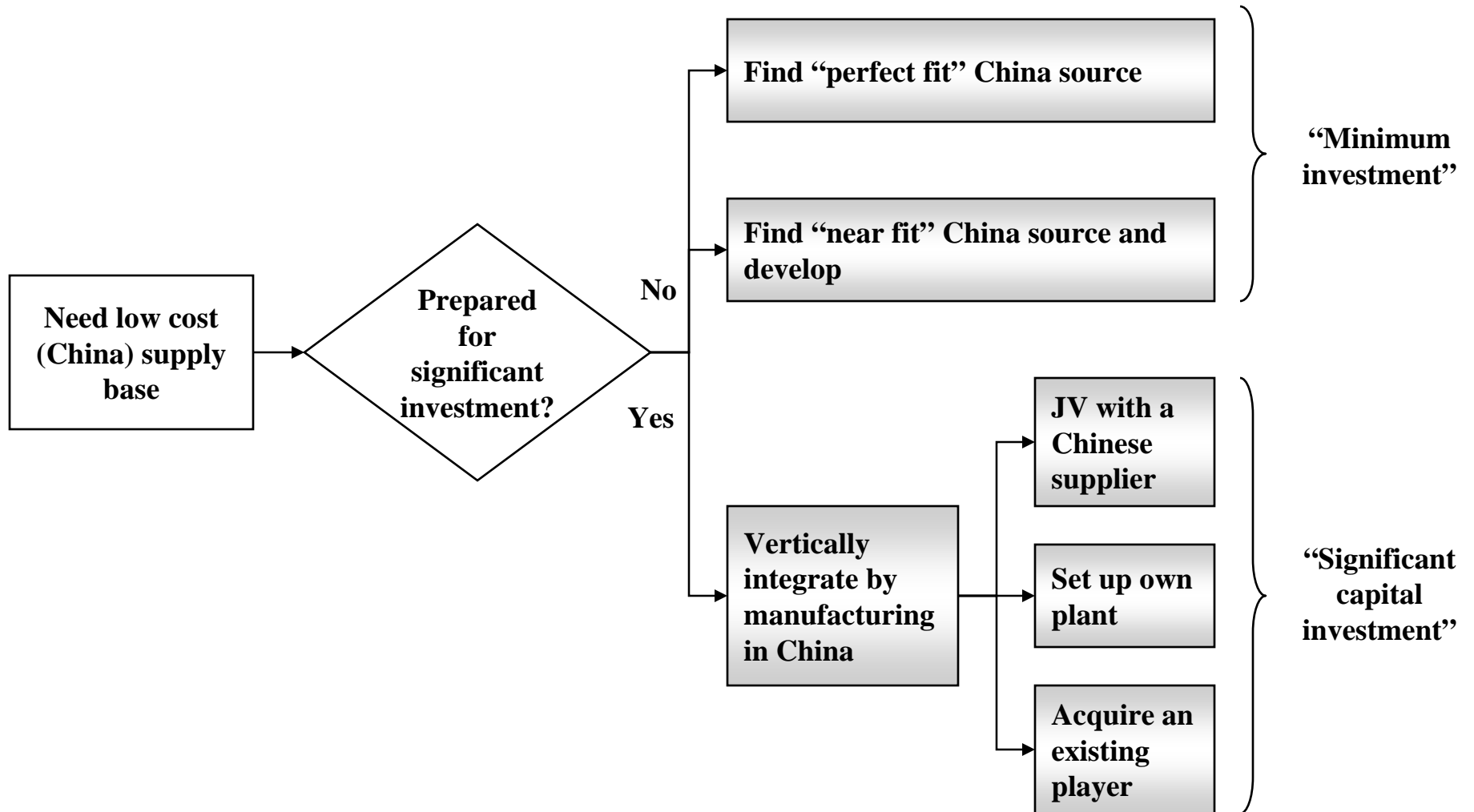

Developing a Supply Base in China



There are two major types of approach to developing a supply base in China



Key benefits and trade-offs for these approaches and their options

	<u>Key Benefits</u>	<u>Issues to Resolve</u>
Find “perfect fit” China source	<ul style="list-style-type: none"> • Lowest capital investment route to a low cost supply base • Fastest ramp up and benefit delivery 	<ul style="list-style-type: none"> • Difficult to find such a supplier
Find “near fit” China source and develop	<ul style="list-style-type: none"> • Low capital cost • Easier to find than “perfect fit” 	<ul style="list-style-type: none"> • Significant time and effort needed to develop supplier to required level
Vertically integrate by manufacturing in China	JV with a Chinese supplier	<ul style="list-style-type: none"> • Lowest capital cost for vertical integration route as investment risk is shared with JV partner • Finding a suitable partner is difficult • Intellectual property leakage may be a concern
	Set up own plant	<ul style="list-style-type: none"> • Surest route to low cost supply base if upstream manufacturing capability exists • Requires significant time before own plant is up and running
	Acquire an existing player	<ul style="list-style-type: none"> • Immediate access to low cost supply base • Difficult to find good targets • Cost will be high if there are several buyer after the same pool of targets

Finding the right sources in China is rarely easy

Markets are immature

- **Low market transparency:** limited available/reliable secondary information
- **Suppliers often too optimistic:** supplier visits are mandatory
- **Shallow supply base**
 - Either very fragmented industry structure (or sometimes very concentrated)
 - Low productivity in many cases (due to state ownership or protection)
- **Government still playing important role** in business through state intervention
- **Significant number of legal abnormalities** with weak intellectual property protection

Cultural differences

- **Language issues** complicate all interactions
- **Verbal communication preferred** (“human touch” as opposed to written “cold” communication)
- **“Time has no value”:** deadlines are often not respected

Geographic issues

- **Large regional differences,** increasing complexity of operational sourcing
- **Time differences** – China’s geographic position

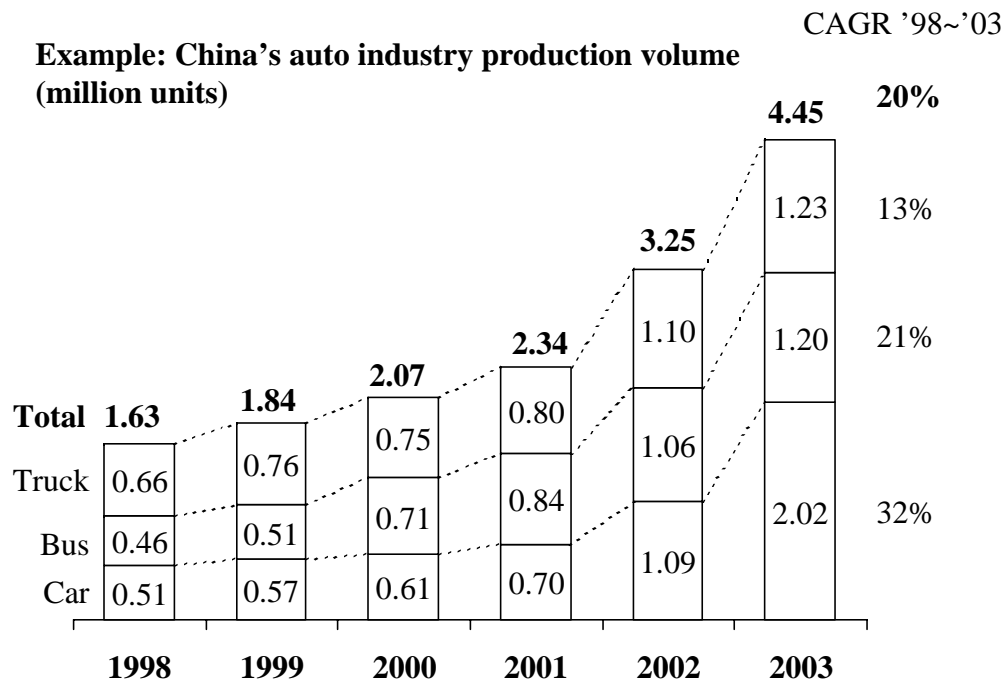
Underdeveloped logistics

- **Limited availability of advanced logistics services:** basic storage and transportation only, fragmented trucking, outdated storage facilities, inefficient railways
- **Low reliability of logistics services:** low on-time rate, high loss/damage rate
- **High handling costs:** logistics and inventory carrying costs are high – e.g. often second largest single line item in costs after materials in consumer electronics; can exceed 20% of total landed cost for basic "hard goods" sourced from China to US/EU

“Perfect fit” sources are increasingly difficult to find, and buyers will have to settle for “near fit” and invest in supplier development

Rapid economic growth has been and will continue to consume supplier capacity...

... so buyers today are increasingly facing suppliers that need development



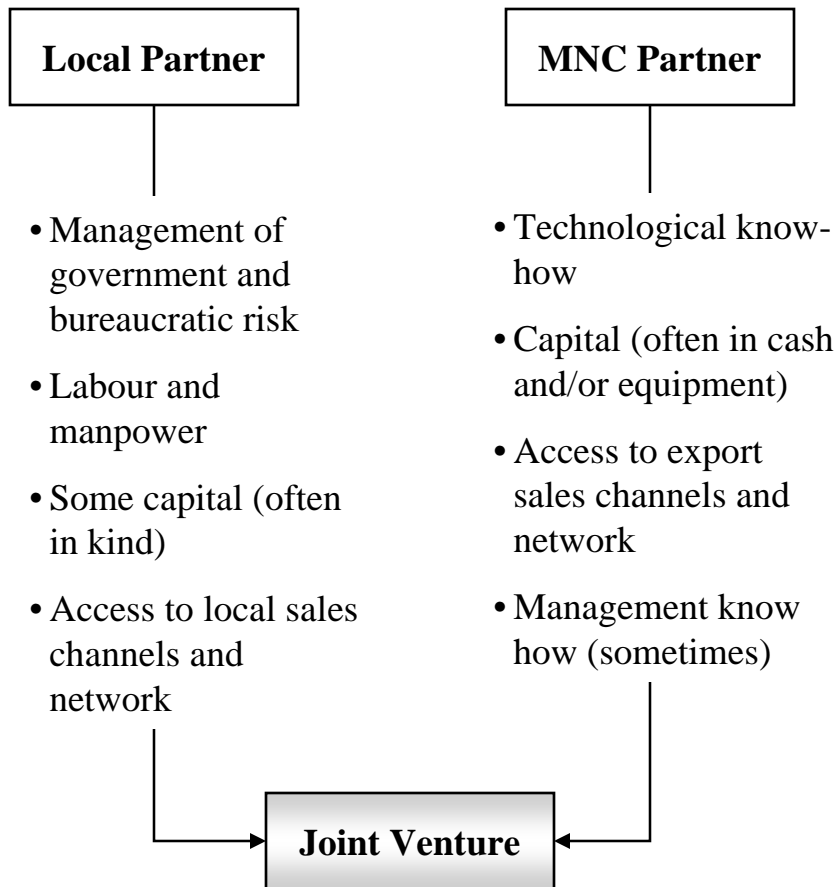
Very often, the best suppliers will have been taken by first movers

Typical supplier choices today

- Technically capable with MNC experience, but just too small
- Technically near capable, but with little MNC experience, eager to catch a big MNC fish – often POE
- Technically capable, but opportunistic – in-source player
- Technically capable, may even have MNC buyers, but commercially slothful – often SOE

JVs with Chinese partners have often been unsuccessful, and are fraught with risk

Partnership Expectations



Some Typical Manufacturing JV Outcomes

- Local partner's sales channels are positioned very differently to where the MNC product is
- Vicious circle – poor sales, poor plant utilisation mean low cost is impossible to achieve, driving poor profitability, resulting in strained relationship
- Local partner foists own staff, suppliers and culture on to the JV and cannot accept the MNC management approach - “not the Chinese way”
- Quality stays low due to poor supplier base and weak manufacturing management capability in the JV
- No export sales possible due to low quality
- Local partner seeks more on-the-ground control as most revenues are coming from local sales
- Local partner uses JV to gain manufacturing know-how
- Different branch of the local partner sets up shop as a low cost competitor

Vertical integration through manufacturing in China for exporting components is the approach chosen by some companies to access a low cost supply base

Examples of Recent Vertical Integration in the China Auto Industry

Bridgestone decided to set up a steel wire cord production company in Shenyang, with aggregated investment of US\$ 100 million and a capacity of 24,000 tons per year

Volkswagen set up a gearbox JV with FAW⁽¹⁾ and SAIC⁽²⁾ to substitute imports of gearboxes for its two sedan JVs (Shanghai-VW and FAW-VW)

- Builds in-country upstream supplier management capability (which a China Procurement Office might not be able to provide to the same degree)
- Gives access to a different sort of supplier – slightly more “local” i.e. capability needs more interventionist management

Note: 1) FAW—First Auto Works, Chinese partner of VW’s sedan JV in Changchun, China

2) SAIC—Shanghai Automotive Industry Corporation, Chinese partner of VW’s sedan JV in Shanghai, China

Source: China Chemical Industry News; VW China website