In a high inflation context, back to basic supplier squeeze or more supplier management?

The Temptation

Today, most organizations face increasing prices across the board. Inflation rate has almost doubled since its recent low. When their objectives were set, at the end of 2006 or the beginning of 2007, the Euro area HICP overall index had, in October 2006, reached 1.56, its lowest point since the beginning of the century. Since August 2007, it has sharply increased from 1.75 to 3.1[i]!

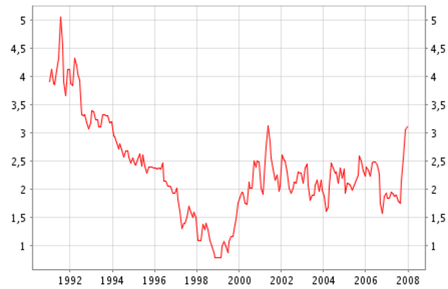

Figure 1 : European HICP overall index monthly variations

To meet their objectives, the first reflex of many supplier management professionals (and the accountants measuring their performance) has been to pressurize their suppliers for price concessions, to refuse price increases and to launch aggressive tactics to contain the invoiced cost inflation, and the deviation versus the dreaded "standard price". What is the likelihood that those strategies pay? Let's evaluate where the gains can come from, depending the situation of the buyer.

If cost reduction has not been a priority in recent years, that approach is a sure win, but the inflationary pressures have nothing to do with it. It is the case when suppliers are still mainly local, historical vendors, even if alternatives in lower cost countries exist. Simply applying pressure on the suppliers is probably the first step in the transformation of the Purchasing Department into a modern supplier management team. To build on those successes, the CPO must then move to "intelligence based negotiation", where rigorous global market analysis and total cost of ownership understanding will bring the long term control over costs and launch a sourcing effort to identify then qualify more cost efficient suppliers.

On the other hand, if cost reduction has been a priority for years, what could be the gains of a more aggressive approach to negotiation? Can gains similar to those of the early years of modern purchasing be repeated? Where did those gains come from?

- The push to source in low labor cost countries and the subsequent capacity build-up and production transfer to those countries.
- The efficiency increase across the supply chain: in the user factories, in the supplier's factories and in the logistics system. Those productivity increases have reduced waste, shorten lead time, and improved productivity of labor, capital, raw materials and energy.
- Innovation that brought new skills to manage efficiently, new tools to produce differently. It has been illustrated spectacularly in IT but it is not limited to that field. In every area, new

solutions have been developed to eliminate waste, smoothen processes, reduce energy requirements, reduce workload, etc.

The first two of those opportunities are not available anymore. Low cost countries have been turned into giant manufacturing sites; today those countries feel a shortage in some labor categories. Productivity has grown significantly since the mid nineties, but this growth is decreasing today. For instance, the US non-farm business productivity has increased until 2003 but appears to be decreasing now (Figure 2[ii]

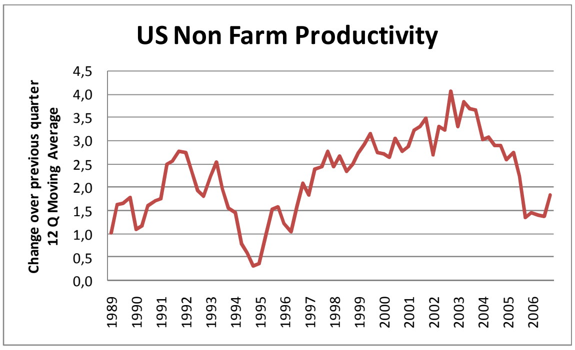

Figure 2 : US Non Farm Productivity quarterly variation 12 months average

Competition, and supply and demand economics have probably already pushed the supplier's profit margins to the minimum acceptable long term return. If prices can be pushed down, where is the source of productivity? Commodity manufacturers have already pushed cost cutting to the limit. The threat of moving business can convince suppliers to cut cost will only work if they can themselves push that burden to others, an action most took already. What's left is de-featuring by lowering quality or service, reduction of fixed costs like research, or reduction of profit margin below long term sustainable rate of return.

History can help us predict the result of this approach. If we look at GM, one of the best known "aggressive negotiators", we will observe that important suppliers like Michelin refused to work with them[iii], and that the suppliers that stayed with GM decreased their R&D spend allocated to GM every year, while increasing the spend allocated to GM Japanese competitors[iv]. GM purchasers satisfied the accountants measuring their performance, but kept losing market share and saw the company operating efficiency falling behind the performance of its competitors.

Ultimately, the logic behind a "high pressure negotiation tactic" is that the Purchasing team has not done its work properly in the previous years and therefore must increase its efforts to capture the money left in the pockets of the suppliers, or change for better performing suppliers. But we know that for the past 20 years, the Purchasing Science has evolved significantly, from basic negotiation, to integrated resource management. Less intelligence and more brute force will not solve the issue. Moreover, brute force may be an option for a very large operator, but hardly a guaranteed success for a medium sized company.

The Call for Systemic Supplier Management

Advanced purchasing organizations will take another approach. They will assess, correctly, that the inflationary pressures are caused by fundamental economic factors rather than the ineffective purchasing negotiation approaches that were commonplace 20 or 30 years ago. In the last 20 years, international exchanges have been multiplied by five. Exports from China alone have been multiplied by 20! Twenty years ago, minimal sourcing efforts allowed identifying low cost suppliers that were either located in lower labor cost countries or were ready to outsource to those countries. That effort to identify low cost components has continued relentlessly since those days, leaving little opportunity for further LCC sourcing. Additionally, those countries face energy and raw material inflation like all operators, but also skilled labor shortage. Finally, the increasing attention on practices deemed unacceptable by their clients, in labor relation, in environmental practices, in adherence to specifications, will increase the costs of the compliant suppliers in LCC.

Today, the productivity improvements are generated by chasing waste and inefficiencies, rather than switching the sources of components. Smart purchasing organizations will obviously be as vigilant as any to counter the inflation trends, but their methods will be different. Obviously, they will not accept price increases without a fight, but that fight will not be misguided against their suppliers. Yes, they will use their detailed knowledge of the products and services they buy to assess the legitimate cost increases, factoring in not only the inflation in raw materials but also the learning curve, the productivity improvements. Yes, they will compare that requested price increase versus what the market offers. But no, they will not transfer the problem to their suppliers. Rather, they will jointly identify the opportunities at hand and devise strategies to capture them.

They will also look at inflation in historical perspective: 2001 also saw a peak of inflation, but it was short lived. They will realize that all disruptions in the environment create opportunities for those capable to adapt. It never hurts to be assertive in explaining our objectives to our suppliers. But focusing all our efforts on pressurizing them into concessions that they cannot accept without either compromising the service they provide or their survival is neither productive nor sustainable. We risk losing the suppliers that refuse to serve us or the customers that find our quality decreasing. Indeed, reacting to inflationary pressures by returning to supplier squeezing is akin to consider the pair vendor-buyer in isolation rather than in a economic system going from the producers of raw material and basic services to the final users, with multiple economic systems competing for the same resources and the same users. Today, if there is raw material price inflation, it is fundamentally because too many users are chasing resources in limited supply, and because the efficient supplier management approach of recent years has exhausted many approaches to offset that inflation. This applies to basic commodities like energy, steel or soybean but also to qualified labor, quality service, specialized assembly skills, etc. This is a significantly different situation than twenty years ago when the Purchasing function emerged from the back of the factory to the limelight, where productivity could be gained by switching to better suppliers.

Conclusion

Therefore, facing renewed inflationary pressures, CPOs must increase their investment in "Intelligent Supplier Management" rather than returning to the brute force of Power Negotiation. They will chase inefficiencies by working collaboratively with their preferred suppliers, focusing their efforts to solve the same problems rather than fighting each others for the same stripped bone. The inflationary trends demand that productivity continues to improve. The changing prices demand new equilibriums between labor, raw materials, capital and transportation. Those new solutions will be developed more accurately and implemented faster by the most efficiently managed economic systems.

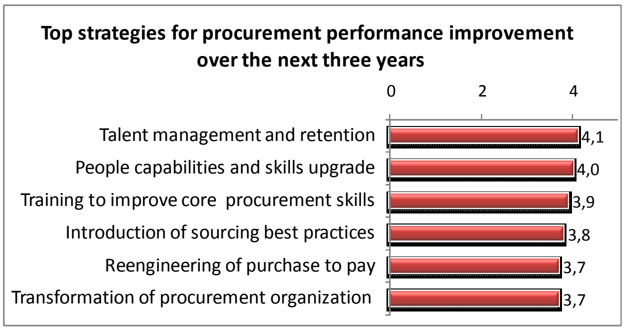

Figure 3 Performance improvement priorities in Procurement

To implement that approach successfully, CPO must continue to strengthen the capabilities of their teams from the basics, like negotiation and cost analysis, to the most entrepreneurial like supplier network leadership and strategic resource development for value and competitive advantages. Those purchasing entrepreneurs are also trained in soft skills, leadership, communication, etc. This has been recently identified by a survey of executives (Figure 3) about their strategies for Procurement performance improvement[v]. This will require that supplier management teams strengthen their approach to hiring and training, but also that more attention be paid to training in the fundamentals of supplier network management in business and engineering schools.

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Michel Philippart is a fellow of the Center of Excellence for Supply Chain Management, University of Louvain Business School and a Big Fish Associate. He has 20 years of experience in Purchasing and Supplier Management, starting in 1989 for Booz-Allen & Hamilton in Chicago and Paris. He joined PepsiCo's Frito-Lay International in 1994 to develop the international supplier management strategy. After 6 years with PepsiCo, he joined McKinsey Purchasing Practice as an Associate Principal, based in Geneva. Recently he led the successful transformation of Global Procurement at GSK Biologicals.

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[i] European Central Bank Statistical Data Warehouse, Euro Area overall index
[ii] US Bureau of Labor Statistics Series
[iii] "Michelin has reached the conclusion that its strategy is no longer compatible with General Motors' purchasing policy. Consequently, Michelin will not renew its original equipment tire shipment contract with General Motors Europe which expires on July 31, 2002 " Michelin First Half Results 2002 Press Release
[iv] Planning Perspectives Inc. Press Release, WRI 2007 results, June 4, 2007
[v] Source: IBM 2005 CPO Survey, IBM Institute for Business Value