Haute Performance

The Supply Chain Savvy Buyer

The changing face of supply chain procurement

September 2014

Executive Summary

Supply Chain procurement is fairly unique in the portfolio of goods and services categories purchased by Industrial Corporates. It is large, complex, and usually only thoroughly practiced every 3 to 5 years – in the best of cases.

The Supply Chain Service Providers' industry is increasingly dominated by large players who control and command the assets, the intellectual capital and the human resources, tilting the balance of power their way... Effective spend of supply chain budgets therefore requires a scarce combination of skills: a good command of large B-to-B procurement processes and a good understanding of the nuts and bolts of logistics.

Having managed multiple supply chain procurement processes in different industries over the last 10 years, Haute Performance has identified some of the key factors that influence strategic interactions between Principals and Suppliers, and the latest trends in South Africa and to a lesser extent in the rest of the Continent. These trends can be exploited equally by actors on both sides of the fence, and will become even more relevant as South Africa continues its current slow growth trajectory with resulting cost containment, partly through procurement squeeze.

These trends can be summarised along 4 main axes:

- The sourcing choices go beyond the traditional dichotomy of in-house vs outsourcing. Asset ownership models are taking very sophisticated forms. Some of the latest schemes distinguish between financial, operational and liability aspects
- Pricing models are becoming more sophisticated as well, refining the traditional fix/variable or closed/open books schemes. In particular, the labour component has received a lot of attention lately, due to its rising share of total cost and its social sensitivity
- Logistics solutions are not merely about efficiently moving product from A to B; creativity still has a major role to play It can influence resulting supply chain cost more than price negotiation and in turn help Principals gain (or lose) market share
- As the models become more sophisticated so too is the necessary legal contracting – The traditional process of hand-shaking between Supply Chain professionals and the subsequent handing over to lawyers (who can then argue among themselves), is not working anymore – Lawyers need to play their role early on in the negotiation as large corporates are less and less willing to commit resources and responsibilities on the back of simple Memoranda Of Understanding's (Mou's).

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Context

Due to its size, supply chain spend should be one of the procurement priorities within industrial/manufacturing companies:

- Even when a particular company's policy calls for managing supply chains in-house, it will nowadays invariably outsource some aspect of that supply chain (be it long term vehicle leases, or long-haul bulk distribution).
- Supply chain is in fact fairly unique in the traditional procurement matrix: it is one of the few spend categories that is sizable, of high strategic importance to any industrial company, especially to FMCG companies, and also has high levels of supplier concentration, as shown in Figure 1.
- Managing supply chain spend requires a good understanding of both procurement processes and the nuts and bolts of logistics. These competencies rarely sit within the same divisional structures, but value for money is unlikely to be realised if input is missing from one of the 2 disciplines.

However, purchasing reviews and contract reallocations viewed from the standpoint of individual companies, generally occur only every three to five years – a lifetime in the evolution of the South Africa supply chain market!

Having managed multiple supply chain procurement processes over the last 10 years, Haute Performance has identified some of the latest trends that are driving negotiations between Principals and suppliers. Four such trends are expanded below.

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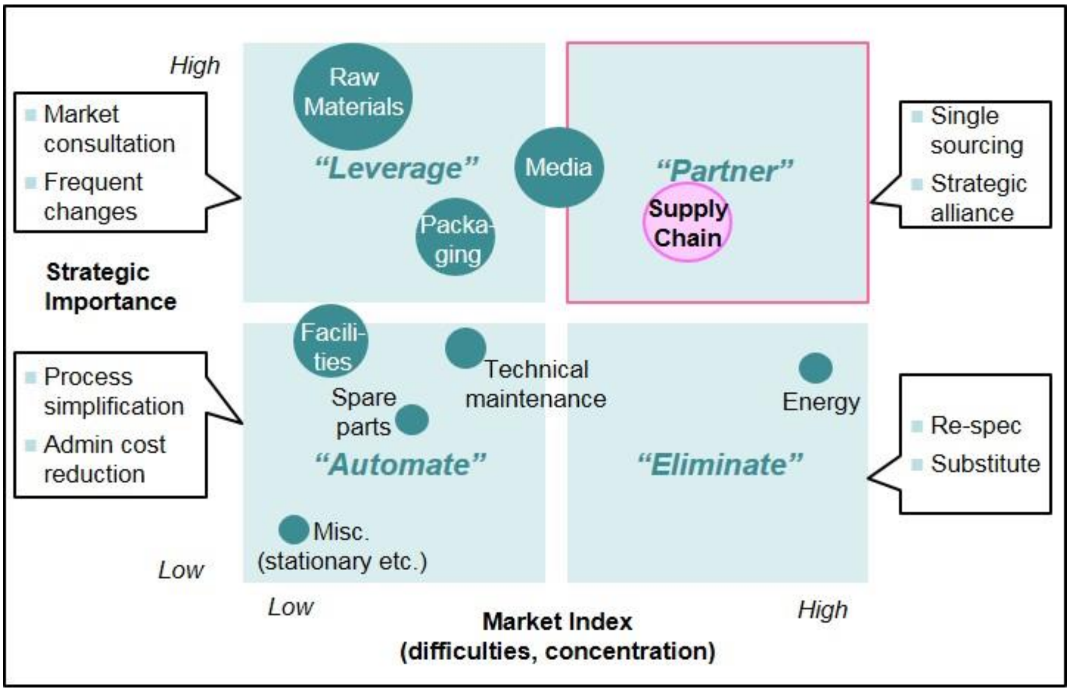

Figure 1: Example Category Spend Matrix

1. "Justify your ownership"

Ownership has historically revolved around the single criteria of asset utilisation: If Principals could provide enough utilisation within their operations, then they could own the assets – if not, they had to rely on their suppliers to pool the utilisation of different Principals.

Traditional models of suppliers owning vehicles are now changing, taking into account how commoditised the services are.

For highly specialised services, Principals prefer to own the assets, be it trailers or vehicles or loading equipment. This serves a number of purposes:

- Firstly, an increasingly specialised service will result in a greater degree of asset exclusivity in differentiating the offer. In other words, the Principal is less likely to allow the asset to be used by its competitors.
- Secondly, the timing of the maintenance of the asset is often in the control of the Principal.
- Thirdly, and most importantly, highly specialised services can lead to difficulty in switching between service providers. Owning the assets can reduce lock-in and ease the transition from incumbent to new provider. In terms of the procurement matrix (see figure 1), it enables the movement of the category from right to left, thereby moving the balance of power more in favour of the Principal.

For generic services, ownership tends to be retained by the service provider. This is the case for traditional FMCG companies where the service providers (under significant pressure due to retailer DC centralisation) offer aggregator services to multiple Principals, all of which require delivery at the back door of the traditional modern trade outlets. In this instance, an individual Principal pays only a portion of the service.

For highly commoditised services, Principals are placing even more importance on enterprise development. In some cases (e.g. Lafarge, ABI, SAB and more recently Adcock Ingram) commoditised services can be outsourced via owner-driver schemes. Although the service is technically outsourced, the funding mechanisms employed grants control of the vehicles to the Principal, in substance if not form, as shown in Figure 2 (next page).

The models have differing implications for role players:

- For service providers, the onus is on proving their competence in the effective management of the assets over their life.
- For Principals, the key is to ensure retention of any proprietary aspects of the supply chain, ensuring that they are not unnecessarily tied in by long-term contracts and can therefore keep their providers "on their toes".

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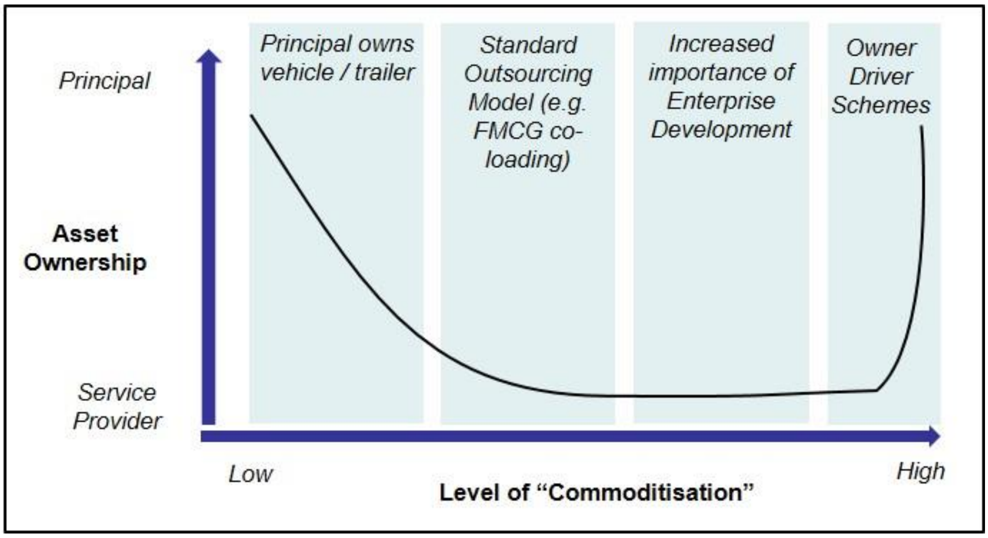

Figure 2: Asset Ownership Trends

2. "Price for service"

Principals and service providers are moving away from simple Fixed/Variable or Closed/Open-book models to more advanced pricing mechanisms that better reflect the risks and responsibilities of each party.

> ***Client Example 1***
>
> *The supplier is responsible for the management of staff; therefore an aggregate hourly rate is agreed upon for staff cost per route type (local milk run vs long haul) that includes a reasonable allocation of overtime.*
>
> *If the supplier fails to manage their staff allocation correctly per route and run into unexpected overtime, this has to be absorbed as part of the agreed upon blended normal and overtime rate.*
>
> *In this way, the Principal is assured of quick turnaround and the supplier has every incentive to keep the working time equal to or even below the estimated cycle time.*

Full open book (also referred to as "cost+") pricing leads to suppliers having little to no incentive to manage costs down as they are all passed directly to the Principal – in fact the reverse incentive is true as the supplier earns greater margin when the cost is higher.

Traditionally, Principals have overcome this problem by enforcing a commitment to deliver savings – but the saving commitment percentage is often a fairly arbitrary number, and it is almost always difficult to measure (Did overall costs drop because my volume decreased? Did my volume switch to more local deliveries, changing my distribution mix? How did the unexpected fuel increases impact the overall savings programme?)

Closed book or fixed pricing means that the supplier must build in sufficient "fat" to protect itself from unexpected events such as delays in loading etc. Consequently, Principals will not benefit from cost savings if they are performing their roles better than the industry average.-

Leading companies recognise that pricing should be structured so as to align the interests of both suppliers and Principals, and take into account the allocation of responsibilities.

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3. "Re-engineer your supply chain"

At its core, supply chain services are about getting products from point A to point B, reliably, within required SLAs and at the cheapest price. There is however only so much margin that can be squeezed out of the rates of a supplier before the offer becomes unsustainable.

Best in class companies know how to re-engineer the solution so as to obtain the savings they require. In other words, it is not a pricing game anymore, but rather a process reengineering matter, which requires Supply and Demand considerations.

Conceptual Demand

While it is a tried and tested maxim in Customer Service in general, we often find that companies are guilty of not understanding the importance of specific KPIs to the end customer.

This leads to over-delivery in areas that are less important to customers and under-delivery in the areas that could be driving customer loyalty.

Principals can ensure they are not presenting an "over-specified" solution to meet customer requirements, as shown in Figure 3.

> ***Client Example 2***
>
> *The Principal believed that a next day delivery promise "no matter what" would differentiate them in the market which was in general accepting of long lead times. The implication of this service level was that a new inland warehouse was required.*
>
> *While both the customers interviewed and the sales team had recollection of the multiple times an emergency order was required, an analysis of customer ordering patterns revealed that only ± 10% of orders were made outside Nominated Delivery Day (NDD) due to unforeseen emergencies.*
>
> *This insight meant that inland customers could be serviced primarily from coastal depots, with minimal emergency stock being maintained for the exceptional next day delivery.*

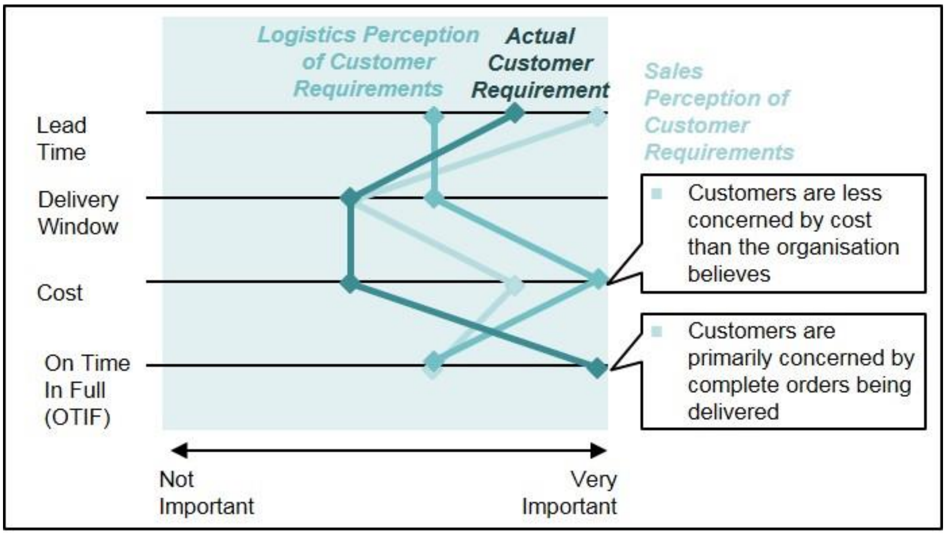

Figure 3: Matching Performance to Customer Requirements

Conceptual Supply

One example of changing supply that frequently appears is the management of return legs. The flow of freight across South Africa is heavily imbalanced. If a vehicle is not able to secure backhaul volume, it returns empty. The frequency with which this happens will be reflected in the rate that the supplier is able to provide.

> ***Client Example 2***
>
> *The Principal required flexibility in fleet size to deal with the highly cyclical nature of product demand. Instead of choosing a specific size of core fleet and renting in additional vehicles to cover peak volume (at significant cost), they made use of the existing spare capacity of supplier fleets.*
>
> *This was done by including overall fleet size and operational set up as a commodity in the tendering processes. Suppliers were requested to quote on what proportion of vehicles in the core fleet could be "re-absorbed" should they not be required in a given month.*
>
> *Those suppliers that could effectively smooth the principal's peak demand requirements with their own demand cyclicality were best placed to provide a competitive bid.*

Traditionally this has meant that companies will either make use of Freight Brokers, or alternatively request frequent updates to quoted rates to account for the changing contractual volumes obtained by their suppliers. We have seen two emerging and divergent strategies which companies employ to address this problem.

The first strategy is to effectively bring the broking model in-house. This means building the tools to allow a wide range of suppliers to continuously and electronically bid on routes. It enables suppliers to accurately reflect their own contractual economics. Thus, if a supplier is able to secure a two month transport contract with a local farming cooperative shipping product from Limpopo to Gauteng, they can afford to bid significantly cheaper on Gauteng freight being transported to Limpopo. In theory, in-house broking tools provide the most accurate market rates, without the broking margin (provided the supplier base is sufficiently representative of the pool of transporters operating in the region).

"Principals are able to ensure they benefit from the supplier synergies, and importantly that their competitors cannot"

The second strategy is to contractually place the risk of return loads onto the supplier or consortium of suppliers. The strategy requires a good understanding of the economics of both haulage and overall product flows across South Africa. Effectively the tender process identifies the supplier (consortium) that has the best "contractual balance" of return freight and locks them in to the arrangement.

This arrangement can be highly beneficial to both parties:

- Suppliers are provided with an opportunity to run back-to-back contracts with a significant improvement in their asset utilisation levels.
- Principals are able to ensure they benefit from the supplier synergies, and importantly that their competitors cannot!

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4. "Read the fine print"

More impetus is being placed on this once neglected area of the contracting process. The focus on the key cost metrics (rate cards, cost/km etc.) during negotiations can often lead to savings in the first year of a contract, that are quickly eroded when escalations begin to kick in. Fair escalation mechanisms are critical in ensuring that a contract is extended beyond the initial period.

- Fuel surcharges are often used to control for monthly fluctuations in the price of diesel. Companies are moving away from flat rate changes, taking into account the actual proportion of diesel cost per element of the contract (i.e. short haul vs long haul), as shown in Figure 4.
- The selection of which index to use, as well as what proportion of the contract will be linked to what index is also a relevant topic. As can been seen by the variations in some of the major indices, the selection of an escalation method can have a material impact on the overall cost, as shown in Figure 5.

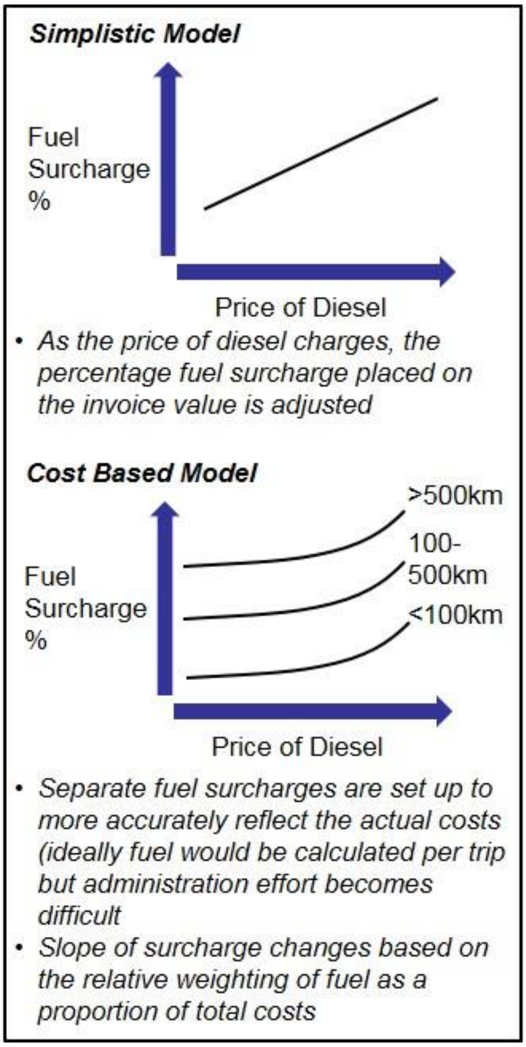

Figure 4: Fuel Surcharges

Year	CPI	PPI	SEIFSA-L1	SEIFSA-L2
2004	1.4%	2.3%	6.0%	5.8%
2005	3.4%	3.7%	11.5%	10.5%
2006	4.7%	7.7%	9.7%	8.5%
2007	7.1%	10.9%	7.7%	8.5%
2008	11.5%	14.2%	26.0%	24.5%
2009	7.1%	-0.1%	-9.5%	-6.9%
2010	4.3%	6.0%	6.7%	7.1%
2011	5.0%	8.4%	13.2%	12.0%
2012	5.6%	6.2%	10.2%	9.6%
2013	5.7%	6.0%		8.6%
2014 (YTD)	*6.0%*	*8.20%*		*4.7%*

Source: StatsSA, SEIFSA

Figure 5: Escalation Indices

The question of who bears the cost of fixed assets if a *Force Majeure* is declared is generally a difficult topic and one settled by who holds the balance of power at the negotiation table. It is important to know and state contractually what the base fixed costs are, stripping out all variable costs and supplier profit.

These can also be based on the type of *Force Majeure*. For instance; in the case of a national transport strike, all salary and benefits related costs should not be included in the fixed cost base. In instances where all efforts have been made to continue operations but to no avail, the fairest distribution would be for both supplier and principal to share the contractually quantified fixed cost equally.

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Conclusion

Logistics Procurement is confirmed to be a critical component of most companies' cost bases and is often chosen as a differentiating factor. One is likely to see further developments along the 4 axes above as well as other dimensions of logistics services procurement.

As the economy moves into a slow growth trajectory, one will see more emphasis on cost containment on one side while customer service will still need to be maintained and even improved on the other. Supply Chain procurement usually features as a first port of call in such a context, and can certainly still provide corporates with levers and opportunities for cost savings and service improvements.

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For more information on how to optimise your supply chain cost, do not hesitate to contact Haute Performance at info@hauteperf.co.za, or the authors:

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