Operational Due Diligence Of Family-owned Food, Personal, And Home Care Products Manufacturer: Rapidly Establishing Manufacturing Outsourcing Economics And Requirements

The Challenge: One of our middle-market PE clients was looking to invest in a family-owned manufacturer of food, personal care, and home care products. Our client was attracted by the opportunity to grow the target's 100+-year-old brand of natural products but was concerned about operating the equally-old manufacturing facility with potential safety, quality, asset, and labor risks. On behalf of our client, Gotham conducted a rapid operational due diligence to: (1) develop pro-forma financials with manufacturing outsourcing; and (2) establish plant shutdown requirements and risks.

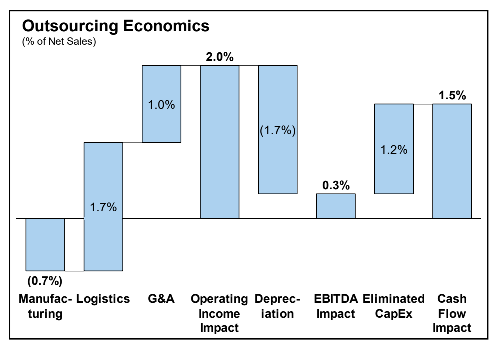
Rapid Manufacturing Outsourcing Assessment: To quickly assess the manufacturing outsourcing opportunity, Gotham:
- Built a bottom-up view of the target's cost structure by function and expense type using trial balance and headcount data
- Established current product cost (material, labor, and overhead) by analyzing and correcting available SKU costing data
- Conducted plant walkthrough and interviewed operations management to understand manufacturing processes and assess operations
- Interviewed companies engaged in food and personal/home care product outsourcing and gathered outsourcing cost structure benchmark data
- Built up expected co-pack cost by line and ABC SKUs based on differences in labor costs, differences in operational efficiencies (e.g., line speeds, efficiencies yield, purchasing), and expected co-pack margins
- Developed operations and G&A organizational structure required to support outsourced manufacturing operations
- Developed transition plan and estimated one-time transition costs including: redundant manufacturing overhead; excess freight/warehousing cost during transition; severance/stay bonus; IT; and professional services cost.

3rd Party Manufacturing Cost Estimated to Be Breakeven or Less for Non-Food and Slightly Higher for Food

Gotham's assessment of personal and home care co-pack costs suggests breakeven or possible small savings even after co-pack margins and a penalty for C SKUS tail as there is a large competitive co-pack market for personal and home care products and co-packers' cost is estimated to be lower than the target's – lower labor rates, higher purchasing power on chemicals and bottles/packaging, and better yields and efficiencies. For food manufacturing outsourcing, we estimated a cost penalty due to limited availability of co-packers for the target's food products and proprietary/unique manufacturing process for one of the food product lines.

Logistics and G&A Cost Savings Opportunities More Than Offset a Net Slight Increase in Manufacturing Cost with Outsourcing

Gotham's logistics and warehousing model suggested that the target can save significant freight cost by locating its new warehouse in a more population-central location as that would reduce freight miles by 15-18% vs. the current location. Our benchmark-based estimates of 3rd party warehouse costs (put away, storage, and order pick) suggested some savings in warehouse costs. Gotham estimated substantial G&A savings from not having to manage the plant and from associated headcount reduction (about two-thirds of accounting, HR, and IT headcount can be eliminated after manufacturing outsourcing).



Successful Outsourcing Requires System/Process Enhancements and Management of Key Risks

We established that the target needs to: clean up standard costing before rationalizing SKUs and negotiating co-pack costs as the target's cost standards are highly inconsistent and don't align with industry norms; and strengthen demand planning as current process weakness (e.g., poor forecasting accuracy and system parameters driving high inventories) make it difficult to provide reliable schedules to manufacturing. Potential outsourcing risks include: co-packers' willingness to take on long tail of low-volume C SKUs in a cost-effective manner; protection of the target's proprietary food manufacturing processes; potential loss of private label food products business due to disintermediation; uncertainty around successful real estate disposal; and effect on brand image that was built on the target's long history. We established that a phased and increasingly fine-tuned transition plan can best manage risks, with an ~18-month timeline required to: address barriers to successful outsourcing; identify and select outsourcing partners; and fully implement transition. A phased approach is in sync with Gotham's assessment that there was no urgency to exit in-house operations due to safety, quality, asset, and labor concerns.

The Outcome: Gotham's rapid due diligence effort provided clarity on manufacturing outsourcing economics, requirements, and associated risks. As our assessment indicated higher costs and risks associated with outsourcing food products, our client successfully pursued a restructured transaction of carving out personal and home care brands and products. A transition services agreement with the target gave our client time to establish a standalone organization and find outsourcing partners for manufacturing and logistics. Gotham supported our client's accounting due diligence firm on developing the carved-out financial statements and provided a carve-out planning framework to support creation of transition plans.

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