1 Beyond low prices

If you're still stuck on how to tackle the recession, **Richard Wheeler** offers some advice for short and long-term approaches

IMAGE: GETTY

Demand is falling, the car industry is in crisis, banks are reining in their lending, and all other economic pointers are heading down. It's accepted we have a global recession and a credit crisis. It's also widely agreed that, while a challenge, it is an opportunity for purchasing. So what's the best way for us to help our organisations through these times?

The temptation is to focus on using power in the marketplace to wrest lower prices from our suppliers. Of course, we should be doing this but it is far from the whole story. In times like these it is essential we use the entire range of best-practice strategies and tactics. By doing so, we contribute to the goal of not only surviving the recession but emerging from it with strong, reliable supply chains and sound supplier relationships.

STRATEGIC APPROACHES

The first stage is to ensure risk management plans are up-to-date. With suppliers moving to short-time working, closing factories or going bankrupt, eliminating or limiting supply disruptions is a high priority.

This doesn't need to be a big exercise. The steps are: first, brainstorm to identify risks; second, rank the risks in terms of likelihood of occurrence and impact if they do occur; and third, put in place a mitigation plan to address at least all those ranked as high likelihood and high impact. Do this for all your key categories of spend, main suppliers and major contracts. Don't limit your thinking to first-tier suppliers – if there are any components that are bought-in by your suppliers, you'll need to consider the impact if a second-tier component vendor fails to deliver.

The next strategic issue is to have a full and detailed understanding of your main supply markets. It is helpful if a comprehensive category management process has already been started, because market analysis will be in place as a basis for category strategies. If so, they need only to be refreshed.

If you're not in this fortunate position, don't despair. You need to identify your main supply markets and, for each, consider what drives capacity, availability and price. Then ask yourself what changes in those factors have occurred in the past year and are likely to occur in future.

There are some structured tools to help you through this analysis. 'Porter's Five Forces' considers the inter-relationship of supplier power, buyer power, competitive rivalry in the market, barriers to entry into the market and the possibility of product substitution.

'PESTLE analysis' is another technique to consider. It helps you think about the future of markets in terms of six forces or trends that could have an influence – political, economic, social, technological, legal and environmental.

It is particularly important to maintain effective communication with suppliers. Long-range planning is difficult, unexplained short-term changes in the quantity of goods required can lead to overreaction down the supply chain and potential future shortages – the so-called "bullwhip" effect.

Speak to major suppliers frequently. Share demand forecasts and give them early warning of reductions from normal levels of purchases. Joint cost-reduction exercises, including short and

long-term improvements, can benefit both sides and help build the relationship. Try to be the supplier's best customer – the least trouble and cheapest to serve.

Additionally, find out all you can about the financial position of important suppliers. They may be prepared to reveal a great deal in the context of a long-term relationship, but you should look at published sources, credit agencies and news reports. Be especially vigilant for long-term debt coming up for refinancing. This can be a crucial problem for businesses while the current credit problems continue because failure to refinance can lead quickly to bankruptcy.

TACTICAL RESPONSES

A supplier's financial position is largely outside our area of influence, but there are a couple of tactical steps we can take to ease problems for the supplier and benefit our organisations. The first is to lessen pressure on their cash flow by paying on time. Not only is this ethical practice, it also stops them wasting effort chasing payments.

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Often the buyer can borrow money more cheaply than a supplier, which means you have a lower cost of capital. In this case there are opportunities for making early payments in exchange for price discounts.

If you have e-procurement/e-payment systems in place, you can make use of one of the internet-based services that enable a supplier to see their invoice is approved and choose case-by-case, whether or not to accept early payment in exchange for the discount offered. Involve your finance department to ensure the discount exceeds the cost of early payment. Of course, these tactics depend on your internal invoice processing system working smoothly.

Another funding tactic that can benefit both parties is to arrange pre-payment for raw materials used by the supplier. This can take several forms.

One structure is for the buyer to acquire the materials and make them available free of charge to the supplier. It is important materials are properly marked as the buyer's property and segregated from other goods in the manufacturer's plant.

Another structure is for the buyer to make advance payments to the supplier at the time it acquires the raw materials. In this case the usual safeguards should be in place – certificates of ownership, bank guarantees, parent company guarantees, and so on. Make sure you involve your finance and legal advisers before entering into these arrangements so that, should the supplier go bankrupt, you can claim your goods.

In difficult times companies have to cut costs and unfortunately this can sometimes lead to cutting corners. Quality can suffer and customers who are not vigilant can find themselves receiving goods or services that do not meet specified requirements.

Consider taking larger or more frequent samples for inspection and, if any significant changes in rejection rates occur, take action promptly. If you suspect a supplier's quality standards are slipping contact them immediately, increase inspections and consider carrying out quality-assurance visits to the supplier's plant. Send the message you cannot be fobbed off with sub-standard deliveries.

DEMAND FLUCTUATIONS

Given the uncertainty of the current business climate, your own requirements for supply may be subject to unforeseen fluctuations. Volume commitments will usually get the best prices, but you can't risk making a commitment for your total planned requirement.

How do you get the best prices under these circumstances?

A useful approach is to consider future requirements in three tranches. The first tranche is the quantity you are certain you will need. How big this is depends on the uncertainty in your business. You can apply sophisticated statistical analysis of past fluctuations to quantify risk, but in the present climate you may do just as well with personal judgement.

Whatever method you use, decide on a figure you are pretty certain you will need and negotiate a contract based on a firm commitment for this amount; it could be as little as 50 per cent of your expected requirements but you should be able to get it at the best price.

The second tranche should cover the remainder of your expected requirements. For this one, negotiate the contract on the basis of forecast needs only, with no firm obligation to any particular quantity. You can't expect to get as good a price as for the first tranche but you are controlling your risk of a downturn in business.

The third tranche is for any volume that exceeds your forecast requirements and that your contract supplier(s) cannot provide. To meet these needs you will have to buy on the spot market. The price may be high but if demand is so strong that you are in this position you will probably be able to pass the cost on to your customers.

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FALLING PRICES

Prices have fallen dramatically in the past year over a wide range of categories. If you entered into fixed price deals at or near the peak, it is tempting to terminate them and put in place new contracts at current low prices. Take care with this approach and ensure you understand exactly what the termination provisions are in each contract.

This is particularly important when dealing with overseas suppliers or if the contract is not governed by English law. Even when the law is on your side, termination will leave a bitter taste in the supplier's mouth and will be remembered long after the economy has improved.

A better tactic is to approach the supplier for renegotiation based on quantifiable changes to their cost structure – for example, on the cost of raw materials or exchange rate changes, which can be calculated from independently published indices.

When you do go into the market

MORE INFO

SIGI OSAGIE: TIPS FOR PURCHASERS

In boom times many businesses throw money at problems instead of spending time and effort looking at the effectiveness and efficiency of their supply chain operations.

It's a lot easier to make structural/process changes when activity levels are reduced. Businesses that do this will be best poised to maximise gains when the upturn comes. The robustness and nimbleness of their operations will provide an advantage that will translate into better margins than their competitors.

Change programmes should address questions about the circumstances that can boost or damage an organisation's underlying profitability. These should include:

☛ **Are our operational processes effective, and are they aligned to our business objectives and goals?**

☛ Do we have the optimal organisational structure and capability?

☛ **Do we have the tools and enablers to ensure our activities are efficient?**

☛ Are our sourcing and supply chain strategies aligned to our business needs?

The number of organisations driving through change programmes indicates that quite a few are capitalising on these "bad times". But far too many are sticking with the sub-optimal infrastructure they have.

Most, if not all, organisations have the same opportunity but not enough are taking advantage of it.

Sigi Osagie, director, EPG Solutions
(sigi.osagie@epgsolutions.co.uk)

for a new contract or a one-off purchase, online reverse auctions remain one of the best ways of ensuring you get the best deals. Don't be put off by those who say e-auctions work only for simple commodity items; modern auction tools are sophisticated enough to allow you to adjust for variations in specification, quality and delivery between bidders.

Be careful you pre-qualify the bidders and ensure they understand your wishes and contract terms. It's no good getting a low price only to find the supplier didn't understand your requirements and can't meet them at the bid price or is about to go bankrupt.

Finally, take care when entering into fixed-price contracts. The market will improve, and it can be tempting to lock in current low prices but in certain markets prices could still have further to fall. It's vital you understand your supply markets and what's driving them.

Consider protecting yourself by building in escalation or de-escalation clauses based on underlying changes in published indices and exchange rates (this provides for the agreed price to be adjusted up or down if there is a change in the underlying costs). If you are a sufficiently important customer, try to negotiate "most favoured customer" clauses. These guarantee you never pay more than the lowest price the supplier sells at in any period.

The recession is a difficult period for all of us but it is a time when purchasing skills are in demand. It's also an opportunity to introduce new strategies and ways of working. There is nothing like a crisis to open people's minds to change. SM

☛ Richard Wheeler is an independent consultant in contracting and procurement **(richardjwheeler@ntlworld.com)**

PROCUREMENT PRACTICES: WHAT CAN YOU DO?

ACTIONS	TOOLS/TECHNIQUES
STRATEGIC	
Update supply chain risk management plans	☛ Risk analysis ☛ Risk response plans
Understand changes in main supply markets	☛ **Porter's Five Forces** ☛ **PESTLE analysis**
Communicate with key suppliers	☛ Shared demand planning ☛ Joint cost-reduction ☛ Financial analysis ☛ Monitor debt due for refinancing
TACTICAL	
Cash flow	☛ **On-time payment** ☛ **Early-payment discounts** ☛ **Online negotiation of discounts**
Ensure quality does not drop	☛ Increase the inspections you carry out on delivered goods ☛ Discuss quality problems immediately with the supplier ☛ Consider QA visits to suspect suppliers
Coping with unforeseen fluctuations in demand	☛ **Three-tranche approach to contracting**
Best prices	☛ Internet reverse auctions
Manage price fluctuations	☛ **Lock in low prices with fixed-price deals if you expect the market to rise** ☛ **Use escalation and de-escalation clauses** ☛ **"Most favoured customer" clauses**

MORE INFO

OLIVIER DURAND: THE CPO'S POINT OF VIEW

It is one thing to identify practical steps for buyers to improve the standing of an organisation in a recession, but how do you shift the perception of procurement from "purchaser" to "strategic adviser"?

In a series of interviews with CPOs across Europe, buyingTeam found this to be a crucial challenge.

One of the most important obstacles is employee engagement, especially from those who have previously had a bad experience – it is important not to try to convince everyone at once. Support from the CEO is vital but not the complete solution.

CPOs should seize opportunities when they see them and look for quick wins that demonstrate capability and understanding. Be aware that internal customers may be looking for help with pain areas, not simply cost savings. But don't focus only on quick wins; if your help fails to address the crux of the problem, it can burn relationships and damage credibility.

The best chance for procurement to prove the value it can add to the purchasing of indirects is by working closely with the team that needs them. Find out what they want to achieve – which may be about improving overall value, not just reducing costs.

Success is not setting a process in place and sticking with it; initiatives need constant review, feedback and improvement. There is no pain-free path but some routes are definitely better than others.

Olivier Durand, head of European operations, buyingTeam **(Olivier.Durand@buyingteam.com)**