Magnetics: Industry Overview *by* Walt Benecki

China's Impact on Your Business: What Should You Do? ……

Many readers of my last article covering China Mag 2002 have expressed concern about the long term impact of the Chinese magnetics industry on their business equation. A prediction made by some is that all western magnetics manufacturers are doomed to eventually close their doors. I must respectfully disagree with this prognostication of doom. The solution lies with the answer to the most common question asked by those in our industry: "What should we do about the Chinese?"

The China issue reaches far beyond the narrow scope of magnetic materials and components producers. It will impact transformer and power supply manufacturers, motor manufacturers, raw material suppliers, capital equipment suppliers and a broad range of supportive industries. Over the next twenty years, the influence of China on international commerce will likely be far more profound than the Japanese emergence during the last century.

The magnet industry has already witnessed the total replacement of western suppliers of hard ferrite speaker ring magnets by Chinese producers. This transition took place over the past five years. Prices dropped from $1.00 per pound to about $0.35 per pound. Speaker rings were particularly vulnerable because the vast majority of product is purchased in high volumes and is considered a commodity.

Today, Chinese manufacturers of compression molded NdFeB magnets are reportedly quoting prices in the range of $65 per kilogram, approximately 50% of western price levels. Another segment of the magnetics industry that will continue to be under severe price pressure from China is soft ferrites. Chinese soft ferrite producers are rapidly improving quality and increasing production capacity. As a result, serious price pressure has already been experienced by most western manufacturers.

Those who are not financially capable and cannot define a business strategy that responds to this changing landscape may, indeed, be faced with their eventual demise. On the other hand, those well-managed companies who are proactive and set a course that *takes advantage* of the Chinese trend, while assuring they fulfill *all* their customer's requirements, should enjoy a successful business future.

Customers are welcoming the Chinese for one obvious reason: cost reduction. Chinese pricing has been, and will continue to be, substantially below historical western levels. As a result, volume buyers of magnetic materials are attracted to these significant cost savings. But all is far from satisfactory from the customer's viewpoint. Chinese producers prefer high volume business and sometimes shy away from short runs and lower volume requirements. In addition, many customers do not like to deal with the communications issues that can arise when sourcing from a Chinese supplier. Finally, customers have occasionally been hurt by inconsistent quality or service problems when sourcing from China.

The key to developing a viable business strategy is to focus on the customer's needs (what a novel concept!). A supplier who provides *full service capability* to the customer will have the opportunity to gain market share and likely enjoy profitable operations.

First, it is critical to invest in product development and applications engineering capability to meet your customer's needs for advanced materials capability, new products and design assistance. Highly qualified engineering assistance needs to be "on call" to work with customers when they are needed, not when they are available. Many western customers continue to depend on applications engineering assistance from their local suppliers.

Second, local suppliers need to provide exceptional response to their customer's requirements for samples and prototype assemblies. Lead times for samples and prototypes needs to be measured in hours or days, certainly not weeks. Also, customers need to know that their local supplier can be counted on to respond to their needs for smaller, rush orders that must be manufactured and delivered with ever-decreasing lead times. Unfortunately, all this is not enough.

It is also necessary to meet your customer's requirements for competitive high volume price levels. The key to meeting this customer need is to source high volume requirements from China! There are two primary options available to accomplish this. First, one can simply source products from Chinese manufacturers on a "buy-resell" basis. Many companies have employed this strategy and have assumed responsibility for assuring quality, carrying inventory to meet delivery expectations and sheltering the customer from communication and coordination issues.

The alternate to such traditional sourcing is to establish one's own operation in China. Many larger companies have already taken this step, but many smaller companies have shied away from this option because of perceived risks in doing so. One of the prime reasons that many smaller companies have not committed to Chinese operations is that such a decision can be both difficult and unpopular. As a result, many owners of private companies opt for short term harmony, at the risk of the longer term devaluation of their business.

There are numerous horror stories about unsuccessful jo int ventures between Chinese and western companies. As a result, this approach has lost its luster over the past few years. Currently, the two most popular vehicles to establish an on-the-ground capability in China are (1) a "Processing Company" or (2) a "Wholly-owned Foreign Enterprise" (WOFE).

The Processing Company approach permits the import of materials and components into China for value to subsequently be added. All finished product is then exported for sale. Taxes are assessed only on the value-added component of the exported product. A local Chinese company typically provides the facility and factory employees, but management of daily operations is in the hands of the Processing Company owners.

A WOFE is far easier to set up today that is was just a few years ago and many smaller companies are pursuing this option. Establishing a WOFE permits a western company to have a corporate entity in China and conduct business on its own. Significant tax incentives are typically offered to foreign companies establishing such operations in China.

It is also worth noting that reduced labor costs are often *not* the major financial incentive to manufacture in China. Cost reductions achieved in raw materials, purchased components, tooling and capital equipment often provide greater financial benefit than labor costs. On the downside, the WOFE generates challenges for expatriate management to meld the company's western business ideology with the Chinese social and business culture.

The strategic “sweet spot” is a combination of a strong local service capability and the low-cost manufacturing advantages of a WOFE. Developing this balanced approach permits a western supplier to meet the full scope of their customer’s requirements. It is this combined capability that it key to success, and sophisticated customers are eager to align with suppliers who have positioned themselves accordingly.

As the transition to China begins to mature, we will also see more product development and purchasing functions relocating to China. This will require a corresponding transition of capability from suppliers. Asian sales offices, staffed with applications engineering support personnel, will be required to continue serving the customer’s requirements.

In summary, sound business strategy is always essential for a company’s long term success. The Chinese “threat” demands such strategy development. Remember, however, that strategy alone does not assure results. The quality of management’s day-to-day execution of key programs *that are directly linked to the long-term strategy* will ultimately determine the degree of your long-term success!

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