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Global Transactions – Managing Risks in Global Sourcing.

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The policy of global sourcing is a strategic imperative for many businesses; it has raised the competitive ‘bar’ to the point where it has become a qualifier for survival rather than a competitive edge in its own right. There has been huge investment to secure low unit costs through the chain and drive volume and margin simultaneously. The low wage areas of Asia have attracted high labour content work from garments to computers to consumer products to engineering.

The first consequence of this drive for low cost is the core characteristic that global sourcing is not ‘adjacent’. Global chains are extended in terms of the time that is locked up in the sequential processes of ordering, provisioning, manufacturing and shipping. This extended time is a precondition of the margin opportunities that can be extracted. It is therefore not value-adding but it is essential.

Work by the authors for Maersk Logistics (i) indicates that the global supply chain transaction time content contributes in the range 30% to 50% of the total time in the chain, but adds just 2% to 5% to the transactional cost of the article. Indicatively the gross margin gain is not less than 20% and is often much more.

The same work showed that there could be as many as 7 additional parties to executing the global sourcing transaction, including consolidation centres, shipping lines, customs and compliance authorities. There is therefore a time and transactional control issue that greatly exceeds the supply chain execution costs.

The second consequential characteristic relates to the nature of the capacity that is being used. The investors are carrying a much higher ‘cost of capital’ and need to secure a return on their investment. There are huge pressures on them to produce, such that prices will be lowered until capacity is consumed. This determination to make investments pay has created a platform for sustained deflationary pressures on prices that our politicians have been happy to embrace. However, we may now be at the point where the behavioural impacts of producers and buyers, both fighting to maximise margin at the expense of each other, creates a trading environment that is highly volatile. Supply chain promiscuity and unreliability are about to become rife.

The combined characteristics of this changed supply~demand dynamic with extended timescales work to generate levels of transaction risk that need to be understood and managed in order to ensure a net benefit from the long term trend to global supply.

The Evolving risk profile of global sourcing

Back in 1988, Markides and Berg writing in the Harvard Business Review (ii) identified the trends to manufacturing offshore and roundly criticised it as being both unnecessary and risky. They argued that existing manufacturing capacity could be made more competitive and that the hidden costs of obsolescence, inventory holding and demand unresponsiveness are risks that counter the headline benefits. Given the date of that paper and the scale of the subsequent trend to offshore sourcing, their warnings have over-ridden by the inexorable drive for gross margin.

However the risks of global sourcing may yet be coming into focus as the ‘first mover advantage’ dissipates. If we set to one side their assertion that the trend to global supply is unnecessary and deal with the reality, their catalogue of the risks remains accurate today.

- 1 There are risks that the total acquisition cost may be greater than anticipated and erode the net benefits that the initial purchase cost imply; When all factors including transportation, handling, duty, obsolescence, inventory, lost sales and ‘market blocking’ are factored in, the total cost may not be as attractive as the headline advantage – labour costs are typically as little as 7% to 10% of the total product costs and even less on the selling price.
- 2 The extended chain cannot be as responsive to variations in demand as local sourcing – hence there may be opportunity costs of lost sales.
- 3 There may be risks with quality and execution due to the long distance relationships and the many hand-offs in the processes to move the product to its destination – inaccuracies cause service failure and hence cost.
- 4 Valuable know-how may be given away to vendors allowing others to enter markets and for product and engineering skills to be lost.
- 5 The long-term impact on supply and demand is less clear and may distort markets both in terms of the benefits gained and also for the risks of secure supply.

At the headline level, these factors are known and understood. How companies internalise them and mitigate their implications may be less consistent. The conclusion is global sourcing is not a consistent proxy for sustained higher profits. The volatilities of the business climate, consumer demand, competitive actions, fashion, quality of execution and market dynamics, inter alia, all combine to make the outcome less certain than deterministic planning models would have us believe. Boards will need to start to focus on the complete mix.

Critical Success Factors

We think of global supply chains as having three dimensions: design, planning and execution. These have decreasing horizons of impact, but often the actual trading impact increases when risks are encountered; there is less time to put things right before trading is impacted.

Here we are dealing with executional / transactional risks. The measures to mitigate such risk in global supply chains require 6 capabilities. It is these capabilities that are the critical success factors.

1. **‘Total Acquisition Cost Management’** – the ability to analyse and predict the total cost-to-serve from the source of supply to its final point of sale. The capability in this analysis is not to simply build up the logistics costs by differentiating the physical characteristics of the freight and the duty and customs regimes that are applicable. It is more important to analyse and build into the costing the inherent markdown and lost sales risk of the

product by developing and applying a market-risk and cost risk profile. The inventory holding cost through the chain must also be factored in. Experience has shown that this analysis identifies products that should never be traded on a long lead-time, or that should be the subject of a postponement strategy. It is also likely to show that there are some products where actions to reduce lead-time and increase flexibility will justify a higher initial purchasing cost.

2. **‘One touch information flow’** – to avoid double entry, duplication, mistakes and inconsistency as the same transaction moves through the many points of contact in the chain. Accuracy of information is a precondition of pro-active management and the ability to exercise risk mitigation measures. This capability is systems enabled; it is critical to have the widest view of the total chain on one information platform with the ability to recognise inconsistencies.
3. **‘Total product identification and compliance’** – to ensure fast accurate product and handling unit identification that feeds the “one touch information” requirement without delay. The use of bar codes and RFID (Radio Frequency Identification) to the correct standards is the enabling technology; this needs to be quality assured and enforced on the ground across many sites with failures being fixed where they occur.
4. **‘Real time routing through dynamic visibility’** – the capability to see through the chain, know what is coming, and test for events that have not happened as planned; to interpret the implications of failures in a pro-active way and make decisions to minimise their impact. This is the ‘traffic control’ of global supply chain management; it must be managed transparently and with the proactive co-operation of all the parties in the chain.
5. **‘Vendor development - cycle time compression linked to real demand’** – the capability to understand and improve the long-term performance of vendors in terms of cycle times, timeliness, quality and accuracy is central to time compression and risk reduction. Based on historical performance of the end-to-end chain it is possible to identify improvements programmes to develop supplier reliability. The ultimate goal is to issue orders and schedules on shorter lead times, reflecting real demand or more accurate forecasts. Understanding the underlying performance of the vendor, and his category of products in the marketplace is the starting point for this; it is dependent on information across the chain.
6. **Information platform to provide consistent and timely information** – the capability to put in place, operate and maintain a full supply chain visibility solution. All of the above capabilities are anchored by the operational skill to secure and maintain the information backbone with the diverse data structures that are needed by each supply chain function.

All of these capabilities relate to management information and the skills to apply that information with greater precision; information on the extended chain in terms of accuracy and speed of availability is central to these capabilities.

Our research suggests that companies are moving from the first stages of quick wins into a more mature phase of global sourcing. Those that have learnt the new game will be more able to sustain the advantage they have won so far.

Biography

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ⁱ Maersk Logistics – White Paper, Making Global Networks that Maximise Net Margins, 2003 – www.maersk-logistics.com

ⁱⁱ Markides & Berg ‘Manufacturing Offshore is bad business’ Harvard Business Review, September-October 1988

This article is based on the authors research included in the chapter “The supply chain risks of global sourcing” in “Managing Business Risk: a practical guide to protecting your business” Edited by Jonathan Reuvid, Kogan Page, 2006