I. What Outsourcing Is

During the most recent political season barely a day went by without one candidate or another extolling the evils of outsourcing. Outsourcing is thought to be the primary cause of loss of jobs in the New Economy, with more and more jobs being continually moved to foreign jurisdictions having lower costs and wages. Outsourcing may be this, but it is much, much more. The reality is that outsourcing has been a standard practice in this country, and in all industrialized nations, for hundreds of years.

After the Civil War, the industrialization of the southern United States began. As a result of this movement, jobs began moving from the industrial cities of the North to agrarian regions in the South. For the first time large industrial complexes like Atlanta and Houston began to evolve. In the twentieth century this movement accelerated, with many northern jobs being “outsourced” or moved to lower wage, lower cost regions in the South, leaving behind what has now been dubbed the “Rust Belt.”

In the last quarter of the twentieth century and into the twenty-first century, the never ending quest for lower costs and lower wages has driven many companies to send jobs to foreign destinations. Now, not only is the northern United States seeing an exodus of jobs, but the entire country is subject to this trend. In addition, not only are many manufacturing jobs continuing to be exported, but with the advent of the Internet and the virtual company, even many services are being exported to overseas providers.

Outsourcing is so much more than the politically charged lamentations of the loss of high-paying jobs. Relocation of jobs is but one component of outsourcing. The most basic premise of outsourcing is the desire of a company or an industry to maximize the use of its assets or resources.
Specifically, one must identify what it does well, in an efficient manner and with maximum profits. This is what creates economic expansion, which in turn creates jobs.

During the middle part of the twentieth century, many companies were significantly vertically integrated. An example from the early 1970s can be found in Cincinnati Milling Machine Company, once the world’s largest machine tool manufacturer where the unofficial company motto was “If we don’t make it, we don’t use it.” The company’s products were machine tools, namely, grinding machines, lathes, industrial drilling machines and milling machines. The machining systems were largely hydraulic control systems. The machines were rugged precision instruments housed in a cast iron base. The company foundry made the base. The machine shop ground it to fine precision. The hydraulic shop made the valves, and assembled, installed and calibrated the systems in the machine tools. When computerization took over, the company made its own computers to control the machines, even making and assembling its own circuit boards.

By the mid-seventies, outsourcing was coming into its own, led by the aerospace and automotive industries. GM and Ford stopped making bumpers and began to outsource this and many other components. Boeing stopped making avionics. Large cottage industries began to emerge. By way of example, Strattec Corp., a subsidiary of Briggs & Stratton, is a two hundred million dollar business that makes only lock and key sets for automobiles. In any event, Cincinnati Milling sold its computer business to Siemens, sold its foundry to a Japanese consortium, and closed its hydraulic shop, thereafter outsourcing that which it had previously made.

The impetus for this movement was and is…profits. This is not always driven by the lowest cost/lowest wage formula. A lot of it has to do with recognition of a company’s core technology, an understanding of what it does well and what it does not do well. In the case of Cincinnati Milling, it became apparent that the company would never be in the forefront of computer technology and would never have the volume to be able to drive the costs down on a per piece basis.

When a company identifies its core technology/competencies, or what it offers to the marketplace that distinguishes it from its competitors, it can then begin to consider the advantages and disadvantages of outsourcing non-core aspects of its business.

Even old line companies that never thought of outsourcing in a historic sense now realize that certain aspects of their business have to be outsourced in order to compete in today’s economy. Today, many companies outsource functions relating to their information work flow (often referred to as Enterprise Resource Planning or ERP), as well as other aspects of information technology, such
as network support, computer systems and the like. Likewise, many companies outsource human resource services, payroll functions and financial services functions. As outsourcing of one component of a business becomes more commonplace, it becomes easier to outsource other aspects of the business as well, like key/lock sets for automobiles or computers for machine tools. Once outsourcing takes hold, the retraction of a company or industry to its core base begins. The driving force is and always will be...profits.

All outsourcing does not cost U.S. jobs. Strattec is headquartered in Milwaukee, Wisconsin, for example. Many of the outsource vendors for the American automobile industry are located in the Detroit area. In fact, as these vendors become experts in their own technology they can expand their own markets, as well. Again, as an example, Strattec makes key/lock sets not only for GM, Ford and Chrysler, but also for Mercedes, Volvo and BMW, itself becoming part of the Global Economy.

In summary, outsourcing historically means managing a business in a manner to maximize what it does well, while at the same time minimizing the negative impact of the costs, manpower and inefficiencies associated with what it does not do well--by turning this area of its business to outside experts.

Recently, the trend might appear to be to outsource everything, but in the long run that will fail because a company that does not retain its core technology that distinguished it from competitors does not have any reason to exist. Cincinnati Milling Machine Company is a case in point. The company outsourced itself out of the machine tool business.

II. When Outsourcing is the Right Decision

In order to determine if outsourcing is the correct approach for a particular aspect of your business, you should consider the following:

What is your core business? Define what it is that you do that makes a customer buy your product or service and why that customer keeps coming back. Cincinnati Milling Machine started losing its edge when it outsourced its precision hydraulic control technology. This is what made it stand apart from all of its competitors. It had the most accurate machines in the world. When this technology was outsourced, two things happened that accelerated the demise of the company: (1) It lost engineering control over its core technology and was no longer on the leading edge, and (2) The
superior accuracy of its systems diminished down to commodity status. This permitted the cheaper, less reliable Japanese entries to become competitive and an industry was lost.

Recognize your core business and protect it. Cheaper does not always lead to bigger profits and bigger is not always better.

Is the component or product proprietary to your business? As an example, at one point in the late 1970s, Mercury Marine, the marine engine division of Brunswick Corporation, developed a proprietary starter for its two-cycle outboard engines. Its volume requirement was only 250,000 units per year. During a cost review, it was determined that this volume was insufficient to permit Mercury to take advantage of cost savings associated with a larger scale operation. It was far less expensive to have Delco Division of General Motors make these components since Mercury could play off the buying power of a company making 5,000,000 starter systems per year. This would appear to be a logical decision because of the cost savings. However, the component was only protected by trade secrets; it was not protected by patents. Once the drawings, specifications and operating requirements were released to Delco, the product ended up in the aftermarket and was soon adopted by Mercury Marine’s largest competitor Outboard Marine. Of course, Delco cut substantially into Mercury Marine’s aftermarket and Outboard Marine was appreciative for the inexpensive source of superior starters. Mercury Marine did save about thirty cents an engine in its manufacturing costs, so all was not lost.

The point is that the savings may look attractive, but make sure you know how the decision affects other aspects of the business. Make certain that you are not giving something larger away at the back end of your market in order to achieve what appears to be attractive savings at the front end.

Select the Right Outsourcing Partner. When making the decision to outsource, select the right vendor. When I am asked: “what is the most important attribute of an outsourcing vendor”, I give a simple answer: “Its culture.”

To the extent the vendor you choose to administer payroll, health care benefits or human resources does not fit your culture, it will create problems. If your employees are used to a collegial atmosphere, where a real person answers the phones and tries to deal with their problems on a real time, personal basis, making each employee feel appreciated and needed, then Behemoth Personnel, with its automated answering system and e-mail response to inquiries within three business days,
will create morale problems. Morale problems lead to inefficiencies which lead to more costs which lead to less profit. So in the end, what is saved? This does not mean that certain aspects of your human resource operation should not be outsourced, but take a hard look at the impact it will have on your business. Cheaper and bigger is not always better.

Of course, when you are outsourcing critical components of your product, the culture of your partner is far more important than it may be with human resources. The vendor that gives you the best delivery and price promise will not be of much value if you have to hold up your production line because it is consistently late with deliveries or because product which is delivered has an unusually high reject rate. You should select vendors that have business cultures similar to your own.

The reason your outsourcing partner’s components are less expensive than making it yourself should be because the non-core component you are buying from them is part of their core technology. The cost savings should be tied to their superior knowledge of the component, resulting in increased productivity and profitability for them, which can be passed on to you.

Protect the Family Jewels. There are times when even core technology has to be outsourced. For example, demand may exceed manufacturing capability. Or, even though the component to be outsourced is part of your core technology, you simply do not have enough volume to justify manufacturing the product. A case in point is again Mercury Marine. When Mercury made the decision to incorporate fuel injection systems in its two-cycle outboard engines, it developed a proprietary, patented fuel injector nozzle. Mercury made the decision to manufacture this product in-house because it was so critical to its competitive position. However the costs of doing so turned out to be prohibitive and would have priced the high performance engine out of the market, regardless of its superior performance.

Mercury Marine went to Bosch, one of the largest fuel injector nozzle manufacturers in the world, and by outsourcing the proprietary nozzle to them, Mercury was able to bring the per unit costs down to within competitive range. The reason was simple. Mercury Marine’s maximum annual unit volume was 1,200,000 nozzles. Bosch’s minimum order was 10,000,000 units. By loading Mercury’s volume on top of other orders, significant cost savings were achieved. However, having learned from its experience with the Delco starter, Mercury put in place a strong patent position and comprehensive non-compete provisions in its arrangement with Bosch. This added a
premium to the unit costs, but the protection of the marketplace was well worth it. Mercury Marine
had the only fuel injected two-cycle marine engine for about five years.

It is important to obtain protection of core technology by obtaining patents, and copyrights
where applicable, and by including enforceable confidentiality provisions, non-compete clauses and
employee protection policies in the agreement. If core technology is to be outsourced, take every
step available to make sure it does not end up in the hands of a competitor, or worse yet, makes the
vendor a competitor. Do not outsource yourself out of business.

Assess the Risks of Outsourcing. Recognize that anything which is outsourced will cause a
shift in risks to your company. Sometimes this is merely a tradeoff. In fact, the risks in not
outsourcing may be higher than those associated with outsourcing. As a case in point, if you cannot
meet the demand for your product without outsourcing then you leave yourself open to new
competitors. It is better to take a risk you can control than to create a risk you cannot control.

Typical risks and the related issues are:

a. Will it change the company culture? This may be good or it may be bad, but it will
   be an issue.

b. Will you lose control over something you consider proprietary? What is the worst
case scenario if this happens? Do you lose market share? Will this reduce profitability?

c. What is your exit strategy? How do you cancel or unwind the relationship if the
   vendor does not perform well? What if you no longer need this vendor or this component?
   (Mercury Marine no longer needed carburetors after it adopted fuel injection). What if your volume
does not meet expectations? (Of course, business cycles are completely predictable and only move
upward).

d. What if the vendor cannot perform? It does you little good if your manufacturing
   systems are shut down because the vendor cannot deliver needed product. You have to have a fall
   back strategy. Just-in-time can quickly become “in-the-nick-of-time” and ultimately, “too little, too
   late in time.” Canceling the vendor for non-performance may be legally useful, but it will not get
product out the door. One example is AM International, a large U.S. manufacture of offset printing systems for the magazine industry and for in-house publishing such as high quality advertising brochures and the like. AM was forced to ship product from Chicago to Europe on leased 747’s because $200,000 commercial printing presses could not be shipped without a $4 internal ink-drip pan which could not be delivered on-time by the vendor. This resulted in a thirty day delay of shipments to Europe, thus eliminating the possibility of using normal ocean transport. A back-up strategy was put in place the following quarter, of course, after a painful explanation to shareholders and analysts when the quarterly report was issued.

III. Due Diligence in Selecting Vendors

Do not, I repeat, DO NOT be a guinea pig. Chose established vendors with proven track records. Your Uncle Bill’s neighbor, who just bought a machine shop and can give you a really good price because he is just starting up and needs the business...IS NOT A GOOD CHOICE!!! His problems will become your problems. His mistakes will become your mistakes. His price may be great but the risk is too high. He will cost you money.

Work from the following checklist:

- Select a vendor known in its industry.
- Check out the vendor’s relationship with other customers. Good vendors will be pleased to provide references.
- Review vendor records to check for quality and on-time delivery.
- Review the culture of the company. Does it mesh with yours? Is customer service a priority? You are the customer.
- Has the vendor been in litigation with its customers or its suppliers?
- Does the vendor have its own proprietary information? How does the vendor protect it? No matter what an agreement states, your proprietary information will only be protected to the extent the vendor protects its own proprietary position. You do not want a vendor who is reckless with your proprietary information.
• **Rely on your instincts.** If it walks like a duck and quacks like a duck, it is probably a duck. Do not be afraid of your intuition. If the relationship doesn’t feel right then it probably isn’t. The comfort level with a relationship best surfaces during negotiations. Are your requirements met with open and candid discussion about each party’s issues or are they dissected and re-negotiated at every step of the process? This does not mean you will not have issues, but there is a difference between an honest difference of opinion and an indication that there is no appreciation for your point of view. I cannot tell you how many times the verbal negotiations have gone very well and the first draft of an agreement shows a completely different side of the partner. Conversely, be wary of a wolf in sheep’s clothing. If it sounds too good to be true, it probably is. Remember, Uncle Bill’s neighbor will agree to anything to get the business.

• **Make certain the vendor intends to deliver what has been promised.** It is amazing how often a sales brochure does not quite match the specifications of the product being delivered. One school system here in Harris County outsourced its cafeteria inventory system. The brochure showed a slick point-of-sale accounting and inventory capture system that was guaranteed to be compatible with the school district’s on-line accounting hardware. During negotiation of the agreement, the sales brochure was attached as an exhibit and it was requested that the vendor represent and warrant that all of the features and functions in the sales brochure would be met. The vendor refused to do this, its legal team pointing out that the sales brochure was not intended to be a legally binding document. When it was requested that the vendor specifically point out what it could not do that was in the brochure, it became clear that the two systems were not necessarily compatible. This saved the school district from buying a problem. Use Statements of Work to particularly specify what will be provided and tie this in to the warranties.

### IV. Negotiating the Deal

This should be a partnership, not an adversarial relationship. There should be many areas of agreement right from the beginning of negotiations if you have selected the right vendor. Both you and the vendor should be equally open to discuss prices, quantities, delivery, scheduling, fail-safe provisions and exit strategies. You must be able to express your primary objectives in a manner that
permits the vendor to understand its requirements and these objectives must be clearly and concisely expressed in the written agreement. (Of course, none of you would think of outsourcing under an oral agreement or by using a standard vendor form agreement.) But if the vendor’s standard form agreement is overly one-sided in favor of the vendor, this is probably an indication of how the vendor intends to operate, regardless of what they may say. Remember, you really cannot change the culture of the vendor.

In many respects, the boiler plate, i.e., termination provisions, choice of laws, alternate dispute resolution, assignability, covenants and warranties, is the easy part since these are things that are clearly visible or on the table for all parties to see and negotiate. The important, and much more difficult, part of the agreement is the fundamental relationship between you and the vendor. How you expect your vendor to act. How you resolve routine disputes. How your vendor will manage your account. In essence, how your vendor fits with your needs. Define what the day-to-day working relationship will be. Identify key personnel on both sides of the agreement.

You must identify in advance those issues that are negotiable and those that are not. Be willing to give on those you can and stick to your position on those you cannot, no matter how mundane the vendor may think they are.

If you do not understand a clause in an agreement, insist that it be re-written so that you do. Do not rely on a “legal” interpretation. You have to live with the deal, not your lawyer.

The best deal is the one where once the ink is dry on the agreement you feel you could have operated on a handshake. But put it in writing anyway.