AlixPartners

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Money on the table: maximizing the potential of procurement in lower-cost countries

The promise of reducing costs by buying products from markets with cheaper labor has long tantalized business. But it wasn't until China began opening to foreign investment in the 1990s that this potential began to be realized at scale. China emerged as the de facto 'factory of the world,' thanks to low labor costs, sufficient infrastructure, and investment-friendly government policies.

Following Deng Xiaoping's famous southern tour in 1992, China confirmed its commitment to economic reform and openness to foreign trade and investment. Businesses in Hong Kong and Taiwan, facing rising wages in their own territory, moved manufacturing to the mainland en masse. This was the beginning of the now ubiquitous 'Made in China' product.

Most large buyers, both industrial and retail, have gone through a learning curve, starting with using sourcing agents, progressing to establishing their own offshore procurement operations, and then building strong capabilities there to get the best deals. However, although mid-sized companies have tried to emulate this, they have had much less success, resulting in substantial opportunities for savings being left on the table.

To see how they frequently fail, it's helpful to first understand the stages that companies go through in moving their procurement activities to lower-cost countries.

OFFSHORE PROCUREMENT IN FOUR STEPS

Step 1 – Use agents

The early days were an era of 'high risk high return' for buyers. The incredibly low costs came with unknown factories, variable quality, uneven delivery, and arbitrary laws and contract enforcement. And so, the sourcing agencies provided a solution as they matched global buyers to nascent suppliers, managing the risk from beginning to end thanks to a combination of local knowledge and familiarity with international norms. Agents managed everything – selecting suppliers, placing orders, inspecting products, managing delivery schedules, and resolving customs issues. They delivered peace of mind, and even with hefty commissions of up to 12% on the price of goods, companies were still able to realize substantial cost savings.

Step 2 – Bring it in house

But it was inevitable that buyers started to question the commissions paid to agents. The hard work of finding reliable vendors in these markets had been done by their agents in the early years and operating in these markets no longer seemed as risky. As a result, many well-known retailers and consumer goods brands, such as Wal-Mart, Home Depot, Sears, Carrefour, and Kingfisher Group, brought these buying activities in house by establishing their own offshore procurement operations in China. By doing so, they swapped the 12% agents commission for in-house management costs of 3 to 7%, even without changing vendors.

Step 3 – Expand footprint across Asia

As the new millennium dawned, new centers for low-cost manufacturing emerged to challenge the status quo as vendors in coastal China became gradually more expensive. India, Bangladesh, Vietnam, and inland China all beckoned as new large scale sources of supply. Many of these global buyers expanded their footprint into the Indian sub-continent and Southeast Asia as they switched volumes to newer and ever-lower-cost locations and vendors.

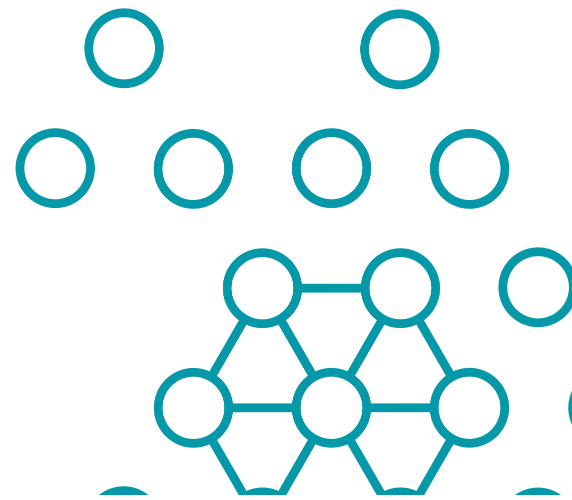
Step 4 – Continued cost reduction

Today most of these offshore procurement operations focus on maintaining the momentum of reducing costs. In addition to continued shifting to countries or regions with the most appropriate cost structures, typical efforts include consolidating to fewer, larger vendors to gain scale; building 'should cost' models to negotiate more effectively with vendors; shifting routine product development activities to vendors; and collaborative buyer/vendor operational cost reductions.

MID-SIZED COMPANIES OFTEN GET STUCK AT STEP 2

Many mid-sized companies followed the lead of these larger competitors, setting up their own offshore procurement offices. We have seen companies with revenues of a few hundred million dollars establish their own offshore procurement office in Asia to manage vendors there. However, in many cases, they make little progress beyond taking over the management of their vendors.

Typical issues that occur include remaining stuck with the same vendors for many years or even decades despite drastic changes in supply markets. They often still buy from the same vendors who have usually relocated their factories into lower cost countries. Yet they often ignore the potential of vendors which are truly home grown in low-cost countries, like mainland China or India. Or they may not have disintermediated agents and are therefore still paying commissions. Complacency may also result in service and quality control issues as vendors do not feel the need to compete. Not getting through Step 3 raises costs whether in the form of higher prices or in inspection and/or remediation costs.



Even when they do find new or best-in-class suppliers, these smaller buyers are often outmaneuvered as those vendors have outgrown them in size and sophistication. Reliance on cost breakdowns from vendors for the same products that they supply is common, providing an illusion of transparency – 'we know what raw materials, labor, and overhead costs at our suppliers.' However, vendors frequently deliberately hide profit by inflating costs, and they do it well enough that they somehow always seem to remain profitable.

Lastly, in cases where the supply base and buyer's procurement office have stayed unchanged for an extended period, the risk of overly 'cozy' relationships cannot be discounted. In the worst cases this may result in collusion between buyer and vendor, which not only adds to costs but also drives capable vendors to competitors.

To address these concerns, we have identified three levers that mid-sized companies can use to begin to maximize the potential of their offshore procurement efforts.

1. Introduce new vendors

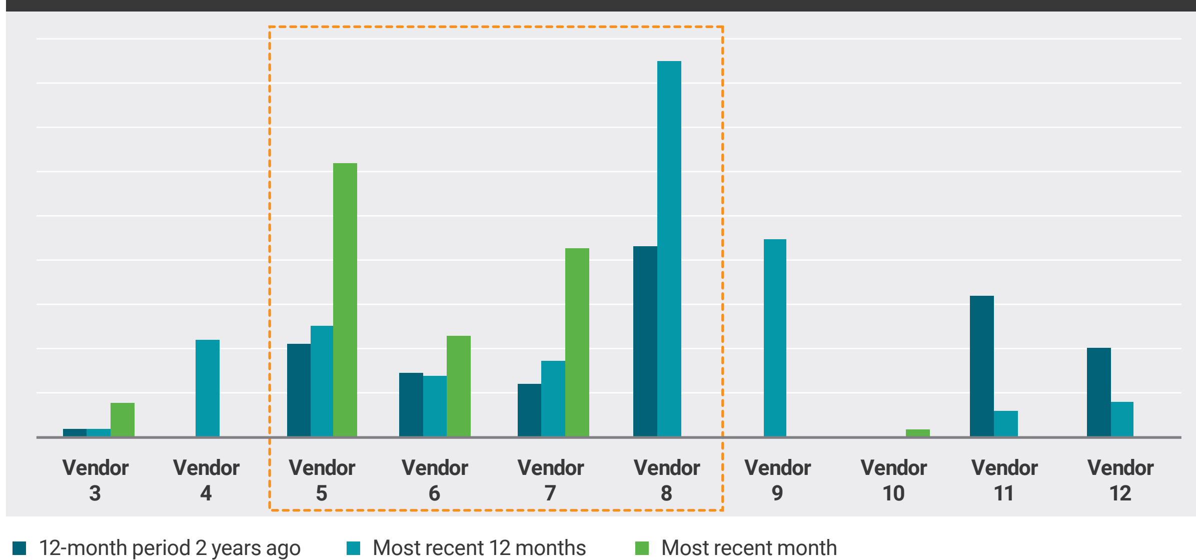
In one recent case, a client had continuous and significant quality issues with three of its most important vendors. However, these vendors had been in place for more than 10 years (one of them for more than two decades), and the client had never offered any credible threat to these suppliers. As a result, these vendors did not believe the client would move business away from them and had become complacent (figure 1).

This client was hardly unique. We have encountered this with products as diverse as footwear, bags, toys, hardware, and consumer electronics.

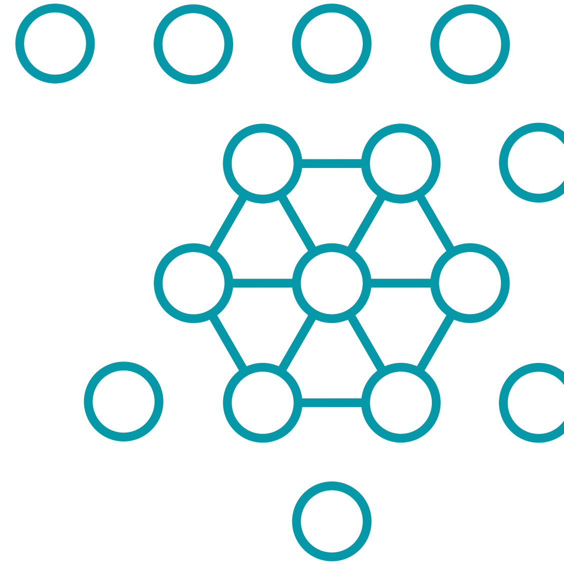
Introducing new vendors works well in situations like this as it forces such incumbent vendors to sharpen their game on both cost and service. In some cases, it is strategically necessary as the most competitive vendors may no longer be where they were 10 years ago. For example, simple jeans should no longer be purchased in coastal China today but from Bangladesh.

Introducing new vendors often results in savings that are both low risk and delivered quickly as incumbents respond to keep their business. However, the threat of losing business has to be real – if the incumbent vendors believe it is simply an 'exercise,' nothing significant will happen. For one retail client, which was facing significant time pressure to control costs, a combination of competitive pricing via an RFQ process, the introduction of new vendors, and elimination of agent relationships at both the factory and raw material levels led to identified savings of about 13% in just 14 weeks, of which half was implemented in less than half a year.

FIGURE 1: CLIENT EXAMPLE – INSPECTION REJECT RATES BY VENDOR OVER TIME



Source: AlixPartners analysis



2. Independent 'should cost' techniques

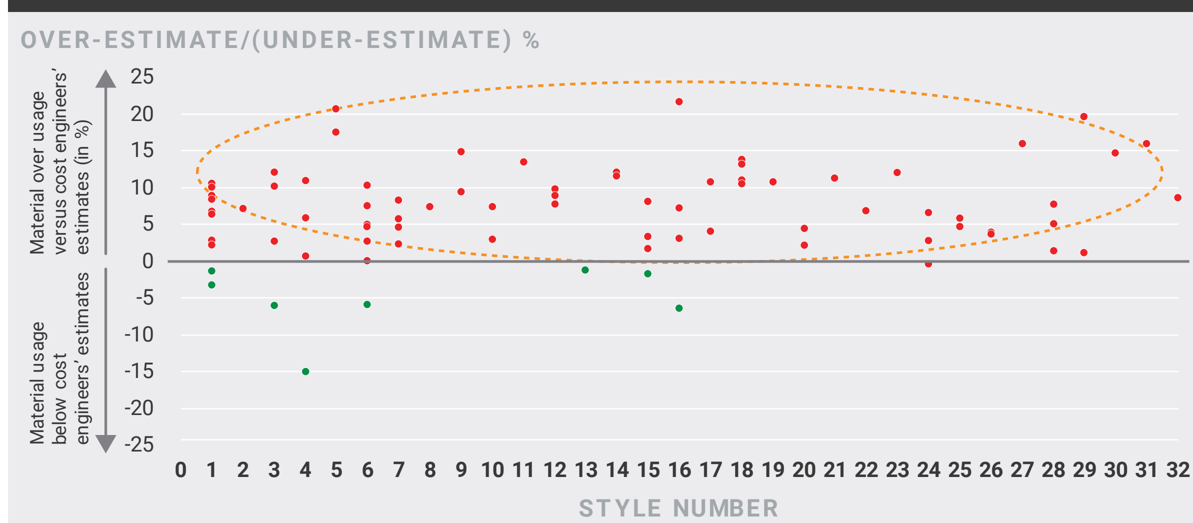
Very few mid-sized companies have implemented effective techniques for estimating what their products should cost when purchased from vendors. Most continue to rely on vendors to provide breakdowns of raw materials, labor, and overhead and compare them from year to year or across similar products to negotiate with vendors.

We advocate the use of cost engineers to tear down product to enable accurate 'should cost' modelling. These cost estimates can then be compared with what existing vendors quote. This process of disassembling products to identify component costing information often reveals overestimates in the use of raw materials. Doing this across a range of products often reveals which vendors are prone to overcharging and by how much.

In one recent case, we deployed this approach for a footwear client and compared the raw materials estimated quantities from tear down with vendors' quotations across approximately 80 shoe styles. The majority of shoes were being quoted with substantially higher material usage than our estimates, which led to an effective renegotiation with suppliers (figure 2).

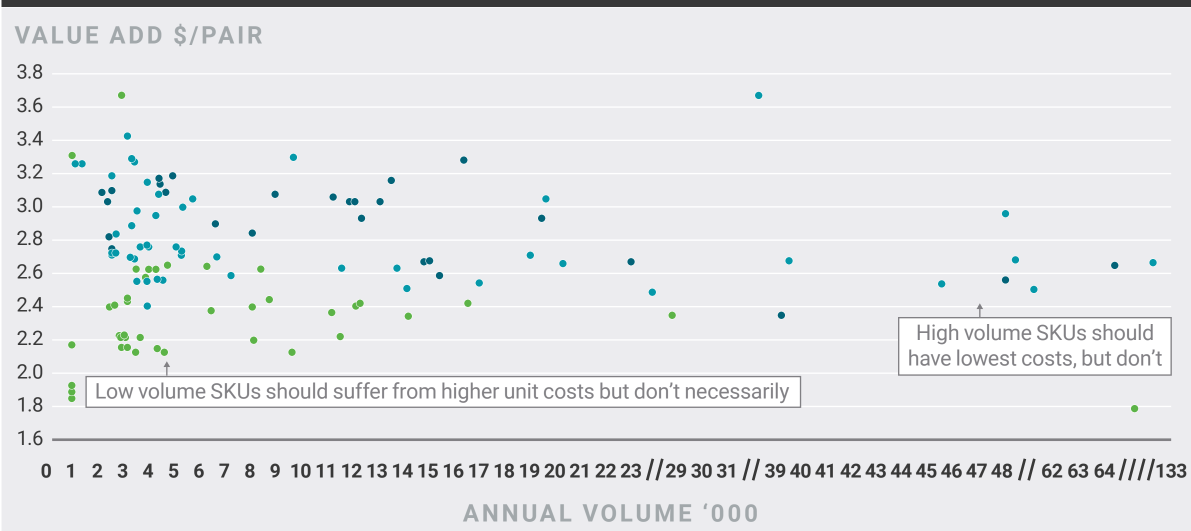
By the same token, manufacturing process audits can be used to compare actual time versus quoted time. Doing so often reveals that vendor quotes for labor costs are often excessive (figure 3). By making appropriate adjustments to labor cost by country, one can also expand the 'should cost' analysis to different countries, thereby modeling the option of relocating sourcing to other lower cost countries.

FIGURE 2: CLIENT EXAMPLE – INDEPENDENT COSTING VERSUS VENDOR COSTING OF MATERIALS USAGE



Source: AlixPartners analysis

FIGURE 3: CLIENT EXAMPLE – VALUE ADDED FOR A SINGLE SHOE SERIES BY SKU AND VOLUME



● Vendor 1 ● Vendor 2 ● Vendor 3

1. Value add = direct and indirect labor and overhead costs

Source: AlixPartners analysis

3. Introducing regular competition into buyer/vendor relationships

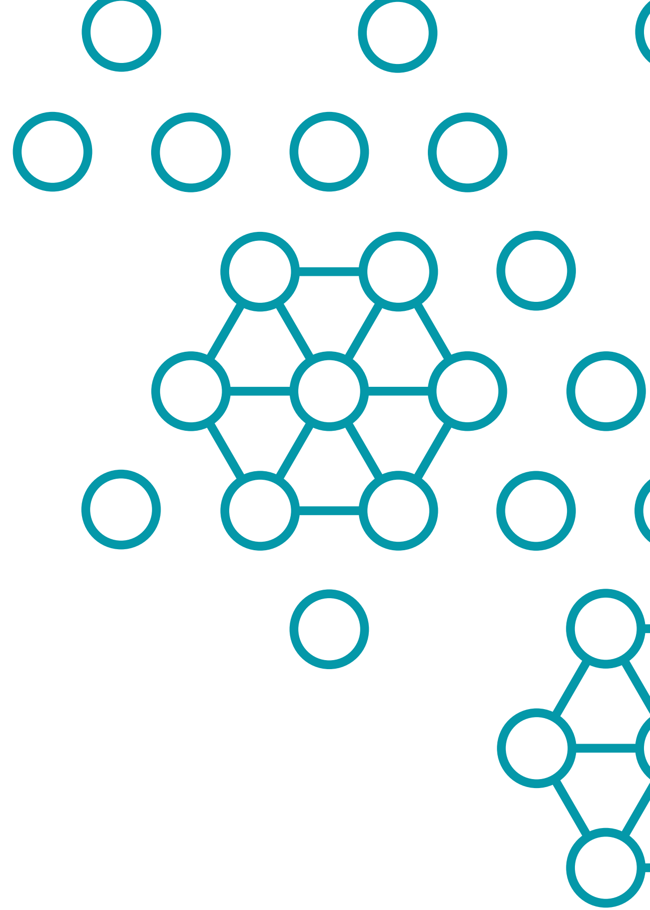
There is a Chinese saying: 'The sky is high, and the emperor is far away.' Headquarters' attempts to push for better prices are often frustrated by offshore buying offices which have been conditioned by vendors to depend on them. Long comfortable buyer/vendor relationships ensure little willingness to really 'push' vendors in Asia. In the worst case, buyer/vendor collusion may occur adding to costs and driving capable vendors to competitors.

This last issue is difficult to address as there is rarely conclusive proof, yet there are clear symptoms that 'something is not right.' For example, in one recent case a client realized that the largest volumes were allocated to the least capable supplier with the most expensive price. However, regardless of whether it is a case of 'conditioned dependence' or the worst case, our experience is that the introduction of real competition in a transparent process is a trigger for forcing such behavior to the surface where it can be addressed. The only difference is in the precautions taken if the latter is suspected.

We have a process to evaluate these risks by examining a set of eight symptoms of such activity. By adjusting the procurement approach accordingly, we are able to identify participants in non-compliant behavior for further action and to deliver savings to the company. Our experience shows that this typically results in additional savings of 1 to 3%.

IT CAN BE DONE

Significant cost savings are still possible in low-cost country sourcing, particularly for mid-sized companies that have not yet realized the full benefits of offshore procurement operations. Introducing competition and applying 'should cost' techniques are effective ways to achieve savings. Moreover, headquarters need to closely monitor the operations of their offshore procurement offices. If they see signs of a procurement office having overly 'cozy' relationships with suppliers, or in the worst scenarios where collusion occurs, they need to intervene and address the issues directly and immediately. **A**



CONTACT THE AUTHORS:
Lian Hoon Lim and Michelle Wong.

FOR MORE INFORMATION:

OUR STRATEGIC PROCUREMENT & TRANSFORMATION LEADERS

Andrew Bergbaum
Managing Director
+44 20 7098 7454
abergbaum@alixpartners.com

Sanjay Shetty
Managing Director
+1 248 262 8437
sshetty@alixpartners.com

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