

Harnessing the Potential of Global Sourcing

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A solid sourcing strategy that's supported throughout the organization and carried out among worldwide locations is critical for successful global sourcing initiatives.

In this article ...

At a glance, here are the main points covered in this article. By reading it, you will learn:

- The difference between international purchasing and global sourcing
- How to manage currency fluctuations
- The reasons behind a global sourcing initiative
- How to protect intellectual property

As global economies have changed, so too have organizations' outlook on sourcing. Many are expanding their enterprises into vast regions of the world. Whether it's Eastern Europe or Asia, global sourcing initiatives are underway to capitalize on lower costs and cheaper labor, as well as to locate new sources of technology and remain competitive. However, what are the decisions behind a global sourcing strategy? What determines the potential supply source? How are global sourcing strategies measured? When should assessments of these strategies take place? All are critical questions in the sourcing process that may ultimately determine success or failure.

The idea of global sourcing is not a new concept. Industries have engaged in cross-border and overseas buying practices for many years. What is new is a willingness to take a more structured and proactive approach to global sourcing. The sourcing practices of the past are being re-examined and new strategies are being developed. The success of a global sourcing initiative rests with the ability of organizations to communicate, consolidate and coordinate their worldwide sourcing efforts. The following areas highlight the necessary elements to be successful in those endeavors.

- Defining global sourcing
- Deciding on a global sourcing initiative
- Examining supplier relationships and cultural differences
- Conducting a global strategy assessment

Defining Global Sourcing

What does it mean to be a global organization? For some, it means doing business with suppliers outside U.S. borders (i.e., North America), while others define it as relying on an overseas supplier for products or services. In both instances it means much more. Simon Bell, director of the Global Business Policy Council for A.T. Kearney, Inc. in Alexandria, Virginia, says that a globalized supply chain sources and operates in parts of the world where it's done best regardless of specific domestic market needs. However, even the most progressive

organizations in industries such as automotive, computers and semiconductors are just beginning to scratch the surface of global sourcing and rarely look beyond the borders of one country. "U.S. organizations consider different sourcing locations as anyone from Massachusetts to Arizona or anybody from Miami to Seattle, but view it as a qualitatively different decision to decide between Miami and Bangalore, India," says Bell. "A global company thinks of itself as one large talent pool and market as opposed to a series of separate markets."

While the terms are often interchanged, fundamental differences exist between **international purchasing** and **global sourcing**. International purchasing relates to a commercial transaction between a buyer and a supplier located in different countries. Organizations must contend with longer distances, increased rules and regulations, currency fluctuations, customs requirements, and language, cultural and time differences. Global sourcing, on the other hand, involves proactively integrating and coordinating common items and materials, processes, technologies, designs and suppliers across worldwide buying, designing and operating locations. Firms that pursue global sourcing must still contend with the operational issues that affect international purchasing. What changes is the amount of cross-functional and cross-locational coordination that is required.

The degree to which an organization is global in its sourcing efforts can be determined using a five-level continuum. This scale provides a hierarchy against which organizations can compare their sourcing activities. The following is a breakout of the sourcing scale:

- Level 1: Engage in domestic purchasing only
 - Level 2: Engage in international purchasing as needed
 - Level 3: Pursue international purchasing as part of the sourcing strategy
 - Level 4: Integrate and coordinate global sourcing strategies across worldwide locations
 - Level 5: Integrate and coordinate global sourcing strategies with other functional groups
- (Levels 2 and 3 represent international purchasing and levels 4 and 5 more closely reflect global sourcing.)

How do U.S. organizations stack up against this continuum? Most firms operate at level 3 on the scale, which means that many are not tapping into the opportunities that a global sourcing initiative can yield. Two major factors can be attributed to these missed opportunities. First, decentralization exists in many organizations. Because a global sourcing initiative requires collaboration across worldwide business units, a decentralized enterprise often hinders that ability. However, as sourcing initiatives evolve, organizations are expected to migrate toward centrally led purchasing and coordination.

Second, while a majority of organizations are globally aware, especially on the marketing side, they're less astute on the sourcing side. While they understand what's required to sell their products or services to one or more regions, international purchasing and global sourcing decisions are more opportunistic and reactive in nature (also referred to as a fashion and fear motive) rather than based on proactive strategies. As opportunities expand in India and China, those regions attract U.S. operations because of the business trends (e.g., lower costs and cheaper labor) that exist there. Also, the fear of competition or backlash from industry analysts creates impulsive sourcing decisions. Thus, a proactive approach is needed that brings together all organizations' buying units worldwide under one global sourcing strategy umbrella.

Presently, many companies lack a true comprehensive global strategy because there are few suppliers with global capabilities. Sourcing strategies are often pushed back to the regional level and the regions decide where to source worldwide. A global supplier is one that can competitively meet an organization's requirements on a worldwide basis. Regardless of

location (the United States, Europe or Asia), a global supplier can work operationally, logistically and organizationally with a buyer.

As organizations progress along the global sourcing continuum, the issues encountered during basic international purchasing, such as supplier negotiations, currency fluctuations, shipping product over long distances and measuring suppliers, don't disappear. They're just as important in levels 4 and 5. What evolves are organizational relationships where supply managers may be working on a team with members from different regions and functional groups rather than a team that is strictly domestic or populated with professionals from a single region or site. It's within this team that global sourcing activities are developed, implemented and maintained. But even more important is weaving these activities into the overall business strategy of the organization. This begins to define the true nature of global sourcing.

Deciding on a Global Sourcing Initiative

With global sourcing defined, what are the factors that drive global sourcing initiatives? As previously discussed, there exists a fashion and fear motive that drives many firms to venture into other regions for supply. However, as the global landscape evolves, organizations are beginning to re-evaluate their business and sourcing activities. Reasons for sourcing worldwide should be based on a comprehensive analysis rather than a reactive decision.

At Pfizer Inc, a research-based global healthcare company in New York, special consideration is paid to the company's assessment of the opportunities and local and regional readiness to support global sourcing strategies. Frank Callaghan, director of global sourcing for Pfizer, says that an assessment is based on information gathered from finance regarding the size of the actual spend in different areas and how it's spent. Is spending focused on one or two suppliers or is it fragmented among many suppliers? Is it a large enough spend that the company would want to put a concerted effort into reducing it based on benchmarks through consulting and other resources? "We try to understand the operating plans, the plan of action for the year, to ensure our sourcing efforts are aligned with Pfizer's business strategy and prioritized appropriately," says Callaghan.

He adds that the potential supply source in a global initiative is determined by the size of the opportunity and the probability of team success. Using Six Sigma tools such as failure modes and effects analysis, the risks of sourcing material from a region are identified. "By evaluating each of the risks (e.g., political instability, currency fluctuation and logistics issues), Pfizer can develop a plan that would mitigate all or part of those that impact our ability to be successful," he says.

Pfizer is a good example of a company that examines the global landscape to ensure that resources are available before committing to a sourcing strategy. Organizations have several reasons for determining that going global is the right decision.

1. **To gain a global perspective.** Based on its strategy or strategic planning process, the enterprise has decided to elevate its sourcing from a regional to a more global perspective. For example, the enterprise may decide to search for a supplier that not only can produce in North America but also can competitively supply to Europe and Asia.
2. **The cost/value benefits.** After a comprehensive analysis, the enterprise selects a supplier that offers the greatest cost advantage, regardless of that supplier's location. While a common answer for worldwide sourcing is to look for cost reductions, supply managers must examine the benefits beyond a simple price factor and measure the total landed cost. This means taking a variety of elements into consideration, such as production and logistics costs. The initial price may be lower, but the total cost could outweigh any price savings.

3. **Search for new product and process technology.** Depending on the technology, there are often just one or two regions that meet enterprises' product or process requirements. In fact, several studies have found that greater access to product and process technology is a widely cited reason for global sourcing (after cost reduction benefits). Global economics and production capability can also dictate the sourcing decisions surrounding technology innovation. With a heavy focus on China and India, these two regions are prime sourcing locations for many technology-related items. Hence, Bell believes that within the next 10 years, the growth of multinationals from China and India will accelerate. Much of the new competition for the United States will come from these two regions. "The earlier that U.S. organizations are sourcing and operating in those markets and observing the competitors there, the better," he says.

4. **Transition from selling to buying in a region.** Because of the enterprise's desire to sell to a region, it may decide to source there. By establishing a global presence, an enterprise is benefiting its marketing effort because the region is already familiar with the enterprise as a customer.

In a manufacturing environment, sourcing decisions are often dependent on whether it's a standard item or raw material, or an item with a high degree of engineering and design content. If supply managers are sourcing a technical, value-add item, factors beyond price such as innovation, technical capabilities and technology roadmaps will determine the supply source. For standard items that are available worldwide, it may be based on whether the supplier can meet cost, quality and delivery requirements.

From a services perspective, more organizations are trying to locate global providers. The primary concern in a services environment is whether the supplier has resources available where operations are located. For example, in facilities management, an organization may have 70 facilities worldwide with heating, ventilation and air conditioning (HVAC) service needs. Rather than have every facility use its own HVAC supplier, one or several global suppliers are chosen to manage each of the facilities. In every case, a global provider must respond quickly to emergency needs and have the capacity to support continuous operations.

When considering a global sourcing initiative, supply managers must step back and ask three questions.

- First, are we simply buying something or are we developing a worldwide strategy?
- Second, are we reactively buying or proactively developing a worldwide approach?
- Third, are we centrally leading the strategy with coordination from a high level or are the operating sites buying in a decentralized environment?

These are important questions to consider when making global sourcing decisions.

Examining Supplier Relationships and Cultural Differences

During the development of a global initiative, it's important to examine the implication a decision may have on supplier relationships as well as any cultural issues that may arise. How will supplier relationships change? Are these changes beneficial to the organization? What is the organization's ideal relationship with the supplier? Like any relationship, there are going to be challenges.

A major challenge involves the supply chain adjustment of using a new supplier. From a relationship perspective, not everyone in the supply chain may agree with the change. Bell says that historical attitudes can be a major detriment to global sourcing. There's often

organizational resistance when a sourcing team is presented with the opportunity to source the same product or service from an overseas supplier as opposed to a long-standing domestic supplier. "Individuals from the existing organization have a solid relationship with a select group of suppliers and now they're suddenly dealing with foreign countries, foreign languages, different regulations and additional complexity," he says.

Another issue is the cultural differences between the organization and the supplier. It's important for supply managers to observe a supplier's cultural heritage. Unfortunately, many organizations hire the services of a third party to navigate this uncharted territory. Bell says that when building relationships with suppliers, partners and customers, organizations must understand the way people operate with each other and understand how to build trust and relationships with people locally. "This means recruiting as diverse a workforce as possible for all of your supplier and partner relations."

Callaghan believes that having team members who are resident in the region increases the chances of success because it improves competitive intelligence and supplier relationships. When constructing a sourcing strategy, regional team members can make recommendations based on the realities of the local marketplace. For example, things such as software and communications capabilities that U.S. organizations rely on to conduct business are not always accessible in other regions. "Identifying those issues in the planning process, regional members are critical assets in the successful implementation of the initiative," he says.

Possibly the largest challenge is the issue of time and distance. Ideally, organizations want a supplier that has a presence in the areas in which they operate because it leads to frequency of contact and problem resolution. One trend that's occurring, says Bell, is that OEMs in a number of industries are encouraging their global suppliers to follow them to new markets such as China or India. "In markets where organizations want to sell and source products, they're asking their first- and second-tier suppliers to go there and establish their own plants, which can deepen the relationships with existing suppliers," he says.

Bell says another trend is turning to new suppliers in emerging markets to enhance the business and develop new products. What can occur is friction between existing suppliers because new competitors are being introduced. Also, developing relationships with new suppliers requires more hands-on supplier management. "If you're going to develop a supply chain from India or China that has the same reliability and polarity that you expect from your Western suppliers, then you must spend more time on training, supplier development and quality management," he says. "Thus, it becomes more of a supplier development function rather than simply a supply management function."

Conducting a Global Strategy Assessment

Because the development of global sourcing strategies should be a continuous process that organizations go through to identify opportunities, constraints and plans, a regular assessment is essential to ensure that the goals of the strategy are being met. While organizations should have a commodity team that assesses supplier performance on an ongoing basis, an annual strategy review is still needed. Callaghan agrees and says that as economic and political changes occur, organizations will need to reassess their role in a region. "When an organization assesses its business strategy, it should also assess the sourcing strategy because the two should be aligned," he says. "Whether that's predicated by company, industry, economic or political changes, it will determine if the sourcing strategy should be tweaked or redrawn."

Some companies have a defined process or tool in place to help review sourcing strategies. For example, in an organization's contract repository, a warning system may notify a supply team six months before a global contract expires, allowing the team to begin a planning review. Callaghan says one of the most important processes in place at Pfizer involves executive sponsor updates where sourcing team accomplishments and issues to be resolved

are reviewed. "It's an interactive discussion that keeps the sourcing community informed of business changes and new priorities," he says. "We also have spend tracking tools that allow us to understand what the most significant supplier positions within Pfizer are to ensure that our sourcing strategies take them into account and are being implemented."

Today, the boundaries are wide open where organizations can source products and services. What's required is a solid sourcing strategy that's supported throughout the organization and carried out among worldwide locations. Supply managers are an essential part of promoting the advantages of global sourcing and should be a core participant in communicating and coordinating worldwide strategies. As organizations become more astute regarding their global sourcing activities, their total costs should decrease as their supply chains operate more effectively.

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Managing Currency Fluctuations

Any executive who travels extensively knows how swings in currency rates can alter prices around the world. But supply management professionals know that currency fluctuations are part of doing business when buying internationally. And many of these same professionals know that at times they may gain rather than lose from currency changes. For most supply managers, however, their objective should be to protect their firm from risk due to currency fluctuations.

Consider a firm that originally negotiated a contract for \$75,000 to be paid in Canadian dollars (the currency of the supplier firm). At the same time, the Canadian dollar was \$1.37 to the U.S. \$1.00. A mere six months later, when the Canadian dollar had strengthened to \$1.20 to U.S. \$1.00, the buying firm faced a 14-percent increase in the number of U.S. dollars required to pay for the equipment in Canadian dollars. Now imagine this simplified example extrapolated across several global contracts. Fortunately, a variety of approaches and techniques that can be implemented into overall contract strategies help manage currency changes.

Buy in U.S. dollars — Paying for foreign goods or services with U.S. dollars seems to be the easiest and, at first glance, the most logical way to manage currency fluctuations. This approach, which shifts currency risk to the seller, may not be as easy as it sounds. Foreign suppliers are aware of currency fluctuations and may be unwilling to accept any risk. Furthermore, many foreign suppliers incorporate a risk factor into their price when assuming responsibility for currency fluctuations.

Ignore currency fluctuations — Ignoring currency fluctuations may make sense under certain conditions. Some purchases are short-term, one-time or involve relatively few dollars. Also, a buyer may be confident that a foreign currency will remain stable against the dollar. The buyer may conclude that ignoring currency fluctuations, at least in the short term, does not present an unacceptable risk.

Buy from countries that peg their currency to the dollar — Some countries maintain or peg their currency at a fixed or relatively stable rate against the U.S. dollar. China is the most notable country that continues to peg its currency at a fixed rate against the dollar. (China pegs its currency at 8.2766 yuan to the dollar.) As long as a country maintains its currency at a stable rate compared with the dollar, currency risks are minimal.

Share currency fluctuation risk — Sharing currency risk involves the equal division between a buyer and a seller of a change in an agreed upon price due to currency changes. While sharing risk does not eliminate risk, it helps minimize the impact of any changes that

may occur.

Negotiate currency adjustment contract clauses — With this technique, both parties agree that payment occurs if exchange rates remain within an agreed upon band or range. If exchange rates move outside the range, the parties can renegotiate or review the contract. Currency adjustment clauses usually stipulate that exchange rates are reviewed before delivery (delivery-triggered clauses) or at specified time intervals (time-triggered clauses).

Hedge currencies — Hedging involves the simultaneous purchase and sale of currency contracts, often over a timeframe that coincides with a foreign purchase. A gain realized on one contract will offset a loss on the other contract. The objective of hedging is to avoid risk rather than realizing a financial gain. If the purpose of buying currency contracts is to gain financially, then the purchaser is *speculating* rather than hedging.

Supply managers who enter into longer-term or high-dollar contracts with foreign suppliers should consult with their finance or treasury departments. These departments often have extensive international currency experience and can give advice or even take responsibility for hedging, currency forecasting, developing currency contract language and clauses, or making payments to foreign suppliers. For a comparison of historical currency exchange rates by country, visit www.x-rates.com/cqi-bin/hlookup.cqi.

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Protecting Intellectual Property

Several years ago, a Midwest maker of power tools realized that to remain competitive, the company had to dramatically reduce its product costs. Management decided that outsourcing its lower-end tools to an Asian contract manufacturer should result in double-digit cost savings. Unfortunately, the Taiwanese contract manufacturer selected by the U.S. toolmaker saw nothing wrong in "borrowing" the customer's design to produce and sell its own line of tools across Asia. And to make matters worse, the U.S. producer began to see inexpensive tools working their way into U.S. distribution channels. The company soon found itself competing against its own designs and tools. A strategy that was designed to increase competitiveness had gone terribly astray.

International purchasing presents a new set of risks compared with domestic sourcing. Supply managers must contend with longer material pipelines, currency fluctuations, increased risk of theft or loss, and, of course, the possible theft of intellectual property (IP) including copyrights, designs, patents and trademarks. While movies, books, records, clothing and other consumer goods have been routinely pirated or counterfeited, producers of industrial products must also be prepared to protect what is rightfully theirs. Estimates of the costs of intellectual property theft to U.S. firms are not insignificant — they range from \$80 billion to \$250 billion annually.

Given the risk of intellectual property theft when using foreign suppliers, what are some ways to help manage or even prevent this risk?

Disperse your sourcing requirements — One way to manage IP risk is to disaggregate and disperse your firm's sourcing requirements among several providers rather than providing a single supplier with access to your entire design. Of course, final assembly still must occur at a trusted location.

Establish proprietary assets in a foreign country — Another option that provides greater control over IP is to establish operations in a foreign country or form a joint venture with a

foreign partner. This is probably not the best option when sourcing components or raw materials. Rather, it is more likely when producing finished products. Keep in mind that most firms are increasingly reluctant to take on new capital assets.

Seek legal support and legal remedies — Legal experts are available who can help identify preventive measures as well as legal remedies if IP violations occur. These experts can also help purchasers develop contract language and non-disclosure agreements that address intellectual property protection, including where to establish jurisdiction in the event of an IP dispute. Legal groups can also help with the filing and protection of patents, trademarks and copyrights before doing business in a foreign country.

Develop trusted in-country representatives — A major risk when sourcing internationally is not having a local representative to represent and protect the supply manager's interests. This representative, who is usually local to the region where sourcing will occur, can work in conjunction with a firm's global purchasing office or be an independent representative. Many small- and medium-size companies have found that using a trusted local representative to identify qualified suppliers is essential for protecting intellectual property.

Use international purchasing offices (IPOs) — IPOs, usually staffed by foreign nationals, can provide a strong in-country presence. These offices can evaluate potential suppliers with an assessment of the supplier's willingness to respect intellectual property. The IPO can also maintain a list of suppliers to avoid by region or country.

Avoid countries that are IP offenders — As U.S. firms move quickly to source from China, the basic fact remains that many individuals in China view IP as a form of exploitation by Western countries, and as a result believe they have a right to that property. Our concept of private property is relatively new and even unknown in some countries. U.S. producers may simply decide to avoid certain regions when sourcing proprietary items due to the risk of IP theft.

An expert on the subject of IP protection has commented that managers must face some harsh realities when they expand their sourcing operations internationally. In the search for new markets and lower cost structures, particularly in China and western Asia, supply managers will have to put far more effort into protecting one of their most precious assets — their firm's intellectual property.

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