Surviving and thriving in an economic downturn with supply management

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Forward

Companies operate in an increasingly global and competitive marketplace – and now are facing growing economic uncertainty. In the last economic downturn in the early 2000s, many companies simply rushed to cut costs and, as a result, made hasty decisions that ended up costing the company in the long run. As companies wrestle with the question of how to deal with an economic downturn, they should realize that the decisions they make today will impact how the company is operating in a year or two years time.

In the last 10 years, a meaningful number of Fortune 500 companies have gone out of business or otherwise fallen from the top 500 rankings. That is just one indicator of how quickly things can change in a dynamic business environment. Consider also that in that same 10 year period, over 600,000 American businesses of virtually all sizes filed for bankruptcy. Many of these companies were "walking wounded" at some point, but failed to take effective, timely action to combat the threats against them or turn around their poor performance.

There are too many examples of companies that have tried the 'quick and dirty' approach to cost reduction, only to find that their wins were not sustainable over time. CFOs, CPOs and top management need to think strategically and work collectively to manage spending and help ensure meaningful, effective action. Those who get lean intelligently now, can excel in the future.

In this white paper, a supplement to the book *Straight to the Bottom Line®: An Executive's Roadmap to World-Class Supply Management*[1], I will show you how to determine if your firm may already be among the "walking wounded," and share some reliable strategies to gaining corporate financial health using world-class spend and supply management.

The connection between CPOs and CFOs

Communicating and understanding the value that modern procurement organizations can deliver has often been challenging for procurement teams who historically have spoken a different language than their peers in finance and the executive office. The need for effective communication between procurement and their peers in finance takes on heightened importance in an economic downturn or recession.

To communicate effectively, instead of talking about a percentage spend under management or percent saved in a negotiation, procurement executives need to talk in terms that resonate with the CFO and CEO, so that they can gain the executive support and sponsorship needed to pursue strategic programs that can have a positive impact on the financial health of the business.

In this white paper, I explain from the perspective of the executive office the value that procurement can deliver. The paper lays out direct connections between world-class supply management and a company's return on invested capital (ROIC) and earnings per share (EPS). Understanding this connection is important for both procurement teams looking for the tools to communicate with the executive office – and for financial and operational executives looking to understand how their business can benefit from world-class supply management.

Concerns of c-level executives (CEOs, COOs, CFOs)

When I was a senior executive with two large corporations, I knew what was keeping me and my "c-level" colleagues awake at night. Today, as a consultant and advisor working with other firms and executives, I find that their drivers and concerns are about the same. Senior corporate officers tell me that they need to:

a) Meet or exceed the earnings expectations of Wall Street and their investors.
b) Achieve growth in revenues and earnings, and sustain that growth year-over-year.
c) Reduce the volatility in revenues and earnings and thus reduce surprises and risk.
d) Improve Return on Invested Capital (ROIC) and thereby reduce the amount of capital needed to fuel the growth of the business.
e) Create a business model that is difficult for competitors to copy.

One of the best kept secrets in the business world is that advanced procurement and supply management can impact virtually all of these senior management objectives—simultaneously.

ROIC as an indicator of health or trouble

In classic financial management courses, the professor will tell you that to enhance shareholder value you must achieve returns on invested capital greater than your company's cost of capital. The best-performing companies, and the best stocks over time, tend to be those that have ROIC greater than their corporate cost of capital.

The flip side of the equation is more sobering. When your ROIC is less than your cost of capital, the lifeblood of your firm is draining away—you are among the walking wounded. How fast your firm falls behind or dies will depend on how much of a shortfall exists between ROIC and cost of capital, and how much you have in financial reserves to fund that shortfall. In the absence of ROIC improving, the firm inevitably disappears.

ROIC is typically defined as earnings of the business, divided by the capital invested in the business. When you increase profits, that improves ROIC, and it also improves cash flow. When you improve capital utilization, that improves ROIC and cash flow. When you improve both profits and capital utilization, you create a powerful compounding effect on both ROIC and cash flow.

Obviously, then, ROIC is dependent on the profits of a business, in relation to the assets invested in the business. As we will see shortly, advanced procurement can have an enormously positive impact on virtually all elements of the ROIC equation.

With regard to the top-line of the income statement—the revenue line—success with customers is often heavily influenced by the effectiveness of your supply chain. How well do your suppliers work in tandem with your own organization? Getting the supply side in good shape can help to grow revenues and change the competitive dynamics in your favor. Just imagine the impact on your business if you could make it to market with new products months—if not years—ahead of your competition, and with a lower cost structure.

With regard to costs, in most companies more than 50 percent of the cost structure relates to procurement and supply chain costs. In spite of that importance, most senior executives do not know where to start to dramatically reduce those costs and improve their bottom line on a sustainable basis.

Further, with regard to the assets invested in the business, advanced procurement and supply management—working with the supply base—can have a significant impact on working capital levels, and on capital projects, thereby favorably impacting ROIC.

There are many strategies to address each of these important drivers of ROIC. We will take a look at each component strategy, and then show you the magnitude of what is possible. Then, we will address the specific topic of how you can put it all together into a successful transformation plan that can turbo charge your Return on Invested Capital and Earnings per Share—and make the difference in your company's future.

Advanced procurement can improve ROIC in many ways

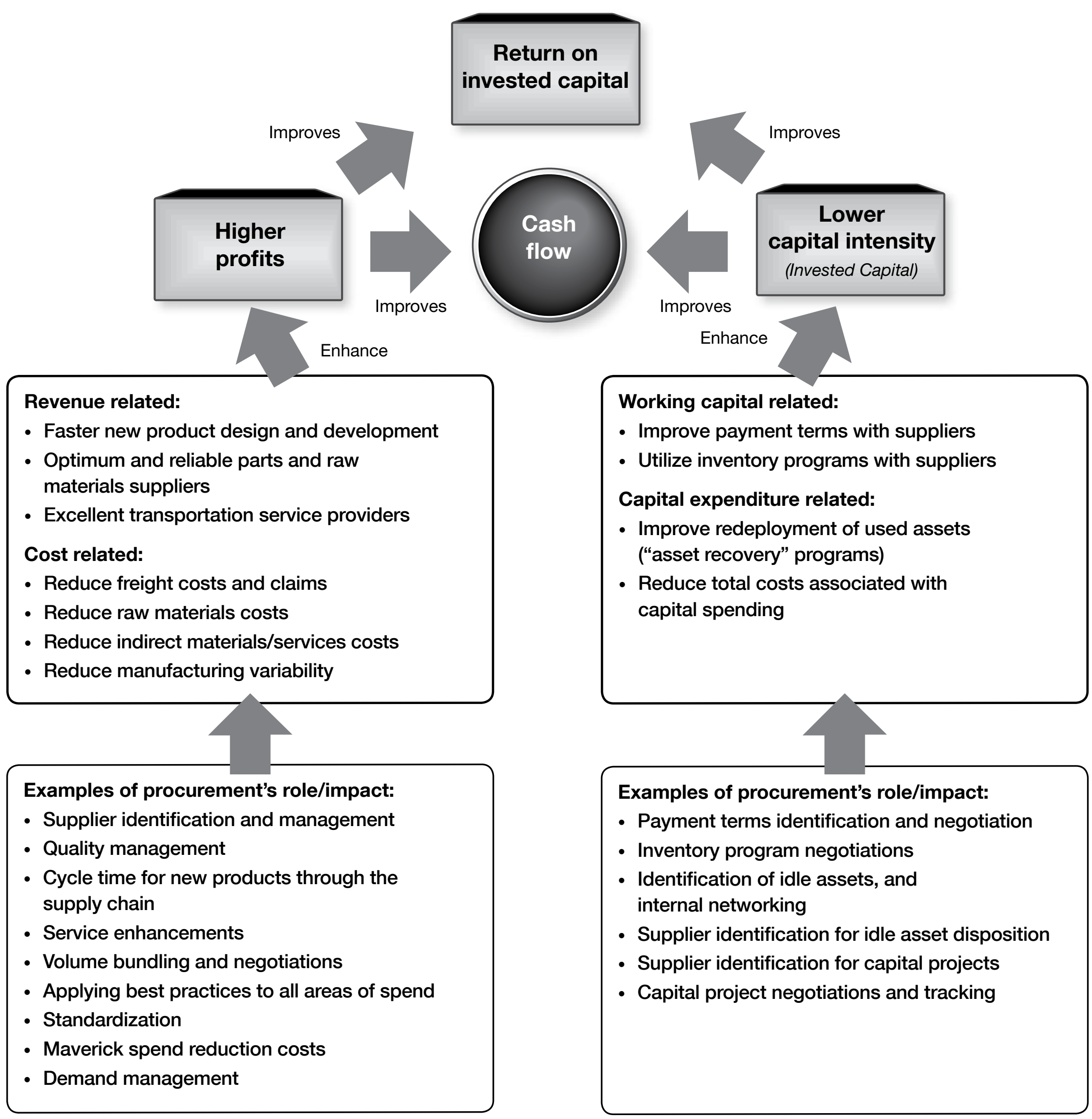

Figure 1: How advanced procurement can improve ROIC

Procurement strategies that can impact total business performance

In the last 20 years, world-class procurement departments have adopted new, powerful processes and tools to unlock and create new shareholder value, to accelerate change, and to create powerful supply chains with which their competitors are now trying to catch up. So, what are the key strategies that you need to know in order to add value to your bottom line?

When it comes to improving margins and profits, procurement can have an impact through initiatives that favorably impact revenues and other initiatives that directly target costs of the business. For example, on the revenue enhancement side, more companies are beginning to realize the value of working collaboratively with suppliers on innovation, and on reducing the cycle time from product concept through delivering that new product to the marketplace. With regard to costs, world-class companies view virtually all areas of spend as being within the scope of modern procurement practices (for example no category of spend is too "strategic" or off limits), and pay particular attention to reducing maverick spend and helping ensure compliance with negotiated contracts.

When it comes to improving the capital intensity of the business, procurement can have an impact through initiatives that favorably impact working capital—and initiatives that impact the total investment in capital assets. For example, payments terms offer enormous opportunity to add value and financial flexibility, by negotiating longer "net" terms, plus attractive discount options if you elect to pay early. Similarly, inventory programs offer the opportunity to free up significant working capital, and so-called "asset recovery" initiatives offer a disciplined approach to realizing value from under utilized or idle plant and equipment.

To summarize the framework we have discussed so far, advanced procurement—if given the right role, the right tools and adequate resources—can directly impact all four strategic drivers of ROIC.

What is the potential impact on my business?

Let us now take a closer look at the degree of impact that procurement can have in several key areas.

For example, what is possible in revenue support and enhancement? Consider the subject of new product development cycle time. Would reducing the time from product concept to shipping improve your competitive standing and win new sales? If you could reduce that cycle time by 50 percent and beat competitors in the marketplace, while also reducing total sourcing and manufacturing costs, would that be a plus for your business? For most companies, that would have a huge positive impact. Supply management, working closely with key suppliers, can help make this happen.

With regard to costs, the conventional wisdom is that procurement should focus principally on the "big ticket" areas of spend, such as raw materials and energy. Further, you certainly should devote attention to raw materials and energy—not just to reduce costs, but also to reduce volatility through better risk management.

However, if you focus only on the big ticket spend categories, you could be missing out on the enormous opportunities presented by virtually all other, indirect areas of spend. It is often possible to achieve double-digit reductions in costs for those indirect spend categories (see "Figure 2" page 6).

What is possible in cost reduction?

Category	Benchmarks
Raw materials	2 to 5 percent and better risk management
Packaging	10 to 20 percent
Indirect materials and services	10 to 20 percent
Information technology	15 to 30 percent
Professional services	8 to 15 percent
Logistics/transportation	7 to 15 percent
Media, marketing, promotional items	10 to 20 percent
Other indirects	5 to 15 percent
Capital projects	7 to 15 percent

Source: Straight to the Bottom Line®[2]

Figure 2: Possible reductions in costs for indirect spend categories

The bottom line is this: focus on both direct and indirect spend. Doing so can have a powerful effect on corporate performance.

A few years ago, I was interviewing the president of a major business regarding his impressions of the company's procurement activities. He offered some very specific advice: "Bob," he said, "we need to spend more time and effort on raw materials costs." I asked him why he said that. The answer was simple: "Because it is the biggest part of my cost structure."

I took out a pen and paper, and proceeded to sketch out the illustration you see on the chart on the following page. He suggested that he would be happy with a 2-3 percent reduction in raw materials costs. I said, let's shoot for 5 percent, which in my experience is achievable.

I then told him that for the so-called indirect spends (those things which do not become part of the physical product), it is often possible to achieve 15-20 percent cost reduction. I completed the math on the page, and his reaction was straightforward: "Let's get started!"

What is possible in cost reduction – The math may surprise you

Hypothetical manufacturer:	
Raw materials purchases: Assume 5 percent cost reduction:	**$ 1.0 billion** $ 50 million step change in cost structure
Indirect materials and services: Assume 15 percent cost reduction:	**$ 0.5 billion** 75 $ million step change in cost structure

Figure 3: Hypothetical cost reductions

With regard to working capital initiatives, modern procurement departments are including payment terms in their Requests for Proposals (RFPs) and are often pleasantly surprised by the responses. This can have a very meaningful impact on your business. For example, for each $1 billion of purchases, moving from Net 30 days to 45-1 percent-15 offers the option of:

a) taking the payment discount and improving earnings by about $10 million/year (minus the interest earnings on the cash used to pay early), *or*

b) the ability to grow accounts payable and cash by about $40 million, by paying in 45 days.

Similarly, including inventory terms in the RFP can offer suppliers the opportunity to show their creativity as well. Inventory programs with suppliers can free up tens of millions of dollars in capital for other purposes.

For capital projects, there is a direct correlation between the total costs associated with that project and the moment that procurement is involved. The message here is very simple: involve procurement and suppliers at an early stage to help optimize the total costs of virtually any capital project. I have seen it happen too many times. Well intentioned engineers and plant operators go running down the path of conceptualizing the project, and designing the equipment, before seeking virtually any input from their professional procurement colleagues.

Getting procurement and suppliers involved early in the process, even at the concept stage, makes it more likely that the best ideas are considered before it is too late, and that the commercial foundation for success is established before too many "technical details" are locked in.

An illustration of what is possible

I have been describing some of the impacts that advanced procurement and supply management can have in particular areas relating to improving profits, and improving the capital intensity of your business. Let us pull it all together with an illustration of an income statement and a balance sheet.

In figure 4, you will see a simplified income statement for our hypothetical manufacturing company.

Turbo charge your ROIC – income statement

	Pre-Transformation
Net sales	$ 25.00 Billion
Purchased goods/services	15.00
Other cost of goods sold	5.50
Gross profit	4.50
SG&A expenses	3.00
Depreciation and amortization	0.50
Income before taxes	1.00
Provision for inc. taxes	0.20
Net Income	$ 0.80
EPS	$2.00 per share

Figure 4: Simplified hypothetical income statement

$800 million net income—not bad, you might say. Well, whether it is good or bad requires some additional information.

In the next figure you will see a simplified balance sheet for the same company—very consistent with the size and profitability shown on the prior chart.

The ROIC for this company—pre-transformation—is calculated by taking the net income and dividing it by the sum of long term debt and stockholders equity. In this example, the company has an ROIC of 7.8 percent.

Turbo charge your ROIC – balance Sheet

	Pre-transformation
Cash and equivalents	$ 2.00 Billion
Accounts receivable	4.00
Inventories	3.00
Property, plant and equipment	4.00
Other assets	7.00
Total assets	20.00
Accounts payable	1.25
Other current liabilities	5.50
Long term debt	4.00
Other long term liabilities	3.00
Total liabilities	13.75
Total equity	6.25
Total liability and equity	$ 20.00 Billion

ROIC =
$800 / (4,000 + 6,250) =
7.8 percent pre-transformation

Figure 5: Simplified hypothetical income statement pre-transformation

We need one more piece of information to complete our pre-transformation assessment—this company's weighted average cost of capital is about 10 percent.

This company's ROIC is less than its cost of capital. It is among the walking wounded. Whether that condition proves fatal will depend on the actions that its management takes to significantly improve ROIC.

Now comes the fun part. The changes which are possible—based on what I have described so far, are identified in figure 6. Revenues are shown to increase 3 percent, purchased goods and services costs (as a percent of revenues) are reduced from 60 percent to 55 percent, and SG&A expenses as a percent of revenues are reduced by 1 percent. Those three improvements—which, by the way, are very achievable based on what we have covered so far—have a large cumulative impact on net income and EPS.

Turbo charge your ROIC – income statement

	Pre-transformation	Post-transformation
Net sales	$ 25.00 Billion	$ 25.75 Billion
Purchased goods/services	15.00	14.16
Other cost of goods sold	5.50	5.67
Gross profit	4.50	5.92
SG&A expenses	3.00	2.83
Depreciation and amortization	0.50	0.50
Income before taxes	1.00	2.59
Provision for inc. Taxes	0.20	0.60
Net income	$ 0.8 Billion	$ 1.99 Billion
EPS	$2.00 per share	$4.98 per share

Figure 6: Cumulative impact on net income

The balance sheet changes are shown in figure 7. The revenue growth causes accounts receivable to grow slightly. Inventory levels are reduced slightly because of the lower level of purchased goods costs plus a modest 2 percent reduction from inventory consignment programs. Accounts payable grow because the company has renegotiated payment terms from net 30 days to net 45 days. Plus, the reduction in capital intensity due to the improvements in A/P and Inventories (less the growth in A/R), allows for a pay-down of Long-Term Debt.

Turbo charge your ROIC – balance sheet

	Pre-Transformation	Post-Transformation
Cash and equivalents	$ 2.00 Billion	$ 2.00 Billion
Accounts receivable	4.00	4.12
Inventories	3.00	2.77
Property, plant and equip	4.00	4.00
Other assets	7.00	7.00
Total assets	20.00	19.89
Accounts payable	1.25	1.88
Other current liabilities	5.50	5.50
Long term debt	4.00	4.00
Other long term liabilities	3.00	3.27
Total liabilities	13.75	13.64
Total equity	6.25	6.25
Net Income	$ 20.00 Billion	$ 19.98 Billion
EPS	$2.00 per share	$4.98 per share

ROIC: From 7.8 percent to 20.9 percent

Figure 7: Example balance sheet changes

The compound effect of better profits and better capital intensity has an enormous impact on ROIC—going from 7.8 percent pre-transformation, to over 20 percent post-transformation.

That is real change. And, it is not fantasy. Each of the changes I mentioned is very doable.

What is needed for success?

You might ask, why lots of companies are not performing at 20+ percent ROIC? There are two reasons. One, there might be other adverse trends in their business that are partially or completely offsetting the good impacts from advanced procurement. For example, weakening product selling prices, or skyrocketing labor and health care costs. However, setting those factors aside for the moment, the main reason you do not see many companies with 20+ percent ROIC is that these improvements do not just happen by themselves. It takes tremendous leadership, a well thought-out transformation plan, the right best practices in the right sequence, effective and enabling technology, and a few other key ingredients.

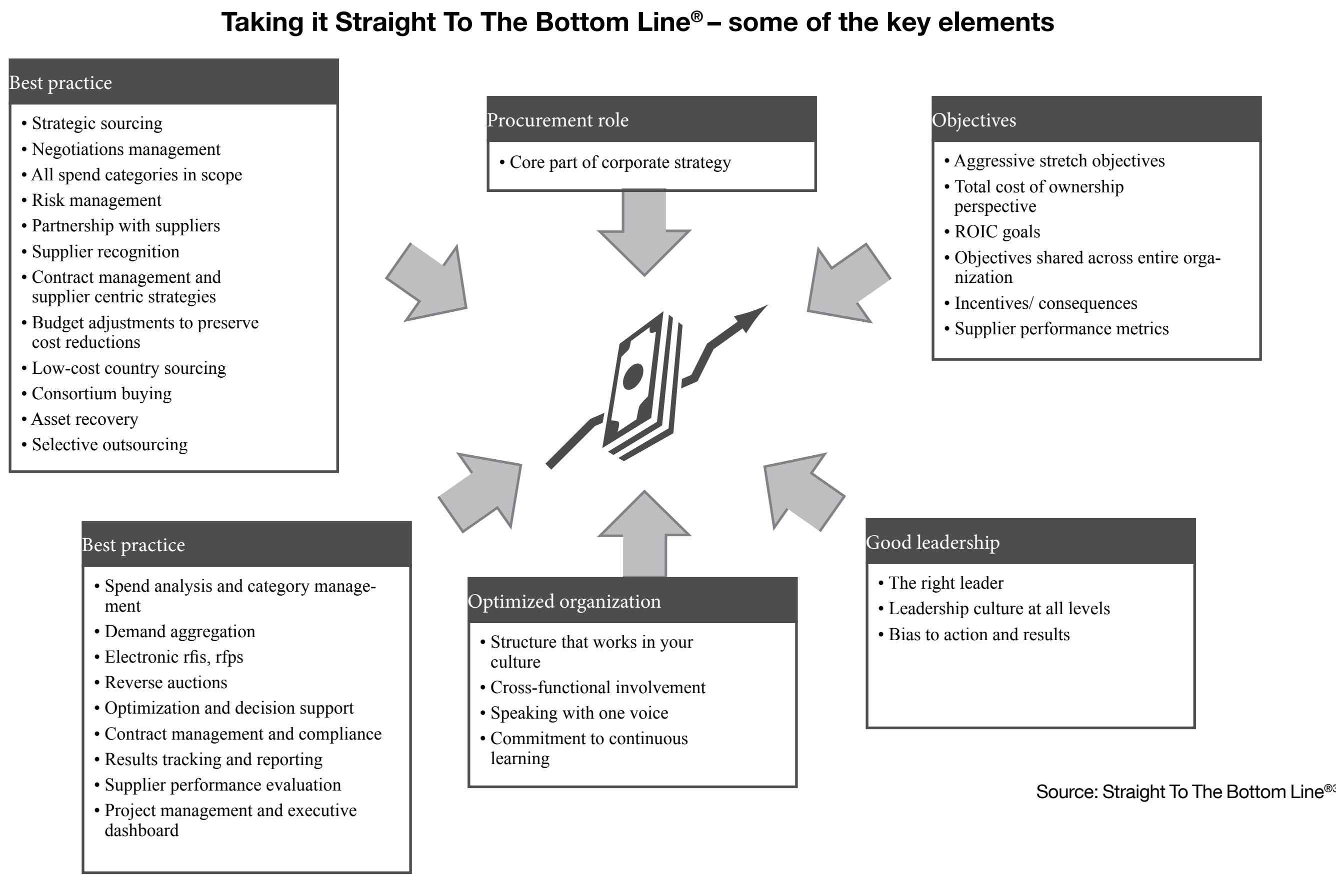

Figure 8: 6 key elements

The first critical element of success or potential failure relates to the role which procurement has in your organization. Companies who make procurement and supply management a core part of their corporate strategy are more likely to have great results and success.

The next area of attention relates to objectives. It is important to have stretch objectives that are based on a total cost of ownership perspective, ROIC goals, and it is also critical that these objectives are shared across the entire organization. To say it another way, if procurement's objectives are not shared by operations and other key functions, the chances of success are diminished.

A key enabler is innovation and technology. The sub-functions shown here can provide significant value to your activities, and, better yet, solutions available today are reliable and well-integrated to help ensure that the savings negotiated up front by procurement actually make it to the bottom line. One of the historical challenges facing procurement managers has been that many of the technology tools that supported procurement were separate, standalone applications or only available through consultants, making it difficult (and expensive) to use them broadly to have the type of impact we demonstrated in figure 8. That has changed dramatically and you need to see what is possible today.

Just a few topics from the category of optimized organization: it is important to have a structure that works well in your organization's culture. That can mean centralized or center-led hybrid. It might even mean decentralized if you have a very decentralized corporate structure, though the internal politics of a decentralized corporate structure can be successfully addressed if you design a center-led procurement approach properly. Cross-functional involvement is also critical for success, as is having the entire organization speak with one voice in virtually any contact with suppliers.

Good leadership involves having the right senior person. It also involves encouraging and developing a leadership culture at virtually all levels of the organization. Furthermore, it involves creating a bias toward action and results.

Finally, best practices are critical to a successful transformation. In the book, we go into an executive-level explanation of 12 key best practices.

Compliance, results and the role of the financial office

When I was offered the opportunity to step outside my financial career track and run the global procurement and transportation operation of Bethlehem Steel, I had a memorable meeting with my new boss, the President and COO of the company. He offered me an observation which guided my early plans. "Purchasing keeps telling me they are saving this company millions, but I can not find it on our income statement."

There are numerous reasons why savings reported by the procurement department fails to hit the bottom line. One of the principal culprits is maverick spend.

In the final figure (figure 9), you will see a table I refer to as the "Strategic Sourcing – Compliance Multiplier." The matrix shows different levels of negotiated cost reduction for a new contract (5 percent, 10 percent, 15 percent, or more), and different levels of compliance with that contract (from 25 percent up to 95 percent). The table shows the amount of benefit that actually makes it to the bottom line based on each combination of negotiated cost reduction and actual compliance. Just to make the illustration easy to follow, we are assuming a $10 million amount of spend that could be directed to that new contract.

For example, a fairly typical result might be to negotiate a 5 to 10 percent cost reduction with your supply base. That sounds pretty good, until you realize that in many companies the initial compliance with that new contract might only be 25 to 50 percent. So, what you are looking at are true, bottom-line results in the boxed area.

For modern procurement to really add value, it needs to utilize best practices to identify the best suppliers and negotiate world-class contracts, and then help ensure a high level of compliance.

Strategic sourcing/compliance multiplier

Compliance with new contract

Percent cost reduction	25 percent	50 percent	75 percent	85 percent	95 percent
05	$125,000	$250,000	$375,000	$425,000	$475,000
10	$250,000	$500,000	$750,000	$850,000	$950,000
15	$375,000	$750,000	$1,125,000	$1,275,000	$1,425,000
20	$500,000	$1,000,000	$1,500,000	$1,700,000	$1,900,000
25	$625,000	$1,250,000	$1,875,000	$2,125,000	$2,375,000
30	$750,000	$1,500,000	$2,250,000	$2,550,000	$2,850,000

($ To the bottom line for each $10 million of spend)

Best practices + good compliance = $ to the bottom line

Figure 9: Strategic Sourcing – Compliance Multiplier

On the chart (figure 9) you can see the impact of negotiating a 10 to 15 percent cost reduction, combined with an 85 to 95 percent level of compliance. In this case, we are looking at a significantly-higher number hitting the bottom line. Additionally, to really make sure it gets to the bottom line, it is critical to communicate the new contracts and relevant spend to your business unit controllers, and ask them to adjust budgets so that the favorable variances created by your sourcing successes are not automatically spent on other things.

Five immediate actions you can take

The above provides the basic framework to successfully transform procurement into a driver of shareholder value for your company. It is not necessarily easy to do, but it certainly can be done – and the benefits are well worth the effort. The long term benefit is that you can turbo-charge your organization's financial performance, and help to ensure its success well into the future.

The following are recommended steps that can be followed:

Strategy #1 - get quick visibility into spending: A company can not control what it can not see. Gaining global, enterprise visibility into spending is much easier now than it was even a few years ago with the advent of automated spend analysis technologies. With software programs or outsourced aggregation of data, companies can get a current view into spending in as little as 90 days. Spend visibility updates should be done on a quarterly basis at a minimum, but for relatively limited costs, it is realistic today to have monthly spend visibility updates company-wide. Leading spend analysis software technologies can aggregate data from dozens of different systems, including virtually every major ERP platform, and can analyze and drill down on spending along dozens of different dimensions including by commodity, cost center, General Ledger (GL) account, geography, time, payment terms, and more.

Strategy #2 – take steps to mitigate inflation: Inflation is the X factor in this economic downturn, and getting ahead of it is critical. The panel recommended re-negotiating contracts with target suppliers and sourcing for value as immediate steps to help insulate against inflation. In sourcing and contract re-negotiation, the first priority should be a focus on high value, high risk areas such as transportation and fuel. Focus on categories where you can negotiate lower prices with suppliers without incurring higher costs elsewhere or damaging your long term interests around delivery, performance and availability.

Strategy #3 - renegotiate and enforce compliance to contracts: One of the big areas of loss for companies is in supplier non-compliance to existing contracts. Whether it is enforcing negotiated pricing, realizing quantity discounts or ensuring quality standards and associated penalties and discounts, contract compliance becomes even more essential in a recessionary environment. Further, companies should target certain contracts for re-negotiations in an economic downturn, noting that key suppliers may be more willing to re-negotiate than perceived. Technology can play an important role in helping companies link contract terms to spending and thus reducing leakage – and in linking contracts to supplier performance to track commitments versus actual performance metrics.

Strategy #4 –mitigate risks when pursuing cost reductions: A bad sourcing decision or supplier issue that can be addressed and weathered in a good economy, can be devastating in a bad economy. One of the biggest strategic mistakes companies make is strictly looking for lower costs, rather than evaluating overall value with suppliers. The drive for lower costs that has led to outsourcing and Low Cost Country Sourcing (LCCS) has brought with it sometimes unforeseen downsides, such as poor quality components, delivery issues, increased risks and service interruptions. Thus, an increased reliance on LCCS and outsourcing demands an even greater role for evaluating overall value and capabilities when sourcing for lower cost. Optimization is a concept and technology employed by the leaders in global sourcing that helps executives balance risks and rewards. Sourcing technologies and services with optimization capabilities allow for sourcing events that factor in a range of requirements which enables decision making that extends beyond cost.

Strategy #5 –do more with less: In a recession budgets are being trimmed and head count reduced, yet with global competitive pressures your department might be asked to do even more. Seize the challenge and focus on making your department more efficient. One of the surest ways to improve efficiency is in the smart application of technology. According to studies, virtually all the productivity gains made by US companies over the past quarter century have come through technology. However, experts caution that there are risks associated with the selection of which technologies to implement. They recommend going only with reliable, best-of-breed technologies that have been tested and shown to be successful at other leading Fortune 1000 companies. Consulting partners, peers and leading analyst firms, such as Gartner and Forrester, provide a good starting point for the evaluation of such technologies.

Short biography of author

Robert A. Rudzki is President of Greybeard Advisors LLC, a consulting firm that assists enterprises improve their financial performance (www.greybeardadvisors.com). He is also board director of a privacy and security software company, and is an Advisory Board member of several companies.

Previously, Robert was Senior Vice President and Chief Procurement Officer at Bayer Corp., where he led a nationally recognized transformation effort. Prior to that he was an executive of Bethlehem Steel Corp., which he led to recognition from Purchasing magazine as a Best Places to Work, and a top-quartile ranking in a best practices survey of 160 global corporations. In the course of his career, he has held various executive management positions in the financial office, as well as positions in procurement and logistics, business development, and P and L responsibility. He is co-author of the book *Straight to the Bottom Line®: An Executive's Roadmap to World-Class Supply Management*, is a frequent speaker at professional conferences, and also conducts in-house management seminars on improving financial performance. He is also author of the business book *Beat the Odds: Avoid Corporate Death and Build a Resilient Enterprise*.[2]

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For further information on "*Straight to the Bottom Line®*" or other books by Robert A. Rudzki, visit:

www.GreybeardAdvisors.com
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[1] Robert A. Rudzki, Straight to the Bottom Line ®: An Executive's Roadmap to World-Class Supply Management (USA: J. Ross Publishing, September 1st 2005)

[2] Robert A. Rudzki, Beat the Odds: Avoid Corporate Death and Build a Resilient Enterprise, (USA: J. Ross Publishing, February 1st 2007)

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