

The Growth Potential in Managing SUPPLIER RISK

By Wayne S. Evans and Sven Blawatt

The downsides of a supplier failure are pretty obvious. Less clear are the advantages to be gained by aggressively managing and mitigating supplier risk. Two supply chain management executives from DHL tell how their company transitioned from a reactive to a proactive approach to supplier risk. This approach not only results in greater supply continuity but also serves as a building block for future growth.

The global economic downturn changed some fundamentals in nearly every industry, geography, and area of business—from finance to operations, from compliance to procurement. The global recession may be dissipating, but its effects and lessons learned will have a significant impact on our approach to risk as we dust ourselves off and begin working in a recovering economic environment. As procurement professionals, perhaps the biggest change we see pre- to post-recession is the increased importance and focus on risk. Furthermore, we've witnessed an evolution in viewing this area more holistically from risk management through risk mitigation.

The downturn moved risk from a good practice to a must do, best practice. For us at DHL, like many other companies, the eye-opener came when a number of suppliers started showing very weak financials with some Dun & Bradstreet scores indicating a high probability of near term business failure. As a consequence, supply chain risk management was abuzz again in C-Level suites and corporate boardrooms.

The Aberdeen Group, an independent research firm, conducted a study on supplier risks before the downturn. The report, "Supplier Risk Increasing While the Market Stands

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Still,” provided a glimpse into a more laissez faire attitude about supplier risk, with 49 percent of companies surveyed reporting that they did not have a developed supplier performance and risk management program in place.¹ Even then, many of these same companies, 62 percent of them, reported that they expected supplier risks to increase significantly over the next three years due to factors such as the globalization and disbursement of their supply base. Enter the global recession and, combined with existing trends, supplier risk management has skyrocketed in importance.

Even as we enter an economic recovery, most compa-

nies competing in the global economy will face increased pressures and risks to their operations. As companies emerge from the downturn there will be a continued effort toward leaning the supply chain and outsourcing areas when there is a compelling value proposition. This brings about reliance on suppliers who can proactively manage risk more dependably and on lower risk suppliers in areas such as logistics. There will also be increased responsibility on purchasing professionals to proactively manage and mitigate risks by choosing optimal suppliers, monitoring them, and ultimately balance risk and return.

Going into the recession, we needed to prepare

for supplier failures as decreased demand increased competition and drove revenues down. On the way out, demand could again be a problem; this time we need to prepare for constrained resources. For example, as the recession deepened we noticed that some of the larger print companies were taking presses off line and, in some cases, destroying them—thus reducing capacity in line with demand. Similarly, the airlines started taking planes out of service to match demand. These strategic business moves lead to capacity constraints, and as the economy recovers this will lead to an impact on delivery, price and quality. Also during the recession many fledgling suppliers went out of business, which again will add to supply risk and pricing pressures.

Although the economy may be seeing improvement, this heightened demand pressure alone, will lead to additional supply and quality risks as suppliers attempt to increase capacity. Therefore, we must be proactive and provide contingencies for these risks going forward. Solutions include building up and engaging a diverse supply base and, through collaboration, establishing a consistent service offering that mitigates any potential drop in quality. Supplier relationship management, which is based on the concept of collaboration, is one of the key factors to secure a continuous service offering on a high level standard.

The current risk environment is compounded as companies and customers are globally distributed and dispersed, and driven by a desire to grow the top line and cut the bottom line. As worldwide supply chains are expanded, risk mitigation practices will help differentiate those that succeed from those that fail. Regulatory requirements and accompanying pressures have increased ten-fold. (With political leaders in Washington seeking to bolster regulatory and enforcement efforts to protect against another “Great Recession,” you can bet those requirements will increase.) Competition in most industries has dramatically intensified. These increased business pressures are driving an ever-greater reliance on understanding, monitoring and mitigating supplier risk. Companies are under growing pressure not only to avoid supply chain disruptions and problems, but also to improve supplier performance and collaboration to mitigate future risks—and to improve business value. This leads to improved bottom line results and product/service quality.

Like most global companies, we took aggressive action to take costs out in the recession. And, as with most enterprises, our primary focus in supply management

A New Definition of Supplier Risk

Historically, supplier risk management has represented those processes that a company employs to limit unforeseen supply disruptions. Recent events have expanded this definition to include practices that protect the business from supplier events that can have an impact on the company operationally, legally, and financially. While techniques to guarantee materials and services continue to drive supplier risk management programs, the definition has evolved to include methods and technologies that limit the level of exposure of the business to regulatory, brand, or legal risks.

A successful supplier risk management program can become a continuous supplier improvement program—enhancing the quality, speed, reliability, and costs at which suppliers deliver.

was cost reduction. One of the most effective models was to send out “cost reduction” letters to the key suppliers asking for a firm percentage discount. As we move towards a sustained economy our focus is shifting to supplier development and supplier relationship management. To be successful, we realize the continued improvement process can no longer be just focused on taking cost out. It also must focus on creating tighter relationships with suppliers, which is a key factor in a continuous supplier improvement program. Establishing suppliers across individual business units provides the opportunity to standardize frame contracts, bundle volumes, and align targets and expectations along the company’s long term strategy. Key strategic initiatives are focusing on, for example, carbon efficiency, equipment and machinery utilization, and continuous process and efficiency improvement. In the future our opportunities for cost reduction will rely on continuous improvement programs and driving down the cost of doing business.

Procurement Can Lead in Mitigating Risk

Most in the supply management profession would likely agree that supplier risk has become a heightened priority and that the C-suite’s interest in the topic has peaked. Yet there is still work to be done in educating our organizations on the importance of supplier risk management.

The procurement organization looks at risk more “holistically” than other parts of the typical global company. (The accompanying sidebar offers our perspective on what constitutes supplier risk today.) Although it may seem somewhat counter-intuitive, purchasing professionals evaluate the buying process as more than just about price. They are interested in Total Cost of Ownership (TCO). We have the perspective, data, and

the tools necessary to help our colleagues—from finance to operations—understand that purchasing is more than a cost-decision, and that supplier risk management is more than just avoiding pitfalls. We need to bring these perspectives and data tools to bear as widely as possible if we are going to truly have an impact in mitigating risk for our organizations.

Based on our experience at DHL, and in past positions at major consulting firms, we offer the following thoughts on what procurement brings to the table in terms of mitigating risks in key areas:

1. Compliance risks. Simply stated, the procurement organization has standardized processes for buying goods and services. When departments source without consulting procurement, there are likely to be problems documenting the purchase process, which increases the risk of non-compliance and the risk of an audit. Our message internally to the more “independent” executives is simply, “cover yourself.”

If you source on your own you’re opening yourself up to potential compliance issues. Whereas, purchasing has a clear, compliant and auditable trail.

It is common practice for internal and external auditors to review the acquisition process for high dollar items. We have all seen several instances where a significant purchase made through the business did not follow a rigid, fair, and transparent bid process and failed to meet the audit requirements. Furthermore, the documentation, if it existed, was difficult to find and not stored in any central repository, leading to the perception that there is a non-compliant process. This risk can be mitigated by utilizing an electronic repository from an eSourcing application. DHL uses these and the other robust capabilities in Emptoris Sourcing.

2. Legal and contractual risks. Traditionally, if procurement is involved, then legal is also involved. When procurement and legal are not brought to the table, contracts tend to lack consistent, favorable and compliant terms and conditions. In our experience, we’ve seen contracts ended without proper termination provisions, liability issues without proper indemnification clauses, and intellectual property disputes without protective language. On several occasions in our careers, we have been brought into circumstances where procurement was not initially involved in creating the contract but later asked to “clean up a mess” that could have been avoided.

3. Statement of work (SOW) risks. When business units operate independently in contracting with suppliers and service providers, there is typically signifi-

cant risk related to poorly defined SOWs. This makes resolution of issues with the supplier or service provider that much more challenging. Our experience has shown that “non strategic sourcing” leads to inconsistent SOWs with the same supplier. We’ve also found that without a solid statement of work, it is extremely difficult to manage the supplier and “hold their feet to the fire.”

4. Financial risk. All of these factors contribute to financial risks—from failure to leverage economies of scale to contract leakage, from financial exposure to legal or production issues. It is important to identify and mitigate financial risk as early as possible. One potential solution is to monitor risk or market intelligence indicators from third party providers. Dun & Bradstreet’s

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Supplier Evaluation Risk Rating, for example, is created from statistical models to predict the likelihood of a company ceasing operations without paying all creditors under state/federal law over the next 18 months. Information such as age of business, payment trends and performance, financial ratios compared with industry averages, sales and profitability, and more all are taken into consideration. A change in score of two or more, triggers an automatic email alert to procurement signaling them to launch actions on replacement or backup suppliers. This kind of alert mechanism allows procurement to act rather than re-act on a potential risk.

When executives in a business unit want to award business to a specific company, they usually don’t realize what the broader relationship is with that company. Nor do they understand the competitive situation in the category. They usually have a preference because of an existing relationship or good experience with that supplier. There have been instances where we already have 30 percent of a category with one supplier company and a business unit owner wants to send a new piece of business to that same supplier. This would result in putting more than 50 percent of that category with that one supplier, thereby creating the potential for increased risk by concentrating significant spend with a single supplier.

Complex Sourcing: A Top Priority for Risk Mitigation

Over the past two years, purchasing has become increasingly involved in complex sourcing projects for transportation services—across all operational business units of

DHL. We have done this by offering our sourcing expertise, procurement tools, and a broader view across all business units in support of their internal requirements. As one may imagine, reducing internal transportation costs is significantly important to DHL—given that Deutsche Post DHL, is the world's largest mail and logistics services group with more than 470,000 employees in more than 220 countries and territories worldwide. We see our involvement in this strategic area as an important sign of the relationship between purchasing and other strategic departments at DHL. By providing a service to those unit—not a barrier—we increase the value that procurement brings to the table. The entire organization has come to recognize that having procurement involved as a subject matter expert (SME) can ensure proper due diligence and governance. Moreover, it can ensure best outcomes covering interests on a business unit and overall company level.

The holy grail of strategic sourcing has long been the high-value, high-dollar, complex supplies and services that are critical to a company's operations, as with transportation spend in our case. We refer to this as “complex sourcing.” With the introduction of sourcing technologies and e-auctions, the “low hanging fruit” was the logical first target for cost savings. As costs were wrung out of supply chains, and as technologies evolved, it became possible to leverage these solutions for complex events. Today, not only can sourcing technologies assist with complex RFx's but optimization technology is available for conducting complex sourcing events. Plus, the standard “three bid and a buy” sourcing process becomes even more efficient because the real-time feedback technology reduces the negotiation lifecycle.

The days of massive spreadsheets, teams of experts and months-long processes are quickly vanishing. Today, the sourcing optimization technologies offered by the top software providers, such as Emptoris, are capable of simultaneously evaluating hundreds of different procurement inputs. Such evaluations can take into consideration the global market, specific current supply chain conditions, and individual supplier conditions. And importantly, they offer solutions that address the buyer's and supplier's goals in the best possible way.

This obviously has implications for mitigating risks. In fact, we have found that a focus on complex sourcing events is the most important task a company can undertake to mitigate both supplier risk and broader business risks. As another procurement leader noted, “Where there is complexity—especially complexity that is difficult to measure—there is risk.” Too often, complex categories of spend are not sourced at all and are treated as sacred cows. Transportation, benefits and marketing are

perfect examples. As we move to a recovery and economic expansion, procurement has a prime opportunity to engage in the management of complex sourcing events. It's possible to solidify this engagement by offering a procurement service as an SME. Potential support resources include a dedicated team with standardized processes utilized in place, and an array of sourcing technologies supporting the complexity of this commodity.

Once engaged, these resources can address a variety of risks, including:

- *Operational Risks:* It's often the most critical supplies and services that are sourced independently—or sourced without full procurement engagement. The loopholes left in such statements of work (SOW) and contracts can be significant, resulting in a great deal of disruption within the company if the right supplier or service provider is not selected. Historically at DHL, the sourcing of internal transportation was done without our involvement. But with procurement's expertise it was possible to increase the transparency of the transportation spend and to reevaluate and enhance the supply base, providing additional qualified carriers. This increase in the supply base has improved the company's position in terms of providing better lane coverage and more competitive pricing, hence leveraging volumes, reducing the reliance on incumbents and providing true market prices.

- *Financial Risks:* Complex sourcing categories are also usually the highest value and the steepest priced categories and services. The risks associated with these categories will have financial impact not just for a business unit, but straight down to a company's bottom line. Leveraging our technologies and best practice, procurement at DHL has been able to bring about significant changes in complex categories by promoting standardized terms and conditions, SOW's, and processes as well as greater transparency. A recent initiative for a business partner focused on standardizing a supplier surcharge schedule across the business with expected, continuous savings of over \$1 million annually.

- *Suggestive Bidding Risks:* When organizations put out strict specifications without allowing suppliers to present alternative bids and solutions, something is lost in the process. Not least are the supplier's creativity and the ability to find mutually beneficial common ground. Managing this level of flexibility is extremely difficult with paper processes. Complex sourcing technologies, by contrast, allow for more flexible bidding, and thus a broader set of supplier solutions. When you're not allowing suppliers to tell you about themselves and to be creative, you're not getting best value—and there is risk inherent in that limited approach.

Suggestive bidding, which is empowered by sourcing optimization technology, allows the carrier to create its own offer based on modules provided to them in a “sandbox” environment. Let us illustrate with another transportation scenario: Rather than strictly defining routes, the buyer defines all required scheduled stops on a weekday basis and provides them to the qualified carriers. The carriers then create their own routes based on their existing business and cross docks in place. In doing so, they are able to provide a better price and eventually create their own discount structures. Such an approach also supports supplier relationship management, as the carrier is ultimately more successful utilizing its full capacity.

A centralized sourcing optimization technology ensures successful suggestive bidding, leading not only to best price but also to best value. Further, such sourcing practices help identify risks while helping ensure proper compliance and governance. Optimization enforces a consistent and fair bidding process—eliminating the risks related to inconsistency.

Increasing the Value Proposition

In the recession, we’ve seen the business world move forward and increasingly recognize the importance of strategic supply management. Senior executives can no longer afford to simply operate with their “price blinders” on. Value can be delivered in myriad ways, not least of which is through effective supplier risk management. Coming out of the downturn we will experience supply risk, inflation, and continued business failure—all of which can be managed by a proactive procurement organization. (Exhibit 1 depicts a timeline of activities and opportunities associated with the various stages of the


downturn—before, during, and after.)

These realities and beliefs are all reflected in our procurement mission at DHL. We continually ask ourselves how we can advance the value we provide to the broader organization.

Getting cost out is not going to be as “simple” and “easy” as it has in the past. But the value is higher now, the risk greater and the consequences will impact overall corporate competitiveness. As supply management professionals, we need to understand when strategic suppliers are financially strained, and learn how to support them. We need to bring tools to the table to monitor supplier risk proactively. We need to manage suppliers in a different way, in a way that seeks mutual continuous improvement. In short, our organizations are expecting us, as supply management leaders, to move the organization forward to a more secure, more prosperous place in the future.

Before jumping into specific strategies and implementing solutions, the first step in increasing the value proposition is to identify and isolate the one or two key risk types within your business environment. Once you’ve completed this exercise, you can customize your risk management strategy towards monitoring these risks.

Then, identify risk factors or indicators that can be continuously monitored—and develop and implement a dashboard or alert functionality to keep you actively updated on these indicators. Note, too, that supply base intelligence and transparency go a long way to mitigating long term risks. A potential vendor management database should include information on supplier history, process compliance, bidding performance, and current market intelligence (for example, via third party financial risk scores).

Finally, we believe that supplier collaboration can be a significant factor in mitigating supplier risk—and can help you steadily reduce your risk percentage in the long term. By identifying key players in your supply base and sharing your organizational goals and targets with them, customized solutions can be developed on both sides of the relationship, increasing efficiency and mitigating overall risks. 

Endnote:

1 “Supplier Risk Increasing While the Market Stands Still,” The Aberdeen Group, March 2007.

