Fundamentals of International Procurement and Outsourcing

(Chapter 1, Abstract, Acknowledgements)

By: Christopher A. Marshall

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General Introduction

"Boundaries are shrinking and disappearing, and what's becoming apparent is that global purchasing and domestic purchasing are flowing, blending, and converging into one stream."

R. Jerry Baker

"Operating in an increasingly interconnected world, leading companies perceive competition as global and are moving to implement an integrated strategy worldwide. Global competitors are learning to develop and manufacture products that can be introduced and marketed simultaneously in many countries. In doing so, they are sourcing technology, materials, and components from sites and suppliers located throughout the world."

Carl R. Frear, Lynn E. Metcalf, and Mary S. Alguire The Hoover Company, a division of the Maytag Corporation, is in turmoil. Like many other U.S. manufacturers in related industries, virtually all of our competitors have outsourced the production of their products offshore to low-cost labor regions around the world, specifically in Asia. Though Hoover senior management was knowledgeable of these “outsourcing” trends in our industry they did not fully realize the impact that it would have on the company.

Hoover had considered the quality of our products to be our number one strength and, to a large extent, believed that the best way to maintain this quality was to keep the production of our products in our own North American manufacturing facilities.

Further, management viewed many of the moves overseas by our competitors as a “last gasp” effort to save their brands. Up until a few years ago, Hoover senior management did not believe that foreign manufactures were capable of achieving the level of quality that would be necessary to effectively compete against us in the U.S. market. They couldn’t have been more wrong.

The challenges that face the Hoover Company, Maytag, and many other U.S. based manufactures due to low-cost, foreign manufactured products competing with American made products in the U.S. market are significant. Many companies, such as Hoover and Maytag, are meeting this challenge by developing their own international sourcing strategies to outsource the production of products outside of the Unites States.

Thesis Abstract

The purpose of this dissertation is to explore what is required for a company to be successful in international procurement and outsourcing.

My research suggests that there are many actions that companies can take to increases their chances of success as well as minimize their exposure to risks.

Through a combination of: research, personal business experience at The Hoover Company and Maytag, as well as the documented experiences of other companies, I will address each of the following questions:

• Why has outsourcing become so popular to U.S. based companies in such a short period of time?

• What are the benefits and risks of international / global outsourcing?

• What are the cultural issues and challenges that U.S. based companies need to be aware of when dealing with foreign based manufacturers?

• What are the key transactional processes that are critical to achieving a successful sourcing program and relationship with foreign suppliers?

• What are the major distinctions between China, Mexico, and India as low-cost labor countries relating to international purchasing and product outsourcing?

• What is the current political climate in the United States regarding the loss of U.S. jobs attributable to international outsourcing?

Table of Contents

Chapter 1:

Today's Business Environment and Challenges

Outsourcing Trends

"Not made in America? Who cares?" A recent survey sponsored by Marketing Support Inc., a Chicago based branding agency, confirmed what many already knew; that it doesn't much matter to many U.S. shoppers – especially the younger ones – where the stuff they buy comes from.

Politicians may rally against Benedict Arnold CEO's shipping work abroad, and unions may bemoan the loss of U.S. factory jobs. But do Americans care where the stuff they buy was made? Not much, it turns out, and that apathy could hasten the offshore movement.

When shoppers for home improvement or home decorating products at big-box retailers were surveyed, seven out of ten people said that they don't look at the country of origin. What's more, 57% say the national source has little to no effect on what they toss into their carts. The percentages are notably higher for those aged 18 to 24: Nearly 85% in that group don't know where the products that they buy come from or care.

The report predicts that the acceptance of foreign products will only grow, as more nationalistic seniors die off and are succeeded by laissez-fair youth. Another factor: The quality of many imported goods has greatly improved, negating a selling point many American manufacturers once had." (Michael Arndt, Not Made in the U.S.A.? Who Cares? BusinessWeek online, May 2004)

Explaining Growth: Globalization and Cost

"The dramatic pace of growth in many developing countries comes from many internal and external factors. From a commercial standpoint, this growth can be attributed primarily to two key factors:

• Multinational corporations building significant operations abroad to take advantage of skilled, low-cost labor.

• Global firms sourcing both products and services from offshore suppliers to reduce cost margins and increase competitive positioning.

The cost advantages low-cost countries afford can be huge. Compared with Western nations, skilled manpower in low-cost countries in Asia like China and Thailand can cost between 50 to 75 percent less, while unskilled manpower can be as much as 95 percent cheaper. Significant savings go beyond labor costs to reduced costs on production and manufacturing equipment. Tooling, for example, cost roughly 30 to 50 percent less in low-cost Asian regions than it does in North America and Western Europe. At the same time, increased globalization has brought with it fewer trade restrictions and tariffs, lowering the costs of doing business with low-cost countries even more.

While many organizations are just getting started with low-cost country sourcing, a number of global organizations have begun to adapt their entire supply chain to take advantage of the opportunity. For example:

• According to Rubber and Plastics News, Goodyear plans to “nearly double by 2005 the percentage of tires it sources from Asia for North America and Europe.”

• Home Depot, the hardware concern, has opened two sourcing offices in China, one in Shanghai and another in Shenzhen, to “greatly enhance their opportunity to purchase more goods directly from manufacturers” with the goal to grow its imports to about ten percent of sales in stores.

• Wal-Mart, one of the more operationally efficient corporate giants, has already leveraged global sourcing to dramatically improve its bottom line. In Wal-Mart’s Q1 2003 conference call in May of this year, the company noted that “Consolidated gross margins were up 20 basis points in the quarter due to improved mix and the benefits of global sourcing.” In addition, Wal-Mart has leveraged its global sourcing initiatives to compete on price against competitors globally, especially in Europe, where the company was late to the market.” (Bush, Connell, and Lee of FreeMarkets Inc., Low-Cost Country Sourcing – An Executive Overview, 2003)

Caution is the Key

The move to low-cost country sourcing is not an easy transition for many companies. It isn’t simply a matter of building a new factory or searching for new suppliers in a low-cost country. There are unique challenges and additional risks that organizations must plan for and mitigate, from cultural challenges to quality and on-time performance issues. Companies must balance the tremendous opportunity that low-cost country sourcing presents with the risks it can create in order to reap true benefits.

Indeed, low-cost country sourcing can bring significant up front costs without any guarantees of success. Traditionally, companies often pay considerable sums in order to make low-cost sourcing work – from the millions it can cost to set up IPOs (International Procurement Offices) to the large fees (up to 20 percent paid to brokers) to name just a few of the costs. This traditional approach has yielded mixed results for some companies, and created a cycle where high fixed costs have turned into sunk costs.

How to Configure Success Through Outsourcing

• Going offshore for economic gains will only work if you closely and carefully manage your partners. “For many logistics and purchasing professionals, the word configure can sound a bit intimidating. In reality, though it may sound like a technical term, configuring is really just part of a relatively painless process called outsourcing.

Obviously, tackling outsourcing from start to finish can be a cumbersome task. There are many decisions to be made, from selecting an outsourcing provider to determining which business components to outsource to configuring the system. Listed below are some of the key decision-making steps you'll confront.

Start with an assessment of your company's strengths and weaknesses. If your company has optimal resources in the area of R&D or sales and marketing, for example, that is where you should focus.

Every company has its own budget and finite dollars to spend in creating and distributing products. Financial resources and personnel should be directed toward the area where a company shines, not to areas that can be successfully handled by an outsourcing partner. When done right, outsourcing can free up resources, both cash and management that can be better spent on innovation and growth.

• Keep pace with your competitors.

Don't follow a path to self-extinction by operating in a vacuum. To survive in today's competitive marketplace, companies of all sizes need affordable and reliable product assembly and delivery, and most can't do it all themselves. While many companies are resistant to the latest offshoring trends, they need to wake up to the reality that offshore companies are becoming their direct competitors, if they aren't already. You can outmaneuver your competitors with a strategic outsourcing initiative if it's a proper fit for your business.

• Don't just go with your gut.

Evaluation of an outsourcing provider goes beyond liking your rep. It's always important to trust your instincts. However, are you willing to risk unhappy customers by selecting a company based on a relationship alone? Check references, not just one, but a current customer in both the small and large categories, and two former customers.

Look for a strong financial foundation and high sense of security. A long-standing business with customer testimonials to back it up and the security systems to keep proprietary information safe are key.

Develop a relationship with the outsourcing provider by visiting them to see their capabilities and infrastructure, as well as the quality of their people, which translates to their ability to serve your needs through their resources.

Having an outsourcing partner with professionals trained in specific areas managing the process can help enhance accuracy and quality. Well-run outsourcing companies have resources that allow them to do specific tasks more efficiently, and these cost savings are passed on to customers.

• What to outsource?

For starters, consider the high-volume, stable products that don't change much in type or quantity over time. If a product is volatile, it might still make sense to set up some type of logistical chain to get it made or assembled elsewhere. Using a third-party distributor to remove the internal hassle of dealing with product volatility may help manage fluctuations.

What about warehousing and transportation? Ideally, the same provider handling the parts and assembly can do this. The various tasks come together more easily when fewer sourcing companies are part of the plan from dock to distribution. This way companies don't have to chase down their own raw materials suppliers, provide shipping, or worry about meeting production deadlines when a shipment from a supplier is delayed.

Comparing quotes.

When comparing quotes, be sure to compare apples to apples to get the total landed cost. This should include component sourcing, inventory, service lead times, change controls, warehousing, distribution and transportation to your plant or to your customer's facility. Knowing the grand total and what it includes helps end users of outsourcing services save money and pass along savings to their own customers.

A solid outsourcing partner will offer options and solutions, not complications and hassle. If a quote on an assembly was requested, what about the sub-assembly, customs clearance and cross-border transportation with final distribution to the end user? A legitimate outsourcing provider will also tell a logistics officer when it simply doesn't make sense to outsource that component or service. Sometimes the answer is "no," or the answer is not a single solution but multiple options. A modular recipe is desirable with various components segmented as a menu on the proposal.

What about geopolitical factors and duties/tariffs?

Working with foreign entities is a learning process. There's nothing like on-site evaluation, especially when it's not obvious through news tracking. Go to the country and look around. If it seems like chaos and instability, it probably is. Sure, it might be the cheapest deal in terms of labor costs, but if the news yields stories of political unrest over time, it's best to look elsewhere.

Too little or too much police/military personnel, lack of traffic control and illegal behaviors occurring in broad daylight without consequences are all bad indicators . None of these things can be determined without a trip to the country to view it first-hand.

The unavoidable duty/tariff is never a factor to ignore. In fact, this fee can completely change the bottom line cost. It basically comes down to the country of origination of the raw materials, where they enter the country (via U.S. or Mexico, etc.) and in what form. Because of a free trade agreement, the materials could be duty-free if handled within legal guidelines for a specific country. To cite an example, hardwood plywood is cheapest in Brazil. When brought into Mexico there is an 18% duty rate, but it's still cheaper because if the plywood is cut up in Brazil, it has no duty coming into Mexico.

Duties are different in various countries, and there are legal loopholes based on the customs classification of materials. Raw materials versus cut or partially assembled materials play a factor in many cases. A good outsourcing provider will know this and should be able to provide counsel.

With the evolving market, global trade allows the lowest possible resulting cost. The trend toward offshore outsourcing is here to stay, so learning how to work the logistics chain from the supplier's supplier to the customer's customer is critical to staying in business. Those who lead in accomplishing this will dominate the marketplace in 2004 and beyond." (Laird Carmichael, executive vice president of International Outsourcing Services LLC)