

## Im Fokus

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### **Strategic Sourcing in China: The Perspective of Small and Medium-Sized Foreign Enterprises**

### **Strategische Beschaffung in China: Die Perspektive von ausländischen Klein- und Mittelbetrieben**

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#### **Abstract**

This article focuses on sourcing activities conducted by foreign small and medium-sized enterprises (SMEs) in the Chinese market. It asks whether there are any differences between global players and SMEs when it comes to sourcing in China. The characteristics of the Chinese market and the opportunities and challenges involved in sourcing products or services in China are analysed. In order to guarantee a successful business operation, companies have to design specific sourcing strategies of their own.

*Keywords: China, strategic sourcing, global sourcing, small and medium-sized enterprises*

#### **Introduction**

Foreign sourcing can no longer be regarded as exceptional in commercial purchasing. Due to the ongoing globalisation process, companies have to consider sourcing their items around the world to save overall purchasing costs and to stay competitive in an international arena. For many years, research on global sourcing concentrated on “global players”, not on SMEs. In contrast, this article focuses on the extent to which western SMEs include global sourcing from China in their business activities. In addition, differences between large businesses and SMEs with regard to their sourcing will be examined. The current trend shows that SMEs are shifting their sourcing activities towards China. But are the advantages big enough to justify the high costs and the effort inherent in adopting this approach?

At first the selection of the right sourcing concept and the subsequent strategic

sourcing process has to be made. A company sourcing products or services has to choose between various concepts, with single, multiple, local and global sourcing being those most commonly used. In practice, a combination of these strategies is generally employed. The decision as to which concept the company wants to apply to the sourcing process depends on the firm's needs and goals. Each approach has certain advantages, but it can also lead to disadvantages. In order to guarantee successful sourcing, opportunities and risks have to be analysed and assessed. This is especially necessary if the new supply market is beyond local boundaries. A suitable sourcing approach can add value and minimise problems that might occur in the new supply market due to a different culture.

The recent discussion in the media about the quality and safety of Chinese products makes it even more important to spend enough time and effort on selecting the best sourcing concept. In order to successfully source products from this market, foreign companies have to find a reliable supplier. Selecting suppliers is one of the most important aspects of strategic sourcing. Companies need to take regional particularities into account when choosing their suppliers, especially in the case of the Chinese market. During the quality-control phase it is also of great importance to prevent quality and safety from decreasing (Schüller 2007).

Over the last few years, the amount of attention paid to China as a sourcing region has increased tremendously. Only two decades ago it was widely believed that companies wanting to source their products from China were best off focusing on simple, labour-intensive items. The recently gained rewards of sourcing in the rapidly developing Chinese market are significant ones. Sourcing from China has evolved beyond the low-tech sector (The Boston Consulting Group & Wharton University of Pennsylvania 2007:9). With an economic growth of about eleven percent per annum, China is currently the fastest-growing economy in the world. The country is gradually developing from being a low-end production economy into a high-end production market where quality, innovation and after-sales service play an increasingly important role. Not only a greatly improved cost structure can be observed, but product and process innovation are also taking place, both of which contribute to a diversified supply base. Along with the competitive advantages this sourcing region offers, the magnitude of China's market creates strong incentives for companies to source from here (The Boston Consulting Group 2007:1-2).

## Global Sourcing by SMEs

Global purchasing is a fundamental part of a market-oriented procurement policy. The world market is highly competitive, therefore the concept of global sourcing is relevant for companies of all sizes for achieving competitive advantages. If implemented correctly, global sourcing can have major cost benefits, but also benefits with respect to quality due to access to the best sources worldwide. Despite these important aspects, however, it is the cost factor that is triggering global sourcing.

China plays a tremendous role in foreign companies' sourcing behaviour outside their local boundaries; companies that base their business operations on either being cost or price leaders very often choose the Chinese supply market to order goods or services. This has strongly contributed to the increase in China's exports (see Table 1).

*Table 1 China's Global Exports from 2004 to 2006 (in billion USD)*

Year	2004	2005	2006
Exports	593.3 (+35.4%)	761.9 (+28.4%)	968.9 (+27.2%)

*Source: Bundesagentur für Außenwirtschaft 2007.*

Between 1978 and 2006 China's share in world exports increased tenfold from 0.8 to 8.0 percent (Bundesagentur für Außenwirtschaft 2007). Foreign enterprises discovering China as a supply market play a crucial role in China's export growth. Sourced products and services are among the key elements of the unique development of China's exports. A detailed sourcing plan tailored to the characteristics of the Chinese supply market is, however, necessary in order to prevent losses later on. The various steps leading to successful sourcing must be well prepared by the company wanting to become a successful purchaser (MittelstandsWIKI, Oracle 2008).

At the beginning of the "offshore" wave, mostly large enterprises moved their sourcing activities to other countries. Along with the globalisation process, multinational companies adopted this concept and shifted their sourcing operations to low-cost nations. Now that the trend of relocating labour processes and cost-focused technology services has stabilised to some extent, it is the right moment for SMEs to consider adopting this concept as well.

It has become imperative for SMEs to "go global" in order to survive in the

face of international competition. While SMEs may argue that the cost benefits that accrue to larger corporations by virtue of their huge sourcing volumes may not be as large for SMEs due to their relatively small business volumes, there are other strategic and tactical benefits of global sourcing that they must consider. The pressure to go global, however, is definitely very strong for SMEs. In order to keep costs down and enhance their global competitiveness, many SMEs decide to source internationally. When implementing the global sourcing strategy into their overall business operations, most companies achieve average savings of up to 30 percent. But cutting costs is not the only reason for international sourcing; many companies also profit from access to worldwide technology and product knowledge (Cai 2007:30).

Due to tariff barriers falling, co-operation between economic communities and the expansion of free trade zones, the world economy is integrating further. As a result, the terms and conditions of internationalisation are improving. SMEs are profiting from this development. Decreasing transport costs, greater flows of information and the growing number of multilateral economic agreements mean that the likelihood of SMEs succeeding in international sourcing is now better than ever (Brinkmann 2004:48-49).

When it comes to the process of sourcing, however, there are still numerous differences between large enterprises and SMEs. The latter often face more problems than large companies as regards connecting to the right supplier. Large multinational corporations often have substantial resources and several overseas offices to support their global sourcing strategy. Global players are likely to have a good reputation, which leads to a worldwide business network. This is a major advantage and allows firms to get in touch with potential suppliers more easily. In contrast, small, relatively unknown enterprises cannot boast the same networks. Good relations with government authorities can be especially advantageous in sourcing, especially in a country like China.

SMEs have a limited planning capacity and a smaller financial budget for the development of their sourcing activities. The lack of international purchasing experience and lack of capital for the sourcing process represent major challenges to SMEs. Therefore, smaller companies with limited resources may often think they have no alternative but to stay closer to home. Yet sourcing abroad in low-wage countries offers foreign firms a wealth of opportunities for acquiring high-quality, low-priced products. According to some authors, SMEs grow faster when sourcing abroad compared to those sourcing locally (Matteo 2003).

## Strategic Sourcing in China – A Five-Step Process

China's economic liberalisation has attracted many foreign companies to the Chinese market. Today, most multinational companies listed in the Fortune 500 have extended their businesses to China (Ministry of Commerce of the People's Republic of China 2007). In order to be successful in sourcing from here, knowledge about the differences in mentality, communication and in the specific role of personal relationships, or *guanxi*, is essential when operating in the Chinese market.

An important aspect of the Chinese mentality is the concept of "face saving", which plays a crucial role during communication between foreign and Chinese companies. Communication problems can develop when Western companies from a "low-context culture" attempt to communicate with those from a "high-context culture" like China's (Culture at Work 2007). The term "low-context culture" refers to societies in which people tend to have many social connections, but these are of a relatively short duration for some specific reason. In these societies, cultural behaviour and beliefs may need to be spelled out explicitly so that those coming into the cultural environment know how to behave in an appropriate way. In contrast, a "high-context" culture refers to societies or groups where people have close social connections over a long period of time. Many aspects of cultural behaviour are not made explicit because most members know how to act or react due to long-term interaction with each other. The differences between the two context cultures have to be known in order to avoid misunderstandings.

The establishment of good *guanxi* thus plays a decisive role when doing business with China. Foreign companies often underestimate the importance of relationship-building with their Chinese counterparts and neglect to invest in human capital. *Guanxi* is an essential part of Chinese business culture and can be very useful for achieving agreements more easily (Kutscher & Schmid 1997:175-176).

Strategic sourcing can be divided into five steps, which can each bring the company closer to successful sourcing. The process can be applied to companies of all sizes. In each step of the sourcing process, the particularities of the Chinese supply market should be taken into account.

Table 2 Strategic Sourcing in China – A Five-Step Process

Step 1	Step II	Step III	Step IV	Step V
Acquisition of data	Evaluation and selection of supplier	Regulatory framework	Start of business	Quality control

Source: Author's own compilation.

The first step in strategic sourcing is the acquisition of information about the potential new Chinese supplier. Today, not only state-owned companies but also private enterprises are potential sourcing partners. The channels of information about potential suppliers include Chinese trade fairs and external consultants, mediators or logisticians with specialist knowledge of the Chinese market, for example (Vinck 2004:94).

Trade fairs allow firms to collect first-hand information on the spot. However, a huge number of such fairs exist and the choice of the right trade show can be rather difficult to make as a result. Purchasing conditions vary, but generally speaking, prices of sourced items tend to be lower the more local fairs there are. Product quality may not be adequate at local fairs, however, and suppliers exhibiting there frequently have little experience of doing business with international companies (Kriegeskorte 2004/2005:26-27).

The services provided by external consultants can be expensive, but may well be able to contribute to more efficient sourcing. These advisers often have deep-rooted knowledge about the target market and the supplier structure there. Most SMEs do not have enough financial resources to employ such organisations, though. This restriction makes it more complicated for SMEs to find a suitable, good and trustworthy supplier.

In the second step, foreign companies have to make sure that the Chinese supplier has a valid export licence. This is an absolute must for Chinese companies wanting to do export business with foreign buyers. The Ministry of Commerce is responsible for issuing these licences (Vinck 2004:89).

When assessing the collected data, foreign companies have to be aware of the differences between state-owned and private enterprises in China. In the state-owned sector, companies are mostly large enterprises with close relationships and good connections to the local authorities and ministries. This can be an advantage for the buyer. These companies usually have better terms for financing

their operations compared to private enterprises. Private companies, in contrast, are mostly SMEs. They are very flexible in conducting their business activities, thus their decision-making does not take as long as in the state-owned sector. The decision-making in these companies can sometimes still depend on the interaction between the company and government authorities (Vinck 2004:95).

Commissions, quotas, laws and regulations, pricing, quality and location are all important “hard” facts with which to assess Chinese suppliers. It is very common in China to pay hidden commissions (so-called “kick-backs”) to agents in order to get a business started or to make the operation a success. These hidden commissions are part of the Chinese business culture. Western companies, in particular, have to get used to this different approach. Foreign firms, and especially SMEs, need to keep this aspect in mind when evaluating suppliers. Due to the commission, the actual retail price can be much higher than expected initially. “Kick-backs” are more common in rural areas because of the close relationship between decision-making units (Vinck 2004:96).

In addition to the above-mentioned “hard facts” of sourcing, there are also “soft facts” relating to knowledge about managing potential suppliers. The evaluation of their management system is important and makes collaboration with a Chinese company easier. Assessing a supplier with regard to quality and pricing is also important. Many suppliers are tempted to offer very low prices to get buyers’ attention. Prices, however, can often be renegotiated as business in China is strongly based on personal relationships. Thus, when evaluating the supplier on a price basis, the buyer ought to be aware of the limited meaningfulness of pricing.

Another instrument with which to assess suppliers is a detailed quality check of the supplier’s goods. Many Chinese suppliers try to reduce their costs and change the composition of the materials used to manufacture their products – or are simply unable to produce the goods according to the required quality. A detailed description of the product’s composition is necessary. The deal should only be closed if the supplier proves it is able to produce goods of the quality expected.

The location of the production site is another factor by means of which the suitability of a supplier can be assessed. There are two major economic regions in China: the Yangzi Delta, which is the area around Shanghai, and the Pearl River Delta in the South of China, close to Hong Kong. Both locations have a well-developed infrastructure, which leads to benefits in terms of logistical

issues. In recent years the development of new transport lines, freight stations, transport equipments, packaging and shipping facilities has increased. Today about 65 percent of all Chinese exports are produced in these regions (Kracht & Kriegeskorte 2004:118).

During the third step, the analysis of the regulatory framework takes place. This task is very challenging because of the different legal understanding in China compared to the Western countries. The Chinese legal system has been adapting to international standards ever since 1979. Due to international collaboration, Western laws and regulations have been influential in restructuring the legal system (Schulte-Kulkmann 2002). The growing number of new regulations, however, does not always mean greater transparency. Furthermore, some regulations are incomplete and their interpretation can be misleading and even discriminate against foreign companies (Diem 2000:17). Another challenge is the Chinese understanding of contracts and agreements, which always leaves room for later re-adjustment and changes.

The setting up of a contract and the start of the business operation are fundamental parts of the sourcing process (step IV). In most countries a contract is binding, but in China the enforcement of contracts is on a conditional basis: according to the understanding in China, contracts are merely an intermediate result of negotiations and can therefore be adapted to new circumstances. The signing of a contract does not necessarily guarantee its implementation. Often, the contract is only seen as a declaration of intent and modifications are taken as re-negotiations and not as a breach of the agreement. In the eyes of Chinese suppliers, Western companies are too inflexible when it comes to contractual negotiations. Both parties have to make concessions in order to reach agreements. In the process of closing a contract with a Chinese supplier, personal relationships once again play a major role. They provide security and, if well-established, are worth more than the actual contracts in the event that supply problems occur (Chamber of Industry and Commerce Pfalz 2006). In recent years, however, especially since China joined the World Trade Organization in 2001, the situation has started to change. China agreed on international legal standards and thus pressure increased on Chinese suppliers to adjust their business behaviour accordingly. No major difference between SMEs and large enterprises can be observed when negotiating and setting up a contract. The fact that large companies have better access to resources and more financial funds, however, can make a difference when establishing a contract. Due to their size and international acceptance,



they have greater power in the process of contract negotiations (Reisach et al. 2003:145-146).

The fifth and last step in the sourcing process relates to quality control. This step is of special relevance to China. Western companies often complain about inadequate product quality. The challenge here is that many Chinese suppliers are not fully aware of Western quality standards and therefore need a certain degree of support and training before they can achieve them. Supplier development thus becomes an important activity for sourcing teams. So-called quality specifications containing a detailed description about the required quality are helpful in this respect (Granier & Brenner 2004:126-127). Although we can observe that quality standards in China have improved due to the adoption of Western standards and competitive pressure, frequent checks are nevertheless indispensable.

It can be concluded that many legal and cultural particularities of the Chinese market are challenging issues for foreign companies. If adequate attention is paid to cultural differences and special risks at every stage of the sourcing process, then a foreign company can be successful in China. The experience of many companies shows that the evaluation of Chinese suppliers is very time-consuming. Western companies should not expect immediate returns from their operations and should be prepared to adjust their "China strategy" in the course of the sourcing process. With regard to the step-by-step approach to strategic sourcing, SMEs as well as large companies should follow a gradual sourcing process that has been defined beforehand, adapt to market characteristics, learn to accept cultural particularities and carefully check the results at every stage. Differences in financial resources for supporting the sourcing process and in network capacity obviously exist between large companies and SMEs, however, and can influence the efficiency of the process.

### **Opportunities and Challenges of Sourcing by Foreign Enterprises in China**

A recent study by KPMG underlines the fact that while many foreign companies are attracted by the enormous opportunities of sourcing in China, they are not sufficiently aware of the many risks involved in these operations (KPMG 2007:1).

Lewin and Peters (cited in Gadde & Jonsson 2007:6) have shown in their survey that cost savings are the main driver (for 93 percent of the respondents), while market access is of secondary importance (for 33 percent of the respondents).

This picture is slowly changing and other factors such as “improving service levels” and “assessing qualified personnel” are beginning to play a role, too. This demonstrates that sourcing is no longer concentrated on low-cost labour production, but increasingly includes high-tech products and technical functions as well (Gadde & Jonsson 2007:6).

Due to high foreign direct investment (FDI) flows to China, management know-how and technical skills are growing. This has already led to a significant improvement in technological standards and benefits (The Boston Consulting Group 2003).

Looking at the challenges, the client-vendor relationship, which requires investment in the building up of “social capital”, seems to be of utmost importance. Often, however, the network context of the relationship is neglected by foreign firms (Gadde & Jonsson 2007:18). In China’s case, cultural differences can be the cause of serious misunderstandings between foreign buyers and local suppliers. In addition, due to the lack of transparency of ownership structures and government involvement, information about the quality of the supplier is often difficult to obtain (Drozak Consulting 2005).

Foreign companies sourcing in China are frequently confronted with the risk of being copied without their intellectual property rights (IPRs) being respected. As a member of the WTO, China agreed on securing IPRs when signing the TRIPS (Trade-Related Intellectual Property Rights) agreement. Although progress has been made in this respect, China has not lived up to the expectations of other WTO member states so far (European Commission 2006). Companies often complain that the enforcement of claims at court is time-consuming and cost-intensive and that it is unclear whether they will actually win their case if they take a Chinese firm to court. When it comes to legal recourse, SMEs are in a more difficult position due to restrictions in funds and network capacity. Corruption is another problem, which is still widespread despite many anti-corruption campaigns. This makes it especially difficult for smaller enterprises to gain a foothold in China (Ernst & Young 2006).

In sum, SMEs are faced with some imposing challenges in China:

- 1) not enough understanding of Chinese culture and business practices;
- 2) no *guanxi* type of relationship with Chinese suppliers;
- 3) significant expenses for the assessment of Chinese suppliers;
- 4) quality problems and unpredictable costs; and

5) lack of knowledge about customs and delivery procedures in China (Logic Sourcing n.y.).

Sourcing in China thus requires SMEs to pursue specific strategies in order to be successful. An increasing number of SMEs have already discovered China for their sourcing strategies in recent years. Most internationally active SMEs with an annual turnover of between 30 and 100 million EUR have already gained some experience of the Chinese market (Ernst & Young 2006); they are following a general trend towards global outsourcing.

Medium-sized businesses, in particular, are actively adopting the concept of strategic sourcing. Small companies still fear the possible risks and challenges ahead of them. The significant conditions and characteristics of the Chinese supply market are often seen as barriers that are hard to overcome, especially for SMEs with limited resources and little international experience.

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