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BabyFreedom: Stakeholders and Strategy

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COMPANY BACKGROUND

BabyFreedom,[1] based in Austin, Texas, makes a line of organic-certified clothing for infants and children. The company founder and president, Jennifer Thurman, started making the clothing when her niece was born with extreme sensitivity to the chemicals and dyes used in commercial children's clothing. The organic clothing led to dramatic improvements in her niece's condition. Thurman then began to receive requests for her clothing from the local children's hospital's neonatal intensive care unit (NICU) and from parents referred by her niece's pediatrician. As these requests increased, Thurman rented a small office and production area in a commercial park, hired her first employees, and started commercial production of her clothing. Within two years, a full-time accountant/controller, an operations manager, and a marketing/sales manager were hired.

Reputation and Culture

BabyFreedom considers itself to be a mission-driven and stakeholder-focused organization. The company's mission statement (Figure 1) identifies three primary stakeholder groups: customers, business partners, and employees.

Customers and Target Market

BabyFreedom's primary market is "medically necessary" clothing, subdivided into NICU and home orders, both providing the option to customize clothing to accommodate medical devices. BabyFreedom's management team is also developing a "natural clothing" product line to complement the medical market. Marketed primarily to parents interested in sustainably sourced and organically produced products, the natural clothing line for children is the fastest-growing market segment with a projected potential demand greater than the combined "medically necessary" segments. Table 1 presents a list of the most popular clothing items, their sales prices, and their costs.

BabyFreedom's customers are extremely loyal to the company. Surveys indicate that customers greatly value ethical, trustworthy companies that are socially and environmentally responsible and that they perceive BabyFreedom to have those qualities. Customers for the natural clothing line (nonmedically necessary) are especially concerned with issues of sustainability, fair trade, and social responsibility. To address these concerns, BabyFreedom's website includes a great deal of information about its suppliers and employees, including photos and interviews. The company also regularly solicits customer comments and suggestions on its website and on flyers included with product packaging.

[1]BabyFreedom is a fictitious company; however, the facts in the case are based on actual events in the early 2000s.

Throughout its existence, BabyFreedom has emphasized good relationships with suppliers. BabyFreedom also maintains a policy of selecting suppliers with reputations for being ethical and socially responsible. To that end, BabyFreedom managers regularly visit supplier sites and make a point of speaking with employees to ensure the supplier's reputation is based on fact. The suppliers tend to be smaller, family run businesses, and BabyFreedom is usually their largest customer. To ensure reliability of supply and to build strong supplier relationships, BabyFreedom pays a premium for high-quality materials.

The company also has a reputation for being an excellent place to work. Thurman insists on safe, comfortable working conditions and provides healthcare coverage for all employees. The majority of employees are Mexican and Asian immigrant women, often with small children, and BabyFreedom provides a company daycare room for preschool children, an after-school tutor for the school-age children, and encourages workers to continue their education. As a result, voluntary turnover at the company is almost nonexistent and several production workers have taken on increasing responsibility in staff functions in accounting, supply chain management, and operations.

Operations and Information Technology Infrastructure

BabyFreedom leases a large building with combined production, warehouse, and office space in a small industrial park. The production process is very labor-intensive. Although product demand is high and increasing, it is not high enough to justify an investment in highly automated production. Furthermore, an automated system cannot handle the frequent customization required for the "medically necessary" clothing.

The company has a small administrative staff and a single production shift, currently working at full capacity. BabyFreedom is in the process of hiring and training a small second shift with plans to reach full strength within three years. Because the company is fiscally conservative and has a policy of avoiding layoffs, production continues at a steady rate throughout the year, with minimal fluctuations in the volume of finished goods inventory. Since the special materials are so critical to BabyFreedom's product lines, raw materials inventory includes large safety stocks.

During the previous year, management focused on the need to improve efficiency in both production and inventory management. A key piece in this effort was upgrading BabyFreedom's computer systems. The old systems had been added piecemeal as the company grew, and it was difficult to share information among the inventory management, production scheduling, accounting, and customer management programs. In response, BabyFreedom has recently invested in a new, integrated system that can collect, share, and store data across all departments. The new system can also interface with BabyFreedom's internet sales portal and with the website used by BabyFreedom's shipping company. The goal is to have the new system fully integrated and operational before the new second shift reaches full strength.

Currently, the new accounting and customer relationship management (CRM) modules are working well. There are still issues with the inventory management and production planning modules, since BabyFreedom's small suppliers do not have the ability to integrate with the company's computer systems. As a result, incoming shipments must still be inspected, compared with invoices and purchase orders, and then manually entered into the inventory module. The operations manager is testing barcode readers as a way to automate this process. Once barcodes are integrated into the new inventory management module, BabyFreedom plans to help its suppliers begin barcoding shipments by supplying the special printers and labelers. This will allow BabyFreedom to quickly link the inventory module with both the production scheduling and accounting modules.

Prices and Cost Structure

BabyFreedom carefully sources its raw materials to ensure that they have not been exposed to chemicals at any point in the growing, harvesting, dyeing, or weaving processes. Because these materials are costlier to produce and process, and because the suppliers are small independent companies, BabyFreedom's material costs are greater than those experienced by manufacturers of standard children's clothing. The labor-intensive nature of the manufacturing process as well as the company's commitment to a living wage, healthcare, and socially responsible employee benefits contribute to higher labor and overhead costs. As a result, BabyFreedom's prices are higher than those associated with regular children's clothing. Nevertheless, the company tries to keep profit margins low (less than 5%) to make the clothing as affordable as possible, while still ensuring it can maintain its social responsibility initiatives and reputation for high-quality products. Based on current operations and plans, BabyFreedom's management team created a pro forma income statement and balance sheet for the coming year (Tables 2 and 3). But then an exciting new offer was made that could change everything.

THE NEW OPPORTUNITY: A MAJOR OFFER FROM WALMART

Toward the end of the current year, Walmart approached BabyFreedom about carrying the natural children's clothing line in its stores. The potential business with Walmart would nearly double sales volume, but some changes would be required. Walmart is heavily invested in Radio Frequency Identification Device (RFID) technology in its distribution chain and requires all suppliers to use the technology. To accept the contract with Walmart, BabyFreedom would have to invest in and implement the new RFID technology, at least at a basic tagging level, and Walmart would not help with this cost. Further, BabyFreedom could not increase clothing prices to cover the increased cost, since Walmart would also require prices to be lowered significantly (sector apparel gross margin percentages are approximately 46.4%; Walmart would mandate reductions to 29.8%). The new lower prices would effectively eliminate profit margins, and BabyFreedom would have to reduce or eliminate its employee benefits and social responsibility programs.

To meet demand both for the Walmart contract and sales through current channels, BabyFreedom would have to increase production capacity significantly. The new, increased demand could be met by bringing on a full second shift immediately and gradually adding a third shift. It is estimated that using three shifts would provide enough production capacity for the next five years; after that, the company would need to lease additional production facilities and expand shift size.

The RFID tags could be integrated into the new system, either in addition to or instead of the barcode readers. Both systems could provide the data necessary to manage inventories. They also would provide more detailed data that would enable BabyFreedom to allocate shared costs across product lines more accurately. With a little assistance, BabyFreedom's suppliers could begin effectively using printed barcodes; the suppliers would not be able to adopt RFID technology. As a result, BabyFreedom employees would need to scan the barcodes at the dock and then manually apply RFID tags.

Realistically, over the next five years at least, the company would be able to afford only the most basic "slap and ship" implementation of RFID technology, where a supplier simply attaches an RFID tag programmed with basic information prior to shipping the product to the retailer (with no attempt by the supplier to capture, analyze, or store data generated by the RFID tag). Though this would comply with the Walmart mandate, BabyFreedom would be unable to use the large quantity of data the RFID tags generate. To do that, it would need to purchase middleware—software that enables communication and management of data in distributed applications—and make expensive upgrades to the new inventory module while significantly expanding server capacity. It is doubtful that BabyFreedom would use the full level of detail generated by RFID technology; the company needs only basic data that could also be provided by barcode readers. Figure 2 presents basic information for the cost of both implementation options.

Walmart's offer is for an initial contract of five years with a subsequent renewal option. BabyFreedom's projected net cash flows for the five-year contract period, given a 40.00% tax rate and a 6.25% weighted average cost of capital (after-tax discount rate), resulted in a positive net present value (NPV) calculation. If the contract is renewed at the end of the five-year period, BabyFreedom would have to expand its facilities and infrastructure immediately to meet expected growth in its other market segments.

THE CONCERNS

Although the Walmart contract would result in accelerated growth for BabyFreedom over the next five years, there are important concerns to be addressed. If BabyFreedom cannot quickly expand capacity with a second shift, fulfilling the Walmart contract might create shortages and missed sales from BabyFreedom's current channels. The relationship could create opportunities for expansion into other product lines, but management is concerned that Walmart might not be a good channel for "natural" clothing (and the premium prices required by such products) and that Walmart would also begin to press for a less expensive, lower-quality product line with the BabyFreedom brand name. Management is also concerned that shrinking profit margins would significantly alter how the company chooses to do business and its ability to maintain stakeholder relationships.

THE ANALYSIS

After reviewing the offer and the issues associated with adopting RFID technology, Thurman summarized the situation in a special management meeting:

"The Walmart contract is a great opportunity—the potential increase in sales is tremendous. We have done the analysis and feel we can meet the production and tagging requirements and still make a profit. But we need to be sure that this is a good cultural and strategic fit for our company. I am very proud of our reputation for ethical behavior and the trust our employees and customers have in us—we need to be very careful not to hurt that reputation. From a purely financial standpoint, we can sign the contract, but I am concerned whether we should do so from a nonfinancial perspective."

The management team is tasked with reviewing the current pro forma financials, the projected costs of RFID implementation, and the qualitative and ethical aspects of the Walmart opportunity over the next week. In addition to doubling sales volume, assumptions to be used in the analysis include a 15% across-the-board reduction in selling price; a reduction in selling, general, and administrative expenses to 25% of revenue; 80% financing of the compliance option of RFID implementation (the remaining 20% will come from cash on hand); and 20% of acquisition cost for ongoing support and maintenance of the RFID equipment and software. Following a discussion of the outcome in the next week's management meeting, Thurman will reply to the Walmart offer. As part of the management team, you are expected to provide relevant information that will help inform the ultimate decision.

Figure 1: BabyFreedom's Mission Statement

While seeking a fair profit, we are a socially and environmentally responsible company. We provide the highest quality product possible for the health of our smallest stakeholders while maintaining a superior level of integrity in interactions with our business partners and associates. We provide a work environment where our employees can thrive in an atmosphere of excellence.

Figure 2: Projected Costs of Alternative Strategies for Implementing RFID Technology at BabyFreedom

BabyFreedom is evaluating two viable levels of investment in RFID technology to meet Walmart's requirements. A brief description of each level, along with a description of certain key cost items, is presented here.

1. Compliance level: at least US$25,000 in initial acquisition cost for small companies
    - Basic system of readers, tags, automated label printers, applicators and software
    - No data integration
    - "Slap and ship" with hand-held readers only
    - Does not allow for future changes in customer requirements
    - Selected costs:
        - Tags: US$0.10 each (basic, passive RFID tags)
        - Passive, handheld readers: US$3,000 each
    - Human being waves the scanner near assets
    - Great for manual auditing of a location
    - BabyFreedom would require three units (one at the entrance to the finished goods warehouse, one in the shipping area, and one backup unit)
        - RFID tag printers: US$2,500 each
    - BabyFreedom would require two printers (one at the entrance to the finished goods warehouse plus one backup unit)
        - Ongoing costs for technology and maintenance (annual): approximately 15% to 20% of initial acquisition cost

2. Conservative level: approximately US$250,000 in initial acquisition cost
    - Basic system, plus investment in middleware, server capacity, and ongoing service costs for third-party software
    - Provides basic data integration and storage for manufacturer
    - Provides more permanent installation
    - Allows for basic technology consultation and implementation but not for future changes in customer requirements
    - Selected costs:
        - Tags: US$0.10 each (basic, passive RFID tags)
        - Passive, handheld readers: US$3,000 each
    - Human being waves the scanner near assets
    - Great for manual auditing of a location
    - BabyFreedom would require three units (one at the entrance to the finished goods warehouse, one in the shipping area, and one backup unit)
        - Passive, fixed-position readers: US$20,000 each
    - Portal readers installed in doorways to detect assets moving through
    - Cost includes hardware, installation, and configuration
    - For conservative-level implementation, BabyFreedom would require two units (one at the entrance to the finished goods warehouse and the other in the shipping area) in addition to the handheld scanners
        - RFID tag printers: US$2,500 each
    - BabyFreedom would require two printers (one at the entrance to the finished goods warehouse plus one backup unit)
        - Basic middleware package for small operation: US$25,000
        - Initial technology consultation and implementation: US$50,000
        - Additional hardware and server capacity investment: US$50,000
        - Ongoing costs for technology and maintenance (annual): approximately 15% to 20% of initial acquisition cost

Table 1: Current Prices and Costs for Selected Products

Product Description	Price	Absorption Cost
Infant, 0-24 months		
Kimono style shirt	$15	$8.25
Roll waist pants	$20	$11.00
Layette set (t-shirt, roll waist pants)	$30	$16.50
Side snap layette	$50	$32.50
Convertible jumper	$60	$39.00
Leggings with feet	$40	$26.00
Cardigan	$50	$32.50
Toddler, 2-4 years		
Jacket	$100	$65.00
Dress	$60	$39.00
Leggings	$25	$13.75
T-shirt	$25	$13.75
Pajama set	$40	$26.00
Pullover	$50	$32.50
Cardigan	$80	$52.00

Note: All prices and costs are in U.S. dollars.

Table 2: BabyFreedom Pro Forma Income Statement for Fiscal Year Ending December 31, 2018

	Total $	% of Sales
Net Sales	$5,013,879	100%
Cost of goods sold	2,921,034	58.3%
Gross profit	$2,092,845	41.7%
Selling, general and administrative expenses	1,754,858	35%
Operating income	$337,987	6.7%
Interest expense (6.25%)	36,527	0.7%
Income before income taxes	$301,460	6.0%
Provision for income taxes (40%)	120,584	2.4%
Net Income	**$180,876**	**3.6%**

Note: All costs are in U.S. dollars.

Table 3: BabyFreedom Pro Forma Balance Sheet, Fiscal Year Ending December 31, 2018

Assets:	
Current assets	
Cash and cash equivalents	$381,209
Accounts receivable (net)	207,570
Inventories	469,934
Prepaid expenses and other current assets	38,672
Total current assets	$1,097,385
Property, plant, and equipment (net)	871,704
Total Assets	**$1,969,089**
Liabilities:	
Current liabilities	
Accounts payable	$730,259
Other current liabilities	105,070
Total current liabilities	$835,329
Loan	584,431
Total liabilities	$1,419,760
Capital account	549,329
Total Liabilities and Stockholder's Equity	**$1,969,089**

Note: All costs are in U.S. dollars.