Knowing your networks: supply and distribution

Organising your network is about cooperating with suppliers, partners and customers. A good network helps you build an efficient business that focuses on its strengths. But getting it wrong can be a costly mistake.

Networks are important – make the most of them to boost your business

Every business is part of a network, dealing with suppliers and customers. The connections in your network can be a great part of your business success, or they can hold you back. Taking time to plan your network carefully is a strategic step in creating a lasting, sustainable business model.

Improve your network to own the distinctive value you create, and control quality and performance. Focus on your strengths by freeing yourself from the things that are not a core part of your business.

You can improve your network in various ways. This page talks about outsourcing, vertical integration and location to give you inspiration. A poor network can undermine your performance, so you can also read about getting supply contracts right and looking after your intellectual property (IP).

Outsourcing — focus on your core strengths

Outsourcing is choosing to buy goods or a service from a supplier instead of making them yourself. When you outsource you are contracting someone else to complete a part of your product or service creation.

Businesses often outsource an activity so they can focus on something else. If you identify a business activity you can do better than anyone else, focusing on that activity is a good way to increase your competitive advantage. But first you need to free up resources (time and money). Outsourcing a different activity that isn’t a point of difference helps you free up those resources. For example, a gourmet food producer might excel at quality and coming up with new varieties, but struggle with striking distribution deals and fulfilling orders. They could choose to ship their products to a wholesaling company that finds customers and distributes their products for them. Outsourcing distribution lets the food producer focus on their strengths.

The pros and cons of outsourcing

Outsourcing has pros and cons. The pros might include:

- freeing up cash flow by not owning plant and equipment
- reducing admin workload to spend time on strategic work
• growing your business with less investment up front
• delegating an activity to a specialist provider.

The cons might include:

• paying a premium for someone else to do work you can do yourself
• losing strategic control of your processes or information like trade secrets
• facing problems with quality control
• relying on the availability and business continuity of another business.

You’ll need to take your time and choose partners wisely, with a particular eye on quality control. And you’ll need a non-disclosure agreement (NDA) in place because you will be sharing information with your partners. Confidential information about production methods or planned production volumes are examples of trade secrets that might not be protected by a patent or trademark.

Outsourcing is sometimes criticised for letting companies lose their competitive advantage. They lose control of valuable knowledge about production methods, and they lose product and market feedback when they are too distant from their customers. That’s why experts suggest not outsourcing unless everything stacks up.

Is outsourcing right for you?

Follow this sequence of questions to decide about outsourcing an activity or keeping it in-house. Ask yourself:

1. Is this activity an important part of your business strategy? If yes, keep it in-house.
2. Do you have the specialised knowledge to do this well? If yes, keep it in-house.
3. Are you currently doing this better than everyone else? If yes, keep it in-house.
4. Will you need to change or improve this activity in the near future? If yes, keep it in-house.

If you answered ‘yes’ to any of the questions, keeping the activity in-house could help you keep control, stay flexible and maintain quality. If you answered ‘no’ to every question, consider exploring vendors who could do this activity for you.

Think about renting vs buying too

The decision whether to rent or buy things you need is related to outsourcing, but different. Renting equipment is a bit like outsourcing your supply of equipment that is suitable and ready to use. Lease agreements often cost more in the long run but remove the need to pay upfront for equipment – saving you the cost of finance, or freeing up money to invest in something more strategic.

Leases that include maintenance ensure your equipment is reliable and ready to go – and if something goes wrong, you are spared the cost and stress of fixing it. If your business is growing or changing, leases can give you flexibility to upgrade your equipment easily when you need to.

Outsource carefully to maintain your quality and unique identity.

Vertical integration — take full control

Vertical integration is taking ownership of, or creating, something in your production process. Some people refer to it as a ‘make vs buy’ decision. Vertical integration is roughly the opposite of outsourcing, starting from the situation where you don’t own or make something yourself. For example, a wine maker might initially buy grapes from around the country, make wine and then sell it to the supermarkets. They decide to purchase a vineyard so they can control the supply of grapes for their winemaking. Or a café might initially buy coffee beans from a local roaster. They decide to source their own beans and roast them so they can manage availability and freshness better.

The pros and cons of vertical integration

Vertical integration has pros and cons.

The pros might include:

• not paying someone else to do work you can do yourself
• keeping strategic control of your processes, quality control, or information like trade secrets
• not relying on the availability and business continuity of another business.

The control you gain can help you create or protect value. Here are a few more detailed examples.

• Controlling supply: A restaurant invests in a nearby farm to guarantee a supply of popular herbs over winter. This helps them plan their menus with more confidence.
• Controlling capacity: A brewery has grown in popularity but can no longer fulfil demand using the brewing kit in their brewery, which also serves as a bar. They set up a larger brewery so they can use the capacity to grow their brand.
• Controlling distribution: A building group in Ashburton want more business in Christchurch city. They decide to buy an existing building business in Christchurch, to gain that company’s good reputation in the city and existing network of customers.
• Controlling assets and IP: A fitness instructor has built up a loyal client base but has reached their capacity for working 1:1 with clients. They decide to buy a business with an established branded training programme. They implement this training programme and hire other instructors to teach this programme to a growing base of clients.

The cons might include:

• needing to buy your own plant and equipment, learn how to use it efficiently, and keep it running smoothly
• spending time and energy on operational problems instead of focusing on the strategic work you’re good at
• making commitments that are hard to reverse, with a lack of flexibility to grow your business quickly or follow trends.

Is vertical integration right for you?

Ask yourself these questions to decide about vertically integrating by taking on another activity or buying another business.

• Is it difficult to depend on other businesses? For example, is your market a young or declining market with poor supply of the things you need?
• Would vertically integrating create or exploit market power by making it harder for competitors to enter your market or copy you?
• Would buying another business get you past a barrier to market entry like expensive machinery, hard-to-acquire customers, or the credibility and track record to get finance?
• Are your products, consumer taste, and the business landscape stable enough for you to adapt to change even as a larger, less nimble, business?
• Do you have the skills and expertise to run the business you plan to buy? For example, a cucumber farmer considers buying a small pickling business, but decides not to when they think about the knowledge needed to succeed: branding, distribution, retailing, ecommerce, and customer insights.
• Can you afford the cost of vertical integration and still have capital or reliable access to finance for your core business?

Australian McKinsey practitioners John Stuckey and David White were wary of vertical integration after studying the outcomes. Their main message: Don’t vertically integrate unless it is absolutely necessary to create or protect value. Vertical integration is risky, hard to reverse, and costly in time and resources.

Think about the resources that make your business unique

Resources are things you control that form part of your business. You use resources to create value for your customers and to stay ahead of your competitors. Resources can be physical (such as buildings, equipment or people) or non-physical (such as processes, knowledge or reputation).

Use this tool to reflect on the resources in your business and whether you’re making the most of them.

For each resource, you’ll think about whether:

• the resource is rare
• the resource is hard to imitate
• your business is set up to use the resource fully
• the resource helps you stay ahead of your competitors and react to changes in the market.
Based on your profile, we'll explain whether the resource helps you compete or holds you back, and whether it makes or loses you money. We'll also give you some tips to make the most of the situation — such as whether you should focus more on an under-exploited resource.

**VRIO Loading...**

### Location, location, location

Deciding where your business locates its shopfront matters, whether it’s a website or a physical store. The same goes for a place of production, both for services and for products.

Where are your customers? Where do your supplies come from? These and many other factors come together to give each business its ideal location. Your shopfront and place of production may be together or in different places, depending on customer need and perception, cost factors, and logistics of suppliers.

For example, you might run an accounting business that services mostly tradespeople. You locate your shopfront in an area your customers visit anyway, such as near the hardware superstore in a suburban business park. You might also decide this is the best place of production, where the accountants do their work, because customers like to pop in and see their accountant.

On the other hand, a catering company might use a website for sales and interacting with customers, preparing its food in a warehouse away from the town centre. The rent there is cheaper, and it can receive produce deliveries more easily. The catering company doesn’t interact with its customers until it delivers the food, so there is no need to pay higher rent for a flashy building in the town centre.

Here are five steps towards choosing the ideal strategic location for your shop front, workshop, office or other facility.

1. Examine the distinctive things that make your businesses competitive, and the characteristics that make up the nature of your market (such as location, size, and competitiveness).
2. Identify which of your business processes can give you a competitive advantage in delivering value to the customer.
3. Find how and where these critical business processes and their inputs and outputs enter and leave the company. Think about the relationships at each of these boundaries: is the relationship critical to the process, and does it require geographical proximity for success? For example, regular face-to-face meetings, delivery of supplies, collaboration, or other work that is best done side-by-side.
4. Identify other potential locations for your shop front, workshop, office or other facility.
5. Use a ‘Return on Investment’ (ROI) approach to compare the alternatives. Take into account each of the critical business processes, how much better or worse they would be, and the one-off and ongoing costs of the move, such as the differences in lease and utility costs. Compare each of the locations to determine the best financial return (on top of the strategic benefits that are now clear).

The prospect of growing your business or changing your focus might influence how much you commit to a location. Moving might involve an expensive fit-out at the new location, or a range of other costs. For example, a brewery might need to install new drainage, install and re-commission brewing kit, and repeat onsite food safety assessments and other paperwork.


### Case study

**Te’s Tees checks out some growth options**

Te’s printed tees started out as a home business, selling at the market and to a few local independent clothes shops. They took out a short lease on a run-down shop with a workshop at the back, but that’s coming to an end. Growing reputation and demand mean a good opportunity to grow the business, but scaling up needs more room.

Te looks at the current production setup for inspiration.
The printing press frames and drying process they use take up space.
The dyes they print with, and their cleaning solvents, are smelly and need specialist disposal.
The manufacturer of the plain t-shirts they print on has a warehouse in an industrial area on the edge of the city.
The best sales results for the last quarter come from an innovative fashion shop in a small old building in the central city.

Te identifies a few options. The top two are:

**Strike a deal on cheap distribution with the local courier company**

The courier’s depot was picked for its accessibility, and they already visit the city centre every day. A cheap production location nearby would help Te afford a bigger workshop. They could continue to sell through the existing network of small shops, with efficient stock replenishment using the courier. They would be vulnerable to changes in the sales network (the independent shops often go out of fashion and close down, so there is quite a bit of ‘churn’). But changes to their ‘shopfront’ locations won’t lose them custom. Their fans will follow them on social media to keep up to date with sales outlets. They could even try out another pop-up shop if they need to.

**Co-locate with the t-shirt manufacturer to make and sell — online too!**

The t-shirt manufacturer only takes up part of the warehouse they use, and the building owner is happy to lease Te the remaining space. Te could move in and benefit from more flexible supply (especially if the manufacturer is happy to set up a new supply agreement). The warehouse already has the waste disposal and safety systems they need. The warehouse has a small area they could set up as a factory shop — fans like getting to chat to Te and their staff. And they could set up an online store too, extending the area they sell to. Swapping from the independent shops to ‘clicks and mortar’ for their storefronts would give them better margins. They’d probably lose a few sales from the town centre shops, but they’d no longer risk losing out if a store goes into receivership.

Both options save rent and fit-out costs over a new central location, where rent would be higher and they would need to install ventilation and fire equipment. Te uses the five-step process above to weigh up the two locations, and decides to co-locate with the t-shirt manufacturer. Saving on equipment costs lets them set up and market their online store. Exciting times!

**Contracts — formalising your network**

Good contracts (also known as agreements) are vital to effective networks. From leases and supply contracts to sales agreements and customer service, contracts formalise your network. They set out expectations and give you a framework for resolving problems. If your contracts are poor or missing, your network is unreliable and could collapse, leaving you out of pocket and unable to meet your own obligations.

Written contracts are a must, despite taking more time and effort to set up. Spoken or ‘handshake’ agreements are legally binding too, but in practice they are very difficult to enforce. Details can be murky, and neither party in a dispute can easily prove what was agreed or how the agreement has been breached. You might have different understanding of a good faith agreement. Writing things down in a contract establishes common understanding up front.

**What makes a good contract?**

Here are some tips for an effective contract. Some apply to any contract, no matter how small or simple, and others might only be necessary for a higher-stakes contract.

- Short is good. Try a three-page limit unless your agreement is very large or complex.
- Outline what the contract is for, who it covers, and how long it lasts. Be very clear about the scope it covers and any specific exclusions.
- Keep the contract simple — avoid jargon and abbreviations. Imagine you’re writing for someone who doesn’t know anything about your industry or business. How would a lawyer use your contract to rule on a disagreement?
- Specify what is being traded, how much, and how often. Many ongoing contracts specify minimum order sizes or frequencies.
- Include any characteristics that affect value, such as organic ingredients, sustainability or ethical sourcing.
- Describe any sequences of interactions between the people in the contract. A process map can help you describe the process clearly.
Include payment terms such as any agreed prices and fees, how invoices will be issued and received, and how and when invoices must be paid.

Include service level agreements (SLAs) with clear metrics for the quality, availability and responsiveness of service provided. For example, ‘the vendor will deliver 95% of orders within 3 days’.

Specify who is responsible for which tasks and what will happen if things don’t go to plan. Consider a backup clause or ‘plan B’ in case trade doesn’t happen as expected, and describe any agreed methods for handling disputes.

Protect your intellectual property by defining who can use it and how.

What happens at the end? Exit agreements can be helpful, especially if the contract is for ongoing supply of products or services. This might be as simple as each party giving a specified notice period before leaving the contract.

Is this trade non-standard for either party involved? Highlight anything unique.

Read about the Government’s five procurement principles. They provide a good starting point for developing and negotiating fair and effective agreements, and most of the recommendations work well for any agreement.


[Continuity and contingency planning](/risks-and-operations/planning-for-the-unexpected-bcp/continuity-and-contingency-planning/)

**Advice for specific types of contract**

If you are writing a contract to outsource manufacturing, read our advice about manufacturing agreements as part of manufacturing overseas. Much of the advice applies to other supply-chain agreements in New Zealand or overseas too.

[Manufacturing overseas](/how-to-grow/importing-and-exporting/manufacturing-overseas/)

If you are considering changing location, our information about leasing or buying business premises might be useful.

[Leasing or buying premises](/risks-and-operations/equipment-premises-and-assets/leasing-or-buying-premises/)

If you are considering vertical integration, our information about buying a business or franchise might be useful.

[Buying a business or franchise](/getting-started/taking-the-first-steps/buying-a-business-or-franchise/)

Your terms of service for customers need to be clear, whether for large commercial contracts or small retail sales. Read our advice about what you need to tell customers.

[What you need to tell customers](/risks-and-operations/dealing-with-customer-complaints/what-you-need-to-tell-customers/)

**Negotiating an agreement**

Negotiating an agreement with another business is part of establishing your relationship with them. The way you negotiate can set a good or bad precedent for the rest of your business with them.

Start by figuring out the most important things both parties want out of the agreement. From there, establish what you agree on, and where you might have different expectations. Suggest terms that are reasonable for both parties. Be ready to suggest and accept changes if they make sense. Any area of your agreement could need negotiation. Here are some areas to think about.

- **Pricing and payment:** Is the seller asking too much, or the buyer not offering enough? How will the pricing change over time? Will payment be before or after supply, and by how long?
- **Flexibility:** How easy will it be to buy or sell more or less than you have agreed? How will it affect pricing or other factors? Who pays for changes to the specification?
- **Disputes and penalties:** What is the appropriate penalty for breaking the contract in some way? Is the impact on the businesses involved reasonable? How will any disputes be resolved?

Some businesses (especially larger ones) have standard contracts for working together. A standard contract could be fine if you check it carefully and find it covers everything you need. Sometimes you might notice something missing, or a provision you need to change to be happy.
Don’t be afraid to ask for changes to a contract — they’re accepted more often than you might think.

Case study

Aroha takes on more brand flavour

Aroha’s café is doing well but she notices other coffee bean suppliers are beating hers on price. She likes her current supplier, so she doesn’t just change abruptly. She gets in touch with the supplier and asks if they have any suggestions to improve the terms of their trade.

The supplier has recently taken on distribution for other products like coffee accessories and condiments, and is keen to grow their distribution and brand awareness. They suggest a supply agreement with four main elements:

1. Aroha pays a special lower price for coffee beans, guaranteed for 3 years.
2. The café displays and sells the supplier’s coffee accessories and condiments on a sale or return basis.
3. The supplier provides free branded coffee cups and saucers.
4. Aroha commits to stick with the supplier for 3 years.

The supply agreement looks good, but Aroha asks her lawyer to look over it. They suggest adding a clause where Aroha is free to end the agreement early if she needs to close or sell the café during the 3-year period. The supplier accepts the change and Aroha signs the agreement, happy to get a better deal without changing her supplier.

Managing IP in your network

Intellectual property can be any creation that is not physical but could have value, such as a logo, brand, trade secret, design or invention. Read our general information about IP and ways to protect it:

- What is intellectual property (/risks-and-operations/intellectual-property-protection/what-is-intellectual-property/)
- Types of intellectual property (/risks-and-operations/intellectual-property-protection/types-of-intellectual-property/)

Your network with suppliers, customers, and service providers can bring opportunities to get value from your IP, but also reasons to be cautious. IP in networks can include information about business strategy, innovations, processes, equipment, customer lists, upcoming promotions, and purchase volumes and trends.

Here are some examples of getting value from IP in your network.

- You and your equipment supplier work together to develop a new manufacturing process that cuts waste. You license the process to your supplier, allowing them to introduce the process across the industry. You get value from the license and also gain recognition for process innovation.
- You develop a new software platform to collaborate with other small businesses as a cooperative, buying raw materials cheaper in bulk. You charge a small fee for each order, so you benefit slightly more than your competitors.
- You don’t have manufacturing know-how for a standard component. You decide to order it from a supplier instead of manufacturing your own, making the most of their manufacturing IP. You agree a contract with the supplier that makes them responsible for any failures, reducing your warranty costs.

Here are some examples of problems with IP in your network.

- You pay a manufacturer to make your products to your design. You later see they are also selling them directly under a different brand name. Your manufacturer is overseas, and it’s difficult and expensive to stop the misuse of your IP.
- You sign an exclusive licence agreement for another business to distribute your products in Australia. Your business does well and wants to expand to new markets, but the agreement is difficult to break. To make things worse the distributor is not marketing your products well, so you don’t make much money from the agreement.
- As your business matures you refine the specifications you ask your supplier to meet. They grow more sophisticated as a result, becoming experts in this industry. They win other supply agreements by promising
to bring unique insider knowledge. Without them or you realising, they are now sharing the trade secrets that make your products so special.


You can protect IP in several ways, depending on the type of information and what you want to protect it against. Some are more expensive and less flexible than others.

A non-disclosure agreement (NDA) is one way to protect trade secrets and other information your network partners such as suppliers and on-site contractors see. Think about requirements not to use the information (as well as not passing it on). Make signing easier by keeping the NDA simple and giving everyone involved the same obligations. Set the NDA to continue for a reasonable time beyond your work together.

Another way to protect trade secrets is to simply limit access to the information. You might manage who in the business knows it, or separate your design or manufacturing space from the areas suppliers or customers see.

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