

DIALOGUE

Dawson Dialogue

Logistics Outsourcing – a leopard can change its spots

DAWSON CONSULTING

a Dawson Group company



About the authors

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Chris Garschagen joined a number of partners to establish Dawson Consulting in 1990.

As Managing Partner he is responsible for developing and delivering strategic and tactical logistics outcomes. His

expertise covers supply chain design, logistics network development, process and operational enhancement, as well as the planning and execution of improvement programmes.

His managerial experience includes ten years in the service provider industry in both Australia and the United Kingdom working for the National Freight Consortium plc (now known as Exel Logistics). He was responsible for managing national operations in FMCG, Automotive, Pharmaceutical and Resources sectors.



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Brad Martin, a Senior Consultant with Dawson Consulting has significant experience in private sector contract and logistics management with a strong focus on contract design and negotiation and operational and financial performance management. Brad has had

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Executive Summary

For many senior executives, it used to be the case that a discussion on logistics was a discussion about a delivery route or a warehouse at the back of their site. These days however, logistics is a complex and continuously evolving element of an organisation's business strategy, requiring the dedication of an increasing share of its focus, time and resources. The increased complexity and sophistication of contemporary supply chains have required a significant investment in both human and financial capital to keep pace with technological change and innovation. Whether driven by fear of this complexity, a desire to reduce costs, focus on core competencies, divesting of assets or any number of other variables, companies have for many years been choosing to outsource their logistics requirements to external logistics professionals¹. This move by manufacturers and distributors is in line with similar outsourcing strategies employed in other areas of their operations where they have acknowledged that they lack the expertise, resources or demand to justify the provision of the functions internally.

The traditional path to outsourcing has been to devolve responsibility for the performance of these tasks via contract to a third party. But can third party providers, particularly those who are asset based (which is very much the Australian experience), meet the increasingly complex demands of supply chain integration and integrated logistics management? Our contention is that in their present form they cannot. Many companies that have outsourced all or part of their logistics chain are even considering pulling the capability back in-house, as they are failing to realise the value they were promised when they first approached outsourcing initiatives in the mid to late 1990s. The failure of these relationships should not be attributed to the failure of outsourcing as a concept, but rather to the manner in which outsourcing has been approached.

As alliances and collaborative relationships continue to grow and expand, a new outsourcing alternative is emerging. Corporations are outsourcing their entire set of supply chain processes to a single organisation that will assess, design, build, and run integrated, comprehensive supply chain solutions². This practice has been commonly referred to as Fourth Party Logistics™, Integrated Fulfilment Solutions, Solutions Brokerage or any of a number of other equally confusing names. The service provider in this case operates as a supply chain integrator to design, develop and

manage resources, capabilities, and technology on behalf of the customer organisation, enabling the delivery of a comprehensive supply chain solution.

Key to this model has been an alliance between the client organisation and an external intellectual resource, which act together to ensure equitable retention of value from the model. Our intent in this paper is to illustrate the validity of logistics outsourcing as a strategic imperative in the current business climate and to discuss strategies for the achievement of sustainable value from your outsourcing program, which simultaneously allows you to retain strategic flexibility. To achieve this, we will examine the evolution of logistics outsourcing on 3 fronts:

Firstly we will look at the key issues driving the move to logistics outsourcing and the development of the provider market in response to that need. This will include consideration of the benefits and disadvantages confronting organisations looking to outsource their logistics functions.

We will then look briefly to the failure of third party

solutions to deliver value in accordance with client expectations. In this section we will include our views on how this failure can be addressed within the existing 3PL context. This will lead to an examination of

what we perceive as a latent demand for Integrated Solutions. In this context we are not speaking of the bundled services offered by many 3PL providers, but of the genuinely integrated, value driven solutions we speak of in the preceding paragraphs. It is this demand, coupled with the failure of third party providers to deliver on their service promise, which we believe is fuelling the rise of opportunities in this market as an alternative to traditional outsourcing programmes.

Finally we will look to the emerging roles this creates and offer our perspective on projected future industry trends and opportunities.

Key Drivers

Money (or cost) is very often the deciding factor when a company opts to outsource distribution functions such as warehousing, carrier management or logistics optimisation. This statement is supported by a recent study by Penske Logistics, in which 85% of respondents

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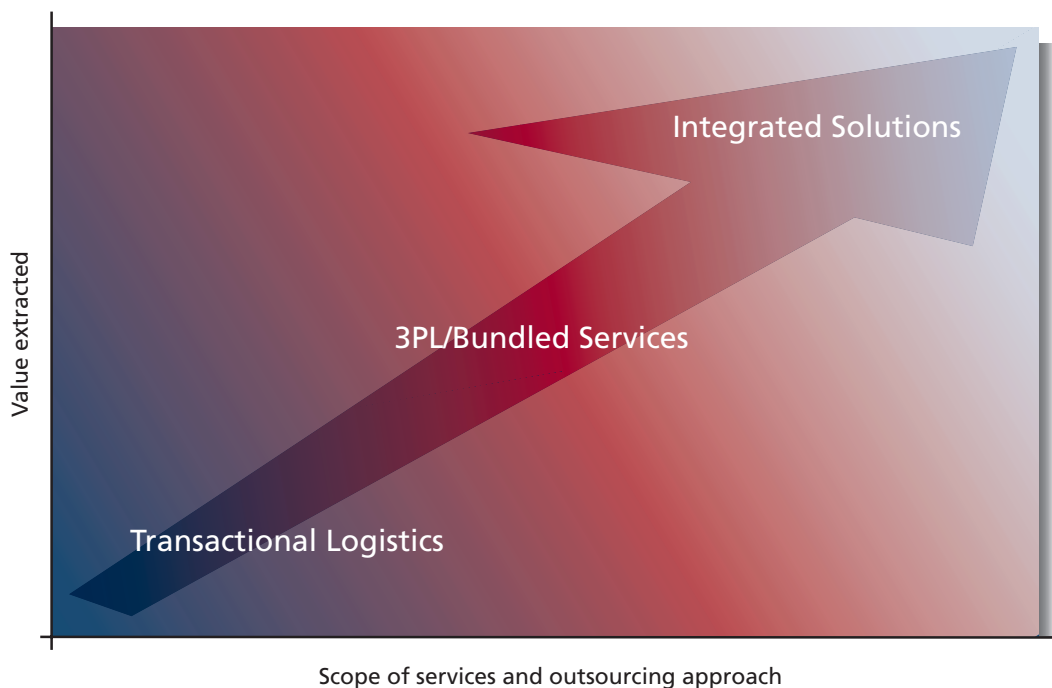


Figure 1 – Integrated Solutions offer improved opportunities for the extraction of value

Figure 2 – Key drivers

Cost and capital aside, there exist a number of additional potential drivers. These include:

- The acquisition of expertise, talent and resources that don't exist internally (Given specialisation, external providers can select and recruit superior personnel and offer an attractive career path)
- Recognition that a business can't do all and be all things to all customers (focus on core competencies)
- Globalisation of markets
- The development of value added capabilities to better serve customers
- The improvement of operations or customer service
- Process Improvement
- Avoidance of labour problems
- Avoiding the cost of complying with regulation

cited a desire to reduce costs through their outsourcing process³. The catalyst for the cost reductions can range from corporate restructuring and benchmarking, to depressed company earnings, declining margins and economic pressures. Regardless of the motivator, realisation of these savings becomes a critical focus.

In addition to potential tangible reductions in operating costs, outsourcing also means a company can free up capital it may otherwise have to invest in warehouse buildings, equipment such as trucks and fork-lifts and supply chain software. This is particularly relevant given the corporate trend to reduce fixed capital expenses to reflect improved Return On Capital Expenditure figures. It becomes even more critical given the significant IT investment required in the present climate to remain at the forefront of supply chain operations.

This list is not intended to be exhaustive, but rather to provide context for the decision to outsource and in doing so provide insight into the expectations of clients in bundling internally managed services for outsourcing.

Trends in Integrated Solutions

What are the emerging trends within the 3PL industry

and what are the implications of these for cargo owners and service providers alike? Current predictions for the future direction of the industry include:

1. 3PLs will become more profitable
2. New customers will create larger and more efficient networks for 3PLs
3. Customers will depend on 3PLs to make sense of technology and technological innovation will be critical to the success of ongoing relationships.
4. Third parties will need significant human assets to deliver on their service promise.
5. Customer – 3PL relationships will last for longer periods of time⁴.

All of these factors point to the creation of significant value for 3PLs and signal a potential shift in the power balance between 3PLs and their clients.

Insight into the potential and means for the realisation of some of these developments is available through reference to a survey recently undertaken by Dr. Robert C. Lieb, Professor of Supply Chain Management at Northeastern University's College of Business Administration. This survey is the 7th in a series of studies by Lieb on the subject of logistics outsourcing. The previous years in which the survey was conducted are 1991, 1995, 1996 and 1997, 1998, 1999 & 2000. The sample included 500 of the largest U.S manufacturing organisations, as well as, the CEOs of the top 25 major contract logistics companies.

Integrated Solutions

Survey results indicate that 73% of users in the most recent study said they employed more than one 3PL. In the first survey in 1991, 79% of respondents reported using multiple providers. Between 1991 and 1998 a steady decline in this figure was observed, until a low of 40% was reported in 1998. This was initially seen as reflecting a significant trend toward rationalisation in the industry, driven by a desire on behalf of a number of companies for Integrated Solutions and a single entity that can discharge their entire logistics task. To meet this challenge, 3PLs have moved towards alliances which allow them to provide the range and geographic coverage of services demanded by customers. It was assumed that if they were successful in achieving this outcome they could enjoy significant growth, as statistics had demonstrated that the longer a company uses outsourcing, the larger the component of its budget that will go to a single third party provider⁵. It is important not to

read too much into this one statistic. Typical users buy multiple services from their provider(s), but perhaps the reversal in the trend noted is an indication that the 3PL market has not managed the challenge of integration well, supporting our contention that a new approach to integration is required. It is also an indication that client organisations are becoming more comfortable using local providers in foreign markets, a particularly important point given that a number of international logistics companies' global expansion has been underwritten by the single point sourcing strategies of their larger clients.

Can real cost savings accrue?

The argument for the realisation of lower costs through outsourcing is based on the assumption that third parties can leverage significant freight volumes in contract negotiations with carriers, to receive rates lower than that which could be achieved by an individual customer. This assumption is also applied to supply chain software systems, through which 3PLs can optimise a client's distribution operations⁶. We would suggest there are inherent flaws within both assumptions, which we will explore later. This aside, there is also strong support and empirical evidence to affirm that cost savings can be realised.

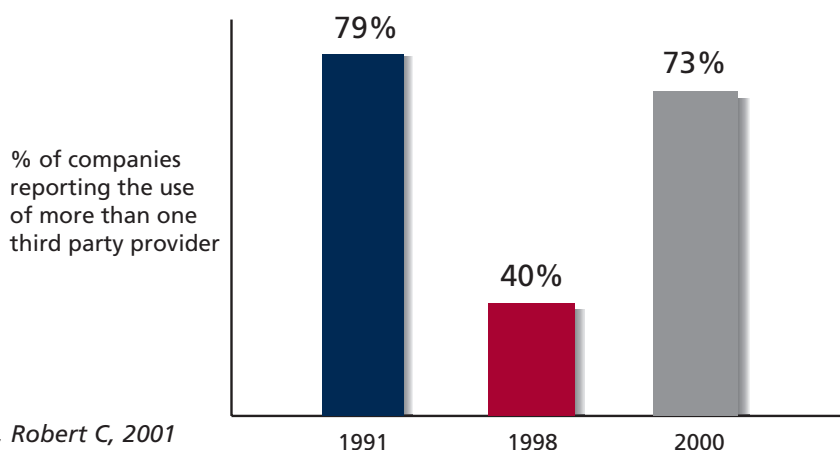
While it may be true that contract logistics companies can obtain lower transportation and warehousing costs, it is equally true that they must make a profit – Mercer Consulting, have observed that while as a general rule, third party logistics companies can cut distribution costs by 15 percent through economies of scale, they then add back a 15% mark-up for manage-

ment, with net savings potential being minimal or non-existent⁷. The further argument on cost reductions, is that economies of scale may not eventuate as the systems, processes and assets are often purpose built for the client's requirements. As such, economies can simply not be realised.

It is the manner in which outsourcing is approached that lies at the heart of this problem. Dissatisfied with internal solutions, companies often hire third party logistics providers to come up with strategic solutions. While this premise is fine, it rarely succeeds as 3PLs often arrive on the scene too late, usually not entering the picture until the customer has mapped out specific requirements. As a result of this and the strong operational focus of 3PL organisations, the third party usually ends up offering service improvements in an operational context only. This is particularly the case in the Australian market where 3PL operators are largely tied to their own asset base. The customer then expects these savings to accrue year on year, but is disappointed to realise they are once off savings. The 3PL must live up to an unrealistic expectation, because it was not in the position, or lacked the intellectual capa-

While it may be true that contract logistics companies can obtain lower transportation and warehousing costs, it is equally true that they must make a profit

Figure 3 – The trend towards consolidation to one 3PL provider has been reversed in recent years, suggesting the challenge of integration has not been managed well



Source: Lieb, Robert C, 2001

Figure 4 – Separation and the risk of failure

As with the outsourcing of any other function, there are a number of issues, which need to be managed to ensure there is no negative impact on the firm. The key areas of risk include:

- Loss of autonomy (i.e.: loss of control over functional areas such as vehicle fleets and warehouses)
- Loss of market presentation and threats to confidentiality (particularly at the critical point of customer interface).
- Short term industrial problems as your workforce comes to terms with the change.
- A possible mismatch of motivations and skills among customers and suppliers; and
- Loss of expertise within your company, which in turn leads to a dependency on the third party provider.

bility to articulate a supply chain strategy with the potential to deliver ongoing benefits.

In addition to disappointing financial results, given the traditional approach to contract negotiation, the parties are often locked into a long-term agreement with limited opportunity for supply chain redefinition. This exposes the client not only to substandard financial performance, but the risk that their competition may recreate its supply chain, gaining competitive advantage as a consequence.

All of these risks have given rise to a large cloud over the logistics industry, that being the well publicised string of divorces between 3PL providers and customers in recent years. While the average contract renewal rate in the most recent Lieb survey was 93%, there were many instances where at least one customer had terminated a contract in the past year, consistent with the performance observed in past surveys.

When asked why agreements had been severed, CEOs cited several reasons. These included management change at the client organisation, problems meeting service targets, client failure to recognise their own organisational issues, sale of the business unit and a change in the client's overall strategic direction. However, the reason most commonly cited by clients, was non-performance by the third party. Surprisingly, the

reaction to these failures has not been to pull the function back in-house. In fact when a contract ends, 89% of shippers advised they found an alternate provider⁵.

The failure rate for third party partnerships is similar to that of marriages according to a survey by the New York based Outsourcing Institute. This survey found that 55% of third party partnerships ended within 5 years⁸. Of those that do stay together, 12% are unhappy with the partnership and regret having ever entered the deal⁸. It is clear that this imbalance needs to be addressed if client organisations are to continue to extract ongoing value from outsourcing relationships.

How then, can we avoid these situations?

Preventative Measures – a different approach to contract negotiation

There are often severe consequences for all involved if a service provider fails to deliver on promised services and the client decides to break the contract. Both parties have usually entered a binding contract with financial obligations, typically for a duration in the vicinity of five years. The problem here is that it is often difficult (if not impossible) at the time of drafting the contract to foresee and account for the potential changes that can impact both parties within the contract period.

The traditional approach to setting up outsourced logistics arrangements has been to have extensive negotiations that eventually result in a detailed contract. Both parties for disparate reasons have considered this mandatory. Establishing clear performance levels and cost structures has been considered essential from the client side, with the legal protection of a contract being important to the 3PL to secure their investment in the analysis, pre-work and start-up processes of a large scale proposal.

To counter this, an emerging trend in the negotiation of an outsourcing arrangement has been for the cargo owner and the external service provider to put off the drafting of a formal contract agreement until at least 6 months experience in the business has been accumulated. This allows the consideration / integration of real benchmark data in the negotiations. During the trial both sides review cost structures, service levels and customer needs. To protect themselves in the initial stages, the companies start with a statement of expectations and a letter of intent. Once the trial period is over, both parties can enter the arrangement with equal levels of knowledge and long-term expectations

and legal obligations can be realistically agreed to. An added incentive is that this trial period can then provide baseline data against which improvement can be measured⁹.

It's therefore clearly critical that we recognise as many contingencies as possible at the contract stage and this approach helps to achieve that end. To further facilitate this outcome, use of a consulting firm with specialised logistics capability can be advisable. Corporate legal representation and internal procurement staff may not possess the necessary industry specific skills to represent either parties best interests, a fact often not recognised due to the misconception that an outsourcing agreement is just another contract. A further reason is perhaps the perception of cost, an unfortunate view when this small outlay may assist in avoiding significant costs in a dispute scenario at a later date.

Adopting a progressive approach to negotiation such as that outlined above also eliminates two of the greatest potential areas of risk in terms of failure. The first is the propensity, particularly in the 3PL market, for firms to oversell their capabilities and present unrealistic goals in terms of start up times and the timeframe it will take them to bring an operation up to the desired levels. It also eliminates the tactic commonly favoured by clients, namely to withhold information if they think it will increase costs⁹. If these two aspects are not avoided, by the time the external provider has begun operations, it has already become defensive about rates and margins and on the client's side, cost, not value becomes the critical issue. This leads to the sub-optimisation of outcomes for both parties and increases the potential for separation.

We will now look to the significance of measurement in Service Provider/ Client Relationships.

Measurement Process

Effective metrics are a critical component of any business relationship. Specific measures need to be tailored to the business requirements in each case. To achieve success in this area and ensure the critical aspects of cost, service and quality are adequately addressed; it is essential that all stakeholders are involved, from both the service provider and client perspective. On the shipper's side this means convening a forum which

includes all of the beneficiaries of the services, including sales and marketing, finance, operations, human resources and any other effected parties⁶.

Once a clear set of metrics have been established, an agreed review mechanism is equally critical. We would suggest engaging an independent company to monitor performance to ensure that the provider has met the contractual matrices, the option here being to have a third party firm audit the results and report them back to both parties⁹. This review forum should also provide your service provider with an opportunity to demonstrate key service improvements and the potential for ongoing innovation.

One final point on measurement. It is important to have a resolution process if the agreed targets are not being met to ensure clarity of responsibility and consequence on all sides¹⁰.

The Future of Integrated Solutions

In addition to the general areas of contract negotiation and measurement discussed, we believe there is a solution which can help overcome the challenges discussed in our paper to date. As foreshadowed in our initial discussion, a clear industry trend stemming from service integration and the increasing complexity of client requirements has been the emergence of opportunities for someone to bring together the needs of the client and the third party for their mutual benefit.

We believe that it is time for a radically different approach to supply chain management and that the success of this approach will be contingent on aligning with a partner that has the knowledge, resources and capability to combine technology, 3PLs and customers, in an integrated fashion to deliver the supply chain value solutions required¹¹. This contention is based on the premise that a 3PL's strengths are in such operational areas as transportation and warehousing, and while outsourcing these operational functions can provide once off cost downs, 3PLs cannot deliver continuous, ongoing savings.

Figure 5 represents the results of a recent Dawson Consulting cross-industry survey focused on determining the level of interest and anticipated future demand in each of the service offerings. As you can see from

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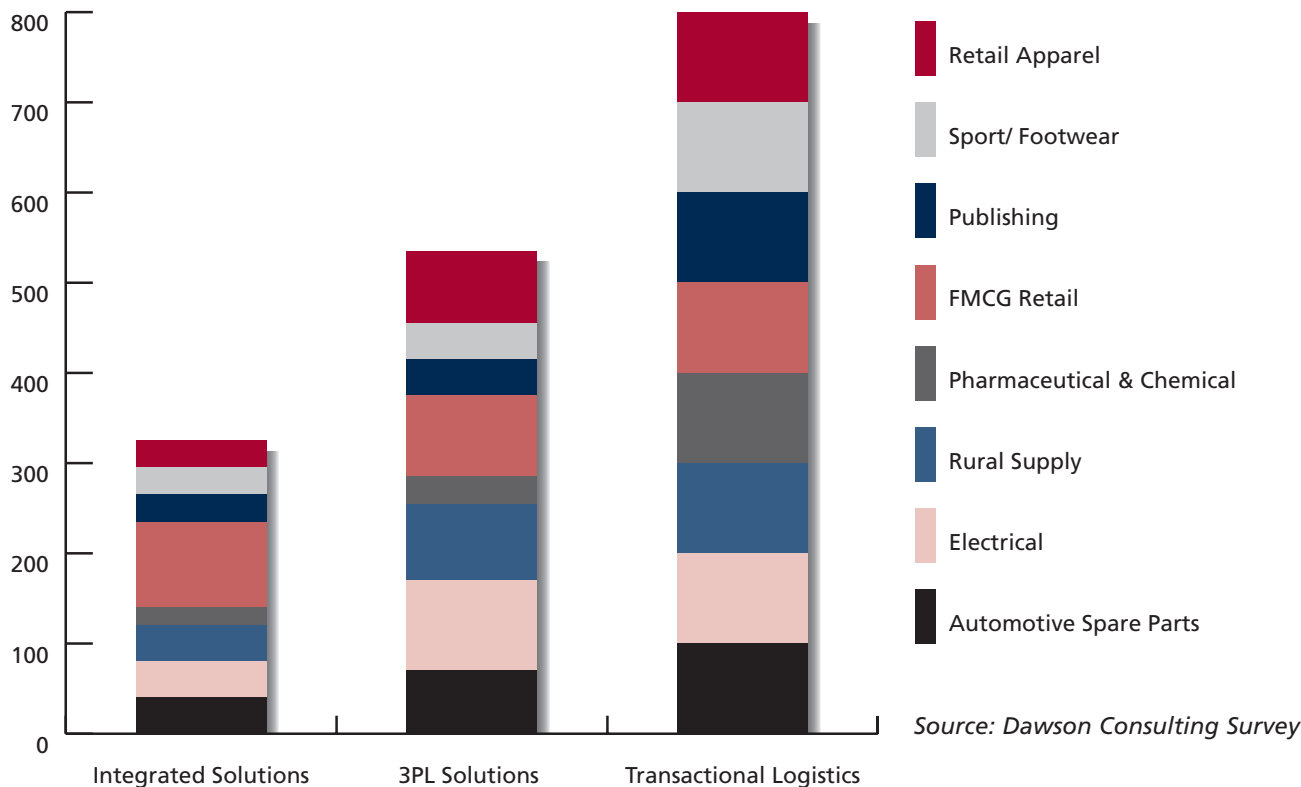
this data, the FMCG sector is driving the development of new trading paradigms, requiring a focus on innovation, expertise and specialisation to a degree unmatched by any other industry sector. Given the early adopter status of the FMCG sector, we believe this serves as a leading indicator of opportunity for services in this sphere and indicates significant latent demand. The FMCG sector has always been an early adopter driving change. This change is then implemented across other sectors. The opportunity is there for organisations to get their processes right now, so that they are positioned to take advantage of these opportunities as they arise.

Case Studies – Who’s Making it Work?

To date there have been only a handful of successful fully Integrated Solutions. This can largely be attributed to the relative infancy of integrated offerings as a strategic alternative. It is also perhaps due to the historically poor performance of 3PL relationships and the subsequent caution of client organisations examining outsourcing opportunities. Certainly Australian evidence is scant, leading us to look to the US for examples.

A key US-based international telecommunications player has established an early form of the integrated model. In rejection of the trend toward an integrated service package from one 3PL, this company elected to maintain some internal expertise and outsource the key functional responsibilities. It chose as its partners in this process, separate parties for international shipments and domestic movements and a third player for truck fleet operations. Representatives of each service provider work side by side in the client’s facility, ensuring that when a transportation need exists, there is one logical place in which to find it. The partners are treated as equals and all provide status updates and take part in monthly brainstorming meetings with the client’s transportation team. The advice the client organisation has offered out of this experience is that it is critical for customers to seek vendors who are willing to adapt and change and look out for the customer’s best interests. The other key learnings from its experience has been to ensure your suppliers are offering flexible, state of the art technology and that they invest in people, not just sales staff, but logistics people. The learning and the outcome from this exercise provides early evidence of merit in the integrated model, however in this case, the client chose to resource the key intellectual brokerage capability internally.

Figure 5 – % of companies that consider the provision of the nominated service a market priority



There exist further concrete examples of success in this field, with a 9-year relationship between an International consulting firm and a division of an international agricultural equipment manufacturer. These parties have operated a joint venture managing Service – Parts Logistics in Europe. The Joint venture, which provided spare parts management from planning, purchasing and inventory through to distribution, transport and customer support, was 20% owned by the consulting firm and 80% owned by the manufacturer. The project's said to have delivered \$67m in savings over its first 7 years of operation, with approximately 65% of these savings having come from operating cost reductions, 20% from inventory management and 15% from freight costs. While the venture has subsequently been disbanded, it provides positive evidence of the opportunity available through an alliance of this nature.

There have been a number of critics of the Integrated Solutions premise. The key argument proffered by critics is that it is little more than an attempt by consultants to extend their penetration in the 3PL market. Most parties acknowledge that consulting firms have done a significant job in improving the metrics in managing 3PLs but critics believe they now wish to reap the financial rewards associated with being more than once-off advisers. In response to this argument we would contend that a consultant's real goal in this exercise is to achieve sustainable performance benefits and value retention for their clients, while also acting as a catalyst for the maintenance of innovation and integrity in the sector. If the Integrated Solutions opportunity can be realised, the party delivering the integration can facilitate the sharing of critical strategic objectives and construct an environment in which 3PLs and cargo owners operate as equals for the benefit of all parties.

Why Integrated Solutions?

One of the key drivers for the emergence of opportunities for supply chain integrators within the logistics industry has been the recognition by many firms of their inability to achieve sustainable value through bundled service offerings, which have been the traditional domain of third party providers. As can be seen in figure 6, the economics work in favour of full service solutions. Given the greater value the integrator can

extract from the supply chain, this allows continued investment in the maintenance of world-class systems, knowledge management and service levels. This increased economic rent allows a win-win outcome for client and vendor organisations. This additional value can be largely attributed to the focus of such offerings on longer term strategic benefits and their leverage of and reliance on the intellectual depth and access of the party bringing the deal together.

As we stated earlier, there is no question that the emergence of the integrated model has been somewhat protracted and that experiences to date have delivered disappointing results. There have been a number of reasons for this, one in particular being the equity focus of the Fourth Party Logistics™ approach, which does not appear to be what clients are seeking. There certainly remains some reticence towards logistics outsourcing and the Integrated Solutions model and we believe this can be traced to its relative infancy and the perceived disadvantages of outsourcing outlined previously. An analogy can be drawn between this infancy and the experiences of firms with respect to the early stages of outsourcing of their Information Technology functions. IT outsourcing programs have evolved over a greater length of time, relative to the current embryonic state of the market for Integrated Solutions. Not surprisingly, similar challenges were also encountered in the early stages of IT outsourcing. Given the relatively recent acceptance of large scale IT outsourcing and the commercial gains that have been achieved through this development, it can be argued that there is an opportunity for early adopters to extract value from an integrated model. This provides increased incentive for firms to get their processes right and extract value for their business now, enabling them to be better placed to extract significant value from their supply chains in the future. The key factor here is to team with someone who can drive your supply chain to the next level.

Conclusion

In conclusion, there is no question that logistics outsourcing and integrated solutions in particular is a growing field and that analysts predict this growth will continue. Certainly the present talk of in-sourcing is limited and contradicts broader trends we have observed in the market. We see many clients further

It is critical for customers to seek vendors who are willing to adapt and change and look out for the customer's best interests

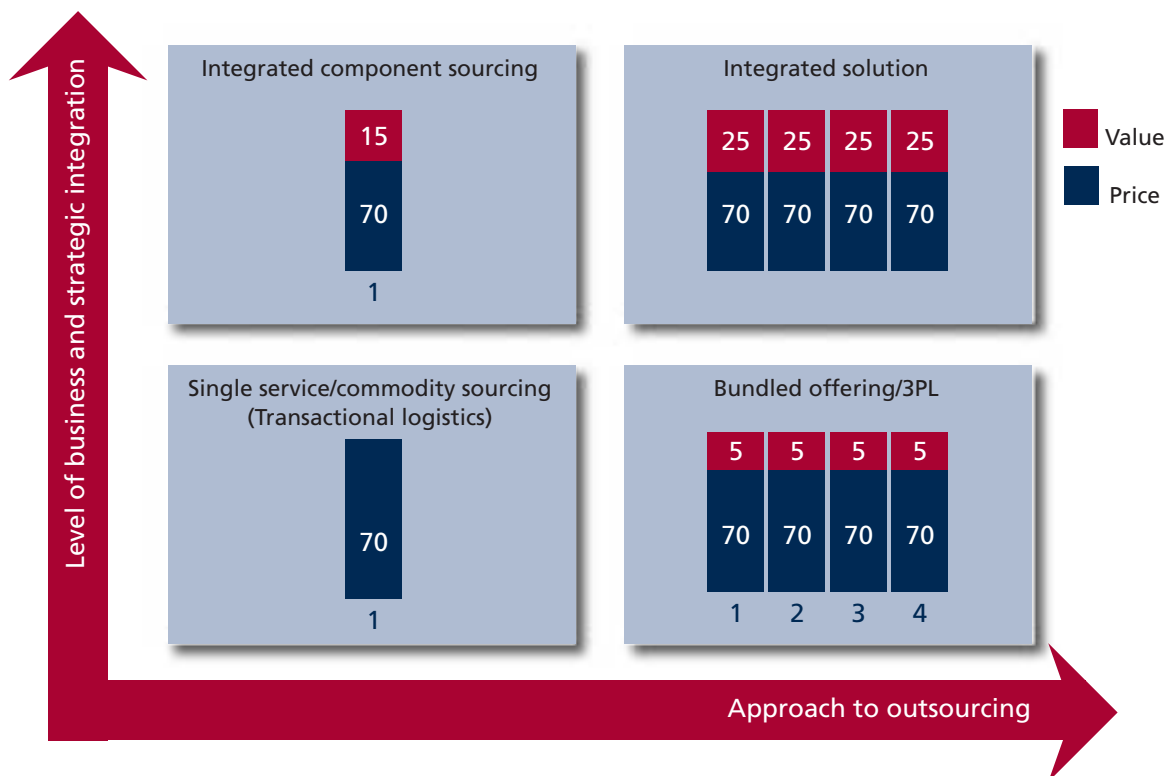


Figure 6 – The value available from integration can be directly related to the approach to outsourcing and the level of business, system and process integration

streamlining the definition of their core business processes to encompass Marketing, Selling, Branding and Positioning of their products, with strategies either in place or under development to outsource Production, Logistics, Procurement and Technology Requirements.

aged by mistakes, or deny them, but treat them as a learning experience.

In assessing whether or not logistics outsourcing and the Integrated Solutions approach is an appropriate solution for your business, we would suggest you ask yourself the following three questions:

Will it increase management focus on the core business?

Will it provide gains in expertise, flexibility and scope for the logistics function?

Will it add sustainable differentiation and value to your business?

If the answer to any of these questions is yes, then it is certainly an option worthy of consideration. It is important to remember that we are not talking about new business models, but rather better managing what we have. We are not talking about asset management, but solutions management. The most important decision you will make in going forward is selecting a partner that can deliver results, not rhetoric and move you toward the achievement of these goals.

As the evolution of outsourced logistics continues to unfold, the potential for the extraction of value from outsourced relationships becomes increasingly evident, provided the metrics and intent are clearly defined and supported. This support must come at the most senior organisational levels to ensure initial reservations and challenges are overcome and early mistakes and problems provide a learning platform from which an organisation can move forward. People must not be discour-

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About

Dawson Consulting

Dawson Consulting, part of the Dawson Group of companies, is Australia's largest management consultancy specialising in logistics, supply chain management, and the application of supply chain technologies.

With a strong bias towards implementation, Dawson Consulting provides practical, sustainable solutions for modern supply chains. Consistently driving towards measurable outcomes, we generate a rapid return on investment for our clients.

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