

# Dividing up outsourced production

*by*

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In a recent column, I suggested that you might want to outsource to an established firm and lose the benefits of competition because this maximised asset sales. Another possibility, however, is that you consider outsourcing to an existing supplier of another outsourced service. So a car manufacturer could consider outsourcing its body panel manufacturing to someone who is already providing it with a steering system or break system.

In this situation, there is no competition issue in the trade-off. Indeed, you can get the benefits of dealing with one firm for both sets of components and it is possible this could reduce your costs further. Further, if that supplier could coordinate some of the product development on those components it could improve quality too.

However, like the issue of outsourcing to established firms or a new entrant, we need to consider the value you receive for your assets. After all, if someone who is not one of your suppliers wanted to pay a lot to become your body panel supplier, maybe that is worth having to deal with an extra party over the long haul?

My own research suggests that this could well be the case. A new supplier will place a certain value -- in terms of an on-going stream of profits -- on the assets you might sell them. Indeed, without those assets, they miss out on those profits entirely.

What about an existing supplier of another component? For them, the new assets will add some on-going profits but what will it do to their position in bargaining with you. To them, your existing relationship gives them some profits and the new ones will add to this. But they will only pay for assets based on the *addition* to profits.

It turns out that for components the addition is less than the new stream. The reason is based on a simple principle: if production of a car generates some value, then the more firms that have to cooperate to generate that value, the less each individual one will receive.

Suppose you have two existing suppliers. What this means for one of them is that, by taking on the additional outsourcing work, they share value with only you: each of you getting a third. If you deal with an additional supplier, you split all this four ways. For the existing supplier, however, that means the gain from taking on the work is only a twelfth (that is, a third minus a quarter) of whatever value is generated. In terms of on-going costs, it is better to deal with two supplier (where you split three ways) than three (where you value is divided into quarters).

But what does this mean for asset value? For the new supplier, they will be willing to bid for assets on the basis of earning a quarter of all value. But your existing supplier will only bid on the basis of additional profits; that is, a twelfth. So selling to them nets you a less in asset value in return for only a modest cost saving later on. Clearly, outsourcing to an independent rather than an established supplier is a better way to go.

So, in contrast to the case where an established firm supplies a competing service to your outsourced one, when its service is complementary (you need both) it is better to go with an independent supplier. While this will raise costs, in the asset market you receive a better deal for your existing assets.

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