

## The Evolving Product Sourcing Value Chain in China

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The product supply chain from China is not what it used to be. Over the past 20 years, Chinese consumer-product manufacturers have become increasingly sophisticated and capable of taking on more “value-adding” tasks or segments of the product creation supply chain and have moved from mere manufacturers to multi-functional suppliers. In doing so, they have changed the game, taking on an array of production functions traditionally handled within “shop-by-product” companies.

This deconstruction of the manufacturing and product-development process has opened up new possibilities for product companies. However, unless there is evolution in the contracting model that takes these changes into account, product marketing (Brand) companies will increasingly face threats to their core roles and functions. For some companies, the evolution of their value chain has been subtle, while for others, the changes have been dramatic and obvious and these companies have come to well appreciate the value and the leverage that the multi-functional supplier brings to table.

The product value chain is fundamentally comprised of three players (represented in Table 1 below):

- Manufacturers—historically focused on the hard aspects of actual manufacture, taking orders from the product marketing companies and manufacturing the products.
- Product Marketing Companies—historically focused on the more intangible upstream and downstream aspects of production such as conceiving, cultivating and launching product and Brand lines.
- Product Distributors—historically focused on the last step in the product value cycle, retail or whole-sale (i.e., pushing product in the last mile to end-consumers).

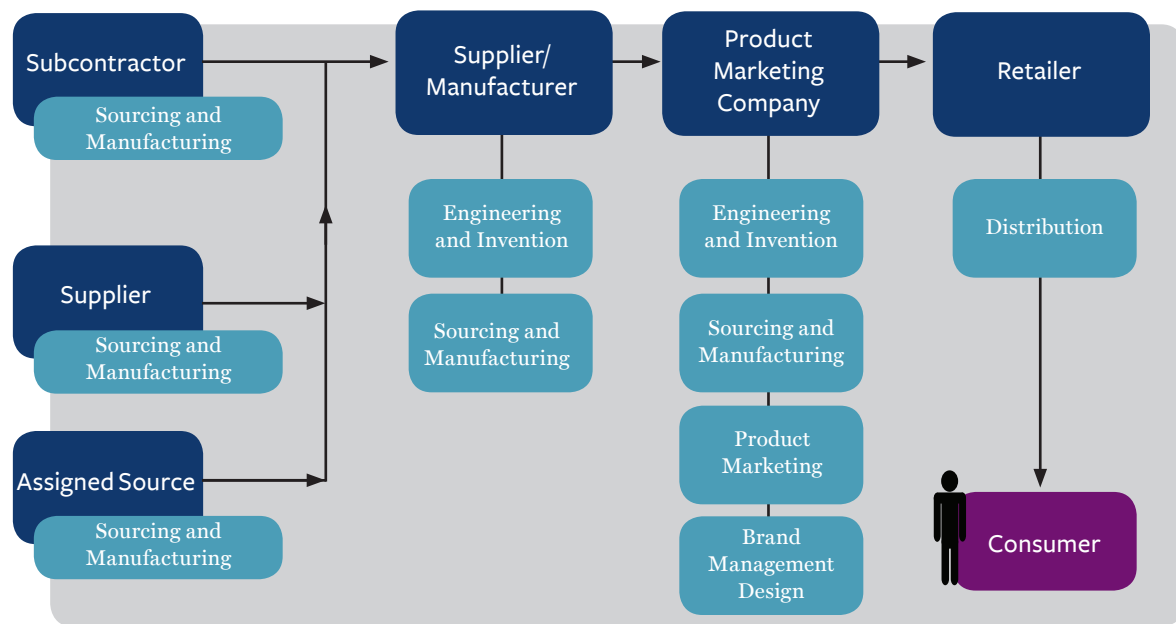
In fact, rather than clearly delineated players, each of these players really represent a collection of functions—of value-add activities that all combine to form the product supply chain. In one of the most significant recent developments, the roles of Chinese product manufacturers have expanded, as these manufacturers have taken on

more important roles in the supply chain, even becoming potential competitors to both product marketing companies and retailers.

It is important now to look at Chinese suppliers as providers of bundles of value-adding services that must be managed through a contractual framework that takes effectively addresses the unique attributes of product sourcing and the Chinese manufacturing landscape — a challenge well-suited to

the outsourcing contractual model. This article will look at the evolution of the Chinese supply base in the provision of Original Engineering Manufacturing (OEM) (suppliers that manufacture to designs given to them), and Original Design Manufacturing (ODM) (suppliers that develop products and designs on their own) and the new world of issues that sourcing customers around the world face with their service contracts.

## The Evolving Value Chain 1990

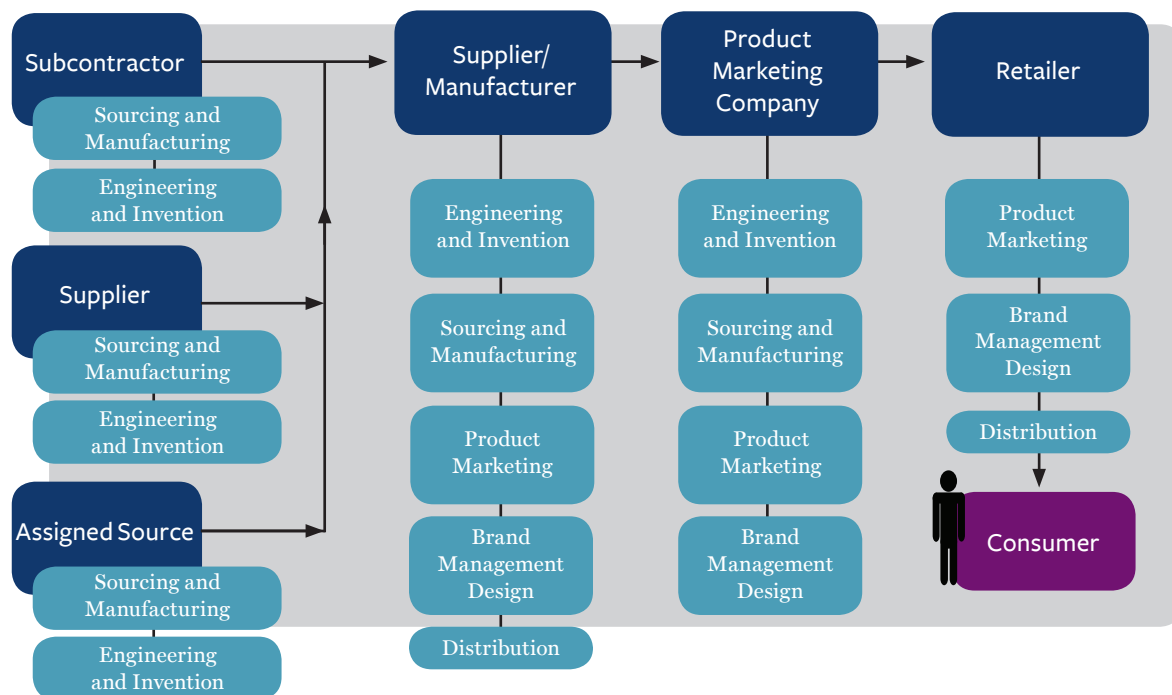


It is helpful to explain the evolution in the value chain through a comparison of the roles of each of the key players in the consumer-product value chain over the last 20 years.

In 1990, brand companies were the key drivers of product innovation as they actively cultivated their connections with retailers and consumers to develop each new generation of product. Key functions, such as marketing, product management, product design, design engineering and manufacturing, were deemed “mission critical” strategic functions that

were naturally controlled internally. Manufacturers in China did little more than fabricate toolings, inject plastic parts, source components and assemble product for their customers. The relative added-value of the manufacturer was limited and as a result their margins were thin. Retailers were primarily responsible for end-distribution and interfacing with the consumer. “House Brands” were few and far between and were limited to opportunistic products at lower price points sourced off-the-shelf from suppliers. In summary, there was relatively little overlap in the roles and responsibilities of the different supply chain players.

## The Evolving Value Chain 2010



Today, product marketing companies involve their manufacturers significantly earlier in the new product development process in order to save engineering costs and time and to provide for a more seamless transition to manufacturing. Chinese suppliers have risen to the opportunity, investing in product development engineering resources required to help their customers get products off the ground—motivated by the ability to raise their margins, notably through the avoidance of competitive bidding for new products. By getting involved earlier, Chinese suppliers “lock-in” their customers, avoid the risk of having to compete on mere lowest cost manufacturing and improve their margins by using their new-found leverage to quote on a “value-base” rather than “cost plus” basis. The integration of manufacturing suppliers into the process has helped to shorten development lead times, but early integration has left purchasing professionals without the ability to source the product with the best cost supplier.

Over the last 20 years, the confluence of three importance factors has shaped the current value chain and shifted leverage away from the brand company to the supplier: (i) consolidation of the retail sector, (ii) the need for brand companies to be more cost-competitive through low-cost country manufacturing,

and (iii) the push by Chinese suppliers to increase their margins and protect their manufacturing through the creation of more ODM products that cannot be ported to other suppliers.

First, consolidation of the retail sector in both North America and Europe has allowed retailers to increase their own margins through the development of “house brands” to supplement their own supplier’s (brand companies’) offerings. While initially undertaken on an opportunistic basis, the trend has become prevalent in hard lines (hardware, electronics), soft lines (clothing) and fast-moving consumer goods (groceries) product offerings, while squeezing the price points where many brand companies operate. As a result of their increased leverage through consolidation, retailers presented an attractive alternative customer base for Chinese manufacturers, allowing both the retailer and manufacturer to greatly increase their margins through the removal of the brand company intermediary.

Second, retailers have pushed their brand company suppliers to offer productivity savings and to lower their prices to consumers with products that are competitively priced against “house brand” products.

Competition has further exerted pressure on the same brand companies to increase margins by lowering their manufacturing costs through shifting more and more of their manufacturing to low-cost countries.

Finally, in order to meet the needs of both retailers and brand companies, manufacturers in China have invested in human capital to increase management skills and English language capabilities, as well as investing in new critical areas such as product marketing, project management, product design and engineering, quality systems and injection-mould manufacturing. To further add value for their customers, these mostly privately held (family-run) companies have the cash to offer other services including injection-mould (production equipment) financing and product inventory and warehousing services. Successful Chinese suppliers have made these investments to stand themselves above their peers and in the process, increased their margins and have made themselves indispensable to their customers.

### What Does This Mean Today?

The entire value chain for consumer products sourced or manufactured in Asia has become increasingly interconnected and mutually reliant—ownership of physical manufacturing assets and intellectual property rights has become more ambiguous and contentious. With ambiguity over ownership and rights to manufacturing assets, customers lose the key leverage of mobility. While brand companies were able to become more price competitive through lower production cost and reduced overheads within their own organizations by outsourcing their design engineering and manufacturing to Asia, their supply chains became longer and, while some new problems are obvious, others remain latent, only to emerge when the relationship breaks down.

### Brand Companies

With greater reliance on suppliers in China to design their products, to finance their tooling and inventory, brand companies have found themselves more and more “married” to their suppliers. As a result, Brand companies find themselves directly and indirectly facing the same challenges as their suppliers: currency and commodity volatility, product quality and labour issues.

Brand companies are using the lowest-cost suppliers who themselves often employ unsophisticated purchasing, finance and management practices. As a result, the brand companies are receiving price increase requests from their suppliers on a monthly and sometimes weekly basis as their suppliers struggle to properly manage these issues. Suppliers that are facing these problems have been known to essentially suspend taking orders unless they get the price increases—bringing the supply chain to a grinding halt. Brand companies have an unenviable dilemma: either take the increases and the hit to their margins, or face the daunting prospects of trying to change suppliers during the product life cycle.

Poor product development processes in place between brand companies and their distant suppliers have given rise to three major problems: unclear responsibility for product quality, delayed product realization and ambiguous ownership of protectable intellectual property rights. Supplier financing of tools and lack of clear assignment and licensing of intellectual property can make it cost-prohibitive or impossible to change suppliers when things get tough in the relationship.

Because Chinese suppliers make up such a large portion of most brand companies’ cost of goods, brand companies are pressured to take into account additional concerns such as their suppliers’ environmental and social compliance (ethical) practices.

Finally, corruption continues to be a major issue in China, and brand companies need to be both proactive and vigilant in their management of this issue. Brand companies need to establish clear expectations for their staff and suppliers and adopt policies for doing business with suppliers that engage in corruption, including termination of the business relationship. Brand companies need to structure their affairs with their suppliers so that they can quickly move away from a supplier that engages in untoward business practices.

### Manufacturers

As a result of their enhanced roles and capabilities, manufacturers find that they have new leverage in the relationship as well as a heightened awareness of the need to protect their interests and investments. Manufacturers also realize that Chinese non-legal

dispute resolution solutions do not adequately meet their needs when dealing with overseas customers. As a result, Chinese suppliers are warming to the idea that manufacturing outsourcing services agreements are not just tools for their customers to control them, but with their new-found leverage, are a means to protect their own interests.

Many Chinese manufacturers today have further taken on advanced marketing services for their customers, including, in some circumstances, to “category management” ranges of products for their customer’s product portfolio. Some suppliers have even greater ambitions—to develop and sell their own brand of products both domestically and abroad.

As a result of increased reliance on manufacturers within the value chain and the investments made by brand companies to improve their manufacturers’ capabilities, brand companies have created a new set of their own competitors that, on their own or in collaboration with retailers, are increasingly well-positioned to chip away at the brand company’s market share and margins.

## Retailers

Retailers (those remaining) have strengthened their positions greatly in past 20 years. Retailers now have two sets of suppliers to choose from: brand companies and Chinese manufacturers. A growing share of high-volume, low price-point products are being sourced directly from Chinese manufacturers, further putting pressure on product marketing companies.

## Conclusion

Dramatic changes have taken place in the supply chain over the past 20 years and manufacturing and product development services agreements used in today’s environment all too often do not adequately contemplate or address either the obvious or the latent issues present in this new highly integrated, mutually reliant value chain. Manufacturing agreements in use today are often based on the 1990s model of distinct responsibilities of the parties with a relatively simple range deliverables of Chinese manufacturers with a narrow focus on the product, rather than the basket of services now on offer (and often provided).

Supply chain contracts need to address the distinct, discrete services performed by the manufacturer, and adequately protect brand companies’ interests. In the absence of contractual coverage addressing these issues, the current trends tip balance of control in the supplier’s favor and raise an ever-increasing list of issues for brand companies to address without the proper tools.

Low-cost country manufacturing is here to stay. The myriad of issues and challenges that exist will increase, and all players in the supply chain will struggle to adequately control them.

Robust manufacturing and product development outsourcing services agreements should proactively address the new order problems that are emerging in the brand company-Chinese manufacturer relationships. A thorough discussion and agreement addressing key issues and providing flexibility for growth and change can keep the relationship balanced and allow the brand company to maintain reasonable options. ♦

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