Supplier risk management

Presentation to CIPS Harrow branch

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Agenda

- Objectives
- Background
- Commercial impact
- Recommended approach
- Case study

Objectives

The purpose of this presentation is to highlight the importance of managing supplier risks

Objectives:

- Recognise the growing importance of supplier risk management
- Frame supplier risk management within the context of ‘leading practice’ in category management
- Outline an approach to help companies to identify and manage their supplier risks

Background

Introduction

Prudent management teams have initiated actions to assess and mitigate potential supply risks in response to the recent economic downturn:

- Revisiting risk models and related early warning troubled-supplier identification systems
- Developing more detailed assessments of troubled, or likely-to-become troubled, suppliers
- Refining skills relating to assisting distressed suppliers, including re-sourcing, acquiring or investing, or managing through bankruptcies or administrations

Who manages supplier risk management in your organisation?

- Procurement?
- Finance?
- Internal audit?
- Dedicated risk management team?
- Shared responsibilities amongst the above?
- No one?

We observe that organisations take different approaches to managing supplier risk

Despite who may have responsibility for risk management, the CPO's role will be pivotal

Legal

- What are the supplier's legal obligations to us?
- Can we call off any of the supplier's finished stock?
- Can we claim for consequential losses?
- Do we have a signed contract?

Operations

- What is the estimated period of supply failure?
- How long before operations are severely disrupted?
- What is the impact of alternative supplies on operations, e.g., unloading considerations, specification?

CPO

- What are the early warning signs?
- Are there wider risks facing the entire industry/market?
- What are the supply contingencies?
- What alternatives can we use in place of the supplied product?

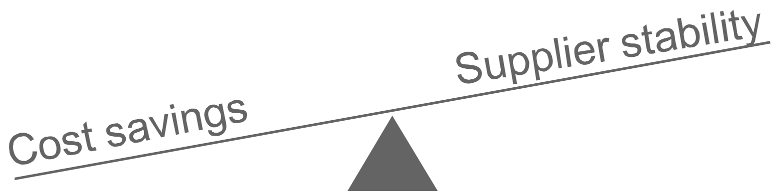
Buyer

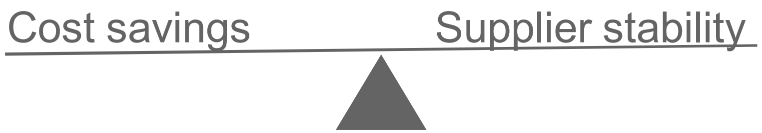
- Which customer accounts should be prioritised for fulfillment?
- How does this impact on service levels?
- Can we supply alternative products/services to customers?

Sales and marketing

The challenge is to balance the need for cost savings with the health of key suppliers

Decisions over supply chain stability depend on an organisation's appetite for risk and willingness to invest in the relationship





Supply chain instability can have negative impact

- Value leakage
- Lack of operational control
- Disruption to supply

Optimising supply chain management can have favourable results

- Value sharing
- Supplier optimisation
- Continuity of supply

Organisations can no longer rely on traditional indicators to predict the risk of supplier failure

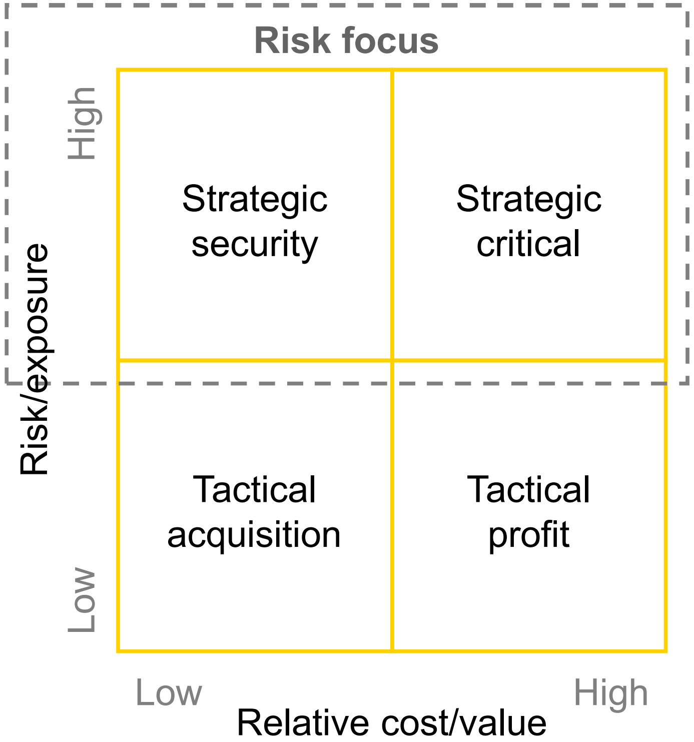
What we observed:

- Increasing speed at which some suppliers went into administration
- Suppliers failed despite the absence of weak financial performance
- Traditional indicators did not highlight the dependency that a supplier may have on one or two customers
- Portfolio of business secured by some suppliers may have been commercially unviable
- Much of the information on supplier risk came through informal channels

Early warning signals now need to include operational and qualitative considerations

CPOs recognise that smaller 'strategic' suppliers can have significant impact if they fail

Risk-based supply-market segmentation

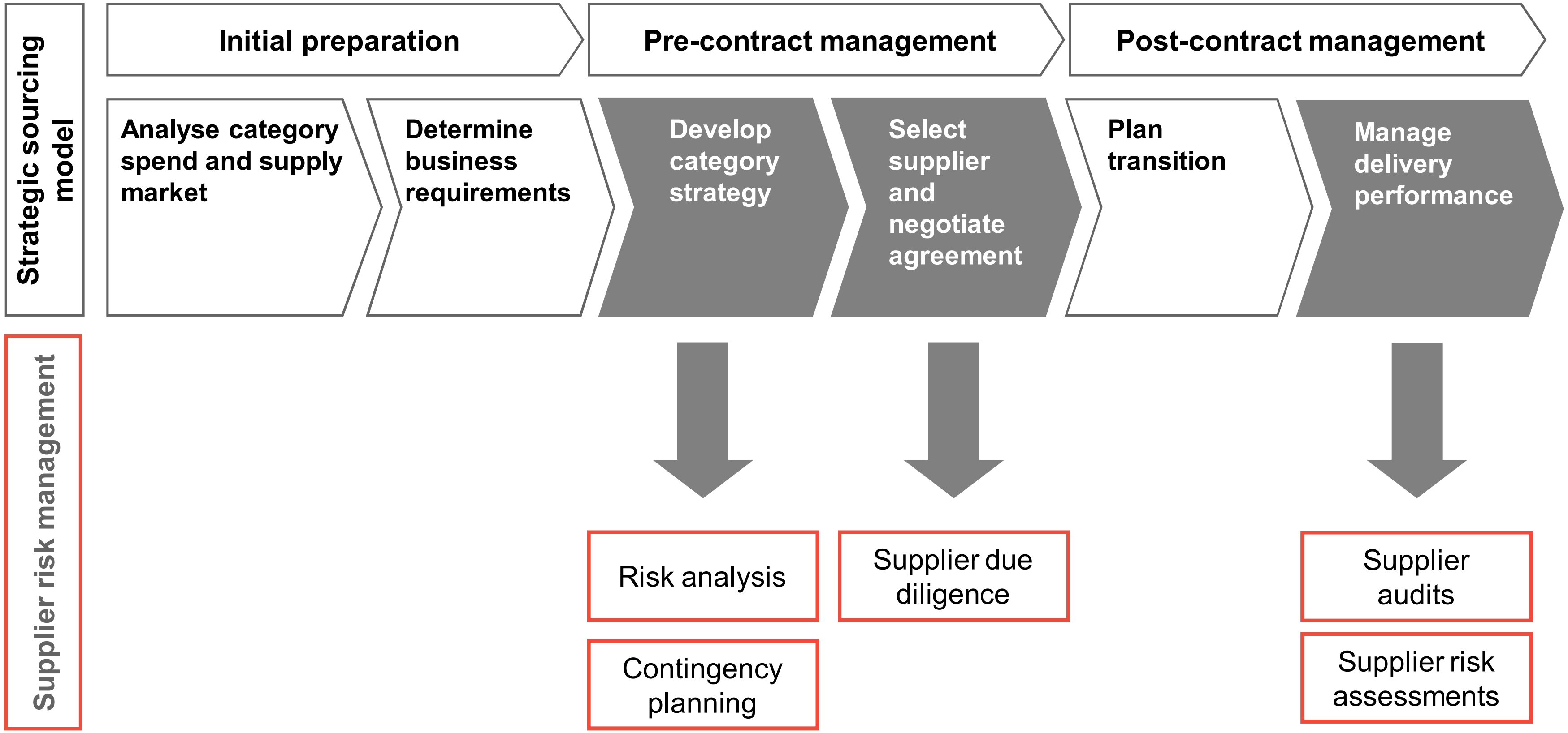


"Rather than start with the biggest spends, we ask which are our most profitable SKUs (stock keeping units) and which suppliers are most critical to those"

Diageo

Small suppliers who supply small things can stop big brands being produced and sold globally

Analysis of a typical strategic sourcing model highlights the opportunities for integration



Commercial impact

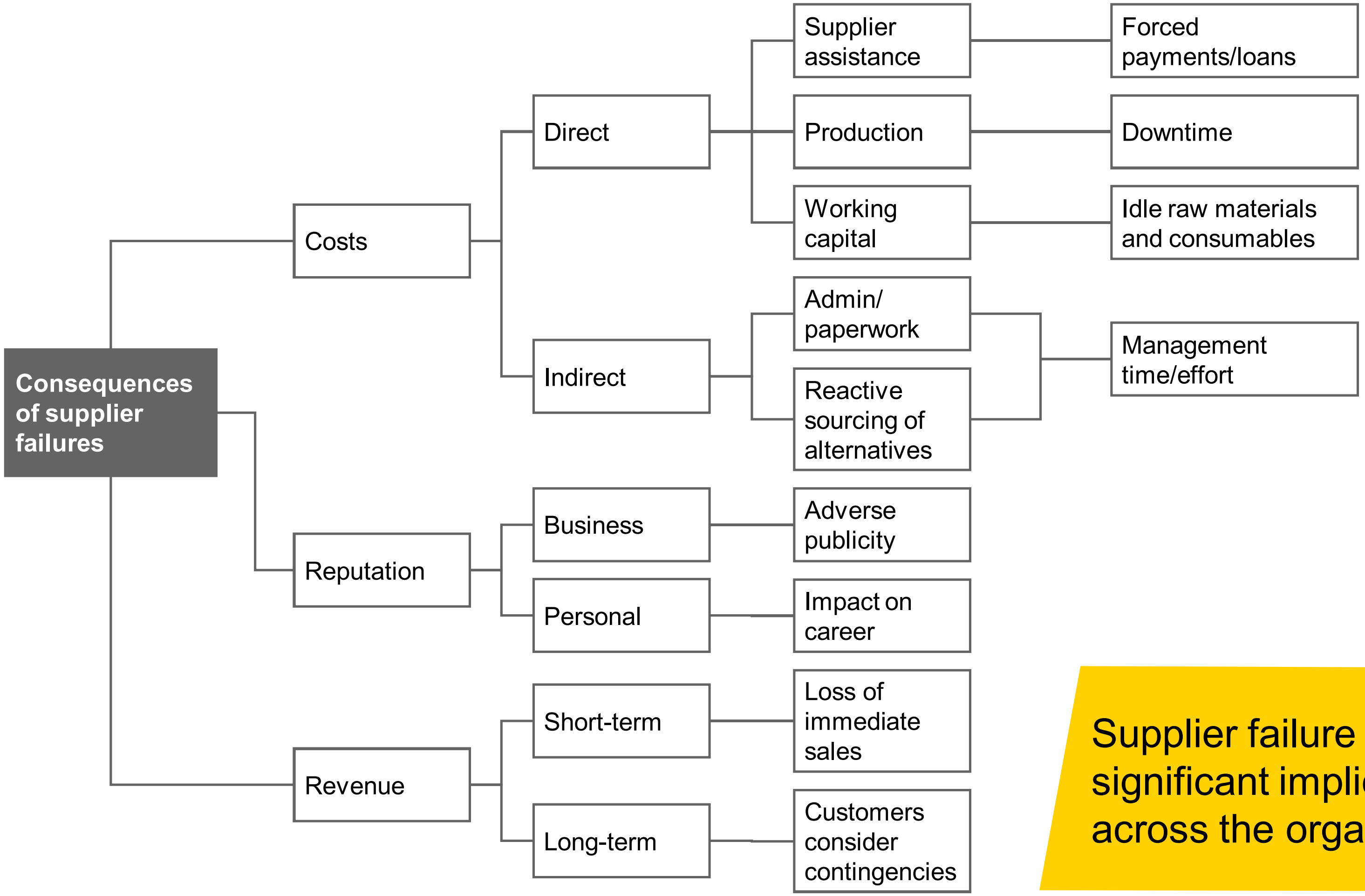
So, why is supplier risk identification and management so critical?

Value proposition/benefits

Benefits	Key value levers
Primary	► Reduced risk of supplier failures ► Reduced costs of supplier failures ► Improved continuity of supply ► Efficient supplier risk management processes

Secondary	► Enhanced category management
	  ► Improved supplier intelligence
	  ► Improved decision making and risk management
	  ► Better tools for costs/financial benchmarking
	  ► Improved supplier performance management processes
	► Support to wider procurement transformation programmes, e.g., supplier rationalisation

The consequences of supplier failure can be significant across a number of areas



Supplier failure could have significant implications across the organisation

Recommended approach

Our approach to identify and manage supplier risk has helped organisations

Early warning screening systems

Operational, financial and qualitative metrics used to profile supplier pool based on risk level

Troubled supplier risk assessment

Detailed risk assessment and mitigation planning for suppliers that pose significant risk

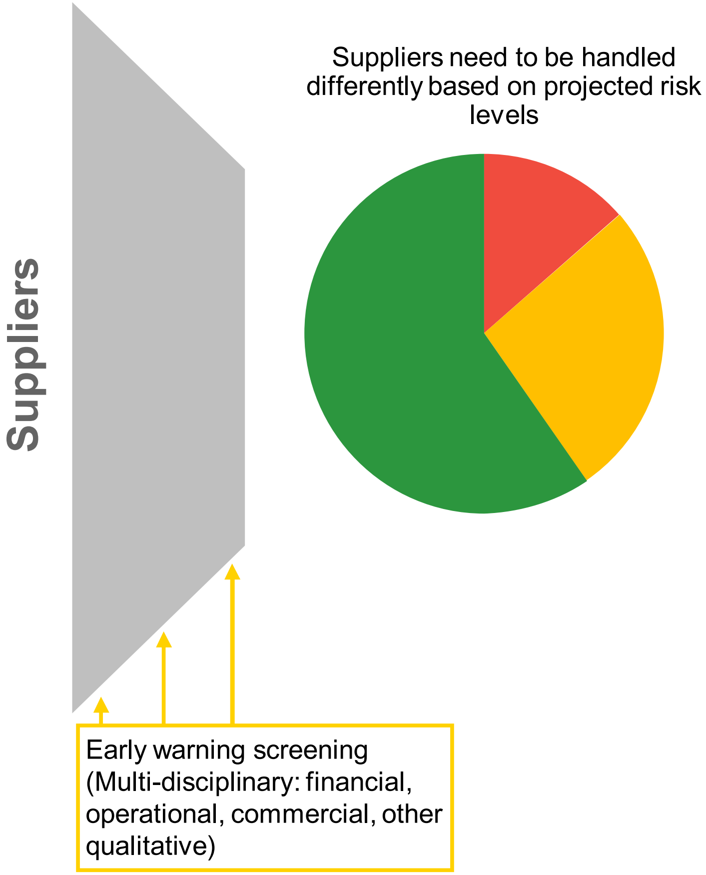
Distressed supplier management

On-site evaluation and review of distressed suppliers with a view to protecting supply

Our approach is flexible and recognises that different levels of information are required to identify and address specific supply chain exposures

Early warning screening system

Supplier risk profiling forms the basis of mitigation strategies



	Risk exposure	Mitigating steps
High risk suppliers 	▶ Disruptive shock to supply chain (revenue at risk) ▶ Collateral damage (customer/brand, share)	▶ Contingency plans to be deployed ▶ Focus (internally/externally) on suppliers regardless of financial health
Medium risk suppliers 	▶ Working capital and order fill creep ▶ Quality and reliability erosion	▶ Increased frequency and scrutiny of monitoring risk indicator trends ▶ Increased dialogue with supplier management
Low risk suppliers 	▶ Minor (business as usual) fluctuations in vendor performance metrics ▶ Limited supply chain disruptions	▶ Continued monitoring for downward shifts in risk indicators ▶ Continue to firmly enforce terms and document variances

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Common non-financial early warning indicators

Early warning screening systems | Troubled supplier risk assessment | Distressed supplier management

Examples:

- Supplier has recently requested improvement in payment terms
- Supplier has recently requested significant price increases
- Evidence that supplier is extending its credit terms with its supply base either formally or through non-payment
- Lending institution(s) recently and significantly reduced the supplier’s line of credit
- Supplier has recently performed significant and/or multiple sale-leaseback transactions in an effort to generate liquidity
- Supplier has been delaying some investments
- Recent increases in quality and on-time delivery concerns

Troubled supplier risk assessment

Early warning screening systems | **Troubled supplier risk assessment** | Distressed supplier management

Objective: confirm initial assessment that a supplier may be troubled and develop a plan to mitigate supplier risk:

- Perform initial financial analysis on selected information of a supplier to assess the key business and financial risks for the troubled supplier’s ability to meet customer production/service requirements
- Based on the observations noted in the initial supplier risk assessment, determine if a more detailed assessment of the suppliers’ financial health is needed
- Develop a troubled supplier monitoring program (quarterly/monthly/weekly reviews)

Distressed supplier management

Early warning screening systems | Troubled supplier risk assessment | **Distressed supplier management**

Objective: minimise disruptions while determining and implementing a support solution or exit strategy:

- Understand supplier business recovery/restructuring plan
- Analyse short-term investment options (pricing/payment terms)
- Analyse strategic alternatives (forced transaction/supply base consolidation)
- Maintain ‘on-site’ presence at distressed supplier for purposes of daily cash flow and borrowing base/liquidity monitoring
- Analyse and advise on potential exit strategies (for example, resourcing, acquisition, forced sale, etc.)

What does a set of proactive interventions by Procurement look like?

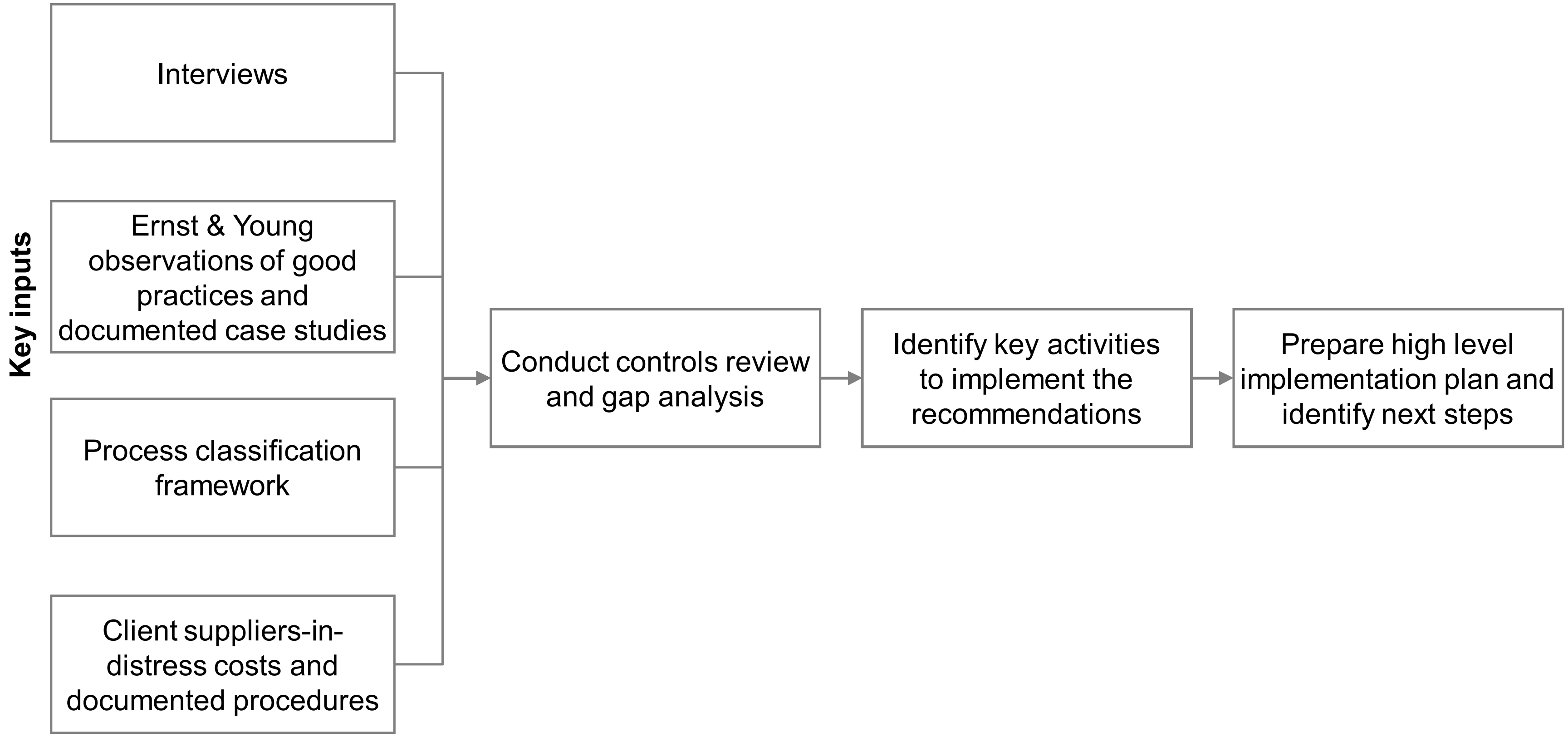
- Deploy a simple **change network** to get feedback from suppliers on what is working and what further interventions might be required to **avoid the need for financial assistance**
- Conduct periodic **supplier performance reviews** to understand whether the procurement strategy is appropriate and working
- Create a **balanced scorecard** which measures the effectiveness of the agreed option/options undertaken by the Procurement function
- Develop a **cross-functional approach** to determine and evaluate suitable options, e.g., specification changes, operational support to help distressed supplier reduce own cost base

- Create very specific **'how to guides'** in developing category management contingency plans that reinforce an aligned approach to the management of troubled/distressed supplier scenarios
- **Get buyers to behave consistently when working with the risk team and suppliers**
- Develop **strategic options** that explain the rationale for each proposed action and what the opportunity might look like to mitigate the need for a financial package
- Conduct series of **communications** to ensure that **all** options are understood and that there is no room for error in executing the agreed plan

Case study

What did we do?

Overall approach



What was the value of the problem?

Profit and loss impact of suppliers in distress = £40 million

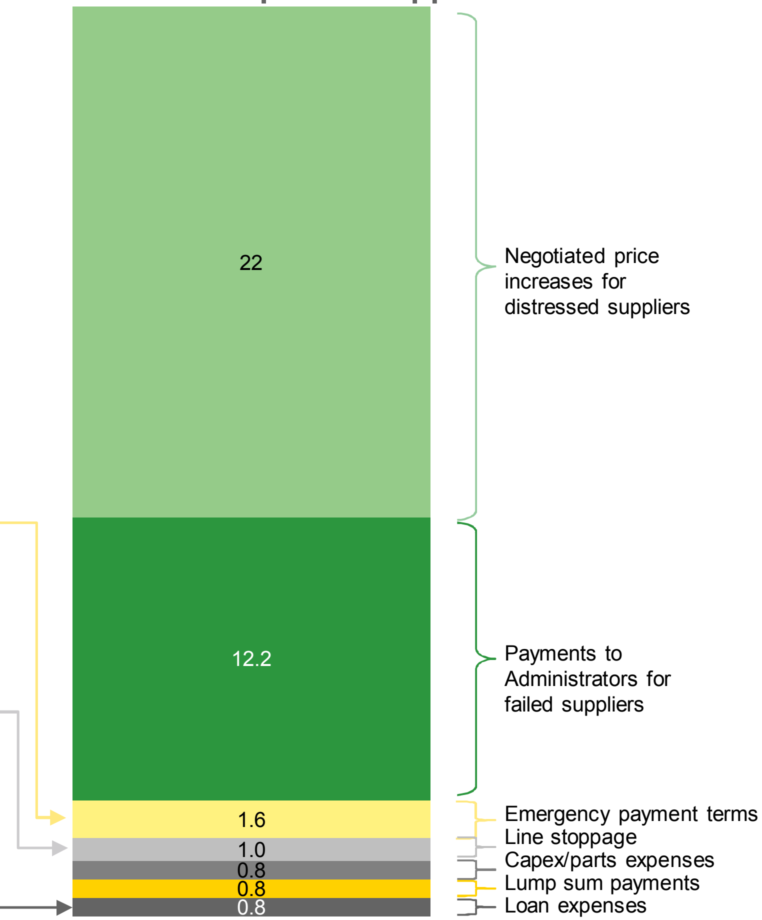
Financial analysis

- 76 reported cases of troubled/ distressed suppliers
- **Cash financial assistance of £170 million in total**
- **Profit and loss impact of financial assistance of £40 million**
- Emergency payment terms account for the majority of the cash financial assistance by value (77%)
- Supplier pricing accounts for the majority of the profit and loss impact by value (56%)

Based on cost of capital of 10% p.a. on reduced payment terms of 60 days to 15 days (adverse cash flow impact of £16.0 million)

Profit and loss impact of high profile supplier failure for six days

Based on cost of capital of 10% p.a. – there was a high risk that a loan of £5 million may not be repaid for at least one to two years



Key issues

- No process to capture and manage distressed supplier costs on a 'joined up' basis across client organisation
- Business functions incur costs of 'suppliers in distress' and fail to understand the impact
- Budget for administrations is the only provision for 'suppliers in distress': other costs are not budgeted for
- Inaction typically exists until a supplier goes into administration as unplanned activities have no budget
- Inaccurate and incomplete information used for supplier risk ratings
- Different systems create disconnects and gaps with management information

The cash impact was £170 million and the cost impact was £40 million (understated due to lack of information)

Key recommendations and benefits

What is the issue?	Why does it matter?	Proposed solutions	Benefits
Supplier risk assessments fail to identify troubled suppliers effectively (existing or potentially new)	► Pre-qualification of suppliers is inadequate and may impact on success of low cost country sourcing ► Incurred costs of managing distressed/failed suppliers ► Potential disruption to production and loss of sales ► Disruption to overall transformation plan for Procurement	► Improve the pre-qualification of suppliers and include risk management considerations ► Develop processes to integrate supplier risk management with sourcing and category management ► Develop more effective processes to manage identified risks and implement timely mitigation plans	► Commodity business plans become embedded and long-term view of risk is taken with strategic suppliers (used in the development of future products) ► Improves the depth and range of cost effective options that are available for managing distressed supplier situations ► Supports low cost country sourcing and supplier rationalisation initiatives through a more stable supply base
Poor quality and integrity of data for supplier risk review	► Undermines the validity of the risk assessments ► Potentially understated risk profiles for supplier companies ► Inaccurate reporting, leading to loss of wider interest and proactive approach to risk management ► Inappropriate actions may be proposed by the Buyers	► Carry out thorough data cleansing exercise to ensure accuracy of inputs to drive supplier risk reviews ► Review the access to the supplier risk database and empower the Buyers/Purchasing Managers to recommend actions ► Review all sources of data used for risk rating system and identify the limitations that impact on accuracy ► Develop a supporting process for the periodic review of all reported distressed supplier cases in relation to the supplier risk ratings and thresholds	► Supports the development and empowerment of the Buyers as part of the wider Procurement transformation plan ► Improves decision making through more accurate information and reliable risk assessments ► Purchasing Managers and Buyers become more engaged in the supplier risk review process ► Reduces the probability of not identifying distressed suppliers through the supplier risk review process
Poor alignment between Procurement and other support functions in managing supplier risks	► Conflicting objectives between business functions and the low level of active involvement in supplier risk management result in sub-optimal decisions for client organisation ► Exposure to potential supply disruptions or substantial additional costs ► Stock levels do not reflect business risk ► Full benefit of overall Procurement transformation plan may not be achieved	► Develop a cross-functional approach to supplier risk management and leverage risk assessment models used by other functions ► Develop business processes for identifying and allocating the costs for additional stock holding relating to financial risks (distressed suppliers) ► Develop a cross-functional team for supplier risk review and options analysis. This team should be made up of senior managers to review sensitive information and make 'joined up' decisions collectively	► Enables the best outcome for client overall to be achieved in dealing with distress by actively tackling on a company- wide basis ► Drives consistency in behaviours, avoids potential for conflicts and leads to cost reduction/avoidance ► Collaboration between the Purchasing and Logistics functions in developing the most optimum solution with timely allocation of costs

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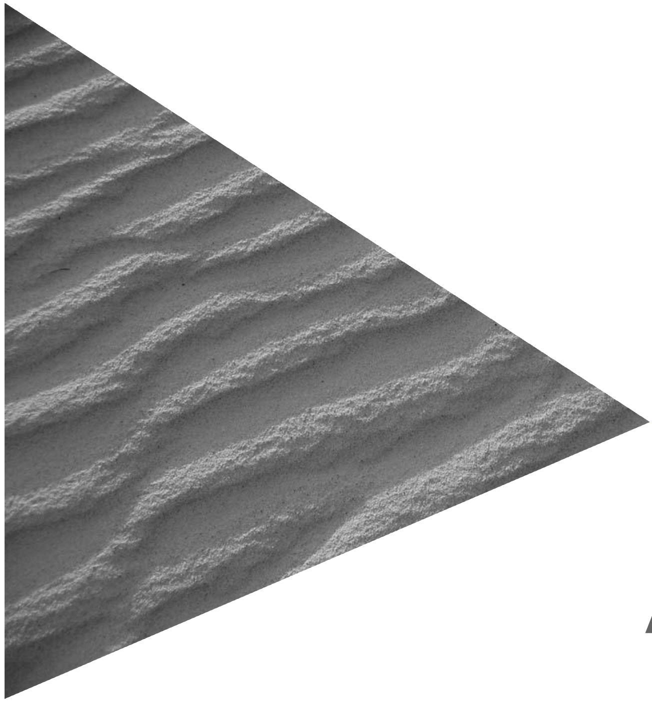

Any questions?

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