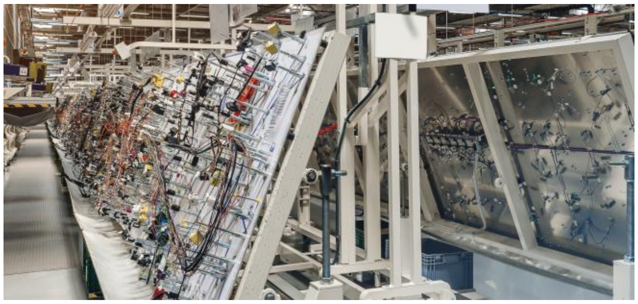
Outsourcing Strategies and Transaction Pricing

Make-versus-buy decisions usually come down to a tradeoff between risk and cost: outside firms may be able to do things more cheaply, but by ceding control of production decisions and priorities, you lose your ability to minimize the possibility of delays. Back when I was CEO of Piper Aircraft, we were very vertically integrated; for instance, we produced our own seats for the airplanes. We bought lengths of steel tubing that we cut, bent and welded to form seat frames. Large squares of foam were shaped into seat cushions. And full cowhides were purchased, cut, embroidered and sewn into seat covers. Yes, seats purchased from a vendor would likely have been less expensive, but we never had to worry about holding up our aircraft production line for want of seats.

Here are a few issues to consider when formulating your outsourcing strategy:

- Are the parts a commodity, such that competitive pressures have driven down prices and finding a replacement supplier would be relatively easy?
- Can the supply base provide parts that are of consistently high quality?
- Are the parts a small % of the total material BOM so that keeping a safety stock of inventory would not be an undue burden on cash?
- Are there domestic suppliers available which allow avoidance of geo-political risk?

Low cost structures yield higher profits and higher returns on invested capital, and buyers of businesses pay more for that. But they pay less for companies that have high risk profiles. During buyer due diligence, sellers will be asked detailed questions about their supply chain, and any perceived weaknesses will cause buyers to discount their bid prices. It is imperative that sellers have sound rationale for their outsourcing policies and be able to convincingly articulate them.



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