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**Performance Improvements in Logistics Outsourcing Relationships –
The Hampering Role of LSPs' Mindsets**

Uwe Zybell and Carl Marcus Wallenburg*

* corresponding author, wallenburg@whu.edu

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WHU – Otto Beisheim School of Management
Kühne-Foundation Chair of Logistics and Services Management
40233 Düsseldorf (Germany)

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Performance Improvements in Logistics Outsourcing Relationships – The Hampering Role of LSPs’ Mindsets

Abstract

This paper extends current literature by identifying and conceptualizing factors that hamper relationship-specific improvements by logistics service providers (LSPs) in contract logistics outsourcing. Thereby it focusses on organizational mindsets that are common for service providers in the logistics industry. Based on exploratory, interview-based case-study research four specific organizational mindsets of LSPs are outlined that hamper the scope and the extent of relationship-specific improvements. They are hierarchical mindset, direct costs-focused mindset, detailistic and zero-error mindset, and hidden action mindset. In addition to the specific improvements effects, this research describes the effects that these LSP mindsets have on the behavior and dynamics in the service outsourcing relationship.

Conventional customers contracting conventional LSPs with respective mindsets results in a stable, but suboptimal situation with limited relationship-specific improvements. Largest improvements are generated when unconventional customers contract unconventional LSPs, while the situation is unstable when one of the parties possesses a conventional mindset and the other an unconventional mindset.

Keywords: Logistics Service Provider, 3PL, Partnership, Outsourcing Performance Improvements, Innovation, Case Study, Organizational Identity, Mindset

1. Introduction

“*Adaptation* is the central problem of economic organization” (Williamson, 1995, p. 218).

With today’s intense competition in global supply chains and ever increasing levels of dynamism (Gligor et al., 2015) and uncertainty (Wieland and Wallenburg, 2012, Christopher and Holweg, 2011, Roberta Pereira et al., 2014), adaptation to the business and the improvement of performance are imperative, if a company wants to remain competitive (Trkman et al., 2015). This also applies to logistics (Langley and Capgemini, 2015), where outsourcing has increased and companies, today, are using logistics service providers (LSPs) for complex tasks that were traditionally performed in-house (Langley and Capgemini, 2015, Liu and Lai,

2016, Leuschner et al., 2014). This field, commonly referred to as 3PL services or contract logistics, for example, now accounts for 20 to 30 percent of total revenue of globally operating LSPs like Deutsche Post DHL (26,7%) and Kühne+Nagel (23,2%) (Kühne+Nagel, 2016, DPDHL, 2016). Due to the underlying transaction characteristics, contract logistics services are provided in relationships with a mid- to long-term perspective, where performance improvements have to involve both the customer and the LSP.

Logistics outsourcing practice shows that LSPs tend to meet customers' ex ante specified cost and service requirements, and that these relationships are generally successful (Langley and Capgemini, 2015). At the same time, relationship-specific performance improvements over the duration of the contract are limited (Busse, 2010, Wallenburg, 2009), and outsourced logistics activities are less successful and show performance stagnation over time compared with business activities executed by the customer itself and show performance stagnation over time (Novak and Stern, 2008, Zybell, 2013). Despite previous research on LSP innovation, much remains to be explored (Leuschner et al., 2014) and the impediments to innovations, both at the LSP company-level and at the relationship-specific-level, are still far from being fully understood (Richey Jr. et al., 2010). For example, performance-based contracting, where financial incentives are intended to induce relationship-specific improvements, provides many challenges and is often dysfunctional (Selviaridis and Norrman, 2014, Selviaridis and Norrman, 2015).

Impediments to relationship-specific improvements may originate from different domains: the LSP, its client, the relationship between the two, and the context in which the two and their relationship are embedded. To extend the current, sparse knowledge on the impediment, we chose an empirical research approach with a broad perspective addressing the first three domains. Following the suggested research approach of da Mota Pedrosa *et al.* (2012), we narrowed our initially broad scope of investigation down throughout the data collection process

focusing on the most relevant aspects. During this process, one aspect within the LSP domain emerged as salient: the organizational mindset of the LSP.

In contrast to visible, organizational characteristics, for example, centralization, specialization, or formalization, which have been outlined to influence the ability of a firm for adaptation and innovation (Daugherty et al., 2011) and are directly manageable, organizational mindsets are both invisible and hard, if not impossible to manage. The most obvious part of these mindsets is what is referred to as mentality, but the mindsets go deeper than that and also refer to the *organizations* underlying, usually unconscious thinking patterns or mental models. As such, the mindsets are part of the invisible operation logic of the company (March, 1988, Anteby and Molnár, 2012), which was introduced in the seminal work of Albert and Whetten on organizational identity (Albert and Whetten, 1985). Organizational mindsets are critical for the enduring success of companies (Collins and Porras, 1996, Albert and Whetten, 1985, van Tonder, 2004), therefore, it is rather surprising that only scant research assessed the inverse notion of organizational mindsets being barriers in business relationships (Richey Jr. et al., 2010).

Because a research gap exists regarding organizational mindsets as impediments in business and regarding the role of organizational mindsets of LSPs in affecting relationship-specific improvement in logistics outsourcing, this research addresses the following two research questions: *(RQ 1): Which organizational mindsets of LSPs can be identified that hamper relationship-specific improvements in contract logistics? (RQ 2): What are the specific effects of these organizational mindsets on the logistics outsourcing relationship?*

2. Literature Review and Conceptual Background

Following established perspectives, collaboration should pay off in sustained value created during the partnership (Vitasek and Ledyard, 2009). Within a relationship framework, this

translates into the idea of constant improvements, which is regarded as a relevant factor of partnership success (Wallenburg, 2009, Langley and Capgemini, 2015).

Against this background, it is problematic that LSPs are not very innovative (Wagner, 2008, Busse, 2010) and less efficient than other companies in turning inputs direct at innovation into innovation outcomes. And while different scholars like Flint *et al.* (2005) and Wagner (2008) propose approaches for service improvements and creating logistics innovations, the literature offers only limited guidance for dissecting possible reasons (i.e., obstacles and barriers) for limited improvements. Notable exceptions are Richey Jr. *et al.* (2010) and Busse and Wallenburg (2014).

In order to extend knowledge to the innovativeness of LSPs, in particular to relationship-specific improvements, this research started with a broad perspective and investigated various aspects pertaining to the LSP, the client and the relationship between them (e.g., resources and capabilities, incentives and governance, structural elements, and the organizational mindsets). The inductively gained results showed that the organizational mindsets are of paramount importance in understanding the LSPs relationship-specific improvement-related behavior. Indeed, the organizational mindsets as core and enduring features of an organization are crucial for all other domains, as they lay the basis for organizational behavior (Albert and Whetten, 1985). These mindsets are “invisible” and often unconscious to the business actors (Willke, 2005, Foerster, 1984, van Tonder, 2004). One example of a prominent organizational mindset in marketing organizations is the assumption that value creation for customers is the key driver of business profitability (i.e., market orientation) (Frösén *et al.*, 2016) And even though organizational mindsets are a well-established concept, Blancero and Ellram’s (1997) statement that “...the typical reader of logistics/purchasing journals is less familiar with this kind of (psychological) literature” still holds true today. Therefore, it is not surprising that organizational mindsets have been neglected in logistics research.

Regarding organizational mindsets, it is characteristic that organizations as complex systems establish an idiosyncratic operation logic that follows a pattern mainly established during the system genesis. The internal operation logic establishes expectations and coins the behavior of the system through its ability to affect “what to see”—the internal operation logic makes an organization selective in what it perceives (Luhmann, 1995, Senge, 1990). In addition, systems are self-referential with external effects only having limited influence on the system, a phenomenon called autopoiesis (Luhmann, 1995). Thus, it would be misleading to exclusively focus on *external* stimuli, for example performance-related incentives, to explain organizational behavior. “Obedience is the hall-mark of the trivial machine; it seems that disobedience is that of the non-trivial machine. However, [...] the non-trivial machine, too, is obedient, but to a different voice. Perhaps, one could say to its inner voice” (Foerster, 1984, p. 10). Therefore, the behavior of an organization can only be adequately understood when the ‘inner voice’, the internal operation logic and the underlying organizational mindsets are understood. Another important characteristic of these organizational mindsets is that they are persistent, cannot be directly controlled and, thus, also not easily changed (Foerster, 1984, Albert and Whetten, 1985). Organizational mindsets are complex and stable sets of rules and interaction patterns of groups and have to be clearly distinguished from mindsets on the personal level (Willke, 2005, Senge et al., 1999, Dyer and Chu, 2000, van Tonder, 2004).

3. Methodology

3.1. Research Design

To gain insights into the complex phenomenon of the improvement-related mindsets of LSPs in contract logistics, a qualitative approach promised particularly interesting insights regarding the current industry practice and the improvement behavior of LSPs (Eisenhardt, 1989b). We chose a single case study with multiple embedded units following the research design proposals of (Yin, 2014) and da Mota Pedrosa *et. al.* (2012). Among the numerous advantages this approach offers for our purpose, we would like to highlight the interaction of researcher

and informant as well as the use of multiple sources of information(Yin, 2014). Another advantage is the possibility to consider the context and experiences of responsible managers (Eisenhardt, 1989b, Benbasat et al., 1987). Lastly, the exploratory stage of the research mirrors the heterogeneous industry practice, which so far lacks a common understanding of relationship-specific improvement as one of the key success factors in contract logistics.

Criteria	Definition	Measures Taken
Transferability	Refers to the extent to which a study's findings apply to other contexts	<ul style="list-style-type: none"> ▪ Description of aim of research ▪ Definition of unit of analysis ▪ Justification of case selection criteria and number of embedded units (demographics)
Truth value	Refers to the match between informants' reality in their particular context and those represented in the study	<ul style="list-style-type: none"> ▪ Identification of data units through coding ▪ Pattern matching of observed patterns with previously predicted (due to exploratory nature of the research, no pattern matching with previous research possible) ▪ Verification of identified data categories through iteration ▪ Triangulation of analyzed data (interviews and archival data) and discussion with informants and among researchers
Traceability	Refers to the documentation of the research process and data sources	<ul style="list-style-type: none"> ▪ Documentation of research procedures as suggested by case study protocols ▪ Explanation of rationale for the sampling & case selection ▪ Usage of comparable semi-structured interview guide and questionnaire for all interviews combining qualitative and quantitative data

Table 1: Measures taken to ensure high reliability and validity of results (based on da Mota Pedrosa *et al.* 2012)

For data collection, we chose the contract logistics industry as unit of analysis and relied on managers with extensive experience based on engagements in a multitude of different contract logistics relationships. The multiple informant approach was chosen for two main reasons: first, to get insights on how aspects, like resources, capabilities etc., within and outside the company are viewed by LSPs and, second, to link the phenomenon of lacking relationship-specific improvements by LSPs to distinct contexts. This clear focus helped to clarify the type of data to be collected and the types of organizations to be approached. Table 1 provides an overview of measures taken to ensure high reliability and validity of results throughout the course of this research.

3.2. Sampling

For the selection of the embedded case units, we sampled with the aim to grasp a maximum richness of information from the cases to allow comprehensive and conclusive insights. The sampling approach was based on criteria which focus on the revelation of unusual phenomena, the elimination of rival explanations, and elaboration of the emergent theory (Eisenhardt and Graebner, 2007). Based upon extensive preparations, the sampling accounted for different criteria such as organizational size (some of the largest LSPs as well as small and medium sized LSPs), ownership type (owner-managed LSPs and family firms as well as publicly traded LSPs), and share of contract logistics activities (LSPs with strong focus on transportation and freight forwarding as well as LSPs specialized on contract logistics). The result is a large spread among the embedded units, which all operate in the German logistics market. Therefore, a broad spectrum of mindsets—if such a spectrum would be present in the contract logistics sector—would be covered, what ultimately results in consistent theory building.

3.3. Data Collection

Based on expert pre-interviews and an extensive review of the literature, a guideline for semi-structured interviews was developed, which comprised qualitative and quantitative elements, such as scaled assessments of distinct relationship elements. Whenever during the course of the interviews interesting new aspects emerged, the interview guideline was adapted to ensure that these aspects were considered in subsequent interviews.

Interviews at the seven embedded units (see Table 2) lasted between 1.5 and 2.5 hours each. They were recorded and subsequently transcribed, generating nearly 6,000 lines of transcripts. A case study protocol was kept as suggested by (Yin, 2014), containing individual notes, transcripts from the interviews, questionnaires, content from the companies' websites, and annual reports. Using multiple data types is recommended to avoid several types of bias, e.g., social-desirability, single-informant, and individual researcher bias (Yin, 2014).

Firm	Employees	Annual revenue [in €]	Share of Contract Logistics	Ownership	Business Focus	Informant
Anthony	10,000-100,000	> 5 bn	0 - 10 %	public	integrated services* / contract logistics	Vice President
Berta	10,000-100,000	> 5 bn	10 - 25 %	public	integrated services* / contract logistics	Director Contract Logistics
Caesar	> 100,000	> 5 bn	10 - 25 %	public	integrated services* / contract logistics	Chief Risk Management
Dora	1,000-10,000	0.5 -5 bn	> 25 %	public	specialized services / contract logistics	Managing Director
Emily	1,000-10,000	< 500 mi	confidential	family	contract logistics / value added services	CEO / Owner
Fred	1,000-10,000	< 500 mi	> 50%	private	contract logistics / consulting & optimization	CEO / Owner
Gus	1,000-10,000	0.5 -5 bn	10 - 25 %	family	integrated services* via partner-network / contract logistics	Manager

* Full scope of traditional transportation and freight forwarding services

Table 2: Demographics of case companies

3.4. Coding and Case Analysis

We applied an open coding procedure to structure all the available information. We identified key categories subsequently and refined them in an iterative process. Initially, our research aimed at viewing different domains of potential causes to lacking relationship-specific improvements by the LSPs (as described in the introduction). During the research process, our iterative data analysis identified the paramount role of the mindsets of the LSPs. The move back and forth between data gathering and analysis revealed that a mindset-oriented research perspective fits well with how the interviewees express their view of the business realities. Therefore, in subsequent steps, we focused on the identification of relevant LSP mindsets and their effects on outsourcing relationships.

Working with tables and lists to compare the respective contexts in terms of literal and theoretical replication as the basis for sound theory building (Yin, 2014) led us to the identification of four specific mindsets category. An example of these tables is provided in Appendix 1, reporting specific information of the LSPs' perception of incentives and the understanding of innovation and improvement for the business relationship.

4. Results

We inductively identified four mindsets that are usual for LSPs. In the following, we present those mindsets and show how they influence a low level of relationship-specific improvements. Subsequently, we discuss how these mindsets unfold in selected relationship scenarios with different types of customers and assess the consequences on relationship outcomes and dynamics.

4.1. Hierarchical Mindset

All analyzed LSPs outline that their customers show very pronounced hierarchical behavior. Over time, this behavior led most LSPs to the development of a corresponding hierarchical mindset of acknowledging the customer to be the superordinate and the LSP to be the subordinate within the business relationship. The general literature outlines that hierarchies build on hierarchy and compliance, coordinate via orders and rule setting, and utilize corresponding management techniques (Jacques, 1991 und Williamson 1999). Typical attributes of hierarchical business relationships are inequality of the actors, restricted autonomy of subordinates, control by superordinates, top-down planning, and hierarchical intelligence (Diefenbach and Sillince, 2011, Williamson, 1999, Jaques, 1991). This is the complete opposite to a collaborative relationship (i.e., partnership) between companies interacting on equal footing. The case companies predominantly exhibit a behavior coined by such a hierarchical mindset as outlined above, which can be illustrated by a broad range of case statements:

„During clarification of open issues, the superior partner (the customer) has played of his position.”
(Anthony, referring to inequality of actors)

„Who is in this business, knows how things work. [] At the end, it is the customer who is the customer and he makes it very clear that you are the supplier.“
(Dora, referencing the same factor)

„Reality is that the focal firms dominate and call the shots.”
(Gus, referencing the same factor)

„Through the way tasks are structured and described, the customer wants to make sure that he is the unrestricted decision-maker who pulls the strings of his service provider.”
(Anthony referring to restricted autonomy and external control)

To validate that whether this really qualifies as a mindset, and not only a situation-specific behavior, it is highly illustrative to see LSPs maintaining this behavior in business situations where they are in the customer position. We found evidence for this in several statements, exemplified by the following assertion that illustrates Emily having internalized the hierarchical behavior, independent from the specific customer situation:

“On the one hand you as service provider do not get insight into the business processes of the customer. In many cases, the customer prevents this. I would do the same. I also do not let my forklift truck supplier look into my business. That is none of his business.”
(Emily)

Customer-LSP relationships which are characterized by a hierarchical mindset of the LSPs will be restricted in the scope and magnitude of relationship-specific improvements as explained in the following.

As outlined before, hierarchy of the relationship builds upon directive and top-down planning, compliance, and hierarchical intelligence (i.e., the assumption that the knowledge and the planning capabilities lie with the customer). Clearly, such a control-oriented set-up will not utilize the expertise of the LSP. This is consistent with the literature on internal innovation (i.e., within a company in contrast to within a relationship), which emphasizes that hierarchy enhances efficiency, but reduces innovation (Hamel and Tennant, 2015, Naranjo Valencia et al., 2010), and the findings that innovation in an relationship is hampered when the service provider is not granted autonomy by the customer with respect to service design and delivery (Sumo et al., 2016). Further, hierarchy implies a reactive behavior of the LSP adhering to rules and routines (Naranjo Valencia et al., 2010) established by the customer, rather than reflecting on own actions and options (March, 1988). The consequence will be that improvements that are based on explicit customer requests will be implemented and thus are rather incremental.

*„When the customer makes rigid specifications, nothing really big can emerge.”
(Caesar referring to the adherence to routines)*

Even if the LSP would still have the tendency to act proactively (opposed to reactively), the hierarchical nature and understanding of the relationship destroys LSP creativity instead of fostering it. Yet, creativity is essential for articulating future visions and finding ways to improve and innovate (Senge et al., 1999, Stevens et al., 1999, de Sousa et al., 2012). Additionally, the hierarchy undermines the motivation of the LSP and its employees reducing proactive improvements by LSPs even further.

*„Satisfaction can only emerge, when you play an active role in the decision process and not when you only succeed in preventing shortcomings and unacceptable rules. This leads to a very distant and (demotivating) business view.”
(Anthony referring to motivation)*

„A customer who only puts pressure on his partner and makes clear who the customer is, is very demotivating. The result is often that the workers batten down the hatches and say: ‘I do not want to work for these people’.” (Dora referring to motivation)

Based on the above, we derive the first proposition:

P1: A strong hierarchical mindset of the LSP is usual and hampers relationship-specific improvements by the LSP.

4.2. Direct Costs-Focused Mindset

The second mindset we identified to be common to LSPs, is one that can be termed direct costs-focused. This is a mindset which lets the LSPs focus on reducing the direct costs of the tasks they perform, while not considering the possible cost reductions they could generate outside their activities. Furthermore, LSPs also lack attention for creating value to the customer by impacting the customer’s revenue side, which is closely linked with improvement and innovation as source of value creation (Eggert et al., 2006, Walter and Ritter, 2003). This mindset is clearly process and output, but not outcome focused and guided by “doing things

right”, not “doing the right things”. In this respect, the interviews reveal that official company statements (e.g., marketing on their website) do not reflect actual company mindset and behavior: Both, Emily and Berta emphasize that quality comes first in their company (and not innovation, which is their official company statement).

This direct costs focused mindset is driven by several factors. Both pricing by customers and their attitude is focused on reducing their payments to the LSP (Lieb and Lieb, 2011), for example, via the practice of imposing agreements for yearly cost-down targets independent from actual performance improvements (Selviaridis and Norrman, 2015). This focus of customers corresponds to observations that the bottom-line and value impact of SCM lacks sufficient attention (Sanders and Wagner, 2011) and that logistics mostly is organized as a cost center by customers. Therefore, a value-based relationship would not suit to the cost-budget logic of the customers. A second reason lies in the limited insights the customers give their LSPs regarding potential overall business outcomes of outsourced logistics, an observation also made by Langley Jr. and Capgemini (2012). Consequently, the LSPs only have a very limited understanding of the value contribution their activities may have for their customers’ competitiveness. The following statements underscore this:

„...the customer makes his assessment only based on our output.”
(Berta referring to the understanding of value contribution)

Complementing this, Gus confirmed that the success of a value oriented improvement approach is a question of mindset.

„It depends on how the workers have internalized the idea, on how the manager applies the concept in his day-by-day business and how he lives the continuous improvement as a standard for his business.”
(Gus referring to the relevance of mindset)

These findings and the apparent contradiction between official company statements and what actually guides behavior within the company underscore our assumption that the identified direct-costs focus qualifies as a mindset, which hampers relationship-specific improvements.

Lastly, the direct-cost focused mindset of the LSP is complemented by the belief that “real” improvements only exist in the setup and the early stages of the business relationship. That would imply that after the right things have been implemented those right things only have to be improved regarding their execution. Such a mindset neglects both improvements that reflect changes to the external context factors of the performed tasks and that new concepts and ideas can be infused into an existing solution even during the mature phase of the relationship (Wallenburg, 2009).

The described direct-costs focused mindset of LSPs will limit all their improvement efforts to increase the efficiency of the tasks they perform and, thus, neglect any value-contribution they could generate by reducing costs or increasing revenues of their customers in other areas. Therefore, we conclude the following proposition:

P2: A direct costs-focused mindset of the LSP is usual and hampers relationship-specific improvements by limiting their scope.

4.3. Detailistic- and Zero-Error Mindset

Third, LSPs predominantly demonstrate a detailistic and Zero-Error focused mindset. This mindset is driven by customers that have integrated contract logistics into their own processes and leave their LSP little room to manoeuvre. The interviewees regard this as a clear impediment for improvement as the customers tend to create an outsourcing performance dilemma in that they focus too much on “how” instead of “what” the LSP shall do (Vitasek and Ledyard, 2009). While the companies express their astonishment about process restrictions not comprehensible to them, they mostly have internalized this as an apparent necessity.

„...why there is a distinct penalty and how it is related to distinct effects has never been explained to me by any customer. By the way, I have never heard about any customer who has explained this.” (Dora referring to unclear process restrictions)

“There are lots of focal companies [] who take the lead, [], I guess. I think that this is in some sense justified.”

(Anthony similarly referring to the role of the focal company)

Customers not only hamper relationship-specific improvements by providing detailistic process requirements, but also by their low level of tolerance for errors. Yet, innovation needs tolerance for errors (Ederer and Manso, 2011, Meyer, 2011)¹.

„There is absolutely zero tolerance, when the system is endangered, may it be only for a short moment. The tolerance is very low...the tolerance for production loss is equal to zero.” (Dora referring to the customers’ error tolerance)

The LSP mindset of avoiding any errors is strongly supported by customer’s quality focus (Kreutzmann, 2011) and so called malus agreements which reduce payment or infer other punishment when agreed upon service levels are not met. Accordingly, zero error related management techniques (e.g., Six Sigma) are implemented at the LSPs. Berta emphasizes that it is not aiming at providing the best solution, but a solution that is guaranteed to work at all times:

„Years ago, we decided to put the dictum “quality first” to the front. We do not want to engage in discussions with our customers about production disruption or any other failure. For us ‘that things work’ comes first.”

(Berta referring to the role of quality)

The necessity that innovation needs the tolerance of errors, creates a direct conflict with a zero-error-focused mindset. To avoid such possible conflicts, all LSPs except for Fred empha-

¹ Meyer (2011) points out that the wanting for innovation with ‘fully coverage insurance’ is omnipresent in business: only 18 % of the surveyed companies sponsor experiments; only 12 % accept bad ideas as part of the creative process. The focus on rule and processes often turns out to be an innovation blocker.

size that, as typical in the industry, they never propose a pricing that remunerates based on improvement to their customers.

Question: When the customer does not mention this point, you don't bring it either?

"Right"

Question: The proposition for continuous improvement agreements (i.e., the agreement on rules of how to improve) comes, without any exception, from the customer?

"Yes"

(Berta referring to continuous improvement agreements)

Focusing on details and avoiding mistakes is a mindset that is generally hostile to innovation and limits the scope of improvements to error-reduction. Consequently, we propose the following:

P3: A detailistic and zero-error mindset of LSP is usual and hampers relationship-specific improvements by the LSP by limiting their scope to error reduction.

4.4. Hidden Action Mindset

LSPs predominantly demonstrate a mindset of hidden action. This is a mindset, which lets the LSPs hide improvements due to the perception of inequity and missing fairness in the relationship. Fairness is a critical enabler for successful business relationships in terms of relationship performance (Dyer and Chu, 2000, Hofer et al., 2012). Fairness concerns play an important role, especially in moral hazard contexts (Fehr et al., 2007). Interestingly, while the effect of shirking is widely associated with an agent's lack of putting in full effort (Eisenhardt, 1989a), there is little knowledge on hidden actions, where agents put in their effort for their own benefit and not for the benefit of the business relationship. The identification of whether or not a business relationship is perceived to be fair is linked to the distribution of risk and reward (Hofer et al., 2012). In our interviews, we found numerous statements related to unfairness:

„Opportunities and risks are not balanced, an external spectator would probably say 'that is not fair', 'that is an unfair system', but that's the way our industry works.'"

„In many cases, the tasks are not sufficiently described by the customer[...] and when certain assumptions we had to make were not correct [...], we frequently see that the customer is not willing to accept this and to correct the prices accordingly.”
(Dora referring to risks and fairness)

The question what type of behavior the perception of missing fairness induces is interesting. Fehr et al. (2007) show that in situations of inequity, reciprocity plays an important role in the sense that agents adapt to the unfair behavior of the principal by minimizing the effort they put in. Yet, in our context, the agent would achieve a similar result by hidden activities, where he tries to appropriate the complete benefit of improvement activities for himself, an approach consistent with Equity Theory (Adams, 1965, Adams, 1963). Additionally, the LSPs as agents experience extremely low profits margins, with the danger to make losses, for example due to risks the customers impose on them. This has invoked an LSP mindset where improvements are made hidden from the customer in order to fully appropriate the corresponding gains themselves as illustrated in the following:

„I would put it like this: Process improvements that we can make without involving the customer are performed without much noise.”
(Emily referring to the appropriation of improvements)

„The LSP is not interested in sharing even one cent with his customer, but, instead, is forced to make the maximum from the contract and, therefore, has no interest in making anything transparent...”
(Emily referring to the same factor)

With respect to relationship-specific improvements, this results in efforts of the LSP to only pursue improvements that can be hidden from the customer and, consequently, that can be designed and implemented without customer involvement. Abstaining from customer input is a clear limitation to the scope of improvements, which leads to the next proposition:

P4: A hidden-action mindset of LSPs is usual and hampers relationship-specific improvements made by the LSP by limiting their scope to hideable domains and abstaining from customer input.

4.5. Interim Conclusion

In deriving the propositions P1 to P4, four mindsets were identified that are usual for LSPs. While most LSPs exhibit these mindsets, it does not mean that all LSPs have them and that all LSPs have them to the same extent. Most notably, Fred does not show any of the four mindsets, and Gus deviates in that it has a value-focused mindset and not a direct-costs focus. In order to reflect the predominant mindsets, and at the same time enable the use of a simple terminology, we refer to any LSP who exhibits the predominant mindset as *conventional* LSP and any LSP with a different, opposing mindset as *unconventional*. Gus is the only LSP where not all four mindsets are aligned in the sense that they all are either fully conventional (five of the analyzed LPSs) or fully unconventional (only Fred); Gus has three conventional and one unconventional mindset.

When deriving the propositions P1 to P4, we outlined the effects each specific LSP mindset has on relationship-specific improvements by the LSPs. The conclusions are based on the implicit assumption of a conventional LSP (i.e., one exhibiting the four mindsets) dealing with a conventional customer. A conventional customer in this sense is one that possesses the outlined characteristics which over time have invoked the four identified mindsets. These are on the side of the customer, a focus on hierarchy, on direct costs, on confined tasks and zero-error, and on customer appropriation of improvements.

Based on this, we conclude that any relationship between a conventional LSP and a conventional customer will result in a situation where relationship-specific improvements of the LSP will be limited. The improvements are limited in scope to ones that are reactive, focused on direct costs instead of indirect costs or value, targeted at error-reduction, and those where the LSP solely benefits from the gains through hidden action.

This brings up two key questions: First, whether the conventional-conventional relationship has any advantages. Second, what the results will be, if in the outsourcing relationship either

the LSP or the customer, or both, have unconventional mindsets. We will first address the former and then the latter question in depth in the following sub-sections.

4.6. Relationship of Two Conventional Parties

“We don’t need flat organizations. We need *layers of accountability and skill*.” (Jaques, 1991, p. 127). Hierarchy, if well designed, is deemed the most efficient structure for large organizations as it allows to hold people accountable for getting assigned work done and, therefore, to structure unified working systems with a large number of actors. Thereby, hierarchy is effective in organizing processes in which a large number of actors are involved guaranteeing frictionless execution of distinct and well-defined tasks in complex working environments (Jaques, 1991). Such a situation of involving many actors, a unified working system, and seamless work-flows are highly typical for the logistics contract business. Accordingly, conventional outsourcing relationships, which are the predominant majority as experienced by all six case companies, will be effective in getting defined tasks “done”, such as implementing the relationship-specific improvements requested by the customer (in contrast to comprehensive and proactive improvement actions by the LSP). Thus, the conventional–conventional setup perfectly suits the conventional customers that have the expectation to assign distinct, well-defined tasks to an LSP and to be sure that these tasks get done – nothing less, but also nothing more. As these expectations will be met by the conventional LSPs, no tendencies will arise to change the situation, thus it is stable over time, but limited in innovation and we propose:

P5: The relationship of a conventional customer with a conventional LSP establishes a stable fit, for an efficient execution of distinct, well-defined logistics tasks, and limits the scope of relationship-specific improvements made by the LSP.

4.7. Relationship of Conventional Customer and Unconventional LSP

The situation of conventional customers interacting with unconventional LSPs was found at Fred and partially at Gus, which both refer to distinct challenges. Fred emphasizes that his business approach to be truly innovative by pursuing comprehensive, proactive improvements is full of friction. With that approach, Fred is addressing the customer organization not from a subordinate position, but rather on eye level:

„How many customers accept an LSP saying: ‘I know that you do not need all resources you put in today.’? This is an emotional issue, whether a customer is ready to accept this [...]. There are many management and planning functions in logistics that are not adequately staffed. I doubt that these people are prepared for an LSP who tells them upfront that there is relevant potential for improvement.”

„This ranges all the way to fears of one’s existence by logistics or operations managers. [...] When we start a change, our partner on the customer side is not the logistics manager [...] because he has fear. We talk to the board of directors.”

(Fred referring to frictions with customers)

These frictions are underscored by Gus, who consequently only takes an innovative, value-adding approach in contract logistics relationships, when the customer is specifically looking for this and, thus, exhibits an unconventional mindset.

Another strategy to deal with the tension created by unconventional LSPs is in changing the attitude of the customer. This is especially necessary when the customer claims *hierarchical intelligence* superior to those of their LSP and does not tolerate other than the expected ‘obedient’ LSP behavior. Here, change can successfully be initiated by top managers of the customers via their internal hierarchy. On the side of the LSP, this requires going “upstairs” by placing innovation and improvement issues on higher levels of the customers’ hierarchy (e.g., the executive management board level), which look at ways to improve overall financial performance outside the “narrow” logistics confines. The effect of this is a situation of a relationship of two unconventional parties that facilitates superior improvement results and mutual benefits as outlined later on.

Another typical way of eliminating the tension is accepting the customer's orders and executing tasks in the conventional way. Fred and Gus confirm that in cases where customers insist on their hierarchical superior position, for example, by a detailistic specification of tasks and thereby limiting the LSPs' room for improvement, they themselves resort to acting like a conventional LSP. In that they accept the subordinate role the customer designates to them in order to receive the contract. In this sense, unconventional LSPs are capable of acting variable and selective, a higher capability than the conventional LSP exhibit – a phenomenon which Social Systems Theory describes as a higher level of contingency (Luhmann, 1995).

The above implies that all settings where an unconventional LSP and a conventional customer meet are unstable for the fact that either the customer changes his attitude and behavior (top-down initiated) and becomes an unconventional customer or that the LSP resorts to conventional LSP behavior. Alternatively, the customer may select a conventional LSP that does not cause any possible irritation or disturbance. Therefore, we derive the following proposition:

P6a/b: The relationship of a conventional customer with an unconventional LSP creates an unstable situation, where the customer receives a temporary stimulus and either a) changes to become an unconventional customer, or b) chooses to switch the LSP and contract a conventional LSP or an unconventional LSP that resorts to a conventional behavior pattern.

4.8. Relationship of Unconventional LSP and Unconventional Customer

In contrast to the previous settings, an unconventional LSP engaging with an unconventional customer form the basis for substantial relationship-specific performance improvements. In this situation, the LSP is neither restricted by any of the identified mindsets, nor by a customer that is additionally hampering improvements by its own behavior.

The non-hierarchical customer allows the LSP to act in the role of a partner on equal footing who is not limited to simple task execution. Correspondingly, the LSP demands and is granted

full participation in all questions of process design. A non-hierarchical outsourcing relationship not only allows the LSP to leverage its own expertise and creativity and merging it with the competencies of the customer, but also to behave proactively. Further, motivation of the LSP and its employees increase when engaging on equal footing with the customer.

*„Having a say, is a must; otherwise we cannot point out improvement potentials.”
(Fred)*

Second, as the customer provides insights in the value-creation process and the larger context the outsourced services are embedded in, the LSP can and does view its tasks in the broader supply chain context of the customer. This facilitates continuously questioning limiting organizational setups and allows for improvements that are more extensive. Because the LSP understands its tasks as value creating, it, may entertain, for example, personnel focused on identifying and implementing improvements not limited by fixed cost-down arrangements, but open for improvements of any kind and any scale.

*„It is absolutely mandatory to evaluate all areas that play a role in the supply chain.”
(Fred)*

Third, as the unconventional customer wants the LSP to provide solutions to its problems instead of making detailistic injunctions regarding activities (Vitasek and Ledyard, 2009), the customer gives the LSP sufficient room to manoeuvre to achieve such solutions. This facilitates an LSP focusing on “what to do” instead of “how to do it”, and with that focusing on outcomes instead of merely processes and outputs. Similarly, a customer’s tolerance for errors incentivizes the LSP to use management techniques focusing on improvements which require some level of failure acceptance (Peters, 1989). Contrary to the conventional LSPs who, as shown above, focus on zero-error and try to avoid agreements for continuous improvements, unconventional LSPs are likely to agree on performance based pricing schemes, which further spur the drive for innovation (Vitasek and Ledyard, 2009).

Question: Who is the driver for joint improvements? Is that you, the LSP?

“In more than 90% of cases, yes.”

(Fred)

Fourth, unconventional customers are characterized by looking for a balanced distribution of risks and reward in seeking superior solutions, hence, signaling a fair behavior to the LSP. Reciprocally this motivates the unconventional LSP to put in his full effort and to make efforts transparent. Consequently, the LSP and customer may even jointly calculate their process costs and make achieved improvements mutually transparent. Instead of hiding improvements, unconventional LSPs sometimes even accept revenue reductions in favor of the trust which may lead to future business growth. This would not be possible with conventional LSPs.

As outlined, it is the combination of the broader LSP mindset with a corresponding customer disposition that leads not only to more relationship-specific improvements made by the LSP, but also to more substantial ones. We infer that this is a situation that is beneficial to both the LSP and the customer and, thus, provides a stable situation as proposed in the following:

P7: The relationship of an unconventional LSP with an unconventional customer establishes a stable fit that enables more, and more substantial relationship-specific improvements by the LSP.

4.9. Relationship of Conventional LSP and Unconventional Customer

At first glance, the situation of an unconventional customer engaging with a conventional LSP may seem quite similar to the other “unbalanced” situation (conventional customer and unconventional LSP). Yet, it is very different as here the expectations of the customer with respect to improvements and adaptation exceeds the capabilities of the LSP due to the LSP’s limiting mindsets, which only allow the LSP to access parts of the existing improvement potential. A good example for such a situation are new entrepreneurs (e.g., start-ups in online-retailing) that are not within the usual conventional customer profile and, in line with their

own innovativeness, expect a similar behavior from their (potential) LSPs. We know of numerous cases in which these expectations were not met and customers ended up being frustrated. For example, in follow-up interviews to our cases, we came across an entrepreneur who perceived the meeting with a conventional LSP like a “meeting of two different worlds”. One chief operating officer (COO) of another successfully growing start-up in the B2C business told us that the LSP they contracted, over time, had no “clue” (i.e., innovative ideas) how to improve the business processes at his customer further.

When expectations exceed capabilities, the customer will not accept such a situation if other options are available. One option, and the one chosen by the aforementioned COO, is to in-source the corresponding logistics activities and (again) perform them in-house. Another option is to choose an unconventional LSP capable of matching the customer disposition. However, and in contrast to the setting addressed in P6, it is not an option for the customer to change the LSP’s mindset.

Why is that? In the setting of P6, a conventional customer can more easily be changed compared to the LSP, because a) the fact that the outsourcing tasks are no longer regarded as core activities, b) another company (i.e., the LSP) is deemed to be more competent in this domain, or c) that in the process of outsourcing, most logistics managers are replaced by the contract logistics provider and, if necessary, the few remaining ones could be staffed with new managers recruited from outside the company. In contrast, it is virtually impossible to change the behavior of the LSP in the short- to mid-term. From the conventional LSP’s perspective, the take-over of a new contract is part of his normal business, which he approaches with his conventional structures, routines and resources. Therefore, and in contrast to the above, there is no change in priorities, (i.e., goals, competencies, or processes) which could induce a fundamental mindset change. Consequently, the established mindsets continue and perpetuate the present structures for the selection of behavior and processes within a system (Willke, 2005).

With a specific mindset in action, the operation logic of a system can be understood to be closed and selective in what it perceives(Luhmann, 1995). In this sense, a mindset creates a blind-spot for other than the established behavior (Foerster, 1984), which even inhibits adaptation and change when an external stimulus, such as a change in customer behavior occurs. Consequently, a conventional LSP is prone to not understanding the different approach of the unconventional customer and, thus, will not change his conventional behavior. Indeed, due to his blind-spot, the LSP will not even be conscious of the fact that it does not perceive what the unconventional customer’s expectations are.

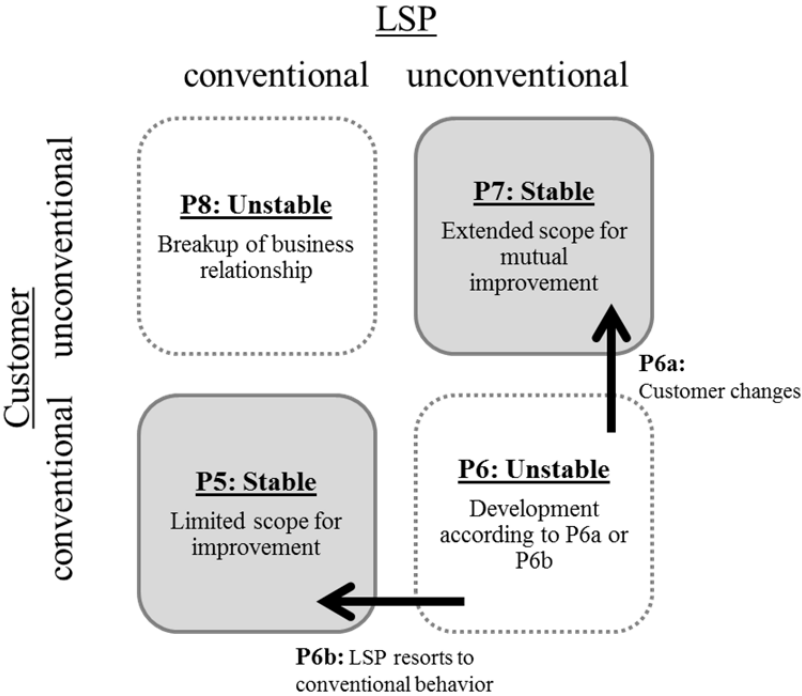


Figure 1: Outcome of specific customer–LSP settings

Furthermore, even if the LSP would perceive these expectations, a key characteristic of organizational mindsets is that they are persistent and cannot directly be controlled and, thus, not easily changed. They are complex and stable sets of rules and interaction patterns which establish a distinct company “spirit or way” (Anteby and Molnár, 2012 p. 517) to do things and in this sense provide a stable, but also limited set of behavioral options for the LSP. Even if

single managers want to develop and provide improvements, the mindset of the LSP does not allow this. Therefore we propose (see also Figure 1):

P8: The relationship of a conventional LSP with an unconventional customer establishes an unstable situation, where the LSP perceives stimuli he cannot process due to his limitational mindset(s) and, consequently, does not meet the customer expectations, which ultimately leads to ending the business relationship.

5. Discussion

In light of ongoing pressure on companies to improve the performance of business relationships and, thus, to provide a setup where innovation and improvement can flourish, numerous contributions outline approaches to such improvements (e.g., Flint et al., 2005, Wagner, 2008, Langley Jr. and Capgemini, 2012), for example via clauses of general understanding, capability developments, or the usage of incentives. However, prior work has not considered the LSPs' mindset. This research shows that a deeper understanding of the business actors' distinctive mindsets is essential to understand the full performance potentials of outsourcing relationships. In this realm and answering research question 1, we found that LSPs exhibit four distinct mindsets that hamper creativity and relationship-specific innovativeness, which we labeled 1) hierarchical, 2) direct costs-focused, 3) detailistic and zero-error, and 4) hidden action. As outlined in the propositions P1 to P4, these mindsets undermine the efforts of companies trying to leverage their outsourcing partners' capabilities to gain a competitive advantage. Additionally, we develop another four propositions, hypothesizing the expected outcomes of specific customer–LSP settings (i.e., conventional and unconventional) with regards to stability and performance.

It is important to note that these counterproductive mindsets, as outlined before, have been induced by the customers behavior and expectations. This resembles a long-term vicious cir-

cle initiated by the customers and leading to most outsourced activities being limited in their improvement potential.

Escaping this situation is not easy because mindsets and the behavior they induce exhibit high stability over time. Yet, in our cases, we also found evidence of mindsets that changed over time. In the case of Fred, the changing mindset from conventional to unconventional resulted from a sharp transformation of the organization from the top. The process was initiated by a new CEO entering the company, combined with the sale of the main business unit of the company (the freight forwarding business) and investing the money in an innovative contract logistics organization. As crucial success factor, the incoming CEO had extensive experiences in several management positions at outsourcing companies (i.e., on the customer side). The top-management change was the trigger leading to the change of the organizational mindsets. However, typically, change of mindsets is a long-term effort (as seen with Berta and its conscious implementation of a zero-error mindset)

From a systems point of view, it is important to consider that no single factor determines the characteristics and the behavior of a complex system, which an LSP is. It rather depends on the interplay of several factors and especially the environment of the system, which tends to amplify systems behavior that is similar to the environmental behavior (Bateson, 2000). For this reason, LSP top-management's effort to change the mindset of the LSP is constantly endangered when the majority of customers undermines this attempt by exhibiting a behavior that asks for a very different LSP behavior.

In conclusion, the above should make clear that straightforward ideas how to change an organizational behavior with the aim to achieve performance improvements (e.g., via general contract agreements about mutual intention for improvements) will not be successful. What Hamel and Tennant (2015) emphasize with respect to internal innovation also holds true here, the necessity to challenge invisible orthodoxies that have become engrained as a common mindset (Hamel and Tennant (2015) refer to them as converged mental models). In addition,

practice, since the early days of strategic business relationships has exhibited a lot of rhetoric on partnering and the desired results (Peters, 1991) and this situation has not changed ever since (Fawcett et al., 2008). Due to the wish to see their own business relationships as cooperative and fair, customers often are biased towards a positive assessment about mutual efforts and success in their business relationships. At this point, all involved actors should remember the wisdom that “not talking, but doing is relevant”.

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Appendix 1:

Context and Perceptions of LSPs Regarding Relationship-Specific Improvements	
Anthony	<ul style="list-style-type: none"> ▪ Company Web-Site mission statement does not refer to innovation or improvements in customer relationships, but emphasizes sustainability and social acceptance ▪ General perception that business parties have rival interests, i.e., incongruent goals -> concept of mutual improvement does not fit ▪ Strong perception of purposeful hierarchical customer behavior, which is associated with large customers -> undermining motivation. Perception of the dilemma that focal companies must control complex Supply Chains. (This is acceptable unless they do not exploit their superior position) ▪ Perception of limited freedom in tightly integrated process designs, which reduces improvement opportunities ▪ Strong perception that mutual improvement is not focus in business relationships, but cost reduction ▪ Strong doubt regarding the “real” objective of current incentive schemes, i.e., penalties -> LSP puts in all effort to avoid the current incentive schemes ▪ Strong perception of one sided risk allocation to the detriment of the LSP ▪ Strong perception that LSP are due to business situation forced to improve -> search for gaps to financially optimize in their own favour, and NOT in favour of the partnership ▪ Success is associated with the creative ability to find gaps in contracts ▪ Strong perception of intransparency and discontentment regarding agreements/methods for performance control for overall SC performance and profit sharing (calculation and distribution)
Berta	<ul style="list-style-type: none"> ▪ Positive assessment regarding hierarchical situation and future expectations for further improvement ▪ Contrasting to Web-Site mission statement, according to which innovation is on first place. interviewee emphasizes “quality first” as core thinking pattern. This is also supported by a newly implemented production management concept. CI agreements are never proposed by LSP ▪ Production management concept emphasizes 0-Error. Implementation is based on systemic approach. A long delay between implementation and sustainable transformation to improvement oriented thinking pattern is expected ▪ More than 50 % of contracts include a fixed “improvement price reduction” scheme, independent from real improvements. Clear perception of dilemma between “quality first” and purchase-driven fixed improvement price reduction schemes (cost down focus). Perception that “improvements” have become an instrument for the purchase department to push down costs ▪ Perception of intransparency regarding some agreements for performance control ▪ Strong assessment that there is no collaborative improvement of products and services and no sharing of results of improvement ▪ Perception of limited freedom in tightly integrated process designs, which reduces improvement opportunities ▪ Bonus and monetary incentives are deemed to lead to mutual improvements
Caesar	<ul style="list-style-type: none"> ▪ General perception that partnering is key to the mutual development and improvement of business relationships. On the other hand clear perception of hierarchical superior role of focal companies. This is seen as necessary to control complex processes. Unfair (one sided) risk allocation is perceived to be highly demotivating (and is associated with large companies). ▪ Company Web-Site profile highlights the importance of innovations in terms of technical solutions. No explicit link to improvements ▪ Clear perception of customer quality focus in business relationships. Complementary assessment that improvement activities play a relatively minor role in business relationships. Frequent perception that customers’ quality focus is controversial to purchases’ cost focus. ▪ Strong perception of limited size of improvement potential linked to contract life-cycle. ▪ Strong assessment that there is no sharing of results of improvements ▪ Clear association of shortcomings for improvement driving behavior (fairness / partnering) with size of the involved organizations (The bigger – the worse). This is due to big corporations “operation rules”. Assessment of relevant gap between importance and reality! ▪ Perception that meticulously (by customers) predefined processes reduce the space to improve

Dora	<ul style="list-style-type: none"> ▪ Generally, claim of partnering understanding of business relationship, but in practice, clear hierarchical understanding of own role and own behavior in similar situations to own suppliers, resulting in one sided risk allocation -> finally assessed to demotivate putting forth of all efforts ▪ Clear internal quality focused (static) thinking pattern vs. cost down focus (dynamic) of customer. Quality first is a clear thinking pattern. Improvement is no vision or mission but an enabler to guarantee future business ▪ Clear distributive thinking pattern regarding distribution of improvements ▪ Clear perception of 0-Error tolerance of customers regarding productivity issues ▪ Strong assessment that there is no collaborative improvement of products and services and no sharing of results of improvement ▪ Perception of intransparency of agreements for performance control for overall SC performance ▪ Perception of dilemma regarding integration in customer processes and freedom to improve ▪ Bonus and monetary incentives are deemed to lead to mutual improvements
Emily	<ul style="list-style-type: none"> ▪ Contrasting to Web-Site statement, according to which partnership is key for success, interviewee shows a very strong hierarchical behavior, which characterizes current business relationships with customers and own suppliers -> resulting in one sided risk allocation. ▪ Contrasting to Web-Site statement, according to which innovation is key for success, interviewee confirms that customer quality is focus in business relationships, and improvement is not a key issue. ▪ Perception of limited size of improvement potential linked to contract life-cycle ▪ Strong perception that incentive schemes for mutual improvements and profit sharing do not fit with current business relationships due to market characteristics, e.g., fierce competition, short contract time, limited freedom for LSP, high risks -> LSP maximizes own profit and does not improve in favour of the business relationship ▪ Clear distributive thinking pattern regarding distribution of improvements ▪ Perception of dilemma regarding tight integration in customer processes and freedom/opportunities to improve ▪ Strong perception of intransparency and discontentment regarding agreements/methods for performance control for overall SC performance and profit sharing (<u>calculation</u> and distribution) -> change would be a significant progress for mutual improvement attitude ▪ Open book is generally deemed to be an effective concept to foster improvements. Open book is peppered with difficulties (missing trust and understanding)
Fred	<ul style="list-style-type: none"> ▪ Web-Site mission statement is closely linked to innovation and improvement ▪ Interviewee confirms improvement to be at the core of the business concept ▪ Strong perception of hierarchical behavior of customers -> complicating effective improvement ▪ Perception of intransparency and discontentment regarding methods for performance measurement for overall SC performance
Gus	<ul style="list-style-type: none"> ▪ Web-Site mission statement closely linked to innovation and improvement ▪ Interviewee confirms strong focus on improvement, referring to the importance of the “mindset of people” to make it a success ▪ On the contrary customers are drivers of performance measurement concepts and LSP prefers to work without ▪ Strong perception of hierarchical behavior of customers and confrontational business relationship (exception Toyota!), which is associated with large companies -> partnership and fairness are perceived as strong incentive ▪ Mixed perception regarding importance of improvement for customers ▪ Perception of limited size of improvement potential linked to contract life-cycle ▪ Perception of dilemma regarding tight integration in customer processes and freedom/opportunities to improve ▪ Perception of intransparency and discontentment regarding methods for performance control for overall SC performance and profit sharing ▪ Penalizing systems are deemed to be effective for the change of behavior and for improvement