



Have You Missed the Slow Boat to China?

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For a while, news stories have made it seem that all manufacturing had moved to China, but nothing could be farther from the truth. In fact, the most competitive supply chains balance the use of low-cost countries with agile final production close to market. We explored this issue at AMR Research's Executive Leadership Conference in Boston this week, drawing on the experiences of a panel comprising our analysts and three clients that manufacture in China to answer some key questions.

Question 1: Why are you going to China?

Many North American companies still think of China as a low-cost production country to make goods for their home market. The pure cost advantage is quickly disappearing for a variety of reasons:

- Low-cost products shipped efficiently by sea means you have six to eight weeks of inventory sitting on the water and a large lag in changes to demand. Telecom manufacturer Adtran solved that problem by running air cargo flights twice a week from Hong Kong to the United States—a possibility only because the product is high-value equipment with highly variable demand.
- Rapid growth is creating a high turnover environment for Chinese workers as they shift jobs to increase their salaries. The cost advantage is reduced while quality and process issues arise. Shortages of experienced engineers in some specialties are bidding up salaries to the point where they may soon approach those in some parts of the United States.

Panelists agreed that the strategic reason for investing in China was the local market. A tactical reason is low-cost exports, but in most cases, you must first establish a viable domestic Chinese business. Indeed, TRW Automotive indicated that the vast majority of its Chinese factories and joint ventures are for the domestic market, with a small bit of product going to Korea and Japan. TRW is in China because China is poised to become the world's largest automotive market.

The Takeaway: Think high-growth strategic market, not just low-cost production.

Question 2: Who owns the factories?

Our panelists took widely different approaches to factory ownership, depending on their goals:

- Applica, a maker of household appliances, started manufacturing in China in the 1970s, building its own manufacturing plants. The company has since divested the plants, relying now on contract manufacturing. Applica found that an excess of capacity for plants producing simple products makes it less flexible and more difficult to be competitive if you own them.
- Adtran uses the Chinese plants of two of the top five electronic manufacturing service companies, having moved much of the production from Mexico. Cost and other advantages combined with its air freight capability make for a high-quality, low-cost, and responsive manufacturing capacity.
- TRW Automotive has established 11 joint ventures in the past 10 years. The downside of joint ventures is that some of the contributed capital may be obsolete plants and equipment. Because of the relaxed restrictions on Wholly Owned Foreign Enterprises (WOFE) recently, its latest investments are its own plants—just right for a company in for the long haul.

The Takeaway: There are more ownership structure options today, and you need to pick the right one based on your products and goals.

Question 3: How do you manage the orders, inventory, and quality?

Our panelists all talked of the difficulties in overseeing operations in China, including the following:

- **Minimal e-commerce infrastructure**—A recent AMR Research/AIAG study showed that phone, fax, and even in-person meetings are the dominant method for communicating with Chinese suppliers. While top brand owners and Tier 1 contract manufacturers may have more modern capabilities, these quickly disappear at Tier 2 and below.
- **Supply chain visibility**—Use of Enterprise Resource Planning (ERP) and supply chain systems is elementary at best, and many Chinese companies are content to mitigate that by throwing people at the problem. While the products get built, it can be difficult getting the information into systems for global planning activities or even having the information to analyze operations. Again, understanding the inventory positions of lower tier suppliers is almost impossible.
- **Maintaining product quality**—While most panelists were able to implement reasonable quality programs at their own factories or those of their contractor, lower tiers revealed a different story. One

spoke of recurring problems with supplied parts: known problems that had been fixed through corrective action would reappear months later. In all cases, high turnover made quality a constant worry.

These are the same issues many companies lived through with domestic factories. They're just exacerbated by time and distance.

The Takeaway: As one panelist put it, "Expect to live with manual processes. You will need people on the ground in China and you can't turn your back." Gaining visibility and agility will be a long-term endeavor.

Question 4: How do you manage business relationships?

Much has been written about the cultural differences between China and the West, and our panelists had similar experiences. Communication can be difficult. The challenges can be as fundamental as the expectations of a contract. Where the westerner may feel it is an iron-clad guarantee, the Chinese see it as a start for the relationship, to be reopened if conditions change.

In a similar vein, the panelists reiterated the same concerns about controlling Intellectual Property (IP). Legal protections are not enough, and you must take steps to control access to all information needed to build a competitive product.

Finally, our panelists warned about being overly focused on price. In China, there is always a cheaper supplier to be found. If you care about quality, responsiveness, and protection of IP, building a good relationship with reliable providers is important.

The Takeaway: Focus on communication and relationships rather than western legal structures.

Question 5: Is it too late to go to China?

The answer: "It depends." The old expression for taking someone out of circulation was to "put them on a slow boat to China." As our panelists have stated, going to China is not fast and not necessarily cheap.

At this point, the consensus seems to be that companies should not blindly rush to China or any other low-cost location simply to reduce parts costs. The maturing of the Chinese economy, changes in monetary policy, and strong internal demand are reducing the savings somewhat. The strategy still makes sense for low-cost products or parts with steady demand, and especially products with a large potential market in Asia.

Some recent AMR Research publications on China and complex supply networks

- "Who Has Just One Supply Chain? No One—Design for That Reality"
- "Competing on Price in China: Trading Short-Term Benefits for Long-Term Profits"
- "VMI: A Gold Mine for 3PLs in China"
- "Intellectual Property: A Growing Concern for Global Manufacturers"
- "Rewire High-Tech Supply Chains and Enterprise Applications for Competitive Advantage"
- "Observations on Navigating China's Supply Chain Waters"