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### **When Low-Cost Country Sources Aren't Inexpensive**

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In the spirit of the old adage "That which gets measured gets done," companies in the automotive industry have been setting goals for procurement of goods and services from low-cost countries (LCCs). The premise is that this will spur the companies through the arduous process of identifying, qualifying, and sourcing to suppliers in low-labor-cost or lesser-developed economies. The resulting savings can be significant, and the anecdotal examples that companies cite are always impressive. But there are also concerns in the supply chain management community that setting quantitative targets is the wrong way to go.

The act of setting targets seems to be concentrated at the OEM and large Tier One level. Just to give a few examples, ArvinMeritor's CEO has set an expectation that its light vehicle operations will buy 50% of its parts from low-cost countries by 2008, up from 23% as of 2006. Autoliv's presentations to investors include a graph indicating that low-cost country sources will grow from 19% of purchases in 2006 to 30% in 2007, 40% in 2008, and to 50% in Q1 2008. Faurecia has a "medium-term target" of purchasing 40% of its parts in low-cost countries. The most ambitious goal we have observed is Valeo, whose website touts an objective of 70% of procurement expenditures in LCCs by 2010.

Companies with sales well south of \$1 billion are less likely to be working toward performance on a specific metric for low-cost country sourcing, but they often experience a trickle-down effect, as customers seeking to meet their own targets pressure sub-tier suppliers to contribute to the cause. Some of these smaller companies have a different point of view on the merits of this approach. Objecting to the institution of measurable targets could be ascribed to a variety of character flaws on the part of those reluctant to participate. Resistance to change, lack of rigor, or even laziness could come into play, but there are also some arguments that are worth considering.

- LCC targets can artificially constrain the options. As one supplier said, "These days, the global price could come from anywhere—a desperate U.S. company, or a supplier in any other country. The best price is often used as leverage to get the company that they really want to use to match that. The real company could be anywhere."
- These targets presuppose that an LCC source will always be the most cost-effective. "It depends" is always a useful phrase, even when it comes to evaluating sources. Companies are experiencing unexpected costs with their LCC sources, such as out-of-pocket expenses that can turn into overhead along the way toward obtaining the necessary quality. Also, some suppliers point to occasions where their domestic costs are lower than a foreign source, and they have to argue with customers to accept the fact that the local option is best. It may seem counter-intuitive, but it can be reality even in this day and age when it seems that companies have to go elsewhere to get low costs.
- Not all companies have mastered the evaluation process or properly considered total cost, leading to costly surprises. One company was using its third container's worth of foreign parts when it discovered, as a result of failures in the field, that its Asian source had redesigned a feature without notification. Failure to adequately impress upon the supplier the systems that would have prevented that ended up posing significant additional costs.

- While there are certainly top-notch LCC sources, there are far more companies that cannot yet make the grade. Prospective suppliers are easy to find, but hard to qualify. Companies are finding that sources that pass the basic screening still involve considerable investment in order to bring them in line with the requirements of global automotive customers. It can take a year or two of work with a foreign company before they are capable.

No one is arguing that it is not worthwhile to pursue LCC sources, but there is support for the recognition that case-by-case analysis is critical. Targets that are developed based on a cursory review of what the savings “ought” to be can lead to rewarding the wrong thing, or to unintended consequences. The bottom line is that the process of determining how to increase the amount of purchases from low-cost country sources is at least as important as tallying up the end result, and probably more so. This is because a focus on the process will ultimately serve an automotive supplier better by ensuring the balance of risk and reward.

The methodology for evaluation and apples-to-apples comparison is complex. Identification certainly involves on-the-ground examination of prospective suppliers, or the use of a known middleman that has a network of pre-qualified sources. Factors to consider include actual freight cost, the inventory costs of a long pipeline, risk exposure with components on the water, additional time required for launch, staff retention, and many more. Companies that anticipate long-term relationships believe it is important to consider the “soft side” of “company culture fit” as well as pure cost factors—e.g., do they believe in the same operational excellence that we do, taking care of the customers a certain way, treating associates properly.

Increased support costs also need to be built into the calculation. One company adds 10-15% to the price of a quote from an LCC source to cover additional “support.” Another supplier has said, “It sounds archaic, but we employ a quality inspection company there to accept or reject the product at the factory before shipping. Otherwise, you run into a problem and it is a \$10,000 trip to go over there and argue it out.” Companies say that arriving at a common understanding is an ongoing challenge that produces risk and consumes time.

All told, the globalization of the economy will drive movement of automotive-related contracts to new locations, but when it comes to low-cost country targets, it is critical to remember that the merit is in the long-term performance, not the metric.