

Outsourcing technical parts: spending or saving money



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Increasing importance

For standard parts and components it is clear that you buy them from a third party. For the special parts, the parts that are designed especially for you, a strategic decision is at hand: do you buy them or do you make them. When you enter a strategic relationship with a vendor (for example: he does manufacturing engineering for you also), we call this outsourcing.

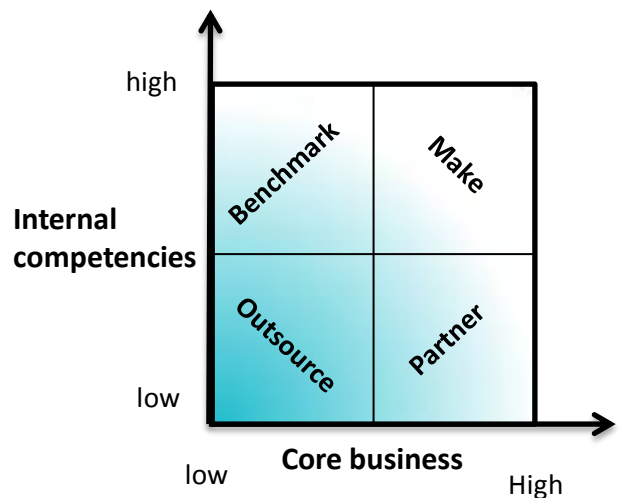
Nowadays outsourcing has become a worldwide business from Eastern Europe, Brazil up to China and India. Just think about your smart phone, made in China! Motives for this on-going process are: costs, flexibility and the ability of a company

to focus its people and resources. Despite the trends there are still doubts about the effectiveness of outsourcing. How do you know for sure you don't pay too much for your outsourcing? Who in your company is in charge of this substantial spend ? Does that person have the skills and experience to determine whether production outside your company is done in its most cost efficient way? In this article we will answer these questions and present a practical solution in particular for equipment manufacturing industry.

Hard to cope

In practice, roughly 30 to 40% of the expenditures of such industry is spent on outsourcing, and this percentage is still growing. Nonetheless, a structural approach of outsourcing is not common in the equipment manufacturing industry, Reasons for this lack of interest are found in:

- ✓ For engineered parts and modules there is not a price list to agree upon, unlike standard parts or products like ball bearings or electrical motors;
- ✓ These parts require both commercial and technical expertise to buy. Often, buyers are engineers that have learned some procurement skills or purchasers with only basic manufacturing expertise.
- ✓ Existing procurement theories are useful for buying standard parts but do not include solutions to deal with technical parts (like category management)
- ✓ Successful outsourcing takes time and experience and therefore is not very attractive for the young potential within the procurement department.



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What is happening in daily practice?

Quotations are sent to two or three suppliers, based on technical drawings. These suppliers are selected on criteria like capacity and experience. The lowest bidder will receive the order. Is this the best supplier, or did he just needed the job? As a result of this ad-hoc way of outsourcing the following will occur:

- ✓ Overall high prices due to lack of competition and selection of the false supplier;
- ✓ A high level of control costs due to a large supplier base;
- ✓ Insufficient use of suppliers power to innovate;
- ✓ Real supply chain management cannot be implemented.

Often the situation as described is defended with the motto : “sour prices will compensated by sweet prices”. In our opinion a ‘sour’ part is bought at the wrong supplier and if a supplier considers a part as “sweet” you pay too much!

A view on outsourcing

The key of outsourcing is asking somebody else to do something for you, because they are better at than you. If not, you better do it yourself! To be better, as a company one has to specialize! The benefits of specialization are economies of scale that results in:

- ✓ Lower costs, a condition for lower prices;
- ✓ Improved quality;
- ✓ A higher delivery reliability;
- ✓ More innovation aimed at better and cheaper solutions.



And now the real challenge: “how to find the specialist for your special parts and products to be outsourced?” We can help you to meet this challenge, based on our approach, practical know how and experience.

Our approach

The approach combines strategy and content. The only thing you have to add is a team of your people with a ‘can do’ mentality, prepared to work together and sufficient knowledge about the products they are buying. Our approach is based on modern category management combined with extensive knowhow of production group technology. It is called *Product Group Management*.

1. Classification of the article base within product groups

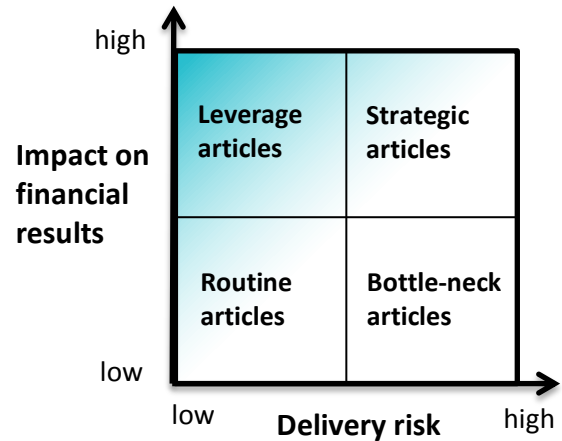
Product groups are defined as a result of product and technological characteristics. As one example one could define a product group like “simple sheet metal with limited welding”. Suppliers with a range of lasers and bending machines are better equipped for this group than suppliers with a broad range of welding techniques who are the buying their laser parts.



Beware of an extensive classification by defining too many product groups. According to the rule of Pareto a few product groups will already contain as many as 80% of the articles.

2. A procurement strategy per product group

With reference to the Kraljic matrix, there are four generic procurement strategies for each of the segments, as illustrated beside. We will focus on the *Leverage articles*, simply because our first aim is to save money. A bench mark strategy is preferred for this segment. For the segment strategic and bottle-neck articles different procurement strategies has to be chosen, with a strong focus on risk reduction. Standardisation of order processing is the key element in the strategy for the routine articles.



3. Investigate the market and launch a tender per product group

As in sales, market search in procurement is also the first step to success. One important aspect of market search we like to address using an example of the behaviour of German beer drinkers. People in Germany always drink beer of a local brand, made by a brewery nearby the church tower of their own home town. We like German beer, however market search should not be conducted only in a



small area surrounding your location. There is a whole world beyond the horizon, with a lot of suppliers worthwhile for your company. To create a short list of suitable suppliers we developed a tool named *Supplier Passport*. Like an ordinary passport it captures all important suppliers' features and characteristics like their machine base. The tender to be launched includes only the 20% fast movers in a specific product group. These fast movers capture approximately 80% of the total costs.

3. Select the specialized supplier

It is essential to have a team of people evaluating the results of the tender as well as the supplier passports of the participating suppliers. Advantages to have a team set up for the selection process are evident, but still often ignored. Just think about matters like:

- ✓ Different views based on different disciplines and interests;
- ✓ More objective;
- ✓ Last but not least, more support in your organisation!

A benchmark tool to be used in the selection process is very helpful to make the decision clear to management and other stake holders. We prefer a decision making process based on consensus within the selection team. In the end, supplier's willingness to accept a transparent determination of prices is decisive for final selection.

4. Agree to a parametric price model

What to do with the new articles not included in the tender? Off course, these new articles have to be bought? at the specialized supplier for the particular Product Group. For new articles the price is not

agreed upon. Therefore, a parametric price model is necessary to ensure the price level displayed in the tender is also used for pricing new articles. Remind you, we are not talking about standard parts, so a price list is not possible. A parametric price model will capture the contractual agreed price levels. The price model contains a set of formulas with the product group characteristics as the main parameters.

5. Implementation

Last but not least implementation will start. Everyone is pleased with the outcome of the process till so far, the new supplier as well as the company. However, results for both sides will only be accomplished after successful implementation. We would like to bring your attention to the following risks in the implementation process as:

✓ *The big bang*

The ink of the contract still wet, all articles of a specific product group are transferred at the same time to the selected supplier. As we look to it, the big bang scenario has a success hardly a chance of success. The new supplier does not have time and opportunity to conduct thorough manufacturing engineering for all this new articles. In such a rush also no attention can be given to small details, only known by a few people and never documented in drawings. It takes time to find out such details, but sure it will pay back!

✓ *Waiting too long*

The contract is signed, but there is no action in transferring the existing articles from old suppliers to the new supplier. This situation often occurs when people in your company worked for a long time with the old supplier and it is hard to say goodbye for them. Remind you, that the old supplier has always been paid for his services. So it is not regretful, it is just doing business in a proper way!

✓ *No response to suppliers suggestions for improvement and innovation*

This behaviour is really a show stopper! A specialized supplier is more acquainted to the manufacturing processes than your engineers. So if there are suggestions to improve, respond to it! This was the attitude you asked for in your selection of the particular supplier. Nobody, in particular your supplier, understands the reason: "we don't have capacity in our engineering to implement changes". Are you not interested in saving money anymore, after a process of intensive selection and negotiation?

Product Group Management, how much to gain?

Eating is the proof of the pudding! We have implemented product group management at several companies, large and medium sized. Based on these experiences we are able to promise you results in terms of:

- ✓ Price reductions over 10% compared to Western European price levels. With global sourcing these price reductions will easily rise to 30% and even 70% in some cases.
- ✓ Improved products designed for manufacturing, will reduce the costs with another 20% to 25%. This will happen only if you use the innovative strength of your specialized supplier!

An additional advantage of product group management, beyond saving money, is found in reduction of complexity of the supply chain. This will enable the following improvements in your supply chain:

- ✓ *Real supply chain management*
Fewer suppliers means reduction of complexity in the supply chain. In a simple chain it is much easier to update your supplier with the latest information about changes in your market demand in terms of volume and mix. After all, this is all what supply chain management is about!
- ✓ *Delivery of assembly kits or modules*
Less complexity in the supply chain and a smaller supply base enables a simple logistic. Now suppliers are able to deliver complete kits of product group parts to your assembly department, preferable already assembled to a module.
- ✓ *Control costs will be reduced*
Costs of controlling a supply chain are difficult to establish, but surprisingly high. What do you think about the costs involved in emplacing inquiries, making proposals, selecting suppliers (in the old way) adapting prices etc. These costs are considerably high and can be reduced to almost zero when both supplier and company use a parametric price model.
- ✓ *Last but not least, delivery performance and quality*
Practice proofs that delivery performance and quality will significantly rise when you work together with specialist suppliers. A 97% delivery performance is possible.

Key success factors for Product Group Management

The key for success is often common sense and knowing your products. We don't want to offend you but common sense is often forgotten. Therefore we will remind you for the following success factors:

- ✓ *How to involve in and out of your organisation?*
Product group management requires a multi-disciplinary approach from the design engineering, manufacturing engineering, procurement and outsourcing department. Participant's competence to have a clear view, despite past experiences, is very important. During the process it can happen that an organisation change is necessary for success.
- ✓ *Strength lies in limitation!*
Do not define too many product groups. Focus on common characteristics instead on differences.
- ✓ *Project management*
While considering the saving potential it is certainly wise to invest in good project management. Project management ensures a short payback time and sufficient support in your organisation.
- ✓ *A parametric price model*
Without this model you cannot agree about prices in the contract. We already mentioned: "subject are technical parts and not standard catalogue parts". Always try to involve the supplier in setting up such a price model. After all he is the specialist and should know how to calculate a price.

Some final remarks from our side. We sincerely hope that reading about Product Group Management gave you a clear insight in the savings and advantages of outsourcing technical parts. Still remains the question as put in the title: "When does one spend money on outsourcing?" Investments in time and money are necessary to implement Product Group Management. You just spend money, if you outsource your technical parts without investing. At first, in a proper approach and afterwards in developing relationships with the right suppliers. Successful outsourcing is the result of finding the right partner and developing a true partnership. Wish you a lot of success with outsourcing in a new way.