

This article will be published in a book called Global Logistics 5th Edition in Autumn 2006.

The contributors will include:

Stephen Rinsler, Donald Waters; Trevor Heaver; Shi Xinping; Remko van Hoek; Phil Schary; Peter Hines; Nathalie FABBE-COSTES; Michael Browne; Martin Christopher; Lars Stemmler; Kirstie McIntyre; John Fernie; James Wang; Helen Peck; Grzegorz Augustyniak; Glyn Watson.

Outsourcing: The Result of Global Supply Chains?

1. Background

There can be no doubt that Outsourcing has become big business. From the early beginnings in the mid to late 70's many companies have travelled the outsourcing road and as technology and accessibility to shared electronic data has increased so has the range of services offered by Outsourcing Companies.

In the past few years The Government has openly encouraged outsourcing and PFI and other deals have spawned. Not all the outsourcing arrangements in the private or the public sectors have been successful. There is a steady but small stream of processes being 'taken back in house' and there have been some high profile failures in the press.

We will explore why outsourcing takes place and how to avoid some of the pitfalls that undoubtedly can occur. We have tried to place outsourcing in the context of the more recent moves to source manufacture from overseas, particularly the Far East.

2. Definition

Outsourcing describes the deliberate movement of a series of connected business processes to a third party who manages them on behalf of the Company. The classic processes were IT, Warehousing and Distribution, Facilities management, payroll, and to these can now be added: call centres, manufacturing, web-development, home shopping, credit cards, and even merchandising and design. In these movements the commercial risk and assets are usually passed to the outsourcing company.

However not all companies refer to the process of business process management transfer as outsourcing, for some they are just buying a service or a series of products. In this case the transfer of assets is unlikely.

The definition of outsourcing does not imply abdication of responsibility.

2.1 Examples

Some retailers over the years became very vertically integrated. They would manufacture their own goods, own and run their stores, own and run their warehousing and distribution to store services, some even ran their own store loyalty schemes: Co-op stamps.

Now many retailers outsource all their manufacturing, they do not own and run their stores, they have outsourced their warehousing and distribution, a bank runs their store cards, and

some have outsourced their design, packaging design and merchandising by franchising their floor space to design or cosmetic houses and niche labels.

For others including manufacturing companies and distribution companies, the accounts function is outsourced.

3. Reasons for Outsourcing

You may have heard these reasons

- We do not have the management expertise
- We need to jump the learning curve
- We want to move fast
- The area requires major re-engineering
- We do not have the management resources
- We pay too much to do it ourselves
- It is not core
- The business is going through major change, need to make more areas variable cost
- We need to focus our resources for training, investment, time, etc.

However some of the strategic reasons above are overshadowed by the personal objectives of the management involved; some like to follow a trend and therefore outsourcing is encouraged; some, when joining a company where that department has been outsourced, start the process of re-integration to enlarge their role.

These reasons for outsourcing can therefore be structures into 5 groups:

- Financial
- Technology
- Managerial
- Resource management
- Personal

3.1 Financial Reasons for Outsourcing

Although companies now have to declare in their Statutory Accounts and to many Stock Exchanges the value of assets leased and the methodology used by their businesses to access their markets; it is still the case that some Companies have limited access to investment funds and see the need to leave the raising of cash to their outsourcing partners.

Sometimes the outsourcing provider can borrow at a better rate than the company since their operation has a lower risk through better focus, sometimes the additional borrowing costs are worth the flexibility.

Flexibility of use of resources is also an important factor; if the Company's use of the

resources can be pooled with others creating better scale and better marginal costs then using an outsourcer ensures some independence of management of those resources and releases the Company from having to manage the other users of the facilities.

Another facet of outsourcing in the past 5 years has been the Pensions Factor. Whilst many larger Companies have seen their pension deficits soar, the companies to whom they outsource often do not have final salary benefit schemes. Thus outsourcing crystallises the deficit at the point of transfer, but it only does so for those people who transfer under TUPE arrangements. There is constant churn and while those people who did transfer can freeze their pensions, new people do not create the same pension deficit as they join defined benefit schemes based on personal pensions. Thus the deficit will decline with time and the actuaries can take that into account at the point of the company sale or merger.

3.2 Technology

Technology half-lives have fallen dramatically over the last 20 years and the predictions are that they will fall faster still. Competitive edge comes from the rapid integration of the new technologies into the company (if they are relevant). Consider the Board looking at the choice of investing in the skills necessary to sell to its clients or the skills needed to operate the latest technology in its delivery vans or the warehouse. If resources need to be rationed, better to concentrate on the sales skills and the sales systems?

Many manufacturers maintain their own machinery completely. Current technology comes often in black boxes that are replaced on failure and the skills of the supplier used to renew them. The UK utility companies have agreed the outsourcing of its maintenance since the engineering companies have better skills, have the latest training and the latest diagnostics; the Company acts as the voice of the Consumer in this instance.

Health and Safety legislation, the tighter requirements of the insurance industry is leading to some companies outsourcing operations since specialisation of knowledge and service leads to lower risk and costs.

In addition the role of IT and the necessity for robust, integrated systems has moved business in two directions: one where they purchase integrated systems and outsource the systems analysis and implementation to IT consultancies or they supplement their IT support staff with analysts and programmers often through a consultancy to whom they delegate the resource provision to create the Company's own software.

3.3 Resource Management

One facet of the management of a company never changes: one forecasts resource requirements and the forecasts are never right, one allows for risk and resource investment is therefore either too high or too low.

By focussing on your core resource business areas you can probably match investment and requirements more closely than in your other business areas. In these periphery areas you either have to apply the same focus as the core areas to manage your resources or you will

not optimise those areas. Given that many of these areas are likely not to use your core skills, the likelihood of optimising them well and achieving good service levels and costs is lower than outsourcing to a specialist.

Furthermore the outsourcing Company can act as an independent manager for your resources should you wish to pool your resources with others and spread the fixed costs.

3.4 Management Skills

The point has been made in the other sections that businesses are better to concentrate their management and training skills in those areas in which they can make a real difference or they should find partners to help them.

Remember you own the vision and strategy, that is part of the management and entrepreneurial skills you need to run a successful business. Maximising your selling and procurement skills, ensuring you have the right products and services to sell to your clients, ensuring pricing provides the cash return you need for investment and paying for services bought should be the management skills you provide.

However if outsourcing is the answer then there are important new skills to develop, namely the skills of choosing your partners and managing them.

3.5 Personal

It is rare for managers to have totally altruistic motives when deciding to in-source (take back an outsourcing contract) or to outsource a series of business processes. Unless there are clear strategic reasons for a change to be made, bringing back processes can often be to enlarge their role just as pushing for outsourcing can be to ensure a job move.

In the past strange decisions have been made: for example a major retailer started to backload goods that were delivered by manufacturers to reduce costs by raising the utilisation of their fleet. But ex-works prices were required, that under EU laws had to be offered to its competitors, then it was found that the primary movements from RDC to store were being delayed as the fleet was not returning to regular times as both the extra running and the pickups compounded to increase the round trip time variability. The fleet was enlarged to cope with that. It is probably not known whether the final cost model was more or less expensive than the original model.

The question that was not asked was whether the fleet was required in the first place.

3.6 Current Relevance

Given the pace of globalisation, it is inevitable that outsourcing will take place. It is not usually sensible for manufacturers to set up their own manufacturing plants in the Far East. Some have, particularly if the products can be sold for internal consumption as well as for exports, but in the main retailers or manufacturers are taking only part of the output of a Far East plant and therefore the manufacture, the distribution to the port and the customs

clearance tends to be outsourced. It is not always economic to have one's own management in place in China or Taiwan or Indonesia, etc. There are specialist skills in arranging consolidated shipments from a port and the use of Freight Forwarders to ensure the shipping is booked and the goods are customs cleared in the UK is very normal.

These extended supply chains have risks like any other supply chain but we will discuss the amplification of the risks later.

4. How different is the Public Sector from the Private Sector with Regard to Outsourcing?

There are some fundamental differences between the public and private sectors: public businesses are about cost containment rather than long term profit sustainability; public finances do not differentiate between capital expenditure and costs easily and therefore to remove all expenditure from the public borrowing figures is often the driver. Investments to reduce costs are far easier in the Private Sector where a return over time can be benchmarked against the internal rate of return for that Company.

Now the Pensions Factor is the same for the public and private sectors with the additional facet that the Civil Service retire at 60 whilst many in the Private sector do not. If the new owning company does not have a final salary scheme then the Pensions cost declines with time as the people who replace the original transferees who leave or retire, join the new pension arrangements.

It is probably the experience of Government trying to build their own systems that has led to the level of IT and business process outsourcing that is currently being progressed. Government wish to distance themselves from the day to day management of projects and they are trying to move the risk of over-run expenditure to their contractors. Politically that is understandable, but as we will see later, it is crucial that organisations outsourcing business processes continue to keep a close eye on the efficiency of any interfaces and the delivery of the strategy.

The other major difference is that of the Stakeholder Community. The private sector includes customers, employees, shareholders, regulatory bodies and suppliers. (For many the local community should also be included and the Press often is included in this category); The Public Sector has customers, employees, regulatory bodies and suppliers but also Parliament, Ministers, Voters, the Civil Service, and a much closer Media scrutiny.

5. The Pitfalls in Outsourcing

Given the outsourcing arrangements are about two companies joining together to provide a service or a range of products then the pitfalls become fairly easy to list when one views the arrangements dispassionately from the outside as a third party. They are in the main caused by differences in strategy, objectives, culture and at a basic level how do the two sets of management who have to work with each other on a daily basis work together, trust and respect each other.

However from the start, one needs to look at how well any tender document was detailed,

how well the tasks were described and how open were the client management about their on-going strategy and the reasons for outsourcing. Any hiding of real facts at this stage and the contract is likely to end in considerable difficulties.

Similarly, any over expectations raised by the outsourcing company, particularly in terms of timing, complexity and the level of cost savings the client might enjoy will also ensure the contract flounders quite early in its life.

5.1 Major Initial Questions that must be Addressed

The Board, and it must be at that level for major outsourcing arrangements, must review the following questions with care. They are designed to highlight the strategic changes needed to accept outsourcing:

- What are the company's current Strengths, Weaknesses, Opportunities and Threats?
- Does outsourcing resolve some of the weaknesses and threats and open up opportunities to build 'new' or consolidate our current strengths?
- What should my partner look like?
- What will I be depending on them for?
- Who should drive the outsourcing project at Board level, who should be the 'project manager'?

With these questions answered honestly the job of writing the tenders and evaluating the outsourcing companies' responses will be that much easier.

Once outsourcing has been agreed as part of the strategy the major questions to be answered by the client company to avert the outsourcing pitfalls are:

- What is our current strategy and what strategic changes are we looking for?
- What are the boundaries to our outsourcing?
- How will we evaluate the tenders?
- How will success and failure be judged in the contract itself?
- How will we remunerate and reward them?
- How will we link the organisations?
- How can we reduce internal frictions and the feelings that they are just another supplier?

5.1 Strategy and the changes we need?

Outsourcing is about dovetailing other companies expertise and focus into your company to improve competitiveness and customer service.

You must keep control of the Strategy you cannot outsource that; however your outsourcing partner will also have a strategy and the marrying of the strategies is an important part of the early meetings between the companies and should form part of the selection process.

Partners with diverging strategies cannot work together for long and outsourcing cannot be a

two-minute wonder; the time period for an outsourcing contract should reflect the life of the underlying assets supporting the contract and the time and effort required to tender, renegotiate and implement a new contract.

The outputs from the strategy that your stakeholders: customers, shareholders, employees, etc can see need to be defined. For example, customer service levels, Return on Investment, etc. These should be discussed with your outsourcing partner only if their input to your business processes has an effect on these outputs.

5.2 What are the boundaries to outsourcing?

There needs to be a Board process that challenges the added value that in-house processes provide to the overall success of the company. This is part of the input into the Company SWOT analysis. The in-house picture then needs to be compared with that provided by outsourcing some of the business processes. The changes to the SWOT analysis need to be tracked. Of importance is the Threats or Risks that change between the two pictures and these must be analysed carefully. Risks in Global Supply Chains are discussed a little later.

5.3 How will success and failure be judged?

Many outsourcing arrangements start without clarity to this question; the Key Performance Indicators have not been agreed, the measurement methodology is not clear and reporting arrangements have not been agreed. This does not allow the two partners to have the same vision of the operation and the lack of clarity will inhibit either side learning how to improve the service, etc.

In many ways if the first question on strategy has not been answered then it is likely that this one will remain cloudy.

The indicators of success and failure and the rewards and redress required need to be fully laid out in the contract before the operation starts.

The KPIs (for a warehouse operation) can cover: Customer Service measured in Customer terms, Budget Performance (savings), Damages, Stock Losses, accident rates, productivity measures, etc, etc.

So when looking at the remuneration of the partner, bonuses for beating customer service targets, a sharing of the budget savings are a good way of incentivising the partnership. Sharing the losses, penalties for poor customer service another powerful way of ensuring the correct behaviours.

5.4 Tender Process

The tender process is a chapter in its own right, but what is important strategically for successful outsourcing is that there is sufficient detail in the tender about the current operations, a clear statement of the Key Performance requirements and a strategic vision which is shared with the prospective partners. Without the detail, without a clear pro-forma

of the response required, it will be difficult to evaluate the various replies. Honesty will provide better answers and honesty will build better relationships; both are needed if the operation is to be successful over time.

5.5 Company Linkage and Reducing Internal Friction

Outsourcing of a number of business processes implies that the those outsourced need to communicate, to link with the rest of the Company's business processes. Thus not only are there data linkages that need to be forged, but the management and administration of the two companies need to be joined as well.

A lot of time a care must be taken to ensure a high degree of efficiency about the interfaces; slow, inefficient interfaces will cost money, increase friction between the two groups and in the end result in poorer customer service and lost sales.

Thus, a good strategic Board will ensure that teams are built across the interface; the outsourcing company must not be treated at complete arms length such that face to face meetings are not accepted as part of the contracts life. The managers working the interfaces must be compatible; they must work together and respect each other. Attempts must be made to ease any cultural differences.

That does not mean that both sides should not challenge each other. No challenge, no creativity and an operation that will slowly fossilise; but challenge must be constructive. The internal assassins to the process of outsourcing must be dealt with.

5.6 Summary

In summary most of the pitfalls experienced by companies outsourcing are down to management issues and down to not being open about strategy or other market or business factors that are germane to the evaluation of the business the outsourcer will perform as they build their bid.

The additional problems can be caused by a failure to gain the buy-in of the Company management during the tender process.

Outsourcing can only work with the active co-operation of both sides.

6. Global Supply Chains and the Outsourcing Risks

Global Supply Chains, somehow, have brought the promise of better margins and both retailers and manufacturers have rushed to move the source of manufacture and some services to Eastern Europe, India and the Pacific rim including China.

Whilst manufacturing costs have undoubtedly fallen, not all commodities have fallen as well: shipping costs, for example, have risen as the laws of supply and demand have remained true.

It should be noted that the new extended supply chain hides a number of potential risks that

if not properly accounted for could have a severe effect on your profits. Boards need to have identified and evaluated the costs of these risks in order to judge the real business case for overseas sourcing. The fact that some companies are now considering sourcing from countries that are geographically closer to the UK means that the balance may be shifting away from very extended supply chains.

What are these important risks? They fall into the following four groups:

- Supply Chain risks
- Management risks
- Financial risks
- Political risks

6.1 Supply Chain Risks

These arise through the new geography that is a back drop to the outsourcing arrangements. The factory is no longer in the UK or nearby in Europe. Many of the problems are the same as the original supply chain but the risk of not resolving the issues increases with distance and the language and culture divide. Problems such as: quality, of specifying exactly what you want after the first proofing runs, of tying the supplier into your business are good examples.

You now have lower costs because you have agreed a single long run production slot with your supplier but the slot is usually not very flexible. Thus changes to quantity and timing are much harder to arrange. Under-order stock, ask for a smaller, more expensive additional run to be slotted into the production schedule and you may have to have the quantity sent by air-freight in order for it to be on the shop-floor in time for the sales period. Realising this additional cost you may feel forced to deliberately over-order stock at the start. Many retailers now have higher stocks than they used to have; that requires larger warehouses and results in lower warehouse productivity. Then the sales forecasts, the merchandising forecasts are not met: clearing unnecessary stock through the sales channel generally requires heavy discounting which means a reduction in profits.

Then there is the quality of goods on arrival, having been packaged, badly often, in the container, you now have an extensive new operation of finishing, steaming, and sometimes pricing, etc that has to be done in the UK to make the merchandise look shop-ready. Who pays for the stock as it resides in Customs awaiting clearance?

Your extended supply chain is forcing you to make decisions on fabrics, design and colours earlier and earlier in the process. There is the real risk that the product range needs to be specified before you have sold in this year's same period merchandise raising the risk of getting it wrong.

Many of the above are judgemental risks that supply chain or merchandising managers have to take, but then there are the physical, environmental risks in the Supply Chain: hurricanes, earthquakes and typhoons all play a part in the equatorial climate and geography; they are risks that must be quantified and sourcing strategies and contingencies should take the results

into account.

6.2 Management risks

The longer the supply chain, the greater the number of nodes, the greater management time that is required to achieve a smooth result. This resource will be more than the Company currently has and even if functions are outsourced there will be the need to co-ordinate the outsourcing partnerships.

The greatest concern in this area for most retailers is quality. It can be difficult to oversee the accreditation and auditing of suppliers and manage proofing runs over a long distance. Once product is agreed, production schedules have to be monitored, which requires time, personnel and particular skill sets.

Outsourcing requires regular contact between the various parties to make it work. The question to bear in mind is, has the cost of the additional merchandising and quality management been taken into account?

Outsourcing is not about abdication; you still need to control the strategy, you need to spend time integrating the outsourced service. The more central the activity is to the heart of the company, the more time that is required to really ensure the outsourced operation is integrated. How the organizations are linked is one of the keys to the success of outsourcing.

The other management risks are that you did not define what the strategic changes that you are looking for are and you may not have shared them with the prospective partner? You may not have decided how success and failure will be judged and therefore not decided whether any form of gain share is appropriate to the contract.

Another risk that requires to be dealt with the risk of poor internal communication about the potential to outsource and once the contract is implemented communicating the successes.

6.3 Financial risks

Your suppliers like hard currency, quite often US dollars, and thus a significant proportion of your costs will be exposed to the fluctuations of that currency. If the dollar strengthens and your margins decrease as you are connected to UK price competition, you are forced to try to reduce the purchase price which may result in reduced product quality and greater finishing costs.

It is possible to hedge the dollars by buying in advance of course, but there is a cost to these transactions. You might buy stock in pound sterling, but if there is currency movement against the supplier, they must in the long run recover lost margin or refuse to do business with you, resulting in time and expenditure accrediting a new supplier.

Shipping costs increase markedly as routes become more popular resulting in a reduction of your margins. If the price of oil increases, so will your shipping surcharges. Were these

potential costs taken into account in the budget?

Your extended supply chain requires you to off-set the supply risk by receiving the stock earlier, and because the stock is produced in one run shipping costs can be minimised by shipping the whole quantity together. But this will result in extra warehousing and financing costs. What must also be taken into account is the cost of the additional write down of unsold stock. Financial information systems will be required that allow all the various costs to be posted against each product in the range so the real margin can be reviewed.

6.4 Political Risks

These are very hard to assess but we have had some examples recently: EU trade quotas, instability in some countries, your suppliers having very different working conditions to European plants. These risks can directly affect your ability to trade or can become consumer relations issues that affect your brand.

6.5 Risk Analysis

The risk analysis required is a detailed review of each step in the extended supply chain starting with ranging and supplier selection and following the course of the product and information flows through the supply chain. At each stage the possible failures (the risks) to the process need to be understood and assessed. The classic quadrant:

High value: Low Impact	High value: High Impact
Low Value: Low impact	High Value: Low impact

needs to be populated. Once done, contingency plans need to be detailed and agreed. These could include sourcing alternative suppliers and additional stocks, starting the next season early, putting in place better systems and management controls, etc.

Risk analysis should also cover the contingency requirements should it be decided, or it be necessary, to take the outsourcing back in house or move the management of the processes to a new company.

7. Summary

The benefits from overseas, Global sourcing need careful analysis both before starting the transfer and at regular intervals thereafter. The analysis requires the whole cost of acquisition of each product to be determined to allow comparison with other countries, including the UK. What is most important is that the analysis must be conducted

dispassionately and that the interests of consumers and the shareholders remain the most important consideration.

'Getting it wrong' is not hard, losing control of the strategy is all too easy; outsourcing requires continual effort to harness the outsourcer but such management resource is at a very different level than running the whole operation one's self. A Company that harnesses the skills and resources of an outsourcing company and provides products and services at a lower cost and high added value than its competitors as a result of letting experts run some of its operations will be more profitable than its competitors and quite possibly more flexible.

Hon Professor Stephen Rinsler, BSc, FCILT, FRSA, FIMC, MCIPS
Director, Bisham Consulting
Chairman, Chartered Institute of Logistics and Transport

Felix Wentworth