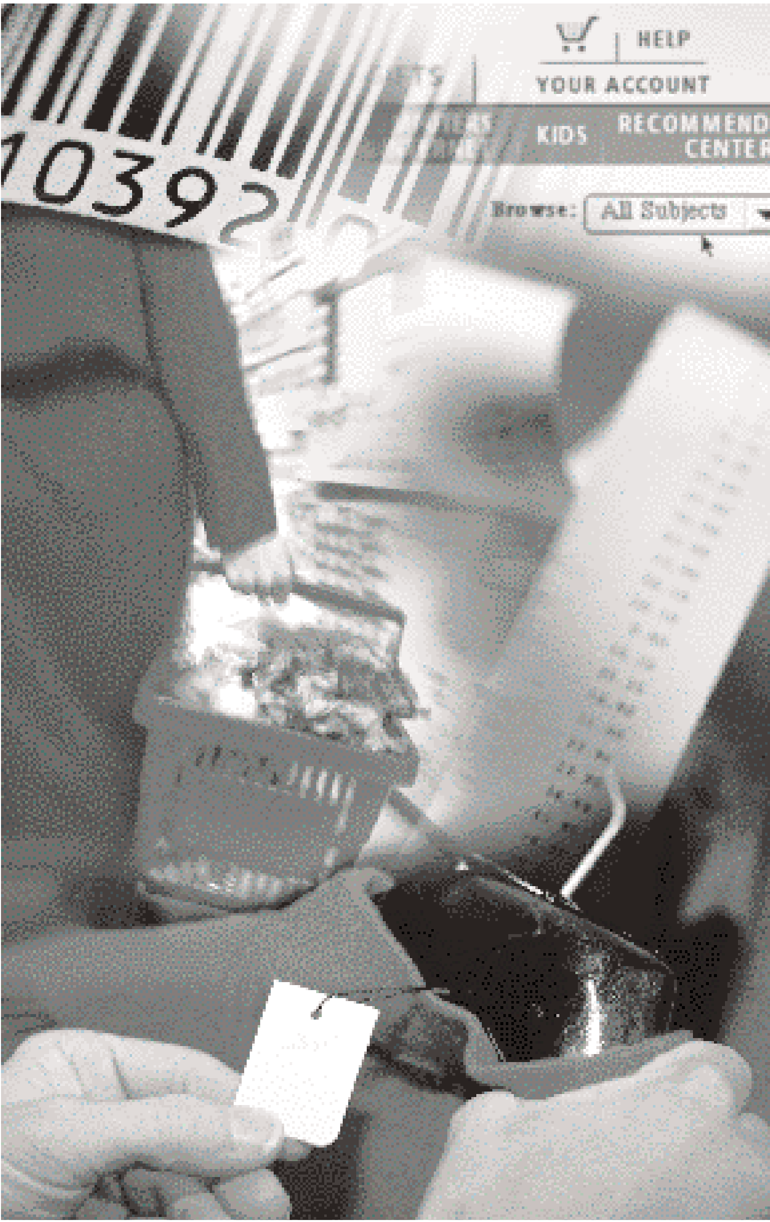
Opportunities for Action in Consumer Markets

Riding the Next Wave of Outsourcing

THE BOSTON CONSULTING GROUP



Riding the Next Wave of Outsourcing

Consumer electronics, footwear, and apparel blazed a path to low-cost countries (LCCs) 20 years ago. Since then, the environment for outsourcing to LCCs has become much more sophisticated, especially in logistics technology, information flows, and the management of supply chains. Advances in those areas—along with improvements in infrastructure and manufacturing quality, the easing of government restrictions, and competitive pressures to reduce costs—are driving many more consumer-goods companies to consider LCCs.

But that doesn't mean that outsourcing is always the right answer for every company. Not all products—and not all portions of a product's supply chain—should be outsourced. Lasting competitive advantage requires a nuanced approach. You must consider internal costs and organizational processes in the tradeoffs you make when deciding what you send, where you send it, and how you operate. Even when outsourcing is the right answer, most companies face a steep learning curve. There will be growing pains.

What to Send?

It's not an all-or-nothing proposition. Labor is indeed inexpensive in some countries, but in our experience rarely is the answer to outsource entire value chains or product lines. It makes sense to outsource some products or manufacturing processes, such as those requiring extensive hand labor, whereas highly automated manufacturing processes, products that need a final finishing step, and heavy products in which the labor savings can't compensate for the freight penalty are better located in the home country. And most products that are late in their life cycle can't afford the initial investment required for outsourcing, which can include the costs of closing home production facilities, building a plant in the LCC, and developing a network of suppliers.

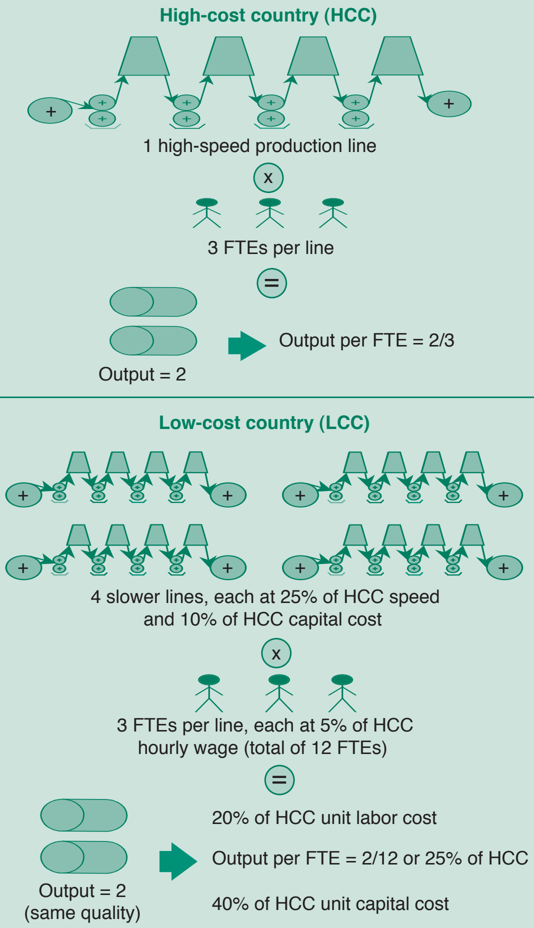
In deciding what to outsource, you must know your internal cost structure at a fairly detailed level, as well as how you will measure the costs. Labor content can be hidden in purchased parts and components, for instance, and you need to tease it apart in order to make fair comparisons. You need to understand the tradeoff between variable and fixed overhead costs in order to estimate the potential benefits of outsourcing.

Cost comparisons should also take into account both labor-rate differentials and the capital intensity of the process. Companies typically focus on the very low hourly wages of an LCC (often as low as 5 percent of U.S. or European hourly wages) but fail to compare the differences in the capital base. Indeed, outsourcing can provide a double benefit—lower total labor costs *and* lower capital costs. Without an operational understanding of the capital employed in the LCC, such as staffing levels and run speeds, companies may believe that labor is "less productive" when in fact it is "differently productive." The total system could offer a much higher return on capital employed than a company might think. (See Exhibit 1.)

Conducting the initial analysis and making decisions on what to send to LCCs can be difficult and time-consuming. Don't underestimate the initial investments involved, including senior management time. Assessing the setup costs won't be easy—most companies get it wrong. But beware of "analysis paralysis."

Exhibit 1. Capital and Labor Costs Can Both Be Lower

"Less Productive" Labor That Uses Less Capital Is "Differently Productive"



SOURCE: BCG analysis.

NOTE: FTE = full-time equivalent.

Search out the numbers you need in order to compare options, then make a decision. Learning comes with getting your feet wet.

Where Should You Go?

Managing the distance disadvantage while preserving the ability to be flexible and deliver on time is a prime challenge of outsourcing. After assessing the availability of skilled labor, costs of transport, and government policies, some U.S. companies use a hybrid approach, such as locating base production in China and "burst" capacity—to handle peak demand—in Mexico or Eastern Europe. So far, however, companies that have tried this approach have had mixed results because facilities close to home are often subscale and expensive. Moreover, it is often difficult to develop local supplier networks for these facilities because they lack sufficient volume.

We like to classify supply chains into five basic models, ranging from those that optimize home-based plants to those with truly global production. (See Exhibit 2.) You can develop a manageable number of supply chain options that combine various locations, as well as sourcing and assembly configurations. Finally, along with the economic analysis, you need to analyze the strategic and operational pros, cons, and risks associated with each option. Such an assessment will allow you to make decisions that are both creative and pragmatic.

Getting Operations Right

Even when you know what to send and where you might want to go, there are still challenges of execu-

Exhibit 2. Companies Can Choose Among Various Supply-Chain Models

Supply Chain Model		Option Description
Optimization of home-based plants		Fully implementing lean manufacturing Achieving reductions in the cost of materials
Selective LCC sourcing	Option A	Single-SKU sourcing: sourcing a limited volume of SKUs for tactical use
	Option B	Single-line sourcing: sourcing 100 percent of a core line on a direct import basis
	Option C	Base-line sourcing: sourcing base-line, peak-season demand of high-volume SKUs
Low-cost production		Producing 100 percent of core lines in low-cost countries
Domestic assembly of LCC components		Assembling to order, in the home country, components sourced from low-cost countries
Global production		Assembling to order, in a low-cost country, components sourced from other low-cost countries

SOURCE: BCG analysis.

tion to consider. Management can avoid some problems by designing processes and products to address LCC issues. For example, they could simplify the product for more manual operations or change the specifications so that local materials could be used. Or a product might be reconfigured so that subassemblies can be unbundled or rebundled to optimize sourcing and assembly in various locations with various suppliers.

It also helps to build the local organization quickly. We recommend hiring someone with experience who knows the country. Although it is important to acquire talent for the long term, it is crucial to install an infrastructure as fast as possible, investing ahead of the curve. At the same time, you want to create a truly "value added" role for the country organization in order to attract skilled local staff.

Generally speaking, the scarcest resources for getting products flowing quickly are the technical people required to find and approve suppliers and parts. Many companies begin by moving expatriates to LCCs while aggressively hiring local people who can be trained for the necessary positions. More experienced companies hire local staff well in advance and send them to the home country for training so that they can build personal contacts and credibility with colleagues at headquarters.

Because outsourcing in LCCs is often fraught with uncertainty, getting operations right can be particularly challenging. Lead-time, delivery performance, and product quality can vary widely. For instance, a U.S. company outsourcing in China received quotes for some parts that varied by as much as 80 percent—compared with variations of 2 to 5 percent for similar parts in the United States. Companies need to institute stringent procurement practices, such as early audits of supplier operations and costs.

Overcoming Organizational Barriers

Many of the internal processes that companies take for granted do not automatically extend into LCCs. And if there are multiple handoffs without good documentation, a lot can fall through the cracks. A company we worked with, for example, neglected early on to identify the right processes to send abroad—causing problems for both its suppliers and its customers. First, because the company had never documented its processes in its home country (before outsourcing), it immediately ran into trouble trying to replicate them overseas. Second, the company failed to adapt its quality-control processes to the different production lines used in the LCC. As a result, the LCC plant had to reset production many times for a single product, leading to high production costs for the supplier and late delivery to customers.

At the root of these issues was an organizational problem: procurement was leading what should have been a cross-functional effort. The quality control group had laid out unnecessarily high standards, and their specifications were difficult for the LCC plants to follow. Although the company's internal manufacturing experts could have anticipated these problems, the company involved those experts less than it should have because it assumed that the manufacturing people would perceive the outsourcing as a threat. The key to outsourcing success usually lies in surmounting organizational hurdles and sustaining momentum. Fortunately, most companies can prepare themselves for these challenges by taking a number of steps.

Set aggressive targets and give the internal organization a chance to meet them. Successful companies ask themselves, "What must I keep at home?" rather than "What can I send to LCCs?" The burden of proof shifts from the LCC advocate (often procurement) to the existing producer (manufacturing), which now needs to prove—and improve—its own competitiveness. Best-practice companies investigate and communicate the LCC options and costs, specify the target costs that will be considered competitive, and then give the organization a reasonable chance to meet or beat the target internally. Usually the organization will increase its efficiency and justify keeping a fairly large portion of the supply chain in-house.

Lead from the top. LCC operations are by their nature cross-departmental. They inevitably force one part of the organization to assume some cost or risk for benefits that will accrue to another. The head of logistics, for example, might have to support a process that will increase lead-times, inventory costs, and freight costs per unit when his or her incentives (and bonus) are based on reducing all three of these measures. The CEO and senior managers must get directly involved to overcome such conflicts. For instance, the head of global procurement for one large company chaired a meeting at 5 a.m. every Thursday to allow teams across the globe to participate by means of several dozen video links. This forum made it possible for them to resolve issues in real time.

Put one person in charge of LCC operations companywide. This person must have execution authority.

Distributing authority among several people, one in each unit, leads to ineffectual decision-making. It is also crucial to identify your starting point and establish balancing mechanisms. If your company is organized regionally, set up a council at the very top level to ensure that someone is pursuing transregional opportunities. If your organization is focused on business units, establish a special task force under the CEO's direction to create the scale required to look into LCCs.

Define appropriate structural linkages and incentives. As noted, LCC sourcing requires cooperation from every department in the organization. Linking mechanisms include processes and conference calls to coordinate cross-functional, cross-regional, and cross-business-unit inputs; meetings to drive sourcing decisions; global e-rooms to share relevant data; and numerous coordinating schedules and tracking tools. Establishing these linkages provides constant visibility, ensuring that nothing escapes attention. It is also critical to align incentives properly across the key departments—joint bonus pools, for instance, for manufacturing, procurement, and logistics if outsourcing yields target savings, quality, and on-time performance.

Don't underresource global efforts. Certainly, global and local operations in the same LCC can realize synergies through various coordinating mechanisms, but they should not risk losing their respective focuses by becoming entirely integrated. In the global operations office, in addition to the people who manage the global links and the local business units, technical resources are needed to qualify suppliers, inspect parts, and ensure quality. Supply chain managers complete the office. Although the size and type of office naturally depend on the size and complexity of the operations being managed, such offices usually have at least 20 people and can have as many as several hundred. They are typically located close to or within the LCC where the company has its largest operation.

Communicate early and often. Proactive and effective communication—both internal and external—is very important, particularly in view of the concerns about the impact of outsourcing on jobs in home countries. On the one hand, analysts are looking for more aggressive LCC strategies to deliver a competitive cost position; on the other hand, the popular press and politicians are vilifying companies that have pursued this path. Several companies have responded by demonstrating how their LCC strategies are linked to shareholder value, product innovation, and competitive prices to customers.

Communication is critical within the organization and across functions. For instance, it isn't enough simply to address risks. The company must also communicate throughout the organization how those risks are being mitigated.

Identifying and Mitigating the Risks

Outsourcing can threaten delivery times, cost competitiveness, and customer loyalty, but those risks can be managed. Risk to intellectual property is a particularly challenging issue. We advise companies to address it in several ways:

- Keep the most sensitive products and processes in-house, even if relevant suppliers exist in LCCs.

- Keep some critical elements out of LCCs, so that the product or subassembly can't be copied.

- Maintain stringent enforcement with frequent inspections and compliance checks, strict inventory management, and rules for overstocks and flawed products.

- Seek patent protection and develop strong contracts that include nondisclosure and noncompete clauses.

- Invest in supplier qualification, training, and reward programs, as well as employee retention programs.

- Lobby LCC governments to raise the bar on the protection of intellectual property.

Price erosion is another risk. But maintaining quality and continuing to focus on innovative product launches can help stave it off. It might mean incurring higher costs for buffer inventories along the LCC supply chain—as well as making occasional "emergency" shipments. Nevertheless, quality, service levels, and innovation are critical to maintaining price realization and customer satisfaction.

* * *

Some products and portions of supply chains will benefit from outsourcing more than others. It all depends on knowing the details of your organizational structures and processes and deciding what tradeoffs to make in choosing what you take and where you go. Although the forces driving globalization are inexorable, our experience suggests that making the right outsourcing decisions for a business is a much more delicate process than what most managers have heard from colleagues or read in the popular press.

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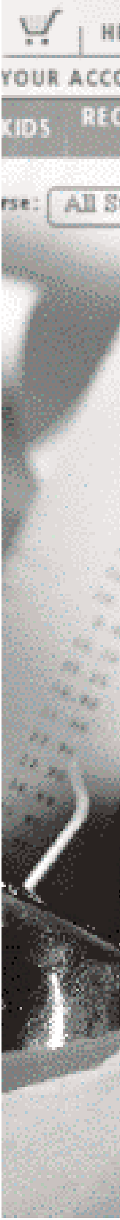

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