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Outsourcing by Manufacturers — Benefits, Risks and Twelve Keys to a Successful Transaction

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Introduction

Over the last several years, there has been an increasing trend in outsourcing by manufacturers. Besides the traditional outsourcings of information processing (e.g., IT infrastructure) and business processes (e.g., finance and accounting, human resources/benefits and facilities management), manufacturers have significantly increased outsourcing of industry unique functions such as assembly, energy supply management, fabrication, and transportation. For instance, manufacturers of drilling rigs and facilities for oil exploration companies might engage other companies with expertise in die casting, grinding, forging and other technical specialties to fabricate key parts and components.

Regardless of the reason why manufacturers have increased the use of outsourcing over the past few years, experience has indicated that there are not only a variety of benefits and risks with this approach, but there are a number of recommendations which should be implemented by manufacturers in order to have a successful transaction. The purpose of this article is twofold: first, to highlight a few of the benefits and risks associated with the outsourcing of traditional manufacturing functions and, second, to identify some key recommendations to assist interested manufacturers in achieving a successful transaction.

Benefits

The outsourcing of certain functions that are traditionally performed by a manufacturer can have various benefits such as the following:

1. **Attention.** Once an outsourcing arrangement has been implemented, management can focus its attention, as well as its company initiatives, on what it considers the core business or "crown jewels" of the company. In essence, executives can concentrate their efforts on the core competence of the business by focusing on long-term strategy and improvements while seeking more effective and efficient performance for certain non-core business functions from other suppliers.

2. **Lower Costs.** The primary driver of manufacturers increasing their use of outsourcing has been to reduce costs by using lower cost contract suppliers. Companies can generally save funds based on the suppliers' greater efficiency and lower cost of personnel (both labor rates and benefits being less based on the location they select for the outsourcing). Further, companies will generally be able to reduce their capital investment expenditures because the third-party suppliers will invest in the facilities and equipment necessary for production.

3. **Expertise.** The contract manufacturer will more than likely have greater skills and experience in the area outsourced than the customer companies. They are also more likely to innovate new processes and procedures for the subject services because they will provide similar services to multiple companies. As a result, the manufacturers will probably get better performance than they could achieve themselves.

4. **Certifications.** The administrative burden and associated costs of complying with any relevant regulations and certifications (e.g., export/import licenses) can generally be handled more expeditiously by the contract manufacturer.

5. **Supply Chain Assurance.** By entering a multi-year contract to outsource certain functions, the manufacturer gains assurance that it will have access to the raw materials, components and products it needs in the future.

6. **Staffing.** By outsourcing certain non-core functions, manufacturers can spend less effort and resources on employment-related matters such as recruiting, hiring and training personnel. Typically, only a minimal number of personnel are retained for the outsourced functions so they can assist with the transition and monitor the efforts of the service providers.

7. ***Scaling.*** Since the third-party supplier is probably performing similar functions for other manufacturers, a company should be able to expand or contract the number of components or products it needs with little, if any, effect on the price per component or product, as long as the third-party supplier has sufficient capacity. The manufacturer should, however, expect to have ongoing discussions with the third-party supplier to reconcile the manufacturer's desire for scaling and lower cost versus the third-party suppliers' desire for greater profitability.

8. ***Accountability.*** Similar efforts across multiple departments of a manufacturer can be consolidated into a single function and then outsourced to a service provider according to a pre-determined budget and agreed performance standards. This process greatly simplifies management's task of holding someone accountable for timely delivery of the desired services.

9. ***Time Zone Differences.*** By outsourcing functions to service providers in foreign countries in different time zones (e.g., India, China, Russia), manufacturers in the United States can have certain services performed when they are closed. This technique can not only lead to greater efficiency but can transform certain aspects of businesses into twenty-four-hour operations.

10. ***Delivery Speed.*** In many cases, service providers are already providing similar services to others that a given manufacturer is interested in outsourcing. As a result, the manufacturer is likely to get faster delivery of those services from a third-party compared to implementing those services themselves, particularly when a new or amended function is involved.

Risks

1. ***Control.*** Regardless of whatever governance model is established, a manufacturing company that is outsourcing certain functions will lose some control of the process and production. In order to achieve the cost benefits of the functions that the manufacturer desires to outsource, a third-party supplier will generally insist that it be able to dictate how these services are performed.

2. ***Quality.*** The manufacturer will be dependent upon the service provider being aligned with it as to its expectations on quality of the component or product being produced, especially because defects often do not become apparent until sometime in the future.

3. ***Flexibility.*** To the extent that needs of the company change in terms of the final product or the production schedule, the contract manufacturer is less likely to readily alter its facilities or process to satisfy the desires of one customer.

4. ***Foreign Constraints.*** To the extent that certain functions are outsourced offshore, there are various risks such as currency valuation, cultural differences and non-enforceability of contract provisions (e.g., confidentiality, intellectual property protections). The magnitude of these risks varies depending on the country where the services are performed.

5. ***Knowledge.*** Once a particular function is transferred to a service provider, the customer does not tend to stay current on relevant market developments. This decrease in knowledge is often enhanced in those instances where personnel are transferred from the company to the service provider as part of the transaction. This loss of knowledge can be detrimental in the future if the company ever decides to bring the services back in-house.

6. ***Regulatory.*** The manufacturer will become dependent on the third-party supplier being compliant with laws and regulations that affect the services including, for example, export controls, data privacy and security laws, and economic sanctions involving foreign countries.

7. ***Protect Management.*** Following transition of designated services to a third-party, manufacturers must manage the service provider through a governance process. Manufacturing companies often do not have personnel with these project management skills and they have generally lost talented leaders as part of the outsourcing process. Further, since the contracts are for an extended time period and hard to exit, ramping up a vendor management department can have adverse effects on the projected cost savings.

8. ***Modified Services.*** Inevitably, companies will desire to outsource a new service or modify an existing services already being contracted to a service provider. The new projects and activities will generally lead to an increase in costs not previously anticipated by the manufacturer.

9. ***Privacy and Security.*** There is a greater risk of a service provider exposing confidential and proprietary data since a third-party is involved, especially if the services are performed offshore where the laws of protection are often not as strict as the United States.

10. ***Integration.*** Service providers are focused on completing assigned tasks and functions as efficiently as possible to maximize profitability. Accordingly, when deciding how best to conduct the services, they are less likely to consider the impact across multiple departments of the manufacturer or how the company as a whole might better utilize the outsourced services.

Twelve Keys to Success

Once a manufacturer decides to proceed with a specific outsourcing transaction after weighing the benefits and risks, implementing the following twelve recommendations have, in the authors experience, repeatedly led to success for companies.

1. ***Internal Review and Analysis.*** Before issuing a Request for Information (RFI) or a Request for Proposal (RFP), manufacturers should conduct an internal review to ascertain what functions may be feasible for outsourcing and whether outsourcing these functions will help the manufacturer achieve its goals and objectives. This initial review should include a base-case analysis which sets forth the costs and performance metrics that are applicable when the manufacturer performs the function(s) itself.

2. ***Identifying and Managing Hidden Costs.*** Manufacturers sometimes neglect many of the hidden costs associated with an outsourcing transaction and, accordingly, will overestimate the savings that might be achieved if certain functions are outsourced to a third-party. For instance, there are internal costs associated with data gathering, RFI/RFP preparation and issuance, identifying suppliers and requesting quotations, conducting supplier due diligence, analyzing and evaluating provider proposals, negotiating the transaction and incurring various transaction-related costs such as professional fees and travel.

3. ***Competitive Process***. Before selecting a service provider to negotiate a transaction, the manufacturer should explore the capabilities of a few service providers. This approach will not only likely lead to the presentation of several good business solutions, but may also result in certain risk and reward concessions by suppliers because of the competitive process. Manufacturers often believe that a sole-service outsourcing without competition will lead to a faster, cheaper and more partner-like relationship, but this is not always the case.

4. ***Price Is Not the Only Important Variable.*** When considering a transaction, the business lead and C-Suite executives will often focus on the transaction costs to the exclusion of other variables because the price is directly linked to the anticipated savings for the manufacturers. A much better indication of whether a transaction will be successful is a value-added approach that takes other significant factors into account besides price. These factors vary depending on the transaction, but typically include an evaluation of who will provide the best business solution and most stringent performance standards.

5. ***Employee Communications.*** Early in the process, there should be a measured delivery of candid information to the affected employees. Such information might include what employees will be transferred to the service provider, whether comparable benefits and employment protection guarantees will be provided and whether some employees might be severed. Further, new requirements may be imposed on transferred employees such as background checks or other screening procedures.

6. ***Realistic Goals.*** It is important for the manufacturer's business lead and negotiation team to obtain senior management support early in the process. This support should not only focus on the time and effort it will likely take to negotiate a comprehensive transaction, but also on the understanding that the parties will be partners in a service-oriented transaction. It is critical that the deal is structured on a "win-win" basis.

7. ***Governance.*** There should be a strong governance model that includes regular reports and meetings with an escalation process if responsible individuals or committees cannot resolve differences. Open and regular communication proves to be an effective tool in addressing the concerns of both parties so tensions do not mount unnecessarily.

8. ***Scope and Performance.*** Once a service provider is selected, the parties should work closely together to decide what services are included in the statement of work to be provided. The contract should specify the performance standards that the service provider must satisfy including measurable metrics that arc agreed upon in negotiations. Further, there should be mechanisms in the contract for adding new services and adjusting the performance standards.

9. ***Pricing.*** There are as many different pricing mechanisms as there are types of transactions, and they can vary from fixed to variable to hybrid in nature, In any case, an algorithm that is relatively simple and straightforward with certain adjustments like cost of living and standard rates for project work is likely to be the most effective.

10. ***Term and Termination.*** In the past several years, the term of outsourcing agreements has generally become shorter due to increased competition and continual improvements in technology. Regardless of the term, a successful

engagement will usually incorporate several exit strategies/termination processes. Depending on the circumstances, there could be termination options for various scenarios like cause, convenience, bankruptcy, or change of control.

11. ***Industry Policies and Company Procedures.*** An effective outsourcing engagement will incorporate applicable policies and procedures of both the industry and the particular manufacturer. For instance, companies that are affected by privacy laws may have certain business associate agreements or data policy and security requirements. In addition, most all companies will have certain guidelines, such as travel policies, that must be accepted by the service provider.

12. **Contract Structure.** Successful outsourcing is dependent on there being a clear, comprehensive and user-friendly contract. Normally, the content will be structured with a set of master terms and conditions, and a series of schedules. The master terms and conditions will set forth the rights, responsibilities, and risk allocation between the parties. The schedules will identify the scope, performance metrics, price, employee transfers and benefits, expiration assistance, approved subcontractors, transition plan and other applicable agreements. There will generally also be a series of exhibits that support the master terms and schedules such as a list of the assets being purchased/transferred, travel policy, sample invoice, data security and privacy policies. In all cases, the documents are meant to provide clarity and facilitate communication between the parties as the services are conducted.

Other Observations

Outsourcing transactions evolve and change based on both the economy and political climate. For example, there has recently been more restructuring/renewals than new transactions; some aspect of cloud sourcing is often incorporated and customers are pushing service providers for more innovation. Further, offshore or near-shore outsourcing remains a viable component of many transactions due to labor arbitrage, but the political sensitivities and pressure to keep jobs in America have increased over the last year.

Besides the twelve keys to success set forth above, there are many other aspects of an outsourcing transaction that need to be agreed upon and memorialized in the contract. Some examples include clarification of intellectual property rights, audit requirements, compliance with applicable laws and dispute resolution provisions. In all cases, it is recommended that the parties endeavor to structure an agreement that promotes communication and provides guidance on how to address issues that are likely to arise.

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