

Managerial Economics
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“Should MagRabbit Hop Into China?”



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I. Overview

Company Synopsis

MagRabbit Inc. is an owner-managed, minority business enterprise (MBE) that provides third-party logistics (3PL) services. MagRabbit specializes in mass customized business logistics, fulfillment, and customer care operations. MagRabbit adds value to its clients' enterprises by designing and implementing highly complex logistics and fulfillment solutions. In addition, MagRabbit provides comprehensive supply chain management consulting services and has the systems, technology, and years of domain expertise that help to deliver high levels of service and accuracy to its customers. Companies like Dell, IBM, Motorola, Hewlett Packard and Novell use MagRabbit for their logistics and fulfillment needs. Dell is MagRabbit's biggest customer, and has given them the ability to garner several local, state, and national awards. MagRabbit is the recipient of Dell's first-ever platinum award for supplier of the year. This means MagRabbit provided the highest level of service ever recorded at Dell. MagRabbit has a strategic advantage in America from being the best Minority Business Enterprise at logistics because government regulations require the use of MBE's as suppliers. However, MagRabbit gained its largest strategic advantage by working with Dell because of Dell's reputation as being the supply chain management leader.

Strategic Issues

MagRabbit has seen substantial growth in its business over the last decade amidst a heavily competitive industry. Some analysts predict that middle-market 3PL companies will face increasing pressure inside their niches from larger full-service providers. This is supported by a 35% projected logistics budget for 3PLs by all corporations over the next

three years, and a 50% share of the Fortune 500 market now using 3PLs in their operations.¹ MagRabbit is certainly not immune to competition and is looking for strategies that will maintain or further its business position. Since MagRabbit is relatively small, the standard industry practice of not giving a deal worth more than 10% of a company's revenue is intimidating. Several strategic alternatives are available for MagRabbit including being acquired by a larger firm, forming a partnership/joint ventures with another firm, or expanding its geographical reach to include higher potential markets like China.

II. History

Logistics' Past

Logistics involves materials management and physical distribution. “*Materials management* is concerned with the procurement, transportation, and storage of raw materials, purchased components and subassemblies entering the manufacturing process and the flow of goods within and through the manufacturing process. *Physical distribution* is concerned with the transportation of finished products from point of manufacture to where customers want them delivered and storage of finished goods at intermediate points along the way.”²

The word logistics was first used in the development of strategy during the Second World War. Eisenhower said that it was the superior logistics ability of the United States

¹ www.stonepath.com

² Shapiro, Roy D., Heskett, James L. Logistics Strategy: Cases and Concepts. St. Paul, Minnesota: West Publishing Company, 1985.

alone that helped to arm its military across two large oceans, leading to the defeat of the Axis Powers.

Inventory control, a logistical process, began when early humans stockpiled food in their caves in order to survive the harsh winters. As technology improved and enabled humans to have more food and clothing than was needed, the main logistics function of distribution began. As the wheel and the subsequent technological progress in transportation evolved logistics became integral in enabling new patterns of trade and economic activity to proceed. World history teaches us that the rise and fall of every great civilization can be attributed to their capabilities in logistics. New York, Hong Kong, Singapore, even the acquisition of Hawaii had its economic roots in logistics advantages. The dreams of Alexander, Napoleon, and Hitler became nightmares when their logistics operations could not supply the demands of their conquests.

Logistics' Present

Firms in many industries are now scrambling to develop innovative ways to move products from raw materials through manufacturing to customers more quickly and efficiently. Some firms are responding by necessity to competition, both domestically and internationally. Others are capitalizing on the continuing stream of dramatic improvements in information technology. They redesign their supply chains to gather, process, transmit, share, and exploit vast amounts of information quickly and cheaply. Still others are applying the different strategy of seeking a cooperative approach among all the players in the supply chain. Huge improvements have been enjoyed by firms able to optimize over their entire supply chains and figure out how to share the resulting gains while breaking down the traditional adversarial relationships. Other innovations derive from deregulation

and lower tariffs, for instance China's industrial sector. All throughout the supply chain, from the raw materials supplier to the end customer, logistics services are the main drivers behind cost reduction and quality increases.³

III. America Industry Analysis

Six Forces Analysis

Product: Third party logistics services and supply chain management

Competition: Eagle Global Logistics, Ryder Logistics, Pegasus Logistics, DHL, UPS Logistics Services, etc.

Threat of Substitutes: LOW TO MEDIUM

Companies can do logistics themselves by hiring their own employees. However, the stress of logistics, compensation costs of managers, and the freedom to focus on their core competency are reasons why firms usually out-source the job.

Rivalry: HIGH

In this industry firms compete heavily on price. Differentiation between firms is minimal, and quality differences are rare between most firms. Therefore rivalry is very intense.

Potential Entrants: MEDIUM

All firms with existing in-house logistics services can spin-off or strengthen their operations to provide service to other companies. Also, it has been possible for teams of

³ http://www.gsb.stanford.edu/mba/learning/curriculum/elect_infoTech.html

individuals with lots of experience, financing, and networking skills to start their own companies with success.

Buyer Power: HIGH

Buyers have a lot of the power in determining the price paid to logistics providers. Buyers include all firms that need enhancement and outsourcing of their logistics operations. Nearly every corporation out-sources some of their logistics operations. Buyers typically seek out 3PL's to reduce the cost of logistics, allow them to focus on their core business, improve customer service, simplify complex operations, and improve supply chain flexibility. The criteria used to determine which firm to choose depend on experience, reputation, network coverage, price, IT systems, strategic fit, integrated logistical capabilities, and whether they own strategic assets. MagRabbit's biggest customer is Dell Computer Corporation, which picks and chooses among its logistics providers to find the cheapest one at a high quality. With Dell, a contract lasts for only a short time (two years), therefore the firms are under constant pressure to outperform and out-bid their competitors. If all the 3PLs decide to raise prices, Dell can simply bring in another firm from outside the area and use their in-house personnel to train the people to do the job. Dell usually has no problem with finding a high quality low-cost provider.

Supplier Power: LOW to HIGH

Suppliers of the products that 3PL's handle for their customers include nearly every known company in the world. For MagRabbit, Dell's suppliers include over 160 companies, including Intel, Sony, Toshiba, Microsoft, etc. Suppliers have bargaining power depending on the degree of competition within their individual industries. Therefore, if they decide to raise prices on Dell, they may be able to get away with it, but

this will typically not hurt MagRabbit if all costs get transferred to Dell's price. However, with Dell's on going price war, one way for Dell to beat out its competition is by squeezing its 3PL providers (something Dell is famous for).

Complements: SOME

Complements to providers of logistics services and supply chain management include information technology, security services, transportation, shipping, warehousing services, and packaging supplies. With all the transactions taking place loads of vital information is getting processed, and both buyers and suppliers would like to get their hands on it. But, since it has typically become standard practice to bundle both services, no one charges extra for it since rivalry is intense. Also, firms with their own transportation services generally are at a disadvantage due to the high costs (fixed and variable) of owning their own trucks, planes, or ships.

IV. China Industry Analysis

Market Characteristics

The China 3PL market is large, fast growing, and in the introductory phase of the product life cycle. The market for outsourced logistics was estimated at \$5 billion in 2001 with an average industry growth rate in excess of 30% for the last three years. The forecasted expenditures for Chinese domestic transportation and logistics in 2003 are \$271 billion, which outpaces the American growth rate by 8%. The forecasted market size of outsourced logistics in 2003 is \$7.3 billion, which outpaces the American growth rate by 25%. The market is fragmented such that no firm controls more than 2% of the market. 85% of the work being done involves simple warehousing and transportation management.

Furthermore, most 3PL providers feel that significant obstacles exist for outsourcing including the quality of logistics services. Most buyers are located in the Yangtze River and Pearl River Delta regions. There is a 55% difference between the amounts of Chinese shippers that use 3PL's compared to multi-national corporations (MNC). Logistics costs are not well tracked by both domestic and MNC shippers. The most important reasons for not outsourcing logistics include in-house capabilities already being utilized, no confidence in service level, lack of good providers, uneducated about benefits, etc.

Foreign 3PLs have an advantage towards MNCs because of their IT systems, industry experience, standardized operations, international network, and financial position.

Chinese providers have an advantage towards Chinese shippers due to lower prices, local knowledge, relationship with the government, and flexibility of operations. Further findings conclude that the main challenges for Chinese 3PL's are the lack of qualified people, ambiguity of policy, government restrictions, IT systems, and customer rigidity.

For foreign firms like MagRabbit, the main problems are foremost government restrictions, finding qualified people, ambiguity of policy; clients have unrealistic expectations, and incompatible cultures. Competition has been building in the logistics market from all angles: foreign firms, domestic firms, traditional transportation companies, and in-house departments. Nearly 80% of these providers are looking for joint ventures or partnerships to achieve growth targets. Chinese providers are looking for partners who can provide an overseas network, greater financial support, management experience, and complementary functions. Foreign providers are looking for partners who can provide customer relationships, strategic assets, operational skills, and domestic network coverage.

Providers feel that the greatest problems include subcontractor management, lack of

agreement concerning requirements or expectations, poor infrastructure, client resistance to change, staffing problems, and poor client data. This creates a great need for complex logistics solutions and supply chain management, but firms to be sure that clients are educated first as to the need of 3PL services. Mercer has found that two distinct market paths exist for 3PL's, one for domestic Chinese shippers, and the other for multinational firms doing business in China. Their needs are different enough to separate the two.⁴

V. Strategic Alternatives

Harvesting

The idea of selling out to another firm can only mean lost opportunity for its management team. Although, the short-term benefits may be quite high, the management workforce is young, and the delay of selling may give the owners a higher price for their company.

Joint Venture

MagRabbit has had a partner that it does a large portion of its work with, Eagle Global Logistics. This alliance has proven to be beneficial and at times a hindrance. The option of forming new joint ventures or partnerships should be looked at more closely by MagRabbit before seeking outside partners to make sure that the pros outweigh the cons, such as culture clashes and power politics. The benefits of a joint venture for MagRabbit include being able to win bigger contracts from clients as their revenues increase, greater network coverage that includes global logistics services, and a sharing of information and

⁴ Mercer China 3PL Survey, 2002

talent. One downside to this strategy is that MagRabbit must share the revenues of its deals.

Entry into China

One of the highest potential markets for 3PL's to achieve growth lies in the Chinese market. Companies are finding that labor cost are substantially lower in China and so firms like Dell already have manufacturing operations in China. It is predicted that many more firms from around the globe will set up there too. MagRabbit should seriously consider heading into the Chinese market to take advantage of the poor quality of logistical services being provided there. MagRabbit's strategy in China should include capitalizing on its reputation with Dell, using its Asian workforce knowledge, and concentrating on providing superior quality. Also, MagRabbit needs to learn how to communicate with the Chinese and MNC shippers to educate them on the benefits they offer. MagRabbit must also decide whether it wants to serve Chinese or MNC shippers, or both, and whether or not it wants to focus primarily on manufacturing firms like Dell. Since no firm has a dominant position in the market, the first-mover advantage of reputation and client contact can play a large strategic role. However, more than likely the firms offering the best quality at the lowest price will fare better in the end. Furthermore, the companies that are most effective at forming partnerships and acquiring strong competing firms will also outperform the market. Caution needs to be practiced before MagRabbit enters China. The potential benefits are quite remarkable; however the current situation shows that the market will not be ready for firms like MagRabbit for another 2-3 years. Factors pushing the market towards fruition include China's WTO commitments regarding liberalization of foreign investment, retail consolidation, and the emergence of national chains. MagRabbit may

need to approach its entry as a real option investment. By entering on a small scale now, once the other firms have educated the market, MagRabbit can execute the option to further invest in China relying on a judo strategy.

VI. Conclusion

MagRabbit's success in the American market has been due to its nimble organizational design, MBE status, and low-cost. Now is a time for MagRabbit to take advantage of its reputation and experience to create more growth for itself. The possibilities are endless for a company like MagRabbit. However, this analysis has shown that the most likely strategies will be forming a joint venture or moving into the Chinese market. By staying in America, MagRabbit may be able to find bigger deals where their margins will not be cut down as much as at Dell. However, the low labor costs and potential to garner a larger market share make China attractive as well. It is recommended that MagRabbit invest on a small scale into China through a joint venture, while maintaining its focus on serving the American market. Perhaps an export/import operation in America can provide the first step to larger success in the Chinese market later on. No matter what MagRabbit chooses to do, its should definitely not give up its position in the market by selling to a larger firm unless the price is high enough to cover all future expected benefits.

VII. Exhibit

3PL providers' views of shippers

Nearly 70% of providers think that clients, particularly Chinese clients, are not ready for outsourcing.

Clients are not ready

"What do they do with thousands of employees and tens of millions of logistics assets if logistics services are outsourced."

"I agree that the market potential is huge, but it will take time for domestic companies to outsource more."

"Many customers are willing to outsource, but only a small part. They are looking for 3PL providers to provide simple services."

"Customers are ready for outsourcing direct transportation services. However, for more complicated services, they need more external pressure to push them to move forward."

Clients are ready

"Clients are ready for outsourcing, especially MNCs. They are trying to outsource as much as possible."

"In China the customers still need some education on logistics, but Chinese companies will accept this idea much faster in comparison with other countries' customers, because they can learn from other experiences and they have more external pressure to improve current products and services to survive."

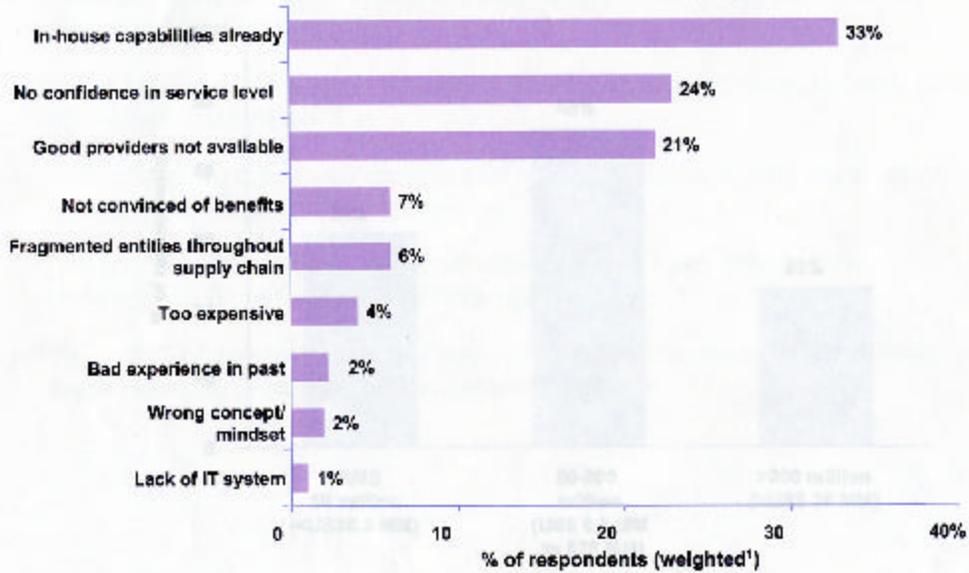
"Domestic manufacturers will outsource more and need more sophisticated services."

"Customers in East China are more educated and willing to outsource."

Shippers' view of 3PL providers

Shippers lack confidence in service levels and have difficulty finding good providers. Many providers are good at marketing but fall short on delivery, especially in delivering high-quality and consistent services across geographies.

Reasons for not outsourcing logistics



Current outsourcing of logistics

About 30% of shippers, particularly MNCs, would prefer to outsource to foreign providers, while more than 20% of shippers, particularly Chinese, would prefer Chinese providers.

