White Paper | by Hannah Kain, CEO, ALOM

Avoid The Unit Cost Trap

Summary

When researching a fulfillment and supply chain vendor, many companies put themselves at risk by focusing only on the easy-to-compare unit prices, such as a per-order shipping fee. Serious quality problems can arise if the wrong vendor is chosen. This can impact the entire organization and threaten a company's survival. Even small quality errors can impact a company's bottom line. This paper looks at how to review costs while analyzing the risks involved with basing a business decision on unit costs alone.

It is tempting to evaluate a vendor based on unit cost since it is relatively easy to compare unit price. It also seems to make sense to review unit cost to save money. Yet selecting a vendor based on unit price is one of the most common reasons companies get burned in the contract package assembly and fulfillment industry.

The main cause of this problem is failure to realize that packaging and fulfillment services are not a commodity. In addition, the cost to package and ship an order is usually small compared to the cost if something goes wrong. Even a small percentage of errors can become costly. (For more information on avoiding errors, read our white paper, "Simple Fulfillment Errors Will Affect The Bottom Line")

Companies who choose services based on cost can be impacted on a strategic level as well. Lack of an appropriate supply chain partner impacts the strategic outcome for companies. Lack of organization, records and reports can impact all companies, especially public companies.

Finally, more comprehensive problems can impact an entire organization and may ultimately cost it its life. Let's outline the thought process for reviewing cost before going into details about of the specific types of problems that can occur.

Strategies for Reviewing Costs

Total Cost of Doing Business

Clever managers have long considered the "total cost of ownership," (TCO) a common metric used for evaluating IT equipment or capital investments. For instance, it is commonly known that some copiers and fax machines are cheap to buy but, in turn, the supplies needed for those specific machines are extremely expensive.

Thus, over the lifetime of the equipment, ownership becomes costly. In fact, it would have been a better financial decision to buy a more expensive piece of equipment and pay less for the supplies.

In calculating TCO, IT managers typically look at several metrics, some of which can be difficult to measure. This includes cost of installation, cost of maintenance, cost of training, cost to troubleshoot, cost of downtime, cost of energy consumption and many other factors.

Similarly, in supply chain management and packaging and fulfillment, hundreds of factors can be reviewed to determine the total cost of doing business (TCDB). Unit cost is only one of these factors.

How, then, does a company select the key factors critical to their TCDB? One way is through a risk profile.

Review the Risk Profile

Let's start by reviewing a specific risk profile by asking the question: What is the impact if the vendor-partner fails? If failure is disastrous, finding the right partner is of paramount importance.

Risk profile can depend on the product type and industry. Many companies in the medical sector routinely find themselves in the high-risk area because any error literally may be life threatening to the consumer. Safety products, cars, planes, military equipment and similar products are also usually high-risk. In addition to the risk to the customer or consumer, companies should consider the impact on their own survival.

One example was a project we completed for a relatively new company. The customer had a major breakthrough with an opportunity of shipping a test order of complicated products to a huge corporation. If the test went well, the company was going to be successful. If the test went poorly, a major potential customer might been lost; the company might lose funding and therefore ultimately fail. While the product was being measured on its functionality and technical merits, all the details in logistics were important for the test to go smoothly. Unit price was of no consequence to the customer.

On the other spectrum are promotional items. They are frequently considered low risk with little impact if the vendor-partner fails. Many times, if promotional items are not shipped or received, it might simply go unnoticed. While promotional items surely are lower risk, they are not entirely risk-free. Problems with promotional items may impact company reputation, customer satisfaction and profitability.

The less importance of a program and the less impact of failure, the more unit cost can be factored in when selecting a vendor.

Defining Complexity

After determining a risk profile, the product, the product management and the process flow need to be assessed. The more complicated the product and process flow, the more likelihood that something could go wrong in the relationship.

One example are products that need to be custom configured to ship, or where frequent changes take place. This is common for high-tech hardware, gadgets and software. Complexity can also be related to process and turnaround. The higher the requirements, the more risk and the more need to select a high-quality supplier.

For instance, we had a customer with a hardware component where the hardware component would lose up to 10% value each month. The hardware component was roughly 150 times more expensive than our service fee for assembly. In other words, if we configured and shipped same day, we could save the customer an amount comparable to their entire assembly cost compared to if they used a competitor with a two to three day assembly/configuration cycle.

If shipping to retailers, businesses need to consider the process flow and complex IT requirements required to successfully maintain the relationship with the retailer. On the other hand, if working with a simple product with a simple setup and few changes, then a simple solution may work.

Getting More Than Just Execution of Orders

Some companies need extensive support and advice as part of their outsourcing. Most companies need and can strongly benefit from having the knowledge and support of specialists in operations to support functions such as export assistance to comply with US Government regulations, and regulations in the receiving country or to provide advice on packaging materials, or to provide carrier selection, or to set up a program to handle returns. If a company has the knowledge, systems and processes in place to control everything, then the vendor-partner in reality is merely performing mechanical functions. However, the cost savings and benefits in having a knowledgeable vendor-partner can be huge.

An example is a software publisher that had previously sold its product via different channels. They approached us for logistics support for their newly developed retail channel sales. Unfamiliar with the routing guides, EDI requirements, labeling requirements and physical requirements of major retailers, they were looking for guidance. While they could have hired consultants to help them during the setup, they would have encountered problems if more retailers were added or if the retailer requirements changed.

On the other hand, some companies can get away with minimal support if they have a stable set-up with few changes and in-house knowledge and resources for making daily decisions. But even in this scenario, do not forget the cost of maintaining in-house staff and the risk of overlooking risks or opportunities for cost savings.

Lack of Supply Chain Processes and Support

Finally, as companies assess themselves as a customer they need to consider strategic supply chain needs. Unless a vendor-partner that can meet future requirements is selected, companies outsourcing all or significant parts of their supply chain may be subjecting themselves to a new set of tactical or strategic restrictions. Just-in-time requirements, flexibility, agility and the ability to provide information instantaneously are becoming more important for businesses to succeed. The cost of being left behind in global competition — where competitors have superior tools, abilities to configure and ship product on a just-in-time basis, manage their processes and keep their customers in the loop — can hardly be measured relative to fulfillment unit cost. It is the difference between having operations as a competitive advantage or a competitive drag.

Minimizing Risks

Reporting: It is extremely important for companies to remain in control when they outsource their packaging and fulfillment. They can do that by getting relevant reports with the correct data compiled the correct way. This allows the company to manage and be proactive.

Record keeping: For public companies, record keeping can move from a day-to-day function to a tactical or even strategic issue in a heartbeat. One of our customers had to restate financials, and we provided four-year-old shipping records with less than 24 hours notice. Without those records the company would not have had the necessary traceability of the source of its revenue.

Focus: Loss of focus due to day-to-day operational issues can be detrimental. Monitor time spent on day-to-day issues and review whether the time is well spent.

The Last Word on Evaluating a Vendor

Evaluating any vendor based on unit cost is simple since it's relatively easy to compare unit price. Though businesses might be saving money in the actual shipping of a product, the potential for serious, business-threatening problems down the line are real. Even in the low impact/low complexity scenario, the impact of unit cost can be negligible compared to the cost of high error rate, lack of control and lack of operational efficiency.

Is it worth saving an extra buck on the backend? If you do a risk analysis, review your actual costs, then compare your "great deal" with the more common problems faced by companies who chose vendors based on unit cost, that answer just may be no.

Assessing and Mitigating Risk

	Low complexity (product, process, supply chain, relationship) with lower risk of failure	High complexity (product, process, supply chain, relationship) with higher risk of failure
Low impact of failure	Consider unit cost when selecting a vendor. However, consider any positive or negative contribution of vendors that you may not have considered (see below)	Consider qualifications and proven ability to execute instead of considering unit cost. Also if selecting a low-cost provider: Consider simplifying. Consider eliminating consulting type activities from daily implementation and execution when asking for a bid. Calculate the hourly rate of the person within the vendor who is supporting key decisions
High impact of failure	Consider qualifications and proven ability to execute instead of considering unit cost. If selecting a low-cost provider consider eliminating the risk elements. "Baby-sit" closely if one-time project and including unit cost in selection criteria.	Disregard unit cost entirely. Consider disqualifying cheap bidders. Qualifications and proven track record should be only consideration. Review vendor-partner's understanding of project.

About the Author

Hannah Kain is CEO and Founder of ALOM. Kain has extensive experience in the packaging industry. She has three university degrees, has won numerous awards, including ABWA, NAWBO and Women's Fund, and has been featured in books and articles, including "CEO Chronicles" and "Women Who Paved the Way."

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