

Is Supply Chain Resiliency Costing You 5-15% More Than it Should?

Manufacturers burned by the pandemic have responded by building resiliency into their supply chains, often at any cost. It's time to look for every opportunity to eliminate costs and leverage efficiencies.

Key Takeaways:

- The global pandemic has put a spotlight on supply chain vulnerabilities. Many manufacturers have overcorrected by building up inventory or being willing to serve customers at any cost.
- Too much redundancy in the supply chain is eroding EBITDA. It's not sustainable long-term. And, it adds cost and waste to the business that can stunt future growth.
- To maintain a supply chain that's both resilient and cost-effective, manufacturers must better understand their total cost to serve, eliminate waste whenever and wherever they can, and invest strategically in sustainable ways to reduce supply chain risk.

9/22/20 | Brian Cromer and Ken Koenemann

How to Fund an Efficient, Risk-Appropriate Supply Chain Strategy

Middle market manufacturers are finding themselves in a catch-22 as the cost of recent supply chain resiliency efforts are taking a toll on the bottom line. When the global pandemic exposed supplier vulnerabilities, companies immediately invested in closing the gaps, usually by throwing more inventory and resources at the problem. This "serve-at-any-cost" mentality, is not sustainable long-term. With extra inventory, excessive processing costs, and other redundancies gridlocking balance sheets, CFOs are asking questions and pushing back. And, many manufacturers are finding that they're spending 5-15% more on resiliency than they must.

While [controlling risk has to be part of a post-COVID supply chain strategy](#), that doesn't mean that lean principles should exit the equation. On the contrary, efficiencies are more important than ever right now as companies look for savings that can help fund necessary resiliencies.

4 Keys to Balancing Supply Chain Efficiency and Resiliency

1. Understand your current total cost to serve
2. Look end-to-end to identify all cost reduction opportunities
3. Introduce more robust controls to protect profit
4. Invest in resiliency measures with the greatest return

1. Understand your current total cost to serve

Even if you had a solid handle on your cost-to-serve pre-pandemic, much has changed over the past six or seven months. As a recent [Fortune interview](#) with Nestlé's CEO Mark Schneider aptly illustrates, desperate times call for desperate measures. Emails to the company sent in late February, as the crisis was just beginning to heat up, stated, "Get your inventory levels up, no matter what. Don't try to be smart—just be sure that we're fully prepared, because you don't know exactly which raw material might be in short supply or which supply chain might be under fire".¹

If your business reacted in a similar fashion, the significant costs and burdens of such decisions are driving up your cost to serve—often in ways you don't automatically recognise. Beyond tying up cash and working capital, the excess inventory results in more orders to be processed, more invoices to be received and paid, and more legwork overall, which drains your resources and could result in costly overtime. All of these extra costs either erode profitability or must be passed on to your customer, which can hurt your ability to compete. Either way, redundancies will have a negative financial impact on the business that is not sustainable long term.

Inventory carrying and warehousing costs are only part of the total cost to serve. The pandemic has adversely affected other supply chain cost centers for many businesses, including logistics, materials, and direct and indirect labor costs. Absenteeism and turnover, currently about 5 to 10% higher than usual for most manufacturers, are also adding to increased costs. It's worth reassessing where each of these costs stand now.

Finally, you must carefully consider the many overhead costs baked into the supply chain, including various costs associated with planning, sourcing, purchasing, and managing orders, along with miscellaneous maintenance, repair, and operations (MRO) costs. These kinds of costs are easy to overlook, but they can quickly add up.

The supply chain accounts for a significant portion of the overall costs of operating a business. With some increases unavoidable right now, it's more important than ever to build out, in detail, and fully understand your total cost of serving your customers in the COVID era.

2. Look end-to-end to identify all cost reduction opportunities

Once you have the holistic picture of your total cost to serve right now, it's much easier to pinpoint your savings opportunities. Inventory and materials are obvious places to look and can often be key sources of waste or fat that can be trimmed. Of course, cutting too deeply here can impact quality and value or raise risks to an unacceptable level, so you'll need to carefully balance both parts of the equation.

OVERHEAD COSTS: THE LOW-HANGING FRUIT

For most manufacturers, overhead costs tend to be an under explored avenue for costs savings. However, when companies do turn their attention here, they almost always find pure waste they can eliminate without taking any value away from the business.

More often than not, the culprit behind such waste is lack of processes and controls for buying and procurement. In many organisations, buyers manage millions of dollars in product with little, if any, oversight. They often take direction from systems. If the information in those systems is inaccurate or out-of-date and no one is actively looking out for anomalies, companies can waste a lot of money before they recognise a problem exists.

A case in point comes from a manufacturer of steel and aluminum panels that recently spent more than \$100,000 on two orders of product in an obsolete color. The system generated a recommendation for the first order, which a buyer promptly executed. After production, the product was found to be obsolete. The company wrote off the first order, causing the out-of-date system to automatically kick out yet another recommendation for replenishment, and the whole cycle started again.

BOOKING ORDERS BEFORE BOOKING SALES

While this example sounds a bit like a comedy of errors, similar situations are much more common than you might think. Another scenario that happens all too often is that large, expensive orders for material are placed before a sale is actually confirmed. Buyers, at the prompting of sales people who want to be ready to close a lucrative deal, pull the trigger too early. If the sale doesn't come through, companies can find themselves with millions of dollars tied up in inventory they don't need and that costs even more money to manage, warehouse, or ship to other locations where it can be used.

¹ Why Nestlé's CEO has been in the office every day since COVID-19 hit <https://fortune.com/longform/nestle-ceo-mark-schneider-interview-coronavirus-pandemic-covid-19-office-business-impact-water-worker-safety/>

MRO: A SOURCE OF HIDDEN WASTE

MRO items traditionally have very little oversight and can be a source of extensive PO generation with great potential for spending that hasn't been approved. These items are also ripe for pilferage. One client we work with has approximately a tenth of its inventory in MRO, representing around \$1.2 million. After noticing that this number was climbing steadily for the past six months, we looked and found that the physical inventory could not actually be located in any plant. For another client, MRO has turned into a big problem because divisions of the company place orders for maintenance and repair supplies that have a long lead time. Later, when the division realised it didn't have the budget for the repairs, it would cancel the order. However, the company had already paid for the supplies. The result is a double whammy: equipment suffers because it's not getting the service it needs while supplies that have already been purchased sit unutilised in inventory.

3. Introduce more robust controls to protect profit

In all of these cases, the answer is more robust processes and controls. Especially during times of great change and uncertainty, S&OP conversations should be happening frequently, at least once a week. ERP system parameters for replenishment need to be regularly updated to reflect S&OP decisions and help ensure the integrity of the system and its recommendations. Finally, exception reporting and analytics should be used to help flush out variances and catch and correct potential issues.

Establishing reasonable approval processes that put limits on the PO amounts any one person can authorise and having approval on bigger orders escalate up the chain of command are additional best practices. Yes, it takes a bit of effort to put such processes into place. But once you establish these checks and balances, the significant sums of money you can save and the efficiencies you can quickly generate can help fund the resiliency efforts that are needed in your supply chain right now.

4. Invest in resiliency measures with the greatest return

The more efficient you are wherever you can be the more resiliency you can afford where you need it. But you still need to pick and choose where your investments will have the greatest impact. More inventory, especially for lean companies, is not going to be the long-term answer. Building up your stores too aggressively can drive up your costs to serve and quickly erode your profitability no matter how efficient you become in your purchasing and supply chain management processes.

Improving your sourcing processes, increasing your supply chain visibility, and strengthening supplier partnerships are higher-value activities that will deliver benefits longer term.

Are You Overinvesting in Resiliency?

6 WARNING SIGNS YOU NEED TO KNOW

In the wake of the global pandemic, it is natural and wise to de-risk the supply chain. But the effort costs money, and when the pendulum swings too far in the other direction, it can have a negative impact on your business and hurt the bottom line.

Track these six leading indicators to understand if your business is paying too high a price for redundancy.

1. Inventory levels continue to grow
2. Overtime keeps increasing
3. Freight costs are rising
4. The number of expedited shipments keeps going up
5. Cost for purchased items is on the rise
6. Headcount for indirect supply chain personnel is increasing

Geographically diversifying your supply chain footprint and looking for opportunities to bring some work in house can reduce vulnerabilities to supply chain disruptions and potentially improve efficiencies or reduce cost to serve at the same time, especially if you are able to source closer to home or leverage internal capacity you already have available.

Given the vast changes in the marketplace, it's well worth looking beyond the warehouse shelves for more fundamental ways to improve your supply chain resiliency long-term and achieve your lowest possible cost-to-serve in a COVID-19 marketplace.

Expect Resiliency and Efficiency

Even in the most challenging times we've experienced in recent history, manufacturers do not have to sacrifice their lean principles in order to create reliable supply chains or meet their customers' needs. While some efforts will need to be made and costs incurred to shore up supply chain vulnerabilities, by focusing on generating and leveraging efficiencies at the same time, your business can continue to give your customers a high level of service while maintaining and improving your own profitability.

EXHIBIT 1:

Hidden Sources Of Excessive Supply Chain Costs

To begin the process of streamlining your supply chain, use this checklist to identify often-overlooked contributors to your total cost to serve.

- ✓ Increased inventory carrying costs
- ✓ Rising warehousing costs
- ✓ Resources required to support planning, sourcing, purchasing, and managing orders
- ✓ Orders booked before the sale is closed
- ✓ Excessive MRO spending
- ✓ ERP system parameters for replenishment
- ✓ Product price variances
- ✓ Purchase order approval processes

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