



MARKETING MANAGEMENT IN CHINA:

WEEK 9:

SOURCING FROM CHINA


OCEAN UNIVERSITY OF CHINA

25th INTL. CHINESE BUSINESS PROGRAM

Marketing Lecture Series

Rainer Appel

Wednesday, 13:30-15:20 & 15:30-17:20

- 
- No need to spend a lot of time on cultural
 - Generally speaking, open to international business practices, your cultural understanding is not a prerequisite.
 - Business First
 - Little language goes a long way
 - Very forgiving of cultural mistakes
 - So many examples
 - **...But there are a few things to be aware of**

Sourcing expectations: Domestic vs. international sourcing

- Culture
- Communication
 - time and language, spoken vs. written
- Travel
- Due diligence
- Contracts / PO's
- Quality
- Product design
- Order quantities

Sourcing expectations:

Domestic vs. international sourcing

- Lead times
 - design phase can take forever, unless explicit... production = 30 + 30 + 30
- Packaging
 - air vs. sea, container, spell it out down to BOM and confirm it... “put it in a box” is not the way to leave it
- Sampling
 - if not off shelf, may not be easy or free... short term thinking... relative value

Sourcing expectations: Domestic vs. international sourcing

- Payment
- Shipping/logistics
- Duties/tariffs
- Customs clearance
- Returns (build it into contract, order extra...)
- Servicing
- IP protection

Sourcing expectations: Domestic vs. international sourcing

- Legal exposure
 - Importer of record, who is to confirm conformance, why not let the supplier determine conformance
- No “common knowledge”
 - If you can't write it down and scientifically confirm it, you can't expect it... example: color conformation



- Why produce in China?

Raw materials are about the same

- BUT labor in set up and production and inspection and packaging

- 3 shift lead times

- Vs. India or Vietnam – access and infrastructure

- Lots of challenges, but the payoff in savings is worth the effort

“everything is possible, nothing is easy”

Disclaimer on China Intellectual Property

- Vast majority of suppliers are honest and a pleasure to deal with.
- Unfortunately in a market as massive and competitive as China, IP is often a casualty.
- This presentation is not meant to condemn Chinese suppliers. On the contrary it is designed to help buyers protect themselves from the few bad apples in the bunch.

What is meant by “IP Security”

- Supplier into Competitors
- Illegal use of brand and designs
- Extra shifts with your tooling to sell to other companies
- Going direct without you



➤ Can we purchase securely?

A buyer can avoid the horror stories, but need proper planning on the part of the buy side.

➤ **Protection = control = integration of supply chain**

➤ **Five options... pros and cons.**

OPTION 1: “be the factory” (invest, JV, WOFE)

OPTION 2: final assembly back home


OPTION 3: define a captive supplier “contractual arrangement”, based on NC/NDA, but need leverage.

OPTION 4: third party warehouse assembly center


OPTION 5:

Traditional buyer- seller relationship most common & the most dangerous

➤ **Must be some ways to limit the risk...**

- 
- Apply at **BOTH** supplier ID&A as well as production phase

 - During supplier identification phase:
 - Register first
 - FTM vs. FTR, bad news vs. good news (play by rules, price to play)
 - Spread it around at component level
 - Avoid “bad” trading companies & why
 - Non-disclosure of final user and/or market (example: SS hardware for Mega Yachts)


- 
- Scrub the blue prints and samples
 - RFQ with a “representative” product
 - Know who you are dealing with BEFORE asking them to quote

Why? Trade show = R&D department

Types of suppliers

Pros & cons

- “Chinese Chinese” factory
- “FIE” Chinese factory
- WOFE
- JV
- FIC (import/export company)
- SOE
- Intermediaries

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- Different from most sourcing destinations

 - Due to a lingering relic from the State Controlled economy – The FTC

Old system

- Giant SOE manufacturing teams with IM/EX company
- Only appointed IM/EX could deal with the outside world
- Results in specialization for manufacturer and IM/EX

Fast forward to present

- The SOEs have been privatized – anybody can IM/EX
- Legitimate manufacturers without marketing skills find it difficult to engage the outside world
- Explosion of trading companies who may or may not legally own a manufacturing plant but are marketing savvy...
Dangerous, 'why?' later

- **Excerpts from “*Avoiding Middlemen – what most China sourcing agents, trading companies and brokers don’t want you to know!*”**
- The vast majority of vendors are actually just middlemen
- Today, the amount of money involved in the China Sourcing game is so large..... **BUYER BEWARE**




Factory Direct or Not? (Good vs. bad middlemen)


- **1. Costs**
- **2. Quality**
- **3. Security plan for IP**
- **4. Enforcement of IP**
- **5. Communications**




Here is checklist of red flags:

- Avoid factories that refuse to list the name or location of the production facility.
- Focus on those factories that can clearly show production experience with your particular product or production method. They should have samples and quality documents readily available if they are a real factory.

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- If you are able to arrange a factory visit:
 - Do your contact's business cards match the factory staff's information? If the cards don't match in name, color and address, then your contact is probably a middleman.
 - Do the people at the factory clearly know your contact or does he give out business cards to factory staff when giving you the tour of "his factory"? At worst case this may be his first time working with the factory and you may as well build your own relationship without him.

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- Look for clear information about operation size, equipment and staffing.
 - Be wary if they supply a very large range of products.
 - Be aware that polished English skills do not reflect production skills. Often the most polished websites are set up by trading companies.

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- Ask for ownership papers of the factory. Be explicit that the production location may be audited by you in person and that this location can not be changed without approval from buyer.
 - You will be surprised at the number of middlemen who will take the buyer on a visit of a factory only to change the location to a less expensive and poor quality option after the buyer leaves.



The Good News

- 1. Even small buyers can succeed in China!
- 2. If you need information and help, it is out there (blogs, seminars, 3rd parties).

What to know about China **BEFORE** you start talking

- **Potential suppliers will probably never tell you “no”.**
- **There will be problems.**
- **You do NOT need special connections or “guan xi” to work in China any more.**
- **Factories are limited in the number of people that can/will make decisions.**

There is no substitute for being here yourself

- You cannot judge a factory by their website.
- You must visit the supplier yourself.
- Plan on multiple trips for better quality and better/faster problem solving.
- There is no way to know if you are working with an extra middleman without being here.
- If you can't be here yourself – you need to hire someone to represent you or at least do some of the verification work for you.

Show Questions

- Owner ship?
- Export History & License?
- Recommendations?
- Actual Capacity?
- Average Order Qty and Production Time?
- When Can You Visit?
- Sales Department:
- Fluent in English?
- Dedicated rep?
- How long with company/turnover?
- Can you talk with managers/engineers directly?
- Who makes decisions?
- Allow 3rd party QC?

Factory Visits

- Plan on spending as much time on the floor as you can – a day, if possible.
- Make sure you see production and QC in action.
- Talk with the factory's other clients – why are they there and what is their experience?
- Bring your own translator (engineer, lawyer too)!
- Visit as many potential sites as possible.
- Talk directly with designers, managers, QC and engineers not just sales people.

Questions to Ask

- Can you honestly communicate with them?
- Do you feel comfortable working together?
- Are you going to have issues justifying the factory conditions to your investors?
- What are the production line bottlenecks that will most affect you? Labor/equipment allocation.
- How much of their production do they outsource?
- Do they have multiple sites? Which one did they show you?
- How many other large clients? What's their order schedule?

More Questions to Ask

- When is their high season?
- What does the price include/not include?
- What is done with non-conforming products?
- How does the factory control molds, design and other IP?
- Is the QC department independent from production goals?
- Do they have any MNC certifications?
- How do they test/QC raw materials or outsourced parts?

Final Points

- Complete more Due Diligence than normal.
- Be involved in the process more than usual.
- Record ALL conversations, commitments, changes, options, problems, suggestions, excuses, dinner menus, EVERYTHING. Photos are great!
- Take ALL legal precautions you can at home and in China BEFORE you sign anything.
- Spending extra time, being extra critical and very specific up front will save you time, money and frustration later.

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- 1. Shipping department at factory declares cargo ready
 - 2. Engages export customs broker in China for clearance and inspection.
 - 3. China Customs allows export (based on license held by factory)
 - 4. Chinese trucking company picks up cargo carries to HK border
 - 5. Customs cleared for export into HK
 - 6. Delivery to Port or Airport (CFS)
 - 7. Export clearance of HK & booking with airline/shipping line
 - 8. Arrival at destination port/airport
 - 9. Customs clearance
 - 10. Local trucking company to pick up cargo at port/airport
 - 11. Delivery to buyers warehouse/facility



Involved parties:

- Factory /Vendor/Buyer (3)
- Customs in China/Hong Kong/Final Destination(4-5)
- Logistic companies: Trucker/Shipping Lines/Forwarder/Broker (5-7)

Total parties involved 12-15

Key Logistics Points

- - **Fast and Slow Air 2-7 days**
- - **Fast and Slow Sea 15-30 days**
- - **Intermodal**

- - **5 years ago vs. Today**

Goal of payments segment:

“How to limit financial exposure while maintaining preferential pricing”

- 1. Simple and safe methods for paying suppliers via TT or cash. (no checks)
- 2. Common pitfalls/best practices for documentation and terms of payment.
- 3. What to do when things go wrong.



Lessons learned:

- Payment Terms are much more than a note at the bottom of the PO
- **Explain a “30-40-30” (from both perspectives)**

Lessons learned:

- Financial Exposure is really Quality Exposure
- Be careful if transferring funds to a private account or 3rd party trading company
- FYI: 20K Chinese Yuan per day opportunity

More Pitfalls and Best Practices

- Traditional Risk
 - Financial due diligence
 - (www.Glo-bis.com) (www.verify.com)
 - Site visits (not a trading company)

- State lead times & penalties in contract

- Tooling & set up ownership as leverage
 - If a custom made part (don't amortize)

- The LV experience
 - China as legal jurisdiction of contract enforcement. Why? Location of defendant, enforcement or ruling, cost of battle
- Evaluate rewards vs. risk (especially for initial production run)
- Communication is key
- Payment Terms are not Incoterms
- Beware of ExW, quote FOB China port during RFQ



Review of PO template

What to do when things go wrong?

- Find the right supplier in the first place
- K.C.C.C. (keep cool, communicate clearly)
- Arbitration
- Legal enforcement as last option (5-0 record at the moment)



If take away just one thing...
30-40-30

If you need a lawyer....




“The realities of China QC and IPR”

Warning:
Scary content for mature audiences only



Video Case


Glass factory in Laizhou

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- Factory floor experience vs. lawyer or consultant's view on IPR and quality control

 - “The way it is” rather than “the way it should be”

 - 50 minutes for:
 - Intellectual Property Rights (IPR)
 - Quality Control (QC)

 - 10 minutes for:
 - Q & A

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- Can we purchase securely?
 - A buyer can avoid the horror stories, but need proper planning on the part of the buy side.


- Goal: Offer practical solutions for SME

- As a fundamental rule, these solutions should not compromise quality, service and pricing
 - ... don't want to destroy the margins...



Case

Extra Shifts in Laiyang Textile Factory

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- Definition of IPR
 - When most people think Intellectual Property Rights (IPR) = Designs and Trademarks
 - But for the course of this program, expand IPR to include other sensitive buyer information such as export value, shipping destination, customer and end user identity, volume and market value of goods shipped
 - Culture Factor: Examples from a doctor's visit, etc.
 - TGIF's, CEO's Eggs & Ambulances

Recipe for IP Chaos

1 part

Communist system which has only recently considered
Intellectual Property Rights (IPR)

mixed with 1 part

Production base/favorable pricing

Plus

Rapid growth economy/changing society...“whatever it
takes mentality”

Remove

Enforcement

And the results are...

But there is another aspect that doesn't make the
international press... So we need to look at IP
protection in two directions

Protection = control = integration of supply chain

➤ Five options... pros and cons

OPTION ONE: “be the factory” (invest, JV, WOFE)

OPTION TWO: final assembly back home

OPTION THREE: define a captive supplier

“contractual arrangement”, based on NC/NDA, but need leverage. Lessons from the Animal Kingdom

OPTION FOUR: 3rd warehouse assembly center

OPTION FIVE: Traditional buyer- seller relationship most common & the most dangerous

➤ Option 5 - Must be some ways to limit the risk...

Apply at BOTH supplier ID&A as well as production phase

During supplier identification phase

- Register first
 - FTM vs. FTR, bad news vs. good news (play by rules, price to play)
- Spread it around at component level
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@Production Phase

- May offend some lawyers in the audience...
...can't hurt but don't rely solely
- The reality of doing it the Western Way
- What happens to that 30-page NDA
- Therefore:
 - 1. MOU core concepts/bilingual/initials/staple to PO
 - 2. Physical vs. legal approach

Non “Legal-based” Methods:

- Own the tooling outright (if custom made)
- 30% Rule of Thumb
- Frequent Visits

To keep an eye on things (tool room)
(warehouse room) (sample room)

Avoid the Italian Silk Tie Story

3rd Party Assembly Option

➤ A.K.A

“black box”, “quality gate”, “firewall”

Car Parts case study

When setting up 3rd Party Assembly/Inspection Don't forget about...

- VAT
- Currency Conversation
- Warranty Terms @ two levels (example of battery toy)
- Document Trails (assembly instructions, client info...) example of PM
- Project Finance
- Reverse Firewall
 - Canadian WalMart Example

- Now on to QC



China QC overview


- Q: Why are China Quality issues always in the news?
- A: Have you ever been in a car in China?

Have you ever been in a car in China?

- 1. New drivers
- 2. Little understanding of road rules and no incentive to follow them
- 3. competition
- 4. Technology does not = Experience

Mega trend one:

Recent and rapid growth of production base

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- Mega trend two:
 - Global interaction made easy thanks to the Internet
 - For example,
 Customers 10 years ago vs. today
 - Q: Who will you meet at any international hotel lobby in China?
 - A: 30-50% of international buyers will be first time sourcing from China, Retailers, distributors, E-bay power sellers. Mom & pop shop keepers...
 - Know how to sell, but what about AQL charts and SPC?
 - I am not saying these buyers shouldn't source direct, but know the situation and don't rely solely on their sub-suppliers.

Let's explore some of the key terms...

Supplier vs. Vendor

- Testing vs. Inspection vs. Audit
 - Testing: Lab. Product, Life Testing = seeing how one (ideally representative sample) handles itself against certain specification and requirements
 - Inspection: Pulling a random sample from production line, warehouse or market place, to compare against agreed standards
 - Audit: Two main kinds
 - FA= tech assessment of people, skills, process and equipment, (see the Supplier Evaluation doc)
 - SA or CSR = child labor, min wage, OT, Insurance, work place safety

- Golden Sample vs. Production Sample (“give me a sample”)

- Quality Control: A system that is put in place by a manufacturer to monitor and maintain quality as goods flow from raw materials (IQC) into semi-finished goods (IPQC) into finished goods ready and packaged for shipment (FQC)
- QA or 3PQC: Outside party that reviews the QC system of the factory and provided additional testing, inspection and/or audit services as “insurance” or a “double check”
- ISO: Family of standards and guidelines for measuring quality in the manufacturing and service industries from the International Organization for Standardization (ISO). BUT ISO 9000 certification does not guarantee product quality. It ensures that the processes that develop the product are documented and performed in a quality manner. “concrete life jackets”
- Min vs. Major vs. Critical Defects



In my view... the best factories understand

- Q can always be improved
- Tools/terms are designed to find problems earlier rather than later, and catch minimal problems before they become major or critical
- A good factory lives and breathes the ISO system

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- Integrated approach to quality in the supply China
 - Learning from the “big toys”
 - As we advance from Concept to Delivery to Consumer, the cost associated with testing and fixing and problems increasing exponentially.
 - At each step of a product life cycle, we will explore the QA tools and related costs.
 - You will see that a few simple steps early on are not only inexpensive, but very effective in reducing the exposure to non-confirming products.

The steps:

- Product concept
- Supplier feasibility study (Supplier ID and analysis)
- Factory audit on top 3-5
- Social audit on top 2
- Gray area between pre-production and full production
- Sampling/test order (PPAP/ISIR)
- (Full) production
- Post production



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