TXM Consulting

What is Your Strategy to Deal with the Challenge of China?

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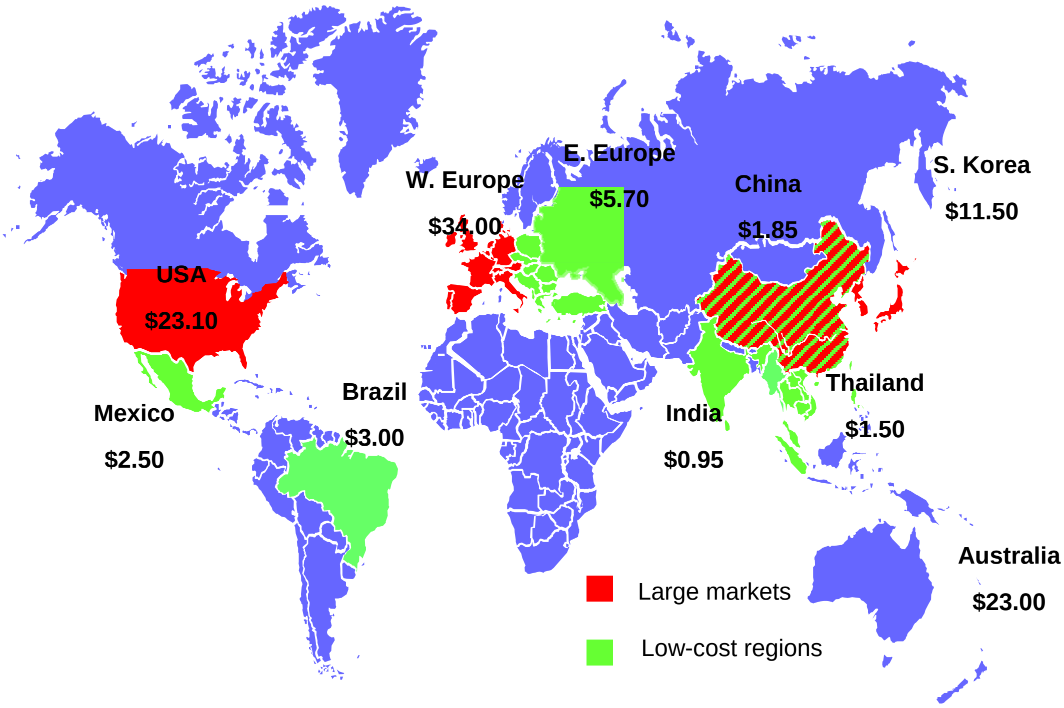

2005 Comparative Hourly Rates for Labour plus on-costs in $US for Different Regions in the World (source: US Dept Labour 2004/US Trade Commission)

In my role as a Supply Chain Consultant and Project Manager, I am finding that an increasingly broad range of products are impacted by Chinese competition. In running procurement projects for major clients, it is clear that the local suppliers tendering for business have a challenging job competing with suppliers from countries where labour costs are a fraction of our own (see the diagram above for labour cost comparisons). Despite this I still find that efficient and customer focused local suppliers can win business over imports, even when they are not the cheapest source. On the other hand it is frustrating to deal with many Australian companies large and small that seem to be oblivious to the competitive threat they are facing and act as if their only competition will come from around the corner as it always has done.

From my experience of managing plastics extrusion and moulding operations and my more recent experience in outsourcing product to China, I can provide some insights into the kind of steps local plastics manufacturers can take to maximise their chances of surviving the current Chinese onslaught.

Understand Your Competitive Position

Understand what your customers value. It sounds obvious, but many suppliers simply fail to listen to their customers, or worse, try to make their customers fit their needs. What is important to your customer - is it service, do they have limits on what they can store, is shelf life an issue or is there brand equity in being "locally made"? Labour costs in all aspects of business will be a major factor driving costs. However offsetting that will be freight costs, tooling costs (if you have existing tooling locally) and working capital costs. One tip—forget about quality as a competitive advantage. With the right supplier and the right technical advice your Chinese competitor will be able to match your quality — and he can afford to employ more quality inspectors just in case. There is no doubt that there is a negative perception about Chinese quality, but this will change over time – the same negative perceptions used to exist about Japanese quality.

Know what you are up against. A good step, even if you have no plans to move production off shore, is to work out what the delivered cost of your products would be if they were made in China or another low cost country. That will give you a good idea of what you have to match. Make sure that you consider all the potential costs, for example additional working capital costs due to the increased inventory involved in importing, the costs of long run as well as short run products, product development costs and travel. All these things add up and understanding them can give you a clear idea where you stand competitively.

Consider your whole supply chain. Recent TXM outsourcing projects have involved savings where the landed cost of the finished product in Australia was significantly lower than the local cost of the raw materials used to make the product. Even if our client's conversion cost was zero they would have still been at a significant cost disadvantage to Chinese product. Likewise an "import proof" product such as empty plastic bottles is not protected if the customer decides to shift their product off shore. Understanding the cost position of your suppliers and customers and their supply chain will help you better understand your own position.

Build your Defense

Develop a plan. You need to develop a specific written strategy to respond to the threat of imports. The sooner you start preparing for the competitive challenge, the more you can do to respond to it. Get some external advice to provide you with an unbiased view of your business and some fresh ideas on how to improve your competitive position. While the particular strategy you choose will depend on your business, there are some common approaches to consider.

Learn to manage complexity. In manufacturing we have spent years simplifying our product range, commonising parts and eliminating complexity. In doing so, we have made it much easier for low cost foreign competitors to match our product offering. Rather than reducing complexity to reduce cost, a much better strategy is to use lean manufacturing techniques to manage complexity. The more you customise your product to meet customers' individual needs, the more difficult it will be for customers to go to another supplier and the smaller the benefits of outsourcing the products.

> **CASE STUDY:** I recently managed the Australian arm of an outsourcing project for a large global company. The Australian and UK plants had rationalised their product range, simplified designs and had many common parts. The French plant on the other hand had a huge range of highly complex and tailored project. French customers had been taught to appreciate the benefits of these highly complex products. As a result it was relatively straightforward to close the UK and Australia plants and relocate them to China, while the French plant is still operating.

Shorten your lead time. Lean Manufacturing is a set of manufacturing and supply chain improvement tools commonly used in the Automotive and Aerospace industries. Lean focuses on the reduction of lead time (from supply of raw materials to delivery of finished goods). The TXM Consulting experience is that by using a process mapping tool called Value Stream Mapping, you can analyse your operation and potentially reduce lead time significantly. Reducing lead time will speed up your response to customers and enable you to get the product there first.

It takes around 16 days for a container ship to travel from Shanghai to Melbourne, therefore with clearance and waiting times, 21 day turnaround is around the quickest that most suppliers will get out of China. However due to the tight credit situation in China, few suppliers will hold inventory and many Chinese suppliers manufacture strictly on a made on a make to order basis. This tends to greatly extend lead times and lead times of 8-12 weeks are not uncommon. If you can supply locally within days or hours, then that Chinese supplier becomes much less attractive to your customer by comparison.

Don’t forget to examine new product development and tooling lead times as well as fast response is often most critical on the first order.

CASE STUDY: I am currently working on the purchasing requirements for a new product development project for a Global company. As the buyer, the ability of suppliers to put in timely quotes, make prototypes quickly and get up and running to meet our launch deadline is as important to me as the actual product price. This will mean that nimble and responsive local suppliers will win business over lower cost off shore competition due to their ability to meet our tight time lines.

Offer more than the product. Look for opportunities to lock in customers by more closely integrating with their operations, providing technical or application support or even (as is increasingly common in the Automotive industry) managing part of their operations. These “value added services” make it harder for the customer to switch and in many cases (such as with the tier 1 – tier 2 arrangements) give you some degree of control over whether the product is supplied or not. These additional services involve additional overhead, so it is better if you can charge for them, but even if you can’t charge it may be worth providing these services to protect your current position and margins. Beware however of handing over designs and intellectual property as a “value adding service”. For example, in my experience in the packaging industry, many suppliers have been hurt when major clients have taken their innovative designs and handed them to a competitor. This means that not only can the competitor use your design for the product they took over from you, but they may take your idea and apply in to other applications.

Resist “Commodification”. Commodification is a term used by clever procurement specialists who like to turn everything into a commodity. It is amazing how successful they can be at convincing suppliers that their product is a commodity just like any other and can be sourced anywhere at a market price. You should know your product and customer well enough to see through this. Of course the procurement people will tell you that the superior performance, value added services and outstanding service that you offer your customer are of little value compared to the alternative - its their job to tell you that. However, if you are confident of the unique benefits that your product offers the customer, then you can sell the value of your product over the alternatives.

What about the Future?

How long will the boom last? This is a very sensitive question in many boardrooms and we have already seen the adverse impacts in China of a “bubble” in automotive production and steel production. In addition, the profitability of Chinese based manufacturers has been squeezed by rising commodity prices and increasing financing costs as the Government attempts to reform China’s banking sector. It seems likely that China’s growth will slow somewhat before the end the decade, however, barring something unforeseen, the long term fundamentals are strong. Currently around 30%-40% of the Chinese population live in cities. Over the next 20 years this is expected to rise to around 75%. This represents around 450 million people who will need apartments, roads, appliances, cars and any number of other goods. Expect the China story to be around for a few more years to come!

Will we ever get a level playing field? One thing to watch is the exchange rate. The Chinese per capita GDP is $US1500, but adjust it for relative purchasing power and it should be $US6200. By comparison Australia’s per capita GDP is $US30,900 and on a purchasing power parity basis it should be $US30,107. On a simple basis this means that the A$ is overvalued by 3% and the Chinese Yuan is undervalued by a massive 413%. Don’t expect the Chinese currency to quadruple any time soon, but these imbalances will eventually have to equalise and don’t be surprised if you see a doubling in the Chinese currency over the rest of the decade. This will greatly affect China’s export competitiveness, but greatly increase the wealth and consumption of the Chinese people, making it an even more attractive market.

Summary - Where to Get Started

Regardless of whether your business has been affected by low cost import competition or not, you need to start planning your response for when it happens. Two key areas to address are understanding your competitive position and improving the responsiveness of your business.

Understanding your competitive position involves both understanding what your customers value about what you offer them and also understanding what import competition can offer them. Ultimately price is important, but it often will not be the only deciding factor, so try to understand all the factors affecting the customers’ purchasing decision.

Improving responsiveness can be achieved by using lean manufacturing tools such as Value Stream Mapping to reduce lead time and enable greater customisation of products to customer needs. Simply trying to cut costs is a race that you are unlikely to win against import competition where labour costs may be 10% of your own, so look to reduce lead time, improve service and offer a more customised product and service package that is harder for imports to match.

Tim McLean is Director of TXM Consulting. TXM specializes in Supply Chain Project Management and Process Improvement. Prior to setting up TXM Consulting, Tim spent 15 years in senior operational roles in the plastics, packaging and chemical industries. Tim has been involved with several major sourcing projects in China in recent years and assists clients to find Chinese suppliers and partners and set up operations in China. Tim also assists clients to use improvement techniques such as Lean Manufacturing to adjust their local operations to the new competitive environment. If you wish to find out more, Tim can be contacted at tim.mclean@txm.com.au or on 0404 480 517.