Chapter 11

Relevant Costs

[Music]

Background music]

Narrator: Navistar International Truck and Engine Corporation is a multibillion-dollar Fortune 300 company, with over 40 major locations, most in the United States. The company had to make a decision, three years ago, whether to expand actual production at their truck assembly plant in Chatham, Ontario, or to outsource axle production to a supplier. The truck business is very cyclical. At the point this make or buy decision had to be made, business was on an upswing. Finance managers had to decide whether to expand the Chatham assembly facility and capacity, in a capital expansion.

In order to meet market demand, when the market increases, we would have to run at a higher production rate. We could not get to that production rate -- that required production rate -- if we did not eliminate these capacity constraints. And the way we dealt -- we decided to deal with the capacity constraints was through a make versus buy: Either spend the capital to increase capacity at Chatham, or outsource the production.

[Background music]

Narrator: Not only did the risks of capital expansion in an upswing have to be carefully accounted for, but they also needed to find a way to eliminate bottlenecks that would be created -- even with expansion -- if they did keep the work in-house.

But because axle and trim take such a long time, the process time through that area is much longer than the preceding functions, so there is a bottleneck impact -- or effect -- at axle, trim and assembly. So we were basically faced with the decision: In rising markets, do we add capacity to our Chatham facility, or do we outsource the production? So to make the proper decision that's in the best interests of the company and the shareholders -- for both long-term and short-term -- we needed accurate and integrated information from all major functions, including finance, manufacturing, engineering, purchasing and human resources.

[Background music]

Narrator: Finance managers had to carefully weigh all the necessary relevant data, to make the decision that was in the best interest of the company, the future of the plant and the workforce. It would be easy to make the decision based on one or two obvious major indicators, like keeping all work in-house to support labor's interests, or like outsourcing to support the financial bottom line. They had to research and accurately measure all the indicators that were relevant to the decision. The International Truck finance managers also had to work in partnership with the Canadian auto workers union, to minimize the effect outsourcing would have on their labor agreements with the workforce.
Another area on the buy assessment that we had to consider, from a cost basis, but also from a human resources standpoint, was to partner with the local unions there -- in the Chatham area -- to make sure that we were addressing their concerns and to minimize the impacts on the union membership. Because we were outsourcing production, we wanted to minimize the impacts there and make sure we were addressing their concerns.

[ Background music ]

Narrator: The supplier had to be willing to be trained to deliver parts and sub-assemblies in sequence with their build.

Training was a very big consideration for us, not only for the project in general, but in terms of the number one priority that I've mentioned before -- and that is not to compromise our quality standards. We wanted to make sure that we could get quality product delivered at the right place and at the right time.

[Background music]

Narrator: The considerable costs of these training initiatives were borne by International Truck. Since they were foreseen and measured accurately, the financial information could be factored into the final decision.

Once we had both of the assessments completed -- in terms of from a financial standpoint -- and the numbers were run, we gave our recommendations as to how we thought the decision should be made. But it was up to the truck executive staff to decide whether we were going to add capacity at Chatham or to outsource. The buy assessment did give us the largest positive financial impact. It met all of our financial hurdle rates. We eliminated the capacity bottlenecks. And the payback was in less than a year. So there was a lot of upfront time spent on vendor assessment and vendor capabilities. And with that assessment, we selected WPP -- which is right down the street from our Chatham facility -- to be our partner in this endeavor.

[Background music]

Narrator: To make the decision to outsource the work to WPP, International's finance experts had to have accurate accounting information that was clearly communicated to all parties, including the workforce. They got the numbers to make sense for the long-term, as well as the short-term benefits of the plant and the corporation. So they confidently made the decision to partner with WPP.

The buy decision was obviously the best decision for us to make, from a financial standpoint. From an operating standpoint, we were able to eliminate capacity constraints, eliminate bottlenecks, but most importantly, we were able to flex our total production cost, as the market dictates.

[Background music]

Narrator: The decision to buy, rather than make, has paid off. Today, the plant is saving 2 to $4 million per year, versus the cost of expanding and making the extra axles. The effect this move has had on the long-term viability of the plant is obvious to all stakeholders. Diligent research of all relevant financial data led to the right decision. As a result, Navistar
International is not burdened by the costs of excess capacity during valleys in the cyclical truck business. This enables them to be more competitive in the market.

[Music]

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