State of Strategic Sourcing 2006

"The Asian Sourcing Boom: How Long Will it Last"

Boston Logistics Group help manufacturers, logistics providers, and operations-focused service businesses build lean supply chains by leading strategic sourcing, logistics optimization, and custom research initiatives. We provide:

- **Strategic Sourcing Programs –** metrics, benchmarks, forecasts, supply market analyses, and comprehensive strategic sourcing programs
- **Logistics Optimization Tools** – process design and custom software solutions for efficient inbound, production, assembly, and outbound product flows
- **Custom Research** – sponsored educational research, papers, and presentations on best practices in operations management

David Jacoby, President of Boston Logistics Group, coordinates this annual study. He has consulted worldwide on supply chain management for 17 years. Previously he was with A.T. Kearney, where he was instrumental in developing several practice areas, including Strategic Sourcing, Logistics, and Transportation. Before that, he analyzed mergers, acquisitions, and trade flows in the Maritime and International Trade Group at TBS and consulted for the World Bank in Tunisia. He has lived in France, Brazil, and China, and speaks French and Portuguese. David received an MBA from the Wharton School and a Masters in International Business from the Lauder Institute. He is Certified in Purchasing (Lifetime CPM), Production and Inventory Management (CFPIM), Integrated Resource Management (CIRM), and Logistics (CTL). He is President of Boston APICS and Past President of the Council of Supply Chain Management Professional's (CSCMP) New England Roundtable, and is a member of the Institute for Supply Management (ISM). He is a Contributing Editor at The Economist Intelligence Unit and speaks regularly on purchasing, transportation, and logistics. He can be reached at djacoby@bostonlogistics.com.

This report summarizes the results of Boston Logistics Group's 2006 strategic sourcing study. The identities of participant companies and some company references have been removed. For a comprehensive edition, inquire about becoming a sponsor. For industry or commodity benchmarks and sourcing workshops, email info@bostonlogistics.com.

Available Upon Request

Results by Industry	Results by Supply Chain Type™	Results by Commodity
• Aerospace & Defense • Automotive & Transportation Equipment • Chemicals/Plastics • Consumer Goods • Distribution & Wholesaling • Electrical & Electronics • Machinery & Equipment • Metals & Minerals • Paper, Pulp & Packaging • Pharmaceuticals & Life Sciences • Professional Services • Retail • Telecom Equipment • Transportation & Logistics	• Customer Direct/Retail • Physical Distribution • Continuous Flow Manufacturing • Design to Order Manufacturing • Discrete or Batch Manufacturing • Pure Services	• Chemicals/Plastics • Contract Mfg • Electronics • Hardware • Metals • MRO • OEM • Office Supplies • Paper & Packaging • Parts & Equipment • Professional Services • Services – Non-Professional • Services – Professional • Transportation

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1 EXECUTIVE SUMMARY

Are your sourcing operations delivering innovation as well as low cost? Are you sourcing from the right locations and the right suppliers? How long will the Asian sourcing boom last?

Boston Logistics Group's 2006 study of executive perspectives on strategic sourcing probed the goals and the relative success that companies had with partnering and long-term contracting, as well as low-cost country sourcing. The annual study has received approximately 300 responses since its inception, including 100 this year. A third of the respondents come from Fortune 1000 companies, and about half hold Vice President or Director-level supply chain positions. The average company has $2.8 billion in annual sales, and companies of all sizes are represented, from those with more than $20 billion to those under $50 million.

Key findings of this year's study include the following:

1. Twenty percent of companies source from low-cost countries today, and those that do save 18%. The practice has set a new threshold of cost-efficiency that others must match, either through low-cost country sourcing or by finding other ways to pare the cost of conventional sources.
2. Companies plan to increase the proportion of spend in low-cost countries to 34% within five years. Those that are sourcing 20% or more of their spend in low-cost countries will invest 2.3 times their annual savings in expanding their global sourcing capability.
3. The top challenges related to low-cost country sourcing are: 1) developing a global sourcing process and staff to identify qualified suppliers; 2) managing the gap in culture, communications, and values; and 3) maintaining visibility and control over the supply chain.
4. China will be by far the most attractive low-cost country in 2011, according to 60% of the respondents. India and Vietnam are distant runners-up, with 18% and 10% of respondents, respectively, rating them the best sourcing option in five years.
5. To the extent that offshoring emphasizes relatively lower-technology parts and services, buyers will rely on strategic suppliers in developed countries to help them achieve faster rates of innovation in product and service design and delivery.

Based on these findings, operations executives should respond aggressively precipitating breakthrough cost reductions and tapping supplier innovation for balanced growth. They should:

1. Ensure low cost, either by establishing an offshore supply base in appropriate categories, or by finding alternatives for reducing domestic costs by 18% or more.

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2. If sourcing from a low-cost country, plan operations thoroughly in order to ensure adequate quality, preserve intellectual property, and develop reliable transportation links.
3. Groom top-notch suppliers and encourage them to collaborate in the design, building, and introduction of new products and services.
4. Partner with an anchor supplier in each category, and expect that supplier to offer product and process innovation, faster design and product or service launch, and flawless execution.
5. Automate transactional, low-value supply relationships to gain efficiencies and channel scarce resources toward higher value-added relationships.

Simultaneous and sustained progress on both cost reduction and robust innovation is likely to spur a period of dynamic growth that will further extend the influence of operations management within the corporation.

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2 STUDY APPROACH AND RESPONDENT PROFILE

Boston Logistics Group conducts an annual survey asking supply chain managers and executives about their partnering, contracting, and sourcing practices and plans. Approximately 300 companies have participated in the survey since 2004, including 100 this year.

The survey asked 26 questions. One part of the survey dealt with contracting and partnering. A second part dealt with low-cost country sourcing. Some data was collected in brackets (0-3%, 4-6%, etc.) to pre-empt sensitivity concerning disclosure of confidential data. The numbers within the brackets were converted to point values (0-3% was translated to 1.5%) for purposes of comparison.

Many of the participating companies are household names. Since survey participants are promised confidentiality, Figure 1 gives generic descriptions of the companies.

The average company has $3.7 billion in annual sales. The sample contains a broad mix of industries, shown as a percent of the total sample in Figure 2. Companies of all sizes are represented, including those with $20+ billion to those under $50 million, as shown in the distribution in Figure 3. A third of the responses are from Fortune 1000 companies.

The survey sample was international and represented 14 countries including the United States, Brazil, Canada, Dubai, Finland, France, Germany, India, Japan, Netherlands, New Zealand, Sweden, and the United Kingdom.

Approximately half of the respondents hold Vice President or Director-level positions in Procurement or Supply Chain, as shown in Figure 4. Figure 5 shows some of the titles represented.

The respondents buy a wide range of raw materials, parts, and finished goods, as shown in Figure 6.

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Figure 1: Representative List of Participating Companies

Aerospace & Defense

- Avionics manufacturer
- Shipbuilder
- Aircraft parts manufacturer

Automotive & Transport Equipment

- Automaker
- Tire manufacturer
- Power transmission manufacturer

Contract manufacturing

- Contract electronics manufacturer
- Construction company
- Electro-coating company

Chemicals & Plastics

- Plastics company
- Agribusiness manufacturer
- Smelting and recycling company

Consumer Products

- Spirits producer
- Processed food manufacturer
- Home accessories company

Distribution & Wholesaling

- MRO distribution company
- Wholesale grocer
- Logistics company

Electrical & Electronics

- Instrument manufacturer
- Consumer electronics company
- Lighting and wiring manufacturer

Machinery & Equipment

- Semiconductor equipment mfr.
- Electronic circuit machinery mfr.
- Printing press manufacturer

Instrumentation & Devices

- Particle analysis equipment mfr.
- Spectrometer manufacturer
- Lab equipment manufacturer

Paper, Pulp, and Packaging

- Paper manufacturer
- Lumber products distributor
- Office supplies manufacturer

Pharmaceutical and Life Sciences

- Pharmaceutical manufacturer
- Biopharmaceutical research firm
- Drug dispenser solution company

Professional Services

- Financial services company
- Insurance company
- I.T. outsourcing firm

Retail

- Multinational grocery chain
- Wireless technology retailer
- Department store holding company

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Figure 2: Responses by Supply Chain Type™

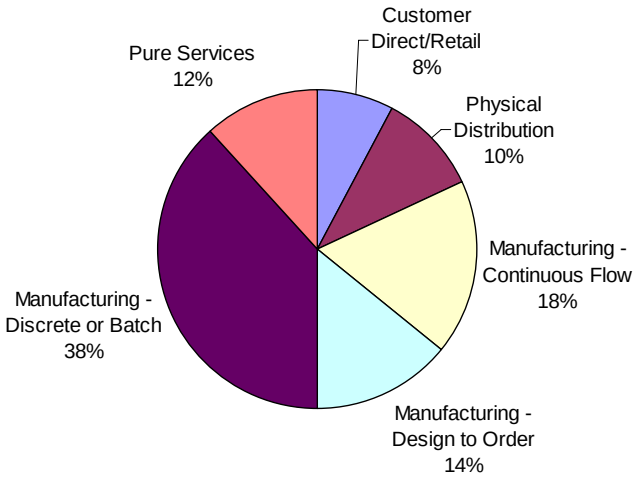

Figure 3: Responses by Company Size

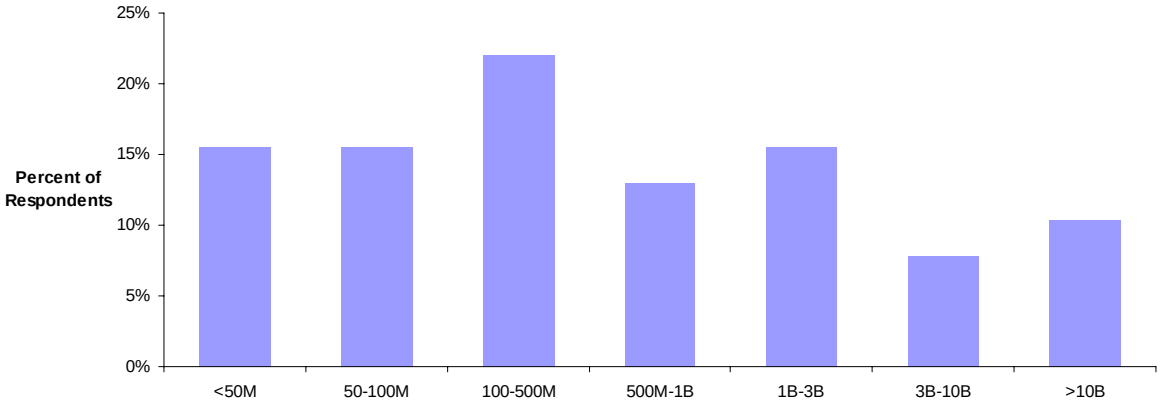

Figure 4: Respondents by Position

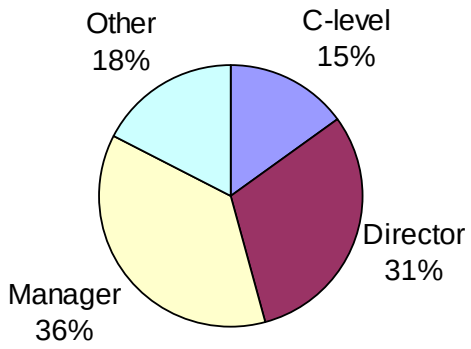

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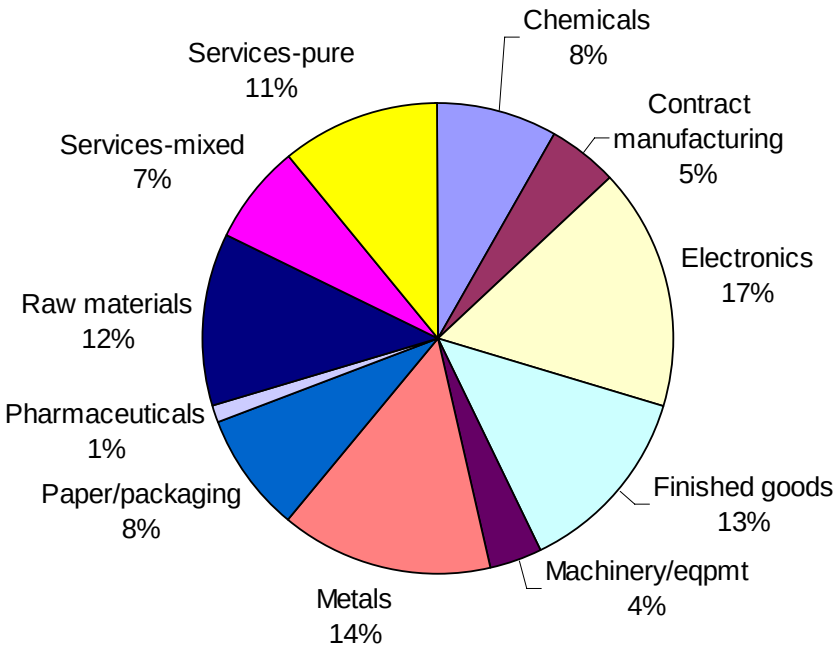
Figure 5: Sample of Participants' Job Titles

Executive / Vice President	Director	Manager
• Controller • Chief Purchasing Officer (CPO) • Senior Procurement Officer • Senior Vice President of Supply Management • Vice President, Global Supply Chain Management • Vice President, Planning • Vice President, Sourcing • Vice President, Supply Chain and Logistics	• Director, Operational and Technological Services • Director, Strategic Sourcing • Director, Supply Chain Management • Director, Commodity Management • Director, Global Procurement • Director, Logistics • Director, Materials • Director, Contract Manufacturing • Director, Operations Management • Director, Purchasing • Senior Director, Operations and Global Supply Chain	• Global Procurement Support Manager • Global Sourcing Manager • Global Supply Chain Manager • Group Global Outsourcing Manager • Manager, Purchasing • Manager, Sourcing/MRP • Manager, Strategic Sourcing • Manager, Transportation Procurement • Materials Manager • Operations Planning Manager • Procurement Contracts Manager • Procurement Manager • Product Manager • Senior Director, Sourcing • Supply Chain Manager

Figure 6: Respondents by Principal Commodity Bought



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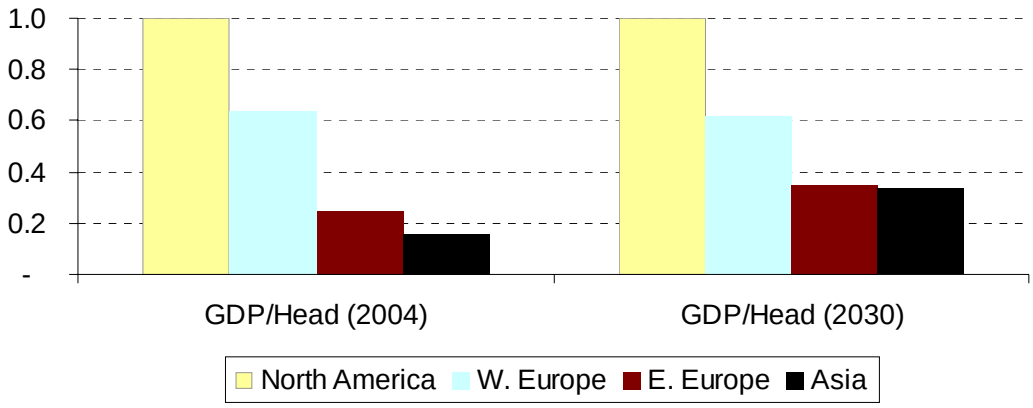
3 TOWARD A NEW COST STRUCTURE

Companies across a wide variety of industries will increasingly be under pressure to lower prices in response to the increasing saturation of mature marketplaces – especially in the developed West – and availability of low-cost offshore alternatives for manufacturing – notably in Asia.

Western and developed economies have more wealth and purchasing power than their developing counterparts, but will grow at slower rates over the next 20 years (see Figure 7). The slower growth will be accompanied by increasing competition and more discount retailing.

Figure 7: Wealthy but Slower-Growing Western Economies



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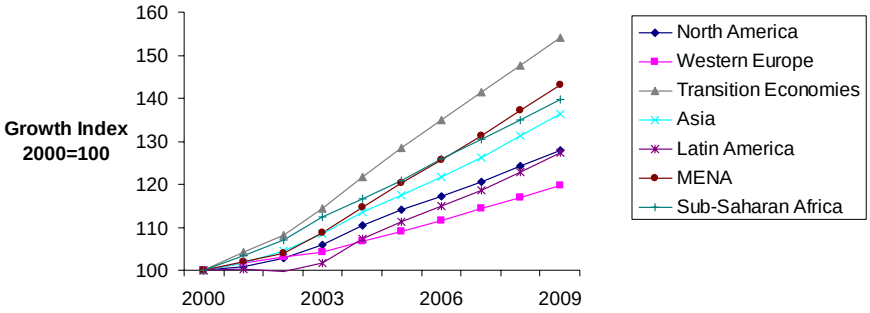
Meanwhile, transition economies in Eastern Europe, the Middle East, and Northern Africa will significantly outpace growth in the developed world, particularly over the next three to five years (see Figure 8[1]).

Figure 8: Rapid and Faster-Growing Developing Economies



Asia in particular is developing not only through strong internal growth but as a viable supply base for the West as well. With a sizable and burgeoning middle class, a larger pool of educated engineers than the United States, and a rapidly maturing industrial base, countries like China are becoming viable sources for many raw materials, consumer goods, and, increasingly, high-technology services.

While Asia represents approximately 60% of the world's population, it currently accounts for only 10% of the world's retail sales. An increasing interrelationship between these and Western economies will ensure that Asian countries will comprise a stable, long-term supply base for Western companies.

To take advantage of the cost differential, many Western companies are sourcing from low-cost countries. The shift is frequently driven by the reality or the perception that their competitors have already established, or are in the process of establishing, a cost advantage through low-cost country sourcing (LCCS).

[1] Global Outlook, The Economist Intelligence Unit, 2005.

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The study's respondents currently source 20% of their external spend from low-cost countries (see Figure 9).

Figure 9: Extent of Low-Cost Country Sourcing Today

Percent of Spend in Low-Cost Countries	Percent of Respondents
More than 50%	6%
40-50%	5%
30-40%	8%
20-30%	9%
10-20%	23%
0-10%	46%
Average	**20%**

The companies that source more than 20% of their spend in low-cost countries (31% of the respondents) save 18% by doing it, after netting logistics and associated costs (see Figure 10). Overall, they save an average of 13% compared to their traditional "onshore" alternatives.

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Figure 10: Savings from Low-Cost Country Sourcing

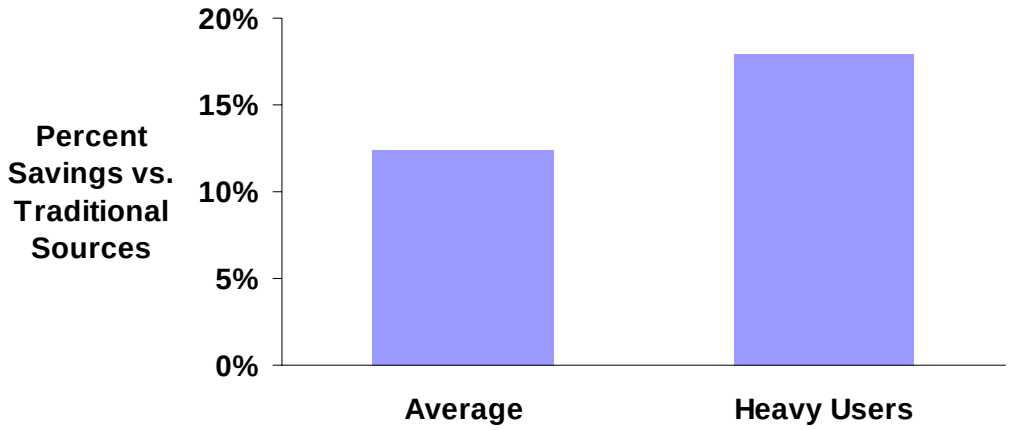
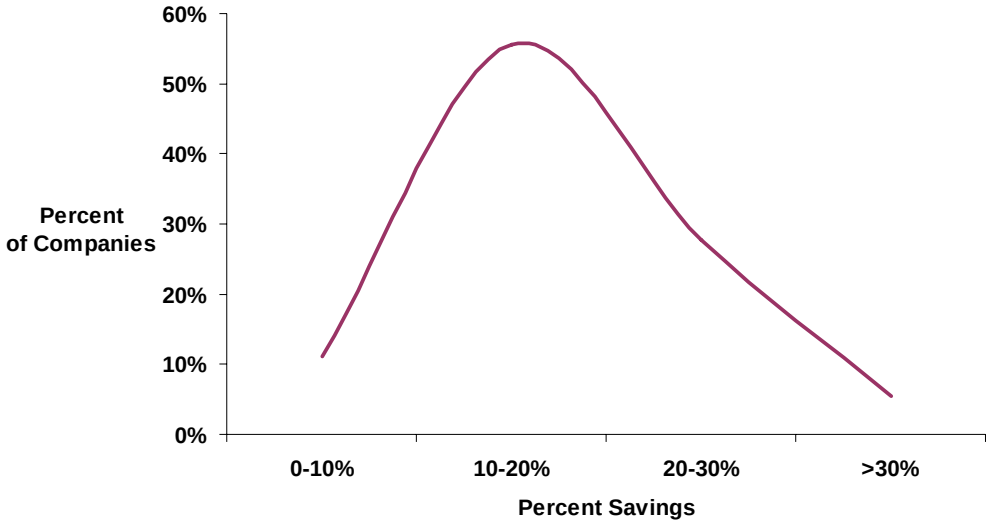


Figure 1 shows the distribution of savings for those that source more than 20% of their external spend from low-cost countries.

Figure 11: Distribution of Savings from Low-Cost Country Sourcing



The savings is so significant that it puts companies that are *not* sourcing from low-cost countries in the near future on the defensive to cut costs to a similar extent or else to justify a premium market positioning.

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4 GOING LONG: INVESTING IN LOW-COST COUNTRY SOURCING

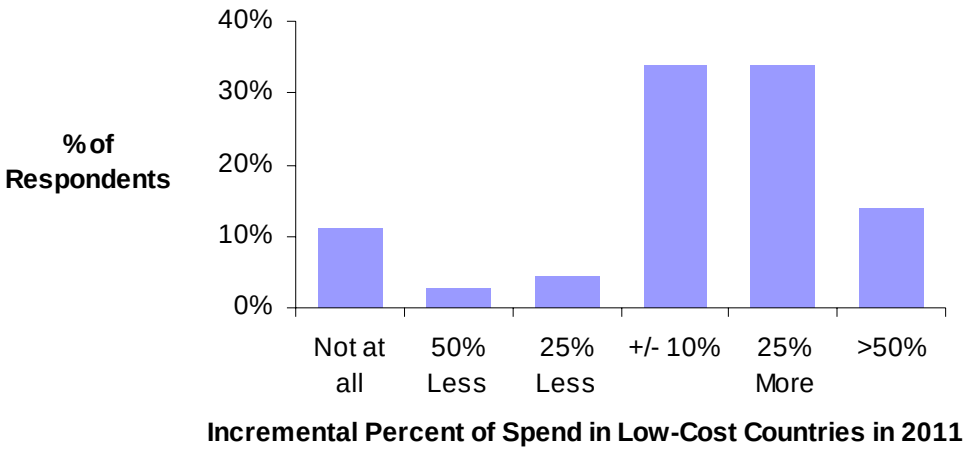
Companies that source more than 20% from low-cost countries are investing 2.3 times their annual savings in developing an infrastructure for low-cost country sourcing, as shown in Figure 12. Considering that the annual savings of those that source more from low-cost countries is higher than those that don't (18% compared to the 13% average), they are actually investing more than three times as much (2.3 x 18/13) as the average. The investments include, for example, plant and equipment, consulting and legal expenses, local and expatriated staff, and offices.

Figure 12: Investment in Low-Cost Country Sourcing as a Multiple of Annual Savings

Percent of Respondents	Investment
66%	0-1x
20%	1-2x
11%	3-5x
0%	6-10x
4%	>10x

Respondents overall intend to send another 14% of their spend to low-cost countries over the next five years, which will increase the percent sourced there from 20% to 34% by 2011 (see Figure 13).

Figure 13: Low-Cost Country Sourcing in 2011 – Change from Today



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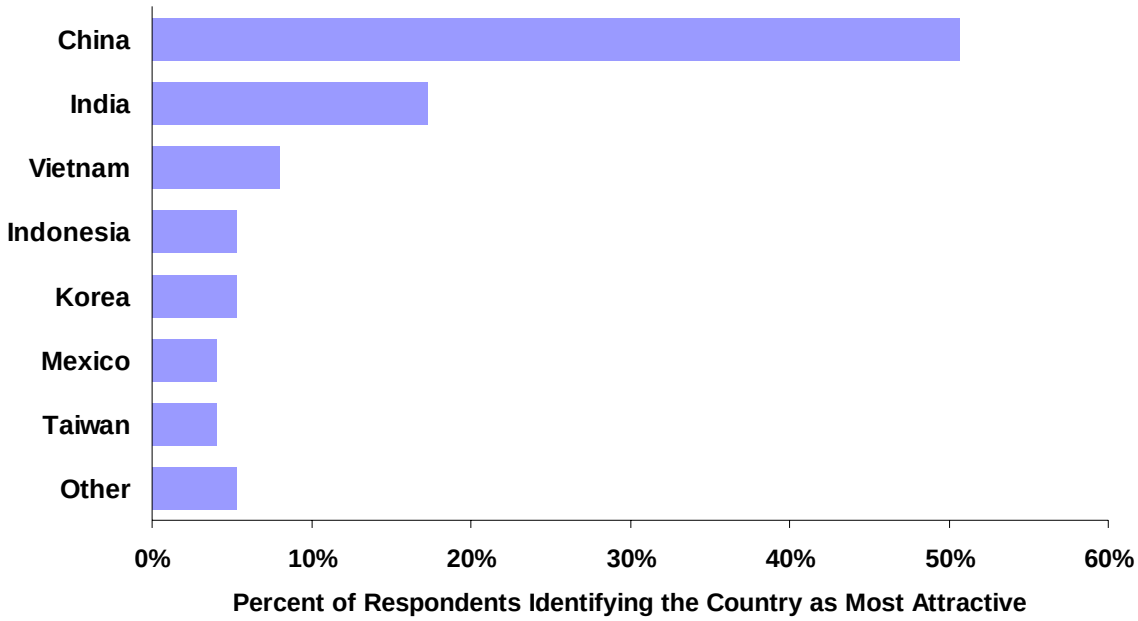
5 CHINA, CHINA, CHINA

By far, respondents voted China as the most attractive country to source from in five years' time. India and Vietnam lagged far behind at 18% and 10%, respectively (see Figure 14).

Figure 14: Country Attractiveness as a Sourcing Platform in 2011



Companies that source from Chinese suppliers divide the country into three regions:

- Northeast China (the Beijing-Tianjin Bohai Rim)
- Central China (the Yantze River Delta)
- South China (the Pearl River Delta)

Northeast China is a sourcing area for Motorola, Proctor and Gamble, General Instruments, GM, Michelin, IBM/Levono, Microsoft, NIKE Beijing, Energizer (China) Co., Ltd; ITT Industries (Tianjin), and Maytag International. Northeast China comprises a multitude of major cities – here are some snapshots of major cities and their economic base:

- Beijing city is a site for many national and corporate head offices due to its proximity to government ministries.
- Shandong Province is known for its fruit and agriculture processing.
- Dalian city industries export products to Japanese and Korean markets.
- Tianjin city has a strong manufacturing and export base, particularly in steel, shipbuilding, automobiles, construction, chemical engineering.

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- Shenyang city, Changchun city and Jilin province are homes to a variety of automotive, pharmaceuticals and engineering firms.
- Harbin is a large lumber-processing city.

Central China has sourcing locations for AT&T, Target, Gillette, Oregon Scientific, Kimberly-Clark, Johnson and Johnson, and Microsoft. Like Northeast China, it is composed of many cities, each with its own economic base:

- Shanghai city has strong representation from steel, automobile, textile, banking, chemical engineering, ship building, real estate, construction, telecommunication.
- Nanjing and Wuxi cities have component manufacturing in auto and other related industries.
- Suzhou city is a textile/garments and IT center.
- Hangzhou city makes textile and garments, as well as component manufacturing for the electronics industry.
- Ningbo city is also strong in textiles and garments, export processing, IT, and component manufacturing.
- Hefei city has a substantial agriculture and fruit processing industry.

South China saw the earliest investment of Western companies. It is now where Wal-Mart, GE, GM, IBM/Levono, Dell, NIKE, Proctor and Gamble, Citigroup, Lehman Brothers, Goldman Sachs, Michelin, Maxwell, Honeywell, and General Instrument have facilities.

- Guangzhou exports many consumer products, electronics, computer parts, automible, textile and garments, heavy machinery, shipbuilding, and IT services.
- Shenzhen and Donguan also export consumer products, electronics, computer parts, and garments.
- Hong Kong is a world capital for shipping and logistics, banking, telecommunications, component manufacturing, and IT services.

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6 OVERCOMING THE HURDLES

Supply chain professionals that source from low-cost countries face a number of challenges and risks. Based on the survey results, the top challenges faced by companies sourcing in low-cost countries are:

1. Developing a global sourcing process and staff
2. Managing the communication, culture, or geographic knowledge gap
3. Ensuring product or service quality
4. Maintaining visibility and control over logistics and inventory

The top risks, some of which are clearly related to these challenges not being met, are:

1. Late or no delivery
2. Loss of intellectual property
3. Supplier failure to meet agreed standards
4. Unfavorable economic or currency shifts

Based on the top challenges and the top risks, three integrating themes are explored below: 1) developing a global sourcing process; 2) minimizing supply chain risk; and 3) safeguarding intellectual property.

6.1 Developing a Global Sourcing Process

Many Western companies find qualified foreign partners through referrals and connections, internet portals, trade shows and expos, traders and agents, and publications. Figure 15 depicts how many of them progress from the information-gathering phase through implementation and control.

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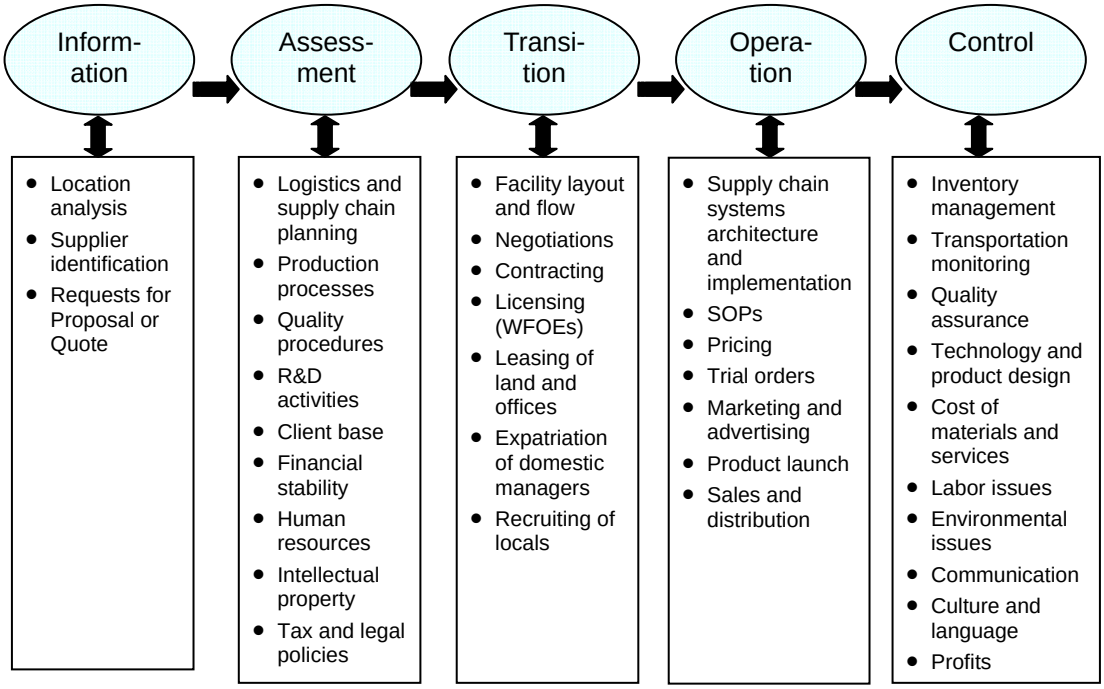
Figure 15: Low-Cost Country Sourcing Process



To mitigate the risk of non-performance in the transition and operating phases, some companies offshore only low and mid-grade specification material and products first, and only offer the offshore suppliers technically complex and higher-risk materials or services once the suppliers have proven their capability and reliability. One company in the study divided its purchased materials into three levels of complexity, and is awarding its Chinese suppliers only the low and medium complexity products until they prove their ability to produce consistently to the required quality levels.

6.2 Designing Reliable Supply Chains

Once suppliers are qualified, the locus of risk shifts to the supply chain since LCCS usually involves long in-transit pipelines.

Transportation can make the difference between sourcing from overseas being economically viable or not, accounting for 20% of the total landed cost of product sourced from Asia, according to survey respondents. Most of the transport cost is due to international ocean freight, which accounts for 12% of the product cost, while source country inland transport cost accounts for another 8%. Many companies still buy product on a delivered basis, which is the surest way to eliminate the many cost and transit time uncertainties of international ocean transportation.

Once in the US, West Coast port congestion was a substantial risk but is now less than it was in 2004 or 2005. "Congestion is in the low range on all EC and WC ports," says one shipping executive. And experts rate all US ports as freely flowing as of the writing of this

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paper, which is a low-volume period. The improvement compared to 2004 is due to several factors:

- Ports and intermodal carriers have made strides to increase turntimes through new investment and process improvement. Take, for example, these initiatives from BNSF:
  - Requiring terminal operators at the ports to release full trainloads instead of partial trainloads
  - Differentiating between northern and southern trains by specifying that they must consist of cars destined for either northern (Kansas City, Chicago, or the Northeast) or southern St. Louis, Texas, Memphis, the Southeast and Florida) stations, but not both.
  - Encouraging the use of northern ports (Oakland, Tacoma, Seattle, and even Portland)[2] for Northern-bound cargo in order to reduce "block swaps," or en-route transfers, thereby increasing average train speed.
  - Increasing the percentage of railcars that it loads on-dock. This figure was 50% in 2004, 60% in 2005, and is currently near 70%, resulting in dwell times of one day or less for mini-landbridge traffic, compared to three days for local traffic.
- Some shippers have shifted their volume northward. The Port of Seattle was North America's fastest growing container port in 2005, according to the port and industry experts – volume grew at 18% in the year. Some shippers even consider Portland or Vancouver to be options, and one construction company shifted its volume southward to Mexico.
- Other shippers have avoided the West Coast entirely by shifting to all-water routes through the Panama Canal to the East Coast. The transit time is longer, however (see Figure 16). These shippers are often hauling low-value freight such as Christmas ornaments and Christmas trees that are inexpensive to carry in inventory.
- Overall, West Coast ports expect to increase their capacity by at least 50% over the next 10 years, according to one rail official, in order to keep ahead of the growth in volume.

Despite the improvements, most experts agree that this autumn will be challenging. Volume continues to grow each year, and retailers continue to ship closer to the time the merchandise will be needed to save on inventory carrying cost. The combination means a risk of demand peaking during a narrow time interval, and a related risk of capacity shortfall.

[2] To the extent that Northern ports work well in the customer's network and the customer is interested in diversifying away from Los Angeles/Long Beach.

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Figure 16: Representative Transit Times from Asia to US Ports

Managing in-transit inventory is "still a pretty manual process," as a trading company characterizes it. The ultimate challenge is being lean and importing from Asia at the same time. American companies commonly face two challenges: handling small orders and less-than-containerload shipment sizes cost-efficiently, and streamlining the logistics network after offshoring.

- Small lot sizes and small order quantities increase the transportation cost per shipment and decrease the viability of the offshore solution. The concept of a lean supply chain with small order quantities is becoming economically viable through services like UPS's Trade Direct.
- Some US companies – including an accessories company and a device manufacturer – have sent manufacturing to China but not completed adjustments to their distribution networks, resulting in redundant product flows. They ship some of their finished products from China to their US distribution centers, then ship them back to China for sale.

6.3 Intellectual Property Risks

Intellectual property has been a concern of companies sourcing from overseas for a long time. Chinese companies have arguably been less concerned with intellectual property than firms from other countries: Japanese and Korean firms have 40 times more patent applications pending in China than do native Chinese firms, according to US trade officials.

Certain recent cases have highlighted the significance of the Chinese intellectual property issue for Western companies. Gaxinqi is one of them. According to E. Anthony Wayne, Assistant Secretary for Economic and Business Affairs, this Hong-Kong handset manufacturer's telephone was directly copied by a Chinese rival, and the rival sold to its customers at lower prices, stealing most of Gaxingqi's otherwise growing business. Gaxinqi is suing in Chinese court.

Most experts agree that Chinese businesses will increasingly come to respect intellectual property rights as the country becomes more and more interdependent with Western firms. Intellectual property protection has improved in China since its accession into the World Trade Organization (WTO) in 2001. However, it will take many such cases to overcome a practical precedent that has ignored or heavily discounted intellectual property rights.

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China: Proactive Intervention is Improving Intellectual Property Protection

Almost ten years ago, China's Supreme Court amended that country's Patent Law, Trademark Law and Copyright Law, and formulated other intellectual property laws and regulations. Hallmark legislation included regulations on the protection of new plant varieties and the layout designs of integrated circuits. With some of these changes in place, China joined the accession into the World Trade Organization (WTO) in 2001.

Since joining the WTO, China says that the number of intellectual property infringements has declined significantly, and that the climate for foreign investment has been improving. It points to this evidence:

- The seizure of 163 illegal CD production lines
- The destruction of 42 million smuggled and pirated CDs during the Campaign for the Destruction of Smuggled and Pirate CDs carried out by the Customs General Administration and the State Administration for News and Publications
- The training of judges in science and technology, including study in the US or Europe, and increased opportunities for judges to communicate with their foreign counterparts
- Intensifying legal publicity activities via news coverage, television and broadcasting, and symposiums, including publicity of the top 10 intellectual property cases each year
- The establishment of intellectual property education in national colleges

According to Chinese officials, these measures have enhanced awareness of intellectual property issues, and have laid a solid foundation for comprehensive legal protection and enforcement by preventing future criminal activities and malpractice.

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Western Experiences and Efforts to Protect Intellectual Property

Despite the fact that some countries have beefed up their intellectual property laws in recent years, Westerners are still concerned that the penalties are light and many countries lack enforcement measures or enforcement capability.

Many foreign companies regard intellectual property penalties as a "cost of doing business," according to Semiconductor Industry Association President George Scalise. Judgments issued by Chinese courts in 2005 are mostly in the tens of thousands of dollars – paltry by Western standards. The problem is not confined to China. Developing countries frequently have relatively weak intellectual property protection. Moreover, when businesses export counterfeit products, the recipient countries more readily become platforms for the same type of violations.

The problem is particularly severe for copyright-sensitive businesses. According to E. Anthony Wayne, Assistant Secretary for Economic and Business Affairs, copyright-based sectors, including industries such as pharmaceuticals, software, electronics, and media, now account for about five percent of the total US economy, and are growing rapidly.

US trade officials are working toward greater intellectual property protection for US businesses around the world, and point to these evidence of their success:

- Hong Kong: authorities passed an effective optical disk law that shut down pirating production lines and drove pirating distributors out of business.
- Singapore: local authorities shut down "night markets" that sold pirated merchandise.
- Greece: legislators passed tougher enforcement laws that have led TV stations to stop showing movies without paying royalties.
- United Arab Emirates: local authorities raided stores selling pirated computer software and ended piracy of U.S. pharmaceutical products.

However, international trade and low-cost country sourcing are expanding faster than enforcement can keep pace, ensuring that intellectual property risk will remain a factor in sourcing overseas for decades to come. The upshot: Western firms need to understand and manage that risk as part of their sourcing processes.

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6.4 Tips for Low-Cost Country Sourcing

When asked about lessons it has learned, one company said that it went "too deep, too fast." As a result, it gave the wrong suppliers in the wrong countries the wrong business. "With 5,500 components in a part, you can get buried very quickly," he says.

Well-planned, methodical, and progressive transitions help to minimize the risks of sourcing from low-cost countries. Some advice from experts:

- Use partnerships, mergers, and acquisitions to leverage others' expertise and reduce the risks. Don't go it alone.
- Build intellectual property protection into the business process. Don't rely only on legal solutions.
- Master the relationship building ("guanxi") before contracting. Don't assume that the written word is the definitive authority.
- Develop suppliers to minimize process variability and manage finished product quality variances. Don't assume the required capabilities exist already in the marketplace.
- Conduct spot audits and inspections before product is shipped. Don't expect foreign sources to apply Western standards of quality and reliability.

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7 BALANCING LOW COST AND INNOVATION

If low-cost country sourcing accounts for 20-34% of spend, then domestic, strategic, and other suppliers whose business will not be offshored account for 66-80% of the spend. How will offshoring affect the relationship with these suppliers?

With lower-technology items and services being the first to be processed offshore, these strategic suppliers will provide the engine of innovation, offering their customers faster speed to market and greater access to ideas and innovation than their offshore counterparts.

Accordingly, procurement and supply chain professionals will increasingly seek top-line, not just bottom-line, value from these suppliers. Take these case studies, for example:

- The CPO of a major metals company says: "It's about value, not just cost. You've got to use the full resources of the supplier," according to a recent study.[3]
- The CPO of a major international hotel chain speaks of the greater inter-dependency and more frequent collaboration between buying and supplying organizations. The speed of product innovation, customization, and service will be a more significant key success factor in the future, he says.
- The Senior Vice President of a major consumer products company speaks of the need to work with suppliers that "add design power, not just arms and legs.[4]"

While last year's State of Strategic Sourcing study showed a preference for dual-sourcing, buyers are increasingly focusing on partnering with a single supplier. Forty percent of study participants are choosing to single-source (see Figure 17) in order to simplify their relationships and to realize creative synergies with their trading partners.[5] For example, a switch and connector manufacturer is single sourcing to reduce administrative costs, provide an easy and simple product pricing structure, and achieve economies of scale. The company is realizing an increasing amount of collaboration with its suppliers in demand forecasting, shipment visibility, and sharing of proprietary information. Also, a construction company's suppliers are increasingly involved in the design phase of its projects.

[3] Jacoby, David. The New Face of Purchasing, The Economist Intelligence Unit, 2005.
[4] Jacoby, David et al. Foresight 2020: Economic, Industry, and Corporate Trends, The Economist Intelligence Unit, 2006.
[5] Some also single source due to long development leadtimes, high transportation costs, stringent technical requirements, or expensive tooling.

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Figure 17: Single Supplier Strategy

Strategy	Percent of Companies
Sole Supplier/No Choice	12%
1 Supplier Strategy	40%
2 Supplier Strategy	31%
Other Strategy	18%

Despite the trend toward single-sourcing, 31% of companies still prefer to have two suppliers. For example, a trading company in the study dual sources because no one supplier can supply the wide number of SKUs that it sells. Others may do it to mitigate the risks of price gouging; quality problems at a sole manufacturing site; product unavailability due to a fire, flood, or other natural disaster; equipment unavailability during peak periods; and supplier financial difficulties.

For their part, suppliers will invest more in their customer relationships, in owning the "pole position." As such, procurement will increasingly require them to participate in the long-term growth of the product or service that they are being asked to supply. For example, a US supplier of food products to grocery chains company is increasingly investing in new product development and measuring product profitability to support its customers' need for rapid product innovation and razor-thin profit. Also, a supplier to a major US retailer routinely monitors the performance of its products' sales, promotions, and prices via the retailer's web portal. Based on the information available to both the customer and the supplier, the supplier manages its business with the retailer proactively.

As partnerships become more widespread, managing their inherent risk will be key. Supply partnerships must entail risk in order to generate the kind of innovation and ultimate reward that they are designed to create. However, that risk will be increasingly measured and managed. "Risk will get a lot more attention in the future," according to one CPO.

One risk in partnering relates to long-term contracting. Buyers are increasingly asking suppliers to share in the costs and risks of product development and introduction, and long-term contracting saves companies 6.5%, according to respondents. However, it sometimes also requires investment and volume or term commitments. One company in the study has risk-mitigating contract clauses related to price escalation, consignment, vendor-managed inventory, warranty, scrap, and freight.

Fifty-one percent of respondents said their longest contract is two to three years. But what is the ideal length of a contract? Some consider a long-term contract to be two years, while others say five or even 10 years is long-term. A decision analysis tool offered by Boston Logistics Group helps buyers decide the ideal length of contract by balancing the risk of

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over-committing against the benefit of securing a guaranteed lower price for a guaranteed high volume or a long period of time.

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8 IMPLICATIONS FOR SUPPLY CHAIN PROFESSIONALS

Maturing and increasingly saturated markets will pressure companies in developed markets to compete more on cost. At the same time, rapidly growing economic and industrial capabilities in developing countries, especially in Asia, will look outward to market their products and services.

As a result of the two trends, companies in developed countries will source from low-cost countries for many years to come. Currently, companies are sourcing 20% of their external spend from low-cost countries, and they expect to increase that to 34% within five years.

Procurement professionals will increasingly count on a critical subset of the remaining 66-80% of suppliers to be innovation partnerships that help drive top-line growth as well as bottom-line performance.

Given the dual imperatives of achieving breakthrough cost reductions and partnering for innovation, supply chain professionals should implement these "best practices" to remain competitive over the next three years:

1. Ensure low cost, either by establishing an offshore supply base in appropriate categories, or by finding alternatives for reducing domestic costs by 18% or more.
2. If sourcing from a low-cost country, plan operations thoroughly in order to ensure adequate quality, preserve intellectual property, and develop reliable transportation links.
3. Groom top-notch suppliers and encourage them to collaborate in the design, building, and introduction of new products and services.
4. Partner with an anchor supplier in each category, and expect that supplier to offer product and process innovation, faster design and product or service launch, and flawless execution.
5. Automate transactional, low-value supply relationships to gain efficiencies and channel scarce resources toward higher value-added relationships.

To create a stable platform for long-term growth, supply management professionals will extend their time horizons and collaborate with internal and external stakeholders to stimulate innovation as well as drive costs to world-class levels.

Simultaneous and sustained progress on both cost reduction and robust innovation is likely to spur a period of dynamic growth that will further extend the influence of operations management within the corporation.

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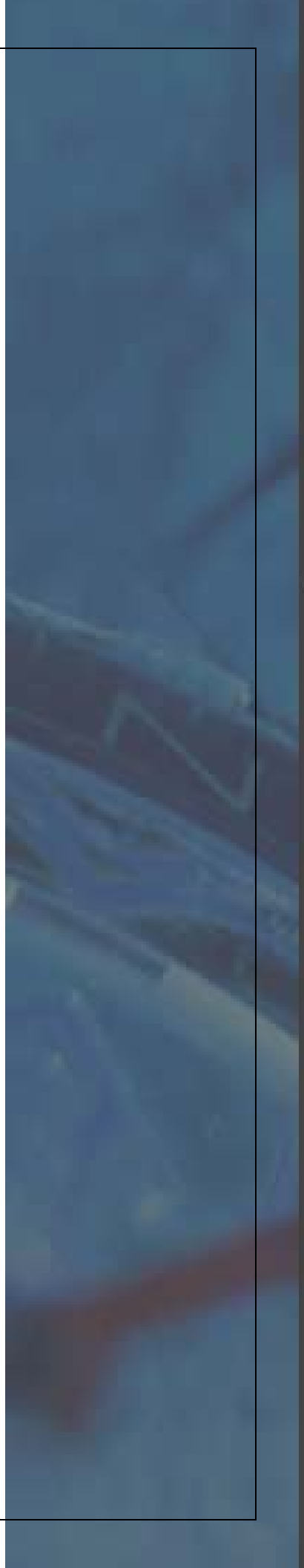

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