Follow the Yellow Brick Road: Low Cost Country Sourcing

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Given the current trends in global sourcing, it would appear that the “pot of gold” which exists “somewhere over the rainbow,” involves LCCS. Highly developed economies, primarily in Western Europe, North America and parts of Asia, are sourcing goods and services in countries around the world that are less developed and pay lower wages. The biggest reason companies’ source from these countries is to benefit from lower unit costs; however, companies do source from these countries for reasons other than lower cost. It is important to note that, over time, for many companies, the ability to sell products in the LCC market will in fact, become more important than achieving low-cost inputs for sales in their home markets. The massive market potential in China and India are two examples of this. Often the decision to LCCS is pursued without a thorough understanding of the risks involved. In addition, the sustainability of the lower cost competitive advantage needs to be evaluated in terms of longevity.

Challenges. What challenges or barriers do companies typically face when pursuing LCCS? We categorize these challenges as “micro” and “macro.” Micro challenges are those that arise within the buying company. Macro challenges are driven by factors outside the company.

- Micro challenges include: resistance to change, lack of management support, lack of business relationships with LCC suppliers, coordination across multiple divisions and regions, lack of effective risk management, extension of control, internal culture and long-standing business policies, lack of thorough TCO (total cost of ownership) analysis, cultural differences, time and distance.

- Macro challenges include: political and social instability, customs and tariffs, lack of developed infrastructure, access to trained labor, shortage of sourcing professionals, language and law and the influence of cultural differences on values, attitudes and ethical business practice.

Understanding the true TCO of purchased goods and service is always critical to making sound sourcing decisions; however, the TCO calculation can become much more complicated when LCCS is involved. Keep in mind that product unit cost is only a fraction of TCO. We will consider five major additional categories of cost when employing TCO to evaluate LCC
sourcing strategies.

1. Logistics and transportation cost: includes the cost of transportation, customs and tariffs, Value Added Tax, packaging.
2. Quality cost: includes supplier qualification, inspection, and quality audits and control costs.
3. Financing cost: includes costs associated with less favorable payment terms, inventory carrying cost, currency exchange cost.
4. Administrative cost: includes costs associated with placing and managing orders and inventory administrative cost.
5. Cost of time: includes all costs associated with the stretched supply chain, longer lead-times and associated cash investment.

Evaluation. How do we determine which products or services are appropriate for LCCS? To address this question, we have created a set of 12 criteria to evaluate.

1. If the material and production content of the product is low, it is likely better suited for local sourcing. If high, it is likely better suited for global sourcing or LCCS.
2. Product with low labor content is typically better suited for local sourcing.
3. Where there is a low degree of product standardization, local sourcing can be the best choice.
4. If product shelf life is short and repeat orders are infrequent, consider local sourcing.
5. When delivery sensitivity is high, local sourcing offers an advantage.
6. Intellectual property concerns have become a significant issue with many companies considering LCCS.
7. If product security is a concern—for example, if the product is of extremely high value and a target for theft, or of high value and fragile, then this risk is best mitigated by sourcing locally.
8. When the client requires a high level of responsiveness, local sourcing should be considered.
9. Products with a high level of creative or artistic content are typically best sourced locally.
10. Products with complete documentation and specifications are good choices for LCCS.
11. If logistical and transportation complexity are high, they are more easily managed with local sourcing.
12. When the savings potential is low, it is less likely to cover the added risk and results in a poor business case for LCCS.

When evaluating products and services appropriate for LCCS, it is important to understand that the LCC supply market is continuously evolving. It is wise to consider whether China will continue to be the world manufacturing hub in next 20-30 years or, will this source of competitive advantage migrate to another region of East Asia or the world, such as South Africa?

Approach. Another important topic is selection of a sourcing approach for implementing a LCCS effort. There are four possible approaches:

1. Establish a local joint venture or a wholly-owned foreign enterprise to manufacture and supply the product.
2. Establish an international purchasing office (IPO), or a sourcing office in the LCC region.
3. Employ a US-based (home market-based) global sourcing company. This approach outsources the global sourcing responsibility to a third party provider located in the same country as the buying company.
4. The fourth approach is to hire a trading agent or broker. The trading agent or broker will be located in the LCC and often consists of either a single individual or a company with a small number of employees.

Regarding supply market and supplier research, the Internet has proven to be a powerful tool. Additional sources of market and supplier information include: trade promotion offices of target LCCs, industry fairs and trade shows, trade journals, the buying company’s own sales office in LCCs, human intelligence (trade broker, freight forwarder, etc.), online B2B sites (www.alibaba.com and http://www.koreatradeworld.com are two examples) of online marketplaces for global trade, and Internet search engines.

**Summary.** To summarize our LCCS key success factors, companies need to:
- Formalize a standard LCCS process. The eight-step model shown here is a model designed for LCCS in general.
  1. Establish a cross-functional team and obtain management approval.
  2. Identify business needs and opportunities.
  3. Determine the product/service to be sourced and the sourcing approach.
  4. Search and identify potential LCC and its suppliers.
  5. Decide supplier selection criteria and process.
  6. Evaluate, negotiate supplier and formalize agreement.
  7. Supplier transition and implementation.
  8. Supplier performance review and relationship management.
- Utilize an advanced analytical TCO model.
- Factor risk into your TCO model.
- Develop a thorough knowledge of the LCC supplier’s culture.
- As with any business relationship—but even more so when dealing with LCC suppliers—communication is a key to success.
- Establish a robust local business network.
- Early supplier involvement is crucial to cost savings efforts—this is especially true if the product to be sourced requires significant design and engineering effort.

Should companies strive to search for “the best” LCC regions? The answer is, *not necessarily*, because each situation is unique. As companies begin to identify and research LCCs, it should become apparent why it is critical to first develop a thorough understanding of their own business and sourcing needs. With this understanding, companies can more effectively evaluate the unique strengths and weaknesses of each LCC in terms of their specific needs.

In terms of understanding these needs, it is helpful to look first inside the company and ask:
- What is the corporation’s 3-5 year goal? its strategic growth plan?
- What core competencies does the company need to develop or strengthen to reach that goal or plan?

Next, look outside the company and think:
- Will globalization, particularly LCCS, help acquire or strengthen those core competencies?
- What are those LCCS candidates?
- What are the respective pros and cons associated with LCCS?
- Which low cost country’s offering best matches those core competencies?

**Conclusion.** LCCS offers great potential for future business growth. Companies need to be clear on the motivators, challenges and risks associated with LCCS, do their homework and develop a comparative view on various LCCS destinations. Most critically, they cannot overlook the culture factors in LCCS and enlist local country expertise to provide cultural guidance.