RECOGNISING ACHIEVEMENT

ADVANCED GCE **2880/CS**

BUSINESS STUDIES

Business Strategy

CASE STUDY

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The Albion Cheese Company (ACC)

If you were to ask Lateef Okunnu what he does for a living he might describe himself as a ‘company doctor’. Employed by Orchard Asset Management, OAM, his job is to go into failing companies owned by OAM, find a cure, and return them to financial health. His current assignment is as Managing Director of The Albion Cheese Company, ACC. OAM has given Lateef an objective of 5% return on capital by the end of the 2009 financial year.

ACC used to be owned and run by a group of dairy farmers in the English East Midlands. Having been told by successive governments and business advisers to add value to their milk they had gathered together to buy a long established, but ailing Stilton Cheese manufacturer, ACC. However, dairy farming is one thing but cheese making something altogether different. Awash with enthusiasm but short on expertise their venture never really flourished. Mounting losses led to arguments amongst the farmers such that eventually they decided enough was enough. The company was put up for sale in 2003. Having had several enquirers, it was eventually sold one year later to OAM for £5m. Now, twelve months into his assignment Lateef is still battling to fulfil his mission.

Stilton cheese is classified under EU law as being PDO (Protected Designation of Origin). PDO classification protects regional manufacturers from having to compete with others who may seek to pass themselves off as the genuine article by using the same product name, hence misleading consumers. As an outsider, Lateef feels PDO actually serves to harm ACC. Many long-serving employees believe PDO gives ACC (and four other local licensed Stilton dairies) monopoly powers, particularly as ACC is the second largest. Hence, when Lateef cited the need to be competitive when faced with a wage demand of 3.2% from the employees, they argued the obvious response is to raise price. This, and the fact that staff had not become 3.2% more efficient in the last year, made Lateef wonder about the commercial acumen of many of ACC’s senior managers. When he talks about financial control and budgetary discipline with many senior managers they simply look confused. For example, when he raised the problem of rising energy costs at a recent meeting he did not feel his colleagues appreciated either the scale or urgency of the problem. Energy costs had been quite stable in 2007 because ACC has a long term, semi-variable tariff, contract with its supplier. This is due to end in September 2008, after which ACC will be faced with the possibility of energy being charged purely as a variable cost. Erin Meenhan, ACC’s Finance Manager, thinks its energy costs could rise by as much as 45% in the coming year. The major use of energy is in pasteurisation and chilled storage.

ACC’s Marketing Manager is Robert Wilson. On Lateef’s arrival Robert briefed him about the Stilton market. Sales of Stilton are seasonal, with approximately 35% of sales being made in the Christmas period. For many households it is an indulgence product, purchased rarely. Stilton’s core consumers are A/B/C1, middle aged. Annually, Stilton has about 2% market share of the approximately 0.5m tonne UK cheese market. Stilton can only be made using whole milk and as such has quite a high fat content when compared to other cheeses. Another aspect of the 200 year old recipe is the inevitable salt content of Stilton. Although ACC has strived hard to reduce this the very nature of the product means that the lowest the salt content can fall to is about 2 - 3%. Lateef feels that salt content may well have contributed to falling sales, given recent government campaigns about healthy eating. In manufacture Stilton needs 10 to 16 weeks for maturation, during which each cheese will be pierced several times to encourage the growth of Penicillium Roqueforti mould. It is this maturity time that can cause production problems, and in particular hinders ACC’s ability to respond quickly to changes in customer demand. A single Stilton cheese is about 7.5 kg when ready for processing and packaging. ACC produces over 200 000 cheeses per annum.

Lateef, as a self confessed non-specialist, sees ACC in a rather different way to most of his colleagues. Not imbued with years of tradition and cultural baggage, Lateef views ACC as actually being two distinct operations: manufacture and packaging. The manufacturing side of the business is highly skilled and labour intensive. The 20 staff employed in manufacture (and most of the 22 administration staff) are passionate about their product. The average age of the manufacturing staff is late forties, with absenteeism a rarity. Manufacturing output tends to be consistent throughout the year, not least because of the nature of the major raw material. In contrast, sales are highly variable. Typically the packaging operation runs a single shift from January to September, with output being boosted with overtime, seven day working and a second shift from October to December. Packaging divides the single cheeses into weights more suitable for the retail customer. The packaging operation is automated, mainly low skilled warehouse work. Union density amongst the 30 full time packaging employees is in excess of 80%. Packaging can produce different solutions, such as flow-wrap and re-sealable punnets. The operation is characterised by above ACC average labour turnover and high absenteeism. In an effort to reduce these ACC has a number of financial rewards in place, but Lateef is unsure the historic incentives are efficient.

One consequence of PDO classification is its regionalized nature, meaning Stilton has to be produced within a designated locality. Consequently any attempt to reduce labour costs by relocating ACC would be impossible. However, in what Lateef feels is a neat bit of lateral thinking, he thinks he has the solution; given he cannot take ACC to a low labour cost area why not bring low cost labour to the East Midlands? Having imposed a zero percent wage freeze in packaging last year, he is now considering how to implement a significant change in ACC employment practices. In essence, he first needs to persuade Helen Aspinal, ACC's Head of Personnel, to replace indigenous packaging workers with those from eastern European member states of the EU. Last autumn, when ACC took on several temporary staff to cope with its seasonal sales, both Helen and Lateef were struck by the far more positive and cooperative attitude Polish workers had when compared to ACC's full time, local, staff. Unfortunately, somehow rumours of this possibility have appeared in the local press under the headline "Polish up your Polish, here come the eastern Europeans." Responding to the press article Helen has received a request from a union official for '..an urgent meeting to discuss the pay and conditions of ACC's staff pending a ballot to take industrial action because of ACC's provocative decision to employ agency staff instead of offering full-time employees overtime.'

To achieve OAM's objective Lateef knows, realistically, he only has two options: reduce cost or boost income. To seek to identify areas for potential cost saving he asked Erin to create a spreadsheet showing monthly costs throughout last year, see Table 1. From this analysis the scale of the required cost saving came into stark focus. However, it did show the benefit of ACC being zero geared. Worryingly for Lateef, he can only see two areas of potential cost savings: direct packaging labour and energy costs. ACC could invest £300 000 to lessen the impact of rising world energy costs. Equipment, for example wind or solar generators, would reduce ACC's underlying energy purchase by about 10%. At the same time ACC will critically analyse its processes to find possible ways to reduce energy usage. However, to get OAM's agreement to any capital expenditure, ACC has to show an accounting rate of return of 8% or more. But, such a 'green' approach could have many other, non-financial benefits, not least the possible competitive edge in selling to the two major UK supermarkets ACC currently supply. These customers, who typically retail Stilton at about £7.10/kg, represent about 50% of ACC's annual sales.

Keen to reduce ACC's reliance on these two customers Lateef has asked Robert to explore the potential for further growth in two markets: exports and internet sales. These, he hopes, will boost ACC's income. Currently exports account for just 10% of sales, primarily to the USA and Germany. Unlike one other Stilton manufacturer, ACC has yet to establish the ability to sell via the internet. The remaining 40% of sales is to independent wholesalers who in turn supply a myriad of delicatessens and grocers throughout the UK.

Another option to boost income might be the possibility of gaining external work from other food producers. Lateef's thoughts again turned to the packaging section. With the ability to package in excess of 200 000 kg per month the plant has poor capacity utilisation for much of the year. Indeed, with overheads covered by ACC's own needs, the scope for an aggressive pricing approach to any external users is obvious. Clearly, other Stilton manufacturers must face similar problems, so perhaps it is simply a case of persuading them to close their own packaging operations and subcontract this work to ACC. They would save costs and ACC would boost income – a win-win scenario. Of course, one way to address both issues is to reverse the scenario: close the packaging section and outsource. To get a rough idea of the relative worth of the two operations Lateef has used a hypothetical transfer pricing model for the cheese as it moves from manufacture to packaging. These rough calculations suggested selling the packaging operation could result in an increase in annual profit of about £1.98m. His attempts to create individual Balance Sheets and Profit & Loss accounts for the two individual parts of ACC proved to problematic, so he is grateful that Erin has been able to give him a Balance Sheet for the combined business, see Fig. 1. The capital raised by the sale of the packaging section would also reduce OAM's equity investment in the remaining part of ACC. Taken together both benefits of the sale would enable Lateef to easily secure his target. This in turn would mean he could leave ACC having returned the business to health, and so move back to London.

Estimated Balance Sheet, as at end of financial year 2007/2008

	ACC £000s
Fixed assets	
Tangible assets	4,500
Intangible assets	10
	4,510
Current assets	
Stock	554
Debtors	473
Cash	25
	1,052
Current liabilities	
Trade creditors	679
Overdraft	500
	1,179
Net Current assets	–127
Net assets	4,383
Share Capital	5,000
Profit and loss account	–617
Equity shareholders' funds	4,383

Estimated P&L account, as at end of financial year 2007/2008

	£000s
Turnover	6,669
Cost of sales	5,078
Gross profit	1,591
Overheads	1,827
Net profit	–236

Fig. 1

Table 1

Production year 2007–2008

	April	May	June	July	August	September	October	November	December	January	February	March	Total
Production													
Milk	£155 927	£171 188	£371 591	£296 675	£317 863	£358 962	£281 326	£161 522	£170 105	£288 369	£288 043	£361 878	£3 223 449
Other ingredients	£1 271	£1 549	£3 147	£2 173	£2 365	£2 723	£2 200	£1 265	£1 320	£2 200	£2 200	£2 750	£25 163
Allocated overheads	£63 733	£74 202	£81 566	£73 171	£73 927	£88 348	£73 033	£77 087	£82 090	£75 685	£71 125	£79 573	£913 537
Direct labour	£27 979	£25 186	£41 713	£46 228	£48 237	£58 009	£47 871	£39 409	£47 701	£42 092	£42 967	£53 737	£521 129
	£248 910	£272 125	£498 017	£418 247	£442 392	£508 042	£404 430	£279 283	£301 216	£408 346	£404 335	£497 938	£4 683 278
Packaging													
Materials	£14 783	£18 581	£21 170	£18 756	£24 553	£41 926	£64 386	£168 609	£201 060	£24 087	£25 087	£29 434	£652 432
Allocated overheads	£63 733	£74 202	£81 566	£73 171	£73 927	£88 348	£73 033	£77 087	£82 090	£75 685	£71 125	£79 573	£913 537
Direct labour	£28 876	£36 292	£33 324	£32 449	£38 680	£50 327	£74 744	£97 284	£127 171	£42 968	£43 391	£49 766	£655 272
	£107 392	£129 075	£136 060	£124 376	£137 160	£180 601	£212 163	£342 980	£410 321	£142 740	£139 603	£158 773	£2 221 241
Overheads													
Indirect labour	*£44 462*	*£40 234*	*£47 584*	*£45 288*	*£45 288*	*£46 452*	*£47 934*	*£47 934*	*£49 747*	*£45 743*	*£45 743*	*£46 916*	*£553 325*
Energy	*£12 567*	*£13 063*	*£18 456*	*£15 921*	*£16 253*	*£19 027*	*£15 046*	*£15 407*	*£17 287*	*£19 436*	*£17 853*	*£19 512*	*£199 828*
Other costs	*£70 437*	*£95 106*	*£97 091*	*£85 132*	*£86 313*	*£111 216*	*£83 085*	*£90 833*	*£97 145*	*£86 190*	*£78 654*	*£92 718*	*£1 073 920*
	£127 466	*£148 403*	*£163 131*	*£146 341*	*£147 854*	*£176 695*	*£146 065*	*£154 174*	*£164 179*	*£151 369*	*£142 250*	*£159 146*	*£1 827 073*
Total cost	£356 302	£401 199	£634 076	£542 622	£579 552	£688 642	£616 592	£622 263	£711 536	£551 085	£543 938	£656 711	£6 904 518
Production 000 kg	83	91	198	158	169	192	150	87	90	153	154	192	1717
Cost per 000 kg	£2 999	£2 990	£2 515	£2 647	£2 618	£2 646	£2 696	£3 210	£3 347	£2 669	£2 626	£2 593	
Packaging 000 kg	91	98	99	115	214	174	187	212	176	109	104	176	1755
Cost per, 000 kg	£1 180	£1 317	£1 374	£1 082	£641	£1 038	£1 135	£1 618	£2 331	£1 310	£1 342	£902	
Total cost per 000 kg	£4 179	£4 307	£3 890	£3 729	£3 259	£3 684	£3 831	£4 828	£5 678	£3 978	£3 968	£3 496	
Sales 000 kg	90	85	86	87	87	224	304	414	87	65	91	89	1709
Revenue	£351 000	£351 000	£331 500	£335 400	£339 300	£339 300	£873 600	£1 185 600	£1 614 600	£339 300	£253 500	£354 900	£6 669 000
Profit	–£5 302	–£50 199	–£302 576	–£207 222	–£240 252	–£349 342	£257 008	£563 337	£903 064	–£211 785	–£290 438	–£301 811	–£235 518

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