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Manufacturing

Innovation in emerging markets

2008 Annual Study

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Playing it safe:

Managing product sourcing risks in emerging markets

It could be termed the year of the recall. From tainted toothpaste to contaminated dog food, 2007 saw scores of products recalled due to safety and quality issues:

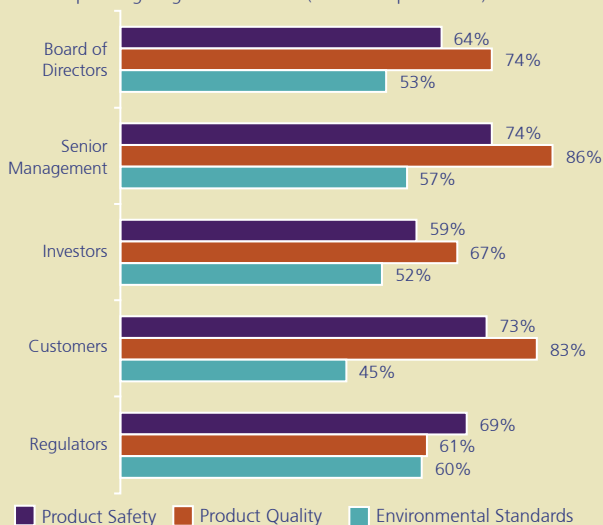
- 1.6 million power tool batteries due to overheating or fracture during use, expelling plastic shards posing burn, laceration, and bruise hazards.¹
- 900,000 children’s charm bracelets and necklaces decorated with paint found to contain high levels of lead.²
- One million batteries used with power tools can explode if a vent on the battery cell is damaged or compromised during use.³
- 110,000 vases in the United States and about 767,000 worldwide for risk of the base breaking off unexpectedly, posing a laceration hazard.⁴

What do all of these products, and a multitude of others who underwent recalls in 2007, have in common? They were all sourced in emerging markets, setting off alarm bells for customers around the world about the safety and quality of items produced in these areas.

Who’s taking the heat?

The recent publicity over recalls has made product safety, as well as product quality and environmental standards, in emerging markets a hot-button issue, with boards of directors, senior management, and investors of global manufacturers across industry sectors sitting up and taking notice (see figure 1). As Soumitra Mukherjee, Bayer HealthCare’s Director of Business Development & Licensing Asia-Pacific, puts it: “It takes 150 years to build up brand equity—it takes one bad pill to kill it.”

Figure 1: Focus by stakeholders on issues with emerging market suppliers viewed by developed market manufacturers
Percent Responding “Significant Focus” (6 - 7 on 7-point scale)

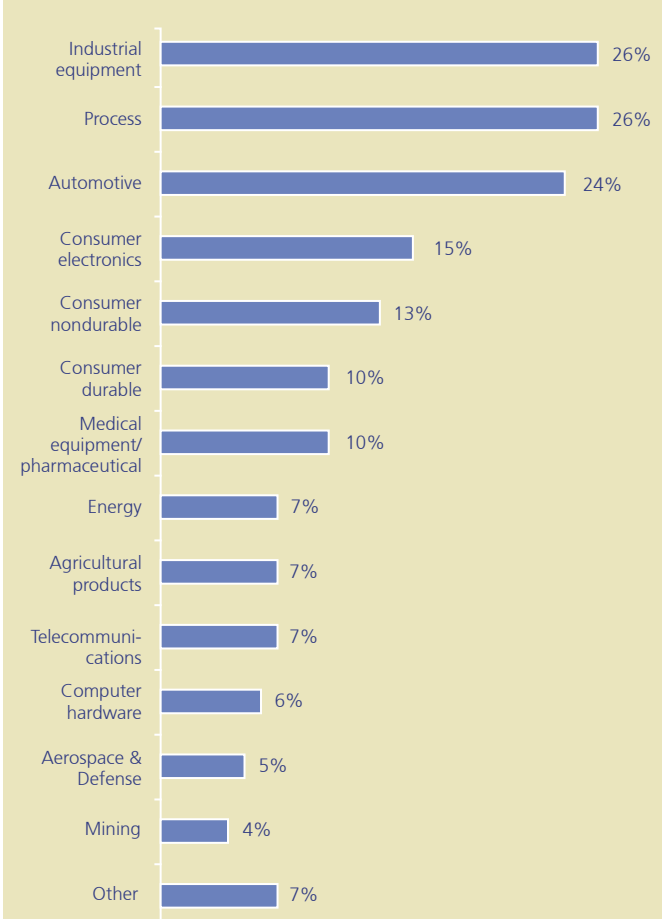


Source: Deloitte’s Global Manufacturing Industry Group “Innovation in Emerging Markets. 2008 Annual Study”

With the significant financial and reputational impact manufacturers can experience from a recall, finger-pointing abounds. And suppliers in emerging markets—especially China—are now finding themselves on the receiving end of increased scrutiny and demands for higher standards.

But it’s often more complicated than a simple blame game. In its “Innovation in Emerging Markets. 2008 Annual Study” on product safety, product quality, and environmental standards in emerging markets, Deloitte Touche Tohmatsu’s (“Deloitte”) Global Manufacturing Industry Group explores how manufacturing executives from developed and developing countries view and handle their exposure to risk stemming from sourcing in emerging markets—and how the most successful companies are working to manage this risk and turning it to a competitive advantage.

Figure 2: Industry profile of global survey respondents



Source: Deloitte’s Global Manufacturing Industry Group “Innovation in Emerging Markets. 2008 Annual Study” Respondents include 237 executives from manufacturing companies headquartered in developed markets and 414 executives from manufacturing companies headquartered in emerging markets. More than one industry sector may have been selected to represent the profile of the business.

The realities of risk: developed versus developing market perspectives

In the Deloitte study, of the more than 650 global executives surveyed across various sectors (see figure 2), roughly three-quarters of developed market executives reported an increased use of suppliers in emerging markets in the last three years, with almost half saying their use had increased significantly. It was also revealed that developed market companies were far more likely to turn to suppliers in China than in any other emerging market.

So it appears that the issue of product safety and quality in emerging markets is not going away anytime soon. But it also appears that manufacturing executives should be acutely aware of the risks involved, with a quarter of both developed and developing market executives reporting that their company had been involved in a product recall in the past five years. And yet the impact of product recalls on developed market companies does not seem to be perceived as great as those in developing markets. Developed market executives at companies that had experienced a product recall were much less likely than those in developing markets to report that it had resulted in a significant impact on their revenues, market share, or reputation.

In contrast, developing market suppliers were more likely to report experiencing significant negative impacts. This is vividly demonstrated by Lida Plastic Toys Co., a major Chinese toy maker and contract manufacturer of Mattel, Inc., who stopped operations after a Mattel recall of lead-tainted toys. Export business was suspended and over 2,500 employees were temporarily laid off without pay when the recall was announced in August 2007. Toys worth about 50 million yuan were overstocked, resulting in a halt of capital inflow. Construction of three factories and a new dorm for short-term employees were shut down—and Lida's owner committed suicide.⁵

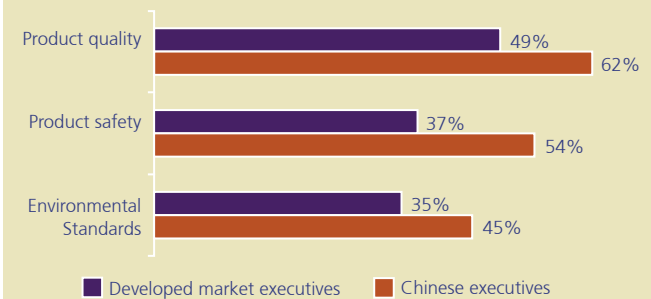
But while the impacts to date have not been nearly as devastating to global manufacturers, who tend to be much larger, executives surveyed at these companies are concerned that sourcing in emerging markets does present a real risk, with 58 percent perceiving the risk to be somewhat significant and 20 percent seeing it as very significant. With this in mind, roughly two-thirds of developed market executives said that quality, safety, and environmental standards had all become more important when choosing emerging market suppliers, while almost half said product quality had become much more important.

To that end, Sesame Workshop, the non-profit company behind Sesame Street, which saw a large recall of licensed products last year, announced that it would send auditors to factories, ports, and stores to check for lead and other problems in toys made by Chinese manufacturers licensed to use their characters. Similarly, The Walt Disney Company began testing toys featuring Disney characters, made under license by other companies, including random testing of products already in stores.⁶ Some companies have taken even more drastic measures, such as Yushan Press, which produces stickers, catalogs, posters, and shopping bags. In order to better monitor suppliers and the quality of their goods, Yushan actually relocated to Shanghai.⁷

This concern with safety and quality is carrying over to developing market executives, especially in China: about three-quarters of respondent executives from Chinese companies said product safety is an extremely important factor when global manufacturers select a Chinese supplier. These executives also seem to be feeling the heat of recent publicity, with more than half saying product safety and quality had become much more important in the last 12 months alone (see figure 3).

Figure 3: Change over the last 12 months in importance of issues when developed market manufacturers select emerging market suppliers

Percent Responding "Much More Important" (6 - 7 on 7-point scale)



Source: Deloitte's Global Manufacturing Industry Group "Innovation in Emerging Markets. 2008 Annual Study"

And the pressure is coming from a range of key stakeholders, including boards of directors, senior management, investors, customers, and regulators, whom executives perceive to be placing a heightened focus on product safety and product quality. Regulators in particular are stepping up the pressure. In China, the government responded to tainted food issues last year by launching a four-month "clean-up" operation, which included plans to close down problem producers.⁸ And in India, the government is most likely going to allow U.S. Food and Drug Administration inspectors in the country to help improve product safety in pharmaceutical exports.⁹

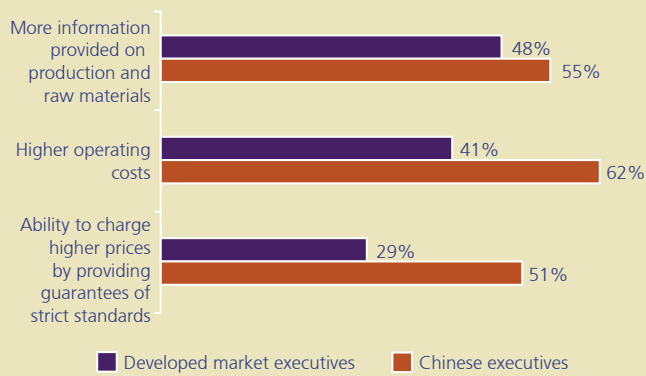
Taking action

With both developed and developing market manufacturers and suppliers expressing—and feeling—real anxiety over the sourcing of products in emerging markets, what actions can they take to avoid risk, protect their brand, and address the concerns of stakeholders? The answers can be complicated in relation to cost and daunting in terms of real action.

According to the Deloitte study, executives from both developed and developing markets agree on the likely impact of the increased concerns over product safety, quality and environmental standards. More than three-quarters of developed market executives thought it was very or somewhat likely their company would favor sourcing from markets with stricter standards and roughly two-thirds expected increased production in company-owned facilities. Likewise, developing market executives agreed that there would be greater demand for higher standards. Executives from both developed and developing markets also anticipate that they would provide customers with more sourcing information that would allay fears about safety, quality, and environmental standards. And all agree that these actions undoubtedly mean higher operating costs (see figure 4).

Figure 4: Likely impact of concerns about product quality, safety, and environmental standards on company over next three years

Percent Responding "Extremely Likely" (6 - 7 on 7-point scale)



Source: Deloitte's Global Manufacturing Industry Group "Innovation in Emerging Markets. 2008 Annual Study"

However, where these executives diverge reveals much about what actions will eventually be taken. Only about half of developed market executives thought they would be able to charge higher prices by adhering to higher standards. In contrast more than two-thirds of developing market executives believed that companies meeting strict standards could command higher prices. This could imply a fundamental disconnect between these markets. If higher standards mean higher prices, but developed market executives don't feel they can pass on the cost, where does that leave the developing market executive—and the customer?

Nothing succeeds like success

One of the best ways to bridge this gap is to look to those companies that, in the Deloitte study, described themselves as very successful in sourcing from emerging markets. From their responses, it is apparent that, while these companies are committed to outsourcing, they had a much better overall awareness of the risks involved. The ability to recognize the risks and manage them seemed to be key to these companies' success.

This doesn't mean successful companies aren't taking the risks of sourcing in emerging markets seriously, but rather owning up to it and making it a priority. Indeed, the more successful companies reported more involvement from their stakeholders. In particular, their boards of directors placed a significant focus on product safety—78 percent versus 64 percent at less successful companies—and product quality issues—88 percent versus 76 percent—regarding their emerging market suppliers.

The more successful companies are also looking for ways to mitigate risk through enhanced standards. Almost 70 percent of executives at more successful companies said they were extremely likely to source more from emerging markets with stricter standards, while 61 percent said they were very likely to produce more from company-owned facilities in emerging markets—compared to 51 percent and 39 percent, respectively, for executives at less successful companies.

For example, Audi sources the parts it obtains in China mainly from branches of its own European suppliers. This way it can help guarantee quality as well as a smooth supplier process.¹⁰ Hyundai has also worked to maintain

its manufacturing quality by building its own factory in India to produce cars that meet all EU emissions and safety standards.¹¹ And the company Coast Products decided the best way to help ensure quality was to directly invest in the Chinese factories producing its products. Coast Products then brought in its own product quality monitors to assess if standards were being met.¹²

Putting more effort into the selection of vendors and suppliers may also play a part. Successful companies went beyond the basics adhered to by most developed market executives when choosing suppliers—quality, cost, and reliability—and placed much more emphasis on the overall reputation of the supplier. And these companies have been engaged—or will likely engage—more rigorously in other risk management activities, including:

- More frequent visits to suppliers' facilities.
- Willingness to address managerial skills and working conditions during visits.
- An expectation that testing levels will increase significantly.
- Including more visits to facilities and approval of subcontractors in their contracts.

Take H.J. Heinz in Asia, for example. It has a detailed audit process that employs questionnaires for prospective suppliers about their production processes and materials, including such issues as working conditions and labor standards. And they are now working to make their processes even more rigorous and consistent in light of the recent publicity over product safety in emerging markets. "The sorts of detailed questions we ask, being able to see the building condition, the equipment condition, how the operators look—all gives us a very good indication about whether there is any potential risk with a particular supplier," said Mike Robinson, Heinz's Director of Manufacturing & Technical Services in Asia. "Our auditors work with the suppliers in establishing the quality of the products and the manufacturing methods, making sure things like the sourcing of materials and the supplier's testing processes are sufficiently understood so that we can have confidence that we won't have problems."

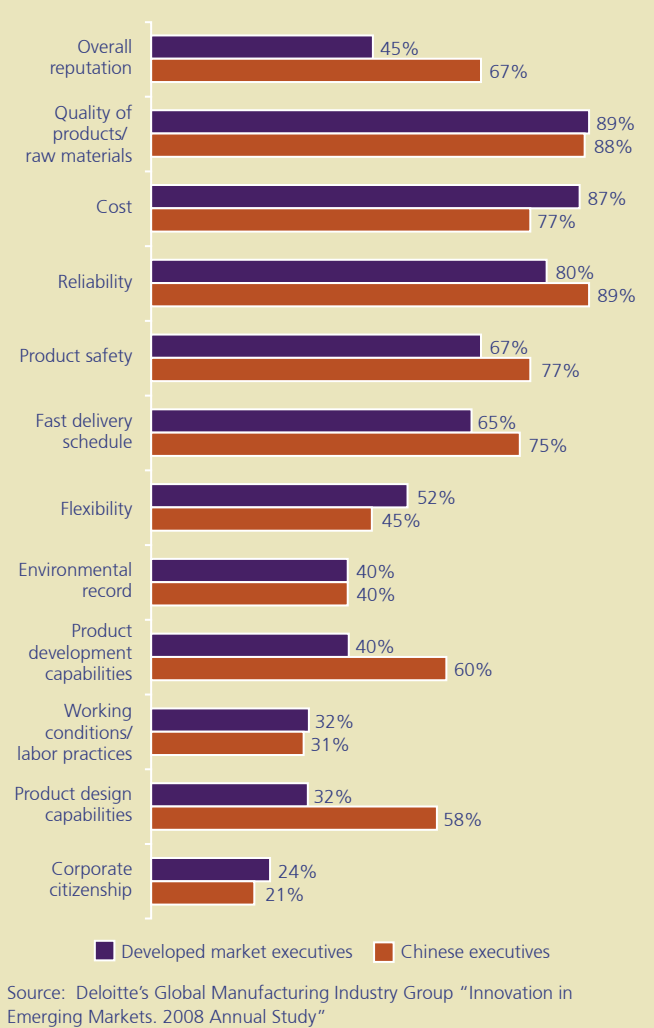
When it comes to managing risk, according to the Deloitte study, developing market executives saw the actions employed by these successful companies as a model for the future, especially with monitoring and testing. Among the monitoring techniques most reported by executives of Chinese companies that were used by global customers were support programs to improve production and statistical product control. These executives also agreed with successful outsourcers that overall reputation deserved greater emphasis when picking a supplier—and even more so, product safety (see figure 5).

Turning it to your advantage

It is true that all of the above actions are going to translate into higher operating costs; but executives at the more successful companies are more likely to anticipate these higher costs. Even more important, they view the entire risk scenario in emerging markets as an opportunity to stand out from the competition by providing guarantees of meeting strict standards—which may allow them to command higher prices.

Figure 5: Importance of factors when developed market manufacturers select an emerging market supplier

Percent Responding "Extremely Likely" (6 - 7 on 7-point scale)



This is where true competitive advantage can emerge. "Companies that take a leading position on producing products using sustainable production processes and quality working conditions have the opportunity to create an appealing brand that can drive consumer purchases," says Keith Davey, Ford Motor Company's vice president of Strategy and Business Development for Greater China. "But the foundation is to get the basics right—producing profitable, quality products that consumers can trust."

To compete on cost alone, as the Deloitte study reveals, can be short-sighted when the potential for brand-crippling damage is so real. But companies that raise standards are likely to find that their competitors quickly follow suit. To maintain their advantage, they will need to execute quickly and be prepared to continue to upgrade to more rigorous standards.

Indeed, those companies in developed markets that continue to compete on cost alone might find themselves out in the cold as stakeholders—from investors to customers to wholesalers—turn to brands that can guarantee safety, quality, and adherence to environmental standards. Already, there is evidence that some retail giants may be impacted due to the perception that they can't be trusted to protect consumers or guarantee adherence to environmental standards. In one recent third-party survey, only 40 percent of respondents felt that they could trust a major retailer to

protect them from products with safety problems that were made in China. And 39 percent of respondents said they were more fearful of buying products from the retailer.¹³

But even more interesting is the dynamic that is surfacing for suppliers from countries like China that are no longer the most cut-rate supplies on the block. And with the stiff competition of companies from locales such as Vietnam and India in terms of cost, Chinese companies should seriously consider the impact of product safety and overall sustainability. This is not only an issue from the view of developed markets, but increasingly from China's local customers, who are demanding more in terms of safety, quality and environmental standards.

Add to this pressure the reality that Chinese companies, like many others in emerging markets, are sub-contracting much of their work—and it only raises the complexity of compliance. Companies in developed markets have little visibility into the subcontractors used by their suppliers: only 35 percent of developed market executives say they perform extensive monitoring of subcontractors. As this is where many of the problems have emerged, developed market companies will need to take a more active role in reviewing subcontractors and including them in their monitoring programs. Going forward, these companies will most likely seek out emerging market suppliers that can provide more transparency regarding their subcontractors in addition to overall higher standards.

An example of higher standards yielding positive results in China is the company Shenzhen Hepalink Pharmaceutical Co., a producer of the main ingredient in the blood-thinning drug, heparin. After a major recall of this drug, believed to be caused by contamination in the ingredient produced in another Chinese factory, Baxter International Inc. turned to Shenzhen Hepalink. The company, which has undergone rigorous inspections and built its factory specifically to meet FDA standards, is now the main supplier of the ingredient in large-dose heparin for the United States, including to Baxter's main competitor. Shenzhen Hepalink credits its quality not only to its adherence to high standards, but also to the monitoring of its suppliers, sourcing only from those that are government-regulated and follow strict rules to minimize contamination.¹⁴

So, just as their developed market counterparts have an opportunity to stand out from the competition, Chinese companies—and companies from others emerging markets—can also differentiate themselves by meeting higher standards. By communicating this to stakeholders, they may command—and may receive—a premium for their guarantees. Maintaining their status as the outsourcer of choice, Chinese companies can work to carve out a niche as the locale of high standards, quality control, and environmental responsibility. While higher operating expenses are expected, Chinese manufacturers stand to turn this challenge into a competitive advantage that far outweighs the costs.

Deloitte's Global Manufacturing Industry Group's "Innovation in Emerging Markets. 2008 Annual Study" will be released in mid-May 2008 and will be available on www.deloitte.com/manufacturing. To receive a copy, please email dtmanufacturingcommunications@deloitte.com.

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