported to become first-class one. "If you do so, this is almost a guarantee for you that this supplier will be reliable and can be trusted. This supplier will work on weekends if there's a need for more capacity," he says. It is therefore important to know from the outset what support suppliers will need.

"You have to train your suppliers to become better suppliers," adds a consultant at a foreign-owned Quality Assurance (QA) firm, also speaking on condition of anonymity. Clients can assist with supplier development across a number of categories, including not just quality, but cost, delivery, productivity and supply chain optimization.

In the event that local standards fall short of standards in the export market, says Wartsila's Sollberger, it is the responsibility of the purchaser to explain the problem to the supplier. Or, as the sourcing expert puts it, a supplier exhibiting "quality fade" is a supplier in need of

support. But Fang admits that some suppliers are more receptive than others to suggestions for change. Certain suppliers tend to put up an argument. "We like to choose those suppliers that have worked with international companies," he says, noting that they tend to argue less.

In addition to these tips, it's also important and better, as the Mattel case illustrates, to catch problems at an early stage. A fault discovered at the planning stage may cost one euro, the Quality Assurance consultant says. But if the same problem is discovered as it leaves the factory, it could cost a hundred times that much. And should a product have to be recalled, costs could escalate a thousandfold. Fang adds the caveat, however, that employing a third party tester is not a panacea: Because QA agencies only test for certain key parameters, Wartsila still does its own testing.

The scope of Wartsila's involvement in China mirrors the trend towards improvement. The company, which currently has four factories in China and is building a new supply center, will continue to increase the absolute volume of parts purchased there. Under the company's plan for 2007-2010, one-tenth of the goods it will purchase in emerging markets will come from China.

Paradise Lost and Found

Despite the challenges, Fang is optimistic about the future. As the level of education improves, he argues, so will quality standards, although the pace of improvement will vary from industry to industry. In ship engine manufacturing, the speed of improvement is not very obvious, he says. Yet as a measure of how much things have already improved, Fang recalls that at first, Wartsila had to deal with suppliers that didn't know much at all about boat engines. But a migration of international suppliers to the Chinese market, comparable to that seen in the auto industry, has fostered an improvement in their capabilities. Furthermore, he notes, private sector operators – particularly those that work with foreign purchasers – are growing in competence.

Fang is not alone in charting an upward trend in supplier quality. **John Guise, Fiducia's marketing officer, agrees there has been an improvement in the quality standards of some**

Chinese suppliers in some sectors. Guise attributes improvements to competition with overseas suppliers. In electronics, for instance, Chinese suppliers feel pressure to raise standards to compete with European or Japanese companies. However, this is not the case in sectors, such as textiles, where suppliers compete more purely on price, he says.

The recent international focus on sourcing in China seems to be producing some positive results. Local governments are now carrying out more energetic checks on products for export, particularly in coastal regions, says the QA consultant. Meanwhile, a September survey by Global Sources found that 62% of Chinese planned to spend more on quality control. And Fiducia has observed a shift in supplier awareness following the Mattel furor. Supply manufacturers will now tend to say "no" if they don't have the capabilities to deal with a client's request.

At a macroeconomic level, however, some experts worry that the days of cheap Chinese products are numbered. "The macro perspective shows a move in China's export strategy towards high-end products and efforts to increase value creation in the country," says Juergen Kracht. China will no longer be a "sourcing paradise," he adds. "The end of 'cheap China' is in sight."

Yet even if these fears materialize, it does not necessarily spell doom for Chinese suppliers. After all, manufacturers disillusioned by rising costs cannot simply pick up their factories and leave. "A core challenge when switching one's sourcing activities to another country is to find a comparable sourcing system with regard to logistics and infrastructure," says Kracht. "Over the years, China has built a formidable position in offering efficient supply chain processes which many countries -- such as Vietnam, India or Mexico -- will find difficult to provide."