

SMES AND GLOBAL GROWTH

MEETING LOGISTICS CHALLENGES



SMEs entering new foreign markets should pay close attention to efficient logistics—including finding a balance between outsourcing these functions and performing them in-house.

A small or mid-sized enterprise (SME) establishing a presence in a new foreign market faces steep learning curves on several fronts. It must familiarise itself with the needs and preferences of a new market, ensure compliance with a new set of laws, find and train local staff, arrange financing, and sometimes learn a new language at the same time.

In the excitement of establishing a foothold in unfamiliar terrain, small firms can overlook a less glamorous aspect of the process, but one that is crucial to success: ensuring that components, raw materials and finished products reach their destinations on time, in good condition and at competitive prices. That task—establishing supply chains and distribution channels—falls to logistics managers; the quality of their performance can make the difference between a successful international expansion and an expensive disappointment.

Logistics pitfalls abound even in an SME's home market, and can be compounded when using an overseas manufacturer. One typical example, involving underestimating shipping costs, is related by Entrepreneur magazine¹, a North American publication focused on small business. A small California supplier of wedding-cake toppers, Younique Boutique, received an order to ship wedding toppers to a television production set. When the order ballooned unexpectedly to 280 toppers and the television production set was belatedly revealed to be in Hawaii, the SME's founder and CEO scrambled to fill the order using a manufacturer in China. Under time pressure, and without accurate information on the shipment method to be used by the Chinese plant or the added price of a rush order, the owner guessed that the added shipping cost would be \$5 per item—an underestimation that ultimately cost the firm \$800.

HIRING DELIVERY EXPERTS

Mistakes made under time pressure are hard to avoid, but the main lesson here for SMEs is clear: Regardless of where they operate, attention to the nuts-and-bolts of logistics is an important aspect of successful entry into a new market.

To avoid costly logistical problems, many newly internationalising SMEs outsource the logistics function, both for inbound components and returns, and for outbound finished products. They

¹ "Three tips to avoid costly shipping mistakes", *Entrepreneur*, May 27, 2011, <https://www.entrepreneur.com/article/219704#>

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look for experienced logistics services providers, using either partners they already employ elsewhere, or local firms, or a combination of the two. This enables them to concentrate on their core business and leaves the details of deliveries to firms with distribution expertise in the new market.

Consider UK-based Childrensalon, which sells high-end children's clothing via its website and through a shop in Tunbridge Wells, UK. It increased its sales tenfold over the past five years (to £63 million in 2016) by selling internationally via its web site. This expansion required a heavy investment in logistics, including building up the firm's packaging staff and warehousing capacity, as well as updating its IT systems. For deliveries, however, Childrensalon relies on five international freight firms including UPS and DHL. "We found that some companies were more efficient than others for deliveries in certain parts of the world," says human resources director Denise Hamilton, adding that selecting providers for each new market was a process of "trial and error". These outside providers manage the paperwork, such as customs clearance, as well as the actual deliveries.

Childrensalon is hardly alone in outsourcing freight services in new markets. Toby Gooley, editor of the US-based *Supply Chain Quarterly*, says that most companies, large and small, outsource distribution to avoid devoting time and resources to a non-core activity. While freight services provided by a third party come at a cost, outsourcing this function means an SME saves on dedicated staff to deliver goods and to ensure legal compliance with import and export regulations, as well as saving the direct costs of buying and maintaining delivery vehicles.

For a largely web-based company such as Childrensalon, outsourcing freight operations has allowed it to sell, and source, worldwide: it now offers more than 270 different brands and sells to more than 120 countries, fuelling rapid sales growth in recent years. Given that complexity, outsourcing freight operations was a must—even if that meant paying the costs of both initial deliveries to customers and return deliveries when customers do not want an item they ordered. The cost of return deliveries, in particular, cuts into the margins of an online retailer, but is an unavoidable cost since customers cannot physically see or try the goods they order online.

So, for example, Childrensalon pays freight services providers such as UPS or Fedex £9.95 per delivery to an address in the United States, and a similar amount if the customer decides to return the item. The firm pays freight providers £3.95 for delivery to a UK address. Ms Hamilton says that the higher US delivery charges are passed on to US customers (who must also pay return postage costs themselves), who pay them because the charges are relative low compared to the high cost of the high-end products involved. While this works for Childrensalon, high delivery costs in

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export markets could hurt companies in more competitive industry segments by pricing their products out of reach.

In general, experts say distribution and logistics services can add 10%-15% to the cost of goods.² One concern highlighted by Childrensalon is that SMEs often fail to shop around extensively among alternative freight suppliers, even though the cost of freight services can dent competitiveness. Jim Edmondson, CEO of the UK aerospace company Gilo Industries, a privately-held group with 2016 revenues of £3.2 million, is one example among many. His company is about to expand from a specialised to a wider consumer market, but so far is relying on a single supplier, UPS.

Gilo makes a very lightweight engine which can be carried in a backpack to create a powered paraglider (avoiding many of the stringent regulations for conventional aircraft), among other applications. With sales of a few hundred units a year of products costing thousands of pounds apiece, logistics has not been a great concern. Gilo has hired UPS to deliver worldwide, and will pass delivery costs on to customers. This is a practical solution for the firm at a busy time. But with sales expected to increase to the thousands of units when the new product is launched, logistics costs may become more of a factor in the firm's profitability.

KEEPING CORE LOGISTICS IN-HOUSE

While some firms outsource product deliveries, they also keep some mission-critical functions in-house. As noted above, for example, Childrensalon invested in a made-to-order IT system to manage dispatching of products from a warehouse in its home town. Due to the surge in sales and international deliveries that followed its online expansion, the firm recently added two warehouses on the same industrial estate. It also increased its packing and fulfilment staff to 90 people, nearly one-third of its total staff. Centralised distribution makes sense for a company selling to so many different markets: the cost of setting up warehouses abroad would have been prohibitive. More importantly, the in-house central warehousing function allows Childrensalon to retain direct control over a critical service—dispatching products as specified in customers' orders—and to provide direct customer support when needed.

The use of Childrensalon employees to answer customer queries and provide comprehensive product information before purchase has paid off by keeping return rates very low, the firm says. According to Ms Hamilton, only around 10% of orders are returned. This compares to an estimated returns rate of 25% for women's fashion items in the UK, according to an executive of retailer John Lewis.³ Cutting the rate of returns translates into an improved bottom line. The consultancy Clear

² [://www.thebalance.com/pricing-product-for-import-export-1953327](http://www.thebalance.com/pricing-product-for-import-export-1953327)

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Returns says that returned orders cost UK retailers £60 billion a year, a third of which is generated by online retailers

Managing returns is particularly important for companies trading internationally, where the cost of deliveries from and to the home base are typically higher than for domestic deliveries. Raj Sandhan, managing director of UK distributor Metro Health and Beauty, experienced the difference first-hand when it sourced cosmetics in the US. He says that freight charges of 8-10% on US imports, on top of import tariffs, cut deeply into profit margins. "Together, freight and tariff charges can easily wipe out half of an exporter's margins," Sandhan says. Metro turned instead to cosmetics manufacturers in France to reduce both tariff and transport costs, and deals with suppliers there directly.

The heavy capital cost of setting up foreign logistics centres (such as warehouses) mean that companies expanding into new foreign markets generally outsource this function at first. They are more likely to invest in such centres when they are well established in the foreign market and therefore can predict demand, says Christopher Van Riet, managing director of Russian logistics provider Radius Group. Metro's Sandhan agrees, saying that firms tend to use external distributors for the first two to three years in a foreign market.

Van Riet cites the example of John Deere, a large American agricultural machinery maker that started local assembly of its products to facilitate sales to Russian dealerships. Initially, it leased a turn-key assembly plant built by Radius, which bolted together a small number of components imported from the US. Over several years, John Deere built up its own manufacturing operation to take on more complex work; it also started to use more Russian suppliers of components. Although it needed to assemble locally to avoid Russian import tariffs, John Deere built up its manufacturing and logistics operations gradually, to avoid heavy upfront investment in an unproven market.

This approach is different from that of retailers, who—due to the fast-moving nature of their business—are more likely than heavy-goods manufacturers to see warehousing as mission-critical. "Retail stores can open and shut," says Van Riet. "The key for supermarket chains is [control over] warehousing and distribution, so that they can maintain and deliver goods to stores reliably."

For example, Auchan, the French supermarket chain, said in October 2016 that it will spend over US\$100 million on a big logistics and distribution centre near Moscow. It used Radius to develop the project but has kept direct control over the facility. Initially, it will service Auchan's existing 50 stores in the region. But with capacity to load and unload more than 200 trucks simultaneously,

³ Quoted in "UK retailers count the cost of returns," *Financial Times*, January 27, 2017

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the warehouse is expected to help with future expansion of the retailer's store network in Russia. Like Childrensalon, Auchan regards control of warehousing and stock as too crucial to outsource.

Similarly, Ted Baker, a UK fashion brand with 2016 turnover of £456 million, plans to consolidate warehousing and distribution after a period of rapid international expansion. Previously, the firm used three separate distribution centres, which it combined into a single large warehousing and fulfilment centre in Derby, UK in May 2016. Centralising distribution into a single, highly automated, location open around the clock will save money, as well as giving it extra capacity to serve a growing international market, the firm says. On the other hand, in contrast to Auchan, which will manage its warehousing function with its own personnel, Ted Baker outsourced management of its new logistics centre to a logistics supplier. The provider not only bore the upfront cost of setting up the consolidated warehouse, but also provided the IT systems to manage inventories and deliveries.

Given the diversity of SME approaches to balancing in-house control and outsourcing of logistics functions, warehousing and logistics providers are offering increasingly sophisticated menus allowing SMEs to pick and choose the services they want. Some services involve only freight-forwarding—organising shipments from the producer to the final customer or distributor. Others are broader, and might encompass, for example, managing online sales, arranging transport including documentation, and delivering goods to customers. The Royal Mail, the UK's privatised postal services provider, has agreed on such a comprehensive system for Alibaba, the Chinese e-commerce web site. Under this arrangement, the Royal Mail will establish a sales web site for British firms selling via Alibaba, and will deliver the goods to UK customers.

Choosing a supplier requires research into each supplier's specific expertise. Ms Gooley of *Supply Chain Quarterly* says that certain logistics providers specialise in particular industries, others have a certain geographic focus, and still others perform the whole gamut of logistics functions worldwide.

MIXING AND MATCHING

It remains for SMEs to decide on the best balance between controlling their own logistics and outsourcing some of those functions. Some creative mixing and matching of logistics functions—some in-house and some outsourced—may be required. Matt McInerney, vice president of global forwarding sales at the US third-party logistics provider C.H. Robinson, gives the example of an upmarket US kitchen equipment maker that wanted to expand into the UK. C.H. Robinson set up this company's warehousing operations in the UK, sparing the client a heavy upfront expenditure.

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However, the kitchen equipment maker kept many operational functions in-house, for example running its own fleet of 18 trucks to deliver products to a network of more than 100 dealers.

The same principle—choosing what functions to outsource, and avoiding over-reliance on an external supplier—applies as well to outsourced manufacturing and product-assembly services. Supply chains begin with suppliers—of finished products or components or various functions such as freight services—and therein lies a risk for SMEs entering a foreign market. The risk is that an SME will over-rely on a crucial supplier that later fails, causing knock-on problems for the SME.

UK toy-maker Hornby, which had 2016 revenues of £56m and is best known for its model railways, found this out the hard way. The firm had largely relied since the 1990s on a single Chinese supplier of manufacturing services, Sanda Kan. After a series of ownership changes from 2000, the Chinese firm encountered financial difficulties and was bought by Kader Holdings (owner of one of Hornby's main competitors, Bachmann) in 2009. From 2012, Hornby found that supplies of its products became erratic, with many containers arriving without needed products, as the supplier could not fulfil orders. That hit Hornby's sales and its bottom line. Hornby paid £500,000 to sever its contract with the Chinese company. To avoid a repeat of the problem, and to diversify its supply chain and reduce risk, it replaced Sanda Kan with ten different Asian suppliers.

CONCLUSION: THE TECHNOLOGY ADVANTAGE

The cost of logistics—sometimes overlooked amidst the challenges of entering a new foreign market—can prove dangerous to an SME's profit margin. Some SMEs take this risk in stride, choosing to work for thin margins as part of the cost of establishing their brands abroad. The lucky few with a unique market niche, such as Gilo Industries or Childrensalon, can keep margins healthy by passing freight costs on to customers. But whether margins are thin or not, SMEs must find the right balance between hiring outside experts to provide supply management and logistics services and performing these functions themselves in an unfamiliar new market.

The bigger picture related to the cost of logistics is that the logistics function itself is undergoing a profound change, as sellers of a wide range of goods shift from distribution through physical stores and warehouses to global sourcing and fulfilment of orders via e-commerce web sites. Added to this transformation are potentially revolutionary changes in the nature of transport, such as the use of delivery drones or self-driving delivery vehicles. These innovations all rely heavily on information technology; it follows that SMEs with sophisticated IT systems will have an edge in securing the best and most cost-effective logistics support.

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As a first step, advances in communication technology can help SMEs both in researching potential logistics suppliers and managing providers once they are chosen. Information technology can also simplify logistics functions, and can aid SMEs in taking advantage of technological advances in distribution and delivery. Childrensalon's web site, for example, streamlines the sales and fulfilment process, in part by detecting where a customer's computer is located and automatically translating product data and pricing into the local language and currency.

But automation only goes so far; sometimes firms have to intervene manually to fill logistical gaps. "One of our staff once flew over to the US to deliver a very expensive dress on time," when delivery otherwise would have been delayed by a holiday, recalls Childrensalon's Denise Hamilton. That is a shoe-leather approach to logistics: doing whatever is necessary, including wearing out one's shoes, to ensure that products reach their destination on time. It is the sort of thing that modern logistics, backed by sophisticated communication technology, is designed to avoid. "Many SMEs see distribution and logistics purely as a cost," says Ms Gooley. "In fact it is an investment."