

SUPPLY CHAIN CONSOLIDATION – A PROMISING STRATEGY?

by Dr. Dirk Schneider

Supply chains in most industries have become increasingly fragmented. This concentration on core capabilities of each player has increased operational supply chain efficiency significantly. In times of economic turmoil, however, financing cost and, in fact, financial viability of each entity moves into focus. Smaller companies, often squeezed into a less attractive niche of a supply chain may face prohibitive financing cost or become outright distressed. Overall supply chain economics might be adversely affected.

Based on a case-study the following article discusses the overall impact of financing cost on supply-chain economics. It expands the traditional view and highlights the financing aspect for everyone involved in strategic supply chain decisions.

The financial and economic environment still is far away from its pre-recession heydays. But coordinated initiatives of governments and central banks have prevented a melt-down of the financial systems. GDPs and financial markets have stabilized surprisingly quickly and the likelihood of a prolonged recession appears low. Two scenarios appear likely.

In the best of all worlds financial and economic confidence will return quickly, international trade regulation and inflation will remain benign and economies will return to pre-crises levels quickly.

More likely, however, confidence will remain shaky for some time allowing only for a fragile recovery with delays and hiccups along the way. Regulatory and inflationary uncertainties will leave their impact. Financial markets and economies will take a few years before returning to pre-crises levels.

Does this warrant another look at today's increasingly fragmented supply chains? Could supply chain consolidation provide a winning strategy for strategic and financial investors in the upcoming environment?

Supply chains have become increasingly fragmented

In their year 2000 book “Blown to Bits” Philip Evans and Thomas Wurster laid out a compelling argument: the internet with its increasing number of general or industry specific communication platforms will facilitate even highly complex information exchange among industry participants at low cost. Since information cost – or more broadly transaction cost – are the key driver behind integrated supply chains and integrated organizations, a significant reduction in transaction cost will first disintegrate supply chains and then organizations. Traditional industry structures will be “blown to bits” and small, flexible units will organize itself to provide the best possible service in the most efficient way.

This disintegration has taken place. High profile divestments in the automotive Industry, such as Delphi from GM or Visteon from Ford or the emergence of powerful electronics service manufacturer, such as Flextronix or Sanmia are widely visible examples. Less visible and smaller spin-outs have completed the picture of the increasing disintegration. Many industries appear to be in a race to organize companies for the lowest possible value added in each single company. The German auto-

mobile manufacturers, for example, have reduced their value added from 35% in 1990, over 28% in 2000 to a projected 20% in 2010, all according to a 2007 study by Hans-Christian Krcal, University of Heidelberg.

The barely passed recession has shown, however, that information exchange is not the only factor determining the sustainability of disintegrated supply chains or organizations. In times of economic distress – with cash and credit access becoming a more significant matter of concern - the financial viability of each individual entity moves into focus. Larger organizations, often covering several steps along the value chain typically do have the resources to remain healthy, even in a distressed economy. Smaller companies, possibly squeezed into a less attractive niche of a supply chain, on the other hand, are often threatened and may endanger an entire supply chain.

Supply chain consolidation to battle distress

Take a small family owned metalworking company. Two large, financially stable suppliers accounting for 80% of raw materials, three large end-customers accounting for 70% of revenues – one actually being a subsidiary of a supplier – and another sizable customer accounting for 15% of revenues selling the company’s products together with technical services to a larger number of smaller end-customers (Exhibit 1). Profitability of the company had been historically low, the equity account had turned negative and available credit facilities had been used to the maximum. The recession did the rest and put the company into distress. Both large suppliers and the four major customers, however, remained profitable and in a stronger financial position than the company itself.

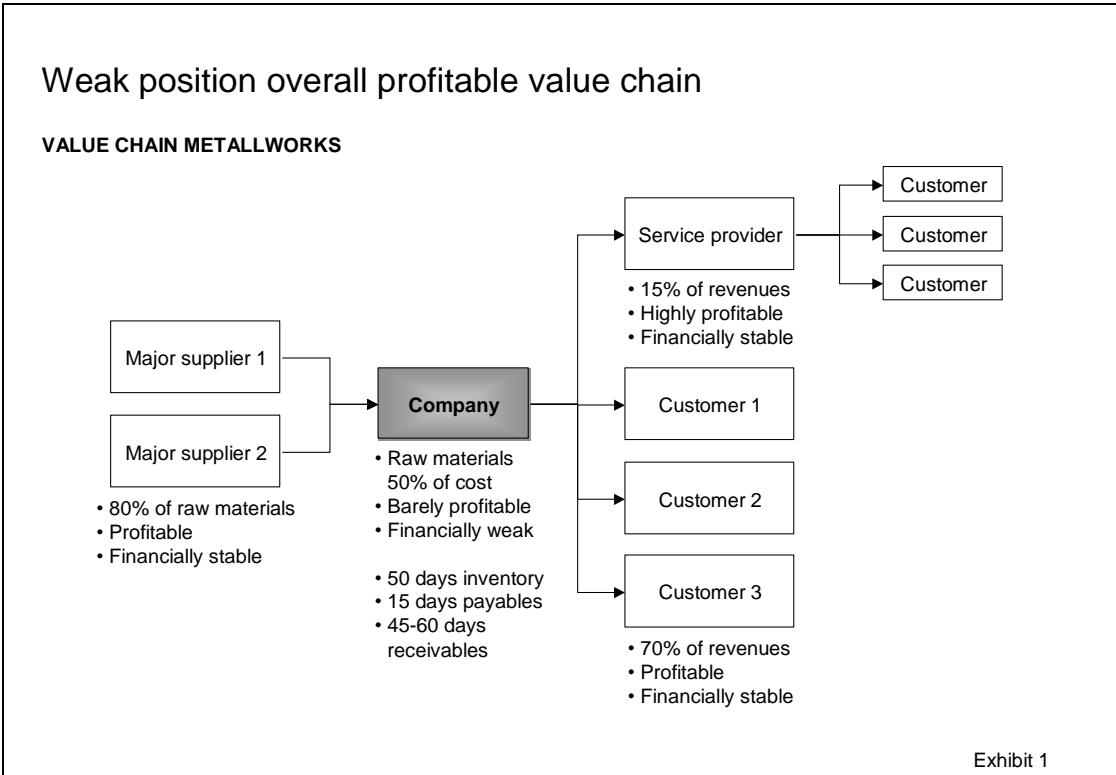


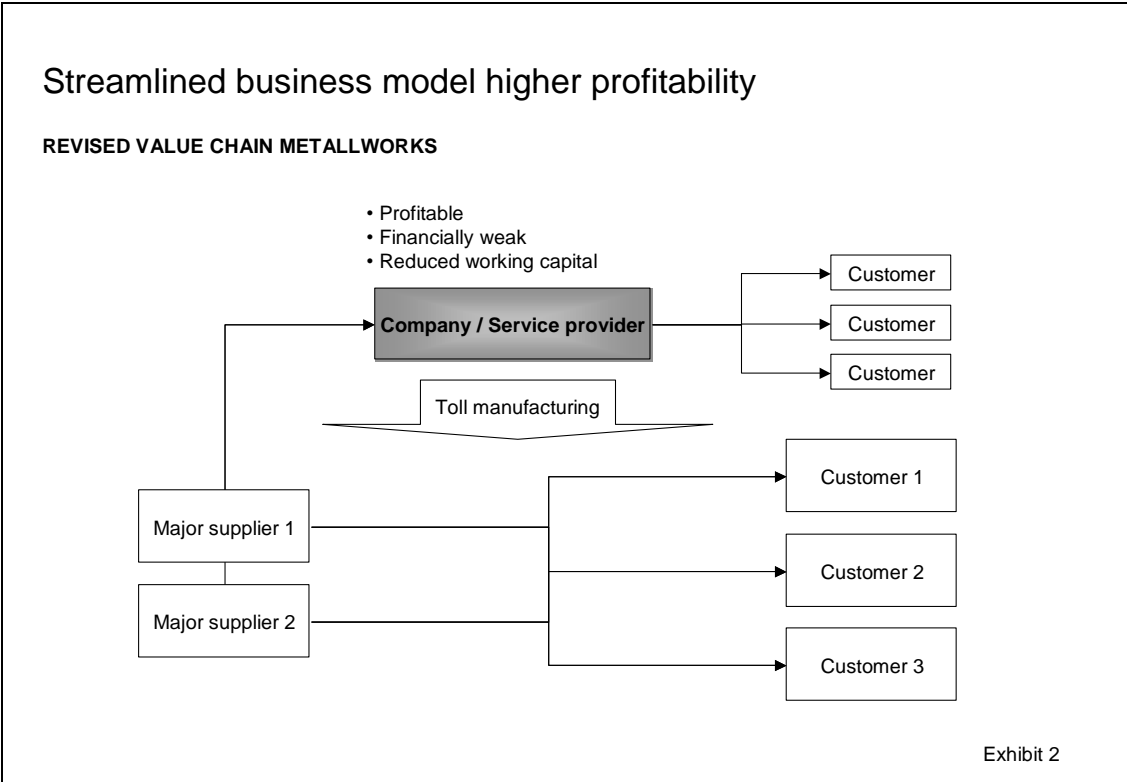
Exhibit 1

In this context, the technical service provider downstream in the supply chain became available for acquisition and provided an opportunity to extent the value chain into a more profitable segment and to

establish direct access to more end-customers. Funding of this acquisition, however, was a challenge given the already distressed situation of the company.

An analyses of the value chain revealed that poorly managed short-term price fluctuations in raw materials - accounting for approximately 50% of total cost - contributed to the historically low profitability of the company. A working capital analyses revealed that accounts payable – reflecting the low credit rating of the company – averaged less than 10 days while accounts receivable ran in the range of 45 – 60 days.

Based on these results the company changed its business model. Leveraging the lower financing cost of its main suppliers and customers, the company switched for this part of its business to toll manufacturing, i.e. the suppliers sold raw materials directly to the three large end-customers while the company only charged a “processing fee” (Exhibit 2).



With this restructuring of the value chain the company could reduce margin fluctuation and free up significant working capital from inventories and net accounts payable/receivable. Part of this working capital reduction was used to cover part of the acquisition of the service provider. A seller’s note and a subordinated shareholder loan closed the gap.

And if so, who should drive such consolidations?

Supply chain consolidation: a promising strategy?

By consolidating the overall supply chain the company could acquire a valuable extension of its value chain, increase profitability and reduce historic profit variability (Exhibit 3).

The arguments in favor of supply chain disintegration have been valid ten years ago and they remain valid today. A general reintegration of supply chains is therefore not a promising strategy. Some destabilizing factor of disintegrated supply chains, however, have been underestimated and the current recessionary environment has highlighted the impact of, e.g., financial instability and high working capital cost to sub-critical players. A tailored reintegration of selected supply chain elements may

therefore turn out to be a promising strategy.

For which supply chain elements might this be applicable? First, the overall supply chain should be robust and serve at least stable, preferably profitable market segments. Distressed situations, if present at all, should be clearly defined to individual players or process steps in the chain. Heavy and light machinery or electronics could become fertile hunting grounds.

Second, some clear signs of “re-integration need” should be visible. This could be individual players already in distress or more general coordination issues along the chain.

And third, the supply chain should have an identifiable “consolidation champion” who could serve as the nucleus for the consolidation.

Who should drive these supply chain consolidations? Financially capable players from within a chain are obvious candidates. They do have the strategic expertise as well as the operational skills to initiate and execute such a move. They are well positioned to identify the most beneficial balance between integration and disintegration and are natural champions to lead the process.

Supply chain consolidation to grow out of distress

“WORKING CAPITAL FINANCED ACQUISITION”

Situation:	<ul style="list-style-type: none"> ▪ Mid-size, family owned metalworking company ▪ Two financially stable large suppliers, three financially stable large end-customer, one customer as maintenance provider serving smaller end-customers ▪ Low profitability, negative equity account, no access to further external funding ▪ Strategically attractive opportunity to acquire maintenance provider
Objective:	<ul style="list-style-type: none"> ▪ Develop and implement acquisition concept for maintenance provider
Work performed:	<ul style="list-style-type: none"> ▪ Change to toll manufacturing for large end-customers to free up working capital <ul style="list-style-type: none"> - Leverage strong credit rating of end-customers - Reduce net receivables / payables by 50% - Reduce inventories by 60% ▪ Structure acquisition financing to minimize external funding needs <ul style="list-style-type: none"> - 50% freed working capital - 30% seller’s note - 20 % equity
Result:	<ul style="list-style-type: none"> ▪ Successful acquisition with low equity requirement ▪ Additional benefit: reduced exposure to price volatility of raw materials

Exhibit 3

Financial investors with the right strategic and operational skills can drive the process as well. They can pick one player from within the chain, supplement his financial, strategic or operational capabilities and turn him into a champion. This, however, requires a potential champion who only lacks financial means or a financial investor with deep strategic industry insights.

Conclusion

Supply chain consolidation is not a promising general strategy. But in the current environment and with the right supply chain and industry structure it may provide attractive opportunities. Strategic and financial investors with the right skill mix will find rewarding targets.

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