

## **The White Paper**

The Hidden Costs and Risks of Doing Business with ABC Industries, Inc.

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Recently, an internal decision was made to recommend that ABC Industries, Inc. (NASDAQ: ABCI) is to be retained as the sole supplier of the [product] for the [Navy program]. However, I would like to offer a perspective on the various potential risks associated with this decision.

### Background Information

ABC was selected [a while back] as the lowest cost bidder on a contract to replace the aging [system] with more modern [high tech] units. However, because of numerous issues with ABC being unable to deliver on their contractual obligations, a search for an alternate supplier was initiated [just two years later] culminating in a decision that it would be too costly to switch providers.

After numerous technical problems, scheduling delays, and cost overruns, the [units] were finally delivered to the customer. Unfortunately, they have proven to be extremely unreliable, with roughly 40% of those in the field experiencing catastrophic failures to date. Therefore, it was decided to resume our search for an alternate supplier, which resulted in two serious bids from Manufacturer A (NYSE: AAA) and Manufacturer B, a division of [a Fortune 500 company] (NYSE: BBB).

Yet, once again, primarily due to cost considerations, it was recommended that ABC be granted a new contract. Ironically, this would not only allow them to support our future needs, but could potentially enable them to sell us replacement units for the faulty ones which they have already delivered.

### The Selection Process

As a team, we relied on the formal Kepner-Tregoe (K-T) process to choose the best supplier. The primary selection criteria included the manufacturers' ability to deliver a reliable product in a timely fashion and at a reasonable cost. In absence of the latter consideration, and based on all the other merits, either Manufacturer A or Manufacturer B could have won by a wide margin. However, because ABC's quoted NRE cost as well as their unit price were assumed to be the lowest, our K-T analysis resulted in a tie. Therefore, the final recommendation was made based primarily on financial considerations.

Unfortunately, the formal process didn't take into account many of what I believe are extremely serious concerns, as demonstrated below.

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### **Our Prior Experience with ABC**

In order to provide an objective "apples-to-apples" picture, the K-T process had to ignore our past experience with ABC prior to the new bidding process. But, considering our long history of having to deal with ABC's lack of military experience, countless product design errors, poor manufacturing processes, inadequate quality control, considerable development delays, and numerous instances of serious miscommunication, I believe that this issue needs to be revisited.

Furthermore, while the original contract was signed for [a large amount], the actual NRE cost was as much as [almost twice the initial bid], with only about half of the difference covered by the Navy. The unit cost also went up considerably. On top of that, ABC required a lot of management and engineering oversight on the part of General Dynamics, which was an extra cost to us. Finally, we had to spend [hundreds of thousands more] out of our own pocket on trouble shooting activities and in continuing to invest heavily in this project, which was supposed to be completed years ago.

In light of all of the above, a reasonable suspicion should be raised as to the accuracy of the new bid that ABC has supplied to us. In the past, it has cost them well in excess of [a seven digit number] to bring their product to the market, only to discover that it was unfit for our application and had to be recalled. Thus, their ability to deliver on their promises this time around on merely a third of that amount should not be taken at face value. Nobody in the industry, including themselves, seems to be able to develop a product with such a small NRE investment. This is, at best, wishful thinking on their part.

### **Company Profile**

As a company, in contrast to its competitors, ABC is currently not profitable. They posted a loss of [several million] in the latest quarter (Q2) and have a negative profit margin of [a double digit number]. Their stock also lost more than two thirds of its value over the past 12 months, with a lot of insider trading activity in the meantime. Additionally, on [a recent date], a class action lawsuit was filed against ABC charging that they "have issued materially false and misleading statements regarding ABC's increasing financial results and the strong demand for... [their flagship] systems." While this suit might or might not have merit, it is certain to have a negative impact on ABC's already poor financial standing as well as their reputation. [Numerous financial research references were provided in this paragraph.]

Furthermore, although ABC's overall revenue is growing, the portion of it that is derived from defense contracts accounted for only [a small percentage] of the whole and, over the past year, has fallen an alarming [50% plus]. Worse yet, their commitment to manufacturing stand-alone [units] should be called into question as this product currently accounts for only a tiny fraction of their revenue, is clearly of "declining importance" to them [professional analysis reference provided], and could be completely phased out in an event of a restructuring.

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What's even more troubling is that they have in fact stopped making the kind of product that they were still under a contract from us to deliver, [a model number], effectively leaving us with no choice but to look for alternatives. There is absolutely no guarantee that this won't happen again.

### **Technical Considerations**

Unlike in the case of the alternate solutions, the product that ABC is offering to us is brand new and has no track record of reliable performance. Also, while both Manufacturer A and Manufacturer B have a long history that demonstrates that they can easily exceed our goal of [tens of thousands of hours] of life expectancy (they quote [double] and [triple the required number] respectively) ABC merely contends that they can estimate their product's longevity analytically [all three references provided]. Unfortunately, this presents an unacceptably high risk that they won't be able to meet our requirements once again.

Not only that, but a longer lasting product could potentially offer a superior value, even if the up-front cost seems prohibitively high. Thus, additional cost-benefit analysis has to be performed before a final decision is reached.

### **Customer Expectations**

The Navy, our customer, has shown a very strong preference for Manufacturer A, a fact which has numerous implications. First, they would be far more likely to give us additional financial support if we chose to leave ABC behind. Secondly, they would be less inclined to conduct extensive quality audits and reviews, which, as history shows, could be expensive to support on our part. Finally, they would benefit from a longer life of a product, something that they have repeatedly noted to be one of their top priorities, second only to reliability.

Alternatively, if we indeed continue on our path with ABC and run into any technical issues whatsoever, our reputation with our customer could suffer greatly.

### **Additional Considerations**

As demonstrated by our experience with Manufacturer C, the leading candidate as an alternate supplier the last time around, companies which have already gone through the bidding process tend to be highly suspicious of repeated bid solicitations [references provided]. It is, after all, a large effort and a significant expense.

Consequently, it is quite unlikely that either Manufacturer A or Manufacturer B would be interested in our project if we were to come back to them in an event of yet another ABC failure. In other words, with each round of bid solicitations, the already narrow field of potential candidates is shrinking.

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### Conclusion

While it might seem to make sense to stay with ABC for a variety of reasons, such as supposedly low cost, their familiarity with our requirements, as well as their apparent desire to clear up their name, there are also grave risks associated with this path forward.

In particular, there is absolutely no guarantee that their new product would end up meeting our expectations or that they would even continue offering it in the future. Additionally, although ABC's bid appears to be the lowest, their product's value is questionable and their past performance makes it next to impossible to trust their cost and scheduling estimates. Finally, and most importantly, the risk of not being able to live up to our customer's expectations is far too great to ignore.