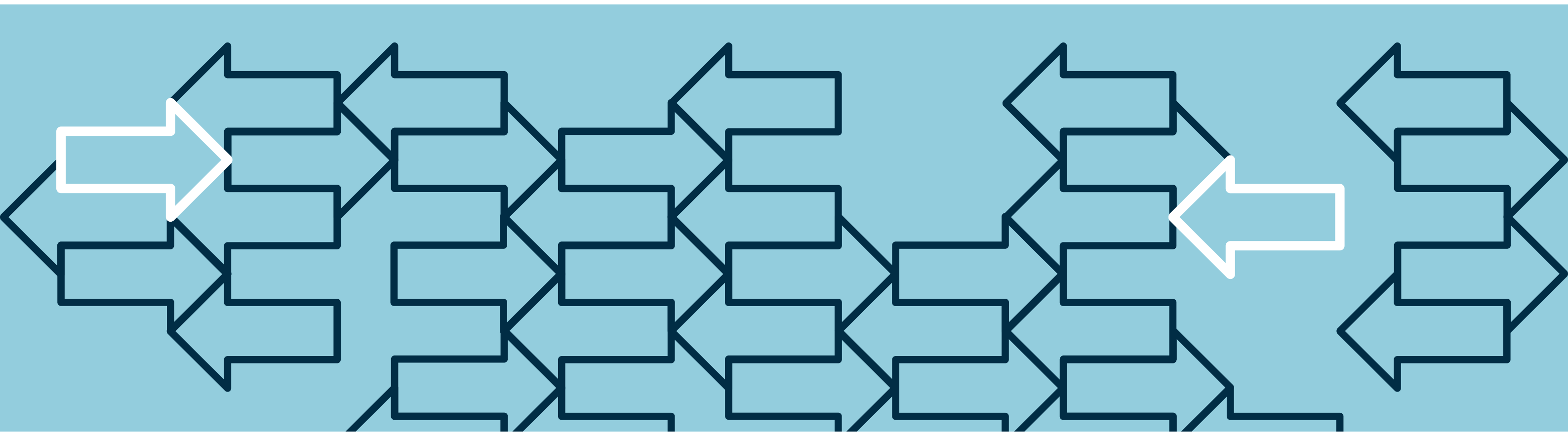
MAY 2018

Rough seas ahead for procurement



For the past decade, we have enjoyed a favorable environment for procurement. Why? During periods of overall disinflation, negotiations with vendors to lower costs are relatively straightforward, leading to easy wins for procurement teams.

However, we are seeing rising inflationary pressures for the next 18 to 24 months. We anticipate some sectors will see mild inflation, although for others, increases are likely to be dramatic.

Companies that navigate these changes in a proactive way will pull ahead from their competitors and be best positioned to weather the coming storm.

HOW WE GOT HERE: FAIR WINDS AND FOLLOWING SEAS

Various factors drove prices lower over the past decade. Trends toward increased global economic integration and the spread of new technologies combined to hold down inflation by reducing wage pressures, increasing productivity, and encouraging competition. In addition to these secular trends, the 2008 recession and the relatively weak economic recovery that followed also reduced price pressure in many sectors, particularly in commodities.

The globalization of the world economy has been characterized by increased international competition, falling international tariffs, and the relocation of manufacturing to lower-cost countries. These factors have contributed to making markets more efficient and reducing relative costs. Unsurprisingly, then, those industries whose supply chains are most exposed to the effects of globalization have seen the largest relative cost reductions over time.[1]

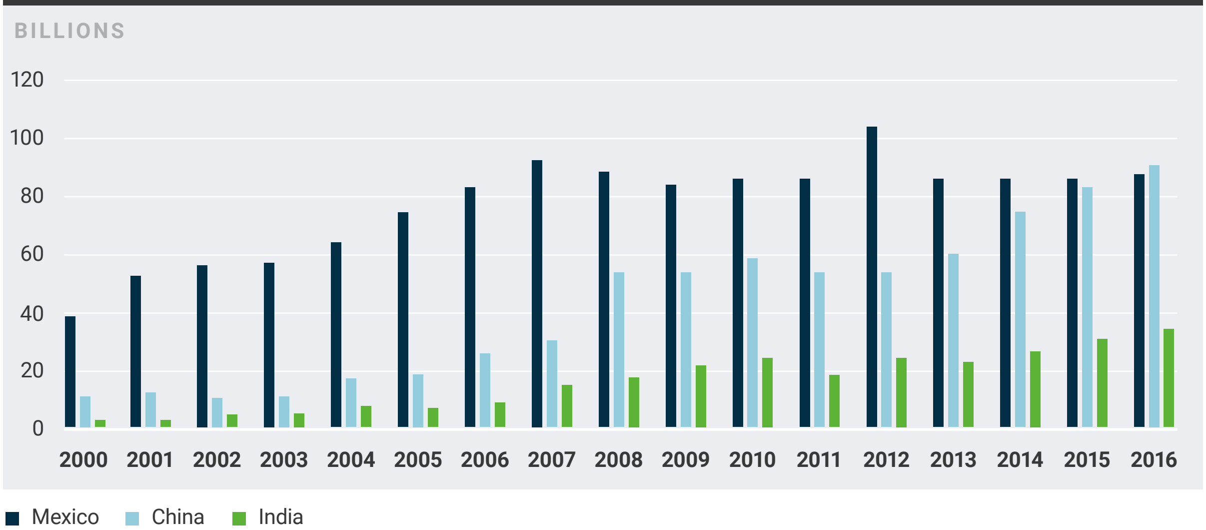
Since the 1990s, the reintegration of China, India, and the former Soviet bloc into the world economy has more than doubled the effective global labor force from about 1.5 to over 3 billion people, and simultaneously, the costs of moving goods, services, and information have fallen dramatically. Manufacturers have taken advantage of this opportunity by relocating production to lower-cost countries.

[1] International Monetary Fund, 'World Economic Outlook: Globalization and Inflation,' April 2006.

While an imperfect measure, foreign direct investment (FDI) by US multinationals demonstrates, at least directionally, that such activity has soared in recent years. For China, FDI increased by 733% between 2000 and 2016. Over that same period, US FDI in India went up by 1,271%, and more than doubled in Mexico (figure 1).

Economists point to the segmentation of the supply chain, through a combination of outsourcing and offshoring, as a significant factor in explaining recent reductions in producer prices, and their lack of correlation with consumer prices since 2000 (figure 2).[2]

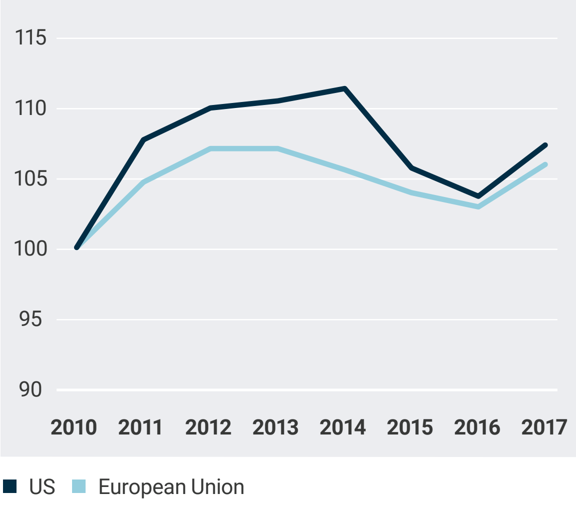
FIGURE 1: US FOREIGN DIRECT INVESTMENT: MEXICO, CHINA, AND INDIA



Source: Bureau of Economic Analysis, US Department of Commerce
Note: US direct investment abroad on a historical-cost basis

[2] See, for example, Shang-Jin Wei and Yinxi Xie, 'On the Divergence Between CPI and PPI as Inflation Gauges: The Role of Supply Chains,' National Bureau of Economic Research Working Paper Series, February 2018.

FIGURE 2: PRODUCER PRICES IN MANUFACTURING; US AND EUROPEAN UNION



Source: Organization for Economic Cooperation and Development
Note: 2010 = 100

Advances in technology have also increased productivity and lowered costs for businesses and consumers. Robotics automation, artificial intelligence, and other process enhancements have significantly reduced expenses across many industries, automating low-skilled tasks and allowing a fewer number of workers to focus on higher-value-added activities.

The traditional business models of many industries are being disrupted by technological innovation too, putting a cap on the ability to pass price increases on to consumers. For example, in the business-to-business space, the e-commerce giant Alibaba has already revolutionized the way smaller businesses source products, displacing smaller, local suppliers, and allowing access to a global supply chain.

Meanwhile, Procure2Pay systems such as Ariba, Coupa, and Emptoris have provided transparency on the requisition, receiving, and paying of goods and services and have improved internal controls, giving procurement teams further leverage when negotiating with suppliers.

Adding to these longer-term trends, the Great Recession of 2008 reduced aggregate demand across the globe and caused commodity prices to decrease. This deflation in commodity prices occurred despite the aggressively expansionary monetary policies of the world's central banks. The Bloomberg Commodity Index tracked an annualized return over the past 10 years of -8.4% for a broad basket of commodities (figure 3).

Looking at individual commodities, energy prices fell the most, with crude oil prices dropping 54% from 2008 to 2016, and natural gas by 70%. Certain metals also fell dramatically over the same period: nickel by 53%, aluminum by 36%, steel[3] by 32%, and copper by 28%.

In this environment, it was straightforward helping companies across a range of industries reduce their procurement expenditures by 9 to 12%, with those just embarking on these efforts achieving upwards of 12 to 18% savings.

FIGURE 3: COMMODITY PRICES, 2008 TO PRESENT

Source: Bloomberg Commodity Index BCOM Index

[3] North American hot-rolled coil steel.

ON THE HORIZON: STORM CLOUDS

While certain secular trends, such as technological innovation, may continue to keep a lid on pricing behavior, other factors are shifting the balance of power back to the vendors, and the procurement team must be prepared.

The prior trend of globalization, which contributed significantly to the disinflationary environment, has encountered serious obstacles recently and is likely retrenching. We have already seen the opening shots of protectionism and nationalism. In March 2018, the United States proposed tariffs on imported steel and aluminum, from which a number of countries (largely US allies) would be exempt (at least for a period of time), as well as additional sanctions on $150 billion of Chinese exports. In retaliation, the Chinese government has threatened to impose 25% duties on a number of targeted US exports.

This potential trade war, with its threat of an escalating cycle of trade restrictions and retaliation, is selectively increasing manufacturing costs while at the same time tamping down demand. The US administration has even acknowledged that there may be 'a little pain' from rising tariffs.[4]

Combined with punitive actions taken against Russia, prices in commodities targeted for sanction have been rising. After initially falling, aluminum prices reached a six-year high on the London Metals Exchange in April 2018, up 20% from the announcement of US sanctions on March 1.[5] Prices for thin-gauge-foil aluminum, which is only produced in China, have gone up three-fold (figure 4). Steel prices rose about 3% over the same period, and certain steel products have increased at double-digit rates (figure 5). Similarly, following China's retaliatory actions on March 27, soybean prices are up by about 2% (figure 6). In its April 2018 survey of current economic conditions, the US Federal Reserve repeatedly cited concern from business leaders about the impact of tariffs on their input prices.[6]

FIGURE 4: ALUMINUM PRICES

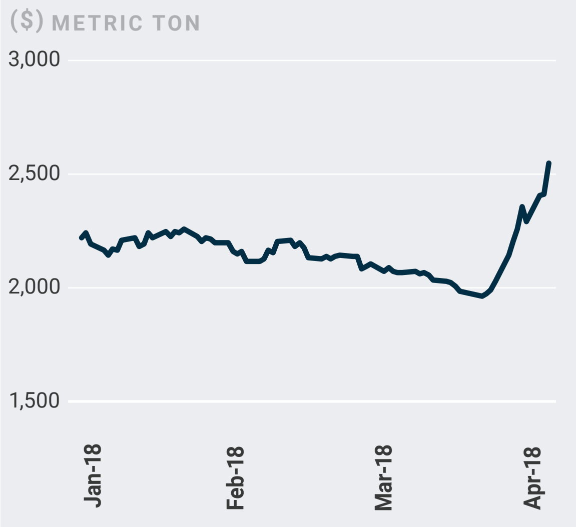


FIGURE 5: STEEL PRICES

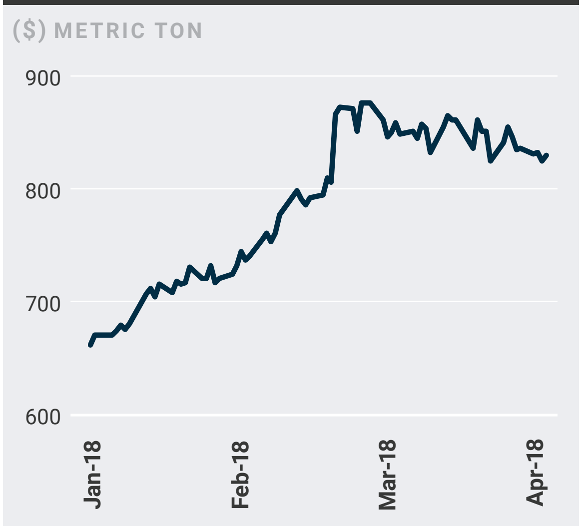
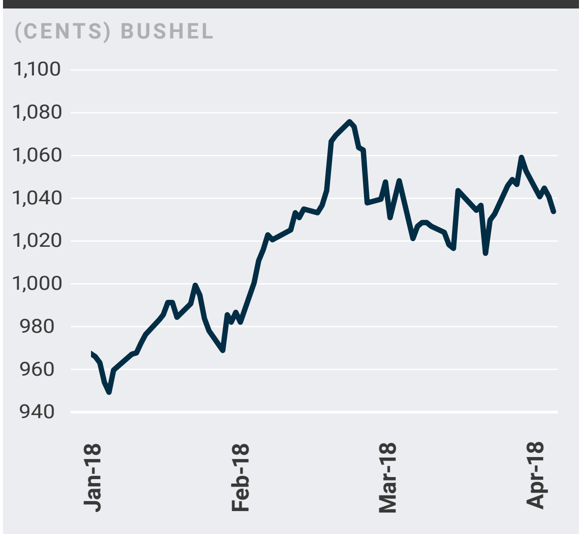


FIGURE 6: SOYBEAN PRICES



Source for all: Bloomberg

[4] 'Bernie and Sid In the Morning Show,' WABC radio, April 6, 2018.

[5] All prices as of April 18, 2018

[6] Federal Reserve, 'The Beige Book: Summary of Commentary on Current Economic Conditions by Federal Reserve District,' April 18, 2018.

Unrelated to the potential trade war, driven in large part by strong global economic conditions and supply constraints in certain sectors, businesses report paying more for other raw materials, as well. The Bloomberg Commodity Index is up over 6% from this time last year. Brent crude prices topped $69 a barrel on April 18, 2018, a three-and-a-half year high (figure 7). Nickel prices have risen some 35%, and Zinc and Copper are each up 17%, from their lows (figures 8, 9, and 10).

FIGURE 7: OIL PRICES

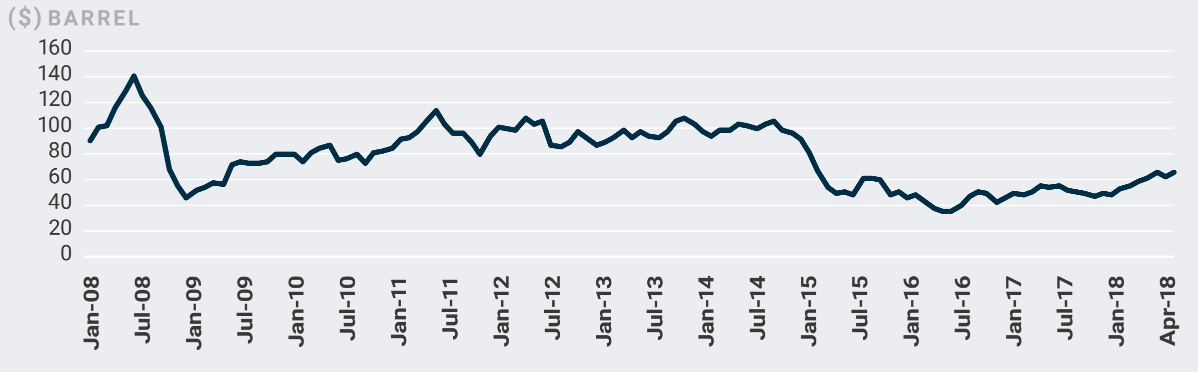


FIGURE 8: NICKEL PRICES

FIGURE 9: ZINC PRICES

Source for all: Bloomberg

FIGURE 10: COPPER PRICES

Source: Bloomberg

Demand for certain manufactured goods and services is also very strong. The cost of some specific electronic components, for example, has skyrocketed. Demand for capacitors, resistors, transistors, and other components has increased as the Internet of Things (IoT) has driven these technologies into everything from automobiles, to medical devices, to utility grids and meters, to toys and gaming devices (just to name a few examples). Supply constraints have also become a factor as consolidation within the technology industry, generally, and the semiconductor sector, specifically, has reduced competition amongst suppliers.[7] The rise in commodities prices which make up a large part of the material cost for these components has also impacted suppliers.

Microchip prices are rising for the first time in years. DRAM prices went up by 40% in 2017, and while they may slow, prices are projected to increase in the single digits in the first and second quarters of 2018.[8]

Separately, as the benefits of globalization lift the standards of living for the workforces in lower-cost production centers, labor markets there are becoming tighter, and costs are rising. For example, nominal wages in China rose by 42% during the five years from 2012 to 2016.[9] While less dramatic, India also saw nominal wages go up by 13% from 2012 to 2014 (the last year for which data is available).[10] And if companies are considering moving production to even-lower-cost countries, there are few with sufficiently large and educated labor pools from which to choose.

And in the developed economies, a tight labor market (figure 11) is nudging wage inflation higher as well. The Organization for Economic Cooperation and Development (OECD) reported in March 2018 that "firms [are] increasingly reporting labor shortages as a constraint on production and raising expectations of future prices."[11] This is more acute in some industries, where the available talent pool for those with necessary, specialized skills is shallow. Wages in the United States increased 4.5% in February 2018, year over year.

7 Barbara Jorgensen, 'Allocation 2017: What's Behind the Component Shortage,' EPSNews, November 16, 2017, https://epsnews.com/2017/11/16/allocation-2017-whats-behind-the-component-shortage/.

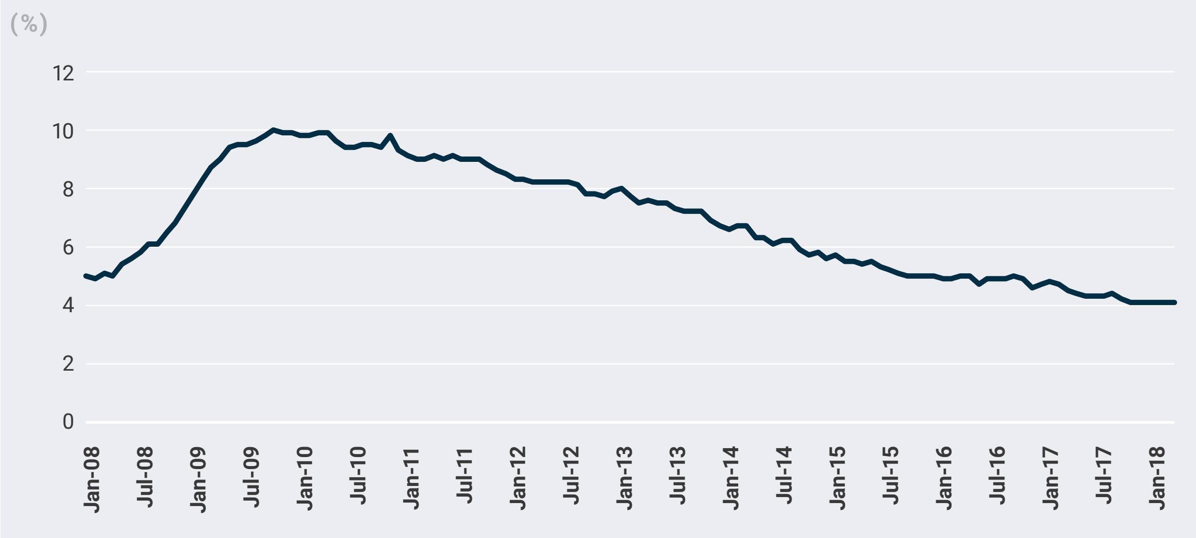
8 Gina Roos, 'DRAM Price Hikes Will Continue to Slow in Q2,' EPSNews, February 28, 2018, https://epsnews.com/2018/02/28/dram-price-hikes-will-continue-slow-q2/.

9 Tradingeconomics.com and Ministry of Human Resources and Social Security, China, https://tradingeconomics.com/china/wages.

10 Tradingeconomics.com and Labour Bureau, Government of India, https://tradingeconomics.com/india/wages.

11 OECD, 'Interim Economic Outlook,' March 13, 2018.

FIGURE 11: CONSTRAINED LABOR SUPPLY: US UNEMPLOYMENT RATE



Source: Bureau of Labor Statistics, US Department of Labor

WHAT YOU CAN DO: SAILING IN HEAVY WEATHER

Given these trends, now is the time to prepare for a more inflationary cost environment. Broadly speaking, there are three levels of activities that a proactive Chief Procurement Officer (CPO) should be undertaking. Each of these steps increases in level of complexity and execution risk.

Step 1: Reef the sails

- Actively communicate with key executives and business owners about potential cost increases that may be coming. Discuss the overall environment and factors which may be driving up costs in the future. A clear and ongoing communication strategy will ensure management is not surprised down the line and allow for more effective risk management.
- With the business owners, consider ways to reduce costs by improving production methodology or by lowering product specifications. Explore strategies, such as cost workshops, zero-based budgeting, and the appointment of a spend czar, to temper demand and consumption of goods and services.
- Engage with the finance team to explore potential hedging techniques through either financial instruments or via customer contracts.
- Work with the warehouse team to employ dynamic inventory management: increase inventory levels for goods as price trends increase, and decrease inventory levels as price trends decrease.
- Proactively reach out to key suppliers to start reinforcing and enhancing the relationships to start the battle for the hearts of suppliers. This is also an ideal time to begin exploring new vendor relationships to find new lower-cost suppliers.

Step 2: Batten down the hatches

- Begin entering into longer-term contracts with fixed pricing. We have seen vendors reduce prices by 2 to 6% by extending contracts by two to three years.
- Increase two-way communication with suppliers. Explore ways the company can modify its business practices to make things more efficient for the vendor and then share in the cost decrease.
- Institute a price increase approval process with vendors to delay the actual price increase for as long as possible. This process would include written justification, duration of increase, and key performance indicators for price reduction.

AlixPartners worked with one industrial client on reducing the purchasing cost of batteries. Through a limited request for proposal process, our client was able to consolidate its business with one vendor, gaining a volume consolidation discount, while also identifying a new vendor in Asia that offered very competitive pricing for new products. Through this process, they have been able to achieve approximately 10% savings on battery purchases since 2016, despite a 40% increase in lead pricing (the primary material cost in batteries) over that same period.

Step 3: Run downwind

- Aggressively trim smaller vendors to consolidate the supplier base by each category in order to increase negotiating leverage and press for lower rates.
- Institute a 'champion/challenger' model for all key categories with 70 to 80% of the business going to the champion and the remainder going to a single challenger. This will keep both parties hungry. The champion and challenger should also be rotated periodically, though not too often as business disruption is also costly.
- Search for new suppliers and give new suppliers a chance to prove themselves if the pricing is better than the incumbent. Potentially try a new vendor as the 'challenger' (or as a second 'challenger') to balance disruption with cost savings.
- Execute a 'cost-to-price' initiative. Assemble a cross-functional team to help quickly understand the direct relationship between input-cost inflation and necessary customer price increases to maintain or improve product margins. For global companies, this should be done on a country-by-country basis with key performance indicator heatmaps to ensure proper indexing of price inflation.
- Hold a supplier conference in which the suppliers are given indicative cost reduction targets and asked to come and present to the company their ideas. This demonstrates a commitment to the relationship and working together to solve pricing concerns.

The reality is, the calm seas we have enjoyed for the past decade are ending. Prices are set to rise, and in many cases already have. Unfortunately, we cannot go back in time, and there are no panaceas. However, with communication and a proactive and coordinated strategy, the CPO can prepare for the coming instability. The winners of tomorrow will be determined by their planning today. **A**

CONTACT THE AUTHOR:

Clifton Wessels-Yen
Managing Director
+1 212 845 4033
cyen@alixpartners.com

FOR MORE INFORMATION, CONTACT:

Manuel Backhaus
Managing Director
+49 211 97 55 10 47
mbackhaus@alixpartners.com

Sanjay Shetty
Managing Director
+1 248 262 8446
sshetty@alixpartners.com

Andrew Bergbaum
Managing Director
+44 20 7098 7454
abergbaum@alixpartners.com