

## The Truth About Sourcing

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### **Forward**

This white paper was prepared as a practical means to answering the most commonly asked questions and concerns about global sourcing specific to China. The document provides a conversational, Question & Answer overview from the perspective of Vital Co-Founder, Jason Sprong -- and has been written for those interested in knowing more about manufacturing their products in China or partnering with a China sourcing company.

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## **Why is it that I am intimidated about manufacturing in China when so many companies and most of my competitors are already doing it?**

If you're not intimidated by China, you should be. It is immense, complicated, ever-changing and inherently different than the West. Unlike Europe or the Americas it has been open for business only since the end of the 1970's. The interaction and exposure between East and West has been miniscule compared with the changes that have occurred since the industrial revolution. More than a lack of history though, is the actual historical differences between the East and West that make it so intimidating.

There are inherent ideological and philosophical differences in the way Westerners and Asians view the world. Most people understand that it is difficult to do business in China. What they don't realize is that these deep cultural differences are at the root of most problems. Without a thorough understanding of why Eastern and Western differences exist, companies will be at a strategic disadvantage in any China efforts.

China is intimidating, but companies today must have a China Strategy. When the average hourly wage is 25 times less than the US and 4 times less than Mexico it becomes a competitive necessity.

The other reality to bear in mind is that anyone who buys a product made in china can claim to be "Sourcing from China." In reality, no company without a presence in China, whether themselves or with a viable partner, can ever know much about the supply chain of their items. In practice many companies claiming to purchase goods in China have had their fears and doubts allayed by a variety of middle men. The problem with this is the lack of control maintained over their products and the numerable profit levels added by these middle men.

Many companies erroneously believe that if they are simply buying from China they are doing what they can to stay price competitive. The companies that truly excel, however, know that China is much too large and complex for this to be the case. The Western companies that have been successful in China have established positive partnerships, nurtured relationships of mutual understanding, and constantly stay on top of daily business in Asia.

## **I'm told that if I go to China for product, I will get a good price, but my quality will suffer – is that true?**

There is certainly a lot of precedence for this thinking. Much of that has to do with how China first began producing for the West and with Westerners' demands and expectations on the Chinese.

The major impetus for any company to source product from China is of course price. The most common mistake, however, is to demand price decreases from the network of people purchasing and producing goods while not fully understanding the processes at work. When there are 5 levels of profit built into the cost of an item and pressure is constantly coming from the customer for a cheaper price, every one on the supply chain will be giving up dollars and thus will give up some level of quality.

Perhaps the largest problem is the level of removal from the customer to the actual producer. Without a relationship built at this most basic level any customer is at the mercy of the agents, trading companies, and middle men involved with a factory. How can a company in the West ever truly know the history between a factory owner and the other individuals

involved in the procurement process? What responsibility would anyone feel to someone 5 times removed?

Does this mean that the Chinese can't produce quality merchandise? Most certainly not. They are capable of producing the highest quality products. The means by which so many Western companies actually purchase goods is the wrench in the machine.

Just last month I had a client tell me that Chinese glass was far inferior to that made in Europe. I asked him why he would think that – was Chinese sand less pure than European? His response was that he'd tried to get it before and it was sub-par. In the end I had to send him samples of fine crystal and thick, high-quality glass to allay his fears. He was not wrong to be wary of the quality available in China, but he was wrong in his generalization of all things Chinese. In his previous experience, there were too many levels between him and the actual manufacturer. It's like the game Telephone, where someone whispers a phrase into another person's ear and they do the same to the next person and so on. When the last person speaks aloud what they have heard, it is almost nothing like the original phrase.

The lesson here is that past experience is of little value without reliable knowledge gained from it. Generalizations like, "the Chinese don't get it" occur as a result from such experiences. From a humanistic perspective, it is far easier to simply say "Chinese have bad glass" than to understand our own shortcomings in initially sourcing the product.

### **Is sourcing from China a never-ending battle with quality control and materials, plus things I would probably never think of?**

Running a business that manufactures products anywhere in the world requires tedious work. In China, as with the West, there are always issues that arise, from raw material procurement to fabrication concerns. The problem is that most companies do not conduct the due diligence to truly understand the processes at work in the Mainland, and to maintain the type of oversight that they would demand in the West.

Problems we wouldn't naturally think of will often arise in Asia. This is inherent in dealing with such a foreign place, with a history and culture so very different from ours.

One friend of mine owns a large cut and sew factory in China that makes clothing for fashion dolls. He did a lot of work for Mattel – Barbie products to be specific. Mattel is about as sophisticated a manufacturer as there is in that market. They could not understand, however, why the daily output of a specific outfit was less in China than in their own facility in the States. They knew how long it took to cut the fabrics, how long it took to sew them, how many workers were on the lines, and how long it took to package the goods. Somehow in a 10-hour work day the production of the outfits in China was far below their estimates.

Ultimately my friend figured out that the difference lay in the physical make up of the factories being compared. In the States Mattel owned a one-floor factory (taking up a lot of land.) In Southern China land is at a premium and my friend's factory was built vertically – 4 floors tall. In China they had to walk the goods up a flight of stairs for a secondary finishing process that delayed the number of outfits they could process. These small inefficiencies accounted for considerable lost margins. In the end he re-arranged his facility to mirror the process at Mattel and brought the costs back within estimates. The Chinese weren't slower or less skilled laborers, they just had to carry buckets of doll clothes up too many stairs. This example demonstrates 3 things: you cannot foresee all the issues that will arise, many problems will be endemic to the situation in China, and you need to have very good partners to solve such problems.

## **How many layers of people do I *really* work with when I try to get product out of China?**

It all depends. It could be as small as one layer or as large as 5 or more. Only the largest producers with millions of dollars invested in China are one layer away. They are the GE's, VW's, and Chryslers of the world. They form partnerships with large Chinese producers in joint venture operations. The vast majority of companies that work with China go through a number of middle men. In some cases "middle men" is an inaccurate term, and in others it fits like a glove. For example, someone who helps the factory understand their processes is a lot more than a middle man - he's an on-site asset adding considerable value. Someone who sends orders to facilities that they don't know well and collects papers for their clients is a true middle man.

In china all business is based to a large degree on interpersonal relationships. The importance on relationships is a deep-seeded aspect to life in China and has been a defining element of the Chinese psyche for over 3000 years. It is ingrained and unavoidable. For this reason when a company enters into China in search of providers it must do so via a conduit. This conduit will be a person or company that knows the factory owners, socializes with them, drinks with them, does favors for them, and has somehow maintained what we would think of as a close personal friendship. Many times such a person is not easily accessible to a Western company and they must go to yet another firm or individual that has a relationship with this secondary player – or sometimes a third or a fourth party. Each one of these steps represents a layer and another level of profit, not to mention a step further away from the fabrication floor.

It is imperative to understand that the above is only one element in the chain of involvement. The other is what I call "the invisible hands in the pot." When someone opens a factory in China they often need financial help, help with local and provincial governments, introduction to clients or trading companies...the list goes on. It is very difficult to know how each of these people or entities is compensated by the factory, but many times it is in the form of a percentage of sales. This naturally means that the prices you're getting will be padded with these "unseen" mark ups.

The only way to truly know the number of layers you are dealing with in China is to find the most trustworthy partner available. Only someone with an intimate relationship with the owners and managers of factories will be able to uncover the true nature and make up of those facilities. The hard part is finding such a partner.

Many companies will meet with a trading company either in the West, in Hong Kong, or in Taiwan. These trading companies will speak English and be accessible to most Western companies. Some are good and some are not.

Beware of the Chinese propensity for saying "yes" to just about anything. By nature the Chinese are not a confrontational people. The ideal in Western society is individualism. We praise it. We rear our children to be independent thinkers. We reward those in our society who excel at individual achievement. In China just the opposite is true. The ideal in China is harmony. It is to be in accord with the natural way of things; to be peaceful. In business this often manifests itself as "thick face, black heart." This phrase means that while they may say whatever it is they think someone wants to hear they do just what they want. The Chinese propensity for this has been fueled by the overbearing demands of their Western clients. This often leads trading companies and individuals alike to claim to know just the perfect place to produce a company's goods. It is up to the company to discover if this is true or not.

In the West we place a great deal of import on the words we use. Legal contracts are drawn up with the most minute of details for just this reason. In China, this is not the case – and the lack of any viable corporate legal culture is the result. Words mean much less in China than they do in the West. A wise company will not be easily misled by them.

For these reasons it is imperative to locate an honest partner in China with solid contacts to the types of facilities a company will need to manufacture their products. The company's job will be to cultivate their relationship with this partner.

### **Do I need someone on the ground in China to oversee my operations?**

Unequivocally yes. I run two companies that manufacture products in China. I speak 2 dialects of Chinese. I studied the culture, history, and philosophy of China in the West and in China. I lived in Hong Kong and China for 8 years. And I absolutely depend upon my Chinese partners. It is specifically because I have a solid understanding of the Chinese cultural and historical identity that I know how vital they are to my success.

### **Do I have any recourse if my product is not delivered on time, or if the product that was delivered is not what I ordered or expected?**

It depends greatly on how you structure your payment details with your supplier. Opening a Letter of Credit is probably the safest and easiest way. Within the parameters of the letter of credit you can dictate shipping windows, acceptable quality levels, necessary certificates and forms, proper packaging and carton markings, and any necessary EDI materials. If these terms are not met it will be up to you to decide whether or not to release shipment and thus release payment. The price you pay for this is having access to a credit facility and the 1% a bank will charge – well worth the price.

The bill of lading and commercial invoice will show the contents of any shipment, but to be certain of what is inside you should either have your own QA people inspect the goods at the factory (as they're being loaded into the container) or hire an impartial 3<sup>rd</sup> party to do it for you.

### **How many inspections do I have to do?**

It depends largely on the product you are shipping. If it is a relatively simple item that the factory has produced before than one inspection at the end of the production run may suffice. If on the other hand it's a more complicated item or the first time a factory is producing the item or the first time they are producing for you it is a good idea to be there at the start of production. When a factory is unfamiliar with either the product or the customer, mistakes will often occur somewhere along the production line. By inspecting goods early on and correcting any mistakes you can be more confident that the whole of the production run will be correct.

I used to be in the Toy business. We had just tooled up a new fashion doll that had articulated elbow joints. The joints were part of the internal plastic skeleton that was covered by the PVC skin. We had made a number of prototypes and sold the item to some large US customers. We went up to the factory for the first production run only to find they were putting the arms in backwards. The problem was easily fixed, but if we hadn't gone up early we would have had 300,000 fashion dolls with arms that only bent backwards.

## **How does language impact my ability to be effective in China?**

Language is of major importance in China, not just as it relates to foreigners, but how it relates to the Chinese. Certain dialects and accents will reveal someone's background and heritage. Some may ask, "if two people are speaking the same language what's the difference?" The moral foundations for Asians center around personal relationships. It begins with one's relationships to the immediate family and spreads to other relations, friends, people from the same community, people in the same city, province, region, nation, etc. As with a pebble thrown into a pond there are ever widening circles emanating from the center. If the Chinese supplier is the center than you want to be dealing with someone on the closest circle possible.

For the most part foreigners are lumped into one category: customers. Language barriers are solved by the Chinese middle men involved. You will not know what they are saying, you will not understand all that occurs. It certainly will impact one's effectiveness in China, but with proper knowledge and good partners you can accomplish a lot. More than any language barriers will be the cultural barriers blocking the way. Overcome these and you've gone farther than speaking Chinese fluently by itself would ever take you.

## **How do I approach negotiations with the Chinese?**

Again the major issue comes down to an intrinsic difference in Eastern and Western mindsets. In the West we are goal oriented and view things in a finite manner. Even the way we discuss negotiations implies a finite occurrence: one in which we engage in "negotiations" and then move on. Not so with the Chinese. For the Eastern mind the ideal is harmony. The gauge is comfort level and intimacy. These can only be gained over time and any negotiations will be a long process that never truly ends.

Negotiating in China requires a very high degree of interpersonal interaction. Great import is placed on the level of one's character. They want to know what kind of person you are: are you sincere, genuine, confident, and intelligent. Are you calculating, deceptive, gullible, or insincere. These are all things which require a good deal of time spent with someone to truly discern. They believe that to see someone's true nature you must spend time with them in a variety of settings, not just the boardroom.

The largest problems that I have seen Western business people face is when they take a position of "we're not leaving this table till we settle this." That's when "thick face" comes into play and the Chinese will say what you want to get you out of the meeting. Westerners think they've accomplished one thing only to find out down the road that they did no such thing.

## **How do I begin to create the relationships I need to be successful in China?**

This is no easy task and it requires time and due diligence to do correctly. The best way is to find someone who you know in a similar business, or a friend who deals with people over in China and ask for an introduction to their trading partners. Alternatively you can find many trading companies both in the States and in Asia – mostly in Hong Kong and Taiwan that proclaim to specialize in dealing with Chinese factories. It is very difficult to try to discern the good from the bad while half the world away. It is an essential that you travel to China with whichever company or companies you are considering. First you have to know if you can work with them. Ask for specifics. What systems do they have in place, what do their purchase orders to the factories look like, what payment terms do they accept, and how do they know the factories you will need. Then you must witness them interact with the factories. Invite the factory owners to dinner, speak to them through an interpreter, watch



carefully how they act with the company that has brought you to them. If they are close friends you will know. If they are stiff and somewhat formal odds are they don't know them to well and they might not be the right people for you.

In essence building the right relationships in China means finding the right partner and building your relationship with them and with the facilities they use.

### **Where in China do I go to get my product manufactured?**

By and large the Pearl River Delta makes up the most developed manufacturing region of China. This is the area directly north of Hong Kong and was one of the first places to open up for trade. It was begun as an "SEZ" or "Special Economic Zone" Foreign investors, primarily from Hong Kong and Taiwan set up factories here to take advantage of the low labor costs.

As the region developed and China opened up more and more areas to free-trade the coastal cities from ShenZhen up to Shanghai became major export centers. Getting goods trucked from the factory to the port is expensive and thus it saves money to have a facility on the coast near a port of embarkment. As well, the wages in the coastal cities are far higher than in the more interior areas of China. This draws the better talented people and managers and keeps the highest quality manufacturing in these South East regions.

The cities on the Yangtze river are the up-and coming manufacturing areas of China. Cities like Ningbo, Nanjing, Hangzhou, and Wu Han. They ship goods down the river and out the port of Shanghai, which is growing at staggering rates.

Presently the freight charges for container ships out of China are cheapest from Hong Kong as it is the busiest port with the most competition. Southern Chinese ports like Yan Tian are increasing their percentage of the export market rapidly and it now can cost less to ship out of China direct than to truck products into Hong Kong.

### **Do I have to pay for product samples?**

All up to the deal you make with your partner or trading company in China. Normally if you have to pay for the freight they will cover the sampling charge. The freight is almost always more expensive.

### **How do I figure out shipping cost?**

Be prepared to do so on a daily basis. Shipping costs very greatly with the price of oil and the time of year you're shipping. It all has to do with supply and demand. The more containers at a specific port the less it costs to rent them.

In addition to ocean freight you must include Terminal Handling Charges (THC) and Container Freight Services (CFS) in your cost calculation. These are the charges levied on containers and merchandise by the shipping docks to load your containers onto passenger ships.

You will also need insurance for such issues as containers lost at sea, or goods damaged by falling containers on the ship. These incidents represent a very small percentage, but without them you will be at risk.

In terms of freight rates: the shorter the distance from the port of embarkment to the port of discharge the lower the freight rate. As a very rough guide we as a company use \$3,000.00

to the west coast of the US, \$4,000.00 to the East Coast and \$5,000.00 inland as freight rate calculations (based on a 40 foot container)

As well one must consider the internal shipping costs of getting items from the factory to the port. This can be truly significant if a company is shipping a Less Container Load (LCL). A truck to take products from a coastal factory to the port can cost near \$400.00 USD. This is usually represented in the FOB cost of an item, unless you have asked for ex-factory pricing only.

### **How do I finance getting product from China?**

The best way is to secure a credit facility with a local Bank that knows your business well. This credit facility will allow you to open up Letters of Credit or to pay vendors while you wait to be paid by your customers.

The longer you do business with any supplier in China the better payment terms you can achieve. Again it is about comfort levels and trust.

If you do not have access to a loan or line of credit you can use factoring companies as well as private equity firms that exist for this very function.

### **Why wouldn't I just hire my own full-time sourcing manager to handle my operations in China?**

The problem with hiring a sourcing manager is that the suppliers in China will feel that you have not shown them enough "Face." Typically they like to deal with the owners or directors of companies, not with employees. Once you have established a relationship with them and have been buying and shipping product for a while it is acceptable to let a sourcing manager handle the logistical operations. This is, however, never a substitute for maintaining a running dialogue at the senior executive level.