Sourcing • Supply Base Management

Latin America Sourcing

Survey 2010

Dragon Sourcing 龙 源

Content

Introduction

China, Vietnam, India, and Brazil are countries experiencing unprecedented and exponential economic growth which offers unique opportunities (and risks) to companies wanting to take part in this boom. It is precisely to manage those risks and opportunities that we have created Dragon Sourcing which is focused on helping our clients create long-term and sustainable value in the on-going management of their procurement function and processes in China, India, Vietnam, other south east Asian and Latin American countries.

Achieving procurement excellence in these countries requires the deployment of western style procurement practices adapted to the local context and culture. To that effect, we have built strong and integrated teams of experienced procurement professionals that have built their expertise in the West, Asia or Latin America. Our people originate from either leading consulting organizations where they held key leadership positions in procurement practices or from leading international industrial organizations where they held strong operational positions in procurement. This ensures that we can combine analytical rigor with operational pragmatism; conceptual thinking with down-to-earth "roll up your sleeves" attitude.

After a period of decline in Chinese exports caused by the financial crisis of 2008 and the global slowdown experienced in the western world in 2009 the rate of exports growth from China to the western world has once again reached unprecedented speed in 2010. The tension this has created in bilateral relations between the EU and China and the US and China has incited the Chinese government to modify its exchange rate policy by shifting from a hard peg to the US$ to a link to a basket of international currencies and to gradually remove tax incentives to several Chinese export driven industries (such as textiles) it had reintroduced in 2008 and 2009 as a means to supporting the struggling Chinese exporters. This renewed growth in exports from China is not only putting a strain on international relationships, it is also creating cost pressures internally in China, evidenced by:

- Renewed labour wage inflation not only on the eastern coast of China, but equally in more remote locations as well (see graph 1)
- Labour unrest in several factories that have made headlines recently (Foxconn, Toyota, etc)
- Significant increases in container transportation costs
- The imposition of new anti dumping taxes on several products for which Europe and the US are trying to protect themselves against Chinese imports

Graph 1: The Rise in Manufacturing Labor Costs in China
(average annual manufacturing wages in RMB)

	1998	2008	%change
Guangdong	10,337	25,249	144.2
Guangxi	6,153	21,181	244.2
Hunan	6,108	22,188	263.2
Guizhou	6,193	22,224	258.8
Beijing	11,370	39,076	243.6
Shanghai	12.944	42,311	226.8
Zhejiang	8,321	23,816	186.2
Jiangsu	7,398	25,688	247.2
Chongqing	6,392	24,131	277.5
Sichuan	6,488	22,046	239.7
Inner Mongolia	5,127	22,352	335.9
Tibet	5,612	19,486	247.2

Source: Economist Intelligence Unit

These trends combined with the Chinese government strategic decision to reduce their country's dependency on the export economy by stimulating spending in their domestic market are raising questions about what will happen to China's mid to long term cost competitiveness. This in turn is triggering some strategic rethinking in companies' global sourcing strategies as companies are concerned that they might have put too many of their LCC sourcing eggs into the Chinese supply market. Consequently, many companies have begun exploring alternative sources of supply to manage the perceived country risks associated with China.

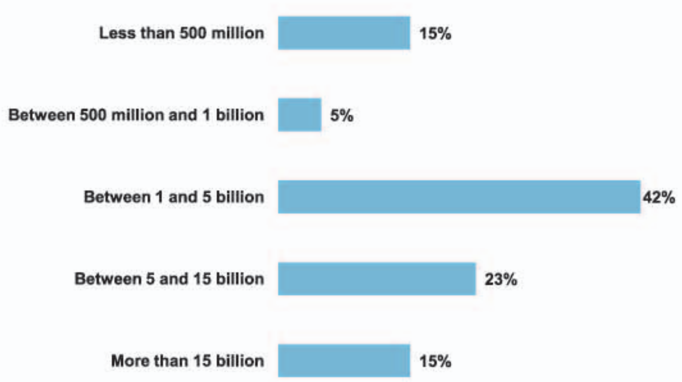
Latin America, and Brazil more specifically, is probably one of the regions which is getting the highest level of interest from companies looking to diversify their LCC sourcing. The interest generated by Brazil is driven by the fact that Brazil is favorably positioned on several key country dimensions:

- On the institutional front, Brazil has experienced a long period of political stability and economic growth which has laid down the foundation for foreign investments to grow and prosper
- On the economic front, whereas Brazilian labour costs are higher than those in Asia, they remain significantly below those in the US or in the EU
- Unlike China, Brazil, and to a lesser extent Mexico benefit from the economies of scale generated by the size of their large domestic market
- Finally, the whole region benefits from shorter lead times and cheaper transportation costs into the US compared to Asian countries

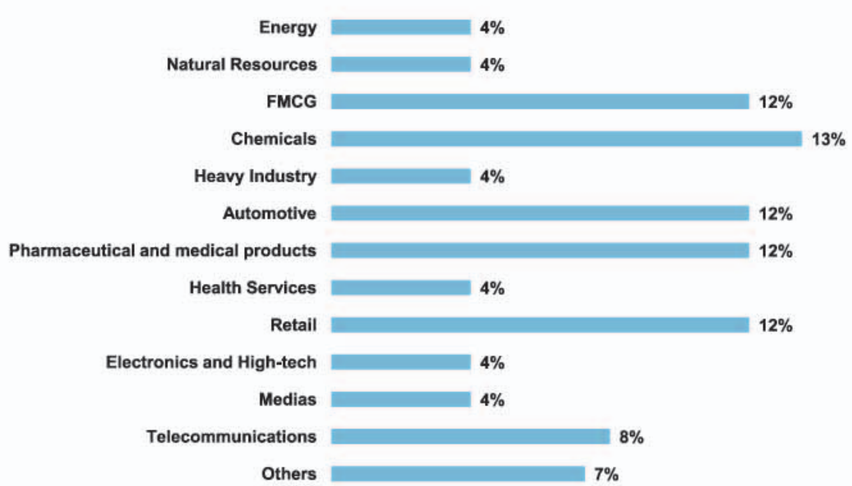
Trends in Latin America Sourcing

In order to assess the level of current sourcing activity as well as the level of interest for developing sourcing activity in Latin America in the future, Dragon Sourcing conducted a survey both in Europe and the US across a set of large corporations representative of all business sectors (see graphs 2 and 3).

Graph 2: In 2009, what was the global turnover of your company
(in €, %age of companies)

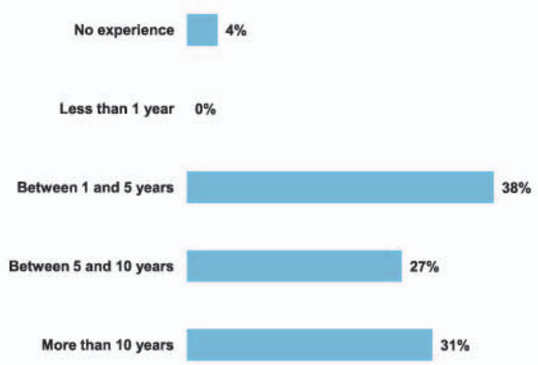


Graph 3: What is the primary business sector of your company?
(%age of companies)

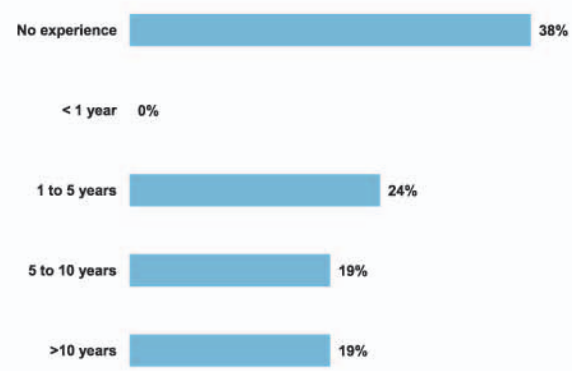


What appears very clearly from the survey is that most companies have significant experience in sourcing from LCCs (86% have at least 1 year of experience in LCC sourcing, see graph 4) and more than 60% have experience in sourcing from Latin America (see graph 5). The importance of this phenomenon is reflected in the statistics of graphs 6 and 7:

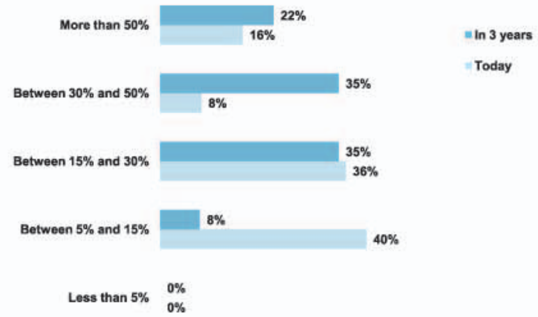
Graph 4: For how many years has your company been sourcing from LCCs?
(%age of companies)



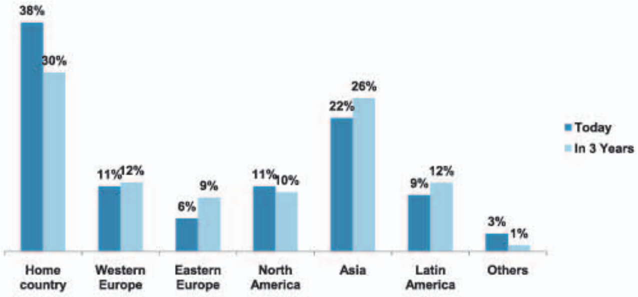
Graph 5: For how many years has your company been sourcing from Latin America?
(%age of companies)



Graph 6: What percentage of your spend is sourced from LCC, today and your estimation in 3 years?
(%age of companies)



Graph 7: Which regions are you sourcing from
(%age of companies) ?



- Whereas 40% of the companies are sourcing less than 15% of their spend in LCCs currently; this percentage is expected to drop to 8% in 3 years from now. Similarly, whereas only 24% of companies are sourcing more than 30% of their spend in LCCs today, this percentage is expected to increase to 58% in 3 years from now

- When looking at these trends in more detail, Asia followed closely by Latin America and Eastern Europe appears as the great beneficiary of the geographical rebalancing which is taking place globally:
    - Currently, 60% of the spend originates from High Cost Countries (Western Europe, North America, Japan); this percentage is targeted to go down to 52% by 2013, a massive 13% drop in High Cost Country sourcing in a matter of three years.

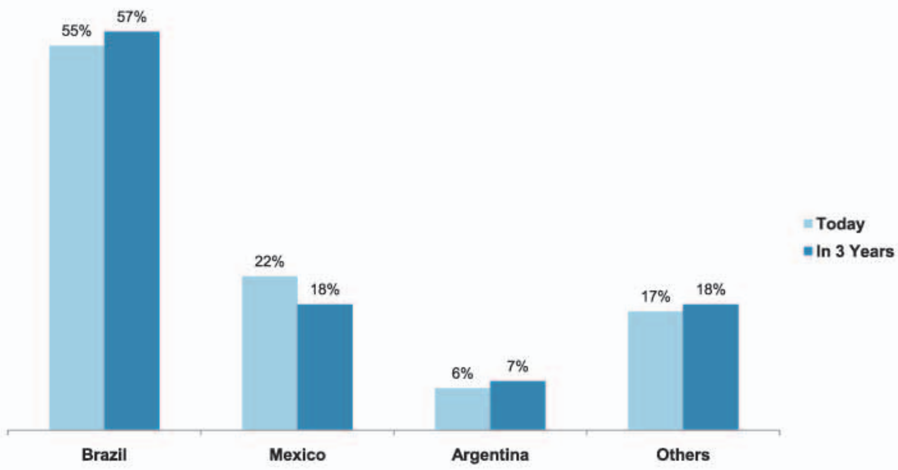
    - This 8 point reduction (from 60% to 52%) is essentially explained by the uptake in LCC sourcing:
        - from Asia which will account for 26% of companies' spend in the world
        - from Latin America which will grow from 9% to 12%
        - …and from Eastern Europe which will grow from 6 to 9%

Within Latin American (see graph 8), the country which is currently getting the lion share of the spend is Brazil (55% of the spend) with Mexico and Argentina being very distant second and third. Interestingly, it appears that Mexico will be losing ground in the near future with its share dropping from 22% to18% at the expense of Brazil for half - which will see its share grow even bigger - and other Latin American countries for the other half.

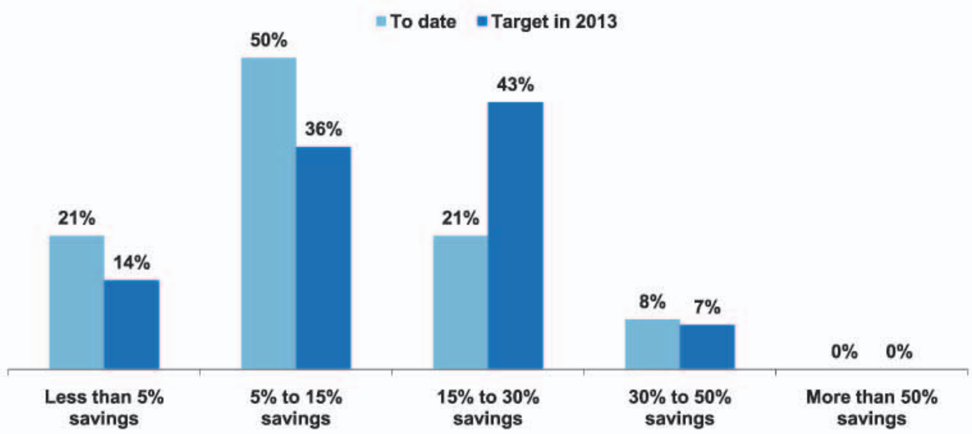
The significant increase in spend which is expected to happen in Latin America over the coming three years is hardly surprising when looking at the level of savings which companies have realized and are planning to realize in the coming three years (see graph 9)

- 28% of the companies have realized average savings of nearly 30% to date
- Similar savings levels are targeted in the coming three years by 50% of the companies in the survey

Graph 8: Within Latam, please indicate how your spend breaks down by major countries
(as a % of your spend in Latam)

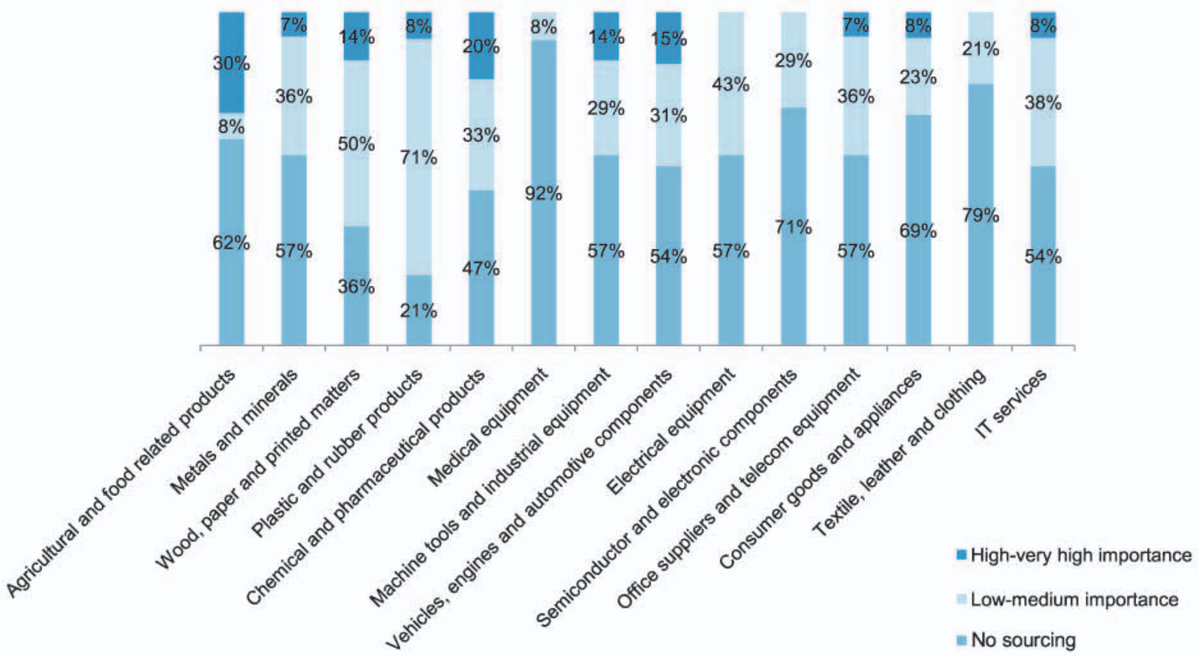


Graph 9: What savings have you achieved to date and what targets have you set for your Latin America sourcing initiative by 2013?
(%age of companies)



The companies that are currently sourcing from Latin America are focusing on the natural resources categories where Latin America has historically been strong such as agricultural and food related products, wood, and minerals. However it appears that Latin America (and Brazil in particular) is moving away from being a commodities exporter only to become a more diversified player in international trade by making inroads into several value added verticals such as plastic and rubber components, chemical and pharmaceutical products, automotive components, machine tools, industrial equipment, and even IT services (see graph 10)

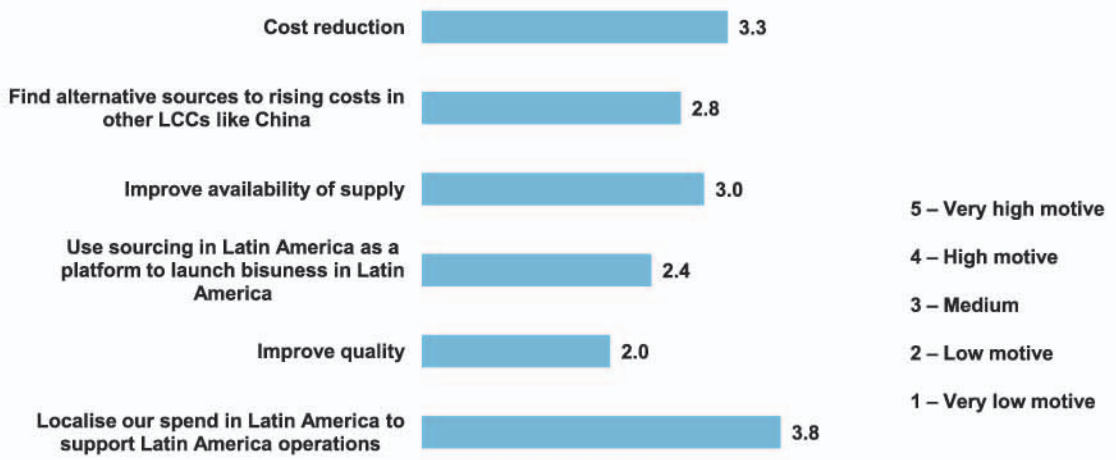
Graph 10: Amongst the following spend categories, please indicate their relative importance in your Latin American sourcing program



Surprisingly the major driver to Sourcing from Latin America (see graph 11) is not the search for cost reduction (which ranks as second in the priority list) but the need to localize the spend in Latin America to support manufacturing facilities that have been set up in Latin America for the domestic markets. This is driven by a combination of factors:

- The spectacular growth which the region is experiencing (especially in Brazil) that has been driven by significant external investments
- The protective nature of the Latin America economies which still impose significant duties on most imports from outside the region thereby forcing companies to find local sources of supply to remain competitive in their domestic markets

Graph 11: What drove your company to source from Latin America?



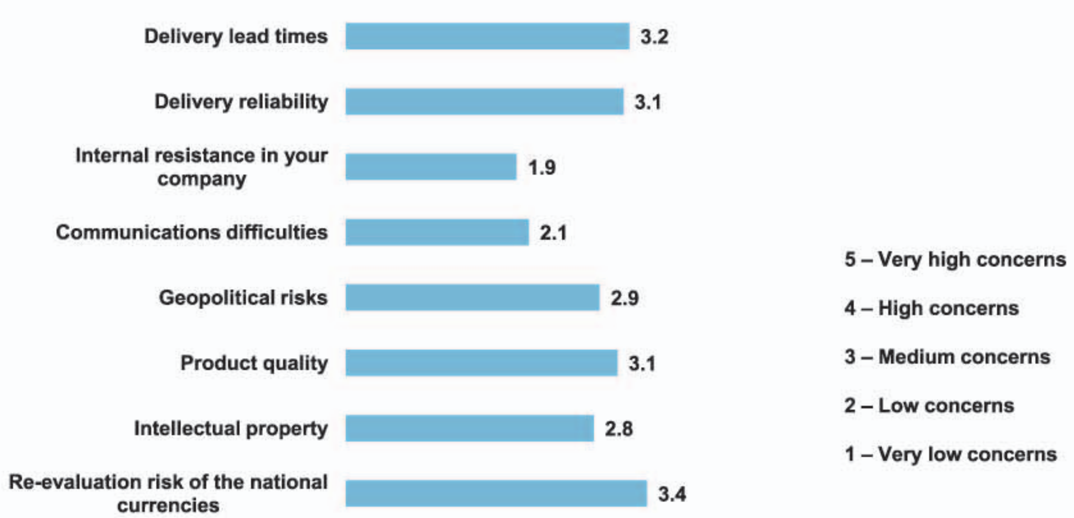
The major barriers hindering companies from sourcing from Latin America are (see graph 12) :

- The risk associated with the potential revaluation of the Latin American currencies in general and of the Brazilian Real in particular is rated as the number one factor hindering companies from sourcing in Latin America. This is a reflection of the lack of currency stability that has been pervasive in the region over the last 10-15 years making it more difficult for companies to assess the longer term effectiveness of their sourcing decisions
- Delivery lead times and delivery reliability which are still perceived as being questionable by many of the survey' s respondents

In addition to these two fundamental issues of currency and delivery; other more traditional barriers that are common to all LCCs are mentioned as well such as:

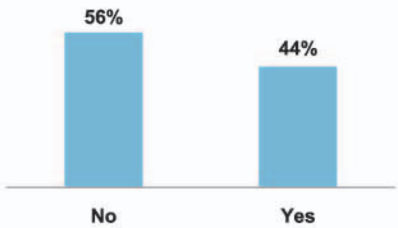
- Internal barriers to change which make it very difficult for procurement professionals to convince their internal customers in engineering, manufacturing, quality, and marketing to take the risk of testing new suppliers
- Communication difficulties which discourage some companies from attempting to reach out directly to potential suppliers in Latin America.
- Quality risks where the belief is that low costs is often synonymous with low quality
- and finally geo-political and intellectual property risks

Graph 12: What are your concerns when sourcing from Latin America?

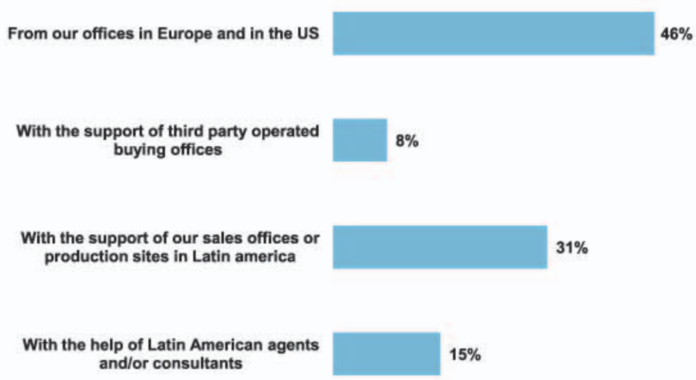


Nearly half of the companies that are sourcing from Latin America are doing so via an internally set up Buying Office located in the region. Companies that don't have an IPO either source directly from their home offices in the US and the EU or leverage the capabilities of their local sales or manufacturing locations in the region (see graphs 13 and 14)

Graph 13: Do you have an IPO in Latin America?
(%age of companies)

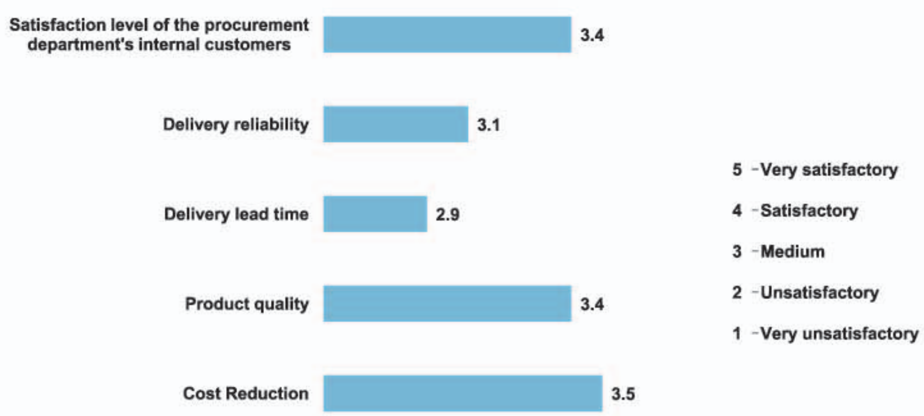


Graph 14: In absence of a Latin American IPO, how do you manage your sourcing from Latin America?
(%age of companies)



Finally, in terms of results achieved, companies report mixed results (see graph 15). On the one hand, they have met their expectations in terms of cost reduction and product quality; however they have clearly experienced difficulties in terms of delivery confirming the related concerns mentioned above when describing companies' barriers to sourcing from Latin America.

Graph 15: What sourcing results have you achieved in Latin America



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Best Sourcing

Practices from Latin America

Identifying the key success factors of an effective Latin America sourcing strategy and leveraging the best practices of the most experienced global corporations in this field constitute the last section of this report. The analysis of the companies with the best practices' has allowed us to identify 3 critical success factors that explain the difference between success and failure in this area:

Engage the whole enterprise in the initiative

Making a success of a sourcing program in Latin America requires overcoming significant internal barriers to change. Key functions of the corporations will raise issues in terms of quality, flexibility, reactivity which will complicate attempts to source from Latin America. To surmount those internal resistances, the Latin America sourcing initiative needs to be driven top down by top management and engage the whole enterprise under the stewardship of the procurement department. The program needs to include from the very beginning key internal customers (engineering, manufacturing, quality, and marketing) and ensure representation from key departments in multi - functional working teams. In order to reduce internal barriers, if possible pick some of your initial pilot categories amongst those categories that are already being sourced from low cost countries. Savings will in all likelihood be lower but the company's readiness to resource from an existing LCC supplier to one located in another country will be much higher.

Deploy dedicated "export buyers" based in Latin America

Many companies initially tried to leverage buying resources from their local Latin America operations to drive their "export sourcing" program. Most of these companies failed in this approach realizing that sourcing for the local requirements versus sourcing for the export market often required a different set of capabilities in the supply base and a different set of skills and competencies (both linguistic and technical) in the human resource base. Best practice entails deploying dedicated buyers, separated from the buyers for the local market, focused exclusively on sourcing for the export market either by opening a fully owned IPO or by leveraging the capabilities of an external Procurement Service Provider (PSP) .

Implement western style procurement processes in Latin America

It is often assumed that buying practices in Latin America are very different from those in the West. Whereas in the West sourcing is a highly structured, fact based, objective and disciplined process, sourcing in Latin America would be more of a network and relationship driven game. Whereas there is an element of truth in that, "Network buying" tends to be the default process which is implemented in the absence of a fact - based process. In our experience, Latin American economies are highly receptive to the deployment of western style procurement practices based on templated RFIs/RFQs, objective supplier selection, negotiation processes, and quality audit procedures similar to those conducted in the West. As a matter of fact the biggest savings are achieved when similar buying processes to those implemented in the Europe and the US are rigorously applied in Latin America.

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