THIRD-PARTY LOGISTICS:

THE RATIONALE AND THE RISKS

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Third-party logistics (3PL) is the practice of using an outside supplier (third party) to takeover complete responsibility for the logistical business processes of a company. This could be the inbound logistics of raw materials and components, it may be the outbound distribution of finished goods, or it could be both.

Another variant of 3PL that has been appearing over the last ten years or so is the total outsourcing of the complete supply chain. The company creates material, markets the products, and the 3PL provider does everything else. As an author, this is what Amazon provides to me. I can create the material and they can do everything else. I expect this version of 3PL to grow even faster into the future.

For this article, we will stick with the more traditional approaches, where 3PL is used in a large scale, multiple SKU environment, with thousands of transactions each day.

There are five key areas of consideration for you going into a 3PL arrangement, and one continuously running question that must always be regularly reviewed throughout the life of the 3PL agreement.

Build competitive advantage

3PL can be seen as a cost reduction activity, or it can be seen as a way to sidestep investment (see next point). The real power, however, lies in the potential to build competitive advantage. If you are looking to build a business case for a 3PL project, work very clearly on how the 3PL solution can lift sales turnover. Every organisation is looking to grow, and the most leveraged way to make more money in an organisation is to grow sales using the existing cost base.

Reducing headcount and the hiring rates of a forktruck fleet are all viable and credible outcomes for a 3PL project. They may not be enough to justify the project in an era where shorter and shorter payback periods are the norm. Remember, the 3PL provider must also make a margin, and that is a margin that you are paying for. If the 3PL project can lift sales by giving the marketing and sales teams a more compelling offer to take to market, then the return on investment in your proposal will be much, much higher.

Focus your 3PL conversation about building competitive advantage, not just cost reduction, and your business case becomes easier to construct and much more compelling for your enterprise.

Much more than just software

One reason that has driven a number of companies to consider 3PL is that their core business systems and skills base are no longer competitive. This issue can be resolved internally, however, the time and capital required may be better spent elsewhere (product development, for example). The 3PL provider can be a 'bolt-on' solution that is faster to implement, and does not involve a large capital outlay such as required for a full-blown ERP platform installation.

The various companies that can perform this work do have specific software applications that usually have some form of proprietary knowledge attached to them. This is one of the reasons you are paying them. The software being capable is an essential prerequisite, however, on its own it is insufficient.

The two most successful 3PL in which I have been involved both had software systems that the client company did not have, could not have developed, and had better use for its funds than trying to develop them. This software was not why these two implementations worked. One of them was actually performing in a fairly mediocre fashion when I first encountered it.

The key to the success of the 3PL operations was the skills and collaboration of the human beings in the key operational roles of both the client and the 3PL business.

Your board may buy the 'brand' of the 3PL company. The project does not work based upon the brand, it will work – or not – based upon the relationship of the key people in both companies, who are charged with making it work.

This group needs to be collaboratively focused on a great outcome for the external customer of the client company, AND be commercially astute for both of their companies. This is not always easy to achieve, and involves the two groups developing a high level of trust. The stereotypical adversarial purchasing approach to this supplier relationship will kill you.

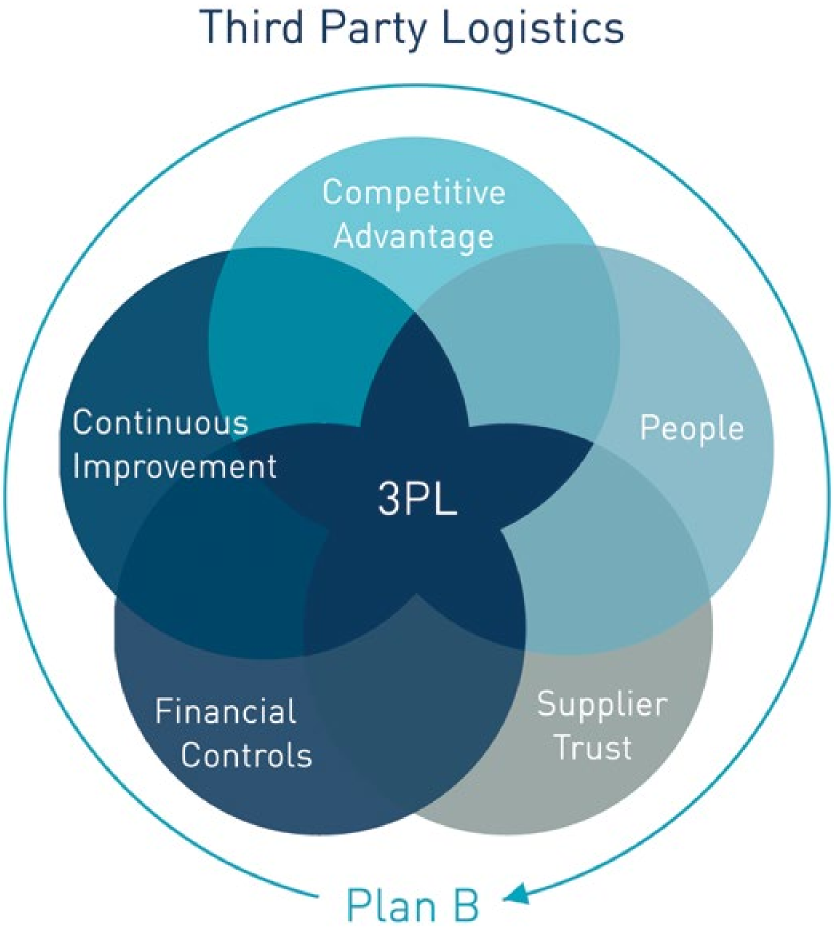
The saving come through continuous improvement, not a one off change

Usually there is an expectation that the initial changeover to a 3PL operation provides some immediate benefits. You no longer have to maintain an obsolete and unreliable forktruck fleet. A few people who have plodded along for years in your logistics operation are no longer there. The reliability of your deliveries (inbound or outbound, or both) is improving. This is just the start.

When structuring your 3PL contract, building into the contract an incentive for both parties to collaborate to improve performance even further is essential. This will require some form of gain sharing and probably an open-book approach to the cost structures and opportunities in both enterprises.

The best 3PL project I have ever been involved in continuously lifted service levels, coped with new products and emergencies, and reduced the cost base by over 10% each year. The approaches used to deliver all of this were not envisaged when the first three-year contract was signed.

The process to identify and work collaboratively on future improvements was. Build continuous improvement into your contract.



Financial controls must be robust

Measurement matters! A feature of 3PL can often be the use of consignment stock, where the customer party owns the goods when they are delivered into the customers facility. In a typical environment where 3PL is worth the effort, this can be many thousands of transactions every day. All of these transactions must be recorded, auditable, checked, and traceable. If they are not, the financial impact on you, the 3PL provider, and the supplier base is mind-bogglingly huge. If you have 10,000 transactions a day – not a large number for an inbound and outbound 3PL project – and 0.1% are faulty, that is 10 failed transactions a day. If each failed transaction has an average value of $250, (a very low assumption,) this builds up to a loss of over half a million dollars over a standard working year.

The data integrity, handshaking and tracking are absolutely crucial.

The trust of suppliers is essential

Your suppliers have been dealing with you for years. Suddenly, there is a third party imposed upon them who will be handling all of the transactions with them, taking control of their product, and providing a point of separation between them and you, their precious customer.

This third party has control of their product. The third party will likely be aware of many aspects of their business. The third party can sometimes have a separate division of its company that directly competes with the supplier. These issues raise many questions for the supplier, especially if they have not been part of a 3PL system before. Typical questions include:

- What does this mean for insurances for loss of product?
- Who has title of the product?
- Who is my contract for supply actually with?
- Who is actually paying me for my work?
- If you go broke, whom do I sue?
- How are quality issues handled?
- How do design changes occur
- Am I about to be told to lower prices again?
- How can I trust them?

The suppliers are critical to your operation. Many of them provide very unique components to you that are not easily or rapidly replaced. Building the trust of a key critical mass of suppliers is essential, and will require a consistent and considerate communication strategy.

Building your 3PL plan so that the supplier's lives become easier should be a key consideration for you. Talk to them about what it is about doing business with you that is difficult, and see if you can improve that situation with the 3PL project. Make sure you deliver on the promises!

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What is your 'Plan B'?

The key question that must be regularly evaluated during the 3PL agreement is what would we do if the 3PL company was no longer here?

3PL services are a specialist field. There are a number of companies offering these services and while the 3PL approach may be attractive to you, are you attractive to one of these companies?

Before you have implemented a 3PL system, you could have always stayed with doing it yourself as you had been. The real conundrum arises when your 3PL provider declines to tender, or the key person who made the 3PL process work so well moves on to another assignment or another company.

3PL contracts usually have an initial period of two, more likely three years, then there is a renewal process. As the deadline approaches, pressure mounts on everyone. If your 3PL partner dramatically increases prices, you may have less commercial power than you hoped because they are already entrenched in your business. If they decline to tender and you have three months left to run on your contract, then it can be terribly difficult to find someone and run a cost-effective and seamless handover. If the original project created a competitive advantage for your company, you do not want to give that away through a rushed and botched implementation.

Once the 3PL provider is in your business, they have the commercial leverage, not you. You need to have a 'Plan B'.

One way to drop the pressure of this deadline-based approach that calms everyone down and gives both parties a chance to smoothly exit if they choose to do so, is to structure your 3PL contract as an evergreen process. What does this mean?

I was involved in leasing some warehouse space and one of my huge concerns was that eight weeks before the end of the lease the landlord could hold a gun to our heads, raise the rent, and if we failed to comply, then force us to vacate. This would have had enormous business continuity risks for us, and would have driven our costs upwards by either paying more rent, or by forcing us to a more remote solution that increased shipping costs.

The solution was to structure the lease arrangement so that each year, the lease agreement 'rolled over' for another year. Effectively, this meant that each party had to give the other party one year's notice of their intention to leave the arrangement. This meant we all had time to move apart without disrupting each other's business.

Consider this option when structuring your 3PL agreement. Make sure you plan your exit approach as carefully as you plan your entry approach to 3PL. Changing providers with little notice is not a recipe for the best commercial outcome and is filled with business continuity risk.

In conclusion, employing a 3PL is widely accepted these days, as are most forms of outsourcing to specialist skills and service providers. There are opportunities to lift business financial performance, the biggest of these is by structuring the 3PL service to create or improve competitive advantage – not just to reduce some transaction costs.

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