Outsourcing: A strategic risk?

Aaron Relph and David Parker discuss the need for commercial caution when evaluating the benefits or otherwise of outsourcing.

Abstract
Many companies use outsourcing as a strategy to reduce costs throughout the supply chain function, with the intention of reducing negative impacts to services, while meeting customers’ demands. The logistics sector in Australia is worth approximately A$57 billion or 9% of Australia’s GDP according to the Bureau of Transport Economics in their 2001 report. However, reducing operational costs and improving the bottom line using outsourcing of non-core business related activities needs to be approached with caution. Before assuming a one-model fits all situation, a company should evaluate the benefits, relationships, risks, and balance of power in equation of pricing that is specific to its particular needs.

Introduction
Currently A$26 billion (or about 46%) worth of logistic functions are being outsourced to Third Party Logistics (3PL) providers; and the market is growing. While the importance of logistics activities and the primary contribution to the economics of the nation is significant, the supply network is also important in terms of the relationships it involves for all stakeholders including suppliers, customers, investors, employers and employees. The decision to outsource is critical to a company’s market positioning, its strategic intent and its ability to meet its customers’ needs.

Millin (2006) explains that the desire to outsource was not a consideration nor formally identified as a business strategy until 1989. Although prior to 1989, most companies were not completely self-sufficient, they would source other organisations to undertake skills/tasks not seen as ‘core functions’ within their own company. The use of external suppliers for these essential but ancillary services, might be termed the baseline stage in the evolution of outsourcing (Handfield, 2006).

The desire by firms to pursue gains from the trade of specialised production has contributed to the rise of specialised intermediate markets in the supply chain (Holcomb & Hitt, 2007). Moreover, power has shifted along extended supply chains, away from the source of the product (manufacture) to being close to the customer (retailer). To ensure supply chain effectiveness, it is imperative to collaborate with upstream and downstream partners. Consequently, supply chain integration is a vital feature – and reliant on responsive information systems. At each stage of the chain, new challenges are emerging – invariably driven by changing customer requirements. Alongside the continual change to meet market needs, raw materials and energy procurement costs are becoming a growing concern. Consequently, customer relationships and market intelligence are crucial aspects in achieving commercial sustainability in a growing digital market place.

Approximately 46% of companies choose to outsource their logistics function. It is known that 36% of companies’ main reason for using 3PL is tighter controls on costs and allowing them to focus on their core business (see figure 1). However, it might be argued that focusing on controlling cost may result in losing sight of other considerations and benefits, such as network relationships,
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processing each recording 27% (Rahman, 2007). It is known that 61% of organisations using 3PLs have been using the services more than three years.

The underlying reason why these functions are outsourced includes their considerable high labour content and comparative large use of resources. Whilst such costs are factored within a schedule of rates, the larger the 3PL, generally, the lower the costs – as labour and resources can be spread over several contracts. Such economies of scale and specialised services invariably mean that outsourced fees are competitive when compared with own-account operating costs.

Companies looking to outsource to 3PL see this as a favourable alternative, as the associated fees can contribute to the profit and loss (P&L) as direct costs of goods (COGS). For companies looking to lower overheads and improve margins, outsourcing is very attractive. Albeit it is the rising costs can be the very reason that companies cease using 3PL and undertake the functions in-house. The importance of 3PL functionality will ensure the right fit for the company’s requirements. Not all 3PL companies can offer the same service; and in the event a wrong company is selected, the functions that are outside of its scope will be an additional cost.

**Decision for outsourcing**

There are three major reasons to drive the desire of an organisation to outsource part or all of its functionality: cost, strategy and politics. While cost and strategy are common and viable in most commercial sectors, the third is less known and somewhat taboo. The desire to outsource with political motivation is
commonly solitary to public organisations.

The pressure of costs and reduction in business risk is the primary driver for many companies to outsource and evidentially becomes the reason to dismiss any other motivators for sound decisions. Benefits, risks and factors need to be reviewed holistically, ensuring all subsectors are thoroughly risk assessed. While the decision for outsourcing is complex and many underlying factors need to be considered a framework (figure 2) must be followed to ensure best decisions are investigated.

Benefits, risks and factors in combination with a business framework will assist in exploring all considerations for the use of 3PL. Care should be taken not to being enticed by pricing and the direct saving on companies’ margins. It is important to remember that 3PL companies can be fraught with danger. With this in mind, not all companies have the internal expertise to analyse the decision framework and recommend the best decision for their organisation.

1. Expected benefits of outsourcing
O’Flynn (2012) argues that when outsourcing of any service, commodity or practice within an organisation is considered, the first and foremost question that will always be raised is “What are the service benefits and costs?” For many organisations, value for money is the primary driver for anticipating the move to outsource part or entire sectors of its operations. An assessment is made whether an external party can do the work more efficiently or effectively.

The rapid growth of outsourcing suggests that both public and private organisations expect benefits from outsourcing. Naturally, different organisations in varying circumstances will expect different benefits. Most organisations, however, may expect cost savings – even though in public service, eg government, the typical cost savings are only about half of what the private sector achieves (Kremic, 2006).

Costs alone should never be the primary reason for outsourcing: factors including customer service, business efficiency, flexibility and sustainability, also need to be investigated to ensure the value of outsourcing is truly viable. If these factors are neglected the value to outsource will quickly be consumed by costs forwarded by the 3PL for any inefficiencies the parent company has caused. These additional costs are where the 3PL improves its revenue and makes profit.

What are the relationship costs?
While costs are at the foremost of thought and decision-making, there is a more discreet but vital question that all companies must consider and identify. Even if another company can do something cheaper/ better, what is the cost for making it happen and continue to be successful? When looking at engaging another company to undertake work/ services there is effort and resources absorbed in actually making it happen. The parent company has to define the services, run tendering processes, to select a provider, and monitor that it is doing what contractually they are required to do (O’Flynn, 2012).

Companies that do not factor in these costs for maintaining relationships, risk paying more for less service. Sometimes this cost is identified as ‘budgeted’ in other core sectors – for example contract management. However, if there is a high level of demand to manage the outsourced company, any savings initially identified can quickly be eroded through contract management; or in the worse scenario be regarded as a breach of service. High-level supplier relationships are critical for the initial period of the services; and important throughout the contract period. This ensures all services are kept sustainable and both parties are delivering contractual agreements.

A company needs to determine the complexity of the relationship to ascertain the level of outsourcing (see Figure 3), to minimise risks and impact within the business to customers, and also the relationship with the contractor.

Potential risks to outsourcing
There are numerous concerns associated with outsourcing logistics processes to a service provider. For example, outsourcing secondary transport to another company means losing the direct

Outsourcing differs from alliances or partnerships or joint ventures, in that the flow of resources is one-way, from the provider to the user.
interface with the customer. This can mean that there is less customer contact and therefore loss of control over the relationship.

Furthermore, 3PLs have great knowledge about their own business, however, time is required to know your business, and usually this is one of the most misinterpreted relationships required. Most relationships at the ‘start-up’ stage are focused on understanding the soft processes – how many trucks? What time? Where are the delivery locations? What are targets measured against? And so on. These are important, though it usually takes months if not years for the 3PL to truly understand their customer’s direction, values or strategy.

Another risk is that once a long-term contract is signed and a commitment made by both parties, the 3PL’s customer mindset may diminish. Often a logistics provider that is operating in a business-to-business (B2B) environment loses the business-to-customer/consumer (B2C) focus. Once a company loses vision of its customer’s requirements and product demand, it won’t take too long for impacts on customer service to show a decrease in sales and market share. Companies do not exist without their customers, therefore the question that needs to be answered is: “What might be the impacts to customer service and relations?”

Imbalance of power

Most companies have little or no in-house experience repository of knowledge of best practice in logistics contracts. Even if the company is moving from one provider to another, the situation is not much different – outsourcing contracts typically last for three to five years, so the last negotiations are a distant memory and the people involved may have moved to other positions or left the organisation.

The customer’s organisation often suffers from a competence-gap between the logistics, purchasing and legal department. Companies’ logistics teams are typically focused on operational matters, as this is their day-day responsibility. Purchasing departments, especially in small and medium-sized companies, often lack cross-category depth of knowledge and do not have the time to strengthen their awareness of complex commercial issues in logistics contracts. Finally, few in-house legal departments (and even fewer external law firms), have specific knowledge of the business issues involved; their input is usually restricted to ensuring documents are appropriately set in the local context.

On the other side of the table, the 3PL negotiates many highly similar contracts every year, giving them the immediate advantage of significantly better knowledge. Additionally, unless the client has a template contract already prepared, negotiations will start from the 3PL’s template and thus from the 3PL’s best case commercial position. (Chazanow 2012)

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Conclusion

It might be argued that the decision to outsource part or entire departments of a company must be evaluated through many lenses of consideration. The critical success factors must be identified from the point of view of the company, regardless of the financial benefits that appear to be as a result of adopting a 3PL. A company that does not have all of its objectives and concessions identified, will limit the benefits from outsourcing with possible critical repercussions. A company that has already efficient and effective business processes may gain significant value through a 3PL. A balanced approach in considering risks, benefits and market factors, must underpin a company’s evaluation to utilise 3PL.

Further more, if a company ignores the need to investigate and highly scrutinise the benefits, relationships, risks and balance of power before entering into any negotiations, the outcome will ultimately lead to cost blow-out and poor customer relations. The true cost to fix the decision to utilise the skills of a 3PL could far outweigh the cost to improve internal processes and systems.

References


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