Managing Logistics Outsourcing Relationships

Why 3PLs need to be embedded in your business

A KANE Viewpoint

Current models for managing outsourced logistics relationships limit the ability of third-party logistics providers (3PLs) to drive the innovation that their customers crave. Changes are needed that allow 3PLs to become strategically embedded in their customers' organizations, with full access to long-range business and supply chain plans. Empowered by this information, 3PLs can move beyond tactical execution to fulfill the more important and powerful roles of supply chain innovator and change agent.

Market pressures over the last few years have put CPG and other manufacturers under pressure to find new, more systemic ways of cutting costs while keeping inventories at the right level and delivering great customer service. These companies have become increasingly reliant on 3PL services to drive inefficiencies out of complex supply chains. So far, that's worked out pretty well. A vast majority – 89% – of 3PL users surveyed for the 2010 "State of Logistics Outsourcing" study reported that they viewed their 3PL relationships as generally successful.

But with many of the quick and easy changes long since explored and exploited, the emphasis now is more on innovation to drive performance and savings gains. It's here that manufacturers say 3PLs are coming up short. In the same study, only 68% of shipper respondents, versus 95% of 3PLs, said that 3PLs provided shippers with new and innovative ways to improve logistics effectiveness. This disconnect between customer and provider is referred to in the report as "the innovation gap."

Manufacturers are right to demand value-driving innovation from their 3PL partners. But the root of the problem isn't a lack of ideas; it's a lack of context to drive new thinking.

A 3PL's experience across many different customers and supply chain scenarios provides valuable perspective when examining strategic alternatives. Unlike outside consultants, who might also have strategic expertise, 3PLs are already operating in and around the customer's business and understand the operational implications of wider decisions. But manufacturers often don't leverage this understanding and limit 3PL involvement to pure execution, not planning and problem solving.

Let's take one tactical example. The marketing department of a large CPG company designed a point-of-purchase display that looked great but took 28 hours to assemble in the distribution center and was inefficient to ship. The company's 3PL suggested changes that maintained the basic look of the display

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but cut assembly time in half and allowed for more efficient loading onto trucks for better cube utilization. The suggestion saved hundreds of thousands of dollars. But these dollars could have been saved from the outset with a $0 investment by inviting a 3PL representative to participate in early-stage meetings.

Lack of 3PL involvement in planning is not limited to tactical issues like display building. When it comes to future business planning and supply chain strategy, 3PLs are too often outsiders looking in. The customer's assumption: 3PLs can help determine HOW to implement, but not WHAT strategy makes sense given the business objective.

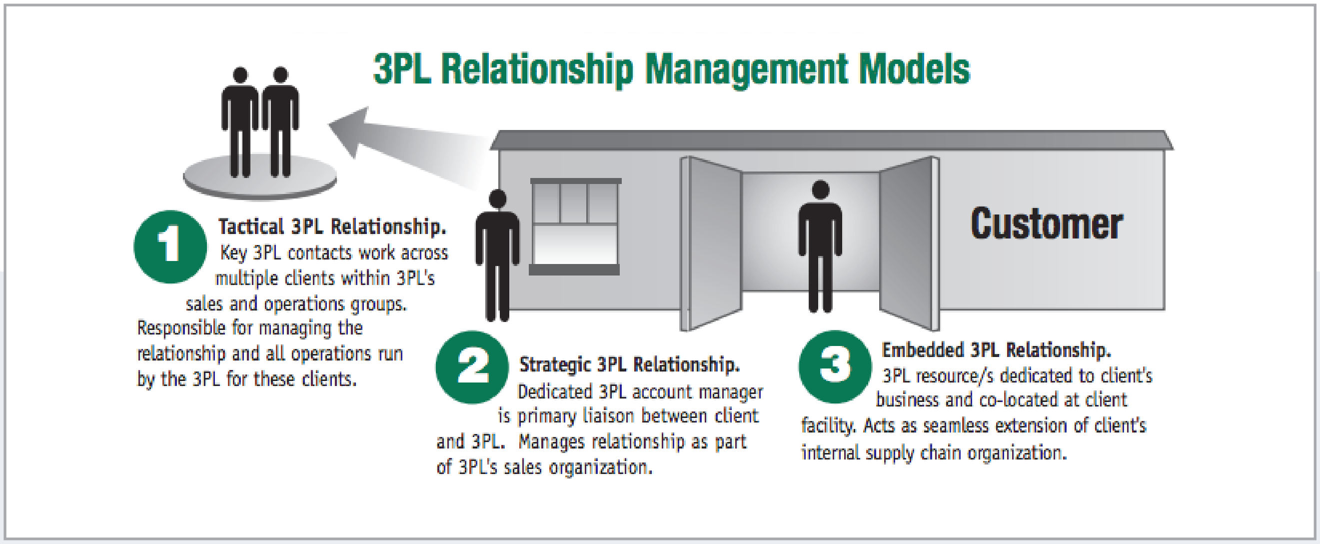
According to Dr. John Langley, of Penn State's Supply Chain and Information Systems Department and Center for Supply Chain Research (CSCR), and the lead researcher on the State of Logistics Outsourcing study, "Our research with 3PL users is clear that many companies want their 3PL partner to be more proactive in suggesting strategies and ideas that reduce costs and improve service. But the best ideas will spring from a clear understanding of the client organization's direction and strategic priorities. To achieve the best results, firms that outsource operations must be willing to let the 3PL in on future plans and strategies to enable the 3PL to provide the best service possible."

What's Needed is a New Relationship Management Model

Some things are obvious. For instance, there are traffic jams in Atlanta because, in the last 20 years, the Atlanta Metro area's population has increased from 2.9 million to 5.7 million, while road infrastructure has not increased at nearly the same pace.

The same type of blatant disconnect is driving a rift between shippers and 3PLs. Customer reliance on their 3PL has grown, but the relationship management model has not changed to address this increased reliance.

For large strategic accounts, most 3PLs have operations people dedicated to running a customer's day-to-day business, but few actually have an operations resource 100% dedicated to managing the relationship and understanding the business.



Instead, they have dedicated "strategic account managers," or SAMs, who typically report up through the 3PL's sales organization. As such, their objectives are 3PL-centric: retention and growth of the account. Ideally, the SAM's objectives should mirror those of the customers they serve.

The broad goal of SAM programs is closeness to the customer – a good thing. The theory: closeness leads to access, access leads to information, and information leads to more opportunities to add value through new services. But close is still too far. The goal of the 3PL should be to work hand-in-hand with the customer to develop the strategy, not just to get close enough to hear about it.

The SAM program is an old model that is no longer effective

in managing today's strategic outsourcing relationships. Manufacturers are demanding innovation from their 3PL partners, but the current relationship and contract structure keeps 3PLs at arm's length – and at risk. Until 3PLs participate in supply chain strategy as part of the customer's internal team, they will lack the context to feed the idea engine and close the innovation gap.

The Solution: Get Inside

What's urgently needed is a deeper partnership that allows the 3PL to participate in supply chain management at a more detailed level, and earlier in decision-making processes. The manufacturer needs to invite its 3PL partner to become embedded as a collaborative team member, not just a resource brought in to solve day-to-day problems. That means locating on site at the customer's offices and working as a seamless extension of that customer's supply chain organization. (See sidebar: The Basics of an Embedded 3PL Model)

The "embedded 3PL" concept is really the relationship management component of a larger outsourcing concept called "vested outsourcing," based on research conducted by the University of Tennessee Center for

The Basics of an Embedded 3PL Model

The basic idea of an "embedded 3PL" model is to install a representative of the third-party logistics provider (3PL) inside the customer's supply chain organization in order to gain the insight required to develop and implement innovative strategies to improve supply chain performance and save money.

Who pays for this dedicated resource to manage the relationship? This is a 3PL investment. But the embedded 3PL model also requires significant investment from the customer, who must involve the 3PL in relevant planning and strategy meetings and make sure the partner clearly understands the company's supply chain goals and strategies.

Where is the embedded resource located? Ideally, at the customer's location, where the 3PL contact can easily work with those charged with crafting logistics and supply chain strategy.

Whose interest does the embedded 3PL resource represent, the customer's or the employer's? In the long run, BOTH. But the focus of the embedded resource is to serve the customer's interest by leveraging the resources within the 3PL organization to address that customer's biggest challenges.

Who owns the savings from 3PL-driven innovations? The embedded 3PL concept assumes a level of uncompensated investment from the 3PL. In exchange, there would be both a risk-share and gain-share component to the contract. Contract details would be customer-specific, but the intention is for both parties to have "skin in the game" as they partner to drive supply chain innovation that creates competitive advantage.

Executive Education. In vested outsourcing, the contract between a client and its service provider is structured to deliver mutually beneficial financial gains. Outsourcing providers make more money when they achieve the client's desired outcomes. Vested outsourcing leverages the service provider's expertise by allowing them to determine the best possible way to solve the customer's problems.

Kate Vitasek, co-author of Vested Outsourcing: Five Rules That Will Transform Outsourcing, has worked on several vested outsourcing projects. Says Kate, "An onsite relationship manager 'embedded' within the client is a good start for building a stronger relationship and can lead to better results from the 3PL. There's a fear factor that must be overcome in relation to sharing forward-looking plans. But companies that have invested to become more strategically and structurally aligned with their partners are seeing the benefits of that investment."

Brain Drain

A shift to an embedded 3PL relationship management model comes at a good time. During the latest economic squeeze, manufacturers have experienced a "brain drain" of sorts. Staff reductions, often with emphasis on dismissing experienced workers, resulted in a huge loss of insight built up over the years. 3PLs have a great deal of accumulated insight of their own because of the length of time they've spent dealing with a range of supply chain challenges. With the loss of precisely this kind of knowledge internally, manufacturers need the expertise of 3PLs more than ever.

How might manufacturers make better use of 3PL brainpower? Today, 3PLs are often on the receiving end of customer mandates to reduce operating costs in a distribution center or across a distribution or transportation network. In an embedded 3PL model, where the 3PL shares in the financial gains from value-driving initiatives, the 3PL might invest engineering resources to explore not only incremental improvements but a complete shift in distribution strategy. Rather than operational changes that may yield a 3% annual savings, the 3PL might recommend an overhaul of the distribution model to generate 5 or 10 times that savings. Current relationship and compensation structures stifle that type of innovative thinking.

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What Changes Does An Embedded 3PL Model Require?

A shift to an embedded 3PL model requires significant shifts in both thinking and compensation.

Contract terms need to change since the 3PL is committing uncompensated resources to managing the relationship and investing in innovation. Gain-sharing agreements need to become more the rule than the exception.

According to industry consultant Richard Armstrong, Chairman of Armstrong & Associates, "You can talk all you want about trust and good communication, but the relationships still need to be governed by good contracting. Where 3PLs make investments to improve supply chain efficiency, they need to realize a return on that investment and the contract must allow for that."

While manufacturers must be prepared to share the financial gains from 3PL-driven innovation, there should be plenty to go around. A 3PL with a view into the whole supply chain has a broader scope from which to carve out savings. Getting beyond tactical operations, where most of the inefficiencies have already been wrung out, opens up savings opportunities to previously untouched parts of the supply chain.

Contract lengths may also warrant evaluation in an embedded 3PL model. With gain-sharing, the 3PL needs time to understand the opportunities, generate ideas, implement the ideas, and measure savings over time in order to realize a return on any investment they decide to make. This can be difficult in the context of a three-year contract, so term lengths may influence a 3PL's decision to invest.

Another needed change is that manufacturers must begin to openly share forward-looking information about their business and supply chain strategies. They will need to trust their 3PL partners with proprietary information, and this can be a difficult shift. Manufacturers operate in an increasingly competitive environment, and business processes often constitute competitive advantage. Most 3PLs have multiple clients that can include fierce rivals. Trusting a 3PL with sensitive data about the intimate workings of the company may be scary. But trust is a necessary prerequisite to aligning customer and 3PL resources to attack the ultimate goal of turning the supply chain into a competitive weapon.

Some manufacturers want the added value a 3PL can offer but fail to recognize the connection between trust and innovation. In a recent study on logistics outsourcing, shippers listed inventory management as a business process that would most benefit from more 3PL collaboration. Yet, in the same study, shippers expressed discomfort with entrusting a 3PL with the responsibility of making sure enough inventory is in stock.

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3PLs Also Need to Change

The embedded model is a major shift for 3PLs, as well. To make the embedded model work, 3PLs need to be ready to take on the role of supply chain innovator within a customer's organization. Pre-requisites include:

A change in perspective. While traditional relationships involve the 3PL looking across its own operations and asking "How can I improve?" the embedded 3PL looks across the customer's entire business and asks "How do I drive overall supply chain efficiency?"

Patience. The embedded model assumes an uncompensated 3PL investment in resources that won't have a near-term ROI.

Guts. It's a tough decision to put your management fee at risk with gain-share/risk-share agreements. 3PLs must have confidence in their own ability to drive value.

Brainpower. Having access to the customer's strategies and an open invitation to drive innovation means nothing without the engineering resources to develop, evaluate, and model different logistics strategy options. These resources require investment (see Guts).

Realize the Full Potential of Logistics Outsourcing

Traditional models of managing logistics outsourcing relationships are inadequate to meet today's supply chain pressures and the absolute need for innovation and ongoing cost savings. The better answer is to bring a strategic 3PL resource literally inside the customer organization, with access to that business's long-term strategies, and enact new contract terms that incent 3PL investment and innovation.

The 3PL industry is absolutely ready to fulfill the promise of this more strategic role. Done successfully, an embedded 3PL model can turn the 3PL from an outside engine for supply chain efficiency to an inside engine for supply chain innovation and competitive advantage.

About KANE

KANE helps consumer product companies get retail goods to market efficiently and effectively. We operate in every region of the U.S. and our logistics services include transportation, distribution, packaging, cross-docking, retail consolidation, and people logistics.

Looking for ideas to make your retail supply chain work better?

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