

The risks of outsourcing overseas

OVER THE LAST few years, the retail deflation has been driven in part by the move to overseas sourcing of manufacture. "Lower manufacturing costs with Far East sourcing has been the route to maintaining or improving our margins" is a quote that could have been taken from many retail board reports to City analysts and shareholders.

It may be true, but the answer is not a simple balance of manufacturing costs plus the cost of shipping to the UK, then less the costs of UK production and delivery to the warehouse. 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:

1. supply chain risks
2. management risks
3. financial risks
4. political risks.

Supply chain risks

The decision to source overseas has been made, so you are now running an extended supply chain. The factory is no longer in the UK or nearby in Europe. Problems of quality, of specifying exactly what you want after the first proofing runs, are still the same but the risk of not resolving the issues increases with distance together with the language and culture divide.

You have low costs because you have agreed a production slot with your supplier but such a slot is usually not very flexible. If you find that you have under-ordered stock, you may have to 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. In order to avoid this potential cost, you may feel forced to deliberately over-order stock at the start. Many retailers now have higher stocks than they used to have, which require larger warehouses and result in lower warehouse productivity. Reducing unwanted and unnecessary stock via the sales channel generally requires heavy discounting, which means a reduction in profits. Add to these potential costs the problem of clearing goods through customs and also the new cost of finishing work, steaming, etc. that has to be done in the UK to make the merchandise look shop-ready.

Your extended supply chain is forcing you to make decisions on fabrics, design and colours earlier and earlier in the process. Does choosing the product range before you have sold this year's same period merchandise increase the risk of getting it wrong?

On top of these risks, there are risks associated with the environment, such as hurricanes, earthquakes and typhoons, which all play a part in the equatorial climate and geography. They are risks that should be quantified and sourcing strategies should take the results into account.

Once the goods are in Europe, where do you locate your central warehouse for distribution and finishing of the merchandise? The natural result of any transport optimisation leads many companies to the use of an area of Europe loosely bounded by Amsterdam, Lille and Frankfurt, known as the Golden Triangle, which is a major concentration of industry and population. Here the marginal costs of entering the triangle from a property or labour point of view are increasing as

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ensuring supply of warehousing, transport and skilled labour becomes more difficult. Whilst it is not too expensive to move out of the triangle, additional transport costs and time costs are real and must be balanced against lower labour and property costs.

Management risks

These risks are not easy to cost but they are nevertheless very real and often result in more management time than necessary being required.

For most retailers, the greatest concern in this area 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?

Financial risks

Your suppliers like hard currency, often US dollars, and thus a significant proportion of your costs will be exposed to the strength of that currency. If the dollar strengthens and your margins decrease, you are forced to try to reduce the purchase price, which may result in reduced product quality and greater finishing costs. You may be able to pass some costs on to the supplier, but only to a certain extent.

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, in the long run they must 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. Was this potential cost taken into account in the budget?

Your extended supply chain requires you to offset 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.

Political risks

These are very hard to assess but we have had some examples recently, such as EU trade quotas, instability in some countries and 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.

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 chain. At each stage, the possible failures (the risks) to the process need to be understood and assessed. The classic quadrant:



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, and putting in place better systems and management controls, etc.

Summary

The benefits from overseas 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 shareholders remain the most important consideration. ■