



Difficult economic times influence supply chain cannibalism

When demand slows and operating margins shrink, companies often resort to practices that weaken supply chain sustainability instead of improving operational efficiency, says **Bradley Feuling**

In every supply chain there is a fixed range of profit to be shared by all contributors. From raw material to finished product, direct input costs and value added transformations dictate this range. This is the basic supply chain profit model.

In an economic downturn, managing and protecting supply chain profit is critical. This can ensure competitive sustainability. Yet, what frequently occurs is just the opposite. The embedded lesson in the classic training game 'Win All You Can' simply isn't leaving a meaningful impression. When demand slows, companies resort to fending for themselves, a retreat to the independent operator model. This reactive impulse can in fact damage the entire supply chain. Here we will consider four examples that highlight key risks to overall supply chain continuity and sustainability.

Logistics and transport

From 2008 to 2009, global trade indicators show dramatic negative impacts in the logistics industry. In February 2009 for example, year-over-year shipments from China, the soon to be largest global exporter, were down 25.7 percent. With some in the logistics sector facing 50 percent reductions in capacity utilisation, many companies struggled to remain profitable.

For some small to medium operators, charging additional fees became a perceived necessity. Examples include sharing demurrage fees with rail yard operators or listing incorrect HTS codes during customs clearance. Although short-term revenues may be created, the strategy is self-defeating. Increased and unexpected costs negatively impact supply chain profitability. This affects all contributors involved.



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In some cases the additional fees may make a product shipment unprofitable. Over an extended period, this could lead to bankruptcy or an exit from the market.

Cashing in on suppliers

With the financial crisis, banks have become restrictive with credit terms. Debtor conditions that were once overlooked are now closely scrutinised. Similarly, retailers are following suit with supplier terms. Supply chain sustainability can be impacted when suppliers are forced into noncompliance.

Even with increasing manufacturing costs, retailers continue to demand unrealistic price reductions. In China these price reductions, upwards of 10 percent, have come when material costs, inflation, local changes in VAT regulations and currency exchange movement have increased supplier costs by 15-20 percent. To meet pricing expectations, material input substitution and quality trade-offs may be required.

A specific example is packaging quality. To meet goal pricing, a retailer may suggest that certain packaging is suitable for shipment. Without a technical knowledge of drop test ratings, this could be merely speculation. In some cases, a supplier may inform the buyer that the packaging does not meet testing standards outlined in the supplier manual. With short planning cycles, the retailer insists on fulfillment so the product can ship on time. The result is product arriving damaged and the supplier is charged for noncompliance. Clearly this strategy will weaken supply chain continuity with a supplier.

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Advanced inventory build up during valleys

For many manufacturers, sudden shocks in consumer purchasing at the end of 2008 greatly influenced demand forecasts. Immediately reducing future supplier orders is a knee jerk reaction, which is costly and creates risks. If demand is to pick up suddenly, restarting supplier production capacity lengthens start up time. In addition, supplier prices may increase as volumes drop and per unit logistics costs will rise as smaller batch production leads to lower consolidation.

In a calculated move, some manufacturers will maintain supplier-purchasing levels during the industry forecasted downturn. This strategy not only reduces the risks of slower ramp up, but also assumes that total orders will decrease. This gives the manufacturer significant buyer power while enjoying lower prices.

The strategy is intuitive, identifying key traits in competitor buying habits. The adverse side, however, is the effect on upstream material and component suppliers. If high purchasing levels remain consistent through a downturn, eventually orders will fall when demand levels return. If the supplier customer base is limited, a delayed reduction in orders could cause a major impact on upstream cash flow. Again, the entire supply chain is affected.

Industry supplier networks

When we hear the words JIT, most people think of Toyota. The company and model have become almost synonymous. It is interesting however, that when Toyota quietly leaked it was moving away from JIT, others did not take notice as to the reason. Fred Standish, a spokesman for Nissan Motor Co. in Franklin, Tennessee notes, “If one company goes into severe economic distress, it affects many others up and across the supply chain.” (Bloomberg, December, 2008)

Supply chains can destroy their own value when major downstream demand influencers focus only on their short-term profit. As others in the industry realise, the entire network is connected. Very rarely is a supply chain from raw material input to the finished product entirely controlled by a single operator. Network effect and specifically negative externalities, are key to consider as a company analyses the long-term health and sustainability of the supply chain.

The recent economic downturn has caused a number of companies to reconsider their own internal operations. In some cases, this has included long-term supply chain sustainability and continuity, but for many, protecting individual profits is still the top priority. When these strategies become counter-intuitive to ensuring both down and upstream profitability, there is some question of whether a sustainable advantage is achieved. In many cases, the supply chain in fact has become more susceptible to failure and risk.

The goal for supply chain sustainability is simple: ensure and protect profit for each critical contributor in the material process flow. In difficult economic environments, coordination becomes critical. Cost reduction strategies and identifying bottlenecks and process improvements with partners are far more advantageous than short-term revenue generation. By involving the key parties, the range of achievable supply chain profit can be more accurately analysed. It is here where the entire supply chain becomes self-sustaining and competitive. ■

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