OUTSOURCE, REINVEST OR TURN AROUND

NAVIGATING THROUGH THE CORE STRATEGIC ISSUES FOR YOUR EXISTING OPERATIONS VIABILITY, NOW AND INTO THE FUTURE. THE CONSEQUENCES ARE FAR-REACHING FOR THE CUSTOMERS, THE BRAND, THE OVERALL ORGANISATIONAL PERFORMANCE, EMPLOYEES, AND THE CAREERS OF THE EXECUTIVES INVOLVED.

JASON FURNESS

The problem

There are many challenges facing manufacturing businesses in Australia this decade. However, the "Thriving Australian Manufacturer of the Future" is not an oxymoron. The nature of manufacturing has moved from inflexible approaches of addressing market demand that are highly forecast-dependent, to highly responsive and adaptable market-focused replenishment and production methods.

The challenge has arisen and continues to rise as tariff barriers are reduced, the quality and quantity of consumer choice increased, and macroeconomic issues of exchange rate and increased competition for skills from other industries (e.g. mining) have increased.

Traditional leadership and organisational approaches have found this transition difficult. They have been highly focused on traditional cost-accounting methodologies and operate in highly functionally divided silo-based hierarchies. This methodology that evolved in the 1920s has been adequate in past eras where competition was limited to other major players who behaved the same way we did, and the evolution in products and services was slow.

A silo-based mentality of management, measurement and decision making will not necessarily create the correct decisions on sourcing and service delivery that are required to ensure success for the next decade.

So what does this mean?

For the "Thriving Australian Manufacturer of The Future" an approach to deciding what parts of the business to outsource production of, what parts to reinvest in, and what parts require a turnaround project to increase performance requires collaboration across departments and a strategic approach to measurement and sourcing decisions.

Dilemma or choice

When you only have two options to choose from, you do not have a choice, you have a dilemma. Only when you have three or more options do you truly have choice.

A new general manager of a large multi-national organisation with Australian and global manufacturing sources faced choices when other people felt there was only a dilemma. The large ($240m+ sales) business was break-even in profitability and had lost money the previous year after being a successful 'cash cow' from the late 1940s onwards. Internal pressure was to source more and more product from external suppliers. The business had a very strong 'sales vs. operations' approach, customers were not able to buy what they wanted, yet working capital was consumed in mountains of stock that the market did not want. The factory produced what are considered commodity products and there was extensive and continually increasing competitive pressure.

An ongoing three-year project resulted in the business moving from break-even to a $5.4m profit in Year One. This was double the global corporate return on sales.

The following year profit was $12.4m, the year after that it was over $28m during the GFC. The business grew market share, volume, set records for quality performance and opened up small but significant export markets into a number of Asian countries including China. The business also in-sourced over 25,000 units of production from Asia and improved customer service on these products while reducing the corporate inventory by just under $2m.

Outsource, reinvest or turn around?

Making the right decision for today, and for the future is the key outcome from our strategic project. We want to make money now, and into the future, in a sustainable way.

> **"The decision to outsource, reinvest, or turn around an existing operation is an intensely strategic, emotional, and complex decision. Getting this right will determine if your organisation starves or generates cash flow."**

1. Outsource

Outsourcing is the complete closure and shutting down of that operation, a section of that operation, or skill-set within the operation. This is generally successful when the business has an operation or section that has:

- Multiple proven options for supply, and
- Strong & stable market demand and where:
- The activity is peripheral to the company for future cash generation.
- High investment (cash the company does not have) is required to regain a competitive edge.
- The customer experience is enhanced.
- 'Exit cash' Cash required to shut down the operation, (redundancies, land remediation, extra inventory etc) still results in a less than two-year payback.

A solid example of this was the out sourcing of the manufacturing and design of automotive tail lights to a specialist manufacturer. The design investment in these parts was very high in order to maintain the technological development, it was peripheral to the core expertise of the business, the design styling options available was greatly enhanced, and existing staff were absorbed into other areas so the exit cash was very low.

2. Reinvest

Reinvesting is the commitment of significant funds to redevelop and upgrade the operation to enable a significant and sustainable boost in cash flow that is rapidly paid back to the business. Reinvestment is generally a popular solution in the wider community and with the workforce. Successful reinvestment options generally include the following features:

- Low payback periods (1- 2 years).
- Stable markets with little volatility.
- Utilisation of, or extending existing skills within the business.
- The customer experience is enhanced.

A successful example of this has been the sustained reinvestment in injection-moulding machines every 8-10 years. The existing equipment has become out of date (but not obsolete) in terms of power consumption and speed. New equipment generates increased cash flow by enabling a faster response rate to variations in demand and by using less power and human staff. The skill-sets required are already existing in the business.

3. Turn around

Undertaking a turnaround operation is the undertaking to significantly and sustainably boost performance of the business, largely with existing resources and within a short period of time (3-9 months). This option requires a change in management practices and behaviours at its core. Successful turnarounds often include the following:

- Significant (50%+) reductions in customer lead time;
- Major reduction (30%+) in inventory;
- Significant changes in scheduling & design processes.
- Realignment of measurement systems to require cooperation.
- Improved responsiveness to schedule fluctuations.
- Improved quality.

One example of this was the largest (at the time) grey iron foundry in the Southern Hemisphere. This foundry was chronically late in deliveries to customers, ran an inflexible two-week production cycle, and had poor quality. The behaviour was driven by a moulds/hr measurement system that was divorced from customer needs.

Over a nine-month period existing resources were retrained and management processes upgraded to improve the uptime and speed on the existing 45+ year-old casting line. Simulation technology was utilised to redesign quality into the parts and performance was realigned to be linked to supplying customers what they needed, when they needed it, regardless of forecast.

The business moved from holding stock measured in weeks, to holding stocks measured in terms of 2-3 days. Export backorders totalling over 5,000 engine blocks that had remained at those levels for many months were eliminated. Quality improved to record levels, as did safety. Instead of operating a six-day week, the business could safely operate a nine-day fortnight, which reduced costs and freed up access to the machinery to build in further improvements in quality, uptime, safety, and cost reduction. Obviously, the extra cash costs of operating a six-day week went immediately to the bottom line.

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PROBABILITY OF SUCCESS	OUTSOURCE	REINVEST	TURN AROUND
HIGH	stable or seasonal market multiple proven suppliers no cash to reinvest low exit cash	payback < 1yr stable or seasonal market uses existing known skills	10 yr+ technology life stable or seasonal market reasonable relationships sufficient core skills remain
	seasonal market unknown suppliers limited choices high exit cash	2-4 yr payback seasonal market needs extension of skills	5 yr+ technology life seasonal market acceptable relationships core skills exist
LOW	volatile market unresponsive supplier supplier as competitor only one choice	low payback 4yrs+ volatile market requires new technology & skills	obsolete technology volatile market dysfunctional relationships core skills have already left

The strategic sourcing matrix.

Factors to consider when making these decisions

1. Lifespan of technology

How long is the useful lifespan of the technology in the business? Technology that becomes obsolete fast is a great candidate to avoid investing in. It is very difficult to gain a superior return on investment when technological changeover occurs rapidly. Conversely, if the technology is high investment (that you made many years ago) and has years of useful service left, then a selective reinvestment and or turnaround project becomes very attractive.

2. Market volatility

How volatile or seasonal is your market? Be very cautious in using scenarios for volume that are radically different to recent behaviour. When outsourcing, be aware that a supplier will often provide a price based upon volume assurances and assumptions. This same supplier will usually not hesitate in resetting their price to you if the volume lowers.

3. Supplier responsiveness

A related issue to market volatility is supplier responsiveness. What happens when the market surges? Can your supplier, reinvested factory or turned around factory respond to the increase in demand so that the customer lead time remains low? If demand drops how does each of your choices respond? Will you be stuck with three months of stock being shipped and chewing up cash flow because you ordered it, or will you be able to turn off orders and cut production in line with true market behaviour? An unresponsive supplier can force you to carry more inventory to try and cope with any market upside or burden you with stock for any downside. They can be so slow to react, forcing you to abandon any notion of chasing un-forecasted upsides. An internal factory that is unresponsive is just as bad.

4. Supplier as competitor

One risk of outsourcing is that you educate your supplier about your market, its behaviour and its standards. Your supplier gains their education, at your expense, for a few years and then enters the market in their own right. The marketplace has become attuned to the supplier's product, and the acceptance is widespread. You have then lost a massive (50%+) of your remaining sales over a few years.

5. Few choices

If you have few choices, an outsourcing strategy becomes risky as you have less commercial leverage on your supplier in issues of price, quality, supply and new product development. This does not necessarily mean that a turnaround or reinvestment strategy is automatically the best option. Broadening the choices for you to use, and developing the ability to move from one source to another, are keys to minimising this risk.

6. In-house relationships

The relationships within the existing facilities are a relevant factor in your decision. Are the relationships reasonable? Are changes to work practices very difficult to implement? Can the management team of the facility be lead to change their own approaches to running the business?

7. Cash required

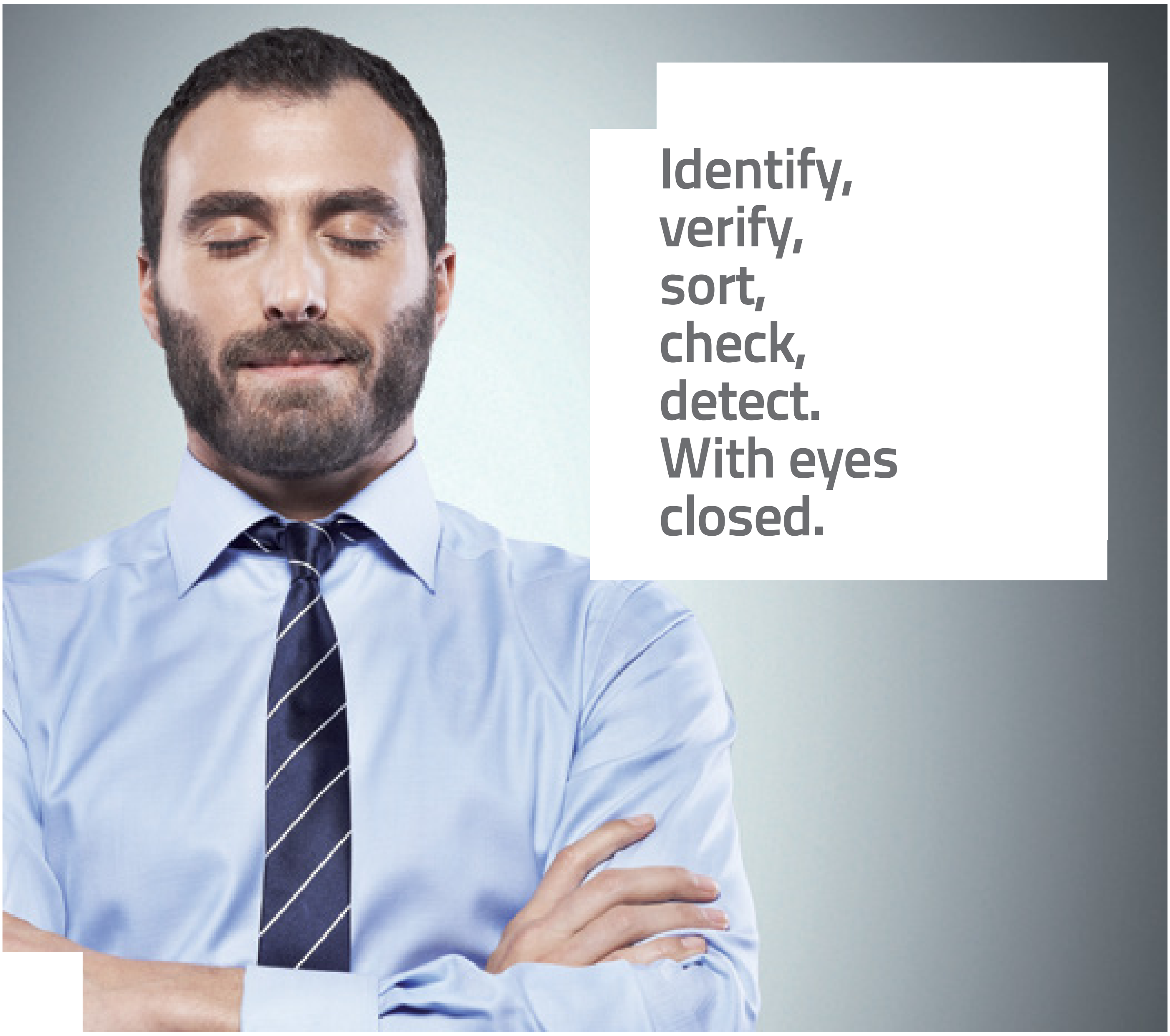
Outsourcing may require cash for redundancies and site remediation prior to any income being generated from the outsourcing relationship, or any asset sale. Reinvestment obviously requires cash for new equipment, and/or product design. It is one thing to say that the project has a good return. It is another issue to see if the organisation has enough free cash or borrowing capacity in its balance sheet to fund the option.

Integrated cash flow impact is the key measure to look at not just in this decision making process but also on a monthly, weekly, and even daily basis for assessing operational performance.

Turnarounds do not consume cash the way an investment or outsourcing decision can. Usually there will be some monies spent on retraining and designing the project. A turnaround should start to generate free cash flow within three months of commencement. If a turnaround does not do this, then it is being incorrectly executed, no more, no less.

8. Skills

The skills profile of the exiting business is an important consideration. If reinvestment requires the development of new skills that are unrelated to the current skills, then that heightens the



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level of risk. Likewise, if highly skilled people are leaving the business and the remaining talent pool is low, then a turnaround or reinvestment requires more thought. If the skill base is still above a 'critical mass' level, then the risk of reinvestment and turnaround are reduced.

The skill base of the supplier is especially critical when you are considering outsourcing. How can you truly satisfy yourself that their promised skills exist in reality? Contact with other customers in similar markets and extensive site auditing are essential before you decide to work with them.

9. Customer experience

How will the choice impact the customer experience and therefore the customer relationship? Unless the choice made can confidently and logically result in an enhanced customer experience in all areas, then we must keep looking to enhance our solution.

Customers care about price, we all know that. Low price and poor quality or availability will soon have them screaming and moving elsewhere. Our solution should provide enhanced profitability for our business and an improved experience (at least one of price, availability or quality) for the customer.

Is there a hard and fast method?

Sadly, there is no hard and fast method. IRR, NPV, Unit Cost all have flaws as a methodology as they do not consider the risk profile of the assumptions used in the calculations. The Strategic Sourcing Matrix outlines a simplified framework to look at the many issues involved and provide a guide as to the style of solutions that are directionally correct.

The most pragmatic approach is to pursue all three solutions in parallel. Pursuing a turnaround project is going to be worthwhile in any significant sized decision. Major reinvestment and outsourcing projects will take more than nine months to explore, test, and conclude. During this investigation period a turnaround project can be executed, and the results will be there for all to see, good or bad.

Trial sourcing and dual sourcing are all valid risk-mitigation strategies before fully committing beyond the point of no return. Likewise for a reinvestment project, significant site visits to previous projects and highly competent project management are worthwhile investments.

When evaluating options, use integrated cash flow and the global return on investment to evaluate your decisions. Scenario analysis is critical to qualify how sensitive your solution is to changes in assumption.

In the end, you do need to make the decision and you will not be able to totally quantify and mitigate all the risks. Doing nothing is rarely an option. You can choose to stay where you are or choose to move…

...your time to choose is now!

Jason Furness is the CEO & founder of Manufacturship. Jason's career spans over 20 years in manufacturing enterprises where he has overseen the turnaround, transition or transformation of many projects from single production lines through to entire business units of over 600 people as a general manager.

As CEO, Jason oversees the development and delivery of the core Manufacturship curriculum, leads the mentoring of business owners and managers through the core Manufacturship process, and sponsors all Manufacturship client projects. Several of these have been part of the implementation of actions plans from Enterprise Connect Business Reviews. For more information call 1300 226 121, email jason@manufacturship.com, or visit www.manufacturship.com. *mhd*

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