THE KEYSTONE GROUP
Atlanta Chicago Dallas

Middle Market Trends:

Offshore Manufacturing and Sourcing

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Executive Summary

Background

As manufacturing costs in low-cost countries have increased, there have been several publications assessing whether it makes sense to re-shore production. Many of these publications have focused on the large corporate market. The Keystone Group's experience working primarily with mid-market companies has indicated that mid-market companies face unique challenges and risks and need to have their own customized criteria and guidelines to assist them in their offshoring and outsourcing decisions. The Keystone Group administered a survey to mid-market C-level executives across multiple industries with the goal to document the current state of mid-market offshoring and outsourcing.

Highlights

Over seventy percent of the companies had revenues of less than $500M and the majority had experience in offshoring and/or outsourcing. The primary rationale for offshoring and outsourcing initiatives included both cost savings and emerging market entry. The majority of respondents realized cost savings, however, nearly a quarter of the respondents did not achieve the level of savings expected prior to beginning the effort. Nearly all respondents reported experiencing increased costs, especially in the areas of labor, raw materials and freight. Many did not anticipate the level of management time that would be required to manage the ongoing effort, both from a sales and operations standpoint as well as increased levels of quality and on-time delivery issues. Overall, the respondents expect the increased level of outsourcing and offshoring to continue; however some companies are considering repatriating production closer to home; suggesting a more nuanced approach.

Keys to Success

Based on these findings, a recommended set of guidelines was developed to assist mid-market executives as they weigh the pros and cons of offshoring and outsourcing.

- **Invest time up front.** Properly assess potential costs and vendors. Set realistic expectations for the impact and timing of the initiative, and find a project manager that can manage to a deadline.
- **Consider strategy in addition to cost savings.** While significant cost savings should be an expectation of offshoring or outsourcing initiatives, a long-term strategy will guide better decision-making.
- **Put more weight on proximity.** Consider near-shoring to reduce the time and expense required for management oversight, allowing for stronger relationships with local teams and vendors.
- **Make internal adjustments.** Redesign sales and operations and inventory planning processes to accommodate the less transparent and more volatile dynamics of offshore supply chains.
- **Build a contingency plan.** Know the risks and devise mitigation plans. Assess success regularly and be prepared to go to plan B.
- **Dedicate the appropriate management resources.** Strong leadership will be critical to the overall success of the project. Arrange an experienced team that can be effective in a changing environment.
- **Learn from others.** Reach out to fellow professionals for first-hand lessons learned.

Introduction

Key Terms

Throughout the article, the following terminology is used:

- **Offshoring:** Overseas or near-shore manufacturing; assembly or production in another country.
- **Outsourcing:** Overseas or near-shore sourcing; purchasing of product from a non-domestic vendor.

Overview

As manufacturing costs in low-cost countries have increased, there have been several publications assessing whether it makes sense to re-shore production. Many of these publications have focused on the large corporate market. The Keystone Group's experience working primarily with mid-market companies has indicated that mid-market companies face unique challenges and risks and need to have their own customized criteria and guidelines to assist them in their offshoring and outsourcing decisions.

The Keystone Group administered a survey to mid-market C-level executives across multiple industries to gain insights into the future of offshoring and outsourcing trends and the key lessons learned. The goal was to document the current state of mid-market offshoring and outsourcing and to provide mid-market executives with common sense guidance to help them with their offshoring and outsourcing decisions.

The survey was divided into two sections: (1) challenges and success factors in offshoring and (2) challenges and success factors in outsourcing. Executives were asked to answer sections that apply to their specific situations. Based on these findings, a recommended set of guidelines was developed to assist mid-market executives as they weigh the pros and cons of offshoring and outsourcing.

Survey Respondents

Firm Distribution

Survey respondents spanned a wide variety of industries including Industrial and Commercial Manufactured Goods, Automotive, Distribution, Consumer Products, and Building Products (Fig. 1). The surveyed firms were also diverse in size, measured in global revenue U.S. dollars (Fig. 2). Nearly 70 percent of the companies reported having less than $500MM in annual revenue.

Figure 1: Industry Distribution

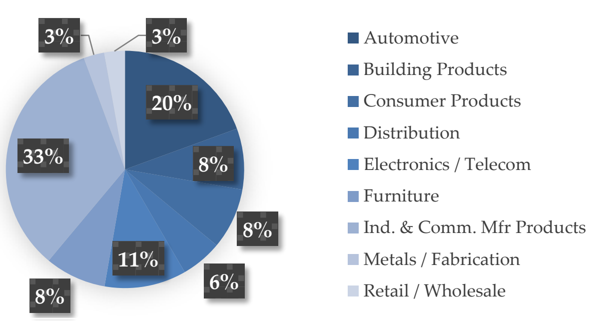
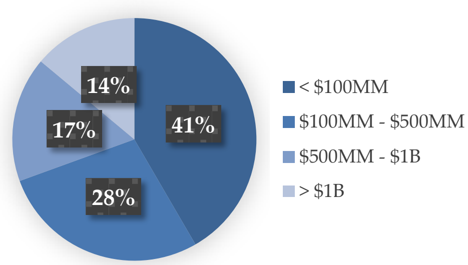


Figure 2: Distribution of Firm Size

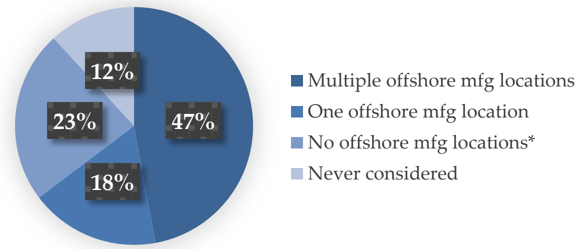
Measured in Global Revenue (USD)



The mid-market companies surveyed have significant experience in offshoring and outsourcing activities. All (100 percent) outsourcing respondents rated themselves as having significant experience sourcing from multiple vendors. Meanwhile, over 50 percent of the offshore respondents have more than one foreign manufacturing location (Fig. 3).

Additionally, the vast majority of all respondents reported having greater than 5 years of experience with offshore or outsourcing activities.

Figure 3: Offshoring Experience



**Performed detailed evaluation process but ultimately did not move forward with the project.*

Figure 4: Offshoring and Outsourcing Countries Used
Percentage of Respondents with Operations in Given Country

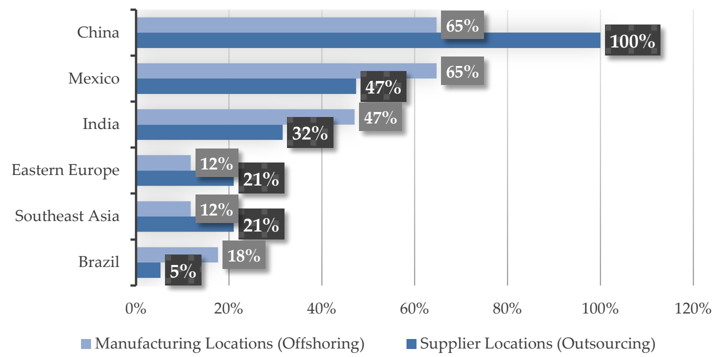


Figure 4 provides the locations where each firm currently manufactures or sources their products. As expected, low-cost countries such as China and India are common locations for both offshoring and outsourcing. Mexico is also a commonly used location, particularly for manufacturing. One respondent commented, "I source products close to where I sell them. The lowest cost option is constantly changing, and cost should only be a piece of the equation."

Rationale and Extent of Offshoring and Outsourcing Activities

Cost savings were not the only consideration in these decisions. When asked for the single primary reason for establishing offshore manufacturing, strategic value played a larger role than cost savings (Fig. 5). Further, when selecting the final factory location (country selection), the cost of labor and proximity to key customers were common criteria, as both were selected by over half of respondents. Capital expense, or the cost of land/building, played a small role in the decision, as just 18 percent of respondents selected this criterion. The weight of each criterion can be seen in Figure 6.

Figure 5: Primary Reason for Initial Offshoring Consideration

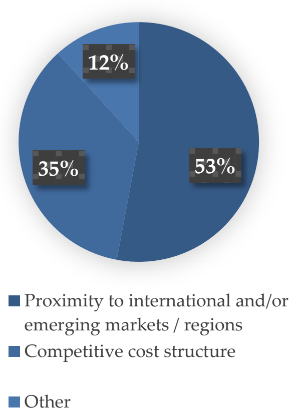
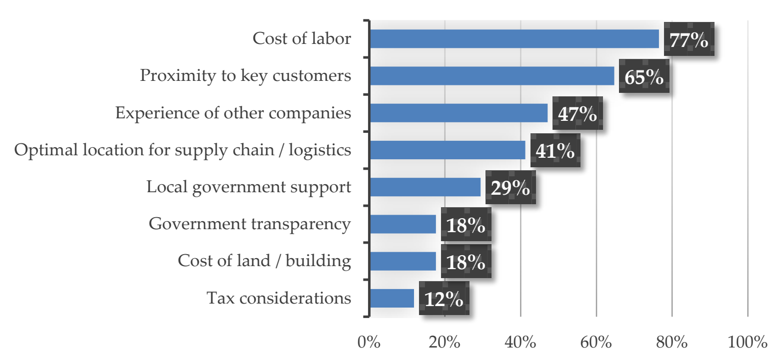


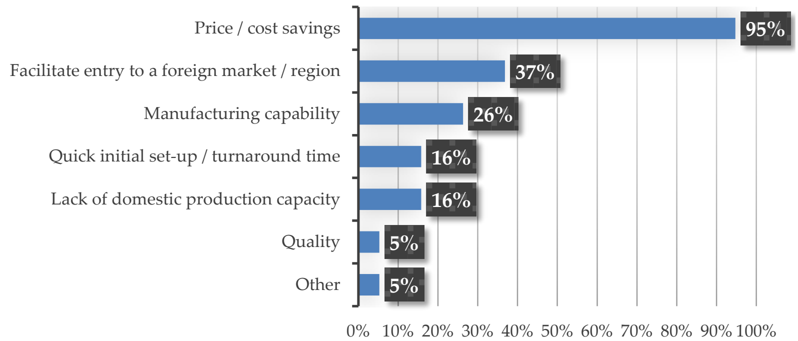
Figure 6: Final Criteria for Factory Location Selection
Percentage of Respondents Who Selected Each Criterion



When asked the key reasons behind the initial consideration of outsourcing, nearly all respondents cited the financial benefits associated with lower cost labor and other operational savings. Figure 7 depicts the key motivating factors behind the outsourcing considerations. 95 percent of the respondents noted that gaining cost structure advantage was a key reason they considered offshoring. Some companies also appear to be considering the strategic impact of the change, as nearly 40 percent of respondents also cited that outsourcing would facilitate their entry into foreign markets. These companies will likely have more tolerance for rising costs in developing countries given the strategic value of the initiative.

Figure 7: Outsourcing Rationale

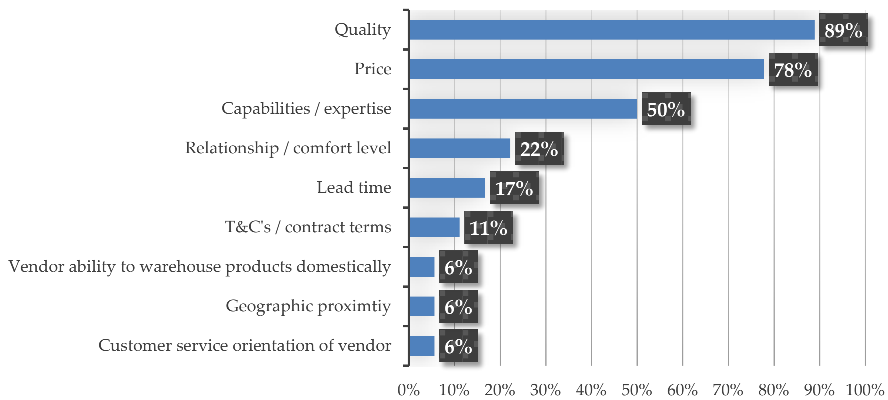
Percentage of Respondents Who Selected Each Criterion



Unlike those considering offshoring, geographic proximity was much less of a concern in outsourcing, as only 6 percent of respondents selected this as a criterion for the decision (Fig. 8). Quality outweighed price in the decision-making process, though both were of high importance for respondents when selecting a non-domestic vendor (89 percent and 78 percent, respectively).

Figure 8: Vendor Selection Criteria for Outsourcing

Percentage of Respondents Who Selected Each Criterion



Although cost is a major driver of the initial assessment, other factors are consistently present throughout the decision-making process: quality and strategy. Companies are unwilling to sacrifice quality for a lower price. Operational strategy also factors into the equation, and in some cases, the initiative is a building block of a longer-term strategy.

Timing and Benefits

Time to Establish

A significant amount of time is required to establish offshoring. Figure 9 shows the total time to establish offshore manufacturing from initial inquiry until first shipment from the facility. Nearly 70 percent of respondents report taking at least one year to complete the transition. "Everything takes longer than expected," shared one respondent. It is worth noting that 40 percent of these respondents built their factory from the ground up.

Based on survey responses, outsourcing can be implemented much more quickly than offshoring. Nearly 80 percent of respondents were able to establish non-domestic vendor relationships in less than one year (Fig. 10). Nearly half completed the initiative within six months.

Figure 9: Time to Establish Offshore Manufacturing

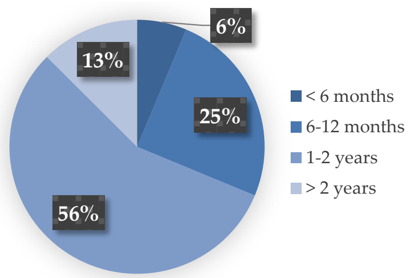
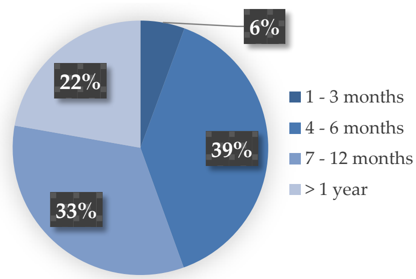


Figure 10: Time to Establish Non-Domestic Vendor



Estimated and Realized Cost Savings

As noted in the previous section, a primary driver for initial offshore consideration was cost savings. As shown in Figure 11, a majority of offshoring respondents expected to save between 10 and 30 percent from the initiative. Nearly 60 percent of these respondents met expectations, while most of the balance of respondents have realized less savings than expected. A select group exceeded expectations. In general, those with lower expectations were more likely to meet them.

Figure 11: Expected Savings and Performance to Expectations
Offshoring

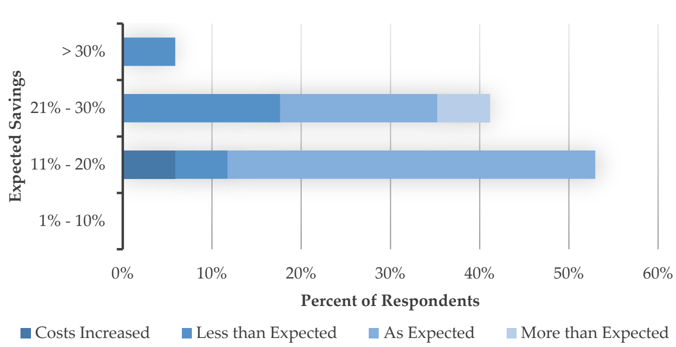
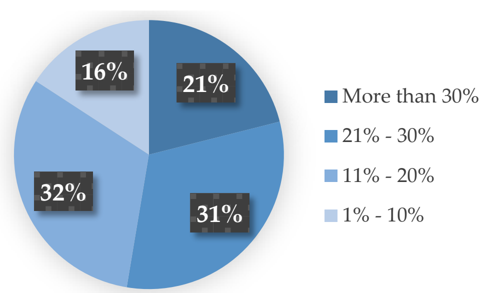


Figure 12: Realized Savings
Offshoring



Over half of respondents realized cost savings exceeded 20 percent (Fig. 12). Further, a majority of respondents achieved savings greater than 10 percent. As one offshoring respondent noted, "It takes longer to start than anticipated but can be very successful."

Outsourcing respondents also expected to save between 10 and 30 percent by selecting a non-domestic vendor (Fig. 13). Over half of these respondents met expectations, while approximately one-quarter of respondents have realized less savings than expected. The balance exceeded expectations.

Figure 13: Expected Savings and Performance to Expectations
Outsourcing

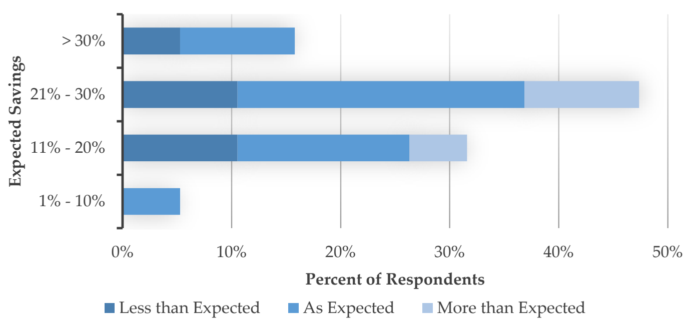
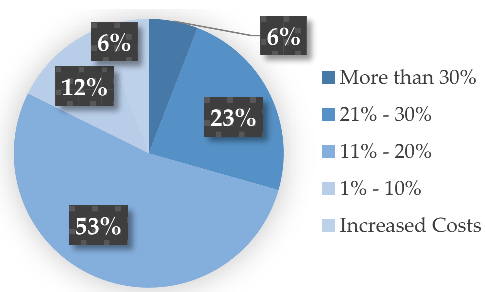


Figure 14: Realized Savings
Outsourcing



Similar to offshoring, a majority of respondents realized cost savings great than 10 percent (Fig. 14). However, less than one-third realized savings greater than 20 percent. On average, offshoring respondents saw greater savings than outsourcing respondents.

Invest time up front. Properly assess potential costs and vendors. Set realistic expectations for the impact and timing of the initiative, and find a project manager that can manage to a deadline.

Cost Trends and Other Obstacles

80 percent of survey respondents reported higher costs than originally incurred in the non-domestic location(s). The primary drivers of the increase for both offshoring and outsourcing are labor, raw materials, and freight/logistics (Figs. 15 & 16).

Figure 15: Primary Drivers of Offshoring Cost Changes
Percentage of Respondents Who Selected Each Criterion

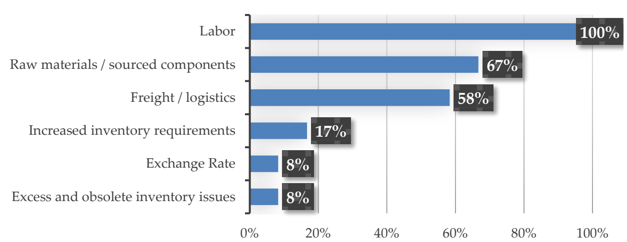
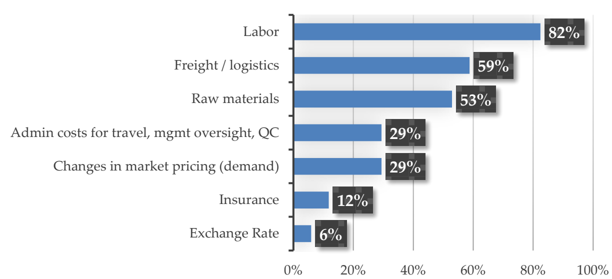


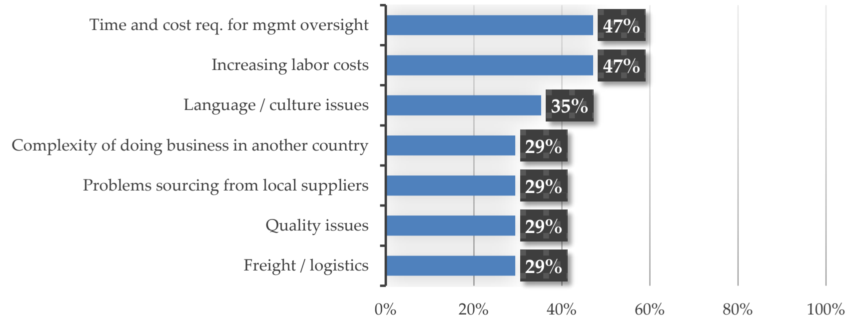
Figure 16: Primary Drivers of Outsourcing Cost Changes
Percentage of Respondents Who Selected Each Criterion



Consider strategy in addition to cost savings. While significant cost savings should be an expectation of offshoring or outsourcing initiatives, a long-term strategy will guide better decision-making.

For offshoring respondents, the time and cost required for management oversight of the initiative was as much of an issue as rising labor costs (Fig. 17). Mid-market companies typically do not have dedicated resources to manage offshore vendors and key relationships, often resulting in a strain on management. Language/culture issues and general business complexity were also issues for approximately one-third of the offshoring respondents.

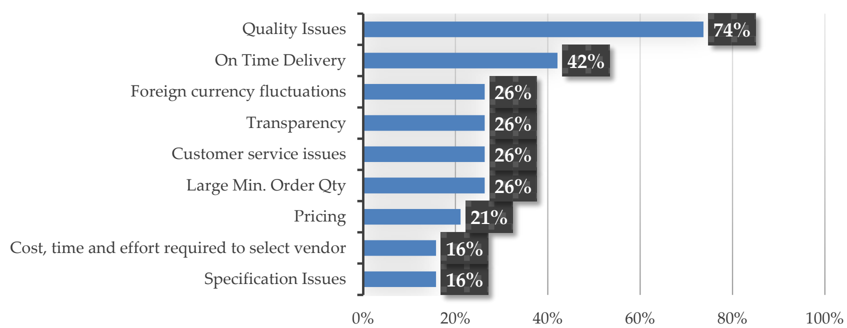
Figure 17: Primary Issues Faced When Offshoring
Percentage of Respondents Who Selected Each Criterion



Put more weight on proximity. Consider near-shoring to reduce the time and expense required for management oversight, allowing for stronger relationships with local teams and vendors.

For outsourcing respondents, quality was the largest obstacle, as 74 percent of respondents encountered issues here (Fig. 18). One respondent noted, "Several suppliers did not have adequate quality processes in place." Additionally, 42 percent experienced shipping delays.

Figure 18: Primary Issues Faced When Outsourcing
Percentage of Respondents Who Selected Each Criterion

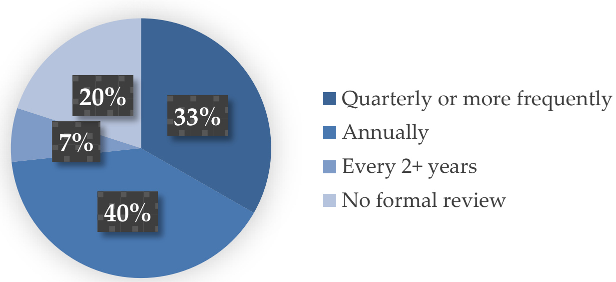


Make internal adjustments. Redesign sales and operations and inventory planning processes to accommodate the less transparent and more volatile dynamics of offshore supply chains.

Evaluation & Relocation

While there appears to be no standard for the frequency of a formal evaluation of offshoring locations, annual and quarterly reviews are most common (Fig. 19). 20 percent of companies performed no review at all.

Figure 19: Frequency of Review Process



As a result, nearly one-third of offshoring respondents have relocated or have plans to relocate since the initial decision was made. However, most of these relocations remained offshore (Fig. 20). Respondents cited shrinking margins, lead times, and quality issues as main drivers of relocation.

Respondents that have outsourced have been even more active. Over half chose to switch vendors, though most stayed non-domestic. Just 11 percent of respondents have returned to U.S.-based vendors (Fig. 21). The top reasons for vendor changes were similar to offshore facility relocations: lead times, diminished cost savings, and quality issues.

Figure 20: Manufacturing Relocation or Plans to Relocate

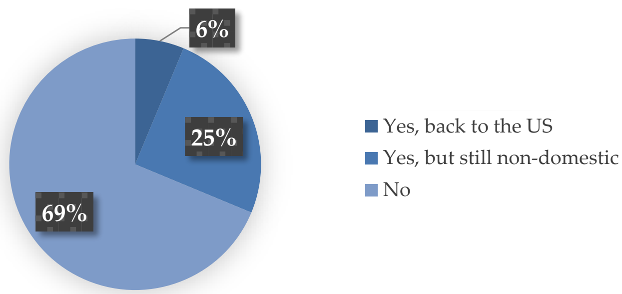
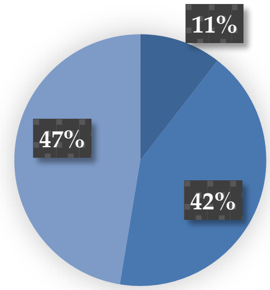


Figure 21: Vendor Change or Plans to Change

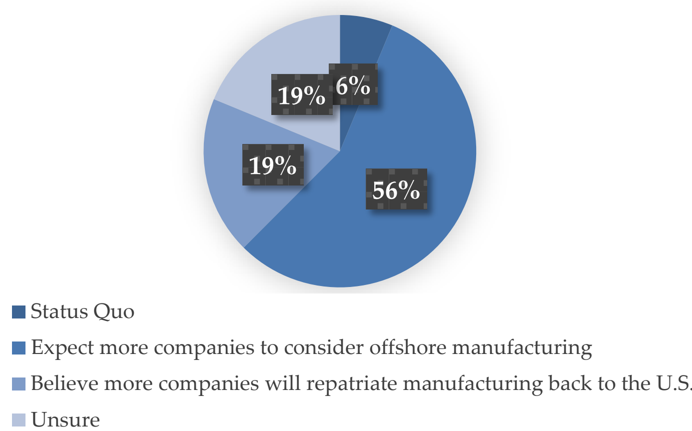


Build a contingency plan. Know the risks and devise mitigation plans. Assess success regularly and be prepared to go to plan B.

Looking Ahead

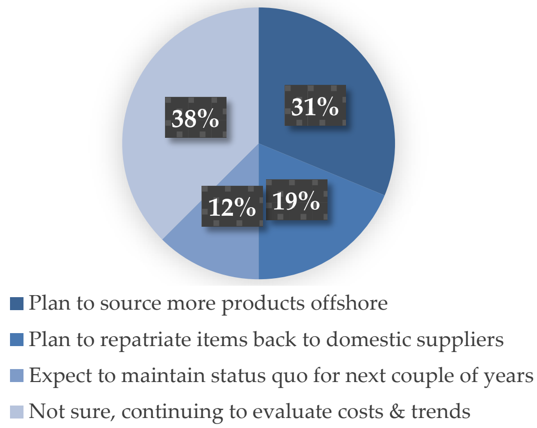
The outlook on the future of offshoring and outsourcing is mixed. While 56 percent of respondents expect more companies to consider offshoring, nearly 20 percent believe more companies will begin to repatriate manufacturing back to the U.S. (Fig. 22).

Figure 22: Offshoring Expectations Going Forward



As for outsourcing, nearly one-third of the group plans to source more products overseas (Fig. 23). Meanwhile, close to 20 percent of mid-market respondents plan to repatriate items back to domestic suppliers. Nearly 40 percent are evaluating next steps.

Figure 23: Outsourcing Plan Going Forward



Despite the uncertainty, it is clear that mid-market companies are becoming more sophisticated in how they approach offshore initiatives. As markets continue to evolve, the ability to properly assess and quickly act will play a major role in a firm's ability to maintain a competitive cost structure.

Dedicate the appropriate management resources. Strong leadership will be critical to the overall success of the project. Arrange an experienced team that can be effective in a changing environment.

Takeaways

When considering offshoring or outsourcing:

- **Invest time up front.** Properly assess potential costs and vendors. Set realistic expectations for the impact and timing of the initiative, and find a project manager that can manage to a deadline. To save time and avoid complexity, one respondent suggests, "Focus on basic products first, and build products that will be in the portfolio for long periods." When the effort is well-executed, the outcome can be great. Says one respondent, "When you find the right vendor, it is surprising how good the offshore quality can be." Lastly, be sure to be realistic about implementation timeframes when creating an external forecast, particularly if there are covenants involved.
- **Consider strategy in addition to cost savings.** While significant cost savings should be an expectation of offshoring or outsourcing initiatives, a long-term strategy will guide better decision-making. As the landscape continues to change, it is important to maintain an overall business focus. "Have a long-term strategic plan to enter the offshore market as opposed to a quick cost savings short-term effort," recommends a respondent.
- **Put more weight on proximity.** Consider near-shoring to reduce the time and expense required for management oversight, allowing for stronger relationships with local teams and vendors. It is worth noting that proximity was not often a criterion in the decision-making process, an oversight that nearly half of respondents noted later as an obstacle. Middle-market companies often do not have fully dedicated management teams to oversee the effort, making managing from a distance particularly challenging.
- **Make internal adjustments.** Redesign sales and operations and inventory planning processes to accommodate the less transparent and more volatile dynamics of offshore supply chains. "Close management of key performance indicators coupled with frequent communications enables issue avoidance," emphasizes one respondent. Formalize the planning process to ensure all facets of the business are accounted for and adjust as new obstacles arise.
- **Build a contingency plan.** Know the risks and devise mitigation plans. Assess success regularly and be prepared to go to plan B. Recommends one respondent, "Balance the supply chain

globally to have alternatives as the business landscape changes." For extra cushion, another respondent suggests, "Maintain heavy oversight and keep a second source near production." Particularly as you get comfortable with your new facility and/or vendors, maintaining a second, less risky source is recommended

- **Dedicate the appropriate management resources.** Strong leadership will be critical to the overall success of the project. Arrange an experienced team that can be effective in a changing environment. "Critical to the process is a strong and experienced management team with a culture of global process improvement," says one respondent. However, local culture needs to be a consideration as well. One respondent offers, "Start with a U.S. based manager that will relocate." The right management team can help navigate the complexities of the new initiative.
- **Learn from others.** Reach out to fellow professionals for first-hand lessons learned.

For more information or to discuss how to successfully assess offshoring or outsourcing opportunities at your firm, please contact Amar Shah at (404) 467-6170 or ashah@thekeystonegroup.com.

The Keystone Group will conduct a follow-up survey in 2016. If you are interested in participating in this or in other mid-market research efforts, please send an email to research@thekeystonegroup.com with the subject line: Mid-Market Trends.