

Understanding the Risks in Global Sourcing

Understanding all Seven Risks, and Taking a Portfolio Management View, Can Reduce Exposure

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As global sourcing moves mainstream, many companies that were somewhat late to the party are now rushing headlong into low cost country strategies, often without well-considering or mitigating the many potential risks that come hand and hand with global sourcing.

What risks should be considered generally and for each specific offshore sourcing effort? Consider this list:

Time Risk: Murphy's Law can apply. Stuff happens, especially to companies that are relatively new to global sourcing, but to more experienced companies as well. Elements such as input/ingredient/equipment lead times, technology development lead times, staffing, consumer/customer testing, capacity start-up, quality issues, and other factors can all impact the time equation.

Lead times for investments or developments are often relatively long, and much can change from project inception to market introduction. Time is money in these situations.

Financial Risk: Will the anticipated savings from offshoring actually be realized? By not fully understanding and anticipating total delivered costs (including overhead costs), or letting potential savings slip away through execution lapses, the answer for too many companies is often No.

In addition to those financial risks that come from basic operations, global sourcing carries other financial risks that differ from domestic sourcing. Those include currency fluctuations, cancellation/delay cost, and supplier solvency/continuity risks.

Supply/Operational Risk: The basic question:

The Seven Global Sourcing Risks

1. Time Risk
2. Financial Risk
3. Supply Operational Risk
4. Regulatory Risk
5. Demand/Market Risk
6. Brand/Environmental Risk
7. Intellectual Property Risk

Can the supplier really supply the product(s) consistently? The challenges range from scale-up problems to quality and service issues when deliveries of the components/goods begin.

Other factors that impact supply/operational risk include the degree of exclusivity to your company, whether it is a sole source/single plant strategy, volume/supplier capacity commitments, rights of first refusal for extra capacity, inventory plans (start-up and ongoing), construction/start-up schedules, and logistics execution.

Regulatory Risk: Regulations can change over time and be harder to meet than expected, leading to delays. Consider both technical regulations (building permits, IT infrastructure integration) and trade regulations (duties, dumping, and political embargoes).

Demand/Market Risk: This risk is tightly aligned with the timing risk. The key question: Will your product really sell by the time you market it? Competitors do not stand still, nor do customer or consumer tastes. Will you miss a window of opportunity, or even worse, hit it and then have it slam shut?

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Brand/Environmental Risks: One only has to say "Mattel" to appreciate these risks. Offshoring can lead to quality problems that if not well managed that can damage the company's brands, in addition to extracting a huge financial penalty. Activists in labor and environmental areas can also cause damage to the brand – for example, it turns out that several leading retailers were selling t-shirts made by a company in China that in turn was using a textile producer elsewhere in China that was polluting local rivers. Activists target the retailers.

Intellectual Property Risk: A growing concern in China and elsewhere, as proprietary knowledge regarding design, engineering, materials and other elements can too easily walk out the door – or companies may even find their own offshore suppliers suddenly competing with them with knock-off products.

Tools for Buyers to Manage these Risks

Given the complexity, uncertainty, and cross-functional interaction required in these risk management scenarios, a structured thought process that manages the risk is essential. This kind of process includes a series of focus areas and several tools that help reinforce those focus areas.

Penetrate and Understand: Think through the seven types of risk, their probability, impact, and potential interdependence. Is there a "devil's advocate" process to subject the project to "what if" analysis of the possible outcomes?

Quantify: To the extent possible, quantify in probability and financial terms different risk scenarios. The reality is that doing this well can easily kill some low cost country sourcing initiatives with marginal returns.

Plan: Out of the understanding and quantifica-

Risk is viewed in two ways: in individual projects and across multiple projects – a portfolio view. Too few companies take this broader portfolio perspective

tion steps comes the need to create mitigation and contingency plans for technical, physical, financial, and communication implications of these risks. How can serious risks be mitigate, and if something does go wrong, who needs to know and what will be done?

Syndicate: Classic risk management theory includes syndication to multiple parties. In this case, the issue is to understand how your risk is shared by the supplier as well as how your joint risk with the supplier might be syndicated elsewhere (such as licensing your unique product for use by non-competing customers of your supplier and use of as many assets as possible versus building new).

Own: Manage supplier investments as if they were your own. If something happens, communicate quickly to avoid wasted investment at the supplier as well as inside.

Consider how you will maintain the ability to manage setbacks without dismantling the effort at the supplier. Tracking the history and using it to improve the results at both companies is important.

Portfolio Management: Risk is viewed in two ways: in individual projects and across multiple projects – a portfolio view. Too few companies take this broader portfolio perspective

Project risk falls into three stages: project can-

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cellation, project shortfall, and project obsolescence.

However, portfolio risk requires four data views:

- **Aggregate Commitments:** What has the company or business unit committed across all its projects?
- **Competing Commitments:** Do you have two projects or more with parallel commitments that could cancel each other out or delay each other?
- **Sequential Commitments:** Is there a next generation project that will make the current commitments obsolete before they are paid out?
- **Supplier Project Aggregation:** How many

projects does a single supplier have and what does that do to the supplier and your risk profile if you have multiple failures and successes? Does the supplier have the resources to manage many projects and are your priorities clear enough?

These views need to be regularly presented to business management and updated so that as changes in schedules, priority, or feasibility occur, the implications to the rest of the portfolio and to the supplier are communicated and managed, plus any financial implications are called out well ahead of time.

Risk is inherent in business, and especially so in global supply chains. By fully analyzing all the major risk categories for global sourcing initiatives, taking mitigating actions, and viewing risk across the entire portfolio of projects and products, companies can greatly reduce their exposure.