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White Paper

The Essence of Global Sourcing

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The Global Sourcing Manager must understand the differences between in-country and international sourcing, know the elements of the international supply chain, be able to identify the key skills needed for global sourcing and ultimately develop a global purchasing strategy.

Introduction

The author wrote the first draft of this article on his way to Tianjin, China. He has just conducted a worldwide best practices study for a customer and is going to facilitate a workshop there on how to implant these best practices within the company and with outside suppliers. Sharing best practices with Chinese subsidiaries to be used with Chinese suppliers . . . a vast change over the last 40-45 years. International or Global Sourcing is now part of worldwide business. Everyone has heard the mantra, sell globally, manage locally," but what does that mean?

Due to the costs of transport, local labor contract requirements, and available low cost sources, organizations today are surveying the world to develop strategies for manufacturing outside their domestic "home" country. There are actually a number of options available:

- Manufacture at home, source abroad;
- Manufacture abroad, source abroad;
- Manufacture in one foreign country, source product in that country; and
- Manufacture and source regionally:
    - North America
    - Latin America
    - Western Europe
    - East Asia
    - West Asia

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And companies aren't confining sourcing efforts only to manufacturing products. Foreign sources can be found for services as well. Take the example of software development services. Many organizations have decided to buy software services from companies in India. IBM has decided to open an office there and has staffed it with over 500 software engineers.

Most companies have a plan for global sourcing . . . a definitive and measurable tangible plan to implement global sourcing tied to corporate goals. Others want to take advantage of low cost sources attained by corporations and other companies but may not have a definitive plan for doing so. General Electric has established a Corporate Vice President position that is responsible for finding potential sources for "problem" parts or part families worldwide. This individual is responsible for locating, sourcing, and implementing new sources of supply worldwide. The key is to have a strategy or plan. But before you can have a strategy, you need to know why organizations chose to deploy a global sourcing strategy in the first place.

The Lure of Global Sourcing

Clothing and shoe manufacturers have opted for global sourcing primarily for lower labor rates and an indigenous group of suppliers and work force. These industries led the way in developing sourcing strategies and systems, and were followed by electronics, both consumer and computer-based in the late 1960's and early 1970's.

I worked for a major minicomputer maker and was given, with others, the responsibility for sourcing a computer terminal internationally. We wanted to source the terminal first, and then evolve into a personal computer. This was our first real attempt at sourcing a complex product offshore . . . and we were pursuing it because we could not meet our customers' target price. A couple of interesting developments occurred during the sourcing process:

1. The engineering staff was against the idea because it meant different methods of communications;
2. Our specifications were wrong, and we still received quotes from companies outside Asia;
3. Our ultimate Taiwanese source had two businesses; Nike shoes and computers;
4. We beat our target price by 30%; and
5. We were surprised with the supplier's creativity and devotion to their customers.

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So why do organizations look to source globally? Probably for some of the reasons listed below:

- Receive lower purchase costs
- Achieve higher quality
- Reduce transportation costs
- Take advantage of core competencies of suppliers and/or geographic regions
- Find spot market opportunities
- Locate near local or regional manufacturing facilities
- Fulfill local content requirements
- Be able to sell in a specific country or market
- Deliver on commitment to become global supplier
- Lower overall cost of ownership
- Reduce cycle times due to technology use.

Oftentimes, organizations choose to source globally for a combination of the above reasons, but ultimately total cost reduction is the bottom line reason.

Differences between Global Sourcing and In-Country Sourcing

Let's direct our attention to the differences between global and in-country sourcing. Some of the differences are tangible and hard and fast, and some are more qualitative and intangible. Let's consider each one in sequence:

1. There are language differences. Oftentimes, you'll need a third-party that can speak the local language.

2. There are time and distance factors. You'll need to consider how to communicate across different time zones. Some differences can be severe, up to 12-14 hours.

3. Business terms are defined differently across cultures. For instance, a business "relationship" or "partnership" will have many definitions.

4. Currencies of exchange may affect the ability of the supplier to hold prices for a long period.

5. Physical movement and key players are unique to international trade.

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6. Legal terms and conditions will be inconsistently integrated across borders although some improvements in standard contracts and dispute resolution processes have become standardized.

7. There are a greater number of payment processes available to purchasers.

8. Different standards and safety requirements may be required of suppliers from various regions.

9. Consideration must be given for longer lead times due to transportation of products from international sources.

10. Tariffs and customs are also part of doing business with many companies in countries around the world, and are required based on sourcing location and type of product procured.

11. Local customs regarding labor used and environmental protection requirements will vary from country to country. Many companies are rethinking their sourcing decision based on child labor laws and loose environmental standards.

12. More intermediaries handle the product in movement across the supply chain.

13. Political and social climates in some countries will pose risk to buying organizations. Careful study of the present and future trends in socio-economic climates must be performed prior to source selection.

14. Local customs will also govern how the purchase will be negotiated, and how problems will be identified, analyzed, and corrected.

15. Depending on the region, the strength of unionization may cause risk in terms of supply continuity.

16. Companies in less developed countries may not be current or sophisticated in areas of cost management, continuous improvement, quality assessment, value analysis, or management techniques.

17. In some industries, local businesses are protected against foreign competition through anti-dumping legislation, as we in the U.S. have seen apply to the computer memory, paper, and steel industries.

18. Problem resolution will be accomplished more through telephone, teleconference, and Internet methods than the more preferred method of in-person meeting.

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19. Supplier identification processes are much more difficult due to distance, language, lack of knowledge about local business; and

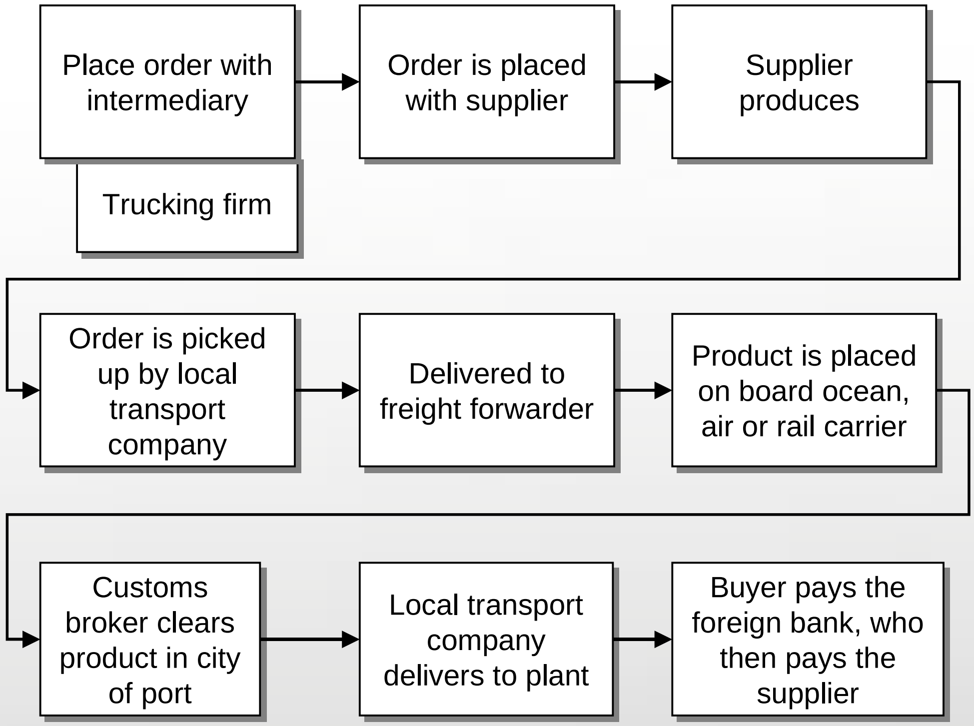
20. Local buying representation may be needed to ensure that the global sourcing strategy is effectively implemented.

These twenty (20) elements just scratch the surface. The supply manager must possess a thorough understanding of the differences in global vs. in-country procurement so that the right amount of resources can be applied and staff within the company can be adequately trained in how to purchase effectively on a global basis.

The Global Supply Chain

In domestic markets, an order is usually placed through a sales organization, and then the order is either produced or shipped from inventory. Payment is made directly to the supplier once the product is deemed acceptable to the buyer. Product shipments are normally accomplished through one transport organization, which then bills directly for their services and either the buyer or seller pays.

In international markets, the chain can potentially become very complex, and be difficult to control. Here is a pictorial of a typical international order:



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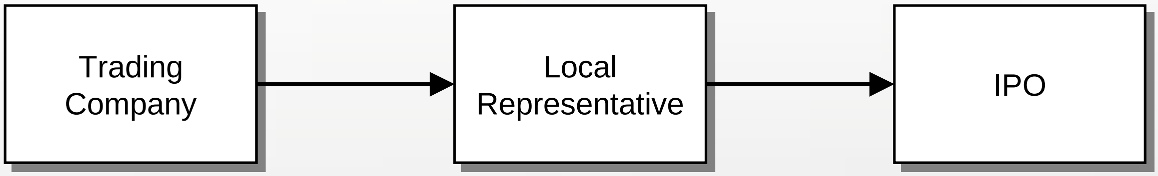
A few more steps. And whereas in the domestic case, one transport supplier “touches” the product, in the international case, four different transport companies touch the goods. A freight forwarder handles all the local in-country paperwork and logistics and the customs broker ensures that the product sufficiently clears customs and all appropriate tariffs are charged.

The payment process is different in foreign countries and commerce. In many international purchases, payment is made through letter of credit. A letter of credit is established between the buyer and a foreign bank, most typically a branch of the buyer’s primary bank. The bank and the buyer agree on terms of payment, and the supplier submits its invoice to the bank for payment subject to those terms. The buyer deposits enough money to cover shipments, so once payment is made, the amount of the letter of credit is drawn down accordingly.

The other element of this supply chain that may be different is the use of a third party to receive the order. Oftentimes, a buyer may need to contract with a local partner in the supplier’s country that may be helpful in identifying potential suppliers, and then receive assistance in securing the contract with the supplier once selected. These trading companies are value-added resources, especially when language barriers exist. Typically, these companies receive a commission or percentage value of the shipments made. These companies can also assist in performing quality system audits, expediting parts, and problem resolution. Most organizations do wean themselves away from these trading companies once they have become more experienced. Another option is to create a locally based international procurement organization (IPO). I started an IPO in Hong Kong for a minicomputer maker, hired local staff, and began regional purchasing of products from Hong Kong, Korea, and Taiwan. The evolution of establishing these relationships can be reflected as follows:



Of course, the creation of these relationships is a function of dollar expenditures, future plans, and risk.

Organizing for Global Sourcing

Creating relationships and organizations to be responsible for global sourcing is critical to success. There also needs to be an analysis of the skill set and knowledge inherent in the current supply management organization to accomplish the necessary tasks.

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I believe that it is extremely shortsighted of companies to ask supply management staff to perform domestic and international procurement. The differences in making these two types of purchases are striking, based on the earlier comparison that was made. Language, cultural influences, time differences, and the need for more specific and managed communications also contribute to the philosophy that separate and distinct responsibility should be considered. Small organizations may have problems justifying the headcount, but at least can structure the activities to ensure that proper concentration and segregation of duties is possible.

The global purchaser must have the following skills and talents:

1. Explicit product knowledge
2. Excellent written and verbal communication
3. Team player
4. Patient and organized
5. Foreign language (if needed)
6. Process-oriented
7. Quality systems knowledge
8. Supplier business assessment
9. Blueprint reading
10. Value analysis
11. Logistics knowledge

Some of these skills and talents can be provided by other supply chain staff, but the most able foreign purchasers have the entire package of skills, particularly technical and market knowledge. Also, since corporations generally buy from more than one foreign country or region, the purchaser must be able to shift approaches applicable to different cultures. The following chart shows the different influence of focus on problems and personal relationships in a number of countries. People refer to this difference in terms of cultural context:

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Personal Relationships		Focus on Problems: Low	Focus on Problems: High
	High	Japan Brazil Mexico	Canada Singapore
	Low	Void (thankfully)	Germany United Kingdom United States

These reflections are obviously generalizations and are not meant to pigeonhole specific culture. It just provides a framework for discussion and evolution. It can be used to help establish an approach to be taken in negotiations, relationship building, and problem resolution. It also helps in providing an initial focus to the tasks at hand.

Setting the Global Purchasing Strategy

In my experience, the strategy is comprised of the following components:

1. Organization
2. Goals
3. Focused Regions/Countries
4. Supply Management Process
5. Relationships
6. Timeframe/Schedule
7. Budget

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Each of these components is covered below:

1. Organization

I mentioned the need to separate responsibilities between domestic and global purchasers. There is also a need to enlist the help of the functional groups within the organization such as manufacturing, engineering, logistics, finance, service, and specific user groups. Full and/or part time staff may be needed to assist in the following tasks:

- Ensure correct specifications
- Conduct process audits
- Evaluate costs and pricing
- Establish freight forwarder and customs broker arrangements
- Set up inventory depots
- Assist in qualifying and selecting suppliers

Training may be needed in the aspects of foreign sourcing. It should be noted that a purchaser will not be able to handle as much international purchase volume or suppliers, as counterparts focusing on the domestic market. This is due to the need for more careful and detailed communication (mostly written) with the supplier.

2. Goals

Senior management can get "turned-on" about global sourcing once they read the Wall Street Journal or the trade press regarding cost savings possibilities. Oftentimes, however, these stories only tell a partial story. Just because a specific country has a lower wage rate does not mean that the workforce quality and efficiency is comparable. Also, the total cost of executing the supply chain described earlier (particularly if you have to use air shipment) may be exponentially higher than the lower wage rates.

So goals may be a point of discussion with management if expectations are higher than a realistic level. Plus, organizations <u>should not</u> revert to global sourcing based solely on purchase costs. This ignores overall total costs, cost of quality, cycle time differences, and inventory issues.

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Goals should be established in the following categories:

1. Purchase Price Reduction
2. Quality Improvement
3. Cycle Time Improvement
4. Use of Technology
5. Volume of Purchases
6. Commodity Specific Purchases
7. Total Costs

These goals will provide the incentive to assign the resources and systems necessary to reap the benefits.

3. Focused Regions/Countries

The supply manager should identify the potential items for global sourcing. Generally speaking, items that are heavy or large cannot be effectively sourced internationally from a cost perspective. Technically advanced products and services may also be difficult to outsource.

After a study of the market, what purchasers normally find is that sourcing products globally is attractive because there is a:

- Large pool of competent suppliers
- High labor content or ability to source raw materials more effectively
- Country or regional focus on specific commodities

For instance, many companies source wire assemblies in Mexico due to high labor content; semiconductors in Japan and Taiwan due to technical competence and a wide pool of suppliers; steel in Korea due to the availability of raw materials; and chemicals in Germany due to the leadership position of the suppliers there.

This component of the strategy should specify the commodities, potential countries or regions, and the potential volume of purchases.

4. Supply Management Process

This aspect solely addresses the procedures to be followed to conduct business abroad. Responsibilities and tasks must be noted for the following activities:

1. Supplier identification

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2. Supplier assessment
3. Supplier selection
4. Supplier management

Internal and external resources may be included in this analysis. Flow charts should be included describing the flow of materials under the global sourcing process, given the focused commodities and regions. Measures of the process may also be included, such as length of time to process an order, select a supplier, or lead-time from supplier dock to organization use.

Policies and procedures should be documented, and affected staff should be trained.

5. Relationships

This aspect covers two critical areas: one relates to establishing relationships with intermediaries to facilitate the process, and the other deals with describing the types of business relationships desired with global suppliers.

We have addressed the use of foreign intermediaries earlier in this article. In terms of relationships with suppliers, most suppliers desire a long-term relationship. This is due to the need to invest in resources to work with foreign organizations and a genuine interest in building volume together.

Length of contracts should be stated in the strategy. Level of organization involvement (e.g., Vice President Level) should be established. Method of communication and frequency of formal correspondence should be stated. Finally, the strategy should address the conditions under which the relationships with intermediaries and suppliers should be severed or redeployed elsewhere.

6. Timeframe/Schedule

The global sourcing process should not be rushed. Pilots should be established and learning applied to follow-on opportunities. Time must be set aside for forming the organization, developing the list of commodities, potential countries and prospective sources, and supplier selection. Once the organization has had experience, the schedule can be accelerated.

I think that it is reasonable to expect that it will take about 3-6 months to get started unless the commodity is a standard product and the country/supplier is geographically close to the purchaser such as France and Italy, and the U.S. and Canada.

The schedule should address the aspects of the global sourcing strategy and specify key tasks and milestones, along with the names of responsible staff.

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7. Budget

Global sourcing costs. Such costs are both tangible and intangible. Both must be included so that a cost-benefit analysis can be done. Finance and upper management will want to see the payback or cost expended. A table describing the categories of costs is included below:

Tangibles	Intangibles
▪ People ▪ Offices ▪ Travel ▪ Telecommunications ▪ Inventory ▪ Customs/Duties ▪ Representation ▪ Legal Assistance ▪ Payment Change Effects ▪ Language Talent ▪ Systems-Related	▪ Cycle Time Differences ▪ Communication Timing Impact ▪ Potential Delays In Problem-Resolution ▪ Effect On Forecasting Errors

In any event, these costs must be estimated, budgeted, and tracked as a way to indicate the efficacy of global sourcing efforts.

Summary

The establishment of global sourcing is an exciting endeavor. It provides an opportunity for organizations to find the best sources for its subcontracted products and services. Many companies source internationally for proven lower costs; then look to benefit from higher quality and lower total costs; still others want to be able to satisfy local content requirements to support its sales commitments.

There are significant differences between buying domestically and buying internationally. Notable differences include language, distance, cycle time,

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communications, standards, culture and customs, differing problem resolution, and technical and business sophistication. The physical movement of product, and the number of companies that "touch" the product, is an obvious major difference.

The deployment of a global purchasing should follow a documented strategy that tracks with the organization's business plan and addresses organization goals, commodities, relationships, processes, schedule, and budgets. The cross-functional team responsible for its implementation should formulate such a strategy.

Global purchasing can provide significant benefits if organizations have a bona-fide plan, commit the required level of resources, and are patient in receiving initial benefits.

In the future, with the Internet as the backbone, international purchasing will be a "click-away" for tactical implementation, but still an overall strategy must be in place.

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