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WHEN A GLOBAL SUPPLY CHAIN FEELS THE STRESS
WHEN IT REALLY MATTERS.

Mischief managed

Against a landscape of macroeconomic and political uncertainty, forward-looking CPOs are taking concrete, practical and pragmatic steps to mitigate risks, writes Robert Jaques

Protectionism and economic nationalism are on the rise, with influential trading nations announcing new tariffs. The UK's potential withdrawal from the European Union has also produced significant uncertainty, as has growing foreign exchange, commodity and interest rate volatility. All of these factors are combining to create a potent cocktail of global risk that threatens everything from order fulfilment to supplier financial health.

"Procurement teams are more concerned than ever before about huge macroeconomic shifts undermining their strategies and compromising their operations," says Clifton Wessels-Yen, an AlixPartners managing director in New York.

While there is no universal solution, procurement teams face the daunting task of protecting their organisations from the very real potential downside risks associated with this difficult economic backdrop.

One senior strategic intelligence executive, speaking at Procurement Leaders' Data, Intelligence & Technology Forum in November 2018, warned current global macroeconomic uncertainty could have a profound effect on the function over the next five years. "There are multiple factors testing procurement: we are in a global environment in which some very basic assumptions about the world economy are being tested to the limit. And, equally, there is deep and growing scepticism over the ideas that have been driving economic expansion for a generation. The long-established positive attitude towards globalisation is changing and being replaced in many countries with a growing economic nationalism."

He added that, on the global stage, a core question is whether the impact of nationalism and regionalism will materially dent growth and start to cause economic pain, particularly in the US: "The question is whether this is really transpiring. Going into 2018, most forecasters were very bullish about the global economy and were talking about synchronised global growth – the return of the Goldilocks economy. Well, we are seeing synchronised growth but it is happening in the wrong direction. The whole global economy is synchronising back on a downward trend. We have reached peak growth. We are facing a pretty tough market outlook."

The executive predicted there will be no return to global trade growth anytime soon. In fact, he predicted worldwide exports will decrease and orders will fall to their 2015/2016 lows – when there was effectively a manufacturing recession.

HISTORY REPEATS ITSELF

Looking back at the lessons procurement professionals can learn from economic history when it comes to tariff-induced trade wars can only be described as a sobering exercise.

Moves in the 1930s to protect US factories against foreign imports saw the imposition of the Tariff Act 1930, which hiked import tariffs to unprecedented levels. This had the opposite effect to that intended by the legislators who passed it and is now widely acknowledged to have greatly worsened the Great Depression. More recently, President Reagan introduced a raft of tariffs on Japan during the 1980s and President George W. Bush backed the imposition of steel tariffs in 2002.

Today, trade tensions are again sending economic shockwaves around the world. In September 2018, the US imposed tariffs of 10% on $200bn-worth of Chinese imports. Beijing responded with tariffs of its own on $60bn of US goods, setting the scene for a trade battle that has been shaking confidence in the continuity of global free trade. In Europe, meanwhile, the tribulations between the UK and EU to agree on a deal over the parties' future trading relationship, together with the potential impact of US tariffs on the region, have been causing grave concern.

"The effects of both the trade war between the US and China, and Brexit will ripple through the global economy and affect procurement functions outside of these geographies. Procurement chiefs are right to be concerned," warned Procurement Leaders' *CPO challenger guide 2019*.

AlixPartners' Wessels-Yen notes procurement chiefs are becoming increasingly concerned over the impact of this macroeconomic turmoil on complex globalised supply chain networks. "The situation we're facing at this particular time across verticals is crazy. If you take consumer packaged goods (CPG) companies, for example, they may be getting raw materials from China, then maybe doing some interim manufacturing in North America. Then a portion of the products may be sold back over to Europe. So, we are talking about getting hit both ways – coming and going," he says.

"Plus, if there is any type of paperwork constraint or red tape that may be levied as part of the protectionism, it further compounds the problem. It is becoming very tough going."

SHIFTING RISK LANDSCAPE

Highlighting this economic disruption on the CPG sector, the CPO at a multinational cosmetics and personal care company – speaking exclusively to Procurement Leaders in February 2019 – warns the global risk landscape

"Now it is a matter of looking upstream and working out exactly how and where a product is manufactured"

UNDERSTANDING RISK IS KEY TO MANAGING UNCERTAINTY

Respondents to Procurement Leaders' *CPO challenger guide 2019* identify geopolitical uncertainty as the biggest supply chain risk procurement professionals face. The report noted that top-of-mind issues for procurement chiefs include deteriorating trade relations between the US and China, as well as ongoing uncertainty around the UK's departure from the European Union.

Respondents consider supplier financial difficulties to be less of a risk, ranking this seventh among supply chain risks for the year ahead. This is potentially surprising given current geopolitical uncertainty, interest rate rises and the fact many consumer brands face financial difficulties. CPOs are likely to think differently, however, if more firms go into the red and interest rates continue to rise. The report advises that the key for procurement chiefs will be to ensure they know where risk can affect their functions as a result of these events.

"Procurement chiefs must understand any threat and plan to mitigate its effects. Aside from these major events, it is also important for CPOs to be aware of smaller 'microrisks' that may strike at any time to devastating effect. Understand the risks to which the organisation is exposed and take steps to mitigate such risks – a fire at a supplier factory or a labour dispute could stall a whole supply chain and many functions are underprepared for such events," the study noted.

"While respondents perceive geopolitical uncertainty to be the greatest supply chain risk in 2019, procurement chiefs should not ignore risks such as fires and industrial action, which may be equally disruptive."

Fig 1: Greatest supply chain risks, 2019

RISK	RANK
Geopolitical uncertainty	1
Supply disruption	2
Supplier non-compliance	3
Tariffs	4
Currency volatility	5
Commodity volatility	6
Supplier financial difficulties	7
Natural disasters	8

Source: Procurement Leaders CPO challenger guide 2019

is "moving by the day", identifying Brexit and tariff wars as the most pressing concerns.

"You have strikes, *forces majeures*, tariffs, Brexit, as well as inflationary commodities to deal with. It's definitely a very interesting environment for procurement, with all these things combined together in a way we have not seen before. There is a lot of talk about Brexit and tariffs but I think there are a lot of similarities between both of those things."

According to the cosmetics and personal care company CPO, procurement leaders should focus on understanding their supply bases more completely, particularly in the context of their sources of supply and the countries in which their products are manufactured.

"This is moving more to the forefront of what procurement is focusing on. Whereas whatever showed up on our dock was fine in the past, now it is a matter of looking upstream and

working out exactly how and where products are manufactured.

"It has been an eye-opening exercise. In the past, it might have been acceptable to take the view that products could simply be sourced from China but now it is vital that procurement can truly understand the location of all the factories of origin and suppliers' capabilities. This is a key component for procurement – more than it ever has been historically."

A second key focus in the CPG CPO's current risk strategy is to improve procurement's understanding of the footprint of suppliers. If a supplier has a factory in Italy, China or Taiwan, for example, it is important to fully scope the location and relative capacity of these facilities. Procurement also needs to know if this supplier is capable of moving specific manufacturing between these countries. It is about really drilling down to understand a supplier's – or potential supplier's – global capabilities.

It is also becoming increasingly important for procurement to develop the ability to understand the economics related to the cost of supply from each such geography. "What are the relative costs of labour in Italy compared with China, compared with Taiwan, compared with Germany? Understanding all these macroeconomic factors becomes much more relevant," says the CPG company's procurement chief.

"Historically, we knew it was out there and it was something we had to consider, but now it is at the forefront of how we operate. The big lesson is understanding the supplier's qualification. It is about understanding the size, the scope, the manufacturing footprint: all these things have become ever-more important to us now than they were previously."

SUPPLY NETWORKS

Deepika Rana, president, supply chain solutions at Li & Fung, a Hong-Kong-based supply chain management company, agrees that building additional flexibility into globalised supply chains is key to coping with today's challenging economic and regulatory backdrop.

"We are focusing on moving away from a supply chain to a flexible supplier network. As the geopolitical environment becomes tougher in the country of production, there has to be a network we can rely on. It cannot be a chain. In a network, one element does not precede or succeed any other. It has to function simultaneously and it has to be dynamic. On the supply side, the flexibility of having what we call a 'borderless sourcing model' is really important to minimise the impact of any trade wars, natural calamity or political disruption that might suddenly arise in a particular country and stymie production," she says.

Rana advises procurement teams should address a number of elements on the sourcing side to improve their flexibility. Procurement leaders need to implement a flexible production and sourcing model, which includes timelines and trigger dates, and enables buyers to seamlessly switch their focus from one country to another. "One way we've done that in the supply side is by having regional hubs. If, for example, you have a South-east Asian hub, there is a conglomerate of countries you can move between. If you have an Indian subcontinent hub and if there is a problem in Bangladesh, you can move to India or vice versa. So, this is one way to keep regional sourcing borderless. I think this is important as the political, trade and tariff models become more volatile."

She stresses that, on the demand side, it is important for procurement – particularly in retail businesses – to respond as quickly as possible to dynamic buying patterns. So how does the function respond quickly to source more product than was originally ordered when demand spikes? And, on the flip side, how does procurement respond in an agile fashion when something is not selling and the retailer finds itself with excess supply sitting as inventory across a store?

"On the demand side, it is important we respond quickly to changing buying patterns. It is basically a push versus pull model. It is about giving enough flexibility in how you are managing the supply chain to be able to pull inventory as you need it and balance what is being manufactured to suit what your retailer demands. That is what I mean by flexibility: the steps you need to take centre on analysing supply and demand and then working to reduce the cycle time between development and final

"The flexibility of a 'borderless sourcing model' is important to minimise the impact of any trade wars, natural calamity or political disruption"

shipping. In the past, there was typically a six- to eight-month cycle. Now, we are looking at monthly cycles that enable the retailer to respond to demand more flexibly," Rana adds.

ACCELERATED DEVELOPMENT

The personal care CPO is being subjected to a similar pronounced contraction in product development/ shipping cycles throughout the company's operations.

"We used to have this model in which we could take 18 months to bring something to market. Now we have to do it in six months; it's a very different environment today than it was just two years ago," he says.

"We have to get suppliers to start making products for us more quickly and, in some cases, we don't have time to get everything fully vetted. So, now we go to them with a letter of intent. Letters of intent are becoming more prevalent, and the contractual legal language around them is becoming much tighter as we have to bring more product to market more quickly."

Key performance indicators the personal care company CPO is "relentlessly" pursuing centre on improving spend under contract with suppliers, with the aspiration of reaching 100% spend coverage in the medium term. The second prerequisite to manage risk focuses on tightening up the language the company uses in its documentation to eliminate potential legal liability, a process the CPO describes as the "battle of the forms".

"When we send a purchase order to the supplier we now have very specific language related to responsibilities, limited liability, responsibility related to not fulfilling orders and potential responsibility for any financial liabilities we may incur as a result of them not performing the task. So, we have already strengthened things from that perspective. But I think there's another level that we can reach. We

INCREASING THE FOCUS ON FINANCIAL RISK

One of the most pressing risks procurement organisations currently face in the prevailing harsh macroeconomic climate is financial, and centres on both foreign exchange volatility and interest rate volatility, supply chain experts have warned.

Over recent years, procurement teams have contended with a relatively high level of forex volatility – particularly between the renminbi and the US dollar. The yuan (CNY) reached a peak in the region of CNY 6.25 to the dollar in autumn 2015. The value of the currency has since fluctuated – moving down to 6.90, and then back up to 6.50: representing a 10% range over that period.

Lian Hoon Lim, an AlixPartners managing director in Hong Kong, notes such volatility is hitting manufacturers hard because, as the value of the yuan decreases, manufacturers are actually paying more as many raw materials hold their international value.

"Depending on the product being made, raw materials/components costs as a proportion of ex-factory could vary quite a lot: as high as 80% in electronics and going down to 40% in highly labour-intensive products. So that's why I say exchange rates are a significant risk for procurement. They are yo-yoing and your average manufacturer is struggling to need to truly understand the additional levers we can exert. I think we have pretty good limitation, liability and identification provisions so we are in a pretty good place there. I believe this makes you focus a little more on that language with the legal group. That never happened to us before."

RISK/REWARD

Although the current heightened economic and political risk milieu is creating significant headaches for CPOs, experts note savvy procurement professionals can use the uncertainty to their advantage in certain circumstances.

"We are rightly talking about risk, but it is not only risk. There is also opportunity. The prices that you can get in China for certain commodities have started coming down. Why is that? It is because suppliers begin having overcapacity," says Manuel Backhaus, a managing director at AlixPartners in Germany.

"Buyers in China should go after their suppliers because the market is getting weaker at the moment. We see that US companies, in particular, have become more careful in giving new business to Chinese suppliers. So, as a consequence, there is an opportunity for European companies to get good deals from suppliers seeking to compensate for that loss of business," he adds.

"You need to manage risk well. But, if you just look at the risk and your buyers lean back and do nothing, you might end up only experiencing the disadvantages. The downside comes automatically, the tariffs come automatically but the advantages – you need to actively go after them."

The personal care group CPO's shares this view of qualified optimism, arguing that against the prevailing background of macroeconomic turbulence it is time for procurement to demonstrate its value to the business as a whole. "In many organisations,

cope with them, running around looking for alternative sources."

It is not only forex volatility that may potentially reap havoc with procurement budgeting over the coming years. While respondents in Procurement Leaders' *CPO challenger guide 2019* ranked financial difficulties relatively low as a perceived risk to supply chains this year, the historically low interest rates that were imposed to stimulate growth after the 2008 global financial crisis are finally inching up, raising the ugly spectre of companies that have gorged on cheap credit suddenly finding themselves in financial trouble and unable to service their debt obligations. If this happens, it could lead to multiple bankruptcies, which in turn would cause extensive damage to global supply chains.

One Scandinavian energy company, for example, has established rigorous supplier onboarding and monitoring processes. The organisation's procurement team leader of portfolio wind projects told Procurement Leaders in 2018 their team works most closely with the credit risk team to ensure exposure to supplier financial risk is carefully analysed at the prequalification stage. It is only when a positive recommendation has been made that procurement will move onto any kind of tender or negotiation.

procurement is a background hum. I think this is an opportunity for the function to demonstrate what it can deliver to the business in these challenging times. We have tariff wars, Brexit, *forces majeures* that have been declared, we have got strikes and political unrest. With all these things coming into play, it is very enlightening and testing for the leadership team, but it highlights the value of procurement," he says.

"You need to look at the balance of risk. Although nobody can predict with any certainty what will happen in the future, you have to look at all of the supply and manufacturing factors, political and economic risks and, most of all, procurement has to be ready. You cannot do nothing. That is the first thing. Your strategy cannot be hope.

"You have to come up with a plan. For me, the plan must incorporate the worst-case scenario – you have to map and plan for the absolute worst that can happen politically and economically, and plan for it happening forever."

ABOUT OUR PARTNER

AlixPartners is a results-driven global consulting firm that specializes in helping businesses respond quickly and decisively to their most critical challenges – from urgent performance improvement to complex restructuring, from risk mitigation to accelerated transformation. These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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PROCUREMENT LEADERS

Published by: Procurement Leaders Ltd
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