

China Supply Chain Disruption – The Hidden Risk

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Much has been reported about economic slowdown in China and its potential effect on the world economy. All the superficial “noise” from pundits masks a potential exposure that U.S. companies risk confronting in the next 12 to 24 months. That risk is supply chain disruption due to the inability of Chinese suppliers to transition their business to a lower growth reality.

It is likely that many U.S. companies will see delivery cycles from Chinese suppliers extend unacceptably, prices increase with confusing rationale, and in the worst cases - business failures of strategic supply partners. Virtually nothing has been written about this looming risk, but it is real and entirely avoidable.

On a macroeconomic level, China will remain the world’s fastest growing large market for the foreseeable future. According to the CIA World Fact Book, China’s economy is already the world’s largest on a purchase price parity basis, surpassing the U.S. in 2013. Additionally, according to International Monetary Fund and World Bank data, even at 6%-7% GDP growth, China will produce more new GDP than the combined total of the U.S., Germany and Japan for years to come.

These macroeconomic facts are interesting, but daily business operates at the microeconomic level, not at the level of GDP. Companies interact with suppliers and customers on a detailed transactional and activity level - designing, producing, and selling products and services. This is where the GDP growth slowdown will negatively affect many Chinese companies -- a portion will struggle and underperform, but some will fail in a lower growth economic environment.

The reason is simple and perhaps surprising to many. The average Chinese company’s business

management systems and skills are much less sophisticated than Western standards. Few have full functional ERP systems, or understand fully the concepts and operating benefits of MRP and sophisticated working capital management. Surprisingly, the vast majority of Chinese manufacturers do not even have cost accounting systems that enable them to understand SKU-level product and inventory costs, including labor, material and overhead cost contribution.

When the Chinese economy was growing at double digit rates and companies were awash in cash, these systemic management weaknesses were masked. Companies could succeed with loose and, in some cases, nonexistent capabilities in what Western companies view as critical and routine functional disciplines. These same sophisticated business systems and skills have taken Western companies decades to develop and enable Western companies to operate effectively in low growth environments, balancing operating, commercial and financial considerations.

In contrast, the Chinese industrial base that serves Western export markets has only about two decades of experience doing so. The more complex operating skills, processes and management systems have not had time to develop, spread through the industrial base, and mature. Compounding the challenge, China has not experienced a real business cycle since the country started its ascendancy to economic power. China has enjoyed a near constant upward growth curve that was impervious to the business cycles encountered elsewhere in the world. While the current China growth slowdown is far from a recession, it will present Chinese manufacturers with operating challenges.

Over the next 12 to 24 months, it is probable a significant segment of the China manufacturing base will begin to confront business problems due to the lack of the advanced management and operating functionalities cited above. Cash positions will become tighter as extended collection periods will not be covered by extraordinary sales growth. Tightening cash positions may restrict or delay the ability to purchase raw materials. Broad material management weakness (e.g. absence of MRP and advance

materials management systems) will likely drive material shortages and production slowdowns. The broad lack of working capital credit lines in China – taken for granted in the West -- will further intensify the problems into financial challenge. Many Chinese manufacturing companies will have no alternative but to delay shipments, others will respond by increasing prices, and others may not even survive.

To be fair, there are many Chinese companies that will thrive in this new environment. When the inevitable shakeout is over, the result will be a much stronger and robust China manufacturing sector. But the transition will be painful for some foreign companies that are dependent on China supply chains. Most Western companies have no transparency into these systemic weaknesses of their Chinese supply base. Many Western companies may not even recognize that these exposures exist until their supply chain breaks down and they are thrust into supply crisis.

Western companies have options to mitigate this risk and control their own situations in a supply chain shakeout. Assuring that a company aligns with the best supplier must not simply focus on product and price. Many Western companies have over emphasized these two factors in supplier selections. Product and price are obviously important, but security of supply chain requires that suppliers have management skills and systems that are strong and able to adjust in a rapidly changing business environment. Western companies need to confirm supplier capabilities across the full range of functional disciplines including:

- Manufacturing – actual production management, equipment and facilities;
- Manufacturing Support Processes (production planning, material management, and supplier management);
- Quality Management;
- Technical Support;
- Logistics;
- General Management (Capitalization, Financial Strength, Credit, etc.)

Western companies with strategic purchases from China suppliers can get ahead of the approaching China supply chain risks by conducting supply chain assessments to gauge the severity of the exposure

and make adjustments before supply disruptions occur. The assessment process should be focused on target supplier capabilities and attributes that are customized to each supply situation. The assessment process must also be unbiased. There is value in engaging third party assessment professionals to provide a fresh and independent perspective. This is not to suggest that the input of a Company's internal supply chain management professionals at a company is not important. However, the experience and comfort with the status quo can overlook underlying weaknesses and exposures when past supply has been satisfactory. In our experience, an independent assessment is the fastest and most effective path to identifying supply chain risk and the development of an effective corrective action.

If you are a Western company interested in identifying, evaluating, and contracting with suppliers in China, comprehensive supply chain assessments can serve as an effective way to address this concern of supplier long term viability.

This looming supply chain exposure is real and has the potential of seriously impacting Western companies. It is avoidable with proactive assessments and aggressive corrective action.