

Leap of faith

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There are signs that a slow recovery is underway. In the private sector order books are beginning to return to pre-recessionary levels and a feeling of well-being, albeit tentative in nature, is returning to many sectors. However, ironically, despite growing optimism there are a rising number of significant dangers within the supply chain.

According to a recent report published by management consultants, PRTM, entitled "Lessons learned from the global recession", many companies lack the capabilities critical for meeting growing demand or for managing an increasingly complex and global supply chain. Among the five key trends identified from the survey of 350 manufacturing and service companies, two really underline the big challenges ahead: The first is that supply chain volatility and uncertainty have permanently increased; the second is that risk management involves the end-to-end supply chain.

If this is the case, supply chains are going to have to change radically and become far more agile, so as to flex with the volatility of the market. In addition, companies will have to adopt risk management strategies that are far broader than are currently practiced - only a small minority of companies measure risk in their supply chains. This will have to change.

Risks

Some risks are well understood, such as the potential insolvency or collapse of suppliers. This can lead to knock-on problems with financing other suppliers, distributors or transport companies. So protecting against cash-flow problems is critical. But there are other risks too: for example political instability, natural catastrophes, strikes, port blockages, piracy, currency exposure and product quality. For insurance companies this is why supply chain risk is different to other areas in which they operate. There are so many different elements that have to be brought together and looked at as a whole.

There are also long-term business trends, such as single sourcing, industry consolidation, just-in-time manufacturing and extended supply chains which have all heightened risk. These business practices have made supply chains far more critical to the success of the enterprise. However, they have also made them far more fragile, which has impacted the financing of the supply chain by rendering them increasingly precarious. It is therefore important to understand the risk costs associated with a supply chain if they are to be priced into the overall financial cost of the supply chain.

Credit checks are important for arranging insurance cover, but risks to the supply chain need to be considered holistically. According to Nick Wildgoose, global supply chain proposition manager at Zurich Financial Services, companies need to be alert to threats within the supply chain. "We've found that supply chains aren't high on the agenda, and only gradually are firms waking up to their responsibilities in this area," he says. "Many just don't realise how complex their supply chains are, and where the weak points might be. It is important that companies have an awareness of the operational risks within their supply chain."

Zurich Financial Services has developed a risk assessment framework based around a "checklist" of 23 risk factors and have created a database of 2,400 previous incidents of supply chain failures, analysed by Manchester Business School.

Wildgoose believes that traditionally, companies have not devoted enough resource to mitigating supply chain risks. He says that the problem for companies seeking to buy insurance cover for their supply chains has been that they have always had to take out separate property, marine, construction, political or insolvency products and hope there were no gaps. However, this is no longer the case as Wildgoose is quick to point out that Zurich has just introduced a product to cover all these areas.

Now that signs of recovery are becoming more widely apparent, it might seem safe for organisations to relax their vigilance over suppliers. However, Colin Maund, chief executive of Achilles Group, a company that manages supplier information, believes the opposite to be true. "Generally, supplier bankruptcies occur when the economy is heading towards recovery. And that's because suppliers have been able to beg, steel and borrow their way through the worst days and extend lines of credit. But it's when the recovery starts that companies face an unpleasant cocktail," he says.

"First of all, they are often at their weakest, their customers are paying late and yet, buyers are still being demanding on terms - if not even more demanding; secondly, they haven't got some of the contracts that they were awarded in the good times to fall back on because those contracts are coming to an end or have ended. And thirdly, they are terrified that the recession is coming towards an end and realise that they need to gear up for recovery," Maund says.

These problems are further exacerbated by staffing issues. Key staff who may have been under pressure during difficult times, and stayed at their posts to ride out the storm, are now looking for new positions. These individuals will need to be replaced, quite likely, by people who are more expensive.

Buyers need to be particularly conscious that coming out of recession, suppliers are going to be more cautious and less prepared to invest. Also, there are going to be fewer suppliers about. Some will have merged and others will have gone out of business. And companies are still going to find it difficult getting bank funding, which means that going to a supplier with a new order may be seen as more of a "poisoned chalice" rather than a wonderful opportunity - it may be they simply can't afford to invest the money up front to supply you.

So, what should the buyer's response be? How can buyers help their suppliers? "In my view," says Maund, "the buyer's response should be to be even more vigilant about supplier credentials and have alternative strategies in place... and to be aware that simply throwing a big order at a supplier is not going to necessarily be regarded as a helpful thing to do."

There are two things they should be doing, he says. "The first is to look at those suppliers they have real influence over and if they do have concerns over any of those suppliers, then they should have a very open conversation with those suppliers about their financial position. In cases where they feel that they don't have enough economic leverage to get the response they are looking for from a supplier, then they should at least have an alternative strategy around another supplier or group of suppliers, should they need to move quickly." He warns that companies should pay particular attention to details relating to ownership of goods - a supplier going bankrupt can lead to complicated issues in this area.

Cutting corners

One of the first things buyers should watch out for is suppliers cutting corners to save costs. This can obviously affect the quality of products and services supplied. Staffing levels may be reduced on projects or perhaps, for example, less testing may be carried out on software. A further danger, Maund points out, is that suppliers may try to save money by not paying subcontractors. "So you may get a knock-on effect - and in some cases the subcontractors are as important as the main contractor."

"Where you really are stuck with a supplier that is critical to your business one obvious thing you can do to help them stay in business is to pay them on time," suggests Maund. "Although don't pay them early, especially if there is a risk that they might go out of business." Another thing, he says, "is to act as some sort of guarantor; I've seen cases where companies have awarded a reasonably long-term contract to allow the supplier to go to its bank and say 'I have every expectation of pulling through this, I've got long-term contracts'." However, there appears to be little evidence to suggest that banks are now more willing to lend. Governments are making a big song and dance about the banks being unwilling to lend, whereas the banks are saying there is simply no demand. Companies and banks are risk averse, and the majority of companies are looking to save money, not take on more debt.

A great deal of tension over future demand relates to the public sector and the slashes in public spending that are expected. For many suppliers to the public sector business has simply "gone off a cliff" and for those lucky enough to have their contracts in place, a large number are being approached by public sector buyers for reductions and changes to their contracts to reduce costs. Then there are the subcontractors, a great many are being asked by the main contractors to reduce costs to help share the pain of public spending cuts - sometimes regardless of the true situation.

All in all, it's very much a case of "buyer beware".