Third Party Logistics: An Analysis of the Feasibility and Contexts of Strategic Relationships

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The Third Party Logistics (3PL) Industry
Third Party Logistics (“3PL”) emerged in the early 1990s when logistics service providers started offering consolidated services and an increasing number of customers, for a variety of reasons, entered into longer business contracts with the logistics service providers. The total logistics market in 2003 in the US was $910 billion (Delaney, 2003) and the 3PL market was around $65 billion (Gordon, 2004). The 3PL market has been increasing for the last 10 years at a rate of more than 20 percent. A survey of 221 companies in the US reported that 78% of US companies are using 3PLs for logistics services and spending 49% of their logistics expenditure on outsourcing which is likely to grow to 56% by 2006-08 (Allen et al, 2003). The growth of the 3PL industry is much faster than the growth in total logistics expenditure indicating that the market is still in its formative stage which makes 3PLs an interesting area of study.

Motivations & Methodology
Individual companies no longer compete with other stand-alone companies but supply chains compete against other supply chains (Christopher, 1997). The performance of the supply chain depends on the operations of all participants. The participants could include suppliers, manufacturers, carriers and retailers. The globalization of corporations has increased complexities and challenges in the supply chain. The companies are now targeting overall cost reductions in the complete value chain. That is, they are shifting from local or silo optimization to global optimization of supply chains. Strong competition, coupled with the factors stated, is motivating companies to build relationships with stakeholders in the supply chain. Thus 3PLs, as one of the stakeholders, are increasingly playing a vital part in customers’ supply chains. Our study, on relationships between 3PLs and their customers, aimed to answer the following two questions:
1. In which logistics outsourcing contexts are strategic 3PL relationships more effective?
2. What capabilities and organizational attributes 3PLs should develop in order to become strategic partners?

The methodology for study consisted of literature review on previous studies on relationships between 3PLs and their customers. We segmented the relationships into clearly defined categories—simple, privileged, and strategic. Then to understand the existing relationships and to understand how 3PLs segment their customers into these categories, professionals in the industry were interviewed.

**Key Findings**

Several recurring findings and themes were gathered. The study reveals that most respondents have a general understanding of the presence of a range of relationships in their customer portfolios. However, none of the respondents communicated pre-existing or alternative segmentation models of relationships. The primary factors and characteristics found in the study that distinguish strategic relationships are (1) Long Term Contracts (2) Compensation Plan / Gain sharing (3) Value-Added Services (4) Complexity in Supply Chain (5) Profit (6) Joint Planning (7) Information Sharing (8) Consultancy (9) Continuous Improvement (10) Joint Venture.

The spread of relationships across the segments are Simple (0-90%), Privileged (0-60%), Tactical (0%) and Strategic (2-80%). While we anticipated a range of results from different participants in the study, the interviews yielded some surprising results. The most striking was the range in the simple and strategic segments. As expected, tactical relationships within the definition presented in the framework were not reported.

The key findings on strategic relationships were:

1. Importance of Value-Added Services
One of the motivations for this research was the reported trend towards commoditization of 3PL services and efforts by 3PLs to expand the range of Value-Added Services offered (Lieb et al, 2003). Our research found evidence to support the view that Value-Added Services provided by 3PLs to customers aid in moving customers and 3PLs along the path to strategic relationships.

2. Compensation Plan Influences the Nature of Relationships

One of the characteristics of relationships described in a framework we reviewed is risk, and the allocation of risk. Relationships on the more closely integrated end of the “coordination spectrum” display a higher level of risk sharing. Strategic customers had a gain-sharing mechanism in their compensation plan. An important finding in this area was the potential for difficulties in relationships when clear performance measures and targets are absent. Despite concerns about performance measurement, the research showed that risk and reward sharing is often an identifier or characteristic of strategic relationships.

3. Complexity of Customer Supply Chains

A recurring concept revealed in the course of the research was that complexity in the supply chain is a factor influencing the nature of 3PL/customer relationships. Some of the participants explicitly stated complexity as the reason for the development of strategic relationships. This complexity was both at specific points in the supply chain, such as in warehouse processing, as well as in overall coordination of the supply chain.

4. The need for 3PL Expertise and Continuous Improvement in Operations

One of the reasons firms give for outsourcing is to gain expertise in non-core areas of their operations. Our research revealed that 3PL expertise was also a factor that contributed to the establishment of strategic relationships. While consulting received less emphasis than traits such as gain-sharing, we observed that some of the distinct characteristics generated by our study are not mutually independent in practice. An additional finding was that this expertise needed to be demonstrated through continuous improvements in the operation of the customers’ supply chain.
Recommendations

I) Contexts for effective strategic relationships

A primary goal of this research was to assess the contexts that are conducive for the development of strategic relationships. Recommendations regarding the contexts in which 3PLs should seek to establish strategic relationships are detailed below.

1. Seek suitable target industries
A factor contributing to the duration and intensity of the interaction between 3PLs and customers was the complexity of the supply chain in the industry. This insight reveals an effective way in which 3PLs, by first segmenting industries, can better tailor the level of effort invested in establishing strategic relationships. Industries with complex logistics requirements are more likely to desire relationships that can assist in ensuring minimal risk of disruption in the supply chain.

2. Seek suitable target clients
Within specific industries, customers can also be segmented based on the complexity of their supply chains. Customers within the same industry may have a diversity of assets and approaches which affect their logistics needs. An added dimension to this focus is the presence of competitors within any one industry. It is necessary for 3PLs to remain aware of the implications; pursuit of one shipper may require the 3PL to forego the business of the shipper’s competitors.

3. Establish the right environment through willingness to share risk
As can be discerned from the experience of some 3PLs, compensation plans have a bearing on the nature of relationships that develop between 3PLs and Customers. Depending on the nature of contracts, it is possible for adversarial or otherwise difficult relationships to arise. Some 3PLs have instituted gain-sharing as part of their compensation plans, facilitating an alignment of interests of both the provider and the user.
II) Capabilities

In addition to selecting environments which facilitate strategic relationships, 3PLs can also enhance their suitability for strategic relationships. We analyzed our research findings to identify some attributes and capabilities that 3PLs should cultivate. These capabilities and attributes are enumerated below.

1. Develop a range of Value-Added Services
   Value-Added Services are the functions performed by the 3PLs beyond traditional basic services such as transportation, warehousing and freight forwarding. Value-Added Services serve as a differentiating factor for 3PLs. Expanding the range of services offered also increases customers’ dependence on 3PLs by allowing 3PLs to penetrate deeper into customer’s supply chains. A related consequence is the raising of entry barriers for the competitors.

2. Develop expertise in areas of operation
   As described in our research findings, customers look upon the 3PLs as experts in the field and this constitutes one of the important reasons for logistics outsourcing. During our interview some of the industry professionals described this as a basic requirement for a strategic relationship.

3. Develop alliances to provide a broad and deep set of services
   Customer requirements in complex supply chains often require expertise that extends beyond the capabilities of any one supply chain vendor or service provider. Forming alliances with businesses that have complimentary capabilities can help provide the appropriate combination of expertise and value added service that is needed by the customers.

As can be determined from recommendations, the 3PL operating environment consists of forces that are outside the control of 3PLs as well as factors that 3PLs can influence when seeking to establish strategic relationships. Our research highlights these factors and suggests ways in which 3PLs can address them in their relationships.
References:


