



China *Supply Chain* Is it right for you?

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On the Cover



Is China right for you?

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With so many sources declaring it imperative to conduct business and grow ever-so-fast in China, shippers have to cut through the hype and make sure they get their supply chain basics and expectations right before making the jump. American Shipper's special report also looks at U.S.-China textile relations, China's inland transport, and Ningbo, Shanghai's neighbor port.



Consultants try hand at logistics

28

After spending two years re-engineering its own extensive supply chain, IBM decided to market the best practices, systems and global partnerships it developed to other companies. IBM and a few other consulting firms are positioning themselves to take advantage of renewed interest in a fourth-party logistics model, in which companies hire a management company to oversee the functions of multiple 3PLs and transportation providers.



Job-in-the-box?

46

Economist John Husing's catch word these days is logistics, and he's trying to sell everyone he meets on it. He says there are a half-million blue-collar jobs in the logistics industry laying in wait if Southern California (and the federal government) gets its act together and build the infrastructure to accommodate a doubling of the number of containers moving through the ports here. But that's a tall order.



Dereliction of duty

78

In December 2004, the breakup of the Selendang Ayu, a large dry bulk freighter, on Unalaska Island in the Aleutians caused a tragic loss of life as well as the loss of all cargo on board and a significant oil spill. The "incident" — the preferred terminology of investigating authorities — rocked federal and Alaskan authorities, and has serious ramifications for international shipping along a major trade route.



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Is China right for you?

*Shippers
looking for golden
opportunities need to get
supply chain basics
and expectations right.*

BY DEEP R. PAREKH

Several of us find ourselves in a mad rush to head east for China these days, with all the articles, business publications, newspapers and conferences, declaring why it is imperative to conduct business and grow ever-so-fast in China. More and more, we find ourselves being pushed by the hype, in addition to a good dose of a keeping-up-with-the-Joneses attitude, seeing our competitors vying for their spot on the Chinese mainland.

Some of the oft-quoted reasons for going to China include gigantic market potential, liberalization, much-lower cost base for manufacturing, market differentiation, competitive moves, and many more. Whereas many of these reasons are fully justified, it seems there are many instances where the short-term gain is the main driver of these decisions to expand to and in China.

Sitting on the sidelines, this actually worries us quite a lot, because we're afraid that companies don't quite sufficiently understand what they're getting into, and don't quite grasp the long-term consequences of our actions in this respect. In many cases we find companies going to China for the wrong



els, manufacturing strategy, distribution strategy, service considerations, business segmentation, product mix, business information and communication models, and resource hiring practices.

There are many publications already criticizing China for all the pitfalls of doing business there. Articles dwell on many of the issues considering corruption, excessive red tape, protectionism, and lack of trade and logistics infrastructure, talent, and many other issues. We realize that these issues exist in many parts of the world, and whereas they are significant issues to be overcome, what's more important then is how to take these issues into account when analyzing whether China is right for you.

The point of view we offer is not one of criticizing China per se, but more about how best to *leverage* China for both short-term and long-term gains for a Logistics Services Provider (LSP). We will shed some light on understanding whether and how you should include China in your overall business strategy. We present many issues from a manufacturer's point of view, so that LSPs can get more insight into what their clients are thinking and develop solutions to address them accordingly.

What drives businesses towards China

We basically see three key motivations to go to China:

- Exploit a huge market potential, i.e. to grow the business in a quantum manner.
- Reduce costs, gain scale through consolidation and efficiencies to remain competitive.
- Give a boost to their revenue engines to compensate for sagging profits at home. We explore all these motivations in this section.

Growth Perspective. A McKinsey & Co. survey published this year showed that when asked "which country do you expect to account for the most growth in the company's sales during the next five years?," 27 percent of respondents mention the United States, and 25 percent mentioned China. Growth is an interesting indicator, which can be misleading in many cases, since it is almost always given as a percentage as opposed to in absolute terms. For instance, a company with \$100 million in revenue says it'll grow by 20 percent, giving exit-year revenue of \$120 million, whereas a company with \$500 million revenue growing by only 4 percent gives the same absolute incremental growth dollars. However, there is an instinctive

tendency to view the former company as a "star" and the second as a "laggard," without reviewing the details! To demonstrate this point further, "one Western conglomerate, recently announced its goal to double its revenues from China over the next five years — a 15 percent annualized rate of growth. That figure may sound weighty, but since China currently represents only 5 percent of the company's revenues, the impact would increase the conglomerate's overall growth rate by a mere 0.6 percent," the McKinsey study said.

LSPs would be wise to analyze their clients' growth figures in detail to understand what type of capacity to make available and how best to price their services to take advantage of this growth. It will be critical to keep in mind that percentage growth figures can sometimes disguise the actual absolute number, which is what the LSP needs to base decisions of how many more lanes to open and how many containers or trucks to add to capacity.

At the same time, LSPs are in a position to know many suppliers, manufacturers, distributors and retailers, thereby giving their clients access to an entire supply chain network of possibilities to set up and do business with, as well as leverage for long-term gains. LSPs can cash in on this information by being in a brokering function and perhaps even create platforms for shipment consolidation and fixed lane routings between several parties, to increase their own efficiencies, and gain margin.

Pricing Pressure. Another recent McKinsey & Co. survey showed that when asked which particular competitive pressures they felt in their businesses, 72 percent of business executives responded: "pricing pressure," compared with a distant second 49 percent responding "difficulty in hiring, retaining talent." Pricing pressure seems to be felt more by the larger companies than smaller ones, perhaps pointing to the fact that larger companies may be facing commoditization of their products more than smaller companies, who perhaps offer more niche products, and are shielded from the pricing pressure.

The survey goes on to say that 77 percent of respondents believe that the competitive environment will be a significant constraint on the growth of their companies during the next five years. Looking retrospectively, 84 percent of executives also believed that competition has significantly increased. All this competition is driving companies to find funding from within to enable growth

reasons, or with the wrong expectations.

There are several examples of companies who have done very well for themselves by going to China for their manufacturing, and also to capture market share. But some have gotten badly burned, and have undergone quite a transformation for the worse. We find in our research that many companies don't quite understand the fact that going to China (for whatever reason) is not a simple decision, and is not "a little experiment" that can be carried out. Going to China has repercussions of a fundamental change in your entire strategy, impacting protecting intellectual property, dealing with partners, regulatory authorities, organizational mod-

and expansion to new markets. This funding must come from margin, and so cost reduction is imperative. Hence the lure of China factors in to help reduce production costs and research and development costs.

With this bleak picture of competition in the present and forthcoming years, LSPs are in an important and strategic position to help their clients. One of the critical elements in their strategies must be to “bundle” their services so as to reduce the transparency in the cost structure. Today, most of their client relationships are with people who came from the logistics business, and who know and intricately understand the LSP pricing structure. LSPs must change the game so as not to come under pricing pressure of their own. By bundling their services into “palletized solutions,” they make the pricing structure more opaque, thereby protecting their own margins, and also providing more value-added services to their clients through the combination of various integrated services.

A good example we saw recently was of the frustration of one customer of a global LSP. He said that on the one hand it was great to have visibility through the LSPs technology systems that the product was going not going to be on time for the customer demand due to a cross-border issue, but frustrating that the LSP was not doing anything about it! In reality, the LSP was not paid to do anything about it, because the service contract was simply about the transfer of product from source to destination. The customer went on to say that, if offered a bundled service of visibility plus expediting due to delays (for which the customer would have willingly paid), it would have gladly accepted it. The lack of such a bundled service leaves the customer frustrated, and the LSP leaves money on the table, for not having utilized the spare capacity that they might have had on an airplane to expedite the product.

Grass Is Greener. When we look at the facts around what executives are focusing on, when they see a new market, we are troubled by what we see. There seems to be a tendency for executives, when expanding in an emerging market, to overly focus on the market size and growth potential, as opposed to other factors. There are several factors, such as political and economic stability, availability of local staff, local laws, existing sourcing or manufacturing facilities in the country, strength of local competition, logistics infrastructure, and physical distance to markets, which need to be part of the overall business case of global expansion.

This desperate desire for growth may be driven by sagging prospects at home and

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the pressure of the market and shareholders to show rapid expansion. This is a red flag for many companies, who will face big problems if this is their only motivation, as China needs to be considered as a long-term play, not a “quick win.”

LSPs need to be aware of their clients' end game with respect to China. They need to comprehensively understand client strategy before committing to serve them in China. Difficult questions about sustainability and expansion strategy are appropriate. Ideally, LSPs should be considered as partners, to be consulted with respect to the development of the company strategy.

Who is going to China

The same survey also showed that although almost the same percent of respondents said the source of their growth over the next five years is the United States and China, when looking at size of companies, the profile is quite different. Respondents from companies with revenue of more than \$5 billion gave the following answers: 41 percent felt that growth would be fueled from China and 24 percent felt that growth would be from the United States. Contrasting this to companies with revenue less than \$250 million, 30 percent of respondents felt that growth would come from the United States and only 16 percent felt that their growth would come from China. In summary, larger companies anticipate more growth in China as opposed to that of smaller companies, perhaps reflecting the size of the investments already made by the former.

This type of analysis can help LSPs target the right clients. Service offerings and bundles can be developed to cater to both smaller as well as larger companies. “Solution bundles” for the larger companies would include elements such as network analyses, component and subassembly milk runs between suppliers and factories, and end-to-end fulfillment services. Bundles for smaller

companies would include finding suppliers, appropriate factories, helping set up complete fulfillment and trade infrastructure, and obtaining clearances and order processing.

How to grow in China

In a world where companies' supply chains increasingly differentiate products of a manufacturer from products of other manufacturers, it seems interesting that executives believe innovation will be the engine that drives the growth train for them. In a recent McKinsey survey of business leaders, most company executives believe the ability of their company to innovate will be a critical capability to fuel growth during the next five years. Further, we see, given the competitive landscape, that companies narrowly prefer to innovate current products rather than develop new products. The manner of growth, too, is mixed, where almost the same percent of respondents felt they could gain a competitive edge through developing better distribution capabilities, acquire an existing business, and enter new geographic markets.

However, one significant finding of this survey includes the response when asked which one step will be most important in achieving growth in the company's sales during the next five years. About 63 percent of executives, an overwhelming majority, responded “expanding existing operations in the market” as opposed to acquiring a local company, creating a joint venture, exporting, or licensing product in the market. Our interpretation of this is that those companies who were thinking of doing business in China are already engaged in doing business there. The potential significance of this is quite large — there will be fewer companies deciding to go there in the future.

Logistics providers thinking of expanding capacity or partnering with local companies should take this into account when developing their expansion strategy in China; to be careful not to spend valuable funding and resources in expanding where there might not be more business. For the smaller companies that may be clients for the LSP, developing a strategic relationship can be the equivalent of buying a stock on its way up. Arranging joint ventures, finding local partners, cutting through the bureaucracy of obtaining licenses, and offering a full distribution network can be critical to the growth of the client company, thereby increasing the top-line of the LSP as well.

Recent research in the *China-Britain Business Review* showed that many small to mid-size enterprises have gotten into the China act, thinking they can do it with business partners in China, and not actually have their own operations on the ground in China. Many of these American companies

think they can just find a few local factories, hand over their engineering drawings and leave the Chinese partners to get on with it, with reckless abandon. Magazines such as *Business 2.0* and *Fast Company* perpetuate this myth, and make it even glamorous. This is one of the surest ways of losing intellectual property, and digging your own corporate grave, so to speak, as the Chinese manufacturers are excellent at reverse engineering, and copying products, and then selling it back in the U.S. market at low prices to beat out the original company.

LSPs need to be aware of the same issues of expanding to China. Developing a partnership relationship just to get the right licenses or leaving an important global client in purely local hands with insufficient guidance can yield unprofitable business results and lost clients.

Intellectual property concerns, logistics impacts

Intellectual property (IP) has been a source of conflict between China and the western countries since the very beginning. Lax understanding and enforcement policies of the Chinese government have made it difficult to conduct business in a manner that is completely open, and where there is freedom of information exchange with local partners. Companies that are careful regarding their IP entering China have been successful in guarding their trade and innovation secrets from copy. There are even enterprises for which research and development is a function that they would never consider outsourcing, as this is their main engine for growth and survival.

Other companies are approaching IP safeguards after the fact, whereby the protection is solely in legal terms. Many times it seems as though the legal terms are drawn up only after the IP has already been stolen, but the other party has not developed their own legal protection for the IP. From becoming a battle of actual IP protection, it becomes more of legal wrangling about the usage of it and the sharing of revenue generation. But the secrets are out and run the risk of rampant disclosure to third parties. Companies that are successful at protecting IP ensure that they do so before it actually happens, thereby reduction of exposure to legal spending, and improving the duration of coverage of their IP protection.

Feeding back into the comments made earlier regarding stiffening competition and pricing pressures, IP is sometimes the only element that prevents the margin erosion and ensures a particular placement on the competitive ladder. One of the strategies that companies are using is to protect their highest-margin IP-intensive products by

Chinese manufacturers are excellent at reverse engineering, and copying products, and then selling it back in the U.S. market at low prices to beat out the original company.

excluding the Chinese market from their sales strategy, and only introduce their lower margin product lines, which are mature and for which patents have run out in the Chinese market. Another way is to also keep the IP engine outside China, and send the Chinese partner or subdivision only the finished product in a manner that cannot be reverse engineered.

There are many measures that companies can take in order to protect IP. Some of these include carefully monitoring exchange of information between business partners in China, doing physical counts of stock of critical components or those that are IP-sensitive, and compare order and delivery manifestos. Further, scrutinize the market to ensure that there are no illegal copies of the product floating around, and frequently audit local partners and subsidiaries. Some companies even make a particular individual responsible for IP protection, as opposed to it being institutionalized; a full-time individual who will diligently guard the property of the parent company.

LSPs with sophisticated software and service portfolios need to be aware of the risks of IP leakage before advancing their operations further in China. Many LSPs have proprietary systems and offerings, which add tremendous value to customers. With the eagerness to go to China, LSPs need to be wary of who they are teaming with in order to expand their network and access to local clients. Local operators are on their home turf, and can defend themselves better than their foreign counterparts who are eager to get a taste of the new market. Ensure that local operators who are not in a long-term tightly sealed agreement with the global LSP have limited access to the information around pricing structure, solution formulas, software code, and competitive value levers that give the LSP the advantage.

Tactical vs. strategic perspectives

A recent AMR Research report on LSPs contrasting strategic ideas versus tactical execution mentions some points worthy

of consideration by LSPs. The first point is that LSPs are the last contact point of transaction between the manufacturer and the customer. In effect, the LSP is the final face of the manufacturer in the eyes of the customer. In the same way that consumers' and customers' expectations of the manufacturer are ever increasing, the manufacturers' expectations of LSPs are increasing as well. Being that the LSP is the final face of the manufacturer to the customer, the manufacturer's expectation is that the LSP increasingly maintains and even enhances the customer relationships and the manufacturer's brand image. A case of this is Crate and Barrel, which uses UPS to stock and deliver entire lines of their products. In the coming years, it is possible that Crate and Barrel may actually request UPS services to actually assemble the products as a "white-glove" service. One can envision such things happening in the mass market as well, where an LSP could be responsible not just for delivery of product to the retailer distribution center, but also for the stocking of product on the shelves.

LSPs can leverage this advantage by actually catering to entire "categories" of product. One can imagine large global retailers segmenting their receiving and stocking operations by product category (personal care, foods, etc.), ordering through an LSP, and enabling a milk-run mode of operation, whereby the LSP collects and consolidates a particular order in a category. This order will comprise multiple line items by multiple manufacturers, who may and probably will be competitors. This shows how the concept of Lead Logistics Provider (LLP) is an emerging concept with high stakes. If LSPs are able to sell this concept in the complex China market from the very beginning, and establish the right relationships and networks, they could certainly be in this game for a very long time, and take in significant profit. But one of the critical inflection points for LSPs to note is that as long as they continue to be focused on supply chain execution (e.g. freight forwarding), they will continue to be relegated into a choice of the many point-service offers that is increasingly becoming commoditized. They need to extend their vision and operations into the strategic opportunities, to be considered as "strategic partners" and not just commodity service providers.

Hype with a grain of salt

A recent *Eurobiz* article stated: "85 percent of industrial companies in China still (handle) their own logistics for final products. Today, third-party logistics providers account for around just 5 percent of

the overall logistics market.” Some of the obstacles quoted include:

- Development within existing national distribution structure.
- High degree of fragmentation and localization of logistics and transportation operators.
- Heavy state protection and lack of coordinated planning from the center.
- Neglected infrastructure.
- Lack of a coherent nationwide strategy.

Ministries of Communications and Railways hold monopolies over various areas of the logistics sector and have provided for inadequate intermodal transport services at both the local and national levels.

Hewitt Associates have found that 92 percent of companies that moved jobs overseas did so to cut costs, but ignored some of the issues related to offshoring, which offset the cheaper labor costs. For instance, about 75 percent of companies had actually studied the impact on supply chain cost, but only 34 percent actually considered the expense of shutting down the U.S. facilities — costs that could offset the potential labor savings. To better explain, Hewitt analyst Mark Harian said in a recent press release, “for most companies, the model is still new, so there are challenges, especially in the areas of accurately assessing costs and concerns around talent, that have yet to be addressed, resulting in decreased value and return on investment.”

However, let us not be under the incorrect assumption that offshoring began recently. In the Hewitt report, of the firms who are using offshore labor, 29 percent began doing so in 1995-1999, while 43 percent began in 2000-2003. Information technology operations are the most often offshored, followed by customer relations, manufacturing, and then supply chain operations. Hewitt goes on to project that in the next three years, companies will likely move more white-

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	Worsened	Stayed same	Improved
Order Fill Rates	25%	68%	7%
Cash to Cash Cycle Time	64%	27%	9%
Order promising	76%	18%	6%
Inventory management	73%	15%	12%
Customer satisfaction	7%	60%	33%

Source: AMR Research.

collar, information-related functions such as finance, accounting, and human resource related jobs overseas.

Again, the message for LSPs is to be aware of the hype regarding offshoring and outsourcing, and not take the numbers at face value. Really examine the targeted sector carefully before making the decision to expand services and capabilities, and investing in resources accordingly.

China's issues

The *China-Britain Business Review* also mentions a recent survey in which more than half of the manufacturers of consumer goods in China claimed they were not turning a profit. The losses were attributed to various factors including lack of knowledge of the provincial locations not yet suitable for such operations, fragmented and chaotic local markets, with significant regional differences, incredible price disparities between urban and rural areas, and different level of regional competition.

Fraud and embezzlement are rampant in China, and numerous examples exist where local manufacturers collude with competitors or suppliers to produce inferior quality products or even counterfeit products using the same suppliers, and using the resources of the parent company, but sold through different channels. Often because of sufficient governance in place in the local operating company, the chief, if discovered, can break off and begin a competing company, having stolen the intellectual property of the parent, and gain a tremendous competitive edge. They may cut major corners of safety, health and environmental governance, insurance, labor protection, and so on, so as to undercut the original parent companies' advantages.

LSPs who are already on the ground, will see such activity through their various channels and their people, so as to advise client companies of these types of nefarious activities, and help put a stop to it.

First get the basics right

An AMR Research study also indicates that the outsourcing experience to an LSP

has been less than satisfactory experience for most manufacturers. Of the companies that outsource logistics services, 57 percent outsource less than half of their activities and only 4 percent outsource all of their logistics. The business benefits gained by companies outsourcing logistics services has been surprisingly unspectacular (see table). These are not impressive statistics for convincing companies to turn over their logistics operations to a third party.

For LSPs considering a significant expansion into the China market, remember that manufacturers will remember their experiences back home to consider whether or not to outsource their logistics function in part or whole to you. Get your basics right at home before you expand and try to capture the China market. LSPs need to create and set realistic expectations for the business before setting out to fulfill them. Manufacturers have developed intricate and advanced models around customer segmentation. LSPs would benefit from such models of their own, to understand the cost to serve each customer — and not just for the tactical services but the strategic solution offerings. A message to the manufacturers is that they need to be more active in the partnership, following the phrase “it takes two to tango,” and not just abdicate responsibility of managing logistics. Using a fair risk-and-reward focused structure between both parties can achieve mutual desired goals. Further, the relationship between the LSP and the company cannot be just with the interface between the logistics functional management, but with all the relevant functional areas such as finance, legal, sales, and customer service.

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