Business Data Management
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Make vs Buy

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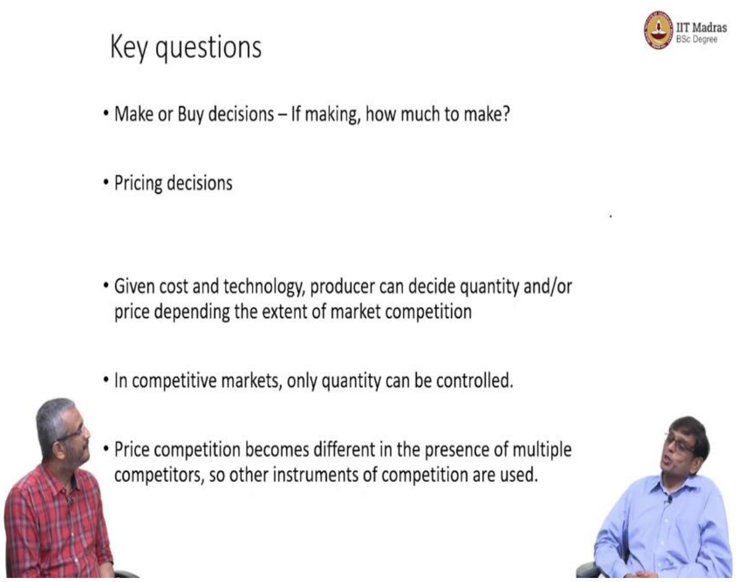

Professor M Suresh Babu: Let me go one more step. That is a very simple analysis that we presented leads us to very important questions about firm. First, what we started in the beginning is that the firm will have to decide whether I should make or buy it.

Professor G. Venkatesh: Big equipment whether I should okay make or buy in a sense that…

Professor M Suresh Babu: Should I produce something or should I buy from somebody…

Professor G. Venkatesh: If I buy from somebody, I do not need to invest in capital. The capital is a key thing right?

Professor M Suresh Babu: Yeah.

Professor G. Venkatesh: If I make it, I need the capital if I have to make it.

Professor M Suresh Babu: So, in a way, we can say that this entire discussion and debate about outsourcing is an offshoot of this decision of make or buy. Should I…

Professor G. Venkatesh: Because I suppose I want to buy if I want to buy from you. You may have already invested in again, and that capital you may be using for doing work for many companies?

So, when I go to you, and I buy from you. The cost that I am going to incur basically is your marginal cost is your phase.

Professor M Suresh Babu: Yes.

Professor G. Venkatesh: Whereas I have to invest in the capital, I do it myself. Then I have to buy it will be my total, the initial part of the total cost curve.

Professor M Suresh Babu: Yes, yes.

Professor G. Venkatesh: Where its capital costs intensive. So, I am at a disadvantage I might as well just buy. So, in the beginning, I could buy and then later on when I get some volumes, and I could decide every

Professor M Suresh Babu: Should I make or should I continue buying this?

Professor G. Venkatesh: I can start making.

Professor M Suresh Babu: But there is one important thing that we need to keep in mind here: it is also a function of what we call the sunk the fixed costs. What do we mean by sunk costs? Sunk cost is when the fixed costs cannot be recovered at all.

Professor G. Venkatesh: Because the value of the goods has changed, something dramatically become lesser.

Professor M Suresh Babu: One or even if I sell that with this crap value then machine, that machine can be only thing say the problem with the machine is that a machine is lumpy. Suppose I want to produce only 20 units. It will matter my possible because the machine might have an installed capacity of 100 units. So, there is a kind of a lumpiness in this.

Professor G. Venkatesh: You cannot do it in this way… though you said 1, 2, 3, 4 hours might not be like that.

Professor M Suresh Babu: Yeah, it may not be like that.

Professor G. Venkatesh: You know many times you have to produce 100

Professor M Suresh Babu: Otherwise, it is not economical. Now, some of these machines - if I am becoming very inefficient in the market and if I want to exit or if I want to shut down or whatever my operations. Even if you sell that, it might not yield you much. So, that kind of often of a cost is called as a sunk cost.

Professor G. Venkatesh: Sunk cost.

Professor M Suresh Babu: You cannot recover that at all. It is a sunk cost. For example, certain contractual agreements for marketing I have already entered into an agreement with an agency. And whether I use it or not, I have to pay it upfront. Then it is up to me to decide whether I should use or how much I should use but if I do not use it.

Professor G. Venkatesh: He is not going advertising phase on something channels (())(06:15) channels.

Professor M Suresh Babu: Yeah, you have to pay upfront.

Professor G. Venkatesh: You have to pay upfront.

Professor M Suresh Babu: Sunk costs. So, depending on the sunk cost, I will decide whether I should actually make or buy it. So, a sunk cost is a very important concept in this decision-making. Now, so that actually comes very close to a lot of real-life examples. So, for example, this entire outsourcing thing is a very interesting model like in the case of Bata in India.

Bata used to outsource even now, footwear to local producers. And they will say that we need so many pieces with this kind of a design with these, these quality specifications we are going to buy from you. I do not have a big factory for you know 1000 workers to come and produce this footwear. But I am selling it, and all that I procure from the local producers will have my company seal.

Professor G. Venkatesh: Stamp on it.

Professor M Suresh Babu: Bata.

Professor G. Venkatesh: Quality standards.

Professor M Suresh Babu: Bata decided to buy it because they think that producing by themselves is not an efficient model. So, a lot of examples in real life we can see in terms of this. But we need to give

Professor G. Venkatesh: Bata might give them materials.

Professor M Suresh Babu: Bata have different models of this outsourcing thing now. The materials some of these models they give the materials also to keep their quality standards. Because there is a possibility that we might not be able to make out what material the other person is using in production process. So, if you want to control over that, we will give you the material. One kind of a model. Another kind of model is basically giving the design.

For example, the simplest kind of outsourcing with the material is this local Papad making unit. Sometimes they give the dough. And then these ladies you know have to make so many Papads ready and depending on how many Papads the day they make they are paid. For every Papads 1 rupee or something.

Professor G. Venkatesh: It is a labor contract.

Professor M Suresh Babu: It is a labor contract. All those decisions are these make or buy decisions. And depending on your cost variables, you arrive at these decisions. The second important decision is in terms of the pricing decisions of firms. How much should I price? It is a function of your costs directly, and we will again keep coming back to that because we will look at some of the basic pricing models later on when we bring in you know different markets also.

Professor M Suresh Babu: Third important concept is that quantity decisions are very important.

Professor G. Venkatesh: How much to produce?

Professor M Suresh Babu: How much to produce? And a firm has control over two variables, basically, quantity or price or both. So, depending on the type of market in which the firm operates. It can actually vary the quantity, vary the price or…

Professor G. Venkatesh: It is a monopoly it can do both.

Professor M Suresh Babu: It can so both.

Professor G. Venkatesh: Right?

Professor M Suresh Babu: Yeah. In oligopoly, sometimes it can vary, but it might immediately invite your rivals, and rivals will respond. In a perfectly competitive market, you have no control over…

Professor G. Venkatesh: So, for example OPEC sets prices. So, prices there is no control.

Professor M Suresh Babu: There is no control.

Professor G. Venkatesh: Only quantity you can decide so much I have to produce.

Professor M Suresh Babu: Yeah, but that is a cartel and OPEC is an cartel. So, you have to go by the cartel rules . You cannot deviate from that. And so, it is a very different kind of model then. Then that actually takes us to this whole concept of competition. Because as we just saw either, I can vary price in certain markets or quantity or both. What should be the kind of an instrument that I should use in terms of competing in markets is determined by your cost variables as well as your market variables strength. So, I wanted to convey that this entire cost analysis then gives us very useful insights.

Professor G. Venkatesh: Okay.