# What's on the horizon?

Issues including oil price rises and this year's bra wars pose a threat to low-cost country sourcing. Alex Coxon looks at how purchasers can keep their offshore supplies moving

**Professional purchasers sourcing goods and services offshore have probably had their fill of bad news this year. Already troubled by oil prices pushing up the cost of transport, the activities of pressure groups such as Friends of the Earth - which is lobbying to increase fuel taxes as a means of reducing transport emissions - haven't helped.**

Shortages in skilled offshore labour have also hit the headlines. So much so, analyst firm Gartner has forecast that staff attrition in India will become an ever-greater problem for outsourced services, as workers switch companies to advance their careers or improve salaries. The Indian government itself is predicting a shortfall of 260,000 staff trained in business process outsourcing (BPO) by 2009.

## Bra wars

And then there's manufacturing. Even those purchasers not directly affected may have been unsettled by this summer's bra wars.

The stockpile of about 80 million items of unlicensed Chinese-made clothing in European ports - and the clearance of these garments based on an agreement to transfer some of the 2006 quotas into 2005 - has left the European Commission in a difficult position.

If textile quotas have crept back into the system, what could come next? Fortunately, the EC has confirmed that quotas only apply to Chinese clothing and not anything else from any other country.

In addition, their enforcement will only present a problem in the medium term; China's accession treaty to the World Trade Organisation (WTO) contains a clause allowing other WTO members to use temporary import restrictions until 2008 to smooth their adjustment to the liberalisation of Chinese textile imports. After that date the restrictions can no longer be applied.

The imposition of tariffs also remains a possibility - and not just on Chinese goods. If ongoing EC anti-dumping investigations show one country's products are disposed of on EU markets and are causing significant injury to producers in member states, then tariffs can be enforced against the exporting nation. Currently, the EU is investigating footwear, DVDs, CDs and black plastic bags.

Members of the procurement community might wonder whether they are about to read a new chapter in the global sourcing story: one that focuses on demise rather than growth.

## Introduce measures

According to Elizabeth Fox, trade policy director at British Apparel and Textile Confederation (BATC), this summer's problem alone will have a major impact on UK companies doing business overseas in the months ahead. China hit small textile retailers and importers hard, she says. Some of these companies have been importing from China for years, and now they won't be able to import anything more this year.

Even large companies have had to introduce measures to combat the problem. High street clothing retailer H&M says it is following the development of quotas carefully. When the textile quotas for heavy knitted garments were filled during the summer, it moved some of its sourcing from China to other countries.

Will there be a longer term negative effect on sourcing from China? George Hadley, global operations director at De La Rue Cash Systems says, The introduction of quotas on Chinese textiles will have no impact on decisions to source from low-cost countries. If businesses can't source from China, they will source from other low-cost areas such as India. He has been involved in outsourcing for almost 20 years with power systems companies Cummins and ABB, and construction firm Caterpillar.

"Companies cannot afford to stop looking for lower-cost alternatives just because they face possible quotas or tariffs" states George Hadley.

Alan Braithwaite, chairman at supply chain management specialist LCP Consulting, takes a similar stance. The offshore manufacturing tide is inexorable. It can cost less than €1 an hour to pay workers in China, compared to €15-€25 in Germany and around €6 an hour in the Czech Republic. Given the freight to labour ratio for products, he adds, it would take a drastic increase in fuel prices to cut the incentive.

## Offshore services market

Though trade wars and fuel prices may not have as much impact on the offshore services sector, this area is also beset with potential headaches. The latest research by consultancy McKinsey into Chinese skills and the country's ability to migrate into the offshore services market concluded that fewer than one in ten Chinese graduates have what is required to work for an overseas company. In India the ratio is one in four. The report from Gartner also found that the requirement for educated recruits with good English language skills has not been met in India, despite more than two and a half million graduates leaving its colleges every year.

However, not everyone agrees that these problems exist as widely as reported, or that they will negatively impact on the quality and cost benefits of offshored services.

"Our BPO activities - about half of which are call centre roles and half data roles - operate out of Delhi, Mumbai and Bangalore, and we have not seen any evidence of a shortage of labour or of high attrition," says Ian Thompson, director of group operational services for Lloyds TSB. "The reasons we went to India in the first place - cost because of the salary differences, and quality because we get motivated, well-trained

The Chartered Institute of Purchasing & Supply



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graduates to work for us, which we struggle to get in the UK - remain as strong for us as they were when we started on the project three years ago."

"If we look at the economics, we see that the commercial benefits for India are sustainable for at least five to ten years. We're not panicking to do something different in the light of recent events."

Meryl Bushell, chief procurement officer at BT Group, is similarly buoyant about Indian skills and the cost benefits of offshoring her firm's software development, systems maintenance and support, as well as some of its call centre capacity.

She believes that, as the Indian call centre and IT sector continues to grow exponentially, the Indian government and outsource providers will ensure that business does not go to regional competitors such as China and Malaysia.

Bushell admits that India has a shortage of good middle managers - a hurdle that BT has overcome by sending its own interim managers there until it is confident that the right skills are in place. But just as the Indian government and outsource providers have put a huge amount of resources into training in IT skills in the past few years, so they are now putting a great deal of time, effort and resources into developing middle management skills, she adds.

**Analyse the risks**

So what can procurement managers do to ensure they stay ahead of potential disruption to supply? According to Bushell, the first and most important step is to analyse the risks involved in your supply arrangements.

"Whenever you are putting in place an outsourced contract offshore, you need to conduct a full risk assessment before you finalise it. Make sure you have thought about what the potential risk areas are and have negotiated appropriate mitigation strategies - be they contractual or transitional," she says.

For Thompson, much of that process can be assisted by taking the time to fully understand the offshore business before becoming entrenched in it. The Lloyds TSB team spent time talking to third-party suppliers both in the UK and in India in order to appreciate the outsourcing environment more thoroughly. Once they had done that, they listed the attributes of those suppliers on a number of risk criteria before reducing their list to just four or five partners and making their choice from there.

"We spent a long time developing an understanding with our partners before we ramped up our offshore operations," he adds. "It's about choosing the right suppliers and working with them in the right way. You have to work openly. Both organisations involved need to understand the potential pressure points and what they're going to do about them before they arise."

Once a potential supplier has been selected - or even if the business is already involved in an offshore outsourcing agreement - Andrew Smith, partner at the global sourcing team of lawyers Morrison & Foerster, recommends that purchasing departments should give their contract careful deliberation.

**Terms and conditions**

Procurers need to be clear in their terms and conditions exactly when a problem becomes their responsibility, Andrew Smith says. That means determining in advance issues such as whether you want to insure your goods while they are stuck in a warehouse in China, or whether you only take liability once they're loaded onto a ship.

Similarly, he advises that contracts should detail how quickly a procurer can switch suppliers and undertake a price review.

"With anything that can affect costs, consider what the constraints are in being able to pass on costs to your customers," he explains. "If your supplier costs shift quicker than you can pass on the increase to customers, then you should make an agreement with your manufacturer or supplier to ensure the price you pay them can shift every month or quarter."

Procurers with a single third-party supplier are advised not to rely on one country to source all their materials. Charles Meechan, director of the customs and international trade group at Ernst & Young, says: Having multiple sources of production or supply would be number one on my agenda, and, I wouldn't commit too high a percentage of my production to any overseas country - particularly China as the issue of quotas is yet to be resolved. You can't tap into next year's quotas and expect that it will have little or no impact in 2006 and 2007.

Certainly, there is evidence that businesses are already going down this route. H&M, for example, buys its products from independent suppliers to diversify the risks. Currently, about 60 per cent of its goods are sourced from Asia and the remainder from Europe.

But creating dual sources takes time. Meechan does not believe it is a remedy that can be applied in six months or less if consistent quality is to be achieved. He also cautions that this method is often difficult to achieve because procurers need to analyse whether the second supply country has the right infrastructure, equipment, people and expertise to produce what is needed at the right price.

"It's about making the right checks in advance of setting up a dual sourcing agreement," adds Elizabeth Fox. "Check any trade regulations that might apply. China was a good case in point. Buyers always knew about the WTO rules: there was always the possibility that quotas could return on China."


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**The big picture**

Similarly, businesses need to be aware that they can get goods in from poorer countries at a reduced tariff rate under preferential schemes. But they sometimes fail to realise there are often conditions to be met in order to do that, such as the need to source fabrics from that country as well. It's important to look at the trade rules: Elizabeth Fox.

Finally, De La Rue's George Hadley says purchasers should not forget the total cost to serve - especially in manufacturing. While it is cheaper for overseas suppliers to source goods, he says, businesses also need to factor in import charges, customs duties, transport surcharges and lead times.

"The mistake most people make is that they tinker with one or two elements instead of looking at supply chain activity as a whole," he adds. "Offshoring is just one part of the equation and its benefits won't be fully realised unless businesses analyse it as a part of the wider supply chain."

**Wal-Mart's 'insourced outsourcing' model**

While overseas outsourcing continues to be the best option for many purchasing departments, some organisations believe that offshore procurement is more effective when managed in-house.

Wal-Mart operates its own global procurement department through offices in 23 countries. The department serves the company's many brands, including Asda in the UK. It prides itself on putting procurement professionals in the local area who not only understand the business' retail market, but also its culture, language and business methods.

"If you look at a traditional relationship with a domestic importer, that importer faces the same challenges of quotas, duties and anti-dumping that are there whichever route you take," says Steve Hoban, business development director for global procurement. "But by managing procurement internally, you have much better visibility of duty and quota implications from all the points of purchase around the world. This helps you manage your risk accordingly."

And it's not only risk management that becomes simpler with procurement professionals in local markets. Wal-Mart says that ethical and social compliance has become more important for the business when it sources products, as has environmental sustainability. According to Hoban, these qualities are now easier to effect because the company has been able to forge direct relationships with suppliers and governments alike.

Wal-Mart's model wouldn't suit everyone. With a portfolio of products to manage, including toys, sporting goods, home textiles, kitchenware and electronics, the business recognises it is in an unusual position in that it offers services in every retail category.

"It was this that made us realise we needed our own approach," explains Hoban. "But it might not be appropriate for those working in one specific area. Utilising a domestic importer or an outsourcer takes away some of the barriers around time zones, culture and language because you don't have to manage that complexity yourself."

"The other issue to think about when procuring directly is that it tends to have a big impact on your internal infrastructure. There are duties and responsibilities that come onto your shoulders around quality, ethical standards and testing - not to mention managing the product through the ports and making sure you're paying the right duty. It's not something you can undertake lightly."

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