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Economies of Skill

Using Smart Customization to Transform the Reach and Scope of the Third-Party Logistics Industry

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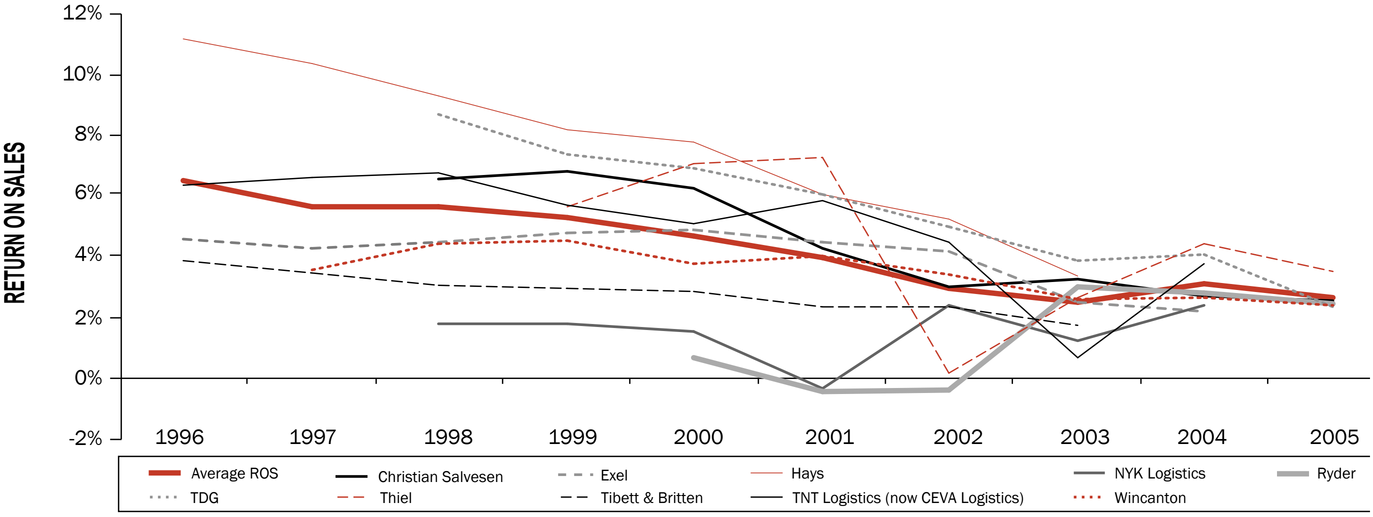
Third-party logistics is now a business worth more than €170 billion. More importantly, it is a driver of the interconnected global economy, which depends on the platform that 3PLs (third-party logistics providers) offer. In allowing manufacturers and retailers to draw on outsourced expertise to move and assemble goods, third-party logistics is as significant a platform for products and things as the Internet is for information.

Yet despite their obvious contribution to the improved efficiency of the global economy, 3PLs themselves have not prospered. Margins continue to shrink across the entire industry, even as 3PLs have consolidated nationally, regionally, and now globally. These service providers might be moving the bulk of the world's goods more cheaply, quickly, and efficiently than ever, but 3PLs have been strikingly unable to create similar efficiencies for themselves.

Booz Allen Hamilton believes that the most significant barrier to achieving economies of scale has been the tendency of 3PLs to engineer solutions based on their clients' unfiltered demands, without fully considering the overall economics that may be implicit in those requests. Ironically, in responding unquestioningly to client requests, 3PLs have put themselves in a position of providing non-differentiating services that offer lower value for the customer at greater cost.

This reactionary approach to client requests has exacerbated two other issues facing 3PLs. First, information technology (IT) systems have proliferated as companies have expanded by acquisition and outsourcing. Our project work indicates that some 3PLs support up to 80 different warehouse-management systems—and these are not isolated examples. For most 3PLs, duplication of systems seems to be the rule rather than the exception.

Exhibit 1
Leading Logistics Players (Return on Sales 1996-2005)



Source: Company reports

Second, the strength of some of the individually acquired businesses in resisting integration, has made the industry slow to make gains on an international scale. Particularly on the national level, many 3PLs have continued to function as separate companies, only loosely affiliated to a larger entity, rather than operating as integrated components of a single business. These boundaries between business units and regions have effectively prevented a full sharing of experience, know-how, contacts, and best practices across the entire enterprise.

In order to effectively address IT proliferation and the integration of business units, Booz Allen Hamilton believes that 3PLs must also reform the way they interact with their customers.

Giving Clients What They Need

Giving clients exactly what they ask for might seem like a recipe for customer loyalty. In fact, the industry-wide pressure on margins suggests that quite the contrary is true. By simply order-filling instead of selling in a consultative, collaborative manner, 3PLs have trained customers to see their service as a commodity, with no differentiation between providers, and 3PLs have come to see themselves in the same light.

Often such behaviour leads 3PLs to agree to service levels that have a huge impact on operating costs and yet add very little value to the customer. For example, mobile-phone operators often place highly variable kitting orders for mobile phones on 3PLs, from zero one day to tens of thousands the next (see exhibit 2). A 3PL's service agreement may require it to complete all the handset-kitting orders in one day, even though a large number of the kitted phones will go directly to the stockroom. Such same-day kitting service might add value for only a limited volume of genuinely urgent orders, but satisfying the agreement could well require the 3PL to install excess capacity and add resources specifically to cover the peaks in demand.

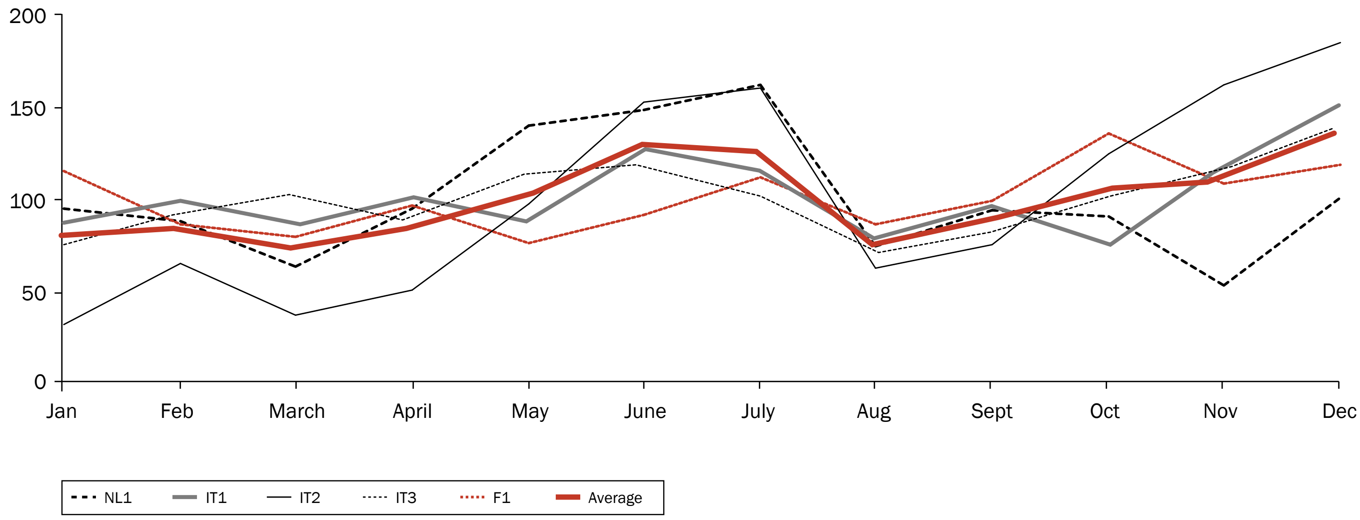
Worse still, the resources used to meet such non-critical demands can easily reduce the 3PL's capacity to fill urgent orders on peak days, which could even result in lost sales for the 3PL's clients.

A 3PL could avoid such problems and offer better service at a lower cost if, rather than simply agreeing to the client's request, it had stopped to ascertain the client's genuine needs and executed a service agreement based on those.

A second drawback for a 3PL that pursues the conventional "everything for everybody" strategy is that its sales representatives have little time to explain any unique expertise that the company may have developed. Even where industry-specific expertise may exist, sales representatives do not have much time to impart that message to potential clients: 70 percent of the typical sales rep's time is spent on coordinating solutions and documentation. The complex solutions that result from this

Exhibit 2

Mobile phone monthly demand variability for 5 sample operators (in '000)



Source: Operations reports

reactive process are difficult to price and often result in money being left on the table.

This contract-specific focus limits efficiencies in subtler ways, too. For instance, 3PLs often overlook potential cost savings through resource consolidation among clients, such as space-sharing agreements, because of the intensity of focus on the individual client.

This unnecessary ignorance is expensive. From a bottom-line perspective, it ensures that levels of operational efficiency vary widely across the company and even within particular business units.

The top line is also frequently affected: A lack of shared intelligence makes it difficult for logistics providers to translate success in one market or geographic area to other markets. Although some overarching key account management may exist within a unit, different units are likely to deal with clients in isolation from one another.

Expertise about a specific industry is seldom shared. Instead, engineers must build specific solutions from scratch for every single project, even if similar solutions were already built successfully elsewhere within the same company. We have observed in several occasions that successful state-of-the-art solutions are not rolled out across countries like for example in mobile-phone distribution. Many 3PLs have not learned how to share internal information about how to win and keep that business.

Applying the Smart Customization Approach

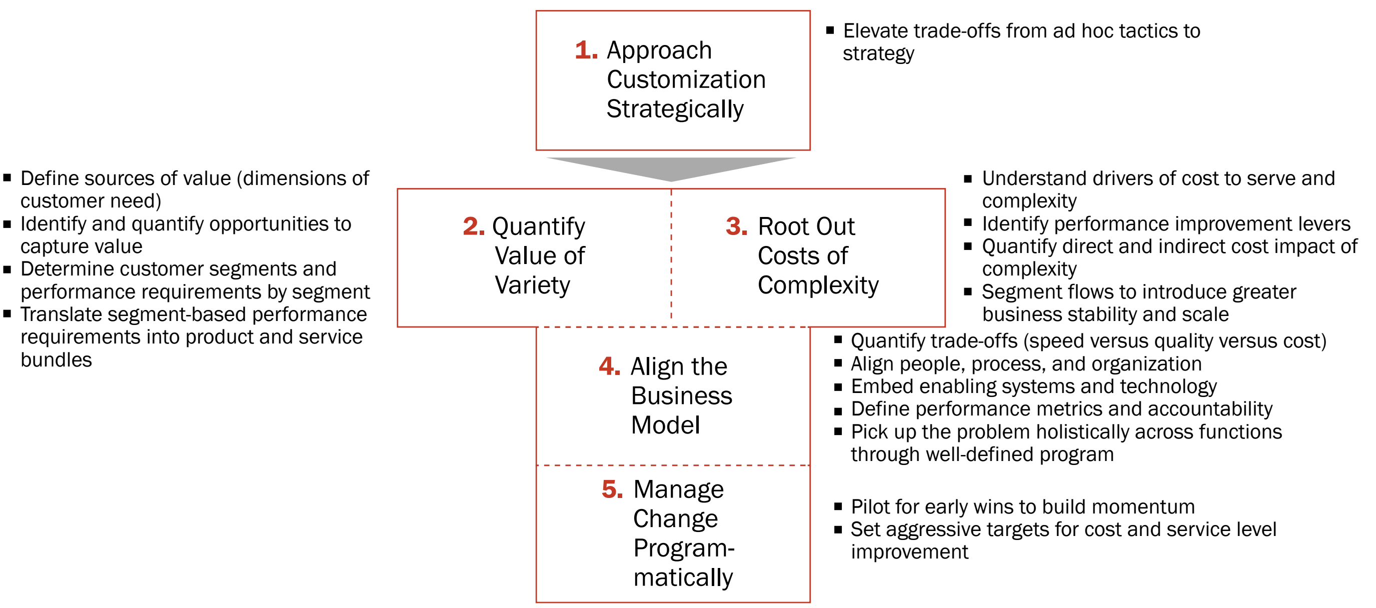
Clearly, a new frame of reference that takes advantage of the greater scale of many of today's leading 3PLs needs to be applied. Logistics providers need a process for reducing complexity and leveraging their extensive but scattered cross-company experience. They also need to learn not just what their customers say they want, but what the firm's collective experience with a given industry suggests they truly value.

Booz Allen's Smart Customization approach offers just such a framework. While the exact form of Smart Customization varies from client to client and industry to industry, the benefits are always compelling and far-reaching. Such programs always build on five key principles.

1. *Approach customization strategically*. Sometimes customization programs bubble up from the suggestion of a client or a rep, simply because they sound like a good idea. While this can be a wonderful source of product innovation, such a tactical approach can also easily generate new levels of expensive and cumbersome complexity.

2. *Quantify the value of variety*. It's essential to understand the value that customization offers the client. Too often, vendors make changes without understanding which ones actually matter to the customer.

Exhibit 3
Five Principles of Smart Customization



3. *Root out the costs of complexity*. Customization programs typically multiply over time. A key part of Smart Customization is keeping a careful inventory of systems and procedures to reduce the number of redundant processes.

4. *Align the business model*. In a badly designed business, there are often perverse incentives that increase customization rates. Salespeople, for example, often have strong incentives to make sales but no inducement to minimise expensive customization. Better alignment of all the company's players can help keep margins high.

5. *Manage change pragmatically*. Never customize simply because the client asks for it. By "walling off" those areas that can be customized, expensive complexity can be kept to a minimum.

Smart Customization has proved its value and effectiveness with successes for a wide variety of companies. It has delivered major benefits in industries as diverse as aircraft manufacturing and financial services. There is no reason it cannot do the same for logistics.

Putting Theory Into Practice

One 3PL is now experimenting with just such a Smart Customization approach. CEVA Logistics (formerly TNT Logistics), a global 3PL provider, together with Booz Allen Hamilton, recently piloted the strategy, which it branded internally as "Smart Standardisation." Although the company initially tested the program on a limited segment of five customer warehouses, the paradigm has proven so successful that it is now a core element of the company's corporate strategy.

It is easy to see why CEVA Logistics executives decided to continue the rollout: Not only did the company experience 20 percent overall productivity improvements in some of its warehouses where the Amsterdam-based 3PL followed this strategy, but the sales pipeline in this sector has never looked better. In fact CEVA Logistics has already won two significant new contracts as a result of Smart Standardisation.

Nor were benefits isolated to particular parts of CEVA Logistics' operation:

- Smart Standardisation has proven very complementary to CEVA Logistics' global roll-out of LEAN, their banner operational excellence approach, providing vital input to teams on the ground driving efficiencies: For example in one core process, engineers found a best practice that was more than twice as efficient as the approach used on some other contracts. Engineers have implemented this, using their LEAN methodology to other CEVA Logistics contracts.

- Redundant IT development, particularly in warehouse-management system (WMS) configuration and interfacing, was eliminated.

- Smart Standardisation has been shown to reduce implementation time by 50 percent, even as the learning-curve costs for new contracts have fallen.

- Specialist services, such as advanced reverse-logistics options, are now available to all customers, since CEVA Logistics engineers realised through the Smart Standardisation process that these were cost-effective options.

- CEVA Logistics has identified new business opportunities in both new and existing markets. Smart Standardisation has enabled CEVA Logistics' marketers to capitalise on the firm's deep knowledge of particular industries.

Behind CEVA Logistics' shift to an approach based on Smart Customization principles is a new way of looking at the business. This view requires every functional unit of the company, from business development and solution design to IT and operations, to move from meeting customer demands regardless of their internal cost (reinventing the wheel for each client) to configuring modular solutions to client needs (offering tailored solutions based on corporate best practices).

Abandoning total customization might sound tantamount to abandoning customers. It is not—because CEVA Logistics' Smart Standardisation isn't ultimately about saying "No." It is about saying "Yes" to the issues that matter most to the client and delivering a more cost-effective solution to the client's problems. By gaining a deeper understanding of the client's industry, more effective internal knowledge-sharing, and a greater understanding of its own true cost to serve, the 3PL can provide even better, more cost-effective solutions than it ever did before.

Hearts and Minds

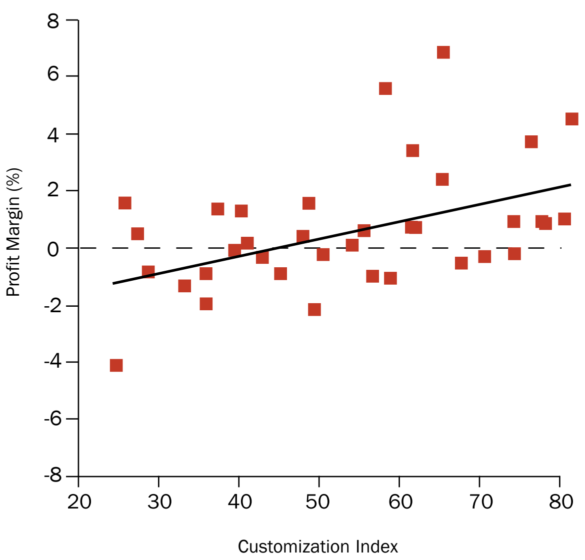
But moving to what Ian Truesdale, Global Director of Operations and Standardisation at CEVA Logistics, calls a "product, not project" approach, isn't easy.

While the technical challenges of Smart Standardisation are daunting, the most serious obstacles have not been operations but people. "It's not a top-down, autocratic organisation, so you're always going to have people who need to be convinced and you've always got to prove your case," Truesdale says. "There's usually someone who's going to turn around and say, 'I like the theory, but that doesn't apply to my situation.'"

With rare exceptions CEVA Logistics believes Smart Standardisation will eventually prove useful for many of CEVA Logistics' contracts. As Dave Kulik, CEO of CEVA Logistics, phrased it in a recent customer newsletter, "Smart Standardisation is not an isolated development, it covers the depth and breadth of [CEVA Logistics] world-wide."

We believe CEVA Logistics will be proven right. Companies in other industries that have followed similar programs have found that moving away from highly customized product offerings to a more modular approach to product development yielded lower costs and higher profits. In fact, one Booz Allen study of 50 firms that took this approach found they typically outperform their peers two-to-one in revenue growth and generate profit margins 5 to 10 percent above the competition.

Exhibit 4
Appropriate Customization Drives Higher Profit



Boeing Aircraft is one such company. Boeing had always focused on the differences between each of its aircraft, even referring to the "snowflake effect." But taking a Smart Customization approach allowed executives to see that within a given family (e.g., 737s or 757s), 60 to 70 percent of each aircraft was essentially the same. Rather than continue to operate the business around the differences, executives decided to take the opposite approach. If they could ensure that a majority of every plane always stayed the same, and if they treated only the exceptions as exceptions, they could create a much more efficient operating model.

The idea worked. Walling off the areas that could be configured to fewer choices that were easier to manage reduced assembly time and allowed Boeing to place two-thirds of its orders to parts and components suppliers in a "basic and stable" category. That reclassification had a dramatic effect on the cost structure: It turned what had been endless numbers of special orders into lower-cost, higher-volume purchases and positioned Boeing for significant competitive advantages against others in the market.

Although the aerospace industry is somewhat different from third-party logistics, the same principles of Smart Customization can be applied to 3PLs: Limiting variations and learning to better quantify the value of variety yields an improved outcome for the customer and for the company.

Conclusion: When Bigger Is Better

Bigger companies are better only if their size creates some advantage in the market—more buying power, pricing power, or the ability to leverage expertise more widely. Third-party logistics providers have largely neglected these basic economics—ironically, in part because of the headlong rush to create large-scale global logistics networks.

As consolidation continues, the old model of logistics outsourcing is breaking down. To succeed now, for themselves and for their clients, 3PLs must take a closer look at their own capabilities and at their customers' needs. Fortunately, the knowledge is largely already within these companies, waiting to be unlocked and shared through Smart Customization.

To reach sustainable profit margins, third-party logistics providers need to adopt a product-focused approach rather than a project-driven approach. CEVA Logistics, for example, is seeing the gains driven by the Smart Customization approach more and more clearly with every new contract. As Ian Truesdale puts it: "We are just at the beginning of a long journey of change."

What Booz Allen Hamilton Brings

Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for more than 90 years. Integrating the full range of consulting capabilities, Booz Allen is the one firm that helps clients solve their toughest problems, working by their side to help them achieve their missions. Booz Allen is committed to delivering results that endure.

With 18,000 employees on six continents, the firm generates annual sales that exceed $3.7 billion. Booz Allen has been recognized as a consultant and an employer of choice. In 2005 and in 2006, Fortune magazine named Booz Allen one of "The 100 Best Companies to Work For," and for the past seven years, Working Mother has ranked the firm among its "100 Best Companies for Working Mothers."

To learn more about the firm, visit the Booz Allen Web site at www.boozallen.com. To learn more about the best ideas in business, visit www.strategy-business.com, the Web site for strategy+business, a quarterly journal sponsored by Booz Allen.

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