Improving Logistics

The key is to have static-free communications among executives, financial professionals, and operations.

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Executives like the concept but don't understand the mechanics. Financial groups want to see results but don't know enough to understand the metrics. Operations people often dread it and subvert the process. No matter how you look at the function of logistics, communications is the key for bringing these groups together to build a shared vision and improve enterprise-wide results.

LOGISTICS LINGUISTICS

The first step in any improvement process is an understanding of both the actual and required costs, as well as a way to measure them.

Logistics encompasses transportation, warehousing, and inventory carrying costs. It's a significant expense item for organizations that manufacture, distribute, or offer products at retail. Depending on the industry and type of services used, expect the following approximate expenses:

- 7%–10% of net sales for all logistics,
- 4%–7% of sales for transportation services, and
- 2%–4% of sales for warehousing.

The communications challenge begins when measurements are applied to this function. Logistics and operations professionals use "unit rate" metrics, such as cost per package, cost per line, cost per pound, cost per order, and similar terms. These make sense at the logistics department level, but they aren't a financial executive's language. As logistics costs are reduced, they must relate to impacts in cost of goods sold (COGS); sales, general, and administrative (SG&A) costs; operating income; and net operating income (NOI) to catch the CFO's attention.

It's critical to address this communications gap if P&L improvement is the goal. If the sole measurement is transactional logistics costs, CFOs are incenting logistics managers to choose only the lowest-cost provider of the services. They may be surprised to find that choosing a higher delivery cost could reduce total supply chain costs when customer returns, adjustments for damages, restocking costs, or quality inspections are taken into account.

I learned a lesson in taking logistics costs beyond unit rate when I was logistics manager for an outdoor power equipment company. We decided to add $5 to the packaging cost of a product, which enabled us to ship via a time-definite, small-parcel carrier (like UPS or FedEx@Home) that also had our retail customers' confidence. As a result, the return rate caused by damage and delivery failures was lowered by almost 50%. This better-negotiated rate, coupled with the savings on returns processing, translated into 40% lower overall product-line logistics costs. This was a measurement better understood and greatly appreciated by the company's CFO.

PERFORMANCE METRICS

Financial executives can help their logistics professionals achieve organizational success by setting the stage for static-free communications. The objective is to create a metrics-based "dashboard" that measures reliability to customers and calculates total supply chain expenses as a percentage of net sales.

Reliability measurements are the ongoing quality monitors that ensure the appropriate value is being sourced, which means not spending too much or too little. A difficult, but necessary, measure is the "perfect order" metric, which can be used for both customer shipments and inbound shipments from vendors. It combines all the components of the delivery process and measures the delivery frequency percentage of the correct product, to the correct place, at the correct time, in the correct condition and packaging, in the correct quantity, with the correct documentation, and to the correct customer. It isn't uncommon to see this rate languish in the 50% to 60% range when you first measure it.

Measuring total supply chain costs will require input from a number of sources: logistics, order management, sourcing, quality, product management, IT allocations, and production planning costs.

A company's logistics costs should be benchmarked accurately against at least two outside databases. This information is readily available for a relatively low cost, but be sure to use the appropriate market vertical for your business—one that has your competitors or similar industries in it. Operations professionals often argue against benchmarking results with the excuse: "We are different." While the level of accuracy may not be absolute, benchmarking is an objective measurement tool if used over time.

Many benchmarking services provide transportation, warehousing, and inventory carrying costs, while more extensive services also offer comprehensive supply chain performance and cost measurement. The specific service chosen is less important than taking the first important step to make the measurement.

The next step in the "dashboard" phase requires senior management involvement. At this point, you understand "as is" costs as compared to the competition. Now it's time to determine the logistics "to be" state. The choice comes down to balancing the pros and cons of positioning the company as a high-service provider or a low-cost provider, but not both. Many executives want to be both, but they must acknowledge that the two are mutually exclusive. Compare the difference in shopping at Wal-Mart and Nordstrom's. Both are leaders in the retail segment they serve, but one focuses on cost, and the other focuses on the guest experience. Both are successful, but they go to market in very different ways.

Finally, outline the opportunity gap between actual ("as is") and desired performance ("to be"). An example of this gap could be in delivery reliability and total supply chain costs. If the company has a mature, commodity product, total supply chain costs typically need to be superior to the competition's costs, while delivery reliability needs only to be at parity. But if you're introducing a new or innovative product, delivery reliability should be the driver, and you can simply meet competitors' costs.

BEST PRACTICES

Best practices can help meet any organization's requirements for logistics cost performance, and industry contacts can help identify the most appropriate practices to emulate. Creating the future "to be" state requires diligence in following these best practices:

Capturing cost transactions. Unless your company has a highly integrated transportation management system, freight bills are paid most efficiently through a professional payment firm. This not only ensures correct rate payment but also the data collection that sends detailed transactions with accurately captured expenses by G/L type and customer. The freight payment service should offer easy-to-use, query-reporting systems available to stakeholders throughout the organization, not just the logistics department.

Competitive bidding. No matter what the size of the company is, all service providers should be competitively bid no less frequently than every three years. Sourcing vendors, transportation carriers, and warehouses all experience change in their markets. Synchronizing the supplier base on a regular basis ensures continued use of organizations that best fit business needs and maintains a level playing field with business partners. They have the ability to make market adjustments for pricing when necessary and eliminate accounts that don't make sense to them any longer. It's a lot of work, but this diligence results in keeping fresh in the marketplace.

Rate changes. Keep in mind that transportation providers set all pricing using a fixed-rate base where appropriate. Since the deregulation of the transportation industry 20 years ago, carriers now offer discounts from a table of rate charges. Logistics teams should use a fixed-rate base that doesn't change from year to year.

OUTSOURCING ROI

While financial executives are certain to get significant pushback from logistics managers, consider thoroughly exploring the outsourcing option for some, or all, logistics activities. It is too important an opportunity to accept anything less than a complete review, even if you decide not to go that route.

Outsourced logistics management is a rapidly growing industry. Estimated at $65 billion in 2002, it has shown steady growth rates of 5% to 10% annually and has doubled in industry size since 1996. According to Armstrong and Associates research, almost 50% of the *Fortune* 500 companies now outsource some part of their logistics activities.

What has changed since 1996 is that high-quality firms now exist in most industry verticals. No longer is optimization lost because the outsource firm has only general capabilities. While they often are viewed as an easy cost-reduction opportunity, the value-added services can help differentiate results. They can provide more than "rate" improvements because many offer sophisticated modeling tools to help improve daily needs. Some now offer to combine one company's activities with another's to help both reduce "run" expense.

Admittedly, outsourcing transportation management is easier than warehousing services. Even though the industry has been around for centuries, the contract and public warehouse and fulfillment market is fragmented and not well developed. While selected market leaders are at the forefront of capabilities, many simply are selling space for storing inventory. If they can be selective and needs-specific, most companies can avoid service failures if they truly understand the contractual relationship. Rates will be higher in a month-to-month environment, so the key is to have a three-year strategic plan for space needs and create a flexible warehouse network to support it.

By selling the buildings, fixtures, and systems and selecting an outsource provider, an organization can trade off potentially higher variable rates for the use of cash. Outsourcing warehousing functions can strengthen a balance sheet, depending on how well the cash is invested in other parts of the organization.

COMMUNICATING PERFORMANCE

From a management perspective, financial executives can help provide an opportunity to all parties to balance and set strategic directions. To be successful, logistics needs to be managed at the enterprise level. Decisions are too often left for local facilities to make. While these local facilities deserve a voice in selecting the service provider, the need to leverage the enterprise should always be the focus of decisions. In quarterly meetings, senior management and the logistics staff can review the "dashboard" metrics and outline monthly and yearly metric goals. By understanding the company's objectives and translating internal metrics to address them, the goal to increase overall value, not just cut costs, can be reached.

A CFO's role is now to help the logistics team manage its "dashboard." Schedule regular meetings to review the dashboard and make plans for improvement. Hold the team accountable for performance improvement, and help clear the way in the organization when they need help. The CFO only needs to appreciate the results of the work effort, not how it gets done.

The use of a mentor is one way to help the logistics team succeed. Mentors often come from outside the logistics field, such as finance or sales and marketing, and have experience communicating with the CEO and other executives. The mentor can review dashboards, cut through confusing lingo, and ensure that activity is taking place to improve supply chain performance. Until the logistics team thinks like a businessperson, a mentor may eliminate communications issues between the team and senior management.

Depending on the maturity of your supply chain, everything I've talked about may be easy to accomplish. Unfortunately, many organizations have neither the experience nor the desire to tackle it. It isn't really that difficult to achieve—someone just has to choose to do it. Success depends more on communication skills than any other factor. As an executive, you can keep your message simple: "Teach strategic down, and translate tactical up." ■

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