

Supply chains in distress

Unseen risks, immediate defences
and long-term remedies

“The response to adversity is driving diametrically opposed behaviour from different companies. 46% of surveyed companies reported that they had narrowed their supplier base to obtain more favourable terms, some 42% had acted to broaden their supplier base to reduce the impact of the failure of an individual supplier.”¹



“Of 400 worldwide purchasing directors surveyed, only 31% of the respondents had fully assessed supply chain risks during the downturn, and failed to evaluate problems such as the financial stability of vendors.”²

1. Opportunities in adversity report, Ernst & Young, 2009

2. CPOs on the hunt for more savings, Supply Management, April 2009

The rise of complex, integrated supply chains, along with the recent global downturn, has increased the probability that critical suppliers will encounter supply disruptions and financial duress. The consequences – from an inability to deliver on promises to customers, to losing access to a supplier’s intellectual property – can be dire.

As well honed as today’s supply practices may seem, a growing number of companies across a range of industries are experiencing rising supply chain risks and, in many cases, significant disruptions. The

truth is that the current levels of financial turmoil are outside the parameters of most risk models and accompanying supply chain processes. Is your supply chain secure – or is it merely an illusion? Prudent management teams are taking note of the rising number of failed suppliers and, in response, are initiating actions to assess and mitigate potential near-term supply risks. This includes:

- ▶ 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 troubled suppliers – including Re-sourcing, acquiring or investing, or managing through bankruptcies or workouts.

For many companies, the need for such actions is both real and immediate.

Faster failures

Supply chain monitoring historically focused on operational performance. Because companies cannot afford failures in quality or delivery of their own products or services, they go to great lengths to monitor the quality of their suppliers’ outputs. So companies tend to calibrate their operational radars to identify trends; they act accordingly to address defects in quality, quantity, service and supply in something akin to real time.

Such operationally focused systems may include a degree of financial analysis. But relative to the speed with which financial turmoil is spreading through today’s markets, such updates refresh too slowly or simply fail to focus on the right variables. Consequently, even those companies with a host of well-honed operational surveillance capabilities can be caught severely off guard, particularly when it comes to understanding the financial warning signs.

In the past, the signs that a supplier is encountering financial difficulty might offer advance warnings during 6-, 9- or even 12-month intervals. So a customer would have many opportunities during a protracted period of time to identify, evaluate and react to what historically would have been an isolated situation. That might mean assisting the supplier or implementing a contingency plan such as diverting material, component or service requirements to backup suppliers.

Today’s business conditions, however, are far from typical. Financial duress isn’t building up slowly, but rather is overwhelming suppliers in weeks or even days. A supplier that might be meeting demands one day can be posting an ‘out of business sign’ the next.

What’s more, at a time when entire industries are being severely stressed, contingency plans developed in better times are proving to be ineffective. In this environment, companies are subjected not only to the financial health of immediate suppliers, but also to the collective financial positions of all those on which their suppliers rely.

With complex supply chains and deteriorating cash and credit conditions, the risks today are an order of magnitude greater than in prior decades. So companies need to deploy significantly greater resources toward identifying suppliers experiencing financial duress, and even more, finding the best ways to deal with these heightened risks.

Signs of potential supplier distress

- ▶ Supplier is requesting improvement in payment terms.
- ▶ Supplier is requesting significant price increases or other pricing considerations.
- ▶ Supplier is extending its credit terms with its own supply base – formally or through non-payment.
- ▶ Lending institution(s) are reducing the supplier's line of credit.
- ▶ Supplier begins using factoring – or asks to implement reverse factoring.
- ▶ Supplier increases its cash payment discount.
- ▶ Supplier is pledging stock.
- ▶ Supplier is executing significant and/or multiple sale-leaseback transactions (monetising assets to generate liquidity).
- ▶ Important turnover recently occurred in top management (including CFO) position.
- ▶ A subsidiary/sister company of the supplier recently filed for bankruptcy or was recently liquidated.
- ▶ Supplier has been delaying some investments or changed its practices relative to funding its purchases or product development activities.
- ▶ Supplier is suffering from frequent litigations with third parties.
- ▶ Supplier is experiencing difficulties dealing with trade unions.
- ▶ Recent trend in increased quality issues (defects measured in parts per million [PPM]), on-time delivery concerns and/or expedited delivery requests.
- ▶ Recent significant acquisitions/divestitures/plant closings.
- ▶ Recent changes in ownership.
- ▶ Supplier has had a major customer or supplier of its own become financially distressed.



Three essential elements

In such circumstances, it is incumbent on executives to implement a programme of supplier-focused risk identification and management. Leading practices in supply chain stability tend to focus on three key capabilities:

Capability one: early warning screening

Companies need to enhance their predictive modelling and consolidate their day-to-day knowledge of mission-critical suppliers. Again, capabilities developed during an era of greater liquidity and stability are likely too slow for today's conditions.

An early warning screening system (EWSS) is a means for identifying potential risks to the supply chain. The screening system utilises a combination of financial, commercial and operational metrics to identify suppliers that pose a risk (threat) to disrupt operations. These early warning indicators allow for proactive responses to avoid operational disruption and mitigate risks to the organisation.

Historically, such systems tended to focus more acutely on issues of operational effectiveness, e.g., on-time deliveries, accurate quantities and suitable quality. These types of variables are still relevant in today's market. However, companies need to introduce a significantly greater

element of financial focus – the means for predicting or identifying suppliers currently experiencing or likely to experience financial duress.

Creating an effective EWSS in today's context requires considerable attention to detail. A critical step is establishing the right team with the right skills.

Certain skill sets are obvious; others less so. Clearly, the team will need the ability to interpret sophisticated financial and operational data. Less clearly, but closely related, the financial analysis team must have an idea of where to find needed public or private data and a sense of what might be 'interesting' to obtain versus what is essential.

It will also be important to have the right commercial and legal representation. The supply chain or operations manager can describe the various metrics and touchpoints relating to individual or groups of suppliers. Plus, legal and commercial staff can add value, through providing

insights relating to the right to audit or obtain financial information within a supply contract or purchase agreement. For now, the group may have to rely on the data collection as enumerated in existing agreements. But going forward, the goal will be to craft appropriate language for insertion into agreements so the company will have appropriate access to the information it needs.

The overarching task for the EWSS team will be to establish criteria to identify critical suppliers and tolerance levels indicating the need to flag troubled suppliers. The group will look not only at individual suppliers, but also at the general size, character and health of a given industry. Is this a case of many suppliers and too few customers? Is it a case of a few troubled suppliers? Whatever the situation, the group will need to develop a scoring system for identifying specific, at-risk suppliers as well as a means of prioritising those in need of immediate attention.

An effective early warning system can help to:

- ▶ Segment a company's suppliers, identifying those most critical to success.
- ▶ Provide early detection of a supplier that may be experiencing financial distress.
- ▶ Minimise risk and avoid severe business disruption.

Capability two: troubled supplier risk assessment and planning

For those suppliers identified by the EWSS as posing significant risk, the company will need to take additional steps. In particular, a customer will need to perform detailed risk assessment and develop a strategy for risk mitigation and contingency planning.

This phase begins with a more robust analysis of the flagged suppliers. If audit provisions in the supply or purchase contract allow, now is the time to execute such options. Of course, where no such provisions exist, the company can request additional information. Refusal of a supplier to provide such insight could be construed as further evidence that there is cause for concern.

A more detailed analysis can give the company insight into the manner in which the supplier is organised, its position in the marketplace and its performance relative to peers. For example, it can be useful to try to estimate the supplier's break-even level of sales, perhaps through analysis of variable and fixed costs.

As further analysis dictates, it may be the right time to formulate or even implement plans for risk mitigation. This begins with subjecting the supplier to more rigorous and frequent monitoring. In the meantime, the company should begin preparation of a backup plan for re-sourcing. Core issues here include assessments of alternative suppliers, market testing, tooling inventory

and even intellectual property concerns. Of critical importance: the company must develop a detailed analysis of operational exposure. Understanding the relationship between the supplier's output and current and anticipated obligations has a direct bearing on choosing the right option or combination of options. This includes potential transition to a new source of supply, providing financial assistance, as well as consideration for vertical integration – including acquisition of the troubled supplier or one of its competitors.

A troubled supplier planning phase seeks to:

- ▶ Gather financial information and operational metrics to use as indicators of the stability of critical suppliers.
- ▶ Perform desk-top financial diligence to validate the stability or instability of a supplier.
- ▶ Identify additional information needed (if any) to complete the desk-top review.
- ▶ Perform detailed risk assessment through on-site financial and operational due diligence if desk-top review raises additional warning signals.
- ▶ Develop and implement a plan of action.

Supplier risk is a timeless concern: procurement professionals have worried about supplier performance and stability since the beginning of the industrial revolution. But with the flood of bankruptcies resulting from the credit crunch and general economic weakness, those worries have taken on ulcer-inducing proportions.

Understandably, other studies have shown that almost 20% of procurement respondents had suppliers who had not been able to meet their supply levels or needs. The lesson is that purchasing professionals have to more closely monitor the financial stability of their suppliers, including supplier liquidity and changes to suppliers' customer-priority rankings.

"The risk disconnect; analysing the supply base is a critical part of risk management. But purchasing can do much more - like serve as a bridge to connect departments and question basic assumptions about company operations."

Purchasing, 3 April 2009

Ten questions to ask about supplier stability risk

Do you know the answers to the following questions? How long would it take to learn the answers? Would the answers be a source for calm or concern?

1. Who in my organisation is responsible for assessing and monitoring supply chain risks?
2. Are our supply chain risk-monitoring systems sufficiently robust to detect financial duress on the scale of today's cash and credit crisis?
3. Does my supply chain management team contain appropriate, cross-functional expertise, including not only procurement and operations, but also finance, corporate strategy and legal?
4. Do our supply chain risk-assessment processes and tools address unique characteristics such as sole source providers, tooling costs, software and intellectual property investments, concentrated spending, switching periods or costs, and rare or exotic material or services providers?
5. What is the timeframe for implementing our contingency plans for our key providers?
6. Does our supply chain risk-assessment and contingency planning delve into relationships with service providers such as IT vendors, payroll or HR services, or other outsourced function providers?
7. Are our suppliers exhibiting any behaviours that would indicate potential distress?
8. How extensive and current is my financial review of the most critical vendors in my supply chain?
9. For our key suppliers, are we fully aware of the prevailing market conditions that are driving cost structure and financial performance?
10. Do we have sufficient resources, skills and contingency plans to handle the sudden failure of a primary supplier without failing to deliver on our own promises to our own customers?

Capability three: distressed supplier management

As supplier distress decays to crisis or even bankruptcy, companies will need still greater nimbleness and business acumen in order to secure or preserve their interests. The goal might be continued output from the supplier or asserting rights to any other value that might be due, but in any case, companies need to understand the best means to these ends.

Responses are not always in line with conventional thinking. A company's fundamental desire is to have an uninterrupted, high-quality, appropriately priced source of supply. So when a supplier encounters severe financial strain, the knee-jerk reaction is to lend a hand – perhaps accelerating payments to the supplier, for example. But in fact, such actions may be precisely the wrong prescription. Banks may already be factoring 75%-90% of sales for the supplier. Early payment may minimally benefit your supplier (e.g., 15 cents on the dollar) but instead may primarily benefit the bank through improving its position while consuming your cash and deteriorating your working capital.

Now matters have escalated to the point where simply terminating the relationship may not be an option – the supplier was too strategic or would be too difficult to easily replace. Options under consideration expand to include everything from investing in the business to a defensive acquisition of some or all of the supplier. So in addition to supply chain expertise, what the company needs now is a crack team with bankruptcy, acquisitions, transition planning, integration planning and similar transactions skills.

The relationship with the supplier is becoming more intimate than ever. More than likely, the company will need to place feet on the ground, working in close cooperation with the supplier to increase its visibility into its day-to-day operations. The company will need detailed information relating to its operational processing capabilities (e.g., bills of materials, routings and service level agreements), other customers' rights and responsibilities, and 'tier 2' suppliers upon which the supplier in question relies. Moreover, the company will need to gain an in-depth understanding of cash positions, liquidity, borrowing availability, forecasts and the basis for forecasts.

Still, it will be important to maintain considerable degrees of discretion and distance. After all, the situation might be a case of merely keeping the relationship afloat long enough to find a new source of supply. Letting the supplier know otherwise could jeopardise access to needed materials or services.

It bears repeating, this is crisis management. As such, the company will need to take steps such as reviewing the supplier's 13-week cash flow and borrowing base availability forecast. Similarly, the company should be in daily contact with its own on site resources gaining visibility into the supplier's:

- ▶ Procurement activities.
- ▶ Productivity (down time; capacity; efficiency; and variances in material, labour and overheads).
- ▶ Projected output (planning and orders).
- ▶ Inventory management (scrap factors, excess and obsolete levels, and salvage capabilities).

- ▶ Sales backlog/pipeline.
- ▶ Working capital.
- ▶ Liquidity and borrowing base availability.
- ▶ Logistics, warehousing, distribution and sequencing activities.
- ▶ Any reports provided by third parties – specialists, consultants.

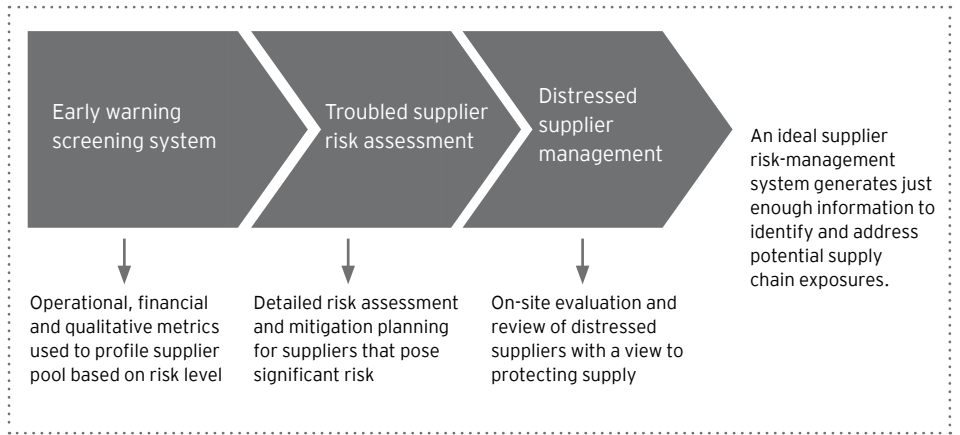
By these and related means, the company will be in a better position to secure its own source of supply. Whether that means acquire or invest in the supplier, get as much as possible from the supplier or simply move on. Through effective supplier management, the company can gather the information necessary to develop the most appropriate strategies for moving beyond the crisis.

The distressed supplier management phase seeks to:

- ▶ Closely collaborate with the supplier to gather detailed information: place feet on the ground.
 - ▶ Prepare recommendations on best courses of action for executive decision makers.
 - ▶ Assist with execution of desired strategy.
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Life cycle of a distressed supplier

An effective programme of identifying and managing the risks of a distressed supply chain can be described in three principal phases or workstreams.



Fix things now, renovate later

The number of suppliers in crisis is on the rise. So companies would be well advised to take immediate action. But then, once these near-term issues are addressed, executives need to begin taking definitive steps toward preventing the future build up or occurrence of similar distressed supply scenarios. Key steps to consider include:

- ▶ Ask for more aggressive audit clauses. Companies should ensure they have the right to review the inner workings of their most strategic suppliers.
- ▶ Consider escrow or liquidated damages provisions. The supplier may seem sound today; the question is how will they appear in a year, two or three?
- ▶ Increase the voracity and frequency of financial analysis. Warning systems based on scant or stale financial reporting generated six or nine months in arrears are not providing adequate protection.

- ▶ Revisit sole sourcing. High tooling costs, the value of intellectual property or seemingly prohibitive switching costs must be balanced against the risks of supplier failure.
- ▶ Analyse entire markets, not just a supplier or two. Industries with high supplier concentration present different risks than those where there are comparatively more suppliers from which a company can choose. Be certain to understand the precise risks and make informed decisions.

So today, companies should be hard at work performing triage when dealing with the most troubled members of their supply chain. Likely, there will be plenty to do. But as overall economic conditions improve and matters stabilise, rather than revert to business as usual, leading companies will learn from these experiences.

But long term, companies need to think more clearly about supplier risks. Moreover, they need to incorporate key risk-mitigating components such as audit clauses in commercial agreements, as well as implementing effective early warning systems.

Supplier failure: the risks are tangible

A 22 January 2009 Ernst & Young poll found that more than two-thirds of executives (67%) say that their companies would experience adverse effects from the failure of any one of their top three suppliers.

Supplier stability: a competitive advantage in a volatile economy

- ▶ Provides insight into key suppliers' ability to meet commitments
- ▶ Allows for a continuous, proactive response to external risk
- ▶ Reduces costs as early detection prevents diversion of resources from operational and market facing activities to crisis management and maintenance activities
- ▶ Enhances supplier selection, favouring suppliers that demonstrate stability
- ▶ Promotes a teaming culture by encouraging cross-functional interaction and operational organisation
- ▶ Integrates the business of supplier selection (pricing, logistics, etc.) with supplier risk management (financial health, sustainability of supply, etc.)
- ▶ Limits exposure, as a focus on supplier operations alone is often insufficient in detecting looming supplier failure
- ▶ Defines your options sooner and more clearly - can the supplier recover? Will a cash infusion or other support be enough or is replacement essential?
- ▶ Delivers working capital benefits through better inventory, accounts payable and receivables management
- ▶ Reduces exposure to bad debts or inventory obsolescence
- ▶ Improves the working relationship between supplier and customer

From adversity to opportunity

A staggering number of suppliers, both public and private, are facing financial distress.

Supply chain monitoring systems designed to track operational tolerances are proving far less capable in detecting fast-moving financial failure. In short, the conventional practices used to monitor supply chains must evolve.

Companies need to think about both near- and then longer-term actions. Immediately, they need to revisit monitoring practices to determine if their early warning screening system sufficiently identifies suppliers in financial distress. Early results indicate practices need to expand to include more timely and more extensive financial and operations analysis.

Once distressed suppliers are identified and prioritised, companies need to improve their skills in taking matters to the next level. Multi-functional teams must be engaged more proactively to assess the extent of the risks and begin mapping a broad range of contingencies.

Finally, companies need to be prepared to, where necessary, take more dramatic action. Having your feet on the ground will help monitor ongoing operations as well as gather additional data to fuel ultimate decision making.

A real crisis could mean severe supply disruptions and or bankruptcy. Conditions may lead to a short-term cash infusion, long-term investment or even an acquisition.

But in all cases, a company must understand its own needs as well as the range of means to their realisation.

Not every company will experience the turmoil of a failed supplier. But executive management teams are beginning to understand that the incidence of supply chain failure is on the rise. This begs the question: what could a supplier disruption mean for our company? For those companies who move to establish proactive supplier stability monitoring and risk-mitigation processes, this is one means of turning adversity into opportunity.



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