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BRUNTON

# Outsourcing White Paper

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## Introduction

To meet global business challenges, many UK manufacturers have already, or are planning to, outsource the manufacturing of products, or offshore production overseas.

This White Paper looks into why outsourcing/offshoring is being employed as a key strategy for the 21<sup>st</sup> Century by an increasing number of businesses; the benefits and pitfalls of such a strategy - and the pivotal role that Information Technology can play in making it a success.

A number of McGuffie Brunton customers have developed strategic outsourcing programmes, or offshored some of their manufacturing operations, over the past few years. Their typically 'positive' experiences and knowledge, together with the findings of recent reports and studies on the subject of outsourcing/offshoring, have contributed greatly to the development of this document.

As well as using comments made by senior management of those customers, this white paper also includes separate case studies on BLP UK, AMOT, Premier Percussion and one SME (Company X) that was interviewed for this White Paper. The latter company experienced quality and logistical issues during a decade of outsourcing its products to India.

## Background

The UK manufacturing sector remains a fundamental part of the UK economy. In total it contributes £152 billion, some 15.6 percent of UK Gross Value Added (GVA) (ONS, UK National Accounts "The Blue Book 2004"), employing 3.1 million people directly.

However, according to the 'Trends in UK Manufacturing' report (which is based on Findlay Publications' Manufacturing Industry Database between 1997 and 2004) the Gross Value Added (i.e. the contribution of manufacturers to the countries' Gross Domestic Product), is now no different from the level recorded in 1997, which then represented 21.2% of the national total. Similarly, the number of factories employing 50+ staff has declined by 26% between 1997 and 2004 and the number of people employed in manufacturing has declined by 27%, since 1997, primarily since 2000.

While these recorded declines are partly a consequence of a recession between 2000 and 2004, UK manufacturing has experienced, and is continuing to experience, significant structural changes based around an increased tendency to outsource.

This outsourcing trend is confirmed by 'Where Now for Manufacturing?', a report from the Engineering Employers Federation (EEF). It states that while globalisation has created new opportunities, it has also produced new threats, especially in terms of cost competition from lower cost economies. According to the Report, which is based on a survey of UK manufacturing, some 95% of firms report a competitive impact from customers demanding lower prices, with 68% rating this as a significant impact. In contrast, only 12% saw competitors producing higher-value-added goods as a significant pressure, with a further 38% reporting some impact.

**Manufacturing contributions to UK GDP unchanged in 7 years**

**1997-2004 number of sites employing 50+ staff down by 26%**

*China is now the  
World's Consumer  
Goods Workshop*

To meet the challenge, UK manufacturers have followed a number of strategies; from an increased focus on innovation, to aggressive price reductions. But, irrespective of overall strategy, in most cases companies have also expanded their focus from their domestic and traditional trading partners to incorporate new and expanding markets. Furthermore, they have had to assess where manufacturing functions are best located to service key and growing markets, and how and where their production processes can be carried out most efficiently and cost effectively. As a result, many have already, or are planning to outsource <sup>(1)</sup> more components and products from, or offshore <sup>(2)</sup> production to, Eastern Europe, India and China.

*BLP UK Ltd, the UK's leading volume manufacturer of MDF wrapped profiles and membrane pressed cabinet doors, is one company that is seeking to leverage China's low cost manufacturing and gain access to new developing markets with rapidly growing GDP.*

While reforms in the latter two countries are at different stages, they do both offer low-cost labour, and lots of it. China, for example, has not gained the title of the 'world's consumer goods workshop' for nothing, and the output of India's transport sector has grown by an annual 10% over the past five years as automotive companies have moved in to take advantage of lower costs and a skilled workforce.

These countries also provide the opportunities of rapidly expanding markets for manufacturers of all types of product and goods. Combine this with rapid technological developments in communications and information technology which allow direct and immediate worldwide interaction, and the potential benefits of outsourcing and offshoring - either cutting costs or accessing new markets - become clear.

(1) For simplicity, this document defines Outsourcing as the practice of taking production activities that were done internally in the UK and paying an overseas contract manufacturer to handle them - at a lower cost.

(2) For simplicity, this document defines Offshoring as the establishment of complete production subsidiaries (either fully or jointly owned) in a lower cost location, to replace or increase existing UK capacity.

*Almost 50% of manufacturers expect to move more of their production overseas during the next five years*

*SME's set to increase levels of outsourcing in order to remain competitive*

## Who is Outsourcing and Offshoring?

### A growing Trend

There can be little doubt that manufacturing outsourcing and offshoring programmes are already well established among many of the UK's larger manufacturers.

However, it is also clear that these approaches form a growing part of the manufacturing strategy for all UK companies, including SMEs.

The 'Where Now for Manufacturing' report from the EEF (Engineering Employers Federation) noted (in 2004) that just over two-fifths of firms (42%) have the manufacturing of parts or components undertaken abroad and a further fifth are planning, or actively considering it.

Of this group, some 40% have invested abroad (offshoring) to increase UK capacity, and a similar proportion have invested to replace UK capacity. Given the amount of initial outlay in terms of time and money, larger companies have favoured these strategies.

Of the 244 firms in the survey that have outsourced or relocated one or more functions abroad, 68% had relocated some of their manufacturing abroad and 10% all of it.

Almost half of all manufacturers surveyed predicted that more of their production would take place outside the UK over the next five years. Around 30% of those not currently outsourcing stated that they anticipate that some production will be located offshore in the future.

Of those that have already invested abroad, 62% of companies expect more manufacturing to leave the UK in the next five years, with a further 70% planning to retain no manufacturing in the UK.

*Nigel Sims, Managing Director of Premier Percussion (one of the world's largest makers of wooden drums, which employs around 60 people worldwide and has a turnover of \$15m) says: "To meet a range of business requirements, we have integrated overseas contract manufacturing (and the outsourcing of all freight movement, warehousing and distribution activities) into our business strategy. Even so, we still produce a high proportion of our products in the UK."*

### Not just for large companies

Until recently outsourcing, and especially offshoring, was still an approach that was more favoured by larger companies. Having to deal with an overseas company over the manufacturing of components can be more time-consuming for smaller companies and potentially requires smaller batch sizes than those needed by a larger firm; two factors which may also reduce possible cost savings. Offshoring is seen as even more risky, especially for SMEs, because of the initial outlay involved.

However, because of increasing competitive pressures, and the fact that there is now greater awareness and support for both outsourcing and offshoring, more and more SMEs are looking at these approaches.

According to the UK based National Outsourcing Association (NOA), small to medium size businesses (SMEs) - which account for 95% of UK enterprises - are set to increase their level of outsourcing and offshore more operations in an attempt to remain competitive.

*75% of companies rate reducing labour costs as key objective*

*Offshoring can also enable firms to gain a foothold in new developing markets*

## Why companies are Outsourcing/Offshoring

Companies are looking to outsource or invest abroad for a number of clear reasons;

### Cost Cutting

The vast majority of those planning to use overseas-based production facilities are doing so to drive further cost reductions. In particular, 75% of companies rate reducing labour costs as the key objective; a proportion that rises to 86% for firms with 500 employees or more <sup>(3)</sup>. This key driving influence is understandable when considering the difference in labour rates.

According to data from the United Nations Industrial Development Organisation (UNIDO), annual manufacturing wages in the UK were around \$30,000 in 2000, compared with less than \$5,000 per year in Central and Eastern Europe and less than \$1,500 in India, China and other parts of Asia.

Furthermore, figures from the US Bureau of Labour Statistics (BLS) show labour rates for mainland China can be as little as \$.33/hr, although they can be up to \$4/hr <sup>(4)</sup>.

### Global Markets

However, cost is not the only competitive advantage to be had. Of those already investing or outsourcing abroad, gaining market access was mentioned by almost half of firms (47%). While, of those companies planning to invest abroad, the fact that customers were moving abroad (65%), and the need to develop new markets (59%) were also important factors for considering outsourcing / offshoring <sup>(3)</sup>.

*Andrew Thorpe, BLP's Financial Director: "One of the initial aims of the new fully owned subsidiary in China is to provide additional capacity. But its long term primary role will be to enable us to target global demand, and in particular provide us with new and direct access to the increasingly sophisticated Chinese market."*

What has been found is that offshoring, either through a joint venture or direct foreign investment, can not only reduce production costs for export, it can also enable companies to gain a foothold in new developing markets with rapidly growing GDPs and a local populace that is eager to offer Western-style products. But this approach does require a higher level of commitment than outsourcing to an allied party.

### New Technology

Some companies, but as yet relatively few (16%) <sup>(3)</sup>, see outsourcing or investing abroad as a route to new technology.

<sup>(3)</sup> 'Where Now for Manufacturing', a report from the Engineering Employers Federation (EEF).

<sup>(4)</sup> DFMA (Design For Manufacturing Assembly) Report – Improved Product Design Practice Would Make US Manufacturing More Cost Effective.

A case to consider before outsourcing to China. Published by Boothroyd Dewhurst Inc.

**75% of  
Manufacturers  
claim to meet  
their objective  
of reduction  
of labour costs**

**Research now  
shows that  
the trend for  
in-sourcing is  
actually increasing  
in some areas**

## Are companies gaining the anticipated returns?

As with all strategies, the experiences of different companies with outsourcing and offshoring vary considerably. To date, most UK manufacturers report positive experiences. Yet there are growing signs that more and more companies are admitting to becoming disillusioned.

One possible reason for this is that more firms are simply admitting to 'jumping on the bandwagon' to be part of the trend. These firms may not have properly examined and executed a strategy, and are therefore unlikely to gain the anticipated benefits. Another problem may be that while manufacturers are gaining expected labour cost reductions, the overall savings are just not materialising due to other costs being higher than expected.

### Reported success

According to the 'Where Now for Manufacturing' study <sup>(3)</sup>, many companies have reported a high degree of success in achieving their objectives. The highest success rates are for reduction in labour costs, with 75% of companies meeting their main objective of reducing labour costs, and a further 15% exceeding their objectives.

However, the success rate varied by location. Over three-quarters of companies whose main location for outsourcing/offshoring activity is China, met or exceeded their expectations on labour costs - slightly below average. Success rates were higher in eastern Europe (non-EU) and India.

Success rates were also high for market access (63% met, 10% exceeded) and increasing production volumes (64% met, 15% exceeded).

*Jason Turrell, IT manager for AMOT UK, (a company that provides industrial control solutions for the global gas, oil, power generation, marine and transportation industries)*  
*"Having a foothold in China enables us to carry out global sourcing and reduce shipping costs. Our strategy is not to cut manufacturing in the UK, but to use our facilities and build on their strengths.*

### Missed potential

Conversely, of those surveyed, 10% of companies failed to meet their objectives on labour cost reductions, and some 15% said they failed to meet their objective of securing market access.

Also, more than 30% of the respondents to a 2004 Booz Allen Hamilton survey <sup>(5)</sup> reported being less than satisfied with their outsourcing/offshoring results. More than 20% of the attendees at The 2004 Outsourcing World Summit said that they were losing a quarter of the value of their outsourcing contracts due to poor working relationships between the companies. Research from Deloitte Consulting <sup>(6)</sup> highlights that the trend for in-sourcing is increasing in some areas, as more and more companies report negative experiences.

(5) CEO Journal - 'Outsourcing the next decade' by Michael F Corrbett

(6) Deloitte Consulting – Calling a Change in the Outsourcing Market.

The realities for the World's largest organisations. April 2005

*Haste and lack of preparation is often fatal*

*Hidden costs can add an extra 24% to the cost of a product manufactured overseas*

## What are the problems?

The reasons why Outsourcing and Offshoring programmes might fail are extremely varied, and while some factors cannot be anticipated, more often than not it comes back to poor planning, poor decision-making and poor communications. As the NOA observes, the problems that companies experience with outsourcing and offshoring are not due to the strategy, but are due to the implementation approach. It notes that haste and lack of preparation can be fatal. For example, Deloitte found that 48 per cent of companies had no standard methodology to evaluate the business case for outsourcing.

### Bad accounting

Many companies fail to achieve the anticipated cost savings because they do not do the maths properly. Business analysts, like Boston Consulting Group and Aberdeen Group are uncovering both the risks of outsourcing and the limited view most manufacturers have about what it costs them to produce their products. They have found that many manufacturers have become myopic in their pursuit of cost reduction. They are drawn by the lure of extremely low labour rates, with outsourcing decisions often made on the basis of cost benefits that are calculated solely in terms of incredibly low labour costs. Other costs, both tangible and intangible, are rarely taken into consideration because they are not allocated to the actual product, but are paid for by the corporation from various other budgets. As a result, the real cost of outsourcing is not understood until it is too late.

For a realistic cost assessment it is necessary to account for all the additional costs associated with offshore manufacturing - and to apply these to the product costs - before deciding if outsourcing/offshoring is the optimal choice.

Overall, a recent study by Boothroyd Dewhurst Inc. claims that all the hidden costs, taken together, can add an extra 24% to the cost of a product manufactured overseas. Crucially, this study notes that these estimates, based on the authors' experiences with various suppliers and product development companies, compare favourably with numbers actually quoted by a number of major US manufacturers. These hidden costs can include;

**Labour:** For instance, setting up a manufacturing project in China usually requires the services of a third party acting as a broker in the deal, and these charge overheads on the labour as fees for their services. This overhead can be significant, increasing the true labour rate from the often quoted \$0.33/hr to about \$5.10/hr.

**Shipping & Logistics:** As well as the basic shipping container costs, this should include the cost of associated land transport, customs and security, plus an estimate for inventory carrying costs and reduction in cash flow while products are in transit. Firms must also insure the cargo against loss. The study <sup>(4)</sup> estimates that shipping and logistics can add 17% to the product cost.

*A key problem that Company X had to cope with was the excessive time required for components to reach the UK. Lengthy transport lead times and delays were/are common, and most are due to the basic logistics infrastructure in India and shipping delays. As one of the company's senior UK managers reports: "This logistical nightmare is further compounded by the administration requirements within the country, and the need for the comprehensive amount of paperwork that has to accompany every transaction."*

*Outsourcing or investing overseas increases supply chain complexity, which has to be managed*

**Ancillary Labour Costs:** The study estimates that to start and maintain a relationship with an overseas vendor, a company spends an average of 1% of product cost on travel, communication and lost time, which is typically allocated to expense budgets, not manufacturing costs.

**Quality Costs:** In reality, outsourced product quality is often less than that of domestic products, and experiences suggest that these quality defect costs can run high. But, again, they are often paid for by warranty funds and never attached to the product cost. The DFMA study estimates that quality defects have a 'conservative' average impact of 4% of product cost.

*Nigel Sims, Managing Director of Premier Percussion, "We have our own employees, located all over the world, who constantly monitor production quality, with the emphasis being on inspection at source."*

**Miscellaneous costs:** The DFMA report also conservatively estimates that miscellaneous costs of outsourcing to Asia can add another 1% to the product cost.

The reality is that not all goods can be produced more cheaply in low labour-cost locations. One machinery company interviewed by the EEF <sup>(3)</sup> looked at sourcing a number of different parts and components from a supplier in China. While some products could be purchased from China for up to one-thirteenth of the price (excluding shipping costs, etc.), others were as much as 40% more expensive to produce in China.

### Poor support

Companies can fail to achieve the supply performance and product quality needed when they do not support the outsourcing project properly.

Outsourcing or investing overseas builds greater complexity into companies' supply chains. Not only is it easier to manage suppliers that are closer to a firms' main operations (i.e. in other developed countries), but there can be greater confidence in the quality of output. This is a critical issue for the success of manufacturing and meeting customer needs. Companies must also be certain that their suppliers can respond to changes in demand, especially as shipping is likely to increase lead-time.

*Nigel Sims, Managing Director of Premier Percussion "By fully utilising an ERP system, we are able to not only manage the head office and front end operations, along with the UK manufacturing plant, but also keep tight control over our whole supply chain, from the placing of an order to the fulfilment of that order (by the third party logistics provider)."*

Many companies report the need to spend considerable time working with partners to get the specifications and quality up to standard to meet their needs.

Some firms overlook this, or just do not have the resources to do it. Secondly, skills availability will very much depend on where companies look for outsourcing or investing.

### Not talking the same Language

Simple relationship breakdowns are a typical reason for disappointing outsourcing results. As with all strategic decisions, the selection process is key, and when short cuts are taken, it is not uncommon to find that the selected partner proves to be in the wrong location, or is simply a business that fails to match up to expectations.

*Companies can not afford to just wash their hands of a process or project once it is outsourced*

*When Outsourcing realism and transparency are the key*

*Without the facts, improving outsourcing's ROI will be hard to do*

## How can companies avoid the problems?

The NOA and other organisations advise that for successful outsourcing companies should:

### Research and be prepared

End users need to go into an outsourcing deal with their eyes open. Thorough research of objectives on both sides is essential - all too often companies think that if they outsource a process or a project they can wash their hands of it - this is not the case.

A number of surveys also found that hidden costs were an issue for firms - if the right research was conducted in the first place and every eventuality thought about, then there would be no costs to jump up and bite the end user.

### Find the right fit

The right supplier is key. Outsourcing means an ongoing relationship and different suppliers will have a 'fit' with different companies. Like any relationship, everyone is different and finding a good match is paramount to having a long lasting and happy partnership.

### Management is essential

Most companies find that outsourcing / offshoring requires more management intervention, at all levels, than they expected.

*Andrew Thorpe, BLP's Financial Director, "As well as providing an important tool that we know will enable the new site to operate effectively, a good ERP system also ensures that overall management of the combined facilities can be easily maintained from the UK."*

### It's not just about cost

Although tempting, cost should not be the only motivation behind outsourcing. The primary concern should be standard of service. Cost savings can be made but be realistic - pinning a supplier to the wall on a contract will mean that service will suffer, or the relationship will break down irrevocably. Realism and transparency are key.

### Evaluate

From the start clear objectives and targets on both sides need to be defined and ways of measuring the completion of those targets need to be agreed upon. If this is not done, the lines become very blurred, with frustration and misunderstanding abounding.

### Better Training

Better training would get the knowledge about what does and does not work where it is needed - in the hands of the people directly involved in creating and managing outsourcing relationships.

### A Focus on Outcomes

The way most organisations go about outsourcing is determined far more by opinion than fact. Very little work has been done to establish a benchmark for high performance outcomes and to identify the processes that lead to superior results. Without the facts, improving outsourcing's ROI will be hard to do and even harder to prove.

*'Putting Technology to Work' should be at the heart of any outsourcing strategy*

## The role of IT

Despite the obvious advantages made possible through manufacturing outsourcing, many organisations find it difficult to effectively incorporate overseas partners into their business practices, and so establish viable outsourcing or offshoring programmes. As has been shown, there are various obstacles that companies have to overcome, with many related to the mechanisms of gathering data, analysis, and sharing information in a timely manner. Any solution that can enable companies to better perform these tasks can help reduce risks and significantly improve the potential for outsourcing and offshoring to deliver a substantial return on the investment.

This is why 'Putting Technology to Work' should be at the heart of any outsourcing strategy. The effective application of IT can make low risk outsourcing (large volume batch components) more efficient, and makes high risk outsourcing / offshoring (the complete replacement or extension of manufacturing close to new market areas) feasible. This is equally true, and particularly important, for all those SMEs now looking at outsourcing / offshoring.

*Far more than just an IT after thought, the SYSPRO 6.0 ERP system is at the heart of Premier Percussion's relatively complex business model, and it is through the adoption of the system that it has been possible for a traditional SME like Premier to tailor a total supply chain solution specific to its needs.*

Multiple studies point to outsourcing failure rates of up to 30 percent <sup>(5)</sup>. Experts believe that the right software tools can help bring this risk down to 10%.

### Internal & External control

In particular, an effective business management system provides the framework on which to build any outsourcing strategy. This is a lesson from the forerunners in outsourcing / offshoring, which have been mainly the big manufacturers, that has to be learnt by the SMEs now following the same path.

A fully integrated internal ERP system, configured with the right functionality can enhance the chances that an outsourcing / offshoring strategy will work. For example;

### **A clear vision of the existing business, including the real costs of production, is vital.**

The effective planning of an outsourcing programme initially requires the ability to internally extract and analyse a wealth of accurate data - from labour costs and productivity to accurate warehousing and distribution overheads. It also requires the establishment of 'real' outsourcing costs - not just labour rates. Only this way is it possible to establish the real baseline of costs and so determine - against an accurate assessment of the real cost of outsourcing - if outsourcing can deliver the cost savings anticipated.

Companies just assuming that cheaper labour will automatically deliver the overall savings anticipated has proven to be the reason for the failure of numerous outsourcing programmes.

*Assuming that cheap labour will automatically deliver the overall savings anticipated has proven to be false*

### **Internal controls are needed to manage the external factors created by having products / components produced overseas.**

Having the internal systems that can effectively track the outsourced components, from order through to delivery and warehousing, and on to the customer is essential. Ensuring any quality issues are caught and managed quickly is one obvious reason. Another reason is that any outsourcing programme that uses contract manufacturing in the Far East to produce components or products that are then brought back to the UK, will reduce a company's flexibility, as the lead time, including shipping, is likely to be significantly extended. Ensuring enough buffer stock is retained can be part of the solution, but retaining too high a stock level can quickly reduce any outsourcing cost savings.

The advantages of integrated systems are well recognised. They include the ability to accurately manage planned requirements (including updates), track and manage deliveries from source to destination including warehousing 'buffer' stock holding and in-transit goods and provide constant monitoring of actual requirements against availability. This will not only provide for efficient ordering and better stock control, but also ensure there is significant prior warning of potential stock outs if requirements change, enabling a rapid determination of the potential impact, allowing the company to manage the situation.

*For AMOT UK there were major advantages for staying with SYSPRO. Significant costs savings resulted in not having to retrain or re-educate staff with a new system. Using SYSPRO also allows AMOT in the UK to keep track of the production process in China, making sure that production runs smoothly and the employees understand the system.*

### **Effective electronic links with contract manufacturers and off shore subsidiaries can deliver major gains.**

The fact is that outsourcing or investing overseas builds greater complexity into a company's supply chain. This complexity is further increased as product cycles increase, and time to market becomes ever more critical. To manage this environment effectively depends on good communication and coordination of activities.

If a company's value chain is linked by an uncoordinated mix of information systems, with communication mostly by e-mail, faxes, phone calls and in-person meetings, then this is likely to lead to problems.

If effective internal IT systems within a company can transmit the necessary information to an external partner's system, to allow them to fulfil their functions, and receive data back, then this standardised and 'automated' flow of information and of management control enables complex production and distribution processes to be optimised across the whole value chain.

Through this internal and inter-firm IT investment, problems can be avoided and higher returns from the outsourcing process can be achieved. For instance, management costs can be kept to a minimum, but more importantly companies can gain from reducing other costs. Each time a physical good is handled, there is a marginal cost. If information can be used to reduce the number of times a product is handled, or to reduce the need for inventory, the cost savings can be significant. For example, direct shipment from a contract manufacturer to the customer is simpler and faster than having the product change hands several times, but it requires the complex information flows to trigger and record physical actions and financial transactions.

*Using information  
to reduce the  
product handling  
can deliver  
Significant costs  
savings*

*Once production is complete, Premier simply contacts its third party logistics company with the details, and the products are picked up (from overseas manufacturers or the UK operation) and either shipped directly to customers 'local' to the production, or to UK warehousing, from where they are subsequently distributed worldwide. Through SYSPRO's goods in transit controls, multiple warehouse functionality and the supply chain transfer facility, to which the third party logistics company has direct on-line access, Premier maintains full visibility, and remains in control of all logistical movements and stock transactions.*

Major improvements in supply chain management can be realised if firms are linked electronically, as originators and outsourcing partners can establish a more complete picture of supply and demand. They can use real-time information moving up and down the value chain to better tap into external economies, and so drive production in response to demand, and when necessary to manage demand in response to production capacity.

However, to achieve this requires proper planning before embarking on any outsourcing programme. This is because EDI is expensive and limited in capabilities and creating closer links between separate firms' internal IT systems often requires costly customisation. Therefore, selecting suppliers with similar systems - or helping outsourcing partners to implement new systems - is a way forward.

## Case examples

**BLP**

**Amot**

**Premier Percussion**

**(Company X)**

**McGUFFIE**  
**BRUNTON**

Baltimore House, 50 Kansas Avenue,  
Salford Quays, Manchester M50 2GL

Tel: 0161 876 4498 Fax: 0161 876 4502

[www.mcguffie.co.uk](http://www.mcguffie.co.uk)