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EXECUTIVE AGENDA

IDEAS *and* INSIGHTS *for* BUSINESS LEADERS

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Make or Buy: New Questions, New Answers

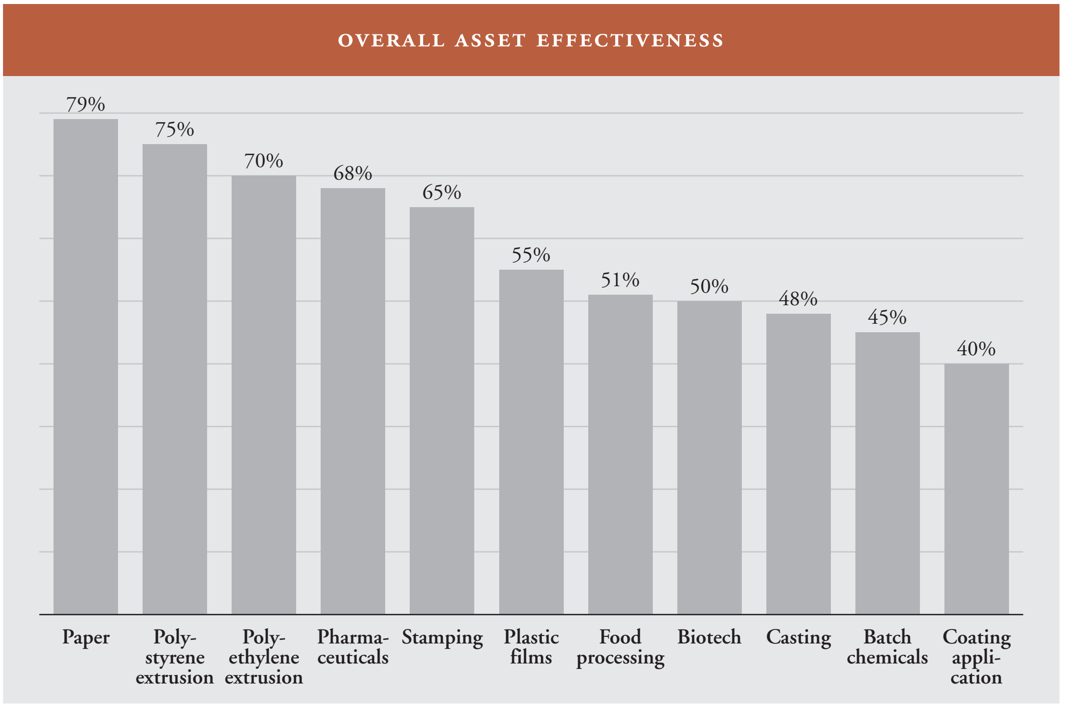
Steering into a stiff economic headwind, corporations are seeking a path toward substantial performance improvements. One promising route is via more effective make or buy decisions: Companies that choose well are earning lucrative results.

Few outsourcing decisions are black and white, but in manufacturing, virtually all seem to come in shades of gray. What was once strictly an operational decision is now being actively discussed in some circles in a more strategic light.

There are great reasons to ask the make or buy question in manufacturing again. Relentless competition is forcing companies to radically improve their business performance. Advances in information technology are opening up new possibilities by allowing value chains to become more modular. In addition, customers are demanding tailored offerings and service levels, requiring heavier involvement of specialist subcontractors. Finally, leading industries are raising awareness about the potential benefits. Electronics, for example, has created an entirely new manufacturing services industry complete with make or buy benchmarks.

At first glance, delegating manufacturing to a third party with state-of-the-art equipment and technology as well as flexible capacity looks like a win-win proposition. The supplier creates value by leveraging

Figure 1: *Manufacturing Utilization Rates Suggest Room for Improvement*



Source: A.T. Kearney

volumes and expertise over multiple players; the buyer is able to focus on its most crucial capabilities rather than managing production issues. The buyer also enjoys greater access to more flexible production capacity than it could create on its own.

Despite these apparent benefits, manufacturing is not outsourced on a large scale in all industries. Other considerations, such as the difficulty in ensuring compatible interests of both parties and the absence of a readily available supply market, can make executives wary of the idea.

Another reason for uncertainty rests with how companies approach the make or buy decision. Under the most common method, manufacturing capabilities are assessed based on their strategic value and economic performance: Functions that are deemed strategically important and efficient stay in-house, while those that are considered non essential and inefficient can get bumped to a third party.

But this approach can be deceptive, often raising as many questions as answers. First, the definition of "strategic" can be broad, and include everything from proximity to markets to unique processes, making it difficult to rank manufacturing capabilities objectively. Second, the make or buy decision is a viable tactic for increasing manufacturing asset performance in *all* categories, whether efficient or inefficient, essential or non-essential. This creates several different types of make or buy decisions ranging from straightforward outsourcing to selective acquisitions to strengthening strategic manufacturing capabilities. *(Read more about how outsourcing decisions are made in "The Many Sides of BPO," on page 5 of this issue.)*

It's time for a new approach. Companies that assess manufacturing in the context of how it affects their most crucial capabilities—the activities or assets that contribute most to the bottom line—are in a stronger position to achieve a sustainable competitive edge *(see sidebar: The Trailblazers)*. This capability perspective is especially relevant for businesses in which value does not derive primarily from manufacturing. In the branded consumer goods industry, for example, value depends on factors such as brand equity, trade leverage, product design and technology patents.

MANUFACTURING: STRATEGIC OR NOT?

Companies that outsource manufacturing often—although not always—have an opportunity to significantly improve performance *(see sidebar: When Not to Ask)*. The average manufacturing utilization rate in the food industry, for example, hovers around an unimpressive 50 percent *(see figure 1)*. In addition, equipment ties up significant capital on the balance sheet and consumes considerable management

The Trailblazers

Most companies have integrated operations, and as a result, theoretically face several make or buy decisions. Companies that leave the comfort zone of non-strategic capabilities for which there is already a supply market, such as logistics or contract electronics manufacturing, generally fall into two groups.

In one group, organizations are forced to consider capabilities that are more strategic or have no ready supply market. In the electronics business, for example, requirements for semiconductor investment have grown steadily over time, forcing electronics firms to become less vertically integrated, creating and growing new industries. In addition, clearing houses, payment systems, and other IT-driven capabilities are becoming increasingly sensitive to scale; as a result, they must take another look at make versus buy considerations.

The second group of companies never really addressed the make or buy decision; they have grown their businesses in buy mode from the start. Palm, Nike, Reebok and Polo Ralph Lauren are examples. These insightful firms focus on the crucial capabilities for the industries they operate in, buy non-crucial capabilities, and work on the assumption that they can always gain access to the products or manufacturing capacity they need. This approach offers interesting lessons for companies looking to bring the concept of "modular" business to their own integrated operations.

attention. Of course companies care about their utilization rates—so why do they seem to accept these seemingly weak figures?

Compare the *total* market capitalization of consumer giants such as Kraft, Nestlé, Unilever, Procter & Gamble (P&G) and Campbell Soup Company against the capital they need for manufacturing assets, plants and equipment, and a conclusion emerges: Although the manufacturing operation represents a significant amount of the balance sheet total, it is a small fraction of the total market capitalization.

In other words, manufacturing does not appear to drive the value of these fast moving consumer goods (FMCG) companies *(see figure 2)*. This in itself is not news; it is generally accepted that capabilities such as brand equity, innovation (ability to maintain brand equity), and trade leverage (ability to be the supplier that retailers need) are stronger drivers of shareholder value than manufacturing prowess for branded FMCG companies. It does show, however, that manufacturing is not necessarily as strategic as is widely accepted.

Companies that assess manufacturing in the context of how it affects their most crucial capabilities are in a stronger position to achieve a sustainable competitive edge.

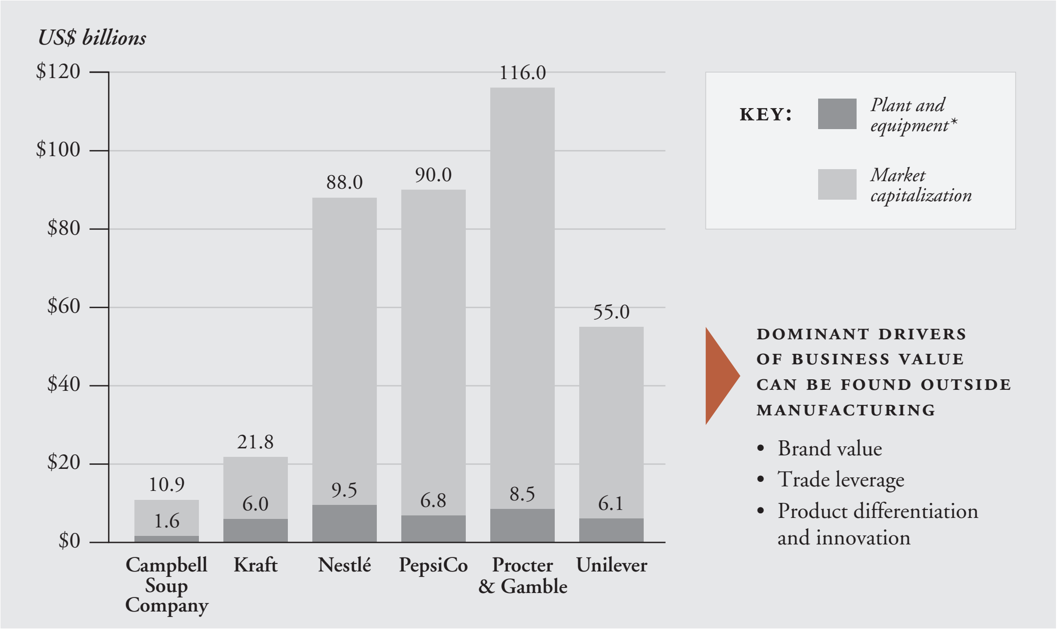
MADE IN VERMONT: ENHANCING THE BRAND

When a company tackles the make or buy decision in manufacturing, the best answer lies not in the manufacturing, but rather in the business capabilities that most strongly determine overall business value. Branded FMCG companies rely on their brand equity, trade leverage and ability to produce innovative products for their value. If this is commonly accepted, shouldn't the specific needs of those capabilities serve as the overriding criteria for determining whether to outsource manufacturing?

Here's a rather palatable example: the manufacturing of Ben & Jerry's ice cream in Vermont. Making ice cream in the Green Mountain State does not necessarily add to the manufacturing process. If anything, it is probably less advantageous to make ice cream there instead of in a more centrally located state. But manufacturing in Vermont enhances Ben & Jerry's brand equity—arguably its crucial capability. It reinforces the homemade and authentic image that Ben & Jerry's has been so successful in exploiting.

Consumers believe that making tasty ice cream in the bucolic Vermont countryside produces a superior product with an honest quality that reflects the spirit of the founders, who began making and selling ice cream from an old gas station. Manufacturing is probably more expensive than it has to be—but the additional costs are more than made up for by the premium pricing of the final product.

Figure 2: *The Manufacturing Capability May Not Drive Shareholder Value for FMCG Companies*



Sources: New York Stock Exchange and the SwissExchange, and annual reports

**Net of cumulative depreciation, book value determined to be close to replacement value*

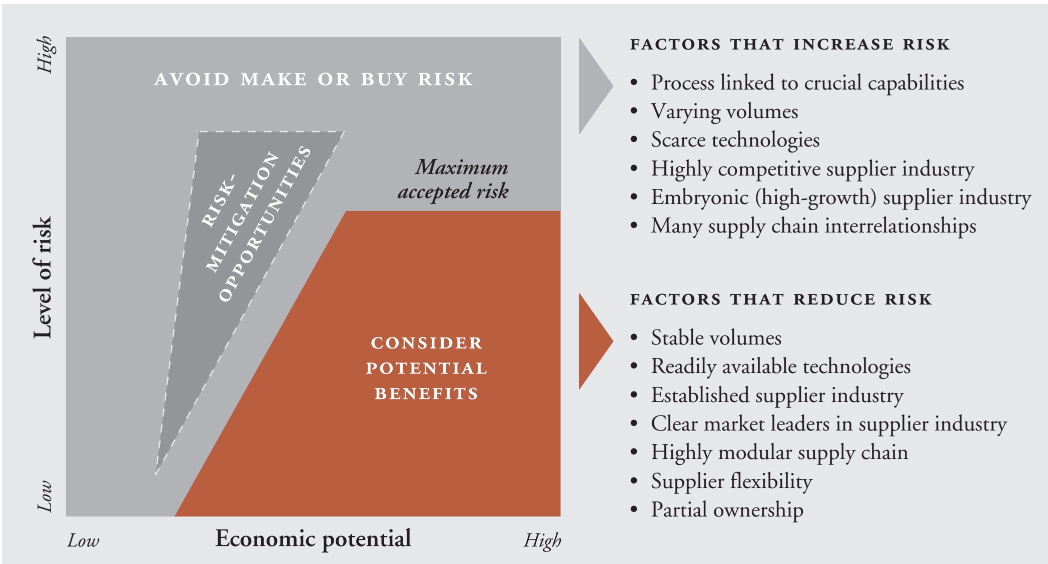
In other words, by choosing to continue to manufacture in-house in a specific location, Ben & Jerry's has made one of its crucial capabilities—brand equity—far more effective. (With tricks like this, you could probably afford a few cows of your own.)

The Ben & Jerry's example is just one illustration of how companies can successfully exploit the relationships between manufacturing and the crucial capabilities that really make a company tick. This assessment, in fact, can be used for other industries and other capabilities in the supply chain.

Just as the manufacturing location has a strong link to Ben & Jerry's brand equity, spare manufacturing capacity boosts the value of another key capability for many FMCG companies: ensuring trade leverage during peak periods in demand. In the ice cream business, for example, it is more important to be able to supply cartons upon cartons of the frozen treat during the sunny summer months, even if this means that factories sit half empty when rain and snow prevail. Excess capacity is also helpful in conducting test runs for new products and for ramping up volume when they are released to the market.

Using crucial capabilities as a guide, the make or buy decision can be assessed in an effective and focused way, avoiding unnecessary discussion of several factors that might seem relevant with more traditional make or buy frameworks.

Figure 3: *Striking a Balance Between Benefits and Risk in the Make or Buy Decision*



Source: A.T. Kearney

RISKY BUSINESS

Although there are significant economic opportunities with the make or buy decision, the associated risks cannot be ignored: Crucial capabilities must never be endangered in search of a few dollars' worth of manufacturing efficiencies. For a branded FMCG company, for example, manufacturing contract negotiations cannot stall a new and innovative product for three months. The potential manufacturing savings represent only a fraction of the value that may be generated through the crucial innovation capability. In this case, insourcing, or taking on another company's volume to increase the efficiency of the manufacturing assets, might still be an option.

On the other hand, relying solely on in-house production capacity can lead to an unwanted lack of flexibility and an inability to serve the crucial capabilities. In addition, keeping too much activity in-house can be costly. If margins offered to the trading partners are too thin, trade leverage suffers.

Keeping these tradeoffs in mind, companies should develop a risk-return ratio that reflects their tolerance for risk. This analysis should include the minimum economic benefit a company will require before it pursues any given make or buy opportunity. Once it surpasses that threshold, the company can accept more risk as the potential benefit increases until the risk level becomes unacceptable regardless of the potential economic gain *(see figure 3)*.

Companies can also take steps to reduce the risk to the crucial capabilities. For example, many integrated organizations rely on a mixture of documented processes and service levels, in addition to informal safety nets that guarantee a soft landing when the official processes fail. But it is difficult to capture both the formal and informal aspects of a contract between manufacturing operations and other departments. A commercial service level agreement, for example, would not likely include the right to make 100 informal phone calls to streamline operations. It would be unrealistic to assume this can be done effectively without implementing

When Not to Ask

When manufacturing is a crucial capability, addressing the make or buy decision is pointless. Instead, the company should strive to increase shareholder value by becoming the unquestioned leader in its given manufacturing process.

Consider mozzarella cheese. Recently Danone divested Galbani, its semi-cured cheese (and cured meat) business. At first, this move appears counterintuitive for a consumer goods company well represented in various food and dairy categories, but a closer look into this particular business reveals the probable rationale.

Think of the traditional branded FMCG company's crucial capabilities: brand equity, innovation and trade leverage. There appears less value in brand equity in cheese than there is in many other food categories: Many consumers perceive mozzarella cheese, for example, as a base ingredient and would be hard-pressed to name their favorite brand outside its home country of Italy.

Innovation has created several useful packaging variations, from sets of small balls to individual servings to larger chunks of cheese. Further differentiation however, might rob it of its ingredient status and associated volumes.

Even for the last crucial capability—trade leverage—the picture looks grim. Specialty and foreign cheeses typically constitute a rather loose category. Local traders are involved in offering assortments, which change over the year and can be geographically narrow. In other words, the large branded FMCG companies cannot fall back on their typical trade leverage advantage to create shareholder value in this business segment. In fact, none of the typical crucial capabilities seem to apply to the mozzarella cheese segment.

Where does this leave manufacturing? It certainly moves up in rank; in fact, we would label it the crucial capability in the relative absence of the traditional ones. The implications are that the player with the manufacturing edge holds the strongest cards in this business. This concept generally holds true for products (or services) that are not strongly differentiated. Price and availability take over as important success factors.

Even though outsourcing will be no real option, insourcing volume might be. In fact, additional volume can even help in taking and keeping manufacturing performance to best-in-class levels with a clear scale advantage over smaller players. ●

additional risk-mitigation measures.

Consider call centers, one of the most popular functions to outsource. Many companies find that the amount of management and operational information related to the call center actually *increases* when it is outsourced. Why? The third parties exist specifically to provide competitive call center services and have invested in world-class systems. The additional data from the third party helps compensate for lost informal interaction with the remaining capabilities.

Similar considerations apply to outsourcing manufacturing operations. More managerial and operational information will probably be needed. Quality control procedures and other measures may also need strengthening to effectively integrate processes and increase the managerial comfort level.

Rather than viewing the supplier market as a risk factor in the make or buy decision, companies might do well to launch their own manufacturing capacity.

IT'S IN THE EXECUTION

As in all strategic decisions, choosing well means nothing without skillful execution. This is especially true when no good candidates for outsourcing provider exist or if there is no ready volume to support insourcing decisions.

Arguably, the situation to avoid is a highly competitive, fragmented supplier industry. Manufacturing capacity might look incredibly cheap in the short term, but the line between a lean supplier and one that cuts corners to become competitive is a thin one. Fierce competition that prompts suppliers to cut costs will also prevent them from investing in process innovation, quality and service levels. The outcome could, in fact, be quite the opposite of the original goal *(see figure 4)*.

But rather than viewing the available supplier market as a risk factor in the make or buy decision, companies might do well to take a more aggressive approach by launching their own manufacturing capacity. The result is a tailor-made supplier market. Companies may be able to combine or reconfigure manufacturing capacity with other, probably smaller, players in the industry in similar situations.

In essence, companies that want to shape the future manufacturing supplier industry through some sort of alliance or pooling will need to choose the most suitable partner quickly. Once the best partners are chosen, only the second string players are left. The end result for those that don't get into the game quickly enough is that they can be stuck with once-competitive manufacturing assets. The leaders that reconfigure the supplier industry, meanwhile, will become the suppliers of choice. Others will have to buy from these new leaders if they want competitive price levels.

Figure 4: *The Buyer-Supplier Relationship Presents a Range of Possibilities*

BEST-CASE SCENARIO	WORST-CASE SCENARIO
• Customer gains from increased business and operational focus • Customer gains from improved scale advantages • Supplier has specialized expertise • Supplier is "lean and mean" • Suppliers set industry standards	• Supplier needs to balance customer requirements against its own profit • Supplier moves from being "lean and mean" to cutting corners • Conflict of interest emerges in a highly competitive setting

Source: A.T. Kearney

TIME TO DECIDE

Answering the make or buy question effectively can earn a company cost leadership and improve manufacturing asset effectiveness. With a greater cache of strategic tools to make that decision, now is the time to take another look at whether to outsource manufacturing, keep it in-house or insource to add new business to the mix. Executives who know which capabilities make the biggest contributions to overall business value have a new context for more accurately assessing make or buy opportunities and managing the potential risks. Best-in-class asset effectiveness is a tough standard to achieve and maintain—but it's well worth the effort.

CONSULTING AUTHOR

Gillis Jonk *is a principal based in A.T. Kearney's Amsterdam office. He has more than 10 years of industry and consulting experience, particularly with large companies in the communications and high-tech, financial services, consumer products, energy and chemicals industries. He has worked extensively in the areas of strategy, business redefinition, corporate governance, and organizational and performance measurement design. Gillis is co-author of* Rebuilding the Corporate Genome *(John Wiley & Sons, 2003).*

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Marketing & Communications
222 West Adams Street
Chicago, Illinois 60606 U.S.A.
1 312 648 0111
fax: 1 312 223 6759
email: insight@atkearney.com
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