Maximizing Savings via Optimal Source Country Selection for U.S. Procurement:
Predicting Medium & Long-Term Price Risk & Behavior Before Selecting and Committing

Why should you care about this topic?
Because it will save you money and reduce risk.

On almost any day in your company, Global Sourcing Teams are evaluating the quotations for products for a new programs, Manufacturing Strategy Teams are making decisions on which country to located the next new manufacturing plant in, and Capacity and Operations Planning teams need to determine which of a handful of company operations around the world will have the best business case over a significant period of time for shipping products back to the U.S. to make up for capacity constraints here.

All these experienced professionals have a very good grasp of how to determine the best landed costs at the point in time that they are making the decision. The 'elephant-in-the-room', that does not usually get addressed, is which country or countries are most likely to be able to or have to:

- Hold the initial costs/prices we have in hand today, over the medium and long term?
- Lower the cost/price in the future?
- Raise the cost/price very substantially after your company is fully committed and the cost in time and resources to re-source are too prohibitive to generate a cost benefit in the balance of the product's lifecycle. Thus one is stuck with the decision made 5 or more years although one would have been far better off going with another country, with a little higher initial cost/price, but would have remained the same or become more competitive?

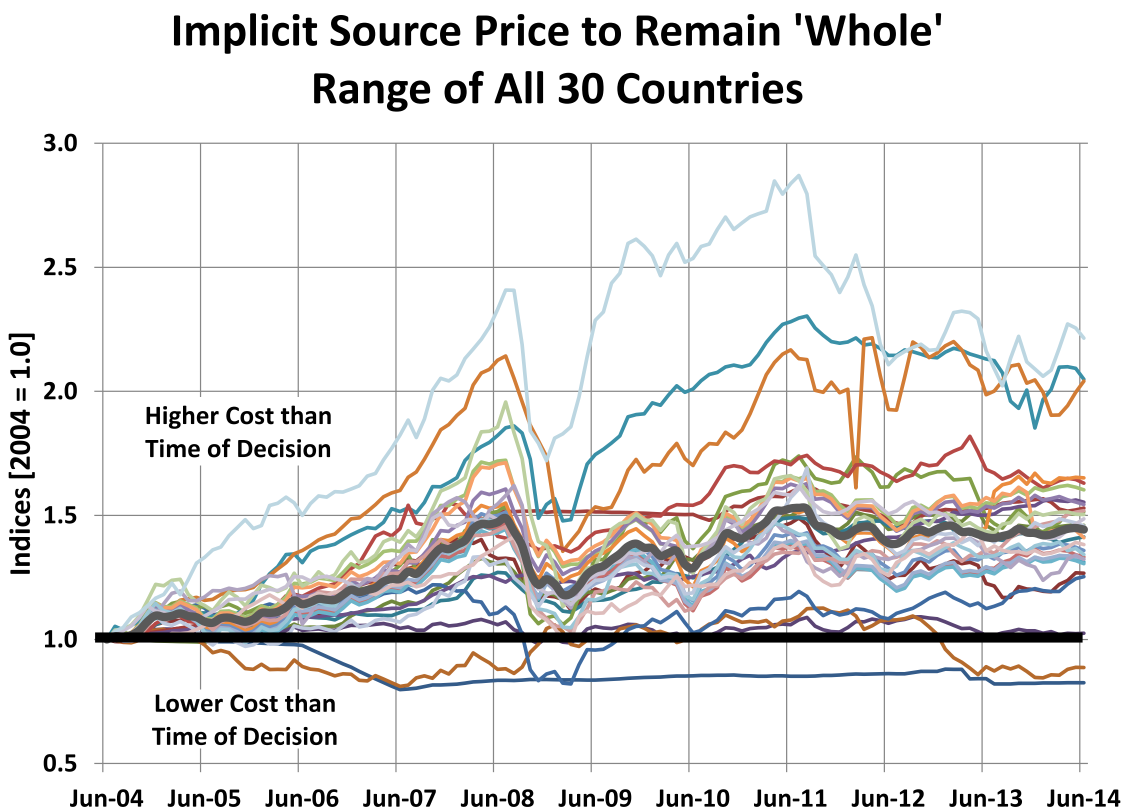
The prevailing belief is that it is not factored into the decision because where exchange rates and supplier costs will go is unknowable. And besides, that the company feels comfortable that since it is purchasing in dollars [not the local currency], that its iron clad suppler contracts will hold the supplier to the original prices in hand today for the full product life cycle many years into the future.

Fortunately the first belief is a myth – One can directionally know the risks of each countries future cost changes. Unfortunately the second belief is a myth as well – if a contract becomes punitively painful the supplier will ultimately break it. Continuing to believe and accept both myths is to take unnecessary risks that can be very costly to all stakeholders.

Recently, J.T. Gabrielsen Consulting, LLC performed extensive research and analysis on the multiple drivers of supplier costs in each of 30 potential outsourcing countries.

Busting Myth #1 – The most likely direction of future costs/prices from another country absolutely can be understood in advance of the sourcing country decision. There are potential source countries that have:

- Increasing Costs and High Volatility – as much as 120% higher within 5 years of the initial cost/price – These suppliers will be demanding price increases.
- Decreasing Costs with Little Variability - little variance over the last 10 years and the trend has been to lower costs and prices – Here you may have left money on the table by locking in a fixed price for too long of a time frame.
- Stable Costs and Little Variability - minimal variance that have remained relatively constant over the full 10 year period – Both parties are able to live happily with the original price for the long-term.



This graph shows one line for each of 30 potential source countries. It includes every country that you ever consider and many that you don't. And both the worst extreme at the top, and the best extreme at the bottom, are among the top handful of the most frequently considered source countries for U.S. procurement teams.

Each line begins with a factor of 1.00 for 10 years ago. If you signed a contract with a supplier in a particular country 10 years ago, this is how much their costs in U.S. Dollars changes over time in order to manufacture your products, and thus what they need to recover in price, in order to have the same economics that their original point-in-time deal provided them 10 years ago. The economic model that has been utilized is not simply looking at Currency exchange rates. In fact, they only drive about a quarter of the change. The critical additional factor is the manufacturing inflation rate in each country. The manufacturing inflation rate in a given country is largely outside of the control of your supplier there because most what drives it is country wide, not individual sector and company specific.

You truly can use the information in the report to analyze your sourcing country options prior to supplier selection and commitment. Notice that most of the lines move in a single direction in a relatively smooth trend, with the exception of a short-term reaction to the great recession, and then return to trend. The point is that allows us to be reasonably confident that they will continue in a similar fashion in the future. Thus we can use them to estimate how the quotations we have stacked on our desk from multiple countries are likely to behave over the longer term. By knowing that is advance you can avoid the highly volatile ones and stick with the ones that are consistent and predictable and relatively tame in terms of cost increases, or even decreases.

The Bold Gray Line – The average Implicit Source Price to Remain 'Whole' is the price in U.S. Dollars that you would need to pay the supplier to have the same financial result as when the contract was signed. It ends the 10-year period at an increased cost of +44%, a +3.7% CAGR [Compound Annual Growth Rate] compared to 10 years earlier. Even a +3.7% CAGR would be impossible for a supplier anywhere to keep holding to an original fixed price agreement. But it is the range that is truly eye opening.

> Becoming Cheaper - On the one hand there are a handful of supplier countries that are becoming consistently less expensive for the suppliers. The best of those has become more cost competitive by over 17% in the past 10 years. If you had a fixed price agreement with them you will have left money on the table.
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> Becoming Much More Costly - At the other extreme, the worst country, one that has absolutely been included in many U.S. companies RFQ distributions, is now +121% more costly today than 10-years ago. That is, their costs are 2.2 times as high today as they were 10-years ago. And for a two-and-a-half year period of time in the years 2009 to 2012 they were over +150% to +187% [2.5-2.9 times as high] as at the inception 10 years ago.

Busting Myth #2 –

- Suppliers - No matter how iron clad a contract with a supplier is, if their costs to produce become so high that they are bleeding to death at the prices and terms that their contract with you holds them too, they will be back at your doorstep begging and pleading for relief in the form of price increases. If you don't grant them some price relief, at best, they will not do as good a job for you including cost corner cutting, declines in quality, and deteriorating shipping performance. And at worst they may cut you off all together when you can least afford it. It's a

lose-lose proposition. So you end up paying more because the bottom line is that it is the lesser of the evils.
- Company Plants importing back to the U.S. [Existing or Proposed] – Regardless of what has been agreed to in terms of transfer pricing, the impact for the total company will be the same if the chosen internal country manufacturing operation's costs escalate significantly. Whereas with more available information to foster foresight one might have chosen another plant where both locally and with exchange rates, the costs would not have increased, or not nearly as much.

The full details of the analysis methodology and results are laid out and quantified in our full report: "Maximizing Savings via Optimal Source Country Selection for U.S. Procurement: Predicting Medium & Long-Term Price Risk & Behavior Before Selecting and Committing" available on the J.T. Gabrielsen Consulting, LLC website at: http://shop.jtgabrielsenconsulting.com/Maximizing-Savings-via-Optimal-Source-Country-Selection-for-US-17.htm

It is because of the reasoning that we have just presented in this article that we have gone out on a limb with the claim that if you use the deep detail for each of the 30 countries in the report, you will save far more than the cost of the report very rapidly. And that without it, you are probably at more risk than you may have realized.

Jon T. Gabrielsen is President & CEO of J.T. Gabrielsen Consulting, LLC. The main focus of the firm is on the market economics of durable good B2B markets and supply chains and the economics of the use of energy for durable goods manufacturing and for transport providers.