

Low cost no longer an option for taking advantage of low salaries

BY BO ESKE NYHUS
CAND. SCIENT.
POL., MBA

Since 1994 European companies have utilized the low cost structure and the proximity of Ukraine to cut manufacturing costs - but recently something has changed! Ukraine is no longer a country for low cost sourcing.

Companies use outsourcing to free resources and reduce fixed costs in order to become more flexible and adjustable to market demands. Indeed, producing at the lowest possible price has become a necessity for survival - not just an option. In the "big squeeze", if you do not service the high-end market, you have to sell products with a small margin, but high volume.

One company that has realized this is the quickly expanding Danish retail company "JYSK", which has a clearly formulated aim to decrease costs of goods purchased by at least 5% every year.

The issue of quality

While there is no question that outsourcing can help companies cut their costs, some critics question the real long-term cost savings. In their eyes, cost savings are set off by lower quality and lower efficiency.

But Danish companies producing in Ukraine have no complaints about the efficiency or quality - in fact they often claim the contrary. Brands such as Vero Moda, Jack & Jones and Brandt are all produced in Ukraine but relatively high end quality fashion brands nonetheless.

That quality is not a problem does make sense, as neither efficiency, nor quality, depend on the individuals employed, but on company organization and management: the challenge is to recruit and train the right people for the right positions.

The issue of organization

Western manufacturing companies, then, may ask themselves

if their inability to compete in a globalized world stems from sub-optimal organization. But it doesn't. In fact, Danish companies in Poland have out-competed their closest Polish colleagues, and since all companies inside Poland are facing the same cost structure, and since their volumes are almost identical, the explanation can only be a better use of production management technologies.

More likely, the reason why Western-based manufacturing companies often struggle to survive is that they are producing in countries with salary levels too high for their type of production.

It's about labor costs

In Eastern Europe, and especially in Ukraine, outsourcing is in practice related to cost savings only, and the main issue is labor costs.

The explanation is rather simple: all basic input materials, technology use, management methods and capital travel without obstacles around the globe forcing price gaps between countries to narrow. The only production factor (land not included), which still cannot move freely between countries, is labor - especially manual labor. Consequently, significant price differences on input factors can only be found in countries where the cost of employment is low.

Searching for a low cost country

In Ukraine, like China, India, Mexico and Thailand, the employment costs level of manual workers is as low as 10% of the Western European level. And even though yearly salary increases in some professions are double digit, they are small in nominal terms. Only if the increase was 30%, would the nominal difference decrease.

While salaries are just as low in China, India, Mexico and Thailand, these countries share one big disadvantage when compared to Ukraine: distance! Firstly, Ukraine is in a neighboring time

zone, and this provides European companies with a larger working hour window. Secondly, transportation of a 40 foot container from China to Europe costs approximately 2,500 Euros, and takes four to six weeks. The resulting time gap between production and realization can pose a real problem - fashion clothes are the prime example as they have to be sold, while the fashion hype is on.

However, not everything related to Ukrainian business has become easier.

Even though the general cost structure for local Ukrainian manufacturing companies remains almost unchanged, foreign companies trying to practice low cost sourcing in Ukraine have found it increasingly difficult to find low cost suppliers. And the very few capable producers

belong to this group. The remaining 90% are all "bad" companies, in which management has the wrong mind-set; technology is obsolete; staff lacks motivation and is under-qualified and so on.

In a competitive economy those "bad" companies would be liquidated or eventually go bankrupt, as other more fit companies out-competed them on resources and customers in a process of "creative destruction".

Unfortunately for companies looking for outsourcing partners, creative destruction happens too slowly in Ukraine - development of the manufacturing sector in Ukraine takes more time than it ought to - too few manufacturing companies die and too few manufacturing companies are established. Partly for historical reasons, the general business framework is not good enough to create the needed dynamics, and most of the management in the existing companies is not strong enough to execute changes. In other words, the invisible hand is too invisible and the visible hand is too weak!

Pricing

As all outsourcing companies search for the few good, well-organized companies these quickly become overloaded with assignments, and at the moment they face the same problem - they cannot produce enough!

And that is a key issue. Companies with no excess capacity set their prices on an opportunity cost basis and not on a contribution margin basis, because the cost of taking in an extra order has to include the cost of not being able to produce for someone else. This is very fortunate for the Ukrainian company, which can ask a higher price, but it makes it increasingly difficult for the purchasing company to find a competitive offer.

The rising prices are reducing the number of assignments that can be outsourced - basically limiting the sectors to IT and the textile business or other processes with high labor intensity per transported unit.

Low cost sourcing at an end

But can Ukraine no longer take advantage of its competitive edge - a well-qualified work force willing to work for a price significantly lower than in the neighboring countries?

In fact, it can. I would argue that there are indeed opportunities for low cost production in Ukraine - but not for low cost sourcing!

Since efficiency is not a national specialty but a question of organization, management and use of technology, the cost differences in salary offers huge opportunities for any company. But to get access to Ukraine's low cost labor force, a company has only one option - to establish ownership of the production process itself. By doing so, a company will face a cost of employment of about 2 - 2.5 Euros per hour. Of course you would have to add to this the many fixed and overhead costs, which would necessitate a rather big volume.

One person who has realized the need for establishing ownership is Jorgen Haar, Director of Danish Hard Wood in Lviv: "You have to produce it yourself in order to do it right and keep the prices down. If I cannot produce everything by myself I do not produce it at all - it will simply be too costly in direct price and in practicalities to ask the local producers to do the work".

Recommendations

So do not be fooled by the low costs of employment - Ukraine is no longer a platform for outsourcing. The country is, however, the cheapest location in Europe for some types of production, and an ownership structure may enable you to capitalize on the low cost of employment. Given that ownership of production can be aligned with your company strategy, Ukraine will be a good choice, as it may give you a temporary lead in the quest for minimizing unit costs.

Producing at the lowest possible price has become a necessity for survival - not just an option

In Eastern Europe, and especially in Ukraine, outsourcing is in practice related to cost savings only, and the main issue is labor costs.

In Ukraine, like China, India, Mexico and Thailand, the employment costs level of manual workers is as low as 10% of the Western European level

Foreign companies trying to practice low cost sourcing in Ukraine have found it increasingly difficult to find low cost suppliers.

As all outsourcing companies search for the few good, well-organized companies these quickly become overloaded with assignments, and at the moment they face the same problem - they cannot produce enough!

There are indeed opportunities for low cost production in Ukraine - but not for low cost sourcing!

It should be kept in mind, though, that transportation from Ukraine can still be a barrier to outsourcing. A full load trailer to Denmark costs about 1,350 Euros or 6.15 Eurocents per kg of product shipped.

The fact that weight and volume matter explains why sectors such as IT and textile have been the first to relocate to Ukraine. Almost 1,300 Ukrainian IT programmers and close to 2,500 seamstresses work on Danish assignments, while less than 500 work in the wood and furniture sector and less than 250 within metal processing.

The paradox

There is no doubt that it has never been better to do business in Ukraine than it is now, and an ever-increasing number of foreign companies are trying to enter the market.

that can be found cannot deliver products at a competitive price. In fact, the price per unit is higher than what can be obtained by purchasing in Poland or other Central European countries.

So, paradoxically, on the one hand we have Ukraine as a prosperous low cost country with low cost structures - especially with regard to salary levels. On the other hand we have frustrated companies unable to benefit from this and unable to explain why!

Lack of creative destruction

The fact is that there are two kinds of manufacturing companies in Ukraine - the "good" and the "bad" companies. The "good companies" are the ones working according to world-class best practice or adapting to those standards very fast. However, only 10% of all Ukrainian companies within any given sector

Munk, Andersen & Feilberg

Aarhus, Denmark
J.M. Mørks Gade 1
DK-8000 Århus C
Tlf. +45 70 22 84 55
Fax. +45 86 28 84 50
mafcon@mafcon.dk

Lviv, Ukraine
Petlury Str., 37a
Lviv 79021 Ukraine
Tlf. +38 0322 418 711
Fax. +38 0322 418 712
lviv@mafcon.dk

Kyiv, Ukraine
Lesi Ukrainky Blvd.,
21, office 6 (3rd floor)
Kyiv 01133, Ukraine
Tel: +38 044 284 55 88
kyiv@mafcon.com

