The Big Order (Epilog)

One day Bill called Ron and excitedly told him about a new sales opportunity. "Wow, this website is working even better than we hoped! I just got off the phone with a developer who is building a subdivision near Denver. He wants to order 150 systems. Do you believe that? This one sale would put us over our forecast for the entire year, and it's only August!"

"That's very exciting news," said Ron, joining in Bill's enthusiasm.

Bill went on, "Yep, I've been talking to these guys for several weeks and they would like to put our system into all of their new houses. They figure it will add a lot of appeal – better heat, lower operating costs, environmentally friendly and all that. They think they can boost the price of the house by two or three thousand dollars."

Ron replied, "Well, you've certainly done a good job of selling them on the benefits … sounds like they're true believers! Have you run the numbers and decided whether you want to take the order?"

Bill almost gasped at Ron's question. "What do you mean, *if* I want to take the order? Why wouldn't we? Sure, they want us to cut our price, but we'll still make lots of money."

Ron said, "Well, I don't mean to be a naysayer, but I think you should do some homework before you agree to a price and take the order."

"I'm confused," said Bill. "We're in the business of selling radiant systems, and here's a customer that wants to buy a bunch of them. We should get great economies of scale that will more than offset any price reduction."

Ron nodded his head, "That may be true, but there's more to consider. All I'm suggesting is that you look all of your costs, both direct and indirect. You may find some that are not immediately obvious. On an important bid like this, I like to go back to basics and build up the costs from the bottom. And if you have been keeping your Materials List and other documentation up to date, it is not that difficult to do. This process forces you to think through all aspects of the deal and spot things that you might otherwise overlook. Is your Materials List up to date?"

"Pretty much," Bill replied. "I haven't looked at it for a while but I know some things have changed. We've switched a couple of vendors to get better pricing or lead-time, and I think there have also been a couple of price increases."

Ron said, "I know it's hard to keep your documentation current, particularly with all of the other things that are going on, but your Materials List is fundamental to your business and it should be a priority to record every change as it happens. Whoever is handling purchasing now should fill out a form whenever a change occurs and give it to your accounting person to update the Materials List. If you are not already doing so, I suggest you keep the List very secure because you do not want a competitor, or someone who wants to become a competitor, to get their hands on it. You put a lot of work into figuring out the best materials to use and the best places to buy them. The vendor names and prices would be especially useful to someone who wanted to startup a similar business.

"I am getting a little off the subject here, but this is important. I have had a couple of occasions where employees walked out the door with critical information like this and either took it to a competitor or used it to start their own business. Now we both know this violates the confidentiality and non-disclosure agreement these employees signed when they hired on, not to mention being highly unethical, but I am sorry to say, this does not keep people from doing it. And once done, the information is out there and it is very costly and often fruitless to go after them legally. I figure what goes around comes around, and so someday, these folks will pay for their transgressions. But in the meantime, I've become a firm believer in not leading people into temptation!

"Anyway, getting back to the subject, you'll need to run the Material List by your purchasing agent and have him note anything that's changed. Then, Tom should look at the system configuration the developer needs and determine what materials are required. We also need to know how they intend to take delivery. Do they want everything at one time or do they want delivery spread out over a period of months. I suspect it is the latter, in which case you may not gain as much buying leverage. That's something you will have to negotiate with your vendors.

"We also need to think about the labor required to do the job. The builder has crews that can handle installation so all we have to worry about is assembling and shipping the orders. But this isn't trivial. You can only put so many systems per day through the shop, and it is already running at 75 percent of capacity. You could add a second shift but you would not get a doubling of production because of constraints on storage and handling space. Most likely, you will have to rent additional space on a temporary basis to handle this order. That is going to add cost for rent and labor to move things back and forth between facilities.

"No matter what, you will have to hire and train some new people. That means taking a couple of your best assembly people off the production line and putting them in charge of training and supervision. That will be a double hit to production costs – you will have to absorb the lost productivity of these top assemblers as well as the low productivity of the new hires who will take a couple of weeks to come up to speed. So when you are calculating your costs for this order, you should add these extra labor costs.

"Another thing to consider is what happens when this order is complete. If you do not have another big order behind it, you will have to move out of the temporary space and lay off the new people you just hired. That will be a real shame given the amount of money you invested in their training.

"And you will have to make certain that quality does not suffer and commitment dates for our primary customers are not missed. These one-time orders are great, and may lead to more things down the road, but today, our customers are individual homeowners. Their good will and word-of-mouth referrals drive growth of the business. We must be sure not to drop the ball.

"So, if you are running X systems per month of the same system through the shop, are there any operating efficiencies you can take advantage of? For example, maybe with an order of this size you could build custom fixtures that would reduce assembly time. That would save a few dollars and add a few more bucks to the bottom line.

"You also need to look at Sales and Administrative costs. As you mentioned before, you saved some money by having to sell to only one customer. That is obviously less expensive than selling 150 systems, one at a time. You will also produce fewer invoices, so you will save money here too. But another factor adds to cost—the cost of capital. With your other customers, you get a deposit and the balance due on completion, which means you have little cash tied up in accounts receivable. Unfortunately, developers are rarely able or willing to do business in this manner. They expect payment terms of at least 30 days.

"Let's look at a timeline to see how much capital you will have to commit to this order. You need to bring in the materials for an order at least 15 days before the customer ship date. Your procurement and manufacturing flow is very efficient, but you still need this much time to receive the items into inventory, kit the parts, assemble and test the system, and get it out the door. Then, let's assume you give the customer 30 days to pay. Now in a perfect world, you would get that check on the 30th day, but for a variety of reasons, you are not likely to see it until the 45th or the 60th day. And if the customer runs into some kind of cash flow crunch, it could take longer. So realistically, you are looking at "carrying" an amount equal to the cost of goods (material, labor, freight, etc) for at least 60 days.

"Now, you get some relief from your material vendors who give you 30 days to pay. And with payroll, you may get 15 days of float. So in rough terms, you cut the carry time down from 60 days to about 30 days.

"If PRH was a well-established company with plenty of cash in the bank, you could finance this amount on your own. This would certainly be the cheapest money since your cost of capital would only be lost interest on the money. But, since you cannot finance this yourself, you will have to borrow it, which means tapping into one of your credit lines and paying an interest rate of probably 10-12 percent. If you do not have enough credit available, you will have to "factor" the receivable, which means your cost of goes up to 15 or 20 percent including fees and interest. In all of the above cases, the cost of money will continue to grow if the customer does not pay in the 30-45 day timeframe.

"The final and perhaps most important consideration is what will happen if the customer *never* pays? When you offer terms, you become a lender and as you know from experience, lenders sometimes get stiffed. A large company may absorb a customer default without too much pain, but it can drive a small one into bankruptcy. That is why the decision to offer terms on a large order is often called a "bet your company" decision.

"Now there are things we can do minimize the risk of a default. First, we ask the customer to provide bank and trade references. Calls to these organizations can provide clues as to the creditworthiness of the customer. We can also buy a D&B (Dun & Bradstreet) report that will tell us about the company's history, financial strength, and track record in paying other vendors.

"Bottom line though, no matter how much due diligence you go through, a company can fall on hard times and default on their payment obligations. So, as the business owner, you have to make a decision as to how much risk you can reasonably afford to take on. You may go a long time, granting credit to new customers and old, and then one day be confronted with a major write-off. If you can afford to take the hit, you can recover over time. But if your company has a fragile financial structure, it may take you down or force you to sell the company or take on debt that will take years to dig out from under.

"I hope this gives you an idea of why I asked 'are you going to take the order?' It was a loaded question and one that a prudent business leader will carefully consider before answering. So let me know what you decide to do."

The following week Bill called Ron to bring him up to date. He explained that he had taken the order but for a smaller quantity. After running all the numbers, he found that the best he could offer the customer was an 18% discount and $10,000 in credit. He worked with the company's financial officer to structure a deal that would work for both of them. The customer decided they would offer Bill's system as an upgrade instead of a standard feature in each home. This would reduce the number of systems they bought but would allow the developer to meet Bill's price and payment terms.

Ron congratulated Bill on working through the problem and coming up with a win-win solution. Bill replied, "Boy, I thought closing the sale was the tough part of business. I had no idea that all of this other stuff needed to go on behind the scenes!"

