Sourcing • Supply Base Management

# China "Go West" Sourcing

## Survey 2011

Shanghai Business Review

Dragon Sourcing 龙源

# Content

# Introduction

China, Vietnam, India, Turkey and Brazil are countries experiencing unprecedented and exponential economic growth which offer unique opportunities (and risks) to companies wanting to take part in this boom. It is precisely to manage those risks and opportunities that we have created Dragon Sourcing which is focused on helping our clients create long-term and sustainable value in the on-going management of their procurement function and processes in Low Cost Countries in Asia, Latin America and Turkey.

Achieving procurement excellence in these countries requires the deployment of western style procurement practices adapted to the local context and culture. To that effect, we have built strong and integrated teams of experienced procurement professionals that have built their expertise in the West, in Asia and Latin America. Our people originate from either leading consulting organizations where they held key leadership positions in procurement practices and/or from leading international industrial organizations where they held strong operational positions in procurement. This ensures that we can combine analytical rigor with operational pragmatism; conceptual thinking with down-to-earth "roll up your sleeves" attitude.



After a period of decline in Chinese exports caused by the financial crisis of 2008 and the global slowdown experienced in the western world in 2009 the rate of exports growth from China to the western world has once again reached unprecedented speed in 2011. The tension this has created in bilateral relations between the EU and China and the US and China has incited the Chinese government to modify its exchange rate policy by shifting from a hard peg to the US$ to a link to a basket of international currencies and to gradually remove tax incentives to several Chinese export driven industries (such as textiles) it had reintroduced in 2008 and 2009 as a means to support the struggling Chinese exporters. This renewed growth in exports from China is not only putting a strain on international relationships, it is also creating cost pressures internally in China, evidenced by

- Renewed labour wage inflation on the eastern coast of China
- Labour unrest in several factories that have made headlines recently (Foxconn, Toyota,...)
- Significant increases in container transportation costs
- The imposition of new anti dumping taxes on several products for which Europe and the US are trying to protect themselves against Chinese imports



These trends combined with the Chinese government strategic decision to reduce their country's dependency on the export economy by stimulating spending in their domestic market are raising questions about what will happen to China's mid to long term cost competitiveness. This in turn is triggering some strategic rethinking in companies' global sourcing strategies as companies are concerned that they might have put all their LCC sourcing eggs into the sole Chinese supply market. Consequently, many companies have begun exploring alternative sources of supply to manage the perceived country risks associated with China.

In addition to exploring other Low Cost Countries such as Vietnam, Cambodia, India,… companies are also exploring opportunities to source from remote Chinese provinces away from the traditional locations of export driven Chinese factories along the east coast (from Beijing to Shanghai to Shenzhen) of China. This is the so called "Go West" sourcing strategy which many companies (both Chinese and Western) have embarked on and which is underpinned by the China Western Development Program.

The China Western Development Program is a policy that was adopted in 2000 by the PRC to boost its less developed western regions that include:

- 6 provinces: Gansu, Guizhou, Qinghai, Shaanxi, Sichuan, and Yunnan
- 5 autonomous regions: Guangxi, Inner Mongolia, Ningxia, Tibet and Xinjiang
- 1 municipality: Chongqing

This western region covers over 70% of mainland China's area but only approximately 30% of its population and 20% of its total economic output in 2009. The main components of the "Go West" strategy include the development of infrastructure (transport, hydropower plants, energy, and telecommunications), enticement of foreign investment, increased efforts on ecological protection (such as reforestation), promotion of education, and retention of talent flowing to richer provinces.



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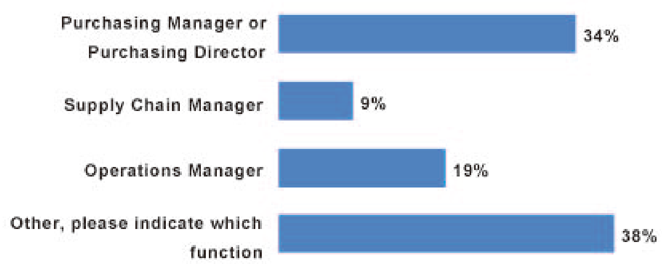
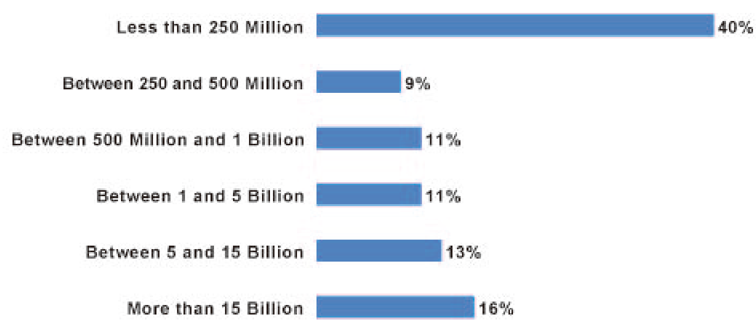
# Trends in China "Go West" Sourcing

In order to assess the level of current sourcing activity as well as the level of interest for developing sourcing activity in Western China in the future, Dragon Sourcing conducted a survey with a set of large corporations in China (both Chinese and Western Companies) representative of all business sectors (see graphs 1-6). The survey also segmented China into 3 major regions (East, Mid and West China) according to the split indicated in graph 7.

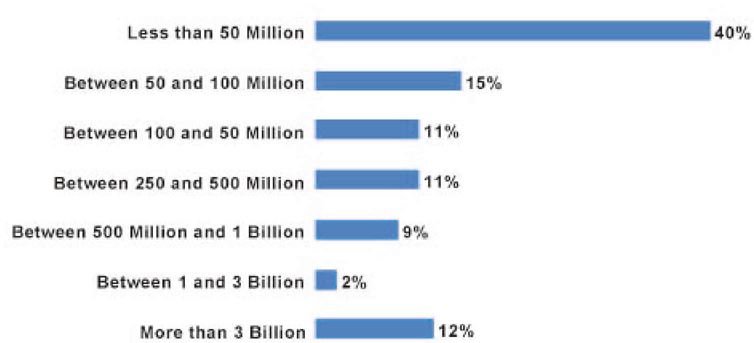
**Graph 1: What is your function in your company?**



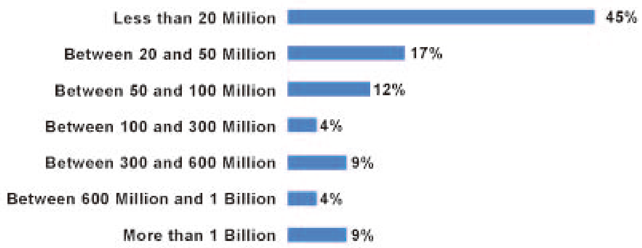

**Graph 2: In 2010, what was the global turnover of your company ?**
(in US$)



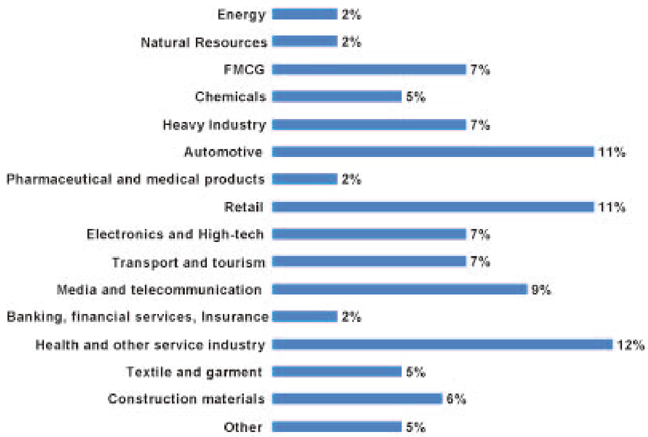

**Graph 3: In 2010, what was the turnover of your company in China ?**
(in US$)



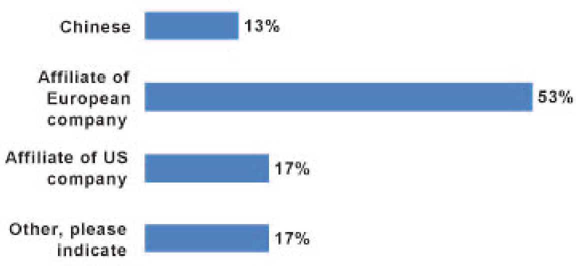
### Graph 4: In 2010, what was the spend value of your company in China (in US$)




### Graph 5: What is the primary business sector of your company?




### Graph 6: What is your company nationality?

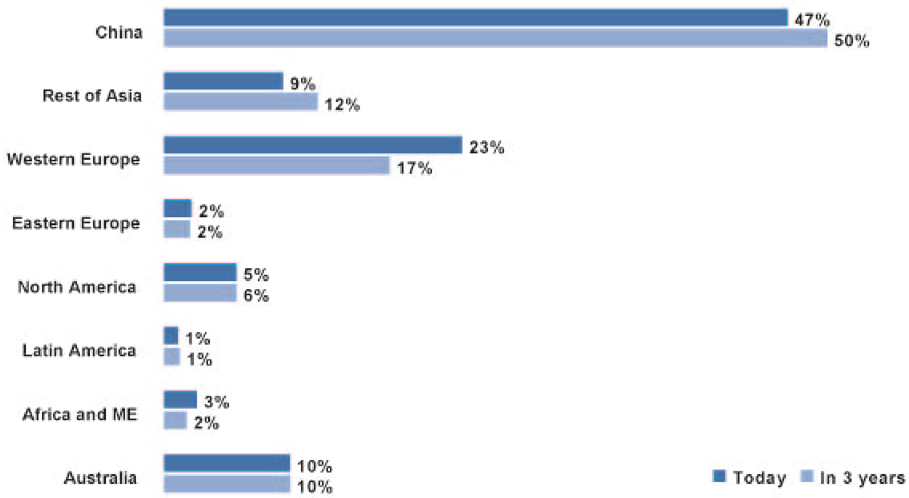



### Graph 7: East, Mid and West China


China is still considered the factory of the world with 47% of companies' spend in 2010, followed by Western Europe at 23% and the rest of Asia at 9% (Graph 8). Looking forward 3 years, we see that the survey respondents are increasingly expected to localise their spend in China and in the rest of Asia (to 62% of spend) in order to reduce their reliance on imports from the EU which will see its share of the spend reduce from 23% to 17% in 3 years from now. Interestingly, the spend from Australia is expected to remain constant at 10%. We can surmise that this spend level is related to the purchase of basic commodities and raw materials that can only be sourced competitively from Australia.

### Graph 8: What percentage of your spend is sourced from which region in the world, today and your estimate in 3 years?

(As a %age of total global spend)

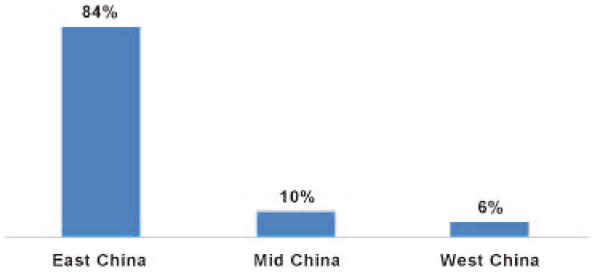



Within China the overwhelming majority of the sourcing spend in 2010 is from East China (84%), followed by Mid China (10%) and finally West China (6%) (Graph 9). On a province basis, the top 5 ranked provinces for sourcing in 2010 were Shanghai, Zhejiang, Jiangsu, Guangdong and Shandong (Graph 10). The survey showed that within the next 3 years the companies did not expect their top ranking regions to change significantly.



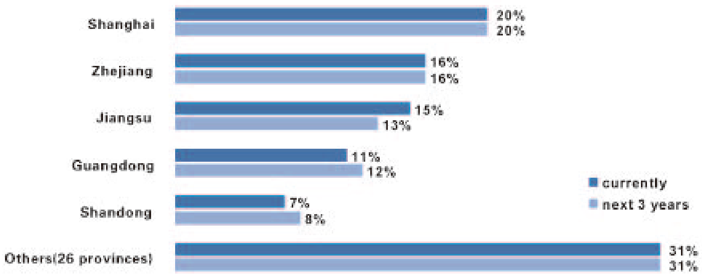
### Graph 9: Within China, please indicate how your 2010 spend breaks down by the following regions

(as a %age of total spend in China)



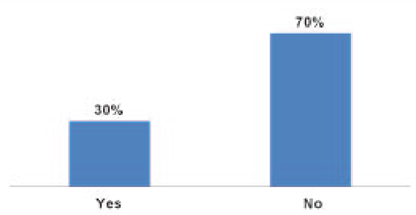

### Graph 10: list the top 5 provinces in which you are currently sourcing

(1: top ranking region , 5: fifth ranking region)

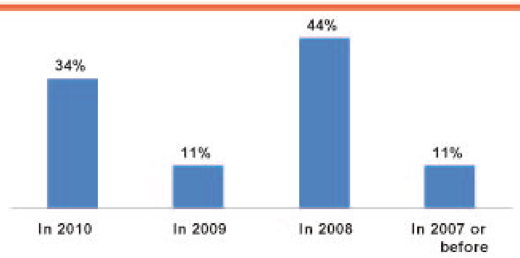


This regional stability in sourcing patterns is vindicated by the fact that only a minority (30%) of companies based in China have so far launched a "Go West" sourcing initiative (Graph 11). By 2007 only 11% of these companies had launched their programs. This included all the textile companies surveyed, probably reflecting the necessity to offset growing competition from other countries such as Vietnam and Bangladesh and the speed with which production capacity can be either green field or relocated in the textile sector. 2008 saw a surge of 44% of companies launching, with a low 11% in 2009 driven we suspect by the effects of the global financial crisis and a pickup of 34% in 2010 (Graph 12). Of the companies in China that have not yet launched "Go West" programs, 22% plan to do so in the coming year (Graph 13) so that by the end of 2011 more than 50% of the companies would have launched such an initiative.

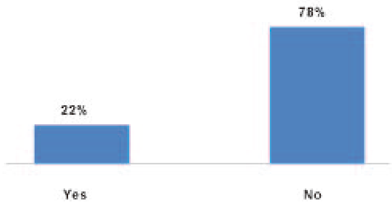
**Graph 11: Have you launched a "Go West" sourcing initiative?** (%age of companies)




**Graph 12: When was the program launched?** (%age of companies)

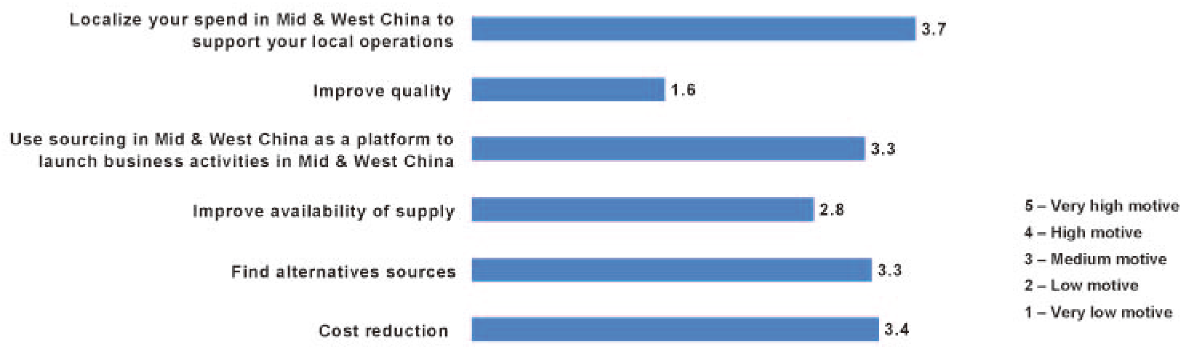



**Graph 13: Do you have plans to launch a "Go West" sourcing initiative in the coming year** (%age of companies that have not yet launched a "Go West" sourcing program)




The drivers behind launching "Go West" sourcing initiatives are varied. The strongest driver indicated is the need to localise the spend in Mid or Western China to support local requirements. This is based on the fact that many companies are relocating factories from the high cost east coast of China to remote lower cost areas and need to secure new suppliers in those regions to support these relocated factories. Secondary drivers for "Go West" programs were (1) the requirement to achieve cost reductions, (2) find alternative sources of supply and, (3) use sourcing in mid and west China as a platform to launch business activities in these regions (Graph 14). This is driven by the continued growth which several western provinces are experiencing which is attracting thereby significant external investments.

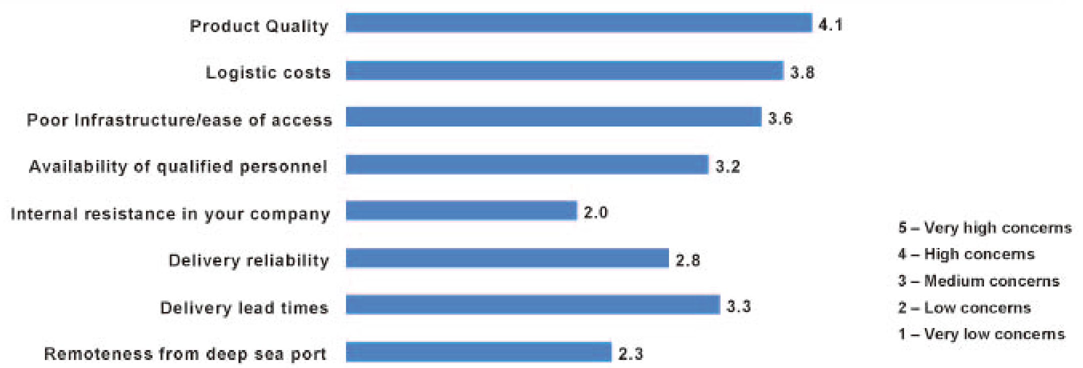
### Graph 14: What drove your company to launch a "Go West" sourcing initiative?




The respondents' highest concerns for their "Go West" programs were related to product quality and to logistics issues (both costs incurred and ease of access/quality of the infrastructure). The availability of qualified personnel, delivery lead times and delivery reliability were also quoted as significant concerns (Graph 15). It is interesting to note that companies are not overly concerned about encountering internal resistance to change within their organisation nor about the remoteness of many Mid/West China provinces from deep sea ports.



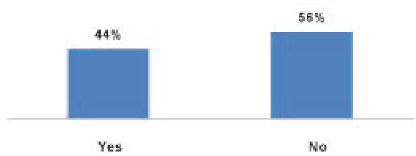
### Graph 15: What are your concerns in relation to your "Go West" initiative?



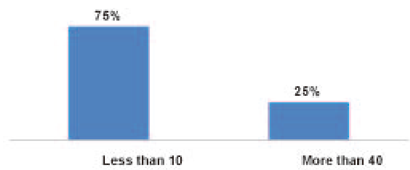

Focusing on the procurement infrastructure, close to half (44%) of companies already have procurement offices in Mid or West China (Graph 16). The majority (75%) of these offices are staffed by less than 10 people (Graph 17). The responsibilities of these offices is evenly split between identification of new potential suppliers (30%), managing request for quotation and selecting suppliers (30%) and procurement operations management (30%). The actual qualification of suppliers (10%) is considered a minority responsibility (Graph 18), one which is probably currently left to the quality auditors based in the historical buying offices of the East Coast.

Overall results achieved from "Go West" sourcing programs were below average expectations in terms of delivery reliability, delivery lead times, product quality and cost reduction (Graph 19).

**Graph 16: Do you have a procurement office in Mid or West China?** (%age of companies that have launched a "Go West" initiative)

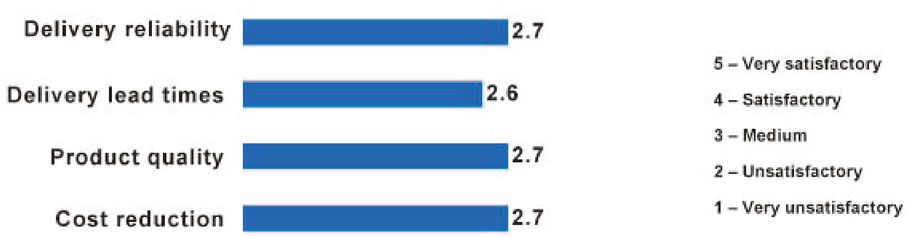



**Graph 17: How many people are staffed in your Mid or West China procurement office?** (%age of companies)




**Graph 18: What are the responsibilities of the Procurement Office?** (%age of companies)

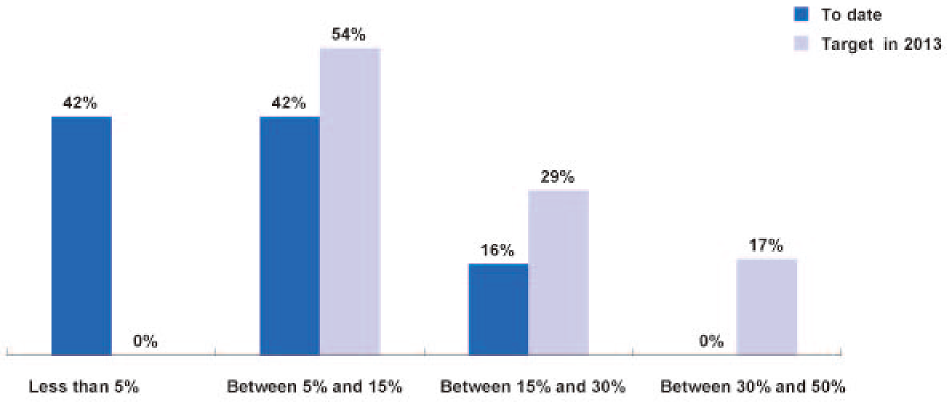

**Graph 19: What sourcing results have you achieved with your "Go West" initiative?**




In terms of cost savings, the existing "Go West" sourcing initiatives have to date generated modest savings for the majority of companies (less than 5% savings for 42% of companies and less than 15% savings for 84% of companies). However, in the coming 2 years, savings expectations are much higher with (Graph 20):

- 54% of companies expecting savings of between 5 and 15% by 2013
- 29% of companies expecting savings of between 15 and 30%
- 17% of companies expecting savings of between 30 and 50%

Graph 20: What savings have you achieved to date and what targets have you set for your "Go West" sourcing initiative by 2013? (%age of companies)



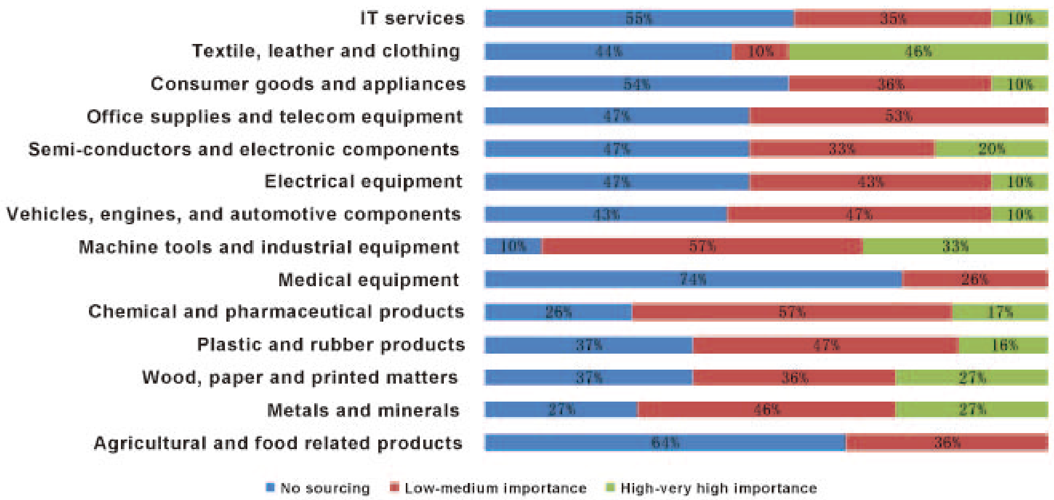

This shows that a significant proportion of companies have only seen low savings to date from their programs. Possible reasons for this include:

- The majority of the "Go West" programs are quite recent, and have not yet completed the full sourcing cycle to deliver savings.
- The crisis of 2008 reduced global demand, causing a surge in spare capacity in the East of China, which forced major price reductions and therefore reduced the relative attractiveness of Mid and West China markets.
- The increase in logistics costs incurred by sourcing from remote areas of China.

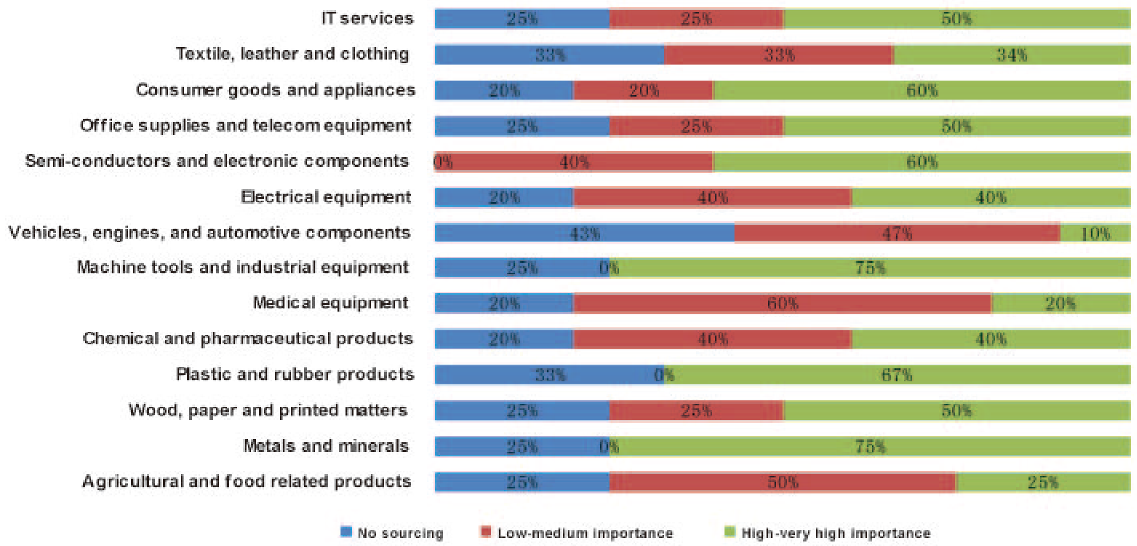
Of the companies that are currently conducting "Go West" sourcing initiatives the high manual labour and low technology categories such as textile, leather and clothing are, not surprisingly, considered the primary focus with 46% of companies showing these categories as very important in their "Go West" sourcing initiative. This is followed by the machine tools and industrial equipment categories (Graph 21).

Looking forward 3 years, companies indicate that their "Go West" program will penetrate a much wider range of categories including the higher technology semi-conductor and electronic components categories (Graph 22).

**Graph 21: Amongst the following spend categories; please indicate their relative importance in your "Go West" sourcing initiative?** (%age of companies)




**Graph 22: Amongst the following spend categories; please indicate their relative importance you estimate they will have in 3 years in your "Go West" China sourcing program?** (%age of companies)



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# Best "Go West" Sourcing Practices in China

Our prediction is that we will witness a rapid acceleration of "Go West" sourcing programs in the short to medium term future driven by the following factors:

- Costs are predicted to continue to increase on the east cost of China forcing companies to look for alternative sources of supply whilst leveraging their existing buying infrastructure in China.
- With the global financial crisis (probably) behind us, demand is resurging turning many suppliers' markets into a seller's market yet again.
- Growth rates in Tier 2 and Tier 3 cities in remote provinces of China will continue to grow attracting thereby an increasing amount of inward investments.
- The Chinese government will continue to promote their western development program by investing heavily into infrastructure programs that will gradually erode the barriers currently refraining companies from launching "Go West" sourcing programs.

Identifying the key success factors of an effective "Go West" sourcing strategy – leveraging the best practices of the most experienced corporations in this field – constitutes the last section of this report. The analysis of the best practice companies has allowed us to identify 3 critical success factors that explain the difference between success and failure in this area:



## Engage the whole enterprise in the initiative

Making a success of a China "Go West" sourcing program requires overcoming significant internal barriers to change. Buying Offices in China that have historically been sourcing from factories on the east coast of China will be reluctant to challenge their traditional supplier base that they have developed and worked with over the years and embark on a program to qualify new factories in remote provinces of China. Other key functions of the corporations will also raise issues in terms of quality, flexibility, and reactivity which will complicate attempts to source from more remote regions of China. To surmount those internal resistances, the China "Go West" sourcing initiative needs to be driven top down by top management and engage the whole enterprise under the stewardship of the procurement department. The program needs to include from the very beginning key internal customers (engineering, manufacturing, quality and marketing) and will require investments in setting up and staffing new buying offices in western China vs attempting to manage the program with the same buyers based in the east coast of China.

## Challenge the "Guanxi" mentality

For Chinese companies particularly, this resistance to change could be compounded by the "Guanxi" mind-set which is pervasive in the fabric of how business is carried out in China. This mind-set makes it difficult to challenge existing supplier relationships and results in buyers often being more loyal to their suppliers than to their employers. To overcome this issue, Chinese corporations will need to bring more western style sourcing practices, transparency, objectivity, and fact based supplier selection processes if they want to take advantage of the supply capabilities and cost competitiveness of more remote Chinese provinces.

## Secure competitive advantage through moving first

Even if investments are growing at speed in several western provinces, the availability of qualified production capacity is obviously far lower in those regions compared to the installed capacity in the east coast of China. Hence it is critical for companies to move at speed to identify and quality new suppliers in those regions in order to lock in and secure competitively advantaged capacity. Companies that will delay moving their sourcing West will suffer a "double whammy": (1) they will not enjoy the savings associated with sourcing from cost competitive advantaged suppliers, and (2) they might suffer from increased supply chain risks if east coast suppliers are forced out of business because of the drop in demand for their production capacity.

# EUROPEAN Offices

**Dragon Sourcing Paris**
50 rue Marcel Dassault
92100 Boulogne-Billancourt, France
Tel: +33 (0)1 46 10 36 70
Fax: +33 (0)1 46 10 41 14
Email: contact.europe@dragonsourcing.com

**Dragon Sourcing London**
Number 3, 59 Jermyn Street
London, SW1Y 6LX, UK
Tel: +44 (0)844 736 1432
Fax: +44 (0)844 736 1430
Email: contact.uk@dragonsourcing.com

# US Offices

**Dragon Sourcing US Detroit**
1255 Beach Court, Saline MI 48176, USA
Tel: 1-877-800-6703
Email: contact.us@dragonsourcing.com

# ASIAN Offices

**Dragon Sourcing Shanghai**
Suite 1502-1503, Jin Tian Di International Mansions
998, Renmin Road - Shanghai, 200021, P.R.China
Tel: +86 21 61 41 39 55
Fax: +86 21 61 41 39 66
Email: contact.asia@dragonsourcing.com

**Dragon Sourcing Vietnam**
C1A Cu Xa Tan Cang, Ward 25, Bint Thanh Dist,
Ho Chi Minh City-Viet Nam
Tel: +84 8 5129390
Fax: +84 8 5129391
Email: contact.asia@dragonsourcing.com

**Dragon Sourcing India**
601 - A - Mota Mahal
Lokhandwalla Complex, Andheri (West)
Mumbai 400053 - India
Mobile: + 91 9867602535
Email: contact.india@dragonsourcing.com

**Dragon Sourcing Hong Kong**
7/F Hong Kong Trade Centre
161-7 Des Voeux Rd Central, Hong Kong SAR
Tel: +852 91 80 40 57
Fax: +852 25 80 24 26
Email: contact.asia@dragonsourcing.com

**Dragon Sourcing Israel**
C 101 Regency Gardens, 1 Ramat Yam Street
Herzlia Pituach 46851, Israel
Mobile: +972 54 420 34 80
Fax: +972 9 955 71 60
Email: contact.israel@dragonsourcing.com

**Dragon Sourcing Turkey**
Yenisehir mah. Viyana Sok. No:11 Atasehir -
Istanbul
Tel: 0216 548 13 06
Fax: 0216 456 85 68
Email: contact.asia@dragonsourcing.com

# LATIN AMERICAN Office

**Dragon Sourcing Brazil**
Vinte e Nove de Janeiro, 17 Vila Jequitib á s
13026-300 Campinas, Sao Paulo Brazil
Mobile: + 55 (19)8246-2655
Email: contact.brazil@dragonsourcing.com