

How to Lose Business to the Chinese in 5 Easy Steps

by Steve Ganster and Kent D. Kedd

Bob Stacey had “the talk” with BigCo, his largest customer the other day: the talk he had known was coming but had been dreading for nearly a year now. As the VP Sales for Ramsey Inc., a \$25 million supplier of custom-designed electrical components to large original equipment manufacturers (OEMs), Bob knew that most of his bigger customers had been sourcing from China for several years. However, since Ramsey did all custom work for their customers and had supplier relationships extending back many years, Bob felt quite confident that his business was safe from the “commodity” sourcing that the OEMs were pursuing in China. But that was before “the talk.”

“As you know, Bob,” started Jill Harris, BigCo’s VP Manufacturing, “we have been sourcing commodity product from China for a number of years. It has been a challenge, but we have seen real savings from it. Now that we are moving more of our manufacturing to the region, we are looking to source all of our products from China.”

“Um...OK,” stammered Bob. “What does that mean for us?”

“Well,” said Jill. “We need Ramsey to be able to supply us locally in China

within 12 months. If you can do that, I can almost guarantee that we will double our business with you in a very short time. If you can’t, we won’t be able to do any business with you at all because we are pretty confident that we can find what we are looking for in China.”

Jill’s words sent shockwaves through Bob’s system. Ever the consummate professional, Bob looked Jill square in the eye, promised that they could meet (or beat) BigCo’s requirements and told Jill he would get back to her with their specific plan in 60 days.

Bob phoned his CEO from his rental car as he left BigCo’s parking lot: “Tom, I hate to wreck your day, but we’ve got ourselves a little problem here...”

Is This for Real?

While the names have been changed to protect the unfortunate, the conversation between OEM and supplier actually happened, verbatim; and it is happening every day to Tier 2 and Tier 3 suppliers to global OEMs in a wide variety of industries. The OEMs are moving more of their operations overseas—particularly to China—and are wanting their suppliers to orient themselves conveniently

around them. Most OEMs would certainly prefer to maintain long-established relationships by having their US suppliers pick up and move with them to China; however, if the US suppliers cannot (or *will* not) accommodate the OEMs in China, the OEMs will find (and *are* finding) local Chinese companies to supply them.

Chinese companies are able to compete with US suppliers for OEM business? Is this for real? Yes, this is for real. It has been real for some time now and it is getting more real every day. Tier 2/3 suppliers like Ramsey are in danger of losing business to Chinese companies in 5 easy steps:

Step One: Emergence of Chinese competition

As a result of robust domestic growth in China over the last 10 years, many Chinese companies have grown rapidly in scale and capability. In addition to expanded capacities, these companies have improved their technical capabilities and product quality up to world standards. Chinese companies in highly labor-intensive industries in low technology products (e.g. textiles, toys, injection molding, etc.) were the first to prosper, exploiting China’s

very low labor rates and abundant workforce. More recently, we have witnessed the growth of Chinese companies in "core" industrial and consumer segments, many of which are relatively mature in the West such as some petrochemicals, building materials, primary metals, low end automotive parts, and the like. As the technologies needed are relatively old and available, the result has been the development of some strong and increasingly sizeable Chinese producers.

China's continued strong economic growth and development, as well as increasing consumption of higher technology products and materials, will sustain the energy to support further growth and maturity of Chinese companies able to compete for multinational business in China.

Step Two: Exports become attractive

As industries grow in China there has been a tendency for over investment in capacity, leading quickly to very aggressive pricing in the local market as companies have fallen all over each other to drop prices. Given intensifying competition within China among low cost and aggressive competitors, these companies have naturally turned and looked outward. Export markets, particularly those in developed countries, not only offered new demand potential but much higher margin due to better pricing levels. The combination of better price levels with low cost manufacturing became a very attractive equation as Chinese companies began developing their export markets.

Initially targeting developing countries in Asia, Africa and the Middle East where product standards were lower, China producers soon found access to the more developed markets of Europe and the US. Channels opened up as distributors and traders sought to match the low cost China suppliers with international consumers eager to find lower priced products. Favorable government incentives such as value-added tax (VAT) rebates have enhanced this attractiveness.

In this cycle, we have witnessed Chinese producers also migrating up the quality chain, expanding from low value-add, commodity products to moderate value-add, mid technology products, even with their own "global brands". Haier, a Chinese producer of appliances and the Chinese computer giant TCL are two good examples here. Originally leading brands in China, both companies have expanded both their products and their brand outside of China's borders and are beginning to make inroads in the West, surprising their US and European competitors who never dreamed of facing a Chinese brand in their own markets. We guarantee that there are other US companies now that are never dreaming of the very same thing!

Step Three: Foreign firms shift production

With a continually growing Chinese domestic market and the appeal of a low cost manufacturing environment, foreign manufacturers began to shift their production to China. Initial investors in the early 90s were Hong Kong and Taiwanese firms but soon expanded to major US, European and even Japanese manufacturers.

Recent foreign direct investment (FDI) figures bear this trend out as more Western firms are contributing to China's position as the world's leading attractor of FDI, nearly \$53 billion in 2003 alone.

This phase in the migration has had a cascading effect, pulling sequential layers of the supply chain to China. The automotive industry is a recent example of this phenomenon. Major vehicle makers, such as General Motors, have aggressively expanded their production capacity in China to meet growing domestic demand for vehicles. As quality parts were not yet locally available in the early stage of migration, these major vehicle makers have pulled into China their first tier parts suppliers like Delphi. Now, companies like Delphi are returning the favor by pulling second and even third tier players to support their production needs. This same phenomenon has occurred in many other industries, such as electronics, appliances and telecom.

The result of this third step has been the establishment of a base of foreign-invested enterprises in China, some of them building incremental capacity to their facilities in the West while others are making a complete shift of their manufacturing from the West to China. This shift has resulted in significant reduction in exports in these industries to China from the West. For the moment, beneficiaries have been equipment suppliers who export high technology capital goods to China to outfit new manufacturing facilities – but their day of reckoning will come as their Chinese competitors are now able to provide capital equipment of equal (or better) quality at a fraction of the import price.

This step in the migration process—the beginnings of Bob's headaches at Ramsey Inc. above—is currently in a very active phase and is critically challenging the survival of many Tier 2/3 firms in the West.

Step Four: Foreign invested firms look to source locally in China

To add insult to the injury already done to their Tier 2/3 suppliers, these transplanted OEMs are now looking to more aggressively source within China from local Chinese suppliers (Jill of BigCo was pretty confident that she could find supply sources in China). As a result of a slow response from their suppliers in the West to move resources to China and due to the often significant cost gap between these suppliers and local Chinese firms, these OEMs are now proactively evaluating local sourcing options. Their goal has not only been to lower product cost but also to lower supply chain costs and improve responsiveness.

Many Tier 2/3 suppliers have been surprised at the aggressiveness and flexibility of their OEM customers in this regard, as well as the performance of local Chinese competitors. These suppliers were confident that the gap in quality, technology and the inability of their Chinese competitors to meet Environmental, Safety and Health would protect them against Chinese competition; however, the gap has not been as wide as was assumed. Much to the dismay of their US suppliers, many OEMs have been willing to compromise performance requirements to gain cost advantage, thus lowering the bar even further for Chinese producers.

This step in the cycle is beginning to heat up in many sectors such as thermoplastics, automotive components and electronic goods.

Step Five: Foreign-invested firms consider using local sources for global supply

The last step in the process, which is in the early stages of development today, involves these OEMs using the now-qualified local sources to satisfy demand in other geographies. Once the Chinese suppliers have been qualified and given their competitive costs, this last step is a relatively easy transition. The implications of this final sequence in the migration could be the most lethal for Western-based suppliers (as Ramsey is experiencing in full, living color).

Many leading OEMs have set up sourcing operations in China with their sights set on supplying global customers and, in some cases, are even moving global sourcing management to China. These operations are sometimes even supported by establishing local R&D capabilities to work more effectively with local producers on new products, both for the domestic and export markets (effectively eliminating Bob's assumed lock on the customer by providing custom design services). GE (in both their Medical and Plastics divisions) and Delphi Automotive are good example here of manufacturers sourcing actively in China while retailers such as WalMart and Home Depot are catching up with maturing China sourcing operations.

What can be done in response to this migration?

Let us return now to the original question Bob asked Jill of BigCo: "What does this mean for us (the supplier)?" It seems that the challenges presented in these 5 steps can be significant, if not life threatening to a Tier 2/3 supplier to global OEMs such as Ramsey. There are a number of things we are advising such companies to do, all involving some sort of proactive action on their part.

Ask your customers before they ask you

Don't wait for customers to call you and ask about your plans for China; by that time, it may be too late. And don't necessarily think that your customers understand what they are doing about China. Often they are experiencing the same challenge in their end of the supply chain and are "feeling their way" out of the dark as well. Be proactive to understand their situation and plans, even strategizing with them to find a joint solution. You don't have to have a plan completely worked out...that will come later. At first, simply start the conversation with your customers and listen to what they have to say. Imagine what a different conversation it could have been if Bob were to have requested a meeting with BigCo six months earlier and had opened with this statement: "Jill, we know that you have been sourcing commodity parts from China for awhile and that it is only a matter of time until you will be sourcing custom supplies from there as well. I want to talk to you today about how Ramsey can grow

to meet your future demand.”

We have seen some very creative approaches to addressing the challenges from Chinese competitors, from joint supplier-customer strategies to shared investment/facilities to simply doing business a different way. On the other hand, we also see many executives stuck in a state of denial, ignoring the reality of the migration and the threat to their organization. We have more than one client that has discovered one of their drawings on the desk of a Chinese competitor—their OEM customers are *that* aggressive in finding local China sources. The threat is real and must be taken seriously, now before it is *really* too late.

Try to slow the cycle time

Certainly the optimal solution is to find a way to stop the migration; however, in most cases, the natural forces are just too strong (most large OEMs have strategic initiatives to find supply sources in "low cost countries" and no amount of pleading or logic from their US suppliers will sway them). One can, however, try to slow the cycle down by leveraging what advantages you still have: a strong and perhaps longstanding customer relationship and comfort level, technical prowess, value-added services, and the like.

To understand how best to exploit these strengths you need to know the nature of your customer's "pain". Your OEM customer often says that they need you to "be in China", but what is behind this request: Cost issues? Logistics? Response time? What do they mean to be "in" China: You need to have full-on manufacturing? Local assembly? A

customer service representative to answer questions via a local phone call in China? The difference is significant!

The nature of the customer's pain can suggest ways (though sometimes short-term in nature) to address these issues. For instance, you might be able to alleviate the pain by setting up a local warehouse in China versus investing in a full manufacturing facility. This move may buy you valuable time to read the tea leaves and sort out your options without risking your current business to a new competitor.

Get ahead of the curve

Often a short-term fix is temporary and a more substantive response is needed, i.e. localizing more resources, including manufacturing, to China. This move is obviously a serious one and could contain substantial risks for your organization. As a Tier 2/3 supplier, we see several critical "potholes" that you must navigate around (or through) on your road to China:

- You don't know what the *real* market opportunities are in China and you are concerned that your "lead" customer's volume is not enough in the near-term to justify establishing a China facility (and you are likely correct);
- You are unsure of the capabilities and capacities of your China competition and don't know where the bar is being set with your OEM customers (and, more importantly, you are not sure how deep your Chinese competitors are already into these OEMs);

- You possess limited (or no) experience and resources for this type of venture and are not really sure where to begin.

- The mind-numbing fear that you will need to shut down a facility in your home market (and the thought of losing long-term employees in the US) is enough to make you want to stick your head in the sand and hope the problem goes away!

These are all very real issues—particularly the last one—but continued ignorance is not the correct path. It takes a significant commitment of time and money to explore these issues in depth and determine the level of threat to your business which, ultimately, will determine how much risk you should take.

However, there two sides to this coin as there may be significant "reward" on the other side of "risk". For instance, a pre-emptive move could put you ahead of your international competitors and afford you the opportunity to penetrate one of their customers in China. Once you have a lower cost manufacturing facility in China, this asset could open the door to expanding your product portfolio to areas you were not competitive in before. The smaller size of Tier 2/3 suppliers have often forced these companies to be creative by thinking "out of the box" in terms of a structure to set up in China. Contract joint ventures, creative contract manufacturing or even asset acquisitions in China can offer ways to minimize investment while still protecting IP and controlling the market/customer.

A China initiative should not simply be seen as a way to keep your current customers; it should be seen (and explored) as an opportunity for significant growth opportunities, opportunities that are quickly dying out in US markets for many industries.

Know Thyself

The most important thing you can do when faced with these challenges is to know yourself like you never have before, understanding how "ready" you are to take on such an initiative. Elements of this readiness include the following:

Know your motivation, why you are thinking of expanding your business to China. Are you responding primarily to customer "pull"? Competitive threat? Attractive market opportunities? All of the above? The answer will determine how you should expand into China (for instance, if you are responding to competitive threat you might be forced into establishing China manufacturing simply to be at parity with your competitors while to a customer need might allow you to take a simpler first step such as establishing a customer service office).

Is your organization ready to take on a China initiative? Are you "healthy" as an organization with your products, processes and people aligned and working well in your home markets? Do you have a key manager with the authority to make decisions and the free time required to explore a China opportunity? Any China initiative will expose weaknesses in even the best organizations so be prepared to recognize and deal with them.

How "risk averse" is your company culture? Do your management team and shareholders thrive on risk and big decisions or is there often a lot of hand wringing at even the smallest of challenges? Neither is necessarily a prerequisite to be successful in China—both the cowboy and the cautious have done well in China—but it *will* affect how you go about your expansion.

How open is your company to working with other resources to accomplish your goals? Are you a do-it-yourself kind of company or are you comfortable with strategic partners, indirect sales resources, consultants, etc. to accomplish your goals? Your China initiative will invariably partnering with local Chinese resources of some kind, from cooperating with government officials to smooth your way into China all the way to doing a joint venture with a key China competitor and working together to serve global markets.

Know before you go. All of these issues (and many more besides) will determine the form of investment you will need to make and the way to go about such an investment. Never underestimate the depth of knowledge that will be required—from China market intelligence to a deep understanding of your strategic intent and your company's ability to execute a China initiative, you will never suffer from an over abundance of information and insight.

What about Bob?

But really, what does this all mean for Bob Stacey and Ramsey Inc? Well, clearly it is serious; whether he knows it or not, all of Bob's OEM customers are either already in China in a significant way or are

considering moving more sourcing to China. Ramsey (and, indeed, most Tier 2/3 suppliers) face exposure to losing significant pieces of business to Chinese competitors. And it is not just China business that is on the table—global business is up for grabs as Chinese companies are proving themselves to their OEM customers and are showing they can be truly global players.

But all is not lost for Ramsey. They still have very strong customer relationships and, clearly, BigCo wants to see Ramsey expand to support BigCo's global business. The chances are very good that, when Ramsey understands their China opportunities and threats and has crafted a good expansion strategy, they will have a listening and cooperative ear in BigCo and other large OEMs. In fact, our experience tells us that larger OEMs are nearly desperate for visionary suppliers and will go to great lengths to find new and mutually profitable ways of working together. It does not take any great stretch of imagination to see opportunities for Ramsey to grow their business through this challenge. What does the China challenge mean for Ramsey and other Tier 2/3 companies? Maybe a recharged, growing and dynamic company. That is news that will make any CEO's day.

This article was written by Technomic Asia, a Shanghai based market strategy firm. Technomic Asia has assisted over 140 multinational firms with their China growth strategies across a wide range of industries. This article is one in a series on myths about China business. For further information, please contact Kent D. Kedl, Executive Director, Technomic Asia at kkedl@technomicasia.com. You can also visit our web site at www.technomicasia.com.