

SELECTING AND MANAGING A THIRD PARTY LOGISTICS PROVIDER BEST PRACTICES

A WHITE PAPER BY THE UNIVERSITY OF TENNESSEE'S HASLAM COLLEGE OF BUSINESS
SUPPLY CHAIN MANAGEMENT FACULTY

JANUARY 2016



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NUMBER TWO IN THE SERIES INNOVATIONS IN SUPPLY CHAIN



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THE SECOND IN THE **INNOVATIONS IN SUPPLY CHAIN** SERIES OF
UT'S HASLAM COLLEGE OF BUSINESS SUPPLY CHAIN MANAGEMENT WHITE PAPERS

JANUARY 2016

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Introduction: What is a 3PL and Why Do Companies Use 3PL's?

What is a 3PL?

Today's 3PL is not your grandfather's 3PL. Third party logistics used to mean transportation and warehousing, but it seems to now encompass outsourcing services for everything. Third party logistics companies have expanded along with the increasing scope of the discipline from physical distribution ('60s and '70s) to logistics ('80s and '90s) to full supply chain ('00s). Examples of modern 3PL functions include:

TRANSPORTATION

- Transportation outsourced to asset-based carriers
- Transportation outsourced to non-asset based brokers
- Private fleet management
- Consolidation
- Transportation cost and service improvement
- Freight bill payment and auditing
- Freight claims and cargo insurance
- Small package services and big box services
- Reverse logistics, green logistics, and sustainability services

WAREHOUSING

- Basic warehouse functions: receiving, storage, pick, pack, ship
- Cross docking
- Order fulfillment
- Yard management
- Shared, multi-client DCs
- Labor recruitment and management
- Returns processing, sustainability services
- Light manufacturing, customization, postponement, and kitting

Today's 3PL

is not your grandfather's 3PL. Third party logistics used to mean transportation and warehousing, but it seems to now encompass outsourcing services for nearly everything.

The scope

of services is expanding well beyond the basics. 3PLs are evolving rapidly from tactical providers of transportation and warehousing services to collaborative partners providing a wide range of products.

GLOBAL SERVICES

- Customs and freight forwarding
- Multi-shipper container consolidation
- Global airfreight
- Logistics operations globally

INFORMATION TECHNOLOGY

- E-commerce: EDI, web portals, and cloud-based systems
- Control towers and visibility tools
- Customer relationship management (CRM): real time visibility to customer data, shipments, and invoices
- Transportation management system (TMS) to ensure loads and routes are optimized
- Warehouse management system (WMS) including all of the latest WMS functionality to ensure optimal DC productivity
- Connectivity with a wide range of applications inside the firm

SPECIAL SERVICES

- Talent acquisition and management from the manager to the hourly associate level
- Omnichannel fulfillment: direct-to-store, direct-to-home, and final mile services, such as “buy online, pick up at store”
- Support for new business development: technology and infrastructure to test new markets
- Backhaul customer acquisition and management
- Supply chain consulting, modeling, and analysis:
 - Predictive analytics
 - Network optimization: supply chain modeling and simulation
 - General consulting
- Basic inventory management, vendor-managed inventory, and physical inventory/cycle counting
- Service parts logistics, including inventory management and replenishment for service parts along with the basic logistics services, and management of expedites, airfreight, and global services for service parts
- Risk free innovation: advanced robotics, big data analytics, drone technology for yard management and warehouse inspections, Uberization to employ excess capacity, 3D printing for robotic parts and other accessories.



That is a lot of stuff! And no doubt, readers can think of more. Admittedly, most of the work of a 3PL still involves the basics. Eighty percent of respondents to the 2015 Third Party Logistics Study used 3PLs for domestic and international transportation, 67 percent customs brokerage, and 51 percent freight forwarding.ⁱ But the scope of services is expanding well beyond the basics. 3PLs are evolving rapidly from tactical providers of transportation and warehousing services to collaborative partners providing a wide range of products. It's no longer possible to use a functional label like warehousing 3PL or transportation 3PL to describe the role of a 3PL.

We haven't mentioned another service: the so-called 4PL that takes on the task of managing a range of 3PLs for the firm and acts as a single interface between the client and its multiple logistics service providers. This is very common in transportation management, but there is a trend for more companies to need specialized services to customize and ship to individual customers. This requires multiple contractors and hence the need for a 4PL to manage them.

3PLs Continue to Grow

The 3PL phenomenon took root over a half century ago, and since the mid-nineties has grown and expanded dramatically. Seventy-two percent of shippers expect to increase their use of outsourced logistics services in 2015.ⁱⁱ Ninety-four percent of 3PLs have increased sales by at least 5 percent annually in 2014.ⁱⁱⁱ

There is a trend toward large 3PLs and mega-3PLs, with significant consolidation occurring in the industry. Today, nearly twenty-five 3PLs have revenue exceeding one billion dollars. Since early 2014, there have been ten major acquisitions by 3PLs totaling \$18 billion due to the need to expand the array of

Companies

expect their 3PL to take direction, respond rapidly, and generate ideas for improvement. They further expect the 3PL to become a strategic partner in efficiently growing the business. Aggressive continuous improvement is assumed.

services offered, expand the geographic footprint, and drive scale.^{iv} The motivation seems to be to achieve scale economies and create a one-stop shop for all 3PL needs. The smaller 3PLs that can offer more customized services are seeing strong expansion as well. A capacity shortage exists in the transportation arena and that limits growth somewhat. These capacity challenges are exacerbated by the driver shortage, and that will not abate anytime soon. However, some in the field feel that the carrier capacity shortage is beginning to turn in the shipper's favor.

Overall the industry is huge. The United States 3PL gross revenue exceeds \$150 billion and is continuing to grow at a rate of 5-8 percent annually. While this far slower than the rate 3PLs experienced from 2000-2008, when revenues more than doubled from \$56.6 billion to \$127 billion, it is still a very healthy industry.^v

Why Do Companies Use a 3PL?

Use of 3PLs is prevalent but not everyone uses them. One large apparel manufacturer felt that distribution center management was an internal core competency. A pharmaceutical company told us they needed to control the security of their shipments, and therefore they kept transportation and warehousing in-house. However most companies selling or producing goods use a 3PL for at least some domestic functions and nearly all global operations. That's because third party logistic providers generate a range of benefits for companies who engage them.

Based on a wide range of interviews with our business partners, companies say they use 3PLs in order to:

- **Reduce current cost:** Cost management is still the number one priority for shippers, and 3PLs often have scale advantage across their total operations. In 2015, shippers who used 3PLs reported a 9 percent average cost reduction, with 5 percent reduction in inventory cost and 15 percent reduction in fixed logistics cost, and an improvement in order fill rates.^{vi}
- **Reduce future cost** by leveraging the 3PL's expertise and technology.
 - The best 3PLs are using tools such as Lean and the latest technology to create continuous improvement.
 - The best 3PLs have a state-of-the-art warehouse management system, transportation management system, and other system capabilities, all of which contribute to greater efficiency.
 - The best 3PLs have state-of-the-art network optimization capabilities to select optimal warehouse locations and better manage omnichannel flows.
- **Improve customer satisfaction,** with accurate order fulfillment and on-time delivery. The best 3PLs have real-time tracking and event management



3PL growth

*and accelerating expectations
do not mean that firms are
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systems to provide real-time alerts when delays occur and are able to respond to change more rapidly and efficiently.

- **Provide global expertise.** This includes documentation, customs, freight forwarding services, duty optimization, global airfreight, etc.
- **Reduce risk.** This includes a range of risks like people risk (e.g. EEOC, workman's comp, union issues, high headcount), environmental risk, and supply chain performance risk.
- **Enable startup.** Logistics and the associated systems, along with labor acquisition, can involve significant capital requirements for a startup operation. Even in an existing company, sufficient internal management resources may not be available to deploy this task. The 3PL can provide this support for a startup operation.

Companies expect their 3PL to take direction, respond rapidly, and generate ideas for improvement. They further expect the 3PL to become a strategic partner in efficiently growing the business. Aggressive continuous improvement is assumed.

3PL activity and accelerating expectations do not mean that firms are employing best practices to select and manage 3PLs. That is our impetus for creating this white paper to provide such a guide. We have access to many companies at the University of Tennessee's Haslam College of Business, both shippers and third party logistics providers. Sixty-five companies sponsor our Supply Chain Forum and many others interface with us in various ways. Based on extensive interviews with a wide range of these companies as well as industry data, we assembled the guide below for selecting and managing your 3PL.



Best Practices for Selecting a 3PL

A successful relationship depends on selecting the right 3PL. To increase the probability of finding the best 3PL for your needs, invest time in two key tasks:

- 1) conducting an internal assessment, and
- 2) developing a rigorous and relevant selection process.

Start With an Internal Assessment

Executives we interviewed said that the biggest mistake they made was not doing a thorough needs assessment before hiring a 3PL, which led in many cases to significant costs and missed opportunities later. A good way to start this process is to go back to the 3PL activities that we listed above, and ask yourself which of these services you need now or will need in the future. For example, do you need special DC services like kitting? Will you need IT services? Will you need last-mile capability?

Next document the *as-is* situation and your vision of the *to-be* process. Do your homework, and evaluate the forces affecting the market, like capacity (e.g. capacity limitations in over-the-road domestic but continued overcapacity in ocean freight) and new disruptive technologies, which we'll discuss later.

Finally document your goals in areas such as cost, service, and new business expansion, and use those factors in considering your 3PL partner.

Next, Plan the 3PL Selection Process

Make sure you have a clearly defined selection process. About a third of firms hire a consultant to help them through the selection process. Often these companies don't have the resources to run the bid, or they haven't done an RFP process in a very long time. Use of a consultant is good if it results in a solid, disciplined process but can turn negative if the consultant prevents communication between the senior level people in the firm and the 3PL candidates.

Make sure you have good data on your operation. You will need accurate information on product type, packaging, palletizing, throughput, product handling and dimensions, and in general anything that impacts the labor content of the operation. This is a "pay-me-now-pay-me-later" situation. If you don't take the time to clean up the data on the front end, you'll likely be surprised with a cost increase once the operation is underway. In spite of that, our research confirms that many, if not most, bids contain bad, unrealistic data.

The biggest mistake made by executives in selecting a 3PL was not doing a thorough needs assessment first, which led in many cases to significant costs and missed opportunities later.



You will want to select several 3PLs to evaluate but not too many. The win rate for a 3PL is under 20 percent, and they are only interested in participating in a process where they perceive a chance of success. 3PLs know if they are just one of a herd, and their focus may reflect that. Base the candidates on your current experience and discussion with your peers in industry. Make sure you communicate any deal breakers up front to avoid wasting a lot of time for both sides. Transparency is good at this stage, so communicate a predefined set of criteria that will be used in the selection process, and know that some 3PLs might pass on a partnership with you.

3PL's pass on RFP's for a variety of reasons:

- The RFP is inconsistent with their expertise.
- It looks like an attempt to get free consulting and put pressure on their existing provider.
- It appears to be a long shot given a long-standing relationship with an incumbent. (One clue is whether the client firm gives advance warning that the RFP is coming.)
- The 3PL is prevented from speaking directly with senior executives in the firm.
- The 3PL's resources are tapped out, without the available manpower to respond properly.

If you are looking to possibly change your 3PL, make sure you determine *in advance* the cost and risk of switching. Often a company will burn a lot of resources walking down this road, and in the end realize that the cost and risk of switching is just too high. This wastes a lot of time for all parties involved.

Before selecting

a 3PL, make sure you have good data on your operation.

You will need accurate information on anything that impacts the labor content of the operation.

Site visits are critical for both sides. It's important for the 3PL to observe the work that will be outsourced, and it's critical for the client to see a couple of 3PL operations to get a sense for its culture and how it operates and manages people.

Selecting a 3PL is a business-wide strategy decision, and the business leaders have to be intimately involved in the process. It should not just be a corporate procurement process. That said, corporate procurement involvement has been a growing trend. One good practice is to have procurement interests represented within the logistics organization. This preserves the use of good procurement practice while also keeping the business closely involved in the process. If corporate procurement does lead the selection process, they should not do this alone. The business owner must also be deeply engaged in evaluation and selection. They'll have to live with the choice and their success will depend on it.

Your 3PL selection plan should include:

1. A CLEAR, FIRM SCHEDULE. Have a clearly defined schedule and stick to it. That way you don't get into an impossible time crunch to meet an implementation date. Allocate enough time for the process and make sure there is sufficient time for face-to-face meetings—that will minimize surprises down the road. A three-week procurement-led bid process is fraught with danger. It's just not enough time to vet a 3PL properly and assess how the 3PL candidate would improve your operations. The more strategic you intend your 3PL to be, the more time you should spend.

2. A CHECKLIST OF 3PL EVALUATION CRITERIA, LEADING TO A FINAL DECISION. You will want to establish your selection criteria and weighting for each element. Once you evaluate the 3PL candidates on those criteria, you will be in a position to make a good final decision. Criteria should be transparently shared with 3PLs in advance as part of the RFP process. This will enable 3PLs that are not a good fit for your business to opt out. It will also help the 3PL focus its proposal on meeting your needs based on what is most important to you.

3. AN RFI PROCESS. For the 3PL candidates, the next step is to generate a request for information (RFI). The RFI process should not be too onerous. If too extensive, a key player may elect not to participate, since the cost of doing an extremely extensive RFI could be prohibitive. Next, you will want to talk with the 3PL's references and visit a facility or two that they manage. At this stage you just need the basics.

4. THE PROPOSAL PROCESS. After reviewing the RFI submissions, you'll want to get a formal proposal for your specific needs. There are four types of proposals that serve different needs. (Note: for more detail on the proposal



process download a free whitepaper, *Unpacking Competitive Bidding Processes* available at www.vestedway.com/tools.)

- **Request for Quote (RFQ).** A Request for Quote is typically used for basic commodities where you are primarily looking to select a 3PL for a standardized service based on price (or their quote). Buyers are typically doing a short-term, non-strategic, spot purchase.
- **Request for Proposal (RFP).** A Request for Proposal is used when you want to compare 3PLs for longer-term needs. RFPs are used when you know what you want to buy and are simply asking the 3PLs to provide a proposal to meet your needs. It's important to be very granular and specific at this point about what you need from the 3PL. After receiving the RFPs, you'll schedule a face-to-face presentation before making the final selection.
- **Request for Proposed Solution (RFPS).** A Request for Proposed Solutions should be used when you are not an expert in the 3PL services that you need and are relying on the 3PL to provide their expertise, not simply perform tasks under your direction. An RFPS differs from an RFP because you do not granularly define the requirements; rather you define your overall needs and ask 3PLs to respond by developing a solution to meet your needs. An RFPS should be used when you want to create a performance-based/managed services agreement.
- **Request for Partner (RFP).** A Request for Partner should be used when you want to select a 3PL to become a strategic partner that will perform integrated or more complex services. A Request for Partner seeks to evaluate suppliers on their overall cultural fit due to the strategic nature of the relationship. Requests for Partners should be part of a Vested Outsourcing Agreement, described in more detail later. (See Appendix A for a description of Vested.)

On the following page is a checklist of areas that you may want to consider in evaluating your 3PL candidates.

Checklist for Evaluating 3PL Candidates

page 1

| YOUR NEED | 3PL EVALUATION CRITERIA |
|---|---|
| A financially stable partner that has been in business a long time and has a great reputation | <ul style="list-style-type: none"> • Are they financially stable, with a long history of successful operation? • Do they have great references? |
| Efficient, high-quality DC operations | <ul style="list-style-type: none"> • Do they use a modern WMS if not yours? • Do they follow Lean principles/have Six Sigma expertise/have ISO certification? • Are they receiving operations ASN-capable? • Do they have good yard management capability? • Do they have a disaster recovery plan? • Do they have ready access to good people resources? • Do they have experience in your industry? • Do they have a demonstrated ability to attract, develop, and retain talent? |
| Special DC Operations | <ul style="list-style-type: none"> • Do they offer cross-docking capability? • Do they have picking capabilities that you may want for your type of products, like voice, pick-to-light, etc.? • Do they offer kitting, light manufacturing? |
| Efficient domestic transportation operations | <ul style="list-style-type: none"> • Can they manage your private fleet/a common carrier fleet/ a contract carrier fleet? • Do they have transportation assets? • Do they have a modern TMS and can it optimize loads and routes? Can their TMS efficiently incorporate various types of fleets (private, common, and contract) into one optimized schedule? • Are they positioned well to deal with the capacity crunch and the driver shortage? |
| Efficient global operations | <ul style="list-style-type: none"> • Do they offer freight forwarding services? • Do they have customs expertise? • Do they have a complete import capability? • Do they have experience in the countries in which you do business? (e.g. Mexico, the world's 14th largest economy and projected to grow to the fifth largest by 2050.) • Do they have C-TPAT expertise? |
| Secure, safe, environmentally sound operations | <ul style="list-style-type: none"> • Do they have SmartWay environmental expertise? • Do they have LEED (Leadership in Energy and Environmental Design) Certification? • Do they have CSA certification? (Compliance, Safety, Accountability certification is a Federal Motor Carrier Safety Administration initiative to improve safety.) • Do they have HazMat capabilities? • Do they have security expertise that meets requirements for your industry (e.g. pharmaceuticals)? |

| YOUR NEED | 3PL EVALUATION CRITERIA |
|--|---|
| Ancillary Services | <ul style="list-style-type: none"> • Do you need lift truck fleet services? • Do you need maintenance services? • Do you want white glove, high touch service? • Do they have cold chain capability? • Do they have high value product expertise: jewelry, art, currency, etc.? |
| Leading information technology | <ul style="list-style-type: none"> • Do they have proprietary WMS or TMS software? If not, do they have a strategic partnership with a best-in-class vendor? • Do they have good availability and response time of tech support during and after normal business hours? • Track and trace capability? • Do they have CRM (customers relationship management) software? • Do they have EDI, web portal, and cloud based services? |
| Leading edge technology (If innovation is important to your 3PL selection) | <ul style="list-style-type: none"> • Do they have experience with robotics? • Drones for yard management? • 3D printing? |
| Support for growth | <ul style="list-style-type: none"> • Can they scale to your projected growth needs? • Can they help you set up the infrastructure and processes to take on new business opportunities? • Can they support omnichannel needs from fulfillment to home delivery? B2B requirements? |
| Strategic expertise | <ul style="list-style-type: none"> • Do they have network modeling and optimization services? (e.g. How many DCs do you need? Where should they be located? And which locations should they serve?) • Do they have warehouse layout and space optimization capabilities? • Do they offer a complete suite of supply chain consulting? • Do they have the capability of direct-to-consumer fulfillment? |
| Innovation (used during a Request for Proposed Solution) | <ul style="list-style-type: none"> • Can they bring the intellectual capabilities and analytical abilities to drive innovation, reducing your overall cost structure and improving services levels? • Are they willing to put skin in the game to guarantee performance levels? • Are they willing to share risks/rewards for meeting overall business objectives (if you are pursuing a Vested Outsourcing agreement—Appendix A). |
| Cultural Fit (used during a Request for Partner) | <ul style="list-style-type: none"> • Do they have overall cultural compatibility and fit with your organization? This is especially important when you want to create a Vested Outsourcing Agreement. |



Best Practices for Managing a 3PL

Once you have selected your 3PL partner, you need to manage them in a collaborative manner that enables both parties to achieve their respective goals.

Once you have selected your 3PL partner, you need to manage it in a collaborative manner that enables both parties to achieve their respective goals. The following list of best practices were identified in interviews with our corporate partners, several 3PLs, and our research on overall outsourcing best practices as part of the Vested Outsourcing work (see Appendix A) we do at the Haslam College of Business.

To effectively manage your 3PL, we recommend you focus on three key areas:

1. Contracting
2. Performance Measurement and Management
3. Governance (managing the ongoing 3PL relationship)

1. Contracting

Good contracting practices ensure that the 3PL contract is fair and balanced for both the shipper and 3PL. Below are several contracting considerations you should incorporate when developing a 3PL contract.

CONTRACT NEGOTIATION

Who should negotiate the contract? Should it be a centralized corporate procurement area? Perhaps, but the executives we talked with believe that corporate procurement is too distant and that ideally there should be a procurement area within the supply chain functional organization. We suggest that procurement and functional owners negotiate the contract together.

While conducting interviews for this white paper, an executive recounted a situation where the corporate procurement group proposed the same contract language they used in buying raw materials. Such a generic start needed to be heavily redlined before it could be used. In another case, a 3PL already had good contract language with a company, but then corporate procurement took over and sent a new boilerplate contract with a lot of non-negotiable terms and conditions. This created a very long, frustrating process. In spite of situations like this, the trend is to have more corporate procurement involvement, and therefore it is incumbent on both sides to learn each other's language. We also heard that contract negotiation is more challenging with the growing number of mega-3PLs.



Regardless of who negotiates the deal, the key is to be sure to follow best procurement practices. (See *Appendix B: Procurement Best Practices* for a summary.)

One last point on contract negotiation: two to three days of face-to-face discussions with the right people can avoid two to three months (or more) of endless back and forth. And, needless to say, it's best to minimize attorneys at the beginning.

CONTRACT LENGTH

The standard and most common contract length is three years, although that might be the time when the 3PL is just hitting its stride. One factor influencing contract length is whether capital must be amortized. A major pharmaceutical company has a seven-year contract with their 3PL due to the special design of the DC operations and the investment required. With a longer contract length, the 3PL can be more comfortable dedicating resources, making investments, and committing to more cost effective building leases. Transportation contracts are of course shorter than DC management contracts. However, data suggests that the timing between transportation bidding cycles is also getting longer. A good rule of thumb is that the contract duration should be commensurate with the amount of risk and/or asset specific investment that the 3PL is taking on.

According to our surveys, 16 percent of 3PL contracts have a one- to two-year term, 51 percent are written for three years, 23 percent for four to five years, and 10 percent were for over five years.

Everyone we

talked with agreed that the relationship between the company and the 3PL needs a balance of accountability and independence.

As one executive said, “Completely hands-on or completely hands-off are both horrible ideas.”

CONTRACT TERMINATION

One-third of all 3PL contracts are terminated within ten years. It is possible that a contract is terminated for failure to meet performance standards, although some firms periodically re-bid contracts to achieve lower cost. But cost aside, in most cases the relationship is ended due to a change in business philosophy, merger, acquisition, bankruptcy, etc. Because contract termination is not uncommon, it is appropriate that 3PL contracts have detailed exit management provisions regarding how they can fairly exit the 3PL relationship. Exit management clauses range from simple terms of convenience for a 3PL operating under a simple transaction-based contract to well thought out exit management plans when your 3PL is operating under more strategic performance-based or Vested Outsourcing (see Appendix A) agreements.

RE-BIDDING

How far can you squeeze on price without doing more harm than good? As mentioned above, before launching a rebid exercise, firms should understand thoroughly the cost of switching 3PLs. In general, something has to change for there to be a sustained price cut. Generally there is no free lunch.

PAYMENT SCHEDULE AND PAYMENT TERMS

Normal payment terms for a 3PL seem to be about thirty days. Some firms who are striving to minimize working capital and maximize cash flow try to push payment terms beyond thirty days; 120 days or even longer is not unheard of. But there is no free lunch here either. Extending payment terms should not be done without a quid pro quo, as it could lead to unintended consequences. In return for longer pay terms, possible offsets are lower payment rates, longer contract terms, or additional business.

CONTRACTS IN THE GLOBAL ENVIRONMENT

Global culture often collides with contracts. One 3PL executive told us that a client in Asia who fully agreed to the terms of the contract interpreted their agreement to mean, “I hear you and expect this agreement will simply be a guideline intended to be changed when pragmatic.”

People in other countries know impatience is inherent in US culture and use that to their advantage. Clearly it's important to understand the nuances of cultures in Asia, Latin America, and Europe when negotiating contracts in those regions.



2. Performance Measurement and Management

Setting up a good set performance management program involves looking at both how you will measure performance (which metrics you will use) and performance management (how you will scorecard and measure the effectiveness of supplier's performance). Ideally identifying the appropriate metrics should be a collaborative process with the 3PL, the first step being a discussion of what success looks like. As one executive said, "In the end, blocking and tackling wins the game, but you have to know the score."

As you define success, you will typically determine service level agreements (SLAs), key performance indicators (KPIs), or even collaboratively managed desired outcomes if you will be operating under a Vested relationship. SLAs are typically metrics that are controllable by a supplier and contractually documented in the 3PL contract, while KPIs and desired outcomes are more strategic and broad in nature.

Regardless of what you measure, metrics should be very clear and include defining how you will calculate each measure, where data will come from, and the standard (or target). It is important that any potential metric be easy to calculate using good, accurate data that both parties agree to. Otherwise, lots of people may be spinning their wheels trying to clarify the metrics a year later.

The Warehouse Education and Research Council (WERC) provides a list of popular warehouse benchmarks for the most common warehouse metrics.

You may decide to financially link incentives or penalties to the SLAs (discussed later in more detail). Research has shown that incentives—rather than penalties—generate better supplier outcomes. Penalties can be counterproductive if each side spends a lot of time justifying or defending against the penalty as opposed to looking for ways to mutually improve performance.

Once you have defined your metrics, you should develop a scorecard. A scorecard is typically the combination of SLAs (contractually obligated metrics) and KPIs that measure the overall success of the business and relationship. Keep the metrics on your scorecard simple and limited. Some of the most common metrics used on 3PL scorecards are shown in the table below.



| CATEGORY | KPI EXAMPLES |
|-------------------------------|--|
| Productivity/Cost | DC productivity Transportation cost per unit, per cube, per pound Total delivered cost Put away time: dock to stock |
| Accuracy | Inventory record accuracy Order fulfillment accuracy Shipment accuracy Billing accuracy |
| On Time/Service | On time shipment On time delivery Reason for late delivery Customer satisfaction for DCs served |
| Quality | Damage/Loss |
| Safety | Lost time accidents CSA scores Internal assessment |
| Innovation and responsiveness | Number of ideas and value of those ideas brought forward by the 3PL Responsiveness to problems Innovative approach to problems |
| Ease of doing business | Subjective ranking Accessibility to 3PL's senior executives |
| Compliance | Environmental Electronic: EDI, ASNs |

Once you have defined the metrics, you should define how you will manage 3PL performance. A strong measurement system serves to provide timely feedback, so management can take corrective action and drive superior results. Great performance is almost always the result of a collaborative effort. Surprises kill performance. As such, a good performance management program should include a proactive problem-solving and dispute-resolution process.

Shippers and their 3PL should strive to collaboratively find the root cause of any service failures and make sure they are permanently resolved. It's important to avoid assuming that poor performance is entirely the fault of the 3PL. In fact, a number of companies admitted to us that they held 50 percent or more of the blame.

The more strategic your 3PL relationship, the more formal your performance-management program should be. Robust performance management programs:

- Measure end-to-end performance against KPIs and desired outcomes, not just service level agreements (SLAs)
- Provide a mechanism to measure the overall health of the relationship and effectiveness of transformation efforts
- Enable the parties to score performance to identify any shortfalls.

When establishing the goals, it's critical to make sure all of the shipper's functional areas are aligned. One 3PL found that they were meeting all of the KPIs, but the compliance department in the client firm had a problem, creating a very frustrating situation. All stakeholders in the client company need to be aligned on the KPIs.

Communication of the performance data with the 3PL is crucial. The best companies share results when they become available through a web portal and have formal face-to-face reviews at least quarterly.

Some companies rank order the performance of their third party carriers, or their third party warehouse managers from best to worst on a number of criteria. Although this is unfair since such a ranking is never apples to apples, it is still motivational. No one wants to be at the bottom of such a list, and anyone at the top wants to stay there, regardless of how fair the ranking is.

3. Governance (Managing the Ongoing 3PL Relationship)

Proper governance of a 3PL relationship is critical. Good governance with jointly established policies, processes, and decision rights provide a shipper and their 3PL with a blueprint for consistent, flexible, and transparent management both for the day-to-day operations and for continuous improvements and enable them to work together effectively.

Everyone we talked with agreed that the relationship needs a balance of accountability and independence. As one executive said, "Completely hands-on or completely hands-off are both horrible ideas."

Micro-management in 3PL outsourcing is a problem. Most of the people we interviewed said that it is hard to have two GMs in the same building. On the other side, even the 3PLs don't want a completely hands-off relationship. They know that to get the maximum benefit and truly optimize performance, the client firm must be involved.

The key to good governance is to collaborate and reach an agreement on management style that respects the culture and strengths of the client firm and



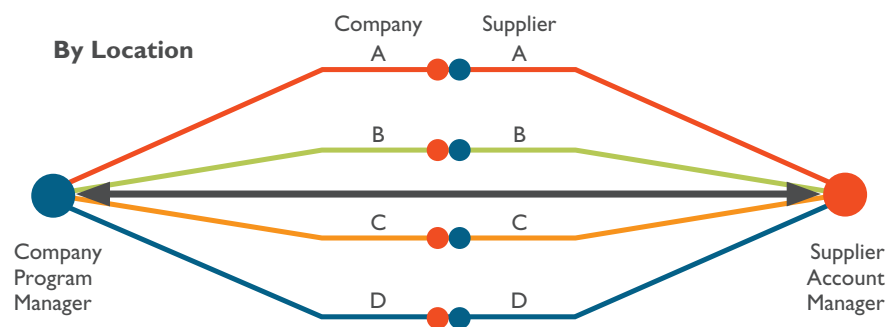
the 3PL. As you develop your governance mechanisms, think of how you will manage the overarching relationship, continuous improvement, transformation management, and compliance/regulatory requirements that are essential to your success. Each area is discussed below.

RELATIONSHIP MANAGEMENT

Relationship management is about operational alignment, the process for arranging the people and systems to manage the outsourcing agreement. Good relationship management promotes free-flowing communication between operational groups, their managers, and the companies' executives.

Relationship management starts by creating the governance structure that will describe how individuals within your company and the 3PL work together. Think of this as a cross-company organization chart. Less strategic and tactical 3PL relationships will often just have one key interface where an account manager will work with your company's operations person. More strategic relationships should increase the number of interfaces and include top-to-top interaction of executives that drive the overall strategic alignment of the partnership. In these relationships, you may have your finance person aligned with a finance person from the supplier, or an IT person aligned with an IT person. This concept is referred to as a "reverse bow-tie" because it enables larger and more strategic supplier relationships to have streamlined communications.

REVERSE BOW TIE ALIGNMENT



The important thing to remember is that your governance structure should be tailored to the needs of your relationship. The larger and more complex your supplier relationship, the more effort you should expect to allocate to governance.

Relationship

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Establishing a regular cadence of communications is an important aspect of the governance structure. It puts in place a practical mechanism to help the parties manage the business. Typical communications include regularly scheduled conference calls and team meetings. Face-to-face formal quarterly business reviews are the grease for the wheels. The most successful teams have formal mechanisms (and informal protocols) for talking on a daily, weekly, monthly, quarterly, and annual basis.

Think about how to maintain the relationship over time. Mutually identify a limited number of key personnel for both parties, and try to maintain that group for a reasonable period of time. Discuss a process for accommodating key personnel changes on both sides.

CONTINUOUS IMPROVEMENT OF THE RELATIONSHIP

It is important for more strategic relationships to include philosophies for driving overall continuous improvement and transformation. More strategic relationships should identify how the parties will jointly identify, implement, and fund innovation efforts. The best shipper and 3PL relationships have formal mechanisms for identifying, vetting, approving, and managing continuous improvement and innovation ideas. These mechanisms are often formally linked in the performance-management program and the supplier's compensation.

SPECIAL CONCERNS AND EXTERNAL REQUIREMENTS

This element of governance pertains to how you will manage special requirements and regulatory protocols with your 3PL. It is important that you and your 3PL clearly understand and adhere to special requirements and regulatory protocols that are essential for your business.

For instance, a 3PL managing chemical distribution globally for a company may necessitate special governance provisions outside the normal manufacturer-supplier relationship. Other examples include working collaboratively with your 3PL to develop a mutual understanding and protocols for IT, finance, and order management interfaces. If you operate in an industry with heavy regulatory requirements, you will need to develop collaborative approaches and mechanisms with your supplier to ensure regulatory compliance.



Future Trends

When we talked with a wide range of subject-matter experts for this white paper, they mentioned some current trends that they believe would continue for the foreseeable future.

- There will be more incentive-based contracts (gainsharing/painsharing and Vested Outsourcing agreements). These are discussed in more detail below.
- The major merger and acquisition trend in the 3PL industry is going to spawn the emergence of small niche players, as it has in the software industry. In this environment, there will be greater opportunity for focused capability players.
- More risk will be transferred to 3PLs (headcount, environmental, supply chain performance, etc.).
- At the end of the day, it's going to be about getting the best people. There will continue to be a major competition for the best and brightest talent.
- Corporate procurement will be more and more involved in the outsourcing process. It is incumbent on both sides to work hard at developing a mutual understanding and trust to get maximum benefit from the relationship.
- Innovation will increase. The wide array of technology and the rate of its adoption will become more and more important in defining how we do business. This will range from omnichannel support to disruptive technologies (e.g. drones, 3-D printing, Internet of things, driverless vehicles, advanced robotics, wearable technology, Uberization, etc.). The professionals we talked with said that future growth projections show e-commerce doubling to over 20 percent of total sales in just three years. Companies will want to partner with their 3PLs to help navigate the maze of a constantly changing business model.
- There will be an emergence of creative ways to fully utilize available capacity, including co-shipping and cohabitating even with competitors.

The Vested Model: A Future Trend

Kate Vitasek has written and spoken extensively on the *Vested* business model for managing a 3PL since publishing her first book, *Vested Outsourcing: Five Rules that Will Transform Outsourcing*^{vii}. (See Appendix A for more information



on the Vested model.) The Vested approach emphasizes mutually defined desired outcomes. Instead of focusing on time and tasks or simple SLAs/KPIs, the partnership changes to measuring success against a set of business priorities. The Vested methodology is anchored around five rules:

- 1. Focus on outcomes, not transactions.**
- 2. Focus on the what, not the how.** Don't micromanage. Trust the 3PL to find a way to deliver the business priorities.
- 3. Have clearly defined and measurable outcomes.** This needs to be done collaboratively with the 3PL and the company developing the outcomes together.
- 4. Implement a pricing model with incentives to optimize the business.** Provide the 3PL with the tools and authority to make strategic investments to optimize the business.
- 5. Establish an insight, rather than an oversight governance structure.** Make sure the governance process instills transparency and trust.



Conclusion

In this white paper, we set out to provide a summary of the best practices for selecting and managing a 3PL. We hope that you can use this material as a checklist when you address these critical areas.

To select a 3PL:

1. Start with an internal assessment of your current and future needs
2. Develop a detailed plan for the 3PL selection process
3. Review the checklist of 3PL capabilities as you develop your RFI/RFP
4. Evaluate, interview, and select.

To manage a 3PL:

1. Develop the contract using the approach discussed earlier. Make sure you use the right proposal approach based on the type of 3PL relationship you are trying to create.
2. Select the appropriate metrics based on the objective of your 3PL relationship and develop a scorecard. More tactical relationships will simply use task-based SLAs, while more strategic relationships will adopt KPIs where the shipper and 3PL are working in a highly collaborative manner to achieve mutually defined desired outcomes.
3. Establish and implement governance mechanisms to effectively manage the business with your supplier. Remember, the more complex and strategic the relationship the more effort you should put into governance.

For those who have the basic blocking and tackling down, consider shifting to a more sophisticated performance-based outsourcing agreement or Vested agreement.

If done correctly, the partnership with your 3PL can truly be a source of competitive advantage for your firm.

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End Notes

- ⁱ C. John Langley Jr., PhD, and Capgemini, “2015 19th Annual Third-Party Logistics Study,” (white paper, Korn Ferry Institute, Oct. 23, 2014).
- ⁱⁱ C. John Langley Jr., PhD, and Capgemini, “2014 18th Annual Third-Party Logistics Study,” (white paper, Korn Ferry Institute, Oct. 23, 2013).
- ⁱⁱⁱ Joseph O’Reilly, “2015 3PL Perspectives,” *Inbound Logistics*, July 2015.
- ^{iv} “The Growth of 3PL Mergers and Acquisitions,” Patrick Burnson, *Supply Chain Management Review*, posted September 28, 2015 http://www.scmr.com/article/the_growth_of_3pl_mergers_and_acquisitions.
- ^v “Big Deal – 2014 3PL Results and 2015 Estimates” (report, Armstrong & Associates, 2015).
- ^{vi} Langley, “2015 19th Annual Third-Party Logistics Study”
- ^{vii} Vested website, accessed December 2015 <http://www.vestedway.com>

Appendix A: Vested Outsourcing

Vested Outsourcing, or Vested, is a sourcing business model and methodology that enables true win-win relationships in which buyers and suppliers are invested in each other's success. The Vested approach fosters a highly collaborative environment that sparks innovation, resulting in transformation, improved service, and reduced costs.

Vested, explained in greater detail in *Vested Outsourcing: Five Rules That Will Transform Outsourcing* combines outcome-based, shared-value principles and relational economics. In a Vested environment, business partners seek to develop a common solution and a common bond based on mutual advantage to achieve desired outcomes. For example, in a supply chain relationship, a company and its supplier may have a desired outcome to reduce the overall cost structure of operations (not to reduce the margin of the supplier). By reducing the cost structure, the company “wins” and the service provider will “win” with higher margins.

The Vested business model evolved from a research project conducted by the University of Tennessee's Haslam College of Business and funded by the US Air Force to find a better way to outsource. Led by Kate Vitasek, research faculty studied some of the world's most successful business relationships—relationships based on true collaboration that achieved transformational, game-changing, award-winning results.

What the researchers found was that these companies had created a radically different type of business relationship—a relationship that transcended traditional buy-sell transactions that focus on one party “winning” while the other “loses.” They found relationships where both parties worked together towards shared goals to drive innovation, create value, and reward success. While very different from conventional outsourcing relationships, researchers realized that these companies were actually leveraging Nobel Prize-winning concepts from Nash's equilibrium theory to Williamson's transaction cost economics.

Researchers coined this new business model “Vested” because buyers and suppliers are invested in each other's success. The UT researchers uncovered more than just an academic link to successful sourcing and some great case studies; they took their academic and practical learning and turned it into a methodology. The basis for the methodology lies in five rules that align with ten elements that become a buyer and a supplier's commercial contract.

Implementing the Vested sourcing business model requires following five rules:

- Focus on *outcomes*, not transactions
- Focus on the *what*, not the *how*
- Have clearly defined and measurable outcomes
- Optimize pricing model incentives
- Establish an insight, rather than oversight, governance structure.

Appendix B: Procurement Best Practices

It is important that procurement best practices be followed in selecting and managing a 3PL. Below is a list of such practices:

- 1. Personal relationships:** Personal relationships and emotion should not play a role in the negotiation process and 3PL selection. All interaction should be on a professional basis with both parties looking for a fact-based, win/win business relationship.
- 2. Leveraging the buy:** Companies should leverage their scale by concentrating the buy. This should be balanced against the need to manage overall risk. In other words, fewer 3PLs are probably better than many.
- 3. Collaboration, and stability:** 3PLs should be assured that if they remain competitive on all dimensions, they will retain the business. This encourages investment for the long term.
- 4. Scorecards:** 3PLs should be evaluated on an on-going basis using a comprehensive scorecard, which includes items such as safety, on-time delivery, damage, cost, lead-time, and ease of doing business. 3PLs should also be incentivized to bring forward ideas for improvement. Routine reviews of these scorecards should be scheduled. The scorecard should be balanced, so that one variable is not optimized at the expense of another.
- 5. Reevaluation process:** The overall business relationships should be evaluated periodically but not too often. It is important to make sure there are mechanisms in place to prevent another 3PL from buying the business for the short term, and that all attributes are considered (e.g. safety, cost, longevity, and service).
- 6. In-depth analysis prior to selection:** Homework is required prior to a bidding process in order to understand independently what the rates should be in each region of the country.

Appendix C: Gain Sharing

GAIN SHARING

Almost everyone we talked to cited performance-based agreements that incorporate incentives such as gain-sharing arrangements as a key trend. Often referred to as “gain/pain sharing,” gain sharing is often a second phase in the relationship, implemented after it matures to some extent. According to our surveys, about one-third of 3PL contacts have some kind of incentive or gain-sharing arrangement and the remaining two-thirds do not.

Those people experienced with gain sharing believe strongly that a gain-sharing arrangement should be initiated only after the 3PL has demonstrated that it can meet all of the performance requirements expected. Once performance expectations have been met and a good cost baseline (e.g. cost/unit shipped) has been documented, it should be possible to move forward with a plan to share in the cost savings.

While most believe adding incentives to a 3PL contract can be important to a successful 3PL arrangement, getting it right can be tricky to set up and administer. Establishing a transparent baseline is crucial to any incentive-based contract.



INNOVATIONS IN SUPPLY CHAIN

A FINAL NOTE

We hope you have found the material in this white paper helpful and useful. We at the University of Tennessee's Haslam College of Business are committed to translating our top-ranked position in academic research into information useful for practitioners. We believe the real world of industry is our laboratory. It's why we have the largest Supply Chain Forum in the academic world, with over sixty sponsoring companies. We are always looking for industry partners to assist us in this journey. Let us know if you are interested in being one of our valued partners.

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