

(Free Copy)

Check out China

A Report on China Sourcing Programs



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GAINING THE COMPETITIVE ADVANTAGE

One more time because it is so vitally important – **The biggest risk related to China sourcing is if your competitor establishes a low cost supply agreement before you.**

Sourcing in China is a STRATEGIC question, not a purchasing decision. This strategy will effect the future of your company and your ability to compete in a international marketplace. Thus, it is important to involve decision makers at all levels in the following evaluation:

Are your customers sensitive to price?	YES	NO
Do you have competitors at your same price point?	YES	NO
Do you often lose sales because your competitor has a better price?	YES	NO
If you could sell your product for less, could you increase sales?	YES	NO
If your competitor could sell their product for less, would your sales decline?	YES	NO
If you could reduce part cost by 40% or more, would you be able to reduce the cost to the customer and increase your profit margin at the same time?	YES	NO

***If you answered yes to the majority of these questions, then do not wait to implement a China sourcing program.

How much would I be able to save in China? Use the following information to determine if your parts fit the criteria for sourcing in China. The best way to know how much you can save is by getting a quote from suppliers within the program group you choose.

- 1) **Labor : Material Ratio** – What is the ratio of labor to material cost on your product? If labor is more than 50% of the total cost, then the part is well suited for China sourcing. The higher the ratio, the more cost savings you will receive.
- 2) **Annual Quantity** – Many people think, incorrectly, that you need to have quantities in excess of 100,000 units. Chinese factories can make 1 unit if necessary. A general rule of thumb on machined parts is at least 1,000 units at a time. Less if there is significant machining time on each part, and more if there is less labor per part. Annual blanket orders will gain even greater cost reduction and reduce the amount of each shipment.
- 3) **Frequency of Design Change** – Does your product have frequent design changes? This is generally not the best candidate for sourcing in China; however, we will show you in a later section how this can be effectively done. Also, you may want to look at your engineering policies on design change. Often times the parts do not need to change quite so frequently.
- 4) **Weight and Size of Product** – The weight and size of your parts will also have a significant impact on how much you will be able to save, however, labor trumps all! Even if you have heavy parts such as dies, molds, or tooling, you will still realize tremendous savings because of the labor involved on such items. Fabricated items that have a lot of dead space when packaged together may not yield the huge savings expected. Included in this packet is information on shipping costs.

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SELECTING A SOURCING PROGRAM

“Blended Supply” is the newest, and in my opinion the best way to source in China. It eliminates virtually every risk of doing business in China and still gives you tremendous savings. This program is absolutely incredible for companies sourcing to China for the first time.

Although Fortune 200 companies have been sourcing in China for the last 10 years, it is relatively new to the general population of small to medium businesses. The most important thing to do especially in the beginning is to reduce your risk as much as possible. Your job as the person selected to review China sourcing partners is to **ELIMINATE RISK**. Whether you save 40% or 45% is virtually irrelevant if you are putting your company and your reputation in jeopardy – Eliminate Risk! Compare the choices - Why would you even consider an alternative?

<u>Type</u>	<u>Description</u>	<u>Risk Level</u>
Blended Supply	U.S. machine shop with their own domestic facilities, and machining capabilities in China. This company can make the first release of your parts here in 3-4 weeks, get the next shipment from China and inspect it before releasing it to you, and also can make parts as a back-up supply if any problems should arise.	LOWEST RISK
Broker	Middle-man to import the parts, add their mark-up, and ship to you. These companies have no manufacturing capability of their own. If parts arrive late or wrong, there is very little they can do about it.	MODERATE RISK
Consultant	For a fee, a consultant will help you find a factory in China, and then turn it over to you to work directly with the factory. You still have all of the risk of dealing directly with the factory – late shipments and poor quality.	MODERATE TO HIGH RISK
Factory Direct	You will invest the time and money to establish your own China supply chain directly with the factory. You will also need to negotiate and track shipments and deal with customs issues.	GREATEST RISK

Risk to Return Ratio Analysis

The most important evaluation tool is the Risk to Return Ratio. You will need to evaluate each of these categories based on the level of risk you are willing to endure to get parts from China. Blended supply has virtually no risk, compared with Factory Direct that has the most risk. Factory direct has the highest potential return because you would be eliminating all supply levels and going directly to the factory, but believe me - the rewards are not worth the risk.

- 1) **Blended Supply** – Under this program, there is essentially no risk to you as a customer. Once price and delivery are set, that is what you get. The domestic machine shop takes full responsibility for the delivery of quality parts. If a shipment arrives late or parts are wrong from China, they will simply make the parts here. It is their responsibility to find China partners that they can trust to deliver quality parts, on-time. Your price remains fixed, so the machine shop will lose money on every part they need to make here.
- 2) **Broker** – Brokers can not make parts themselves, so in my opinion add little value and do not really shield you from risk of late deliveries or poor quality parts. They can make the connections and get you the parts, but their hands are tied if parts come in wrong or late. You will be the one scrambling for a domestic vendor and you will be the one paying the higher price until replacements arrive. Replacement parts from China will take 8-10 weeks.
- 3) **Factory Direct/Consultant** – Whether you use a consultant to reduce your risk or not, you still have the highest risk since you are dealing directly with the factory. Even if you take a year to establish quality procedures, you can never be sure that you will receive quality parts, on-time. If you decide to go factory direct, you should maintain at least a 3 month inventory in case any problems arise.

Time to Establish Program and Receive First Delivery

<u>Type</u>	<u>Lead Time</u>	<u>Activities to Establish Program</u>
Blended Supply	3 weeks	Review quotations and domestic only quality procedures.
Broker	3-6 months	Review quotations, and both foreign and domestic quality procedures.
Factory Direct/ Consultant	6-18 months	Full vendor evaluation of Chinese factories. (Strongly suggest site visits to factories in China.) Establish quality procedures and documentation, set-up outside inspection agencies for CMM inspection of parts, and metallurgical testing including properties and hardness testing. Negotiate shipping contracts for full containers or work with consolidators for partial shipments. Locate a customs house broker to handle clearance of shipment. Negotiate payment terms with factory or go through bank for letter of credit. Hedge currency fluctuations.

MYTHS & REALITIES ABOUT CHINESE MANUFACTURING

There are many incorrect perceptions about Chinese manufacturing that are applied as a blanket to all factories in China. Much like here in the U.S., there are some very high quality manufacturers and some back alley shops that make awful parts.

If you selected the “Blended Supply” program, this information will be less of a concern to you, but if you have decided to go “Factory Direct”, this information will be very helpful. “Blended Supply” vendors are the most highly motivated to select quality China partners because if they don’t, it will cost them a significant amount of money. In the case of brokers and consultants of factory direct, you would be the one losing the money.

The information below is based on my inspection visits to 9 different Chinese factories. Some of the information listed was observed only at our partner factories, so not all factories do these things, but the quality ones should.

<u>MYTH</u>	<u>REALITY</u>
Unskilled Workforce	Just like U.S. factories there are low skill/wage and high skill/wage workers. In China, each cell of machines has an engineer who establishes quality procedures and fixtures for each part. 35% of the CNC operators are from trade schools. The remainder of operators are enrolled in the factory training program (similar to the U.S. Journeyman Program). The turnover is very low in these factories.
Low Technology Equipment	The majority of Chinese factories use the same exact CNC equipment as U.S. factories. Through the influence of U.S. manufacturers, they have adopted new operating procedures and cutting edge technology. Yes, there are some that are still using “hammer and chisel” technology, and they should be avoided.
Poor Inspection Procedures	Many of the factories in China, including our partner factories are ISO-certified. They have been quality approved by several large U.S. manufacturers who require the greatest level of quality control for their parts. Each company has their own inspection facilities that include metallurgical testing equipment as well as CMM and optical comparators. Most of the parts are inspected 100% by the operator, and they use AQL Level 1 inspection criteria for final inspection.
Low Quality Materials	Material is an area to pay special attention. Chinese factories have access to high quality material, but if you do not specify the exact metallurgical properties of the material you want, you may get a lower quality substitute. An example of this would be low supplies of Nickel in China that result in a stainless steels that do not match ASTM standards for stainless. In many cases the substitute material is fine, but in some cases it is not. If you go direct or with a broker, be aware of these issues and clearly specify material standards. A quality partner will also use outside inspection agencies to fully ensure material quality.

Late Shipments	Yes, it does happen often. There are many variables that affect the delivery of these shipments; however, by selecting the appropriate sourcing program you can virtually eliminate the effect of this on your business. (See “Blended Supply Program” details.)
Long Lead Time	3-6 months is a realistic turnaround from China beginning with release of order to receipt of first delivery. This depends on the complexity of your part and the selected mode of shipping. The blended supply program could reduce this time to 3 weeks. Even if you were just saving \$1000/week, that could result in lost savings of \$21,000 or more.
Slow Shipping	Ocean freight does take 4-5 weeks to get from Shanghai port to our facility, however; air shipments are available in 7-10 days for lighter, smaller shipments. UPS, FedEx, and DHL usually take 3-5 days.
Customs Tariffs are High	Customs tariffs vary widely based on the use of the part. Tariff rates range up to 6%.