

LCCS 2.0

Taking low cost country sourcing to the next level



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Supply chain executives and stakeholders gathered for a roundtable discussion on LCCS. Back row, left to right: Harvinder Sembhi, vice-president of supply base solutions, Celestica Inc.; Ronan McGrath, CIO of Rogers Communications Inc.; Shakeel Bharmal, general manager of Purolator Global Supply Chain Services; Mary Anderson, president of I.E.Canada, the Canadian Association of Importers & Exporters; Dave Matts, director of global sourcing with Husky Injection Molding Systems Inc.; David Morgenstern, a leader of Ariba's global strategic sourcing practice; Lino Casalino, Canadian supply chain logistics leader with PricewaterhouseCoopers LLP. Front row, from left: Thad Reece, director of spend management services with Ariba; Paul Rosborough, vice-president of procurement business services with Rogers; Bruce Winder, associate vice-president, reverse flow & quality management, Canadian Tire Corp. Ltd.

By Lisa Wichmann

Low cost country sourcing (LCCS) seems to be sparking one major question these days—what's next? Supply chain managers with established programs are wondering how they can build on their progress.

Others are grappling with metrics. They want to know if their LCCS programs are meeting their goals, and if going overseas still makes sense from a cost perspective. All those factors are framed by risk. LCCS, if not properly conducted, can be fraught with pitfalls.

Throughout the past several years, though, Canadian and US supply

chain managers have learned valuable lessons around quality, supplier relationships, oversight, trade regulations, logistics and contingency planning. They've distilled their experiences down into a set of best practices for the road ahead.

On that note, a roundtable discussion held recently in Toronto was aptly-

named. Called LCCS 2.0, the event spoke to the need to take a deliberate, thoughtful look at low cost country sourcing programs, before moving to the next level.

Delegates from organizations such as Canadian Tire, Celestica, Husky Injection Molding, Purolator and Rogers Communications gathered to share their ideas, opinions and predictions on LCCS. They were joined by industry leaders such as Mary Anderson, president of I.E.Canada, and experts from Ariba.

Participants were invited to analyze the results of a recent survey con-

ducted by *Purchasingb2b Magazine*, in partnership with Ariba's Spend Management Services Practice. The survey, fielded in April of 2008, involved 169 supply chain practitioners in Canada, and 51 in the US.

Respondents were asked about their level of satisfaction with LCCS, their perception of risk, spend volumes, and their future plans. The survey produced a clear picture of how supply chain managers in the US and Canada view LCCS. But participants in the roundtable brought the results to life, with their own real-world examples, anecdotes and words of wisdom.

Cost control

"I've had some clients say 'if we were not sourcing in China, we would be out of business'," said Lino Casalino, Canadian supply chain logistics leader with PricewaterhouseCoopers LLP.

Casalino has noticed for some companies, buying in low cost regions has become an absolute necessity. Faced with fierce competition, and rising commodity and fuel prices, North American firms are drawn to the cheaper labour rates and material costs not just in China and India, but emerging markets such as Vietnam.

In fact, cost control seems to be the biggest impetus for LCCS. When asked about the primary reason for sourcing in LCCs, 90 per cent of respondents in Canada—and 88 per cent in the US—said "cost reduction."

In terms of experience, Canadian respondents sourcing in LCCs have been doing so for an average of 4.6 years, while US respondents have a slightly higher average of 4.8 years.

Delegates at the roundtable varied widely in their experience. Some are LCCS veterans who have been sourcing overseas for more than a decade. Others, such as Paul Rosborough, vice-president of procurement business services at Rogers Communications Inc., are still at the discovery stage.

"I don't think we have a strategy for low cost country sourcing [for the cable and wireless divisions of Rogers] but there are great opportunities in the way the economy is going," Rosborough said. "Certainly this time of [financial] restraint



Harvinder Sembhi of Celestica (left) and David Morgenstern of Ariba highlighted best practices and strategies for optimizing international purchasing offices (IPOs) and leveraging technology.

is a good time to be focused on costs."

With that motivation in mind, Canadian companies source an average 12.4 per cent of their organization's total spend in low cost regions; compared to 14.3 per cent in the US.

China is still the main attraction.

Canadian respondents will spend an average 23.5 per cent of their total LCC budget in China in 2008.

US respondents are fixated on China as well, targeting it for 14.1 per cent of their LCC spend this year. But they seem to be more bullish on India, earmarking it for 7.2 per cent of their LCC spend. But of course, it's not as simple as throwing a dart at a map.

"Over time, the strategies have only become more complex, and risk has become a major issue for a lot of com-

panies as they've extended their supply chain," observed David Morgenstern, a leader of Ariba's global strategic sourcing practice.

"The underlying business case of why companies are sourcing overseas is being put into question. Five years ago, an LCCS plan would have been 'where are we going to save money the fastest?' But as companies realize they're going to end up with 10 to 50 per cent of their spend going overseas, they will begin to have more risk...and risk requires a plan."

In fact, having a plan is crucial to taking LCCS to the next level. And yet, according to the survey, 74 per cent of Canadian respondents, and 55 per cent of those in the US say they don't have a formalized LCCS plan.

Whether the procurement team operates in a silo, or companies are plunging into LCCS with a "one-off" or experimental approach, this lack of formality could create problems. Delegates at the roundtable spoke of the dangers of taking too casual an approach.

"If you have to make two emergency air shipments, all your low cost country savings are gone," Morgenstern advised. In his and Casalino's view, a successful LCCS strategy pulls together all the critical departments, such as procurement, logistics and finance, so each one knows what the other is doing. That way, it's less likely the savings negotiated by the purchasing department will be evaporated by

Survey says . . .

The majority of respondents in Canada (54 per cent) say they are meeting their goals for low cost country sourcing. But only 10 per cent said "yes, definitely," while 44 per cent said "yes, mostly." The same trend showed up in the US, with 48 per cent of respondents meeting their goals. In both countries, companies with less than \$100 million in revenues were more satisfied with their programs than those with more than \$100 million in revenues.



Bruce Winder of Canadian Tire believes quality control can't just be a snapshot in time.

costly transportation or quality defects.

And those problems are certainly occurring. When asked if their LCCS programs are meeting the goals, 54 per cent of Canadian respondents, and less than half (48 per cent) of US respondents said "yes." But only 10 per cent of respondents said "definitely," while the balance said their programs were "mostly" meeting their goals.

Barriers to full success include a lack of resources overseas, perceived risk, and misunderstanding of total costs. Canadian respondents also pointed out external barriers such as longer lead times (51 per cent), quality defects (47 per cent), late delivery (45 per cent), higher logistics costs (39 per cent) and poor supplier response (37 per cent).

Rounding out the list were the problems of supply chain visibility, planning and forecasting, trade regulations, cultural differences, low savings,

unavailability of raw materials and low customer acceptance.

With all those obstacles, it's easy to understand how supply chain managers would view LCCS with trepidation. But LCCS can be done—and done well. Companies such as Canadian Tire, Celestica and Husky are testament to the savings and efficiencies that can be gained.

"In our industry, the technology piece is very critical, especially as we continue to move our production across the world, and integrate those supply chains," said Harvinder Sembhi, vice-president of supply base solutions with Celestica Inc.

"A lot of my effort goes into looking for solutions where we can collaborate with our suppliers electronically and drive some efficiencies in the supply chain."

Survey says . . .

China is still the main country for LCCS. When asked what percentage of their company's total spend sourced in LCCs will go to each region, Canadian respondents said 23.5 per cent will go to China this year. US firms report China will get 14.1 per cent.

Sembhi recently spent three years working in Asia to cultivate low cost suppliers in China, India and Malaysia. He credits Celestica's international purchasing offices (IPOs) for playing a key role in finding and managing suppliers. The company has a formal IPO in Taipei, and a pseudo one in Tokyo, plus

regional offices throughout the area.

It used the basic formula for setting these offices up—sending ex-patriots to get things started and then hiring local talent. "The value proposition is more around aggregation, so suppliers have a single point of contact instead of dealing with 15 different plants," Sembhi explained.

The IPOs are also extremely valuable for helping the company deal with unexpected glitches in supply. Staff at the offices leverage close relationships with local suppliers to resolve any problems. That alone has provided a return on investment.

Supplier discovery is another big job of the IPOs. One search produced 1,150 suppliers, but only 55 were qualified. "So there's a lot of opportunity, but there's a lot of time needed to get to the product that you want...There's no substitute for having local forces on the ground," Sembhi said.

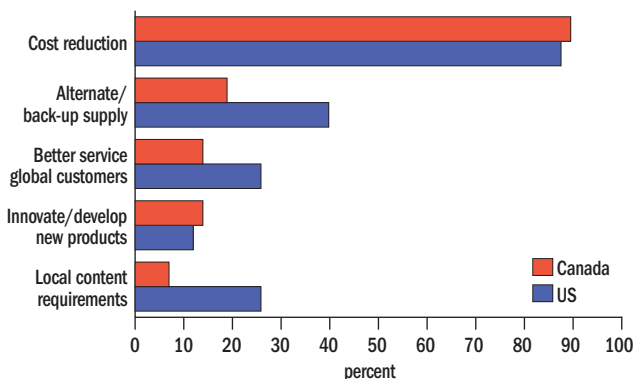
"It's very important to have either an IPO or engineering resources...that can go and personally audit those suppliers and continue to monitor quality."

Ring strategy

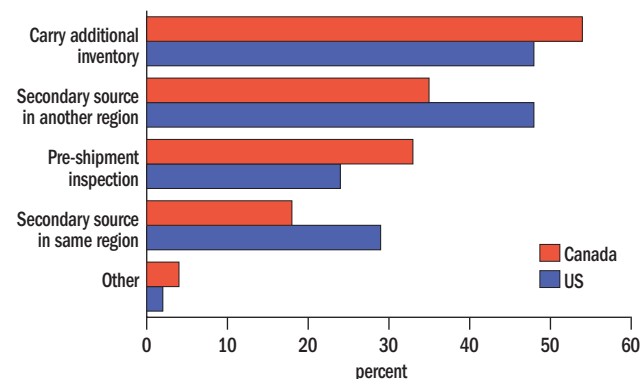
Celestica ensures there are engineers on the road visiting factories, and it also uses a supplier change notification system. "So every time [suppliers] are moving products from one factory to another or they change their manufacturing process, they have to notify us," he said.

The company has received accolades for its innovative "ring strategy." It involves positioning suppliers as close to vital production "nodes" as possible, to reduce lead times.

Why are supply chain managers sourcing in LCCs?



What risk mitigation strategies are in use?



“For the inbound supply chain into those nodes, we see that in concentric rings. Ring one we identify as a lead time of 24 hours. Ring two is a lead time of 14 days, and ring three is a lead time of 30 days; and beyond we have four and five,” Sembhi said.

Clearly, responsiveness is key, and though the distance between China and Toronto may be wide, Celestica is demonstrating how an overseas supply chain can be just as integrated and flexible as a domestic one.

“For the past year and a half we’ve rolled out a tool set that basically does a web-based collaboration between our ERP system and our supply base,” he explained.

“Traditionally, when you’re looking at low cost geography, there’s a lot of paper processing, faxing POs and faxing forecasts. So through this process it’s instantaneous for us...When we get the demand signal we pump it through this application. It goes out on a web portal and the supplier gets an e-mail alert. Within 24 hours they have to respond to that change. We can accept that change, roll it back into our system, and our whole supply chain is integrated again.”

Emerging markets

Aside from leveraging technology, the company is also keeping an eye out for vendors in new markets, and has diversified beyond China to some extent.

“In many cases there are products the customers just don’t want to take to China because of the IP (intellectual property) issues, and Thailand ends up being our best performing site today,” Sembhi remarked.

“We saw Mexico slow down in the 1990s...Mexico is making a comeback. They’ve also gone and reinvented themselves in terms of the skill level that you can get now in those factories.”

India is a good choice for more sensitive projects that require IP protection, he explained. But ironically, some of these suppliers in India are starting to outsource projects—IP and all—back to China, so the market is getting even more complex.

“You have to be very careful about what you outsource because chances



From left: David Morgenstern (Ariba), Thad Reece (Ariba) and Mary Anderson (I.E.Canada) listen as Ronan McGrath (Rogers) discusses his experience with LCCS in India.

Survey says . . .

Canadian respondents say an average of 12.4 per cent of their company's total spend is sourced in low cost countries. In the US, the figure is 14.3 per cent.

are, in six months you’ll have a competitive product on the market,” Sembhi said.

In the beginning, Celestica started LCCS with cost savings in mind. But it was more than just piece price. The company, from the start, made sure to take total landed costs, such as labour and transportation, into account. It saw savings of 20 to 25 per cent or more.

More recently, the location of end customers has started to dictate where Celestica sources. As incomes rise in China and India, manufacturers are finding more of a market there.

Consumer goods ahead

For companies such as Celestica, one of the key success factors is managing risk. The concept rang true for other delegates at the roundtable, including Bruce Winder, associate vice-president of reverse flow and quality management with Canadian Tire Corp. Ltd. (Toronto).

Winder has been with Canadian Tire for 17 years, and 10 of those he spent as a category manager for sporting

goods, buying from low cost countries. He also spent three years in global sourcing. Several years ago, Canadian Tire created a global sourcing area.

“Without that, global sourcing was baked into the minds of 45 category managers,” Winder recalled. “It was fragmented, it was disparate, and there was no plan. Each person had a plan but it wasn’t amalgamated.”

Now the program is much more organized, and Winder has seen plenty of success bringing sporting goods in from markets such as China. Granted, he had a lot of cultivating to do.

“A lot of people in emerging countries may not own a home,” Winder said. “They probably don’t play hockey. They don’t have a lawn to mow. So it’s a different mentality. So what are the challenges in getting that market intelligence over there to develop products that are relevant?”

Fortunately, consumer packaged goods and retail companies such as Canadian Tire were first out of the block with overseas sourcing, so both buyers and suppliers have had time to learn about each other. “We also find a great deal of innovation,” Winder said. “So it’s not just cost savings.”

Like Celestica, Canadian Tire maintains IPOs in Asia for supplier discovery and managing supply. Canadian Tire is also looking beyond China, to keep abreast with risk mitigation strategies.



Thad Reece of Ariba said Mexico may not have enough capacity or speed to meet demand.

"In my opinion there's still lots of opportunity in China," Winder observed. "Obviously, there's a lot of inflation right now in China and a lot of challenges as it relates to raw material, potential labour shortages in the south...A lot of people are talking about a China 'plus one' or 'plus two' strategy; looking at other areas as well."

He's noticed suppliers in China evolving away from the piece-price mentality. They want to compete on other factors beyond cost, in order to sustain their edge. With other emerging markets starting to erode China's piece-price advantage, Chinese suppliers are stepping up their game. Some are even building warehouses to hold inventory for their customers—a novel concept in China.

"They realize they can't grow their economy based on opening price point," Winder said. "They're being encouraged to think about adding more value."

As positive as that sounds, the trend is not without its challenges. Buyers in North America making decisions on cost alone may find their suppliers are quickly outgrowing them.

"Some suppliers, in the beginning, may be low cost but high risk. And some suppliers, as they get more mature and have fancy offices and big overhead, are not quite as competitive. So

where's the sweet spot on that curve? You want to get someone who has enough experience to avoid a catastrophic disaster, but you don't want to pay top dollar in the market either. So it's finding the sweet spot."

Snapshot in time

In Winder's view, one of the more common LCCS mistakes is regarding quality control as a "snapshot in time." It's not enough to visit the supplier's factory once, see the product sample and assume everything will be fine.

Canadian Tire uses a matrix to calculate risk level by supplier and product. They're tagged gold, silver or bronze based on risk. Gold vendors and products are given the full suite of quality control mechanisms.

Through the years, Winder has also noticed the concept of "quality fade." He didn't coin the phrase, but read it in an article, and the idea rang true.

"It's really just the notion that you start out with a great sample...the best materials. It's prime, grade A manufacturing. Then as time goes on and the manufacturer perceives that no one is watching, there's a risk that they start to use secondary or tertiary materials or outsource some of it. Things start to fade."

The key message is never take quality for granted. It also helps to start out on

the right foot, Winder explained. "You have to be competitive but suppliers have to make money too because if they don't, they're going to cut corners...So you have to use a collaborative approach and make sure it's win/win."

Dave Matts agrees. As director of global sourcing with Husky Injection Molding Systems Ltd. (Bolton, Ont.), Matts is involved in sourcing machinery and components.

The challenge is these machines are low volume, so Husky doesn't have as much leverage with suppliers as companies placing huge orders. When going to market for large forgings, for instance, Matts has to compete with the global windmill industry, which is heavily subsidized.

"So in a lot of those specific cases, we have a very difficult time finding capacity," said Matts. "The other challenge is we have parts that require capital equipment...So often we rely on eastern European old World War Two technology because that equipment is still available at a low cost."

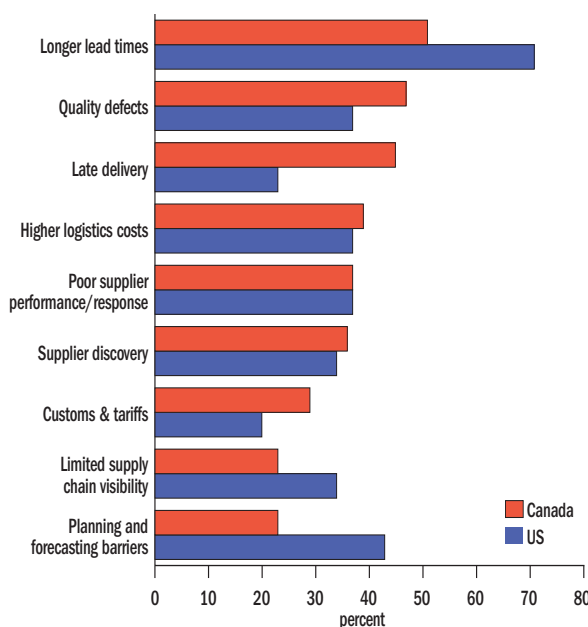
In some cases, Husky has to buy capital equipment on the supplier's behalf. Matts hasn't noticed the same innovation from suppliers experienced by Canadian Tire. While consumer packaged goods are further along the learning curve, suppliers of machinery and components just aren't there yet. Often, the supplier has to be taught how to do the job, and they rarely offer insight or ideas.

The only sure way to know if the machine is correct is to cut it open and effectively ruin it, Matts said. So the company really pays due diligence to quality while the piece is in production.

"We'll have people at the supplier 100 per cent of the time," Matts said. "When you're buying an \$8,000 piece of equipment that's the size of this table, there's a tremendous risk in making sure it lands here correctly."

That's why Matts sees the value in Winder's cooperative approach, which he himself uses. "We have to be careful

What are the chief external obstacles preventing buyers from meeting their LCCS goals?



with every supplier because we're not a high-volume customer. So we're often faced with the challenge that the supplier could just ask us to leave. So we really can't be too stringent... We need to work collaboratively at all times."

As for future plans, Matts and other supply chain managers aren't discounting nearer shores. As fuel prices soar, Mexico is getting a lot of attention again.

"I'm bullish on Mexico," Matts said. "The Mexican suppliers that we've been in contact with have a much better understanding of dealing with North American customers... So I think about China and long term, they're going to be in the game, but I'm concerned about inflation and about currency [in China]."

Maturity level

As interest in Mexico burgeons, buyers should be cautious about rushing in, warned Thad Reece, director of spend management services with Ariba. "My concern is there's going to be a race to find whatever capacity there is in Mexico... You're going to be competing with a lot of other large companies," he said. "The Mexicans can put together a five-slide presentation with numbers on how they can crush China. The question is can they execute? And can they ramp up fast enough?"

Several years ago, he noticed suppliers in Mexico were busy filling orders for production plants "down the street" that had been moved into Mexico by



Lino Casalino of PricewaterhouseCoopers said some companies would not survive if they couldn't source in LCCs.

large multinational firms. They weren't as interested in shipping products into the US and Canada. He isn't sure the situation has changed, and he's also reluctant to give short shrift to China's progress.

"If you think about the level of maturity in China, and the amount of investment the government has put into China, the infrastructure... the Chinese have learned a lot through the process," Reece said.

Other stakeholders, such as Ronan McGrath, CIO of Rogers Communications Inc., said low cost countries provide valuable technical expertise.

"We are beginning to build a barrier," McGrath said. "If you take the British as an example, they cannot bring their technology back to England because nobody knows how to do it [in England]."

Survey says . . .

Canadian firms have been in LCCs for about 4.6 years on average. In the US, the average is 4.8 years.

Canada and the US are in the same boat. Neither country is graduating enough technical IT specialists to meet demand. There are only 50 people in Canada working on IT-related PhD degrees, McGrath noted.

"With the declining technical education right across the US and Canada, where everyone wants to go into marketing and finance, there's a crisis building up... So what you're seeing is this institutional barrier to bringing back advanced technologies into North America."

That, in large part, was what prompted McGrath and his team at Rogers to outsource non customer-facing IT applications to India. "When we started looking at India, cost was obvious but wasn't the prime driver... India has got enough scale so there's a constant supply of newly-educated people."

Finding the right suppliers took months. Getting them up to speed took more months. But Rogers went into LCCS knowing relationships were vitally important. They can't be



Dave Matts of Husky Injection Molding Systems said it's challenging to buy low volumes since you have less supplier leverage.

"managed by remote control," said McGrath, who often hops on a plane to visit with suppliers in India.

Rogers also went into LCCS with a unique outlook. The company realized it would have to make changes internally to execute its LCCS strategy, and not leave all the adapting up to suppliers.

"When we went into India it was an education as to what we ourselves have to do to make things work," McGrath said. "It isn't as if you simply have a menu and you send it out and everybody reads the menu. It's not the way the world actually works. We had a year to ramp up before we found a way to productively manage software development offshore."

Sustainable suppliers

McGrath meets regularly with executives of large global companies. Aside from relationship-building, he said another factor influencing LCCS is the environment.

Companies operating overseas are being asked pointed questions by consumers. They want to know how products are being made and where the raw material comes from. Moving forward, supply chain managers must energize their efforts around finding sustainable suppliers, even in low cost regions.

At the same time, they're also grappling with prohibitive trade barriers, added Mary Anderson, president of I.E. Canada, the Canadian Association of Importers & Exporters.

"We have a regulatory environment that's becoming more stringent," Anderson said. Added to that, her members are struggling to comply with countless different programs for each country they operate in.

"There's certainly a great deal of opportunity to look at harmonization of regulations on a global perspective," she said. "We're seeing the first elements of that within supply chain security. So we're seeing some harmonization for example, between Canada and the United States."

Anderson is keeping an eye on several pressing issues in the LCCS space. One is product safety. Her members are concerned about recalls of product from Asia, and she anticipates supply chain managers doing business abroad will have to step up their auditing of suppliers.

Counterfeit products are another big concern. "It really does impact the brand," she commented. "Certainly there's a safety issue as well. Canada is not considered a very good player at controlling counterfeit goods."

Forecasting failures

Added to those issues are the long-standing challenges around port congestion, truck and rail capacity, and forecasting.

In fact, failure to properly forecast is one of the major hurdles to successful LCCS, said Shakeel Bharmal, general manager with Purolator Global Supply Chain Services. "What we're hearing from our customers is by the time the



Paul Rosborough of Rogers (left) said he's in the discovery stage of LCCS and is eager to learn about the latest trends.

goods get to the store shelves, you've missed the window. So now you've got obsolete merchandise and you're lowering your prices, and great, you don't have the inventory anymore and the CFO is happy. But downstream, your margins are reduced and nobody connects that reduced margin to the fact that you missed the window."

Other companies pad their inventory to avoid running out, but that's costly too, Bharmal said. "I think the key is a tighter link between the information of demand and lead time, particularly with technology."

Purolator recently launched a new direct-to-market service, allowing customers to have ocean containers broken out upon arrival and the product sent directly to the stores. The idea is to skip the warehouse stage, which often adds days to the equation.

Survey says . . .

With total landed costs taken into account, Canadian firms sourcing in LCCs report average savings of 19 per cent. In the US, the average savings are 15.4 per cent for the latest budgeted year.

Moreover, customers often receive containers at the Port of Vancouver, haul the goods to warehouses in Ontario, and then transport some of it back to Calgary and Vancouver. But spending power is surging out west, so importers should be leaving more inventory closer to those cities in the first place, he explained.

Supply chain managers using a direct-to-store model are cutting their lead times by 25 to 30 per cent. The trend seems to be further ahead in the US than in Canada, Bharmal noted.

With so much to take into account, the best strategy, said Ariba's Morgenstern, is to know your own capabilities. "If you're only willing to manage overseas suppliers from North America, you cannot afford to work with a B or C grade supplier. If you're willing to invest in significant supplier quality resources...in an IPO or have [people] on standby to fly out as often as you need, then you can begin to entertain



Shakeel Bharmal of Purolator said product is taking too long to get to retail shelves, eroding margins downstream.

the [cheaper] B and C suppliers...in interior China and Russia."

As companies branch out to new locales, they'll have to set up additional IPOs. These offices are risky since they often have only one or two staff members. If all the intellectual property is in that person's head, or just on paper, all the work will be lost if the person leaves.

The best approach is having an IPO with an electronic database of suppliers and electronic records, along with commodity strategies documented electronically and shared online, Morgenstern explained. Aside from that element, IPOs must also be aligned to the company's business strategy.

"A real best practice is to staff the IPO with somebody who really understands the organization. You can hire a very good strategic sourcing person in China or India off the street, and you may have local supplier intelligence and category and regional depth...But if they're not plugged back into your head office, you're going to have a satellite office...that's not particularly adding value."

Clearly, many variables come into play, and LCCS isn't for the faint of heart. But with the right planning, relationship-building and risk mitigation, the strategy can open up a world of cost savings and opportunity.

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