# Outsourcing: make or buy

Chapter 8

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# Outsourcing

- Outsourcing occurs when an organization hands over part of the value chain it owns to a different firm, while mantaining the number of business it is active in.
- It’s different from divestiture, because with the latter one the firm reduces the number of business it is active in by pulling it out of a value chain and ceasing to offer that product.
- With outsourcing, the firm is no longer producing in house that product: it leaves the production to a specialized firm, selected from the external environment

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- Offshoring occurs when part of the value chain moves to another geography, usally one with lower costs. It can involve or not the outsourcing, since the firm can also keep the business in its value chain and simply decided to just move operations to a different location

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- Thus outsourcing involves refocusing by existing value chain activities, while divestiture involves refocusing by exiting that specific value chain.
- In outsourcing remains an ongoing dependency between the outsourced value chain activities and those that are kept in-house.

- The outsourcing decision occurs when the net present value of the business plus outsourcing is greater than merely the net present value of the business without outsourcing.
- This decision can occur when the jointly businesses fail the synergie test.
- Both divestiture and outsourcing implies selling out the business
- However, an ownership change can destroy the economic value of the business

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- The value is destroyed when: there's a poor compensation of the old owner and/or quality of outsourced goods is lower
- Outsourcing can also occur when the new vendor can do better than in-house unit, in this case that means the synergy test is passed, considering synergies between the value chain as redesigned after the outsourcing of a business

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- The outsourcing test, as instance, is passed when the vendor is a specialist, or  can exploit synergies with her other businesses.
- In this case, the extra-value depends on efficiency, effectiveness, flexibility.
- Flexibility allows to convert fixed costs in variables costs; the decrease of the demand and other market factors dependency for the firm.

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- The core of the outsourcing decision is that the business must be not critical for the corporate, and, at the same time, it must be a core activity for the vendor: that is the proper meaning of “make or buy” decision

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- Efficiency reasons (advantage in terms of lower costs):
  - Wage differences across geography;
  - Economies of experience or scale;
  - Specialization of provider;
  - Incentives;
  - Employee professionalization

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- Effectiveness (customers are more willing to pay, even an extra price):
  - Access to better technology;
  - Continual improvements.
- Flexibility:
  - Scalability;
  - fixed costs converted into variables one.

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- If transaction costs are way too high, or the vendor cannot manage the business better, then, the decision is to keep in-house

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- Transaction costs: contracting costs; transition costs; interaction costs.
- Contracting costs: selecting vendors; negotiating; reaching agreements; monitoring; measurement; dispute resolution mechanism.
- Transition costs: knowledge capture and transfer (to personnel); severance; retraining; employee relocation. There can be failure in coordination and moral hazard. Knowledge is embedded in people, therefore is hard to transfer. It is needed to incentive employee.

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- Interaction costs (between the outsourced activity and the process which still remains withing the original firm): they need is to function in-sync, that's why there are costs.

Such costs can be: coordination costs; ongoing process mapping and interface design; travel and communication; coordination mistakes.

# How to…

- Define service level agreement (SLAs);
- Mantian partial ownership over the new supplier;
- Increase the bargaining power over the vendor through: significant orders; multi-sourcing; keep some production in-house;
- Offshore without outsourcing in case outsourcing is not convenient

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- Standardize and codify for an effective transfer;
- Re-badging (the vendor hires key-employee from the original firm)
- Reduce interdependencies (modularize)
- Employee presence on client site
- Build tacit coordination mechanism (common language teminology; virtual collaboration)