Holland Group

When outsourcing, what must you know for sure?

WP1.1

Oprah Winfrey often asks her guests "What do you know for sure?" When considering whether to outsource any part of a manufacturing process, this question is an excellent starting point.

Outsourcing is a business arrangement in which a manufacturing process is subcontracted to a third-party company. There are many different outsourcing business models, but in all cases the third party is accountable for production results. Generally, fees are tied to some measurement of performance or risk sharing.

Outsourcing promises lower costs and higher returns. Most manufacturers have outsourced some activity already, and many have enjoyed significant cost reductions, increased efficiency, and shortened time to market. Others, unfortunately, were disappointed with the results. What separates the two groups? In the most successful agreements, the manufacturer diligently conducted the upfront analysis necessary to move beyond beliefs and assumptions to fact-driven decisions. These executives acted on what they knew for sure!

When considering outsourcing, manufacturers attempt to determine whether outsourcing will address their problem(s), which outsourcing model to employ, and which vendor can best meet their needs. Each step raises questions that are answered by careful consideration of many factors.

In or Out? Is Outsourcing the Right Solution?

Determine whether outsourcing is a viable solution to your problem before initiating discussions with any outsourcing vendor. There are four key questions to be answered.

- **What problem are you trying to solve?** Motivations for considering outsourcing vary. Although most outsourcing initiatives are driven by a desire to cut costs, outsourcing objectives also include increased competitiveness, greater efficiency, and the ability to focus management attention on strategic business issues. Clear identification of primary and secondary motivations is critical in weighing choices.

  The scope of the potential outsourcing initiative must also be considered. Different outsourcing models could apply to a specific assembly line, a given operation, or the entire plant.

- **What are you currently spending?** To determine the potential cost savings, an examination of the current cost of ownership (TCO) is required. In production environments that are labor-intensive, a reduction in worker costs (including costs associated with recruiting and training) may create considerable savings. In contrast, a highly automated production line requiring limited human intervention will not significantly benefit from moving the operation to a geographic area known for low labor rates. When calculating labor-related expenses, factor in additional payroll costs resulting from production volatility as well as from performance-related issues such as absenteeism or turnover.

  In conducting the TCO analysis, extend beyond the cost of inventory and capital assets to consider all operating costs, including distribution, IT costs, facility costs, and expenses related to any other aspect of the operation that you are considering outsourcing.

- **How well is your current operation performing?** If you have identified problem areas in your operation, assess the cause and identify alternative solutions. Outsourcing can be extremely effective in improving inefficient processes without creating additional work and bureaucracy. Outsourcing also addresses labor issues and can remove the inconvenience of managing non-strategic, time consuming activities.

  Attempt to quantify soft costs that may be reduced or eliminated by outsourcing. These include expenses associated with poor quality, missed ship schedules, and management distractions (e.g., time spent dealing with personnel performance issues or vendor problems). If you decide to outsource, elimination of soft costs should be negotiating points with all potential vendors.

  The type of product being manufactured must also be considered. If demand for the product fluctuates, you need to be able to expand and contract production staff as production volumes change. Outsourcing effectively addresses this problem. Conversely, outsourcers tend to avoid or attach a high price to complicated assembly processes or productions requiring a great deal of specialized equipment, reducing the economic benefit to you. The maturity and stability of your product design will also affect your choice. Start up or new product introductions are less stable, requiring greater oversight and possible "tuning", increasing the required management attention and risk when working with an outsourcer.

- **Can you quantify what you are trying to achieve?** The assessment of existing performance provides a baseline for setting production goals. Quantify desired production/procurement lead times, direct labor and materials costs, and desired service levels.

The answers to the above questions provide the foundation for deciding if outsourcing is the right choice for your operation. If so, you must then choose the right outsourcing model.

Considerations in Choosing the Right Sourcing Option

In entering into an outsourcing agreement, you should expect that the outsourcer will take responsibility for the design, implementation, operation and continuous improvement of your outsourced process. The vendor will provide project management expertise and all required skills to execute and manage all production duties. The agreement will be governed by a jointly developed Service Level Agreement (SLA). Your outsourcing fees are typically based on units shipped, gain-sharing or other performance-based or shared risk models.

Over the past twenty years, a proliferation of outsourcing models has emerged. They primarily vary in scope of operation and location of "the work". Each model's strengths and weaknesses must be considered in determining the approach that is best aligned with your needs and preferences.

Retaining Control with an Onsite Outsourcer
In an onsite outsourcing agreement, the outsourcer accepts day-to-day control of a specific process within the operation while the client maintains overall control of manufacturing. The work is conducted within the client's plant, with the outsourcer operating the production lines, overseeing the operation, and administering quality control. The outsourcer is accountable for process deliverables.

Onsite outsourcing agreements are often motivated by a desire to improve production labor performance. The work is conducted by employees of the outsourcer, and the outsourcer assumes all employer risks associated with attendance, attrition and performance.

Manufacturers typically have responsibility for hundreds of components, supplies and processes, while onsite outsourcers typically take control of a limited number of "non-core" processes. By focusing on a specific process within the overall plant production, the outsourcer is able to "dig deeper" into ways to achieve production improvements.

The Many Variations of Offsite Outsourcing

Traditionally, offsite outsourcers take responsibility for a specific process within a manufacturing operation. This can range from a single manufacturing or assembly process to the operation of a complete plant. Offsite outsourcers conduct this work in their own facilities.

The outsourcer in this model has complete responsibility for the process and associated personnel, and may also take ownership of the capital equipment needed to produce the product. The ability to transition fixed personnel and capital equipment costs into variable costs is often the primary motivation in choosing offsite outsourcing.

The average contract length of an offsite outsourcing agreement is 5 – 10 years, particularly if capital assets are transferred from the client to the outsourcer. This lengthy time period is required by the outsourcer to recoup upfront investments in assets and people.

Some offsite outsourcing shops have expanded to provide entire lifecycle services, offering everything including product design, manufacturing, distribution and logistics. By acting as the manufacturer for many clients, these "contract manufacturers" are able to use their increased capacity, advanced production technology and buying power to significantly reduce costs.

Over the past decade, traditional outsourcers and contract manufacturers have established manufacturing plants outside of the U.S. where labor rates are lower. This phenomenon, referred to as "offshoring", is most prevalent in Asia. Outsourcers include foreign companies, including contract manufacturers as well as U.S. firms with a foreign presence. Recently there has also been an emergence of "nearshoring" – cross-border operations in locations such as Mexico.

Finding the Right Fit

To decide which outsourcing model best fits your needs, build on the "must know" items involved in deciding to outsource by weighing factors affecting costs, risk, and potential management issues.

- **All outsourcing models can yield dramatic cost savings.** Employee-related expenses are always a target for reduced costs. The growing popularity of offshore outsourcing is due in large part to the desire to tap into cheap labor markets, yielding the greatest labor savings. The gap in wages paid to U.S. workers vs. foreign workers is shrinking a bit due to wage inflation overseas, particularly in China. However, many outsourcers still claim to be able to reduce payroll expenses by as much as 80%.

  While offshoring cuts employee-related costs, it also introduces some new costs that can cut deeply into overall savings. Products not destined for overseas markets must be shipped back to the States. Air freight is cost prohibitive, so most outsourcers opt for ocean freight. The long lead times result in carrying higher levels of inventory for longer periods of time. There are also hidden costs associated with government and customs fees, and regulatory compliance. And, all expenses can be affected by currency exchanges.

- **Outsourcing Approaches Carry Different Risks.** An understanding of the level and types of risks your company is willing to accept will help in selecting the right outsourcing model for your organization. Onsite outsourcing guarantees the highest levels of intellectual property protection and enables you to protect products subject to government restrictions, export controls or security concerns. Weak intellectual property laws in some countries can lead to major contract issues.

  Onsite outsourcing is also a reliable option if you need to maintain control over tight production deadlines or you must be able to implement extensive engineering change orders (ECOs). Because onsite outsourcing enables the manufacturer to have complete visibility into the operation at all times, and requires the least logistical coordination, it is typically viewed as the least risky option.

  Offshore outsourcing may introduce additional risks. Communications challenges can result from different time zones and language barriers. Also consider locations of major suppliers in making the outsourcing selection, as coordination becomes more complex as distance increases. Although offshore outsourcing operations apply the same quality assurance techniques as used by domestic outsourcers, there have been high profile problems associated with recalls, brand damage, and lost sales. Risk mitigation strategies should be included in discussions with any potential outsourcer.

- **Outsourcing May Require Increased Management Attention.** A primary driver of outsourcing engagements is the desire to divest the manufacturer of work associated with non-core, non-strategic processes. However, applying the wrong outsourcing model to your operation can have the opposite effect!

  If you have limited outsourcing experience, start small. Select a bounded process that enables you to measure results and adjust the outsourcing model as needed. Recognize that it takes time to implement and adjust to the impact on your culture and organizational processes. Experienced manufacturers will caution you to begin with an outsourcing project in which the capital equipment and labor remain available to you.

  The offsite outsourcing transition effort is arduous, and required a great deal of management attention. Frequently, there are issues with technology implementation. Knowledge transfer is critical, requiring detailed definitions of skills required to meet your needs. The level of documentation detail increases as the distance between you and your outsourcer increases. And, work conducted offsite is not being captured in your internal information systems. Information needed for ongoing strategic planning should be identified and a plan for electronically capturing and providing that information to you should be developed.

  When offshoring, cultural factors influence how business processes are executed, how pricing and terms are negotiated, and how conflicts are resolved. To build and maintain the relationship, you may need a resource at the outsourcer's site supplemented by a U.S.-based staff with sufficient training budget. You may also require third party assistance in dealing with government and regulatory issues.

A summary of how well each outsourcing model addresses each of the key factors is provided below.

Selection Criteria	Onsite Outsourcing	Offsite Outsourcing			
		"Onshore"		"Offshore"	
		Outsourcing	Contract Manufacturing	Outsourcing	Contract Manufacturing
REDUCE COSTS					
Direct Labor	◉	◉	◉	●	●
Capital Equipment	○	●	●	●	●
Plant/Facility	○	●	●	●	●
Production Delays	●	●	●	●	●
Rework	●	●	●	●	●
Transportation	●	◉	◉	○	○
Tarriffs/Fees	●	●	●	○	○
MITIGATE RISKS					
Intellectual Property Protection	●	◉	◉	○	○
Government Issues	●	●	●	○	○
ECO Management	●	◉	◉	◉	◉
Transportation Issues	●	◉	◉	○	○
MINIMIZE REQUIRED MANAGEMENT ATTENTION					
New to Outsourcing	●	◉	◉	○	○
Transition Effort	●	◉	◉	○	○
Outsourcer Management	◉	◉	◉	◉	◉
Cultural Issues	●	●	●	○	○

● = strong fit ◉ = good fit ○ = poor fit

Choosing the Right Partner

The choice of outsourcing partner can make the difference between business advantage and major headache. At first glance, the sheer number of outsourcing vendors – all promoting themselves in similar ways – makes selection extremely difficult. Faced with this dilemma, many manufacturers have fallen into the trap of selecting the vendor offering the lowest per unit price. However, negotiate carefully - you need to know exactly how the relationship will work in advance. Here are some things that you need to know for sure.

- **Qualifications.** An outsourcer should go beyond day-to-day operations to provide continuous improvement. This requires a project management team with extensive industrial manufacturing expertise, knowledge of your industry, and experience in driving quality initiatives.

- **Performance.** Your agreement should explicitly reflect your performance objectives. Specify expected shipment volumes, return on assets, customer delivery targets, and quality and compliance standards. Your Service Level Agreement (SLA) should delineate a clear division of responsibilities, and should indicate how compliance will be monitored and measured. The SLA should also clearly state all guarantees as well as penalties imposed when guarantees are not met.

- **Flexibility.** Things change, and your relationship with your outsourcer must be flexible enough to enable you to adapt to changing business conditions and shrinking product life cycles. Responsibilities should be reviewed and updated regularly. The process for managing future product modifications should be specified, with clear statements as to what level of effort is within the scope of the agreement.

- **Quality.** Terms of your outsourcing agreement should provide incentives for meeting all performance objectives and for continuously improving the operation. Tie fees to performance or risk sharing – not to labor hours. The agreement should set quality standards, describe actions that will be taken to achieve these standards, and determine legal liability in the event of a major quality issue.

- **Ongoing Relationship Management.** Develop a joint transition plan that specifies actions, responsibilities, timeframes, and one-time costs. Agree on a labor plan that addresses recruitment, workforce management, training, and performance incentives. Create a communications plan that ensures that you sustain internal business process knowledge and remain constantly informed of production performance. Define production information needed for ongoing strategic planning, and ensure that the outsourcer's IT systems regularly provide the required information in the needed format.

Summary

Outsourcing can have an extremely positive impact on business performance. However, the old saying "failure to plan is planning to fail" certainly applies here. By using a combination of delivery models, different units of work can be sourced in different ways. For each, the return on investment increases as decisions and negotiations are based on a solid understanding of existing conditions and desired results. By "knowing for sure" the answers to key questions, you can determine if outsourcing is right for you, select the most effective outsourcing model, and choose a vendor that will meet all of your outsourcing needs.

About Holland Group

Holland Group brings the best practices of onsite outsourcing to manufacturing. Our clients enjoy the financial and operational advantages of outsourced manufacturing processes without conceding a significant amount of local control over day-to-day operations.

Using our proprietary methodology, Manufacturing Process Outsourcing (MPO), Holland Group takes full responsibility for a distinct manufacturing process, providing a skilled workforce of Holland employees that meets all production, quality and delivery goals and provides the continuous improvement needed to drive ongoing business growth.

We provide complete onsite management, supervision and operation of a specific assembly line, a given operation, or the entire plant. We revamp existing processes or create new ones. Many clients ask us to take responsibility for production in these four areas:

- **Packing,** including all related pick and pack operations
- **Material Flow,** addressing any of the inbound and outbound functions of the plant or warehouse
- **Pre-assembly and kitting** of product **sub-assemblies**
- **Test and rework** at critical stages in the production process

If you are interested in learning more about how Holland Group can help you,
please visit us at www.hollandgroup.com.

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