Leveraging to the Edge: Can We Afford the Results?

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Abstract. With the growing popularity of e-auctions and the current state of the economy, many companies are drastically cutting costs from their supply base. But several firms are taking the short-term benefits without reviewing the long-term consequences of their actions. This session will look at real-world examples of companies that have leveraged suppliers to the point where the suppliers have either gone out of business or have taken actions that negatively affected the buying company. This session will use examples and present a model showing supply management practitioners and managers the importance of maintaining proper supplier relationships and when to change relationships to accomplish your business goals.

Introduction. In recent years, many small to medium businesses have gone bankrupt, but there have been notorious large business bankruptcy filings, too. One common issue with these small/medium companies is one customer maintains a large share of their output volume. When one customer controls such a high degree of leverage, that customer can dictate the supplier's terms of business.

A supplier who is not profitable cannot give an organization competitive advantage in the long term. With pressure to reduce your organization's total costs, how do you prevent leveraging a supplier to the edge? Your business may not be able to afford the results.

Margin erosion. There are many well-known cases of automotive and retail customers leveraging suppliers to reduce prices, sometimes retroactively, or that supplier will lose the business. Sometimes the leverage isn't just "reduce your price X%;" it's through the use of reverse auctions, slotting allowances, or, in the case of service suppliers, negotiating all invoices and long payment terms. The rise of customer-directed sourcing, especially when the large customer receives rebates from the "directed source," is another way of leveraging suppliers. The suppliers are leveraged to provide value programs like VMI, consigned inventories and freight allowances. Many of the suppliers being leveraged lack the skills, processes and capability to transfer the pressure to their downstream suppliers, so they give back profits and cash until they are no longer competitive, or worse, no longer solvent. This is of no concern to the leveraging customer because there is usually a competitive source to pick up where the now troubled supplier left off. When there isn't another supplier to take over, some large customers leverage the troubled supplier even more by mandating management organization, banking arrangements and even acquisition of the losing business.

Why leverage? The short answer is "because they can," but why do companies want to leverage suppliers? Usually, it is because their own margins are eroding, sales are down or cash flow is poor. In short, they risk becoming noncompetitive. These conditions can cause a short term “stop the bleeding” focus that clouds or obliterates the long term vision entirely. The save-money-now-or-lose-your-job-message is sent throughout the organization, and out come the big sticks to beat up the supply base. Think this doesn’t apply to you or to your organization? Consider how you leverage your suppliers - it isn’t just by asking them to reduce prices.

Ways of leveraging. Webster defines leverage as “power to act effectively.” Today, too many customers think of leverage as “power to dominate” their suppliers. By not considering their leverage to help suppliers become more effective, these customers are simply looking for the easiest way to short-term gain.

To the supplier, leverage isn’t just in the form of a customer asking for price improvement. A few of the commonly used ways of leveraging suppliers appear in the illustration above. While all of these can be effective and deliver value to customers, any one of them could push a supplier to the edge. The supplier’s “edge” could be financial disaster, exploitation of the leveraging customer or abandonment of the customer at first opportunity. None of these deliver value to customers.

How does a company effectively use leverage? Wyeth, Harley Davidson, Honda, John Deere and Wal-Mart have all effectively used leverage with suppliers, gaining tremendous competitive advantage. This does not mean that they have never "leveraged to the edge" in years past, but it does mean that through appropriate relationship management, they use leverage to both their and the supplier's advantage, delivering value throughout their supply chains.

Supplier Relationships. The key to effective leverage is developing the proper relationship with a supplier. Let's review two case studies, both real, but with fictitious company names.

Big Brand Food Company
The Big Brand Food Company was the market leader in their region (roughly one-third of the US) and had a lot of leverage with glass suppliers in the late 1980s and early 1990s. Big Brand learned that they could use their volume to leverage all their glass suppliers, but a major piece of supplier X's plant capacity was devoted to Big Brand, and supplier X was "leveraged" constantly. Supplier X could not afford to lose Big Brand as a customer, even though the relationship was antagonistic. Big Brand didn't care if supplier X was profitable; they had several approved glass suppliers and a lot of volume.

In the mid 1990s, Big Brand's sales were increasing, especially the Wal-Mart/Sam's Club product lines. Since Wal-Mart's food sales is growing ten times the rate supermarket chains are growing, Wal-Mart has a lot of leverage in the marketplace, too. The mid 1990s saw huge growth of the ready-to-drink iced tea market and the consolidation of the glass container market. Supplier X became one of two possible glass suppliers to Big Brands, instead of one of five, and the iced tea product line was so profitable that supplier X no longer had to put up with the "big stick" of Big Brand. In fact, supplier X chose to no-bid any RFQ sent to them by Big Brand. Big Brand was forced into a non-competitive position with their glass packaging and was exploited by supplier Z. Big Brand lost market share in the late 1990s, lost a lot of their volume "leverage" and supplier X still no-bids.

David and Goliath
The David Company, a $50 million company, is supplier to Goliath Auto Maker. In 2000, Goliath Auto Maker accounted for more than 75% of The David Company's sales. The David Company had worked hard to reduce costs, become lean, supply JIT and had invested in new capital. Goliath Auto Maker used threat of delisting as leverage to get price reduction in 2000 and 2001, including a demand in late 2001 for a retroactive 3.5% price reduction.

Goliath's constant de-list threat gave The David Company 20/20 vision: their commitment to quality, innovation and customer service was focused on getting new customers. In less than a year of focus on servicing new customers, Goliath represents less than 50% of The David Company's business. Goliath, despite acknowledging The David Company as a valuable supplier, still uses the "give us X% price reduction or else" ultimatum.

In both cases above, the large customers leveraged a supplier to the point that the supplier made a business decision to make that large customer less important. In both cases, the suppliers "had to take it" from the large customers until they could move to replace that business. Both were successful, and in both cases, put the large customers are at competitive disadvantage.

Many businesses are implementing supplier-development programs like Chrysler's SCORE, General Motors' PICOS or supplier-collaboration programs like Wal-Mart's CFAR to rationalize their supply base and gain competitive advantage and cost optimization throughout their supply chain. The problem lies in determining and managing the appropriate supplier relationship to allow for the greatest gains for both customer and supplier.

Arm's length or the arm? Most companies now use portfolio analysis to map their categories/items of expenditure and are aware that a supplier isn't "strategic" just because a large amount of money is spent on one particular item.

In this session, four types of supplier relationships will be discussed:
- Competitive leverage
- Preferred supplier
- Performance partnership
- Strategic alliance

Categorizing suppliers helps you understand the importance of a particular supplier to the business and helps the supply manager choose appropriate strategies for negotiation. It is important to note that, at times, a business may want to change a supplier's categorization because of changing market conditions, to send the supplier a message, or other notable reason.

Relationships with suppliers range from arm's length (distant) to being a part of the body (extremely close). It is important to understand that a business will have many more competitive leverage suppliers (distant relationship) than suppliers with whom they have strategic alliances (close relationship). It is the company's decision as to what kind of relationship to have with each supplier.

Relationships are not static and strategies can be implemented to move suppliers from distant to close and close to distant as appropriate. There is no "goal relationship" to which an organization should strive to have all their suppliers. The goal, however, is to manage sound relationships with suppliers and determine which categories suppliers should be assigned.

Competitive Leverage

Most supplier relationships typically fit the "competitive leverage" classification. In fact, every new supplier starts out in this type of relationship. Suppliers in this category are one of many available in the market and actively competing for your business. Typical tactical negotiation skills used with these suppliers are:
- Logical reasoning
- Positional bargaining
- Use of emotion

- Power, threat and coercion

Relationships with these suppliers are typically guarded and distant (at arm's length). It is important to always look ahead, especially if you choose leverage negotiation methods. Remember the cases of Big Brand Foods and Goliath Auto Maker - think about where you may want to drive a supplier in the future - you may not want to use persistent power and threat against a supplier that may be strategic in the future.

Preferred Suppliers

Fewer suppliers typically fit into this category. Place suppliers in this category if the supplier is one of several, but within a supply market with fewer choices available. Relationships with these suppliers are closer than with competitive leverage suppliers. Set standards for performance and ensure these suppliers meet them.

Preferred suppliers must pass several tests before they are given this status to consistently meet your standards for quality, service and cost. Placing suppliers in this category means you have assessed the risks of doing close business with these suppliers and have reasonable confidence in their performance and in the market. This includes conducting a supply-market analysis to determine categories for suppliers.

Performance Partnerships

Significantly fewer suppliers typically fit into this relationship. Suppliers are placed in this category because there are very few sources (or a single source) for the commodity. Performance standards are important in these relationships; suppliers are expected to provide high quality service and cost management. Relationships with these suppliers are much closer than with competitive leverage suppliers or preferred suppliers and are usually long term with expectations on both sides for continuity. Such expectations enable supply managers to negotiate better service and costs.

Performance partnerships also have the following qualities:

- The supply manager's company and the supplier combine their operations where necessary
- They share technology, data, people and risk
- The supply manager obtains a high quality of response from these suppliers

Strategic Alliances

Only a select few suppliers would typically meet the requirements of a strategic relationship. Suppliers are placed in this category because they are the only source for that commodity, making them the dedicated resource. Some companies have created subsidiaries to provide supplies or have invested in suppliers to the point of partial ownership of the supplier. Suppliers working under these arrangements meet the criteria of strategic relationship. The purchaser and the supplier work very closely together in this relationship. Members of the supplier's organization may even be co-located at the purchaser's site.

Strong strategic alliances are characterized by an interdependency and synergy between purchaser and supplier. This includes possessing complementary core competencies and contributing expertise to their joint business opportunities.

Performance partnerships and strategic alliances are both principle-based relationships and this is often even more important than any cost-reduction arrangements. The principles below can deliver a competitive advantage and should be included in any contracts or supply agreements you create.

- Best-in-market pricing
- Access to innovation
- Dedicated resource and expertise
- Continuous improvement
- Transfer of expertise
- Excellent response time

Additional factors to consider when categorizing suppliers include:

- Competence and skills
- Management attitude
- Business culture
- Nature of the market
- Continuity of staff
- Resource allocation
- Business value
- Internal relationships
- Required deliverables
- Common goals
- Performance expectations
- Quality of feedback

The supply manager must evaluate his or her company's needs and the suppliers' abilities to deliver them. Some factors will be more important than others depending on the objective of the relationship.

Conclusion. It is important to assure that suppliers are cost effective suppliers, but it is to no one's advantage to consolidate the supply base through leverage. The steel industry is a good example of a leveraged industry that, through government protection by tariff, is regaining the balance of power in the supplier/buyer coexistence.

After all, suppliers are extensions of our capability. We must gain cost transparency and assure that we are managing the supply chain. The goal is to minimize supply chain costs, while leaving the chain intact. However, if a supplier is inefficient, he will not survive. The trick is managing the supply chain from your customer to the starting supplier, and develop supplier relationships that best achieve long-term business goals.