

## Cross-Cultural Management

# Eliminate the Middleman?

by Ming-Hui Huang

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**Summary.** Reprint: R0603A Greg Jamison, the head of global sourcing at USTech, has a complicated situation on his hands. The U.S. consumer electronics giant has long outsourced much of the design and production of its branded offerings to TaiSource, an original design manufacturer, or ODM, in... [more](#)

Greg, it's good to see you again," Joe Lin said, extending his hand with a smile. "It's been too long." Greg Jamison, the chief global sourcing officer at USTech, an American consumer electronics firm, shook Joe's hand and returned the smile. "It has," he said. "But we'll make up for lost time." Greg paused, waiting for Joe to greet USTech's new manager of Asian sourcing, Morris Chang. But Joe simply looked at Morris with a blank expression, hesitating just a moment before turning to say hello to the others who had arrived for the meeting upstairs.

This was even worse than Greg had anticipated. Until recently, Morris had worked at TaiSource, USTech's primary product supplier, where Joe was the CEO. As a Taiwanese original design manufacturer, or ODM, TaiSource both designed and made products sold under

USTech's brand name, primarily for the U.S. market. Morris had managed TaiSource's relationship with the U.S. company, which was one of the Tai company's biggest customers.

When USTech created the position of Asian sourcing manager and Morris asked about the job, his experience and talents made him an obvious hire. Greg had worried that Joe might be upset by the departure of his longtime lieutenant. But he never imagined that Joe would consider Morris to be a traitor. If the two men couldn't work things out, it would put a strain on USTech's long-standing and mutually beneficial relationship with TaiSource.

As Joe chatted with Dan Rollins, USTech's senior vice president for marketing, about preparations for the 2008 Olympic Games in Beijing, Greg wondered where the relationship between USTech and TaiSource was heading. The questions of loyalty and betrayal raised by Morris's move to USTech were only part of this complicated situation, he realized. Indeed, the tense encounter between Joe and Morris, in the lobby of TaiSource's Beijing manufacturing plant, spoke to issues at the very heart of USTech's corporate strategy.

## **The China Question**

Six months earlier, Greg and Dan had met with the rest of USTech's senior leadership team at headquarters to discuss the company's sourcing strategy. The CEO began by setting the context: USTech had positioned itself as a midlevel brand, offering more features than commodity producers and lower prices than higher-end rivals. Its goal was to capture the number three spot in the global market. But the company was losing market share, particularly to CaliTech and TexaTech, the number one and number two players, which were marketing more innovative products. And the commodity producers were pulling down prices and squeezing USTech's margins. "My question," the CEO said, "is whether rethinking our sourcing arrangements can help us regain share and solidify our position."

The CFO jumped in first. “I don’t think we can wait any longer to source directly from China,” he said. “Where else do labor, electricity, taxes, and government fees account for just 5% of total manufacturing costs? Our numbers are showing that CaliTech and TexaTech cut their costs by 20% after they started doing their own sourcing in China.”

“Now, wait,” Greg said. “We should be cautious about jumping on the China bandwagon. What about the indirect costs that CaliTech and TexaTech are incurring? Have you tried to calculate those? Sure, labor is inexpensive in China, but what about dealing with government bureaucracies or resolving long-distance logistics breakdowns? We can’t begin to see all the hidden costs.”

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“But haven’t our years working with TaiSource given us sufficient experience to work directly with the Chinese?” asked the head of human resources.

“Not really,” Greg explained. “Yes, TaiSource has moved most of its manufacturing to China. But that hasn’t involved us. In fact, we’re getting the best of both worlds—TaiSource’s world-class research and design *and* its lower manufacturing costs. We’re getting the benefits of direct sourcing in China without the hassle of coordinating it.”

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“At what cost, though?” the CFO asked. “We should go through TaiSource only if the transaction costs of going to China ourselves would exceed the production cost savings.”

Greg sighed and flattened both palms against the table. “Okay, so why don’t you go ahead and find out—”

“Cost reduction is only a secondary benefit,” Dan interrupted. “The real gains have to come from market growth.”

“What do you suggest?” the CEO asked, swiveling his chair to face Dan.

“With our brand equity, we should be going after the China market more aggressively. CaliTech and TexaTech already have the high-end market there, and the low end is overrun by Chinese firms like Lenovo. There may be a niche for us here, a middle-market space that we could capture—a space that would be easier to occupy if we manufactured in China.”

“I like this approach,” Greg said. “But a midrange branded product requires us to maintain quality, and that means we need Taiwanese suppliers. Chinese companies just don’t deliver high quality yet. Even Lenovo sources components from Taiwan.”

The CEO turned to Greg. “What about a mix of Taiwanese suppliers—whether TaiSource or someone else—and Chinese suppliers? After all, the sole-source model has almost become an anomaly in our industry.”

The COO spoke up for the first time. “If we use more than one supplier, we have to make sure they can work together smoothly. Our operating costs will skyrocket if we have too many suppliers who aren’t integrated into our network.”

“Hold on,” the CEO interjected. “We need to stop trading off cost and quality. Our global sourcing practices can’t be considered apart from our overall strategy. For one thing, if we want to capture that number three position, we clearly need to figure out an effective China sales strategy.”

By the end of the meeting, the senior team had decided, tentatively, to enter the China market, sticking with the company’s positioning as a “premium brand at a lower price.” The team also decided to establish sourcing offices in Beijing and Shanghai, with the aim of identifying Chinese manufacturers that could play a role—to be determined—in USTech’s sourcing strategy.

## **A Cautious Welcome**

Greg replayed the debate among USTech’s senior executives in his head as he and Dan flew across the Pacific en route to Asia. Since the meeting six months ago, Greg had hired Morris, who had opened the two sourcing offices and staffed them with a handful of Chinese employees. During this trip, Greg and Dan planned to check out the new offices, make some initial inquiries about Chinese suppliers, and get a feel for the Chinese market. They would also pay a visit to TaiSource’s Beijing factory and meet with Joe, who spent much of his time there. The first stop, though, would be Taiwan, where Morris planned to introduce them to some executives at ODMs he had identified as possible auxiliary suppliers to TaiSource—or even replacements.

Greg recalled with some embarrassment the obvious bias toward TaiSource that he had exhibited in the executive meeting. Still, it was a rational bias, he thought. Over the years, the two companies had developed a trusting, open relationship. Thanks to the free exchange of information, TaiSource had been able to create high-quality products at competitive prices for USTech. Indeed, Greg had always marveled at how hard the Taiwanese company's engineering and design teams worked to deliver one custom product after another. Before he and his colleagues considered multiple sourcing, Greg realized, he would need to negotiate very carefully with TaiSource to establish rules for collaboration.

When Greg and Dan landed in Taipei, Morris met them at the airport and drove them to the complex comprising the Neihu Technology Park and Nankang Software Park. The parks—home to more than 2,000 companies, including famous Taiwanese firms such as Lite-On and BenQ, as well as R&D units of international firms such as IBM and Sony—were established in 2001 along the banks of the Keelung River, and their award-winning buildings created a spectacular skyline when viewed from the opposite bank.

Morris had arranged meetings with a number of companies, all of whom had track records of innovation and quality, unlike most of their Chinese counterparts. Greg showed the ODM executives some of the products that TaiSource had made for USTech and asked whether their companies could offer a lower price or higher quality. The response was cautious. Some of the companies had codeveloped virtual private networks with their U.S. customers, local suppliers, and Chinese partners. These alliances with their international customers would inhibit them from pursuing similar relationships with USTech.

After the meetings, Greg and Dan slid into Morris's BMW 730 for the one-hour trip up the Sun Yat-sen Freeway to Taiwan's other large high-tech park, the Hsinchu Science Park. There wasn't much

conversation as the three executives surveyed the urban industrial sprawl along the busy freeway, whose congestion was relieved only by the view of the rugged Central Mountain Range rising in the distance.

The Hsinchu Science Park, built in 1980, had the lush appearance of a botanical garden—a stark contrast to the gleaming Taipei complex. The nearly 400 companies at the park focused primarily on integrated circuit design and silicon chip fabrication. In fact, the Hsinchu park alone represented 16% of global semiconductor output. Companies with operations there included Asustek, a contract manufacturer of Apple iPods; Quanta, a supplier to Dell and Hewlett-Packard; and Taiwan Semiconductor Manufacturing, a partner of Qualcomm and Nvidia.

But here, too, the response to USTech's overtures was guarded. As the men headed back to the airport, Greg wondered how varied the company's sourcing options really were.

### **From Supplier to Rival?**

When Greg, Dan, and Morris landed in Beijing, they were met by a driver who took them to USTech's new sourcing office at Shangdi Information Industry Base, a technology park. The 45-minute drive on the Jingchang Expressway provided a striking contrast to the drive along the Sun Yat-sen Freeway in Taiwan. The traffic wasn't particularly heavy, and numerous golf courses along the route gave the area a greenbelt feel.

During the drive, Morris described the benefits of the site. For one thing, it presented a variety of transportation options. Nanyuan Airport, offering domestic flights; Beijing International Airport; the Tianjin Xingang Port on the Haihe River; and Beijing's freight railroad station were all within an hour's drive. The park was also home to such famous Chinese information technology companies as Lenovo and Founder, and to international firms such as Novo Nordisk and Fanuc.

That evening, after the office visit, Greg, Dan, and Morris met at the Grand Hyatt Beijing for a drink. While Greg and Dan ordered Chinese “yellow wine” as a nod to the setting, Morris opted for a single malt. The busy lobby lounge was packed with Western and Chinese businessmen; both “hello” and “ni-hao” occasionally rose above the conversational din as a Chinese singer crooned Western lounge standards. Sitting at a table near floor-to-ceiling windows overlooking the grounds of the semicircular hotel, the men discussed the goals of the trip.

“The Taiwan visit wasn’t particularly satisfactory,” Greg said, sipping from his glass. “The companies were all okay, but none of them seemed qualified enough to replace TaiSource.”

“Yes, but this probably isn’t simply a question of sourcing capabilities,” Dan said, wrinkling his brow. “TaiSource, as a pure ODM player, is very attractive—but I’m not sure how long it’ll remain just that. A lot of ODMs, including some we visited today, have started marketing their own brands in China. If TaiSource decides to do that, it would become one of our biggest rivals. TaiSource sure does know the market here.”

Greg leaned forward in his seat. “I’ll bet a lot of Chinese suppliers have similar ambitions,” he said. “I think our strategic information is safer with TaiSource than it would be with a new Chinese supplier. We have a history with TaiSource. Think how long it would take to build up that kind of trust with a new supplier.”

Dan was shaking his head. “But TaiSource may be too sophisticated. Look at what they can do with R&D and manufacturing—it would not be hard for them to imitate our proprietary products and services if they wanted to launch their own brand.”

Greg and Dan turned to Morris, who had been sitting silently. Morris seemed to gather himself together, and then he looked Greg, then Dan, straight in the eye. “Joe has a plan to enter the China market in the next five years,” he said. “The strategy is to concentrate on the



Asian and European markets first, then move to the United States. But think about it: USTech accounts for nearly half of TaiSource's orders. Joe will not play hardball if we decide to do some of our own sourcing in China."

Dan shifted in his seat. "This all makes me very uneasy. How can we keep sharing our expertise, resources, and technology with a supplier that will soon be our competitor in China?"

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"A sourcing alliance is a mutual thing, not a zero-sum game," Greg said, his voice rising. "We count on TaiSource's capability to produce custom-designed products. We can't afford to damage this relationship. What do you think will happen if Joe starts to sense that we don't trust his company anymore? We could see the quality of our products decrease and our costs increase before we have time to make other sourcing arrangements.

"Let's wait and see what Joe says tomorrow," Greg said abruptly. He drained his glass, rose from the table, and returned to his room.

### **Promises, Promises**

The next day, the USTech executives made their stop at TaiSource's Beijing factory. Following the awkward encounter in the lobby between Joe and Morris, the men headed to an upstairs conference room.

As they walked down a hallway, a number of TaiSource managers emerged from their cubicles and went off in various directions. Greg couldn't help noticing how easy it was to tell the Taiwanese from the Chinese: The Taiwanese spoke to one another in English and to their Chinese colleagues in Mandarin. "One world, two languages," Greg said to Dan. "The question is, where do we fit in?"

When Greg and the others reached the conference room, they were greeted by a new and unexpected face. "This is our new chief marketing officer, May Wang," Joe explained. "She will be our major contact with USTech in the future."

Greg and Dan exchanged a quick glance. A new CMO? The idea of a marketing executive with a higher rank than Morris had had at TaiSource made Greg nervous. Maybe TaiSource planned to launch its own products sooner than Morris thought.

Greg started things off with a question about how TaiSource's Chinese production was going. "This Beijing factory is not big enough to cope with strong demand," Joe replied. "We plan to expand it and build a new factory in Shanghai to better supply our customers." Greg decided that some straight talk was in order. "So, do you have any plans to launch your own brand in China in the near future?" he asked.

"Many global brands have had problems manufacturing in China," Joe said, not skipping a beat, "and consequently the demand for contract manufacturing is booming. I don't see any immediate need to worry you by launching our own brand. Besides, that's not what we're good at."

Then May spoke up. "It is difficult for Joe to change his mind-set," she said, a teasing smile on her face. "He's an engineering guy who is proud of being the top-quality supplier. Brand marketing does not really interest him. But let's talk about this in a more formal way." May switched off the lights and brought a PowerPoint presentation up on a screen.

“We have three initiatives that will enhance the service we provide to USTech,” she said. “First, we are broadening our production base to other Chinese cities. This will improve our economies of scale in purchasing and manufacturing, creating cost savings we can pass along to you. Second, we plan to establish an R&D office in the U.S. that will help us work more closely with you on product innovation. Finally, we are acquiring capabilities that will allow us later this year to ship products directly to your U.S. warehouse, cutting your logistics costs.”

Dan interrupted. “Where will our orders be filled? From the U.S.? From Taiwan? From here in Beijing? Or from your new Shanghai factory? As you broaden your production base, will you be sourcing from other Chinese suppliers? We’re concerned about the safety of our proprietary information.”

“We will separate the design from the manufacturing work,” Joe replied. “Your orders will be designed in the U.S. or Taiwan and manufactured here in Beijing. We also plan to split the production of your orders from others so that your data can be protected.”

“Don’t forget,” May added, “that with our improved design ability and volume manufacturing capacity, we can help you improve your margins.”

The meeting continued, with May describing the ways TaiSource could better satisfy USTech’s requirements and Joe reassuring Greg and Dan about the security of USTech’s innovations. But Greg was aware of a conspicuously quiet participant: Morris. May and Joe both acted as if he weren’t in the room. Greg wondered whether hiring Morris to establish the local Chinese sourcing offices had been a good move. As the meeting broke up, Greg noticed two plaques on the wall of the conference room, each bearing a slogan. One read, “World-class quality”; the other, “Integrity and cooperation.”

## **Culture and Complexity**

The next morning, Greg, Dan, and Morris flew to Shanghai to visit the other sourcing office and several potential suppliers. USTech's office was on the outskirts of Shanghai and, like the Beijing office, was in an advantageous location—another sign of Morris's savvy. The supplier meetings went well. Although the ability of these companies to meet quality specifications was uncertain, their prices were undeniably attractive.

That night, at the Grand Hyatt Shanghai, the highest hotel in the world, Greg looked out the window of his room at the sparkling city below. Across the Huangpu River, he could see the Bund, the famous street symbolizing foreign investment in China in years past. Clustered around his hotel were the skyscrapers of Pudong, symbolizing a new era of Western investment.

He turned from the window and noticed the Chinese calligraphy carved, as a decorative touch, into the wooden wall next to his bed. Someone had mentioned earlier in the day that the characters were in complex Chinese, used in ancient times and still used in Taiwan but no longer in China. The distinction was lost on Greg: The writing would look complex to him no matter the style.

And that summed up his feelings as he tried to decide whether to join Dan and Morris for dinner or take a break and eat in his room. Opting for solitude, he again pondered USTech's sourcing situation. What had been a highly successful relationship with TaiSource was clearly fraying, if not unraveling. Morris's move strained the partnership and exposed the potential shift from manufacturing collaboration to marketing competition. In fact, the two companies were likely at some point to compete in the same midrange market niche in China, with USTech trying to leverage its brand and TaiSource relying on its strong manufacturing platform.

The next day, as Greg and Dan took off from Pudong International Airport, Greg ordered a glass of California red wine and tried to relax. He had a feeling he would need to get used to these long-haul flights.

What should USTech's sourcing strategy be?

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Greg Jamison needs to realize that the status quo—an exclusive supply relationship with TaiSource—is outdated and may no longer help USTech competitively. To improve the company's situation, Greg must admit to a few mistakes and do some things differently. One is to realize that relying on a sole original design manufacturer, or ODM, for both development and production of technology products inhibits a broad understanding of supply chain risks and opportunities. For years, Greg saw the supply chain through TaiSource's lens and couldn't tell if the costs, quality, scheduling, flexibility, and engineering capabilities of TaiSource and its suppliers were current and competitive.

Certainly, a trusting relationship with suppliers is important. But I've learned from my experience both at a Taiwanese ODM, where I oversaw relationships with corporate customers, and at Gateway, where I manage the company's relationships with ODMs, that trust alone is insufficient. Truly effective relationships need to be grounded in a current, quantitative, and shared understanding of the supply chain environment and best practices.

If Greg had looked beyond the TaiSource relationship, he wouldn't have been surprised, or necessarily worried, by changes in it. The growing demand in China for information technology products—and TaiSource's ability to respond to that demand with its own branded products—should have been a sign. Greg should anticipate change as both companies expand beyond an ODM relationship that was originally intended to support U.S. products for the U.S. market.

Greg also should begin educating himself about suppliers in both Taiwan and China—and his education must be more rigorous than a drive up the Sun Yat-sen Freeway, with stops to meet executives Morris Chang happens to know. A crucial first step would be to submit a formal RFI (request for information) and RFQ (request for quotation) to potential ODMs. He may be surprised to find that some Chinese suppliers can deliver the same level of quality as their Taiwanese counterparts.

As Greg gathers data on suppliers, he should consider alternatives to a pure ODM sourcing and fulfillment model. For example, USTech could assume management of the sourcing of key component technologies found in a family of products. Developing relationships with core technology suppliers, which typically span several product generations, would let USTech track changes in the cost, quality, and market demand of such technologies while expanding beyond a sole source relationship.

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Finally, Greg must admit to himself that hiring Morris was a mistake. It's clear that Morris won't be able to manage the relationship with TaiSource effectively, whatever form it takes. While U.S. executives may move easily from company to company, a Taiwanese executive typically wouldn't move to a competitor; if he did, he would likely "apply to resign," a process that could take months. Morris's accelerated resignation probably violates an unspoken covenant with Joe Lin.

But let's face it: Joe's feeling of betrayal isn't just a reflection of cultural differences. Whatever the geographic context, Greg should have discussed Morris's possible move to USTech with Joe in order to maintain good relations with his longtime supplier. Now he'll have to hire someone else to manage the TaiSource relationship.

In addition, Morris seems ill suited for the other part of his job: finding alternative suppliers. At TaiSource he gained experience in production and scheduling, but it isn't clear that he has the expertise to quantitatively assess suppliers in such areas as process control, manufacturing capacity and utilization, and quality management systems.

Had Greg looked at the situation objectively, considering immediate and future needs as well as cultural differences, he could have found a solution that would both meet USTech's changing requirements and protect the company's relationship with TaiSource.

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Greg should consider himself lucky. The cozy relationship between USTech and TaiSource was speeding toward a crisis even before he hired Morris. But thanks to what he learned from that questionable decision, Greg now has an opportunity to fix USTech's sourcing strategy before disaster strikes.

USTech and TaiSource have become so interdependent that USTech must establish either a more formal alliance with the supplier or a more strictly defined arm's-length relationship. Given the distrust on both sides, the only real option is the latter. Greg can now choose to diversify USTech's ODM relationships; source directly in China and Taiwan, which would require quickly mastering certain management and assembly tasks; or combine these approaches, thereby enabling USTech to expand in China at a safe pace. Greg can afford no

illusions: Whatever the choice, USTech's costs will increase. The era of free-rider collaboration for a firm this size is over, and the sooner USTech recognizes that fact, the better.

Greg's next step should be to gather the USTech team for an honest postmortem. In retrospect, the degree to which USTech trusted TaiSource will seem shockingly naive. All interdependent relationships are competitive. Absent a clear ownership structure, or the social constraints that exist within certain Asian societies, such competition will eventually destroy even mutually beneficial relationships.

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Although the relationship with TaiSource looked great on the bottom line, the result was to empower a new competitor. TaiSource has deep knowledge of USTech's products and the ability to manufacture in both Taiwan and China, and it plans to open a U.S. R&D office—another name for a sales office.

A review of USTech's sourcing system, if truly complete, will reveal that the company is still hugely vulnerable in at least one area: political conflict. In the event of political turmoil within China, or between China and another industrial nation, the flow of components on which USTech depends would be cut off. Direct entry into China by USTech would do nothing to lessen this risk. And no matter which ODMs Greg links up with in Taiwan, all rely on work done in China.

Sure, Thomas Friedman and other trade utopians insist that industrial interdependence prevents conflict among nations. But this is rank foolishness. The entirely unregulated industrial relationship between



the United States and China is analogous to the fuzzy “collaborative” relationship between USTech and TaiSource. Eventually, there will come a struggle for a greater share of the profits, or for control of the system itself.

Unfortunately, Greg’s options here are few. Suppliers in the United States, Japan, Korea, Malaysia, and Singapore would all cost more. Given that the biggest immediate threat to USTech is posed by direct competitors, all of whom source extensively in China, the executive team has no alternative but to depend on China and hope for the best.

Which means that Greg’s next call should be to Washington. When any company discovers a political risk that no firm on its own can afford to address, it is time to sit down with the people who shape the market. After all, if no one company can mitigate the dangers, then the political risk has shifted from the level of the firm to the level of the societies that depend on those firms. At this point, Greg must cease to act as an executive and act instead as a citizen.

When Greg makes his call, he may be tempted to speak in anger. It will seem to him that the politicians have screwed up once again, this time by pretending that incredibly complex global markets could somehow be entirely self-regulating. Greg should use his own mistakes to help politicians understand what must be done. After all, just as USTech realized it could not rely safely on one supplier, so too must the United States.

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This may come as no surprise, given my position as the head of a Chinese manufacturer, but I would advise Greg to seriously investigate the Chinese sourcing option. In addition to the likely cost advantage, sourcing in China will give USTech a base from which to penetrate the fastest-growing market in the world—and a supply chain that should be able to react quickly to demand and technology shifts in the Chinese market.

Granted, exercising the Chinese sourcing option requires care. It's not easy to find a qualified supplier in China. And when you do find one, it takes time to become familiar with both the Chinese business culture and your supplier's procedures. To shorten that learning period, you must make a serious effort to build trust with the supplier.

Greg will need to draft a strategy and establish a process for choosing a Chinese manufacturer that can help USTech pursue its strategy in China. He'll also need to hire a purchasing manager who knows both local manufacturers and the culture.

A crucial step for Greg will be educating himself about the local sourcing partners of CaliTech and TexaTech and determining how these relationships could influence USTech's options. As Greg learned during his visit to Taiwan, international companies can lock up relationships with the best suppliers, although the current situation in China is more fluid. Despite these challenges, however, Greg will need to do at least some sourcing in China.

What may come as a surprise is that I would also advise Greg to work on his relationship with TaiSource. He's definitely made mistakes. It wasn't a good idea to hire Morris and then expect him to work amicably with Joe. And Greg should have begun investigating a multisourcing strategy years ago.

But it wouldn't be wise for Greg to abandon TaiSource simply because of the current strains. While USTech identifies sourcing manufacturers in China that meet its requirements, Greg should consider ways he can rebuild his company's relationship with TaiSource. At the minimum, he needs to buy time while he establishes links with Chinese suppliers. And Chinese suppliers, while their production quality can match anyone's (just look at TaiSource's decision to manufacture in Beijing), lack TaiSource's design capabilities.

Greg does need to evaluate whether TaiSource can reduce its costs and pass the savings on to USTech. And he still has a strong bargaining position: Just as USTech needs TaiSource, at least in the short to medium term, so TaiSource needs USTech. But even in the long term, USTech should look for a win-win solution with its supplier. For example, Greg might continue using TaiSource for products sold in existing markets, particularly the United States, while shifting to Chinese manufacturers for new markets.

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I know personally the benefits of pursuing friendly, win-win business relationships. At BOE Technology Group, we make high-end flat panel display screens and other display components used in a variety of products, including televisions, notebook computers, video cameras, mobile phones, and medical instruments. We work closely with our customers—major global companies that, like USTech, sell finished and branded products to the end user—to build relationships that ensure our mutual success.

In the case of flat panel displays that use our proprietary wide-viewing-angle technology, we work with our partners to brand the component screens under our Viewiz brand, just as Intel does with its “Intel Inside” campaign. Although one could imagine this causing tension with suppliers, the increasing strength of the brand benefits us and them.

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As Greg considers his sourcing options, two general principles should inform his thinking. The first—which is related to the issue of transaction costs, raised repeatedly by Greg as a reason to stick with TaiSource—goes something like this: As you seek lower initial product costs by removing parties from the supply chain, objectively assess the value they add and be sure you can replicate that value at equal or lower cost. It seems obvious, but there is a risk in the current environment for companies to say “Let’s source things directly in Asia” (or, in Greg’s case, “Let’s source things directly in China”) without having dispassionately considered this equation.

I recently oversaw Staples’ move to source, primarily from China, a new line of products bearing the Staples brand—everything from flash drives to printer paper. Our situation was somewhat different from USTech’s, in that we weren’t switching suppliers but shifting from selling only other companies’ branded products to selling some of our own. But we had to weigh the costs of taking on a new range of tasks—product design, packaging design, product life cycle management—that our branded suppliers had always done for us. This was the price we paid to obtain the lower initial costs of dealing directly with the factory. And we determined that in some cases it would be economically advantageous to have our new products made not in China but in the U.S. by manufacturers whose products we sell in our stores.

The second principle is that, as you consider your supply options, carefully and candidly assess the economic interests of potential suppliers. In our case, we weren’t making a choice between a Chinese manufacturer and an ODM like TaiSource. Instead, we had to gauge the different interests of a Chinese manufacturer and the sales and marketing organization of a U.S. branded goods company, our traditional source of products.

When you source directly in China, you're typically building a relationship with a factory and the Chinese entrepreneur who owns it. That entrepreneur's economic interests are basically to get a good return on his capital investment in the factory. Although he wants to grow his business by making more things, he's not that concerned about what he makes. Contrast that with the sales and marketing team of a U.S. branded products company. For one thing, the company is interested not only in selling more things but also in selling things it wants to make. And its economic motives are harder to assess, in part because the owner—the shareholder—is several times removed.

Having determined a supplier's economic interests, the next step is to consider whether they're aligned with your own and, where they're not, what the consequences would be. For example, the Chinese factory owner's primary interest in the return on assets means that he doesn't really care who his customer is; he would likely switch to someone willing to pay a marginally higher price. At the same time, because his interests are fairly transparent, it may be easier to work with him.

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One final thought: Greg and his colleagues are almost obsessively focused on the likelihood that TaiSource will begin making and marketing its own branded products. Their concern is justified, but Greg should be trying to identify ways that this apparent conflict of

interests might be transformed into a mutually beneficial situation. Some of our suppliers make their own branded products and those bearing the Staples brand side by side in the same factory. And we've seen some of our traditional suppliers introduce innovations on products even as we launched our own branded versions of the original product. In such instances, everybody benefited, including the customer.

# MH

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