Five years ago, flights to China from Europe, North America, and Japan were filled with sales managers seeking markets for their companies’ products. Today those flights have as many procurement and supply chain managers as marketers. Leading Western and Japanese companies are no less eager to source Chinese parts and products for developed markets than to sell into one of the world’s fastest-growing economies.

The country’s rapid rise as a low-cost manufacturing hub is what draws these men and women. Retailing giants such as Carrefour and Wal-Mart Stores are going to China to buy an expanding range of goods—from televisions and tools to clothing and crockery—for 25 to 50 percent less than the cost of comparable goods made in developed countries. Automakers around the world are pressuring their leading suppliers to open operations in China or are themselves trying to source components there (see “Global sourcing in the auto industry,” in the current issue). Although the proportion of goods sourced in this way remains small even for companies that began buying Chinese-made goods more than a decade ago, the pace is accelerating, particularly in high technology, consumer electronics, retailing, and some industrial goods. The result is that leaders in these sectors are gaining cost advantages over competitors that source components or finished goods mostly in the developed world.
Although the opportunity is certainly enticing, it can be hard to get the many pieces of a procurement operation in China right. Lessons learned ten years ago by companies as they set up purchasing operations in other low-cost regions, such as Brazil and Mexico, travel only so far. Finding high-quality suppliers and negotiating agreements with them is a problem that companies face in any new locale, for example, but the greater geographic distance between suppliers in China and headquarters makes the job tougher for companies based in North and South America. Another challenge is coming to terms with the widespread use of sourcing agents, which can be a boon or a bane, depending on what individual companies need. Then too there are issues—such as sorting out logistics, securing reliable broadband connections, and cultural and language differences—that companies rarely face at home.

Those that do establish successful sourcing operations in China concentrate on a few fundamentals. They make changes at the home office to address the organizational inertia that can slow down the introduction of a purchasing program in China. They attend to the details, monitoring suppliers as closely as possible. And like one Western company that set and exceeded a $100 million first-year target, they establish a firm goal for sourcing and do what they must to achieve it. Such companies also learn to build local capabilities by staffing teams carefully and using third parties to support them in important tasks, such as quality assurance and logistics.

In these ways, companies lay a foundation they can use to relocate bigger and more crucial pieces of their supply chain operations. They gain cost and operational advantages that competitors can’t match and capabilities that competitors can’t easily replicate.

**Opportunities and hurdles**

Manufacturing accounted for 60 percent of China’s GDP growth over the past decade. Multinationals set up operations there, and domestic companies expanded to make goods for export and to sell products and services to multinationals doing business in the country. But that was just the start of the boom.

Even though Ford Motor and General Motors have considerably beefed up their supply lines from China during the past few years, for example, those goods constitute only a fraction of the components used in their vehicles. If the two automakers sourced half of their basic parts (such as carpets, castings, electronics, tires, and wiring) from China, they could together save more than $10 billion a year. Both say that they expect to increase their purchases of Chinese-made parts vastly.
Companies in other sectors are also racing up the Chinese sourcing curve. Wal-Mart bought about $10 billion to $15 billion worth of goods from China in 2003 and hopes to almost double that amount by 2007. Other retailers, including Best Buy, Carrefour, and Tesco, have equally ambitious plans.

The potential is impressive, but so are the difficulties, ranging from intellectual-property infringements and customs delays to poor communication between headquarters and suppliers. Ford reportedly did not meet its target of sourcing $1 billion worth of components from China last year, largely because the job of evaluating suppliers and establishing supply chain connections was bigger than the company had thought. But these hurdles, while daunting, can be overcome. Our work with companies that source goods in China suggests that three important issues should be addressed at the outset; other problems can be resolved later.

Inertia at headquarters
One of the biggest barriers to a Chinese sourcing program is resistance from middle managers at home, who often have a limited perspective. If their performance is measured on inventory turns, for example, they might worry that distant and uncertain supply lines will require them to hold larger inventories, thereby driving up costs and reducing turns. Similarly, logistics managers, who are evaluated on their ability to economize, warn that using far-flung suppliers will push up costs. Procurement managers wave the yellow flag about the quality of goods, while product designers, manufacturing chiefs, and plant managers all have objections of their own.

And they are right, from their specific points of view. Inventory and logistics costs will rise. Adjustments will be needed to deal with the new risks of managing suppliers in China. But companies that succeed there have demonstrated that the benefits of lower-cost purchasing almost always outweigh the increase in operational costs and risks. Even after accounting for them, one retailer recorded overall savings of more than 20 percent in its sourcing operation.

Managers at such companies see the bigger picture. They commit the time needed to make the case for change, sell it internally, and transform organizational structures, incentives, and performance measures. And as we have seen in our own work, there is also clear direction from the top. Without unambiguous support from senior executives, programs languish when procurement departments or operational managers try to implement them.
Executives can overcome resistance to change by making a persuasive case for it. Some sponsor efforts to develop total-cost-of-ownership models that show whether the benefits of sourcing in China outweigh the additional logistics costs, lower inventory turns, and risks to quality (exhibit). At one high-tech company, for instance, managers from functions such as logistics and procurement worked with the CFO to create such a model. This exercise not only encouraged them to buy into the final assessment but also helped middle managers identify cross-functional sourcing issues, including how to get the logistics, inventory, and marketing teams working together to manage longer supply chains.

In addition, executives must find ways to minimize the pain of process changes and to make them acceptable quickly. One manufacturer began by using its existing processes to select, approve, negotiate with, and manage vendors instead of setting up a special Chinese initiative staffed by employees whose powers usurped the authority of sourcing and product managers. Processes and sourcing roles changed only after the company became comfortable working with Chinese suppliers. This manufacturer believes that the experiment helped its managers design a better sourcing program by allowing them to learn gradually about new approaches to purchasing, logistics, selecting vendors, and negotiations.

As a short-term measure, companies might redesign their performance incentives in order to encourage purchasing managers to buy goods from China. One retailer introduced “incubation” incentives to motivate its buyers, rewarding them with bonuses for the volume of products they sourced there.

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### Making the case for China

A total-cost-of-ownership model can be a useful tool in making the case for a sourcing program in China. The detailed assumptions that fuel the model must be constantly updated, however, and alternative scenarios created and explored to account for a company’s changing needs.

<table>
<thead>
<tr>
<th>Typical components of model</th>
<th>Special requirements</th>
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<tbody>
<tr>
<td>Product-by-product assessment of all costs of sourcing in China, including:</td>
<td>• Inventory assumptions require product-by-product information on where title is taken (factory gate, Chinese port, end-country port, end-country distribution center)</td>
</tr>
<tr>
<td>• cost of goods at factory gate</td>
<td>• Transportation cost calculations are heavily influenced by volumes and weight per unit, require product-by-product assumptions on the basis of forecast volumes</td>
</tr>
<tr>
<td>• packaging costs</td>
<td>• Transportation cost scenarios must be built to cover different possible volumes and modes of transportation (such as ocean freight vs air freight)</td>
</tr>
<tr>
<td>• impact on working capital for inventory</td>
<td>• Customs classifications require expert knowledge of products and laws, such as local-content rules for favored export classification from China</td>
</tr>
<tr>
<td>• transportation costs</td>
<td>• Adjustments for risk require assessment of possible problems that could arise (such as delays in shipment, probability of their occurrence, and potential cost to company)</td>
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<tr>
<td>• duties</td>
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<td>• cost of after-sales service arrangements</td>
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<tr>
<td>• licensing and branding arrangements, where appropriate</td>
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Building capabilities

To source goods directly from China, a company must learn a set of basic capabilities. These include ensuring quality and control (evaluating a supplier’s ability to meet requirements, for example), testing preproduction prototypes or samples, and assessing packing procedures. Logistics activities such as satisfying customs regulations and arranging shipments are important as well.

During the transition phase, a company might work with China-based agents—trading intermediaries that buy and ship goods—until it had identified and trained the internal talent needed to deal directly with Chinese suppliers. The first of the intermediaries to go will be those that merely buy and sell, because they offer the least added value. Naturally, these agents are likely to pull out all the stops to keep their treasured positions by arguing that they understand local business practices better than overseas managers can. They also claim to do the heavy lifting so foreign companies don’t have to spend time trawling for suppliers, negotiating deals, and establishing infrastructure and organizations to manage supply. Ultimately, they will contend, they can “do a better job for you than you can do for yourself here.”

In our experience, foreign companies can actually learn to do quite well for themselves, whatever the agents’ persuasive claims to the contrary. The real issue is how to decide when to use third parties. If a company sources more than $100 million a year in goods from China, it makes economic sense to have a unit there that can go directly to suppliers, because the cost of running a direct-procurement operation is a third or less of what agents charge. But though they should generally be used as sparingly as possible and according to strict criteria, there are reasons to take advantage of the specialized services that some of them offer: certain agents are skilled at handling delicate materials or complex product categories, for example, or have exclusive rights to particular factories. Moreover, a steady flow of agents through a procurement office can promote market-led innovation and provide useful information about changes in the supplier base.

Direct sourcing may be cost-effective even if a company procures as little as $40 million a year in goods. In this case, however, it can turn to an array of specialist third-party providers that help it identify reliable suppliers, provide quality assurance and control, and perform logistics tasks. Combining in-house activity with the use of third parties permits a company with lower levels of direct sourcing to set up its own office in China and start reducing its reliance on intermediaries while capturing significant savings.

Companies that set up their own procurement operations should focus on building their leadership teams. Four important posts must be filled: the heads of the office, procurement and merchandising, quality assurance and control, and logistics. The ideal candidate for each role will have a
knowledge of the company, the industry, and China—and be fluent in Mandarin. As many companies have discovered, the perfect candidate rarely exists. If no single person can be found for a job, it might be necessary to build a team that amalgamates these qualities.

Attention to detail
Direct sourcing is a complicated set of activities involving many detailed decisions, from selecting suppliers to managing production, quality, inventory, and logistics. Executives know that companies can stumble in any of these activities as they expand their sourcing options around the world. What surprises executives about sourcing in China is the number of details that can go wrong and the effort required to hold a program together. Companies find that they have to pay much more attention than expected to monitoring their suppliers’ flow processes—working back from expected delivery dates to check that suppliers receive raw materials on time and meet every subsequent milestone until the products ship. In other words, you have to be there. Without hands-on supervision and quick action when milestones are missed, companies face delays. Intensive monitoring is required in every industry and with most suppliers in China.

This level of attention, though not unheard-of elsewhere, isn’t common. What makes China particularly tricky is geographic distance. Managers must not only spend more time on tactical details but also—particularly in the case of North and South American corporations—must do so in vexingly different time zones: they might have to get on the telephone in the middle of the night to communicate with colleagues half a world away. Companies that haven’t mastered the details incur shipment delays and additional costs. More important, some find that because they are constantly fighting fires, it is difficult to scale up the sourcing they do in China.

Setting the stage
Solving the leadership conundrum at home and establishing effective sourcing capabilities in China are today’s challenges. Companies that get it right will be in a position to establish a long-term source of competitive advantage by taking the operations they build in China today to the next level.

One way would be developing additional capabilities in China to cut cycle times. Upstream activities such as the approval of prototypes and samples could be moved there and kept close to the manufacturing operations of suppliers, thus reducing the need to rely on headquarters. Streamlining this back-and-forth process could trim by a third the time—currently half a year or more in many cases—needed to develop and make new
products. Bringing them to market more quickly can have a tremendous impact on a company’s economics by improving its understanding of consumers, increasing the accuracy of forecasts, and reducing stockouts and markdowns. European “fast-fashion” retailers such as H&M and Zara have shown the possibilities of this model close to home. The next such opportunity is applying it to products from China.

Another possibility would be to relocate postproduction tasks there. Attaching price labels, ironing and hanging garments, packing consumer electronics product kits, repacking pallets for delivery to points of sale—all of these activities, currently undertaken in Western warehouses, could be completed more cheaply in China.

Shifting responsibility for procurement or even warehouse activities is a challenge. Not least important, a company that goes down this road will find it necessary to create a local staff that can make the correct decisions. Talented engineers and designers will have to be moved from headquarters or recruited and trained in China. More problematic still, headquarters staff will be required to surrender some decision-making power to counterparts based in that country. Processes and IT will have to change so that people can share information and images (for example, of designs or samples) and feel comfortable about decisions made under the new arrangements.

Procurement practices may well prove to be a source of competitive advantage. Companies that have strong ties to suppliers in China could work with them to adopt best practices that cut operating costs and improve lead times, as Toyota Motor has done in past years. Manufacturers, which already know how to run factories efficiently, will find this approach easier to implement than retailers will. Although retailers will have to learn new skills, they won’t find it beyond their powers. Companies could also introduce sophisticated procurement tools, such as clean-sheet costing, to drive down supply costs further and to set targets for future cost benefits that could be shared by supplier and buyer.

But efforts to build for tomorrow must begin today. The significant competitive operating advantages that companies could begin to harvest in China within three to five years will be possible only for those that establish the proper fundamentals right away.

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