Omega Dairy Products, Cyprus

- Type of restructuring:
  Outsourcing
- Employees before restructuring:
  10-49
- Employees after restructuring:
  10-49
- Nace/Sector:
  Manufacturing
- Country:
  Cyprus
- Date:
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- Keywords:
  Recession/Crisis

Abstract

The outsourcing in the Cypriot firm Omega Dairy Products [not its real name] negatively influenced the company performance. This happened because a subcontractor who had been given lower prices did not, as agreed, make early payments in exchange.

Organisational profile

Omega Dairy Products Ltd is a company operating in the dairy manufacturing sector in Cyprus, producing traditional dairy products such as halloumi (a semi-hard, unripened brined cheese), anari (a soft Ricotta-like cheese made from whey), and yoghurt. It should be noted that Omega is an assumed name, and the actual names of the company and persons mentioned in this report are not disclosed at the request of the owner/managers.

The company was founded in 1960. The shareholders are two brothers, having equal ownership. They acquired Omega Dairies in 1980, a company that was owned and managed by a different family. The brothers decided to acquire Omega because their parents were engaged in the domestic, small-scale production of dairy products and they were used to this kind of work. They had always wanted to have their own business in producing traditional Cypriot dairy products and to keep alive their family tradition. Acquiring Omega (as opposed to establishing a new business) offered a means to capitalise on a business that already had an established reputation and access to retail channels.

The general manager of the company is one of the brothers, who has a mechanical engineering background and who had previously been in charge of a major paper product manufacturer. This is a first-generation family business, involving both its senior and the junior generations. One brother has a son who is in charge of production, while the other has a daughter and a son that are involved in sales.

The organisational structure of Omega Dairies Ltd is that, at the top of the hierarchy is one of the brothers, the general manager, who also is the quality manager. Other key company managers include the production manager (son of the general manager), the head of the maintenance department, and the sales and marketing manager (the other brother). Another key department is the accounting department.

The company employs 35 individuals, mainly semi-skilled, the majority being female (around 60%). The employees are not represented by any works council or trade union. The company has a production capacity of around six million litres of milk annually, aiming to increase this by greater expansion into markets within the EU. Omega is an international company, with 70% of total production being exported. Markets abroad currently being served include the United Kingdom, Germany, Sweden, Greece, Finland, and Estonia.

Cyprus' accession to the EU in 2004, as well as the efforts of the management to facilitate further company growth, led to a number of changes being introduced. These included:

• establishing a new factory in the late 1990s;

• reengineering key processes and systems as part of the harmonisation with respective EU regulations in 2003;

• the acquisition of new machinery and the expansion of production capacity in 2005 due to the initiation of exports

• the decision to subcontract a part of product distribution in 2010.

Since 2005, when the company started exporting, there has been an impressive growth in company revenues. While in 2005 total revenues were €2 million, in 2011 annual revenues reached €5.5 million. This is translated into a 16.7% average annual growth in revenues between 2005 and 2011. As for the profitability, between 2005 and 2010, the company had a 3% average annual growth in net profits. 2011, however, was the first year that the company recorded losses. There was a 1% net loss, partly due to the financial crisis, the unsuccessful restructuring that the company undertook (described later) and the fact that the company invested in new machinery and equipment acquisition during 2011.

Background to restructuring event

In January 2010, the company decided to outsource a part of its product distribution to an external provider. The agreement established between the two parties allowed Epsilon Ltd (an assumed name) to distribute and sell Omega's dairy products to retail outlets around the country. Omega, though, kept the distribution and sales of its products to other clients, mainly wholesalers, including exports abroad. This meant that approximately 50% of total distribution on a local basis would be facilitated by Epsilon.

The company decided to outsource the retail distribution function as a means of avoiding the excessive costs associated with maintaining an extensive distribution network and concentrating efforts in key practices such as production and export. In this way, the company would be able to realise its dual aim of both cost minimisation (that is efficiency) and further company growth. Another reason for this decision was the credit crunch, which started becoming evident during 2009. This led to a number of retailers not paying on time, with many major retail chains paying six months after they received products from manufacturers.

As part of this restructuring event, the two parties agreed that Epsilon would buy the products at a discounted rate from Omega, while paying the manufacturer within 75 days. In this way, Omega was aspiring to solve the problem of late payments and have a healthier cash flow to run the company.

Restructuring processes

The agreement between Omega and Epsilon needed three months, in total, to be finalised. The restructuring process started in January 2010 and ended in March 2010. The decision to outsource retail distribution was made with little planning. As emphasised by the owner/manager being interviewed, while this decision was on the table for a period of time, the decision to outsource was mainly driven by the increasing pressure of late payments in the market and the restrictions that this created in facilitating further company growth. It was just a month before the actual negotiations with the provider, that Omega's management decided to outsource retail distribution.

The choice of outsourcing distribution had been considered by the management for some years. The idea was that this would help the company in focusing on more core activities that was the production of dairy products and further company expansion through exports abroad. According to the general manager, some companies had previously approached Omega with offers to take over the retail distribution of their products. However, as he emphasised, it was after getting exposed in the credit pressures of the market during 2009 that they actually started thinking seriously about this option. During this year, Omega was approached by Epsilon, a newly established business. Epsilon was set up as a company for the purpose of being a mediator between manufacturers and retailers. Taking advantage of the upcoming crisis, Epsilon targeted a number of manufacturers that it felt would be willing to outsource their retail distribution function. To induce them to cooperate, Epsilon promised it could help manufacturers receive money on time for their sales. Omega, which at that time was receiving money from retailers 180–200 days after delivery, was persuaded to collaborate by Epsilon who assured that payments would be received within 75 days.

The agreement between Omega and Epsilon came about as a result of negotiations between the management of the two companies. The person in charge of the negotiations on behalf of Omega was the general manager, who was engaged in the needed discussions with Epsilon for the finalisation of the outsourcing agreement. Both sides put on the table their requirements, which were thoroughly discussed for reaching common points of agreement. Omega went to the negotiations with a concern around late payments, aiming to establish an agreement that would allow them to receive money from the sales of their products within 60 days. On the other hand, Epsilon was looking into an agreement that would allow them a satisfactory profit margin from Omega sales. The end of the negotiations led both parties in satisfying their concerns. Under the agreement between the two parties, Omega would receive payments within 75 days and Epsilon was satisfied by the prices offered by Omega on their products.

No formal plans were in place to accompany the restructuring event. The only formal aspect of the whole restructuring process was the contract that was decided and signed between the two parties. Omega's management did not engage in any formal planning that would accompany the implementation of the restructuring event. This was primarily informal. Problems and complexities were mostly tackled on a reactive basis. However, as it was emphasised in the interviews, no major difficulties were met throughout the restructuring process.

Employees were informed about the outsourcing after the finalisation of the agreement, during an intra-company training session where all employees were involved. There was no particular reaction on the part of employees, who showed no resistance to the decision of the owners to outsource the retail distribution. The fact that the business managed this change with extra care was a reason for not experiencing any reaction. According to the general manager, the employees were reassured constantly that no changes would affect the way each person carried out their tasks. However, three employees were laid off as a result of the restructuring and one employee that had to be moved to production. All these individuals had been occupied in product distribution to retail channels. Though a sensitive issue, the company managed to deal with this successfully. Financial compensation was provided to those employees laid off, and successful efforts were made to secure employment for them in other businesses. During the interviews, the general manager mentioned that these employees seemed to have understood the situation and the reasons behind the termination of their employment. The management of the company had discussions with each of these employees separately, explaining the situation in detail and assuring them they would provide all the necessary financial and other support. This extra care helped avoid any reaction from other employees.

Employees were excluded from the restructuring process and relevant decisions within. No consultation with employees took place as part of this process. The three employees laid off were informed after the finalisation of the agreement with Epsilon, and after careful discussion between the company's managers. All three employees were given a month's notice prior to terminating their employment.

Challenges and constraints of restructuring

Difficulties in the course of the restructuring process were mainly financially related. The first thing the company needed to secure during this process was the bank guarantees of the agreement. This took time, since Omega wanted to obtain bank guarantees from the contracting party (that is, Epsilon) prior of finalising the agreement. This was to make sure that Epsilon would fulfil its obligations as a contracting party and to insure Omega from loss or damage due to non-performance by Epsilon. As emphasised by the owner–manager interviewed, such guarantees are essential at the early start of an agreement, and it is through time that trust between contracting parties is built. In this way, Omega felt sure that the subcontractor would be able to fulfil its contractual obligations.

Restructuring advice and support

Omega's management received no particular financial or non-financial support in its efforts to finalise the outsourcing agreement. In fact, all negotiations and decisions were made by the general manager, while consulting other members of the owning family such as his brother and their children involved in business. The fact that all the family was supporting the general manager and was embracing all his choices was very important in taking the final decision to outsource the retail distribution function of the business. This made the general feel more confident in taking actions on this matter. However, he mentioned the drawback that the family had no specialised knowledge of outsourcing issues. As a result, much of the support that he was getting from other family members was mainly psychological.

The costs of outsourcing were covered in full by the contracting parties. In fact, Omega did not have any significant costs, since no investments were necessary. The only costs involved related to compensation for the employees that were laid off.

No governmental or EU schemes were available, at that time, to support such a restructuring. The owner–manager mentioned that their needs were of a financial nature, but that there was a need for proper advice and consultancy support for making sure that restructuring would be conducted the right way.

Restructuring advice was desirable at the time of the negotiations and the whole restructuring process. However, while it was acknowledged that external support from specialist consultants would be particularly useful in managing the whole process, the management decided against this option as it wanted to minimise costs.

Outcomes of restructuring

Prior to outsourcing, the company received money owed by clients within 180 to 200 days. The aim of the company was that the contractual agreement with Epsilon would allow Omega to collect money within 75 days. However, the outcomes of the restructuring were not as expected. As emphasised by the general manager, cash was hardly ever received within 75 days, since the subcontractor was also facing a lot of difficulties in receiving money on time. As a result, the planned financial gains for the company were never met, and indeed the decision to outsource the retail distribution brought additional problems for Omega, such as further cash flow problems and reduced profitability. While the managers expected to collect receivables much earlier (that is, within 75 days), they found themselves in a similar situation to the pre-restructuring period, collecting cash after 150 days. However, the fact that products were now supplied at a lower price to the subcontractor meant that the company faced an additional financial burden as revenues and profits were lower than before. In fact, the performance of the company was influenced negatively, and this was one of the reasons for the net loss that the company exhibited for the first time since 1980. The company was facing a dilemma at the time of the interviews, looking into various options that would help remedy the situation. The general manager mentioned that returning back to wholly controlled retail distribution would not solve this problem, emphasising that they were in such a difficult financial situation that they might also start considering selling the business.

The restructuring event brought changes to employee structure and staffing. As mentioned, three people were laid off. These included individuals employed in distribution, which was outsourced. At the same time, a fourth person was relocated to the production department, as a result of the company's efforts to strengthen this division. No negative consequences resulted for the business as a result of the need to lay off employees. Since the business provided financial compensations to these employees and exhibited a willingness to help them find employment elsewhere, this was seen positively not only by the affected individuals but from all the company employees.. Indeed, the Omega management persuaded Epsilon to recruit one of these three individuals while, after communication with companies in Omega's network, jobs were secured for the other two.

The general manager acknowledged that a number of lessons were learnt from this restructuring. In fact, he presented this event as a failure that has to be the driving force of future actions. The management team, in fact, failed to realise the planned scenario of collecting receivables within 75 days and this led to a further worsening of the financial condition of the company. He mentioned that this 'failure' led him to reflect on the mistakes that were made in the course of the outsourcing decision and the agreement with Epsilon. He emphasised that next time around he would formally plan such actions, while asking for the support of specialist consultants in undertaking a formal evaluation prior to the event, and in participating in the actual negotiations. This would help to minimise pitfalls after the implementation of the agreement.

Commentary

This case study provides useful lessons that can be considered by businesses during restructuring events. While Omega's management was aspiring to obtain faster payments and thus better cash flow management through outsourcing the retail distribution function, things did not go as planned. One reason for the failure to facilitate changes that would help to improve competitiveness appears to be that the management failed to appreciate the complexities involved in the particular restructuring event. Reflecting on the agreement made with the subcontractor and the process that they went through to materialise this restructuring, the management admitted that the idea to outsource might have been a big mistake.

The failure of Omega's management reveals major issues that need to be considered during business restructuring. The first was the hasty decision to move on with business restructuring without proper preparation. Omega's management appeared to have undervalued the significance of preparation prior to negotiations. Such preparation could have included a feasibility study, due diligence for a thorough investigation of the contracting party, and proper planning that would help set the foundations for the effective implementation of restructuring and the management of change. Simulation and sensitivity analysis would again help obtain a complete understanding of different scenarios in the agreement, prior to its enforcement. These tools could help management to gain a thorough understanding of the situation and decide: first, whether restructuring would be wise and, second, how this process could ideally be managed.

The second major issue that stems from the case is the fact that formal agreements may not necessarily bind two parties in a mutually acceptable performance. While there was agreement on behalf of Epsilon to pay within 75 days, this clause was never met and this was one of the reasons for Omega experiencing losses after the restructuring. An option for Omega was to terminate the contract with Epsilon. But the general manager did not see this as viable since the company would need to invest in reorganising product distribution. As a result, the company chose to do nothing and therefore experienced losses and cash flow problems as a result of the late payments by Epsilon. This could have been avoided, however, if Omega's management had fully understood the decision to outsource and the risks associated with it. One option to avoid this would have been for the company to have had a back-up or reaction plan in the event that the subcontractor would not meet the terms of the initial agreement.

As emphasised by the general manager during the interviews, Omega asked from Epsilon certain bank guarantees prior to the agreement. While these were met, Omega did not exercise the right to claim money as a result of the unsatisfactory performance by the subcontractor. This was not made on due to fears about the uncertainly that would unfold in the case of the termination of the agreement with Epsilon. A back-up plan, however, could have outlined the next steps in case of such a scenario and would have helped the Omega's management to take the necessary steps to minimise potential losses for the company. In this case, it could perhaps have been wise for Omega's management to ask for the help of an experienced consultant in order to avoid the risks of such a negative scenario.

Authors

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Information sources

Interview

General owner/manager of Omega Dairy Products Ltd, Cyprus

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  - European Restructuring Monitor
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    - Restructuring support instruments
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    - Case studies
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- European Observatory on Quality of Life - EurLIFE
- European Observatory of Working Life - EurWORK

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