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The Dangers of Using Supply Chain Brokers or Trading Companies... Plus a Solution

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If your company sources a strategically important product, component or material from China and Asia through a trading company (“broker”), it is not IF but WHEN a serious problem will arise that could undermine your supply chain. The sourcing model in which a broker buys from a China and/or Asia manufacturer, and simply resells to a Western company (without adding any product value content) sub-optimizes supply chain performance. In the best case, the broker's interests are not aligned well with the interests of the Western company. In the worst case, the brokering structure can mask conflicts of interest, ethical challenges, or even malfeasance at some step of the end-to-end transaction.

Lack of Incentive for Continuous Search for Best Quality Products or Suppliers

A U.S. company needs a supply chain process that continually searches for the best quality products delivered reliably at the lowest total cost. Every successful Western company approaches their business at home in a dynamic and continuous process. The process involves continuous assessment of alternative suppliers, direct negotiation with existing suppliers, and supplier changes as needed to assure continuous improvement in an unbiased and rigorous process. This process must be replicated for sourcing success in China and Asia.

The brokering model in international supply chain management does not usually duplicate this best practice approach. A broker's business motivation is to sell products that are acceptable to the Western company at the highest possible price to them. A broker or trading company collects margin on the products purchased from suppliers and resold to foreign customers. Unless driven by the Western company, a broker is not incented to cost reduce to the benefit of the Western company or to seek supplier performance improvement. It’s simple math -- a lower price will generally mean a lower margin to the broker. This is a serious misalignment of interests between brokers and the Western buyer that is inherently present in most broker relationships.

Lack of Incentive for Continuous Cost Reduction for Western Customers

The misalignment of interests goes even deeper. Brokers are biased to keep cost reductions to themselves to improve their own margin and to favor a small number of preferred manufacturers to simplify their supply chain management. Finding new suppliers or negotiating cost reductions with existing suppliers is difficult and costly. Brokers have no inherent incentive to do so. Rather than to optimize the outcome for their existing Western customers, brokers have the primary incentive to seek new Western customers for their existing favored stable supplier base. Suppliers obviously need to be “acceptable” to Western customers, but that is not the same as being “best in class” or best for the specific situation.

Potential Hidden Agendas

Broker/trading company relationships are almost never completely transparent, often making it difficult for a Western company to know what is actually happening, even if there is direct contact between the Western company and the manufacturer. Cost reductions can be lost through "hidden commissions" paid directly to the broker by the manufacturers. It is not uncommon for brokers to have undisclosed investments in or relationships with favored suppliers. To be fair, not all brokers engage in practices that are clearly inappropriate. However, neither are any of these practices uncommon.

Even with the best of supply relationships, problems inevitably happen whether in product quality, delivery, or other aspects of the supply linkage. The test of an effective supply chain is solving the problem as quickly and effectively as possible. If a broker is involved, the Western company is NOT the customer of the actual manufacturer. The manufacturer's customer is the broker because that company pays the manufacturer’s invoices. Solving quality, delivery or commercial problems becomes a three-way process involving the Western company, the broker, and the manufacturer, where the priorities of the parties are not necessarily aligned with those of the true end customer - the Western company.

Case Studies of Ineffective Use of Brokers

Case #1: A U.S. company buying finished goods from a broker/trading company was approached by their largest U.S. customer, requiring a 30% price reduction or the business will be lost. The U.S. company CEO immediately contacted the broker to attempt the required major negotiation with the manufacturer. Within just a few hours, the broker responded with the entire 30% price relief. Good news? Yes, the business was saved, but why wasn't that 30% price reduction offered sooner by the broker, improving margins for the U.S. company? We could question the aggressiveness of the U.S. company in pushing for cost reduction, but it is clear that there was not an alignment of interest between the U.S. "customer" company and the broker.

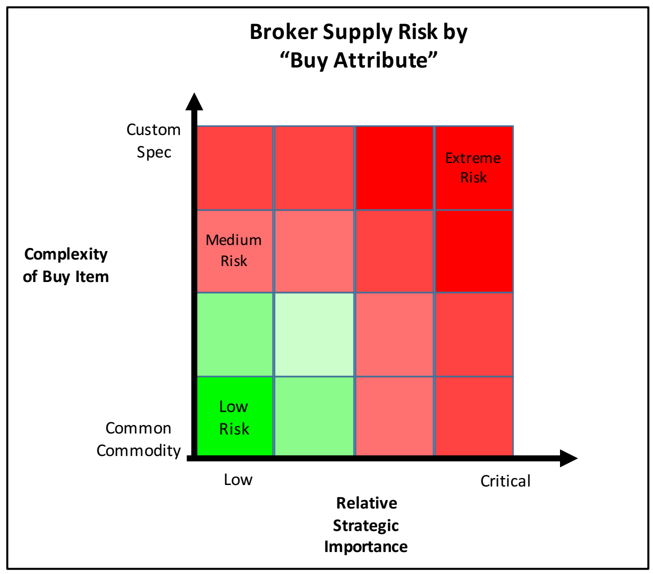
Case #2: A U.S. company has enjoyed a multi-year relationship with a China manufacturer on a critical component, purchased and managed through a broker. The product quality had been excellent throughout the relationship, until three consecutive containers arrived with 75% rejection rate. Safety stocks at the U.S. company kept production running for some time. The U.S. company informed the broker of the problem immediately, demanding prompt correction of the quality problem and replacement of the defective material. The broker resisted any direct financial responsibility (there was no contract between the U.S. company and the broker defining this obligation). The manufacturer resisted financial responsibility for the bad product, because there was no contract between the broker and the manufacturer with that obligation defined. The broker was unable to drive problem resolution over a three-month period. Production at the U.S. Company came to a halt when component safety stocks were depleted. The outcome across the board was bad.

These are only two of countless scenarios of how misalignment of interest -- inherent in a broker relationship -- can injure a company's performance. It does not have to be that way, and there are low cost and high-performance alternatives that can avoid these pitfalls.

When to and not to Use a Broker

To be clear, brokers can serve a valuable role for buying items that are not strategically important to a Western company's success. Due to their commodity nature, brokers are driven to optimize cost and product quality by competitive forces. This is not the case for engineered, complicated or custom products that are not as commonly available in the normal supply environment.

The graphic below depicts the relative risk of sourcing through brokers. As complexity (custom design, quality or performance requirements) increases, the risk of using brokers increases due to the interest alignment deficiencies identified. As the strategic nature of a buy increases, the "broker risk" also rises due to the impact on the buying company's business.



Direct Purchase Model is Recommended for All Strategic Purchases

Using brokers and trading companies for anything beyond non-strategic and commonly available sourcing requirements exposes a company to risks that have potentially serious negative consequences. Therefore, it is highly advisable that companies limit the use of brokers to only lower risk sourcing activities and engage directly with suppliers for strategically important and more custom requirements – avoiding all broker conflicting incentives. This is the only way for a Western company to assure transparency and alignment of interest.

Contracts and purchase orders should be established directly between the Western company and China suppliers. In a signed contract, the "rules of engagement" should be defined and documented across technical, quality, logistics and commercial attributes of the relationship. Invoices and money flows should be direct between the Western company and the manufacturer, which eliminates any ambiguity about who is the customer.

Third-Party Supply Chain Service Providers Can be Utilized When Appropriate

Some companies are prepared for complete internal management of their supply chain, while many companies either don't have the internal resources, experience or desire to manage a direct China and Asia supply chain and prefer to engage third-party experts. In this case, a third-party supply chain service provider can be utilized to help optimize China and Asia supply chain opportunities of a Western company. However, the role of the third-party supply chain manager should be a supply chain service provider managing direct supplier relationships with the Western company, and not as a transactional intermediary taking title to goods and reselling to the Western company.

Optimally, this service provider will have both a local U.S. team to interface during normal business hours with the Western company staff and an Asia-based team performing the in-country interface with the supply base. The transactional buy-sell relationship is direct between the Western company and the China manufacturer, with the third-party supply chain service provider serving as the representative of the Western company – handling all elements of supplier interface and management, but not taking title to any goods. This eliminates the resale margin conflict and assures direct transparency between manufacturer and U.S. company.

Engage only with a third-party supply chain manager that has a structured process for end-to-end supply chain optimization. Execute a services contract with the third-party supply chain manager that establishes a strict code of conduct - with stiff consequences for violation -- that assures continued alignment of interest.

Summary

The critical success factor in managing any successful supply relationship with a foreign entity is establishing a strong mutual alignment of interest with suppliers that is documented and transparent. When needed, use a third-party Supply Chain service provider who does not take title to goods can quickly de-risk the process.