Outsourcing – Panacea, Dirty Word, or Viable Option?

By James Shearer

Outsourcing – a controversial word and one increasingly in the news. The very mention of the word can cause an emotional response. On one end of the spectrum, the emotions can elicit a very strong belief in the right for any business to behave in its own enlightened self-interest. On the other end there can be equally strong beliefs that exporting jobs and technology may not be in the best interest of our country, our economy, or perhaps even our value system.

Although "services" or components can be outsourced, for the purposes of this article, the focus is on manufactured "finished goods" and also on outsourcing a significant portion of current or anticipated future production. (To outsource half a dozen minor products of relatively insignificant impact on the overall organization is more of a routine, tactical decision than a strategic, operational decision.)

There are numerous reasons or conditions that would cause a manufacturer to consider outsourcing. However, they all have one simple thing in common – a need or desire to reduce costs. Listed below are some of the reasons or conditions that might drive a decision to outsource.

- The right to survive in today's marketplace. Survival is a worthwhile objective!
- The legitimate right for any company to improve its financial performance by lowering its operating costs and improving its bottom line, regardless of how profitable it may or may not be.
- The urgent need for a distressed company to quickly reverse unacceptable financial performance.
- The opportunity for a company to achieve strategic cost advantages.
- To counter one or more direct competitors that may already be outsourcing.

Regardless of the driver, today's increasingly competitive global marketplace puts constant, unrelenting pressure on manufacturers to produce their goods ever more quickly and far more cost-efficiently. Any manufacturer who wants to survive and prosper must become, if not "*the* low cost producer," at least "*a* low cost producer." To not respond to this market-driven, economic reality is to invite disaster.

When considering outsourcing, the analysis and decision process must be as unique as the individual business making the decision. There is no simple checklist to use in making the decision, and the owner, general manager, or management team must conduct a very thorough, in-depth and objective analysis of the pros and cons of the decision. The analysis should appropriately include strategic implications, organizational implications, economics, logistics, corporate values, the impacts (both positive and negative) on the business's stakeholders, and the actual implementation approach that might be used.

One way to put all the relevant information and data (which may be conflicting in nature) into perspective is to construct a simple balance sheet. The balance sheet would list each area being analyzed and, for each area, two columns – one for pros and one for cons. When completed, the analysis will lead to an informed, fact-based, objective decision, and one that will have a much higher likelihood of producing the desired results. Let's evaluate some of the areas and considerations in the decision process.

Strategic Implications.

- Is outsourcing consistent with the stated mission and vision of the company?
- Is it in alignment with or in conflict with existing business strategies?
- Faced with the possibility of very low cost offshore production, should the strategies, mission, and vision be re-evaluated and fine-tuned or even changed entirely?

Organizational Implications.

- If a decision is made to proceed with outsourcing on some significant scale, what will the new organizational model need to look like to properly support the new manufacturing approach? What costs will remain and what new costs may be added?
- What are the impacts on the existing organization? Will new reporting relationships need to be established? Will new talents and capabilities be required? Can existing staff be retrained or will new/additional staff need to be added?
- There are organizational fears or concerns that could cause US-based manufacturing companies to have a natural reluctance to outsource. These might include:
  - "We don't know how"
  - "We haven't done it"
  - "Failures we've heard about…"
  - Fear of loss of direct control over manufacturing
  - Fear of loss of manufacturing flexibility
  - The concern that a specific item is simply too critical to risk outsourcing it

  (Although these fears or concerns may be legitimate, each one, if thoroughly evaluated and analyzed, can be overcome by proper, detailed planning, including well-thought-out contingencies.)

Economics.

- First and foremost, the most common reason for outsourcing is economic, specifically greatly reduced direct labor and overhead costs. Although there can be exceptions, the reality is that it typically costs far less to produce most manufactured items in countries with much lower labor and overhead costs.
  - If direct labor wages in the USA are, for example, $15.00/hour and they are $2.00/hour in Mexico, less than $1.00/hour in India, and less than $0.50/hour in China, there is obviously a strong financial incentive to consider offshore production, especially in high-labor-content goods.
  - There are frequently very similar if not even more savings in offshore overhead costs. These overhead costs may include:
    - Land costs (typically by lease)
    - Plant / facility / office construction or lease costs
    - Machinery and equipment
    - Utilities

        - Supervisory / management / staff salaries
        - Healthcare
        - Workers' compensation
        - General liability
        - OSHA compliance
        - Environmental compliance
        - Reduced likelihood of litigation. (And the list goes on!)
    - Detailed and accurate analysis of manufacturing costs, utilizing low labor cost factories with the associated low overhead available to those factories, needs to be undertaken.
        - Firm, stable, and well-understood quotes need to be obtained from one or more reliable offshore factories.
        - At least one, and ideally several, visits should be made to ensure the factory has been properly and thoroughly evaluated for its ability to consistently perform the needed manufacturing tasks and functions. (Well-constructed, well-lit, highly productive, and very well-managed offshore factories, some with ISO 9000 series quality certifications, do exist. On the other hand, a dirt floor, lean-to factory in a remote village in SE Asia is probably not in your best interest!)
- Assuming the outsourcing approach ultimately leads to a significant percentage of offshore sourcing, a new business model will need to be developed to optimize performance under these new global logistical strategies. An extensive, detailed analysis of this resulting business model must be undertaken to identify and quantify all of the overheads costs that will remain. These costs may include different staffing levels, unused stateside plant and equipment capacity, new logistical requirements, new IT and communications requirements, and any number of other overhead costs that will remain or result from the new outsourcing strategy.
- If the offshore factory is located in Mexico, the logistics pipeline (physical distance) may not be appreciably extended beyond stateside manufacturing. If that is the case, additional on-hand stateside finished goods inventory may not be required to ensure that adequate response time to varying market demand is maintained. However, if the factory is located in India or China, for example, the company must at least consider increasing on-hand stateside warehouse stock levels of finished goods to compensate for the extended pipeline. Since this extended pipeline can easily add several weeks or possibly even months to transportation time, the carrying costs of the additional on-hand inventory necessary to cover this inevitable delay must be considered as a cost offset. (Although emergency air shipments of goods manufactured offshore can help reduce the transportation delays, if the products are of any reasonable size, air freight is extremely expensive and will still have customs delays of from a few days to over a week.)
- Total delivered cost must be the basis of any product cost comparisons. Total delivered cost is manufactured cost plus all other costs associated with getting a product on the company's warehouse shelves. These additional costs must be factored into the analysis for it to be meaningful. For example, let's assume that a product manufactured in a company's own stateside factory has a manufactured cost of $2.00. If the factory is adjacent to the warehouse, the manufactured cost will equal

the total delivered cost, in this case $2.00. However, if a company procures an equivalent product offshore for $1.80, F.O.B. foreign factory, additional costs including ocean freight, inland freight, customs/duties, insurance, and brokerage fees must be added to the offshore factory cost to get a total delivered cost. Only then can a true apples-to-apples product cost comparison be made.

- Costs of quality must be considered. If the offshore factory has quality levels below the stateside factory, and those defective items escape detection and make it into the stream of commerce, there is an additional cost to the company to handle valid quality claims and returns. Furthermore, there can be the intangible loss of customer confidence in the company's quality.
- The company must determine if legitimate, net cost reductions from outsourcing will be added to the company's bottom line or passed on, in part or in total, to the customers to protect or grow market share. (If price concessions to customers are needed to protect market share and thus keep the company alive, outsourcing may become an increasingly attractive way to protect margins and ensure survival and financial viability!)

<u>Logistics</u>.

- As previously mentioned, offshore sourcing, through increased transportation distances, typically adds time to the delivery cycle, potentially compromising customer service. This delay must be properly analyzed and managed for its potential negative impact on delivery, or it must be compensated for by increasing on-hand stateside inventory levels of finished goods.
- Greater physical distances equate to decreased communication effectiveness. If the factory is 500 miles away, 1500 miles away, or 12,000 miles away, the speed and effectiveness of written, verbal, and telecommunications will be less than if the factory is 250 feet away. This factor must be properly considered.
- By definition, offshore sourcing infers a different culture, different rules, regulations, and laws, and a different language. These issues can certainly be overcome but not without management effort and associated cost.

<u>Impact on Stakeholders</u>. (Stakeholders are those people or entities that benefit when a company does well and suffer when a company does poorly.)

- Employees
  - When a company outsources production, jobs are lost. Those employees whose jobs are lost will have their employment terminated and their livelihoods negatively impacted, at least until they find new jobs.
  - On the other hand, those employees whose jobs are not directly impacted by the outsourcing may well have a far healthier and more stable employment outlook because the company may be stronger financially.
- Vendors
  - If production leaves, demand for components, materials, and perhaps services will be curtailed proportionally. Stateside vendors will experience a reduction in the demand for their output.

- Customers
    - Ideally, other than country-of-origin marking, a decision to outsource manufactured goods should be invisible to the customer. If anything, the customers may gain the benefit of reduced prices through reduced manufacturing costs. This is especially true in a highly cost competitive market.
    - Some customers, especially government buyers, may have a strong bias in favor of "Made in America." These customers would have to reevaluate the decision to buy from a manufacturing company that changes from domestic to imported goods. The company should know (and confirm) the feelings of its key customers before embarking on an outsourcing program.
- Community
    - If a company downsizes, there are usually negative impacts on the local community. These can include a reduction in jobs, a sell-off of residential property (and resulting reduction in real estate values), a loss of local tax base, a reduction in community retail activity due to the reduced workforce, and, if the company cutbacks are significant, a reduction in the overall quality of life in the community.
    - If outsourcing "saves" the company, the longer term impact on the community will be a more stable, albeit reduced, local job market.
- Owners, Stockholders
    - The most obvious impact, if an objective evaluation leads to outsourcing, is that the company will have reduced its operating costs. These savings can be used to maintain or grow market share through price concessions to customers or to maintain or improve bottom line financial results. Either one is a significant plus to those who take the risk of investing in a manufacturing business.
    - A decision to outsource is rarely popular in our society, and the result can be unfavorable backlash at corporate management and ownership.

<u>Corporate Values</u>.

- On one hand, surviving and making a fair and reasonable profit, thus providing value and an acceptable return to the business owners (and corporate stability to other stakeholders) is the fundamental pillar of our economic system.
- On the other hand, there is perhaps the negative perception that outsourcing is somehow un-American, unfair to long-standing loyal employees, dangerous, or even traitorous.

<u>Implementation Considerations</u>.

Assuming a decision is made to proceed, outsourcing should be considered from an incremental perspective. It is not wise to "bet the company farm" on an initial, first attempt at outsourcing a significant amount of manufacturing. The company should consider starting slowly, perhaps with one or a few items. This prudent, well-considered approach can allow the company to learn from inevitable mistakes and build up knowledge, skills, capabilities and confidence as the outsourcing effort grows. This approach also allows the company to overcome the organizational fears outlined above.

For example, perhaps an organization would start with one relatively minor product. The first step might be to simply subcontract the manufacturing to a capable offshore factory that serves as a vendor. The company exercises little control over the vendor but the risk is relatively small. Over time, as the vendor establishes consistent performance, more items can be sourced from that vendor.

As the company becomes more important to the vendor, it can have greater influence (and hence greater control) on that vendor and on the company's own products as they are manufactured by the vendor. Eventually, as the company gains in capabilities and confidence, it can even establish its own factories or offshore corporations and exercise full control. Although it can take awhile longer, and it requires a strategic perspective, this incremental approach can provide a relatively low risk but highly effective way to implement outsourcing as a corporate strategic imperative.

In addition to the "logistical" aspect of implementing outsourcing, there is also a strategic market consideration. This consideration relates directly to the amount of value added by a company that is now outsourcing a significant portion of its production. In the act of producing goods, a manufacturer adds useful value to the stream of commerce by transforming materials from one form into another, more useful form. If a company ceases much of its manufacturing activity and predominantly uses outsourced products supplied by vendors, it will lose much of its ability to add value through the material transformation process.

In this situation, the company must alter its business model to add value to the distribution process rather than concentrate only on the added value during the manufacturing process. Failure to do so will make the company vulnerable to the fickleness of channel distribution. [Witness the impact The Home Depot ® has had on wholesale distributors of electrical, plumbing, and irrigation products. The traditional wholesalers, acting more or less as brokers, had very little added value. They bought low and sold high, period. They are beginning to suffer from the increased value (convenience, one-stop shopping, more variety, less stock-outs, sharp pricing, attractive product presentation, financing, etc.) that The Home Depot ® provides to professional contractors. In order to survive and prosper, these traditional wholesale suppliers must adapt to a new business environment and provide added value to the distribution process that may distinguish them from the "big box supplier."]

<u>Summary</u>.

Outsourcing is an option or opportunity, not a dirty word and not a panacea. It is an approach or strategy that, under certain conditions, can make the difference between whether or not a company survives in today's highly competitive business climate.

The decision to outsource is a strategic consideration, perhaps one born out of necessity. The management team owes it to all stakeholders to accurately, thoroughly, and objectively assess all pros and cons of the outsourcing question. Only in this way can a fact-based, intelligent, and informed "strategic decision" be made.

The approach outlined above provides both a template and some pragmatic considerations to ensure that the best possible management decision is made and, if the decision is yes, that a well-considered and well-thought-out implementation plan is used.

