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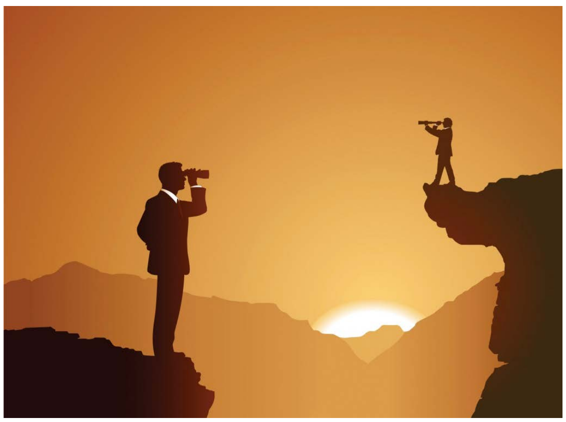
The Limits to Outsourcing: Beware of the Consequences for Market Success!



By **Masaaki Kotabe**, **Michael J. Mol**, **Janet Y. Murray** & **Ronaldo Parente**

Over the past few decades, outsourcing, in particular offshore outsourcing, has become a widely used means for firms to improve their performance. Outsourcing helps lower the firm's breakeven point and improve its return on investment. As a result, many firms have increased their outsourcing activities. In our studies we find that although firms may be able to improve their market performance through increased outsourcing, this is only true up to a point, beyond which market performance actually decreases. But we also find that firms that have a weak internal resource base or are facing strong competition can afford to outsource more. As a marketer you should be aware of the marketing implications of outsourcing strategy so that you can proactively shape your firm's outsourcing strategy.

Outsourcing may be a good way to cut costs in the short run, but do you know how it affects the success of your firm in the marketplace over the long term? This is a question we have been trying to tackle. In this article we will share our insights with you and hope to provide you with guidance on how to achieve a balanced outsourcing strategy for your organization.

Outsourcing helps reduce fixed investment in in-house manufacturing facilities and thus lower the breakeven point, making an outsourcing company less susceptible to recessionary sales declines and potentially helping to boost its return on investment (ROI). Thus, if corporate executives' performance is evaluated on the basis of their contribution to the company's ROI, then they tend to have an incentive to increase outsourcing, especially in the current business environment where pressures for cost reduction are everywhere. This financial logic has appealed in particular to U.S. corporate executives who tend to be evaluated on relatively short-term results.

But marketers, at the other end of the value chain, and top executives, may not have considered the marketing consequences of outsourcing strategy to the same extent. So does an outsourcing strategy help sustain your firm's competitiveness in the marketplace in the long run? Although the marketing performance impact of various strategic issues, such as market structure, brand equity, market share, and competitive strategies, has been widely studied, the outsourcing-marketing performance nexus has eluded executives' attention.

But we have strong reasons to believe that it matters and should be considered alongside these other issues. A series of studies[1] that we have conducted point to the fact that although firms may be able to improve their profitability as well as their market share through outsourcing, this is only true up to a point, beyond which market share actually decreases as a consequence of further outsourcing. Furthermore, we have found large-scale outsourcing to be a suitable strategy only for firms that have weak internal resources and face intense competition in the marketplace.

Before getting into the practical implications of our research, let's consider the following three historical cases from the personal computer industry. First, Michael Dell had established Dell Computer in the 1980s because he had seen a

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burgeoning market potential for IBM-compatible personal computers in the United States. After his immediate success at home, his company began exporting Dell PCs to Europe and Japan, followed by foreign production and subsequently by outsourcing more of its production to Quanta, a major Taiwanese computer contract manufacturer just as other PC brand companies did. In the process, Dell's computers have lost their uniqueness in the eyes of consumers in the competitive market. Second, think about a notebook-size Macintosh computer called the PowerBook 100 that Apple introduced in 1991. Apple enlisted Sony, the Japanese consumer electronics giant, to design and manufacture this notebook computer for both the U.S. and Japanese markets. Sony was long known for its expertise in miniaturization and has been a supplier of disk drives, monitors, and power supplies to Apple for various Macintosh models. In an industry such as personal computers, where technology changes quickly and the existing product becomes obsolete in a short period of time, a window of business opportunity is naturally limited. Therefore, Apple's inclination was to outsource production of its notebook computer so as to introduce it in markets around the world as soon as it could, before competition picked up. However, this outsourcing relationship did not last long as Apple became concerned about a technology loss to Sony. Third, take a look at Sony's own more recent struggle with its worldwide recall of lithium-ion batteries for notebook computers used by Dell, Apple, and Lenovo and its postponement of the European release of the PlayStation 3 game system due to delays in production of blue laser diodes, a key component of Blu-ray Disc players. Sony was once the symbol of technological excellence and product creativity in the highly competitive Japanese electronics industry. One explanation for Sony's recent crises is attributed to the trend of outsourcing to electronic manufacturing services (EMS) companies to cut costs. As a result, Sony has lost consumer confidence and market share.

> **"Firms that outsource component technologies may start to forget their own existing knowledge as well as incurring the opportunity costs of no longer being able to learn about changes in these technologies."**

These examples point to some negative consequences of outsourcing strategy. Our research seems to show that there is an optimal level of outsourcing for all companies, whether in manufacturing or in services, although exactly what that optimum is differs significantly from one firm to the next and over time. Indeed, we found that initial outsourcing helped improve profitability, and as a result of this initial success, companies tended to overdo it, resulting in lower performance, thus forcing them to reconsider the virtue of their outsourcing strategies. Of course neither executives nor academics can get it right all the time, but we still believe there are important lessons to be learned.

How Does Outsourcing Affect Market Performance?

So what is the right outsourcing strategy for a given firm? In observing that many firms do not outsource all their activities but instead use both insourcing and outsourcing, one could argue that these firms are attempting to strike the most effective balance between insourcing and outsourcing to leverage their benefits and mitigate their costs. We know outsourcing can provide advantages, especially when a firm cannot perform certain activities as well as potential suppliers. But outsourcing has drawbacks, too. First, firms often compete for and enter the most promising outsourcing options first, thus leaving less productive outsourcing options when they engage more intensively in outsourcing. Second, as increased outsourcing demands more managerial attention and frequently constrains managerial resources, it may lead to inadequate oversight of the outsourcing activities. Third, increased outsourcing leads to an increase in transaction and bureaucratic costs to a point where these start to exceed production cost gains. And firms that outsource component technologies may start to forget their own existing knowledge as well as incurring the opportunity costs of no longer being able to learn about changes in these technologies. These all result in a slower and inadequate response to the changing needs (or demands) of consumers.

Furthermore, although firms can potentially gain access to a new technology by outsourcing, it does not guarantee that they can integrate this technology into their existing business processes and deploy it in the marketplace. The first reason is that internal capabilities cannot be substituted by outsourcing, since passive capability accumulation is unlikely to occur. Second, comprehending customers' user experience with a new technology depends on various interdependent, tacit processes, which may be interrupted when activities are decoupled across internal and external suppliers. Also, learning about customers' preferences requires successive modifications, which demands frequent updating and renegotiation of outsourcing contracts.

As the examples of Dell, Apple, and Sony presented at the beginning of this article amply attest, upstream outsourcing strategy affects downstream marketing performance, including product quality, product delivery, consumer confidence, brand equity, and even corporate reputation. Academic literature equally suggests that a misalignment (i.e., a wrong governance choice in the circumstances facing the firm) leads to a decrease in performance. In other words, making the wrong decision by outsourcing activities that are best kept in-house, or integrating activities that are best outsourced, is a costly mistake. Our research attests to that and proves that any firm is best off by choosing a mix of insourcing and insourcing. More specifically, we show that outsourcing has a negative curvilinear, U-shaped relationship to marketing performance. This implies that as firms outsource more and more of their activities, they improve their performance, first by quite a lot but gradually by less and less, until they reach the optimal point, beyond which more outsourcing leads to *lower* performance, first a little lower but eventually a lot lower.

The Role of Firm Resources and the Level of Competition

Firm Resources. Our studies show that the optimal level of marketing performance varies with the strength of a firm's internal resources. As you would expect, firms with a stronger resource base tend to rely more on their internal resources and thus outsource less for their optimal performance. Firms with weaknesses in their resource base vis-à-vis their competitors are better off by outsourcing, whereas those with stronger resources can afford to keep more activities in-house. In measuring those resources, we examined whether firms have highly productive resources and whether they manage to create the kinds of products that sell well in competitive overseas markets.

Level of Competition. Competition effectively represents the seriousness of challenges facing the firm when it seeks to market its products. In general, where competition is more intense, firms tend to and should outsource more. It is so

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because competition forces firms to constantly search for cost efficiencies, which may be obtained through outsourcing. But equally, some research also suggests that outsourcing increases levels of competition. As shown in the Dell Computer case, the latter effect arises as outsourcing tends to remove the distinctiveness of a firm's product offerings. Thus, its product differentiation capability is reduced because all competing firms rely on a similar set of suppliers for their inputs.

We found optimal outsourcing levels to be lower with high R&D investment and marketing-related expenditures, as these tend to reduce competition in the industry by building innovative capability and brand reputation. Similarly, the more concentrated (i.e., oligopolistic) the industry is, the less competitive it is, and the less firms in the industry should outsource. So any reduced competitive pressure alleviates firms' need to outsource activities in order to seek cost efficiencies.

As noted above these are not the only factors that determine how much firms should outsource. The best outsourcing strategy also depends on the context. Over time, with standardizati on of components and lower transportation and communication costs, firms are able to outsource more. And location matters a great deal too. U.S. companies tend to believe that knowledge is divisible. Out of curiosity, one of the authors went to Japan and did a study with executives there and found that they tend to believe that knowledge is not as divisible. Similarly, European executives also tend to think that knowledge is less divisible. From an American point of view, Europeans and Japanese appear risk-averse as they do not outsource as much.

> **"Our research shows that the impact of making the "wrong" outsourcing decision is significant, as firms' predicted market shares sink substantially both at the bottom and the top end of outsourcing levels."**

How Bad is a "Wrong" Outsourcing Decision?
Using a firm's market share as a proxy for its marketing performance, we conducted a further analysis to explore how outsourcing levels affect a firm's market share. This helps us better understand how strongly a firm's outsourcing decisions affect its market share. We did this by statistically predicting the firm's market share with all the variables at their means, and then varying outsourcing from very low to very high levels (i.e., all the way from the bottom 2.3% to the top 2.3% levels).

The results demonstrate that the impact of making the "wrong" outsourcing decision is significant, as firms' predicted market shares sink substantially both at the bottom and the top end of outsourcing levels, and the predicted market shares drop by over 20% in some extreme cases. For a large majority of firms, the results are rather less dramatic of course. In all, among our sample of firms, the optimal outsourcing strategy for the "average" firm was actually to outsource slightly more than it did.

Executives' Perspectives from our Fieldwork
Our recent qualitative fieldwork[2] in the automobile industry presents a similar picture to this statistical research and is in line with our main idea that as firms deviate further from their optimal degree of outsourcing, by either insourcing or outsourcing too much, their performance will suffer disproportionately. As stated by one top executive from Ford, "we need to constantly monitor our relationship with our module suppliers it is complicated to figure out what is too much or too little when it comes to restructure a traditional manufacturing plant to implement a modular production approach that involves high degree of outsourcing activities." It seems that pushing to higher levels of outsourcing may also have negative outcomes. "These higher levels of outsourcing are taking up most of our managers' time … It requires extremely high levels of supervision to keep our suppliers performing at higher levels for all the activities we have suppliers performing for us … there are many unanticipated costs we are dealing with …."

Yet another plant manager at Volkswagen, although emphasizing the importance of outsourcing as a way to save costs, suggested that it is very important to know the optimal level of outsourcing: "We developed a modular consortium [using outsourcing] … that requires us to know what activities to outsource and what not to outsource." In general, our respondents recognized the benefits of outsourcing but were also concerned about its potential downside and their ability to decide on the optimal level of outsourcing.

We found in our interviews that there seems to be evidence of diminishing returns to outsourcing in the automobile industry. In general, the managers whom we interviewed suggested that their firm's competitive advantage seems to be linked to decisions regarding how well the firm arranges its methods of production and supply chain. As one respondent said, "it is hard to completely evaluate all costs involved with outsourcing and the potential for product quality problems, delivery schedule problems, and large price adjustments on the supply side." Therefore, there seems to be an optimal level of outsourcing activities beyond which diminishing returns set in. As stated by another respondent, "we have a daily meeting with all our suppliers, so that we predict and identify any potential problems … and make quick [fine tuning] adjustments to the extent we depend on our suppliers…. The key is to find the optimal level of dependency [in outsourcing] that we can afford."

Our fieldwork indicated that auto suppliers are currently providing more and more complete systems through outsourcing and are also taking up more of the engineering design and development. According to a plant manager at General Motors, "our strategy focuses on leveraging our capabilities with the suppliers' capabilities through outsourcing … in our case many suppliers … have been involved in the project since the design phase [and] are working together from the project conception." But while outsourcing seems to be necessary and has some positive implications, the risk of overexposure through a lack of balance between insourcing and outsourcing is also clear according to another executive: "It is important that we leverage our capabilities [with those of suppliers] through the codesign of components and systems, … but we must find the balance between how much to transfer to the supplier side and how much to keep in-house … any miscalculations can lead to problems and compromise our competitiveness."

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We believe that there is a relationship between outsourcing and marketing performance in the form of a firm's market share. Therefore, from a decision maker's perspective, it is important to understand how outsourcing affects the firm's market share and to know that firms can only benefit form outsourcing up to a point.

The first lesson is that firms that do not properly balance their outsourcing and insourcing levels will suffer in terms of their market shares, regardless of whatever other efforts they may undertake in marketing their products. The rationale for this is that if a firm clearly outsources too little, it does not obtain the cost levels its customers are seeking, while outsourcing too much leads to a loss of distinctiveness in the eyes of the customer.

Second, marketers and other decision makers in a firm with strong resources can afford to outsource relatively little, and this is also true if the firm operates in a less competitive environment.

Third, we would strongly urge marketers to have some direct involvement in outsourcing decisions. Firms that decide on their outsourcing levels without properly considering the consequences of those decisions for their market-oriented activities are likely to come to misguided conclusions; therefore, some level of integration of information between the different functions of the firm is essential.

For marketing managers. the key practical implication of our research is to be wary about the effects of either far too much or too little outsourcing, as it will have a detrimental impact on their firm's market share, and ultimately its chances of survival in the marketplace. Our theory suggests that the optimal amount of outsourcing is highly context-dependent, both temporally and spatially, and in addition, varies from one firm to another. Perhaps firms in our sample have now, on average, gone beyond their optimal degree of outsourcing and are suffering performance losses as a consequence. And of course few firms, if any, are "average," and therefore an individual firm should always consider its own idiosyncrasies.

About the Authors

Masaaki Kotabe holds the Washburn Chair Professorship in International Business and Marketing at the Fox School of Business at Temple University. Dr. Kotabe served as the Vice President of the Academy of International Business in 1997-98. In 1998, he was elected a Fellow of the Academy of International Business for his significant contribution to international business research. For his research he has worked closely with various leading companies around the world, and has written more than 100 scholarly publications, including the following books, *Global Supply Chain Management* (with Michael J. Mol) (2006), and *Global Marketing Management* (2013).

Michael J. Mol is Professor of Strategic Management at Warwick Business School. His work focuses on sourcing strategy and management innovation. Dr. Mol has advised private and public organizations on these issues and speaks in business events across Europe. He has published widely in leading academic journals and practice oriented outlets and has (co-)authored four books, including *Outsourcing: Design, Process and Performance* (2007) and *Giant Steps in Management: Creating Innovations that Change the Way we Work* (2008). He has won several awards including the prestigious best article award from Academy of Management Review.

Janet Y. Murray is E. Desmond Lee Professor for Developing Women Leaders and Entrepreneurs in International Business and Professor of Marketing at the University of Missouri-St. Louis in the U.S. In 2009-2011, Dr. Murray served as the President of the Women in the Academy of International Business (WAIB) which has 1,600 members worldwide. Her 2004 paper (with Masaaki Kotabe) titled "Global Sourcing Strategy and Sustainable Competitive Advantage," published in *Industrial Marketing Management*, is among the 2012 top 10 most downloaded *Industrial Marketing Management* articles that were published during the 1971-2011 period.

Ronaldo Parente is associate professor of strategy and international business at Florida International University. Dr. Parente's research has appeared in many leading academic journals and he currently serves on the editorial board of the *Thunderbird International Business Review* (TIBR), *Global Strategy Journal* (GSJ) and *the Journal of International Management* (JIM). He currently serves as National Representative in the board of the European Academy of International Business (EIBA) and is a guest editor of the *Global Strategy Journal* 2013 Special Issue titled "Strategic Modularity & the Architecture of the Multinational Firm."

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