

BNET Crash Course

How to Outsource Your Manufacturing to China

by Geoffrey James

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When it comes to manufacturing, few regions can compete with China's labor costs. Companies that rely on outsourced products, however, have lots of new hurdles to clear — just ask the firms that wound up selling lead-laced toys made in China. So, is setting up shop in China still worth the risk? Our sources say yes: Companies *can* maintain product quality and safety while reducing costs. Here's what you'll need to manage the process and keep your brand — and your customers — safe.

Things you will need:

- Be prepared to pay obligatory legal fees and agent commissions, which can range from a few hundred dollars to tens of thousands, depending on the type of business you're setting up.
- At least three months to set up a pilot program. After you've tested the results and confirmed the product is up to snuff, a project typically can move forward very quickly, perhaps within a matter of weeks.
- **A Local Rep:** You'll need a person who lives and works in your targeted region to act as your negotiator and translator as you meet with Chinese executives and regulators.
- **A Product-Testing Service:** Every product shipment must be independently tested to ensure that it complies with your requirements. Failure to test each batch is asking for substandard products or an expensive recall.
- **Cultural Flexibility:** You can't get along in China if you're convinced that the way business is done in the West is the "right" way.

Understand That Traditional Rules of Business Don't Apply

Goal: Eliminate dangerous misconceptions about doing business in China

When confronted with the skyscrapers of Shanghai, it's easy to assume that doing business in China will be similar to doing business in New York City or London. Nothing could be further from the truth, according to Usha Haley, author of the best-selling book "The Chinese Tao of Business: the Logic of Successful Business Strategy" (Wiley, 2004). "Professionals from the U.S.

think they're dealing with a modern society, when in fact they're dealing with a business culture with roots that are centuries deep," Haley explains.

For example, because the Chinese have a cultural preference for family-run businesses, 90 percent of all privately owned firms in China employ fewer than eight people. As a result, the supply chain — even for a simple product like a child's toy engine — can involve dozens of interlocking firms and a network of formal and informal relationships that would boggle the mind of the typical western executive.

Then there's the omnipresent Chinese government. "The Communist Party is more powerful than it's ever been, which has an enormous impact on everything, even the kind of information that you can gather while researching a potential partner," Haley says. Sometimes that's good — like when you're trying to get China to enforce its copyright laws — but there are downsides, too. China's government is full of locally and regionally deployed bureaucrats, many of whom may need to be convinced, cajoled, or bribed. "There are entire consultancies whose sole purpose is to help other companies avoid compliance with government regulation," Haley warns. Because of this, it's hard to know whether your business partners are operating legally or just getting around the regulations, so you'll need to independently test products to ensure that they meet specifications.

In order to outsource to China without running into product safety or quality problems, you'll need to scrap your preconceptions of how business should be conducted. The rules are different, and you're not going to understand the full range of those differences until you've been deployed in Chinese firms for years, maybe decades. "It can take a lot of time for western executives to learn how to work effectively in China, but the benefits are worth the extra effort," says Frank Liang, general manager in Asia for the Greater China branch of semiconductor manufacturer Broadcom. For example, chip-design engineers who earn six-figure starting salaries in the United States earn less than a tenth that in China — a cost-savings that an electronics firm can pass along to price-conscious consumers.

Nitty Gritty

How to Behave

Addressing Colleagues

- The Chinese give their last name first; it's usually one syllable.
- Use a title, such as profession (e.g. "Director Wang") or Mr./Ms.
- If you know a Chinese person very well, you can use their full name (e.g. "Wang Han").
- If you're meeting in the United States, you can use the western order (e.g. "Han Wang").
- If you're very old friends (20 years of history, say), you can use just a first name (e.g. "Han").

Exchanging Business Cards

- Present your card with both hands, your name facing outwards.
- Never toss a business card onto a table.
- Examine any card presented to you for at least 10 seconds.
- Comment on it; say something nice.
- If seated at a table, carefully lay the card out next to you.

During Meetings

- Expect people to sit and stand too close for your comfort.
- Never touch a colleague. No backslapping or hugging; handshakes are OK.
- Forget jokes and business slang; they'll get lost in translation.
- Avoid broad gestures when you talk; they're considered vulgar.
- Present a small, wrapped gift to all meeting attendees.

Source: The U.S.-China Business Council

Recruit a Local Agent

Goal: Hire somebody who can navigate the local business community

To conduct business in China, you'll need a "local intermediary," an agent who can represent your interests, provide the right introductions, and negotiate agreements. The ideal agent should be fluent both in English and the local Chinese dialect in the region where you plan to do business. Preferably, he will be middle-aged (the Chinese equate youth with callowness), male (China remains largely patriarchal), and married (seen as showing stability of character).

In addition, your agent should have at least a decade of experience working outside China, preferably in either your industry or that of your target customer, according to Tim Wang, regional president of Novellus China, a subsidiary of the computer-chip manufacturer Novellus. "Essentially, you're looking for somebody who can command the respect of the executives with whom you'll be dealing," he explains.

In most cases, the intermediary either will want to set up a separate company or work through his existing company. The advantage to this arrangement is that it isolates your firm from practices that you probably don't want to know too much about, such as bribery and kickbacks. On the downside, the agent may act more independently than you'd like. "I've seen situations where local representatives were running businesses on the side, using the same contact lists, customer lists, and intellectual

property,” Wang says. To keep the intermediary honest, insist on an independent translation of all documents pertaining to the negotiation of any contract, says Tobey Marzouk, partner at Marzouk & Parry, a law firm that specializes in software litigation.

Other Resources

Where to Find a Local Agent

Here are the six most likely places to find a referral for an agent:

- 1. The U.S.-China Business Council.** This Washington, D.C.-based organization promotes trade between the two countries and maintains contacts with many Chinese businesses.
- 2. Local trade associations.** Many states have local trade groups that are similar to the U.S.-China Business Council but smaller and focused on relations between China and individual states.
- 3. U.S.-based MBA programs.** A fair percentage of MBA students in the United States are originally from China and may be open to returning to help you bootstrap your project.
- 4. Alumni organizations for Chinese universities.** Some Chinese colleges — notably National Changhua University of Education — have MBA programs that emphasize cross-culture business problems.
- 5. Your own company.** If you belong to a big enough company, chances are good that it employs somebody who hails from the region where you want to deploy.
- 6. Your Chinese customers.** If you’re actively selling products in China, then you may already have a relationship with an individual who knows your business and can navigate the local shoals.

Clearly Define *All* of Your Requirements

Goal: Ensure that the outsourced product fits your strategic needs

In China, you can’t afford to take anything for granted. Your product definition must specify not just how it will look and how it will operate, but also quality standards for every component, every subcomponent, and every material involved in the product’s construction. More importantly, *all* of those requirements must be reflected in a detailed contract that’s specific to that product and that deal. This is not the time to scrimp on legal fees with the kind of generalized, fill-in-the-blank outsourcing contract you’d

normally use with a U.S.-based firm.

That's not all. If you plan to sell the outsourced product in the United States or Europe, you'd be wise to specify working conditions, the minimum ages of the workers involved, and even the minimum wages to be paid to the employees. The last thing you want is for some sharp-eyed investigative reporter to show the world that part of your product came from a sweatshop full of starving children. And don't forget industrial pollution — a major public relations time bomb. In the age of YouTube and camera phones, it's only a matter of time before a U.S. company gets burned for hiring a Chinese partner that's dumping poison into the local watershed.

Don't fool yourself into thinking that the contract automatically will be honored. Under no circumstances should you advance money for the product prior to shipment. Instead, "conduct all business through a 'letter of credit' that specifies what the outsourcer will supply and the conditions under which the product will be considered acceptable," explains Brad Finn, president of Marlboro Shoes, a multi-million-dollar shoe wholesaler that outsources heavily to China. The letter will come in handy in Step 4, when you assess the product before paying for it.

Hot Tip

Guanxi 101

Nobody can do business in China for very long without encountering the term *guanxi* (GWAN-shee). Loosely (and inadequately) translated as "connections," *guanxi* refers to a set of mutual obligations shared between individuals, irrespective of their position in society or inside an organization. One earns *guanxi* by doing favors that must be paid back in the form of return favors. Once a *guanxi* relationship is established, either party may make demands on the other without warning and without prior discussion. Chinese businesspeople keep close track of *guanxi*, and if they feel that the implicit contract isn't being honored, they may become distant, unhelpful, and possibly even vindictive.

Guanxi is, in some ways, the grease that makes the wheels of commerce turn in China. It provides a way of getting things done without recourse to official channels. Unfortunately, *guanxi* is a double-edged sword. "While your local intermediary, or the CEO of the firm that's your primary outsource, may have *guanxi* that proves useful to your project, unofficial relationships open the possibility that your interests will be sacrificed for the good of the relationship," explains Guo Hai, a business consultant based in Hainan, China. "Because of this, it's absolutely critical that you not depend entirely upon the *guanxi* of others. Instead, you should strive to develop your own *guanxi* network, a process that can take many years."

Monitor, Monitor, Monitor

Goal: Make sure you're actually getting what you've paid for

Even with an ironclad contract and letters of credit, it's up to you to confirm that the product delivered is the one that you originally defined. The best time to check is before the product is in shipment, according to Finn. "Payment should be entirely dependent upon whether those products satisfy your specifications," he says. Demand that an independent laboratory headquartered outside China conduct any required testing, such as checking for lead content in paint. "You should pay for the product only when you're sure that you're getting what you want and that it was made in a way that won't damage your brand," Finn says.

Monitoring the final product is not enough, though. "The only way to truly ensure that you're not importing a product that's hazardous, or supporting a pollution-generating sweatshop, is to demand complete transparency of the supply chain," according to Tom Travis, author of "Doing Business Anywhere: The Essential Guide to Going Global" (Wiley, 2007). He recommends that you insist your local agent provide a complete map (complex though it might be) of the entire supply chain for your product and that you be permitted to tour the outsourcer's facilities — and the facilities of their suppliers — without prior notice. "If you don't know exactly what's going into your products, or exactly how they're being made, you're putting your corporate reputation and your brand image at incalculable risk," he says.

Above all, do not depend upon the ability of the Chinese government to monitor working conditions and pollution. "The problem in China isn't with the laws themselves, which are sometimes as stringent, or more stringent, than comparable laws in the U.S.," Haley explains. "The problem is with enforcement, which is often seen as a way for government inspectors to earn bribes rather than a way to ensure that workers and the environment are protected." In other words, while the central government has good intentions, those intentions don't always filter down to the local level, where the inspections take place.

Voice of Experience

"One of the biggest challenges in China is figuring out the fundamentals: how to find a partner, how to make an investment, how to craft a business agreement. It's difficult because in China there are no credit records, no reliability, and often no record of debts and liabilities. So it's up to you to dig for the truth."

— *Tim Bennett, former COO for the AeA, an electronics industry trade group*

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