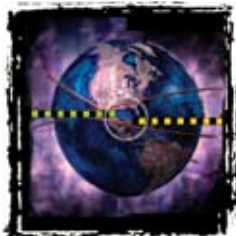


Outperforming the Market Price Reductions

In a period of declining market prices, procurement organizations must deliver and measure price reductions in excess of the market, while exceeding goals for quality, service, and innovation.

By Marc Hochman and John Moyer



Marc Hochman (marc.hochman@atkearney.com) is a Vice President and John Moyer (john.moyer@atkearney.com) is a Senior Sourcing Manager with A.T. Kearney Procurement & Analytic Solutions.

Starting in the second half of 2008, many procurement managers achieved significantly lower pricing for items such as resins, packaging, transportation, and chemicals, as commodity prices declined precipitously and demand slowed with the global economy. For example, the February 2009 pricing for commodities such as aluminum, steel, copper, rubber, and resins has fallen at least 60 percent from the peak prices reached in 2008.

To add value to their businesses, procurement managers must develop sourcing strategies to achieve price reductions greater than the market, while exceeding quality, service, and innovation goals. These sourcing strategies must also deliver value over an extended period, and have the flexibility to ensure competitive pricing over a range of potential future price and supply scenarios. At the same time, effective procurement organizations need to implement tools and models to measure their performance against the market.

Commodity Pricing Mechanisms

There are various mechanisms under which pricing may change based on the commodity cost drivers. In some cases, supplier pricing is reduced automatically under contractual index-based pricing. The price of these items is based on the index for either that item or its key raw materials. An effective sourcing strategy will define the mechanism for index-based price changes with respect to lag period (delay between change in

index and when new pricing becomes effective), collars (the range in which pricing can move), and caps (the negotiated ceiling price).

In other cases, supplier negotiations yield lower pricing as procurement managers leverage market pricing and incremental volume with their supply base. In categories where material costs are a significant portion (60 percent and higher) of the total cost, procurement managers can negotiate decreases of 40 percent or more, from 2008 to 2009 pricing. Some procurement managers did not realize immediate price relief from market declines. The reason: their sourcing strategy relied on fixed pricing or hedging tied to a higher commodity price level, or included a long lag time to the changes in the indexed pricing.

In a period of declining prices, one of the key performance indicators for any procurement manager is whether he achieves pricing, quality, and service-level improvements in excess of the market movement. For example, if the market for polyethylene film declines by 20 percent, a procurement manager who negotiates 10 days additional payment terms, one day shorter lead time, and a 25 percent price improvement, clearly delivers value to his business over and above the market decline. In most scenarios we've observed recently, this additional value was achieved through a combination of sourcing strategies that included volume concentration, joint process improvements, and restructuring incumbent relationships. Procurement managers that achieve only the market change have not delivered incremental value above the market to their companies.

Measuring Price Changes

There are several ways to measure ongoing market price changes. Chemical and resin markets have region-specific subscriber indices such as Platt's, CMAI, CDI, and ICIS, that provide market pricing for many commodity items based on weekly surveys of buyers and sellers. One can also view the commodity pricing on exchanges such as LME, NYMEX, and CBOT to see price changes for agricultural products, energy, fuels, resins, and packaging. Other published indices provide market price changes in IT hardware, labor costs, travel, and other services.

Procurement managers also can track market price reductions using cost models where there is a high correlation between the purchased good and an ingredient or component, typically its feedstock, which is tracked in price surveys. Cost models also have the advantage of taking into account the impact of commodity price changes on supplier processing and transportation costs.

Leveraging Strategies

Nearly all categories have some cost drivers that have declined in the last six months. For example, lower energy pricing affects hotel, travel, metals, mining, and construction costs. Lower pricing for natural oils (such as corn, soy, palm, and coconut) affects cosmetics and food pricing. Metal pricing strongly impacts plant maintenance, parts, and service costs, as well as some dyes and chemicals.

To achieve above-market performance in a declining price environment, the procurement manager must utilize multiple sourcing options. Leverage opportunities abound during times of excess supply capacity—if an organization is positioned to qualify and implement new suppliers quickly. In a weak demand environment, suppliers seek additional volume to increase capacity utilization (and operating efficiency), if the additional volume is priced above their variable cost. In a period of weak global demand, suppliers will shed capacity, especially capacity that is high-cost, poorly integrated, or utilizes less preferred technology. These suppliers need to compete for business to operate their plants, since idle plants do not provide cash flow to cover interest payments, maintenance, or corporate overhead costs.

Successful leverage strategies include bundling spend across multiple divisions, plants, regions, and categories. This is also an excellent time to introduce low-cost country suppliers to the supply base, as local and incumbent suppliers will be under greater competitive pressure to match global pricing.

Supplier Relationship Opportunities

Sourcing during times of declining commodity pricing and weak demand often focuses on leverage techniques, but

there also is an opportunity to advance supplier relationships. To gain volume, suppliers are more willing to work with procurement managers to harmonize specifications, and implement process and supply chain improvements. Procurement managers can introduce additional supplier competition by harmonizing or expanding their specifications. Suppliers are more willing to implement cost improvement projects, especially if savings are shared. Procurement managers should evaluate substitution options as the relative pricing of materials may have changed.

Supplier relationship management strategies will also focus on determining the financial health and future capa-

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bility of the supply base. This is particularly important in the wake of several major suppliers including Lyondell, Smurfit-Stone, Foamex, and Tronox restructuring under Chapter 11 in 2009.

Contract Strategies

During times of declining raw material pricing, procurement organizations also have the ability to add value to their businesses by implementing an effective contract strategy. Fixed price contracts are not a good strategy when prices are declining. However, when pricing is at the bottom of the cycle, it is clearly advantageous to enter into longer term contracts that are structured to protect future pricing. These contracts should limit potential increases, extend periods of fixed pricing, and tie to well-established indices.

Procurement managers have the ability to outperform markets by implementing rigorous category sourcing strategies. These strategies focus on leverage and supplier relationship management to deliver value in weak demand markets. To evaluate the procurement manager's performance, it is critical to measure against market price declines. Market price movements are determined by analysis of market price indices published in industry journals or through cost models. The cost models must be sophisticated enough to incorporate changes in raw material pricing, as well as the impact of changes in processing, by-product, and transportation pricing. To ensure that procurement benefits are maintained, an effective contracting and supplier relationship management strategy is also essential.