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Kearney, Brussels

How procurement can drive value in a commodity crisis

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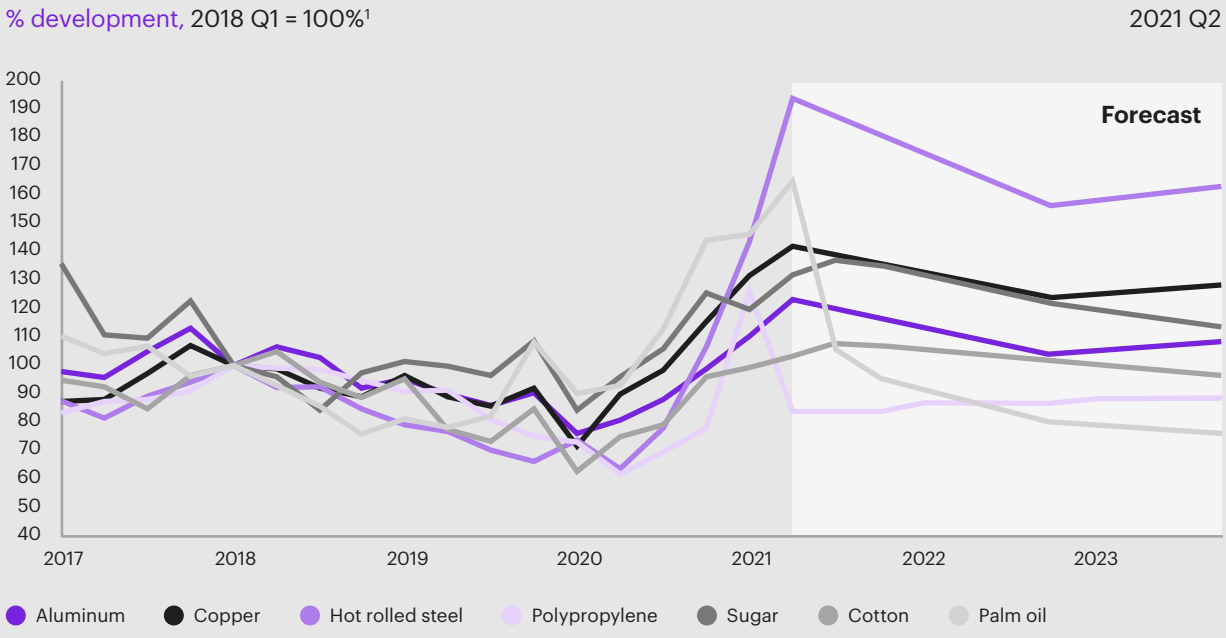
Rapidly rising commodity prices require strong procurement teams, at both ends of the playing field—first the team must defend, then it must switch to attack mode.

Whether we are talking about aluminum, cotton, or polypropylene, commodity prices are rising in most sectors worldwide. While we argue that these price hikes are a temporary phenomenon, many of these increases are expected to stay with us at least for a while (see figure 1). Consequently, firms need to find ways to address these price surges both in the short and medium term—and to do so, they first have to understand the root causes.

These price hikes have come about due to an imbalance of supply and demand. At the start of the COVID-19 pandemic, demand dropped steeply in many industries due to factors such as lockdowns, temporary plant closures, reduced consumer consumption, and general uncertainty. This situation resulted in a corresponding drop in supply globally, as raw material producers reduced production.

A year later, many manufacturers have been caught flatfooted: the recovery in demand has occurred much faster than the supply base has been able to ramp up production, resulting in supply shortages. In some cases, these bottlenecks have even led to manufacturers shutting down production lines for want of materials, impairing recovery. This has had a cascading effect throughout the supply chain, which has been further exacerbated by recent logistics bottlenecks in all modes of transportation: while air transport lost much of its belly freight capacity with so many passenger flights cancelled, sea freight is struggling with container availability and port congestion, and road freight companies are struggling to rehire drivers who were laid off during the initial days of the pandemic.

Figure 1
Market prices of selected commodities



[1] Global for sugar and cotton, Western Europe for remaining commodities
Sources: Bloomberg, NEXANT; Kearney analysis

But the cascading effects of the COVID-19 pandemic are not solely to blame for the current situation. In many commodities and markets, further add-on effects exacerbated the current situation due to factors such as geopolitical tension, trade wars, and even natural disasters. For example, the US plastics market supply capacity was affected by adverse weather and other factors (see figure 2). A one-week blockage of the Suez Canal in March 2021 that affected nearly $10 billion in trade further increased lead times and delayed market recovery.

Clearly, these external shocks have reduced short-term supply availability. Thus, we expect that the current supply shortage will only be a short- to medium-term crisis, as it is not based on a systematic shortage of production capacity. Once the ramp-up of supply capacity catches up with increased demand and supply chain pipelines are full again, prices will move downward and normalize. This should take from 6 to 18 months, depending on the commodity and region. Yet the current rise in raw material prices still poses a significant cost risk to manufacturers—particularly as psychological effects make the situation even worse. As major players start stockpiling to cover their demand for extended periods, competition for already low levels of supply will increase further and more firms will stockpile, creating a downward spiral that artificially prolongs the shortage.

Most suppliers will capitalize on the current situation by pushing for price increases. In other cases, there will be short-term supply shortages and stock-outs, as suppliers will allocate their scarce supply to their strategic partners or those willing to pay the highest margins. In short, short-term supply security is at risk, which poses a significant threat to corporate margins. Apart from the obvious impact price increases have on the bottom line, stock-outs and line stoppages will result in lost sales and even the loss of customers, further harming the top line. This is where procurement is called upon to ensure profitability by not just guaranteeing supply security, but also proactively fending off price increases.

Procurement must address the current situation through a two-step approach. First, a strong defense is required to secure current price positions and supply. Procurement will then have to switch back to offense by using C-level attention and collaborating with other functions to innovate around demand to protect margins and return stronger to the playing field.

Figure 2
Root causes of the US plastics market supply disruption

Example: The commodity price for resin



[1] https://cen.acs.org/business/petrochemicals/Chemical-makers-mostly-unscathed-Hurricane/98/i34
[2] https://www.industrialspec.com/about-us/blog/detail/plastic-raw-material-shortages-rising-prices-delivery-delays-early-2021/
[3] https://www.freightwaves.com/news/global-supply-chains-choke-under-tsunami-of-freight
Source: Kearney analysis

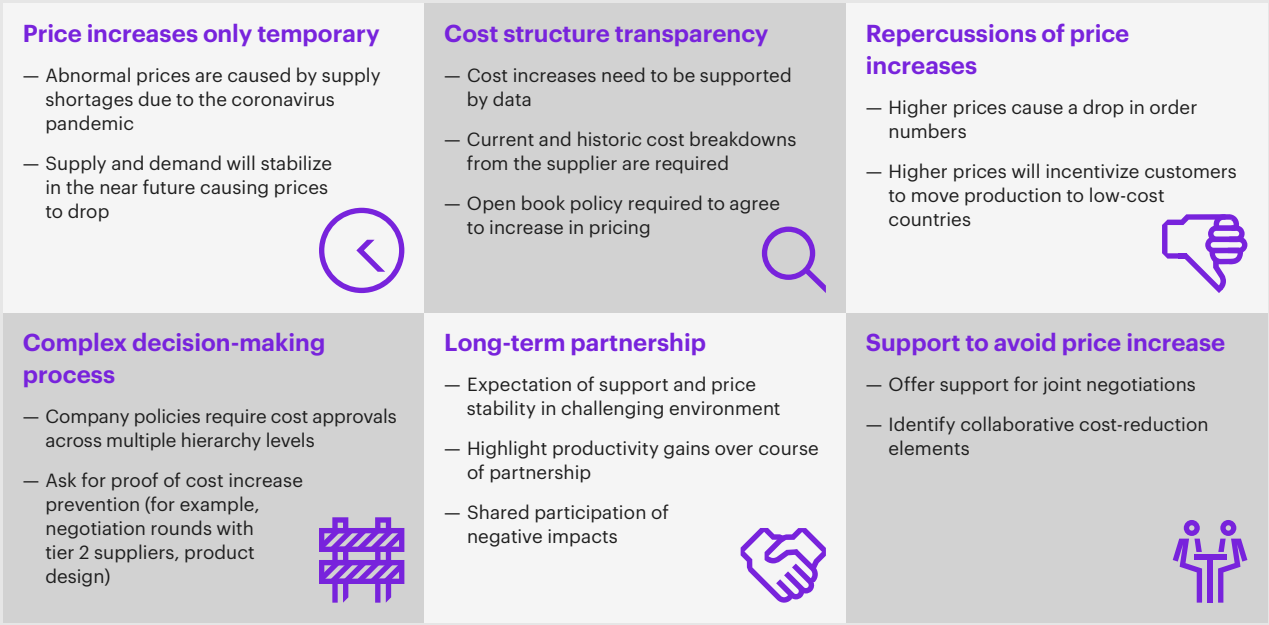
Playing defense in the short term

As a first step, procurement must respond to price increases with a clear and consistent message to suppliers. Taking actions such as referring to longtime partnerships, requesting increased cost transparency, and highlighting the short-term nature of the current market imbalance can fend off smaller price increases. Developing and utilizing a predefined set of short-term responses can neutralize many supplier arguments. Here, ensuring that all departments speak the same language toward suppliers is key. Leadership needs to make sure that "one voice to the supplier" is maintained across all positions and functions, particularly for long-term strategic partners that have multiple interfaces outside of procurement (for example, R&D partners). Figure 3 overviews how a company may align around consistent supplier messaging.

Having a set of standard counterarguments against suppliers helps to buy procurement time to prepare for fact-based negotiations. This time can be used to collect crucial data and market insights to challenge and mitigate against a supplier's price increase request, as well as to loop in essential stakeholders. Procurement must be aware of three key facets prior to any negotiation: the risk position, the cost structure of the product, and current and historical market trends. While procurement is in the lead to evaluate and quantify these three aspects, cross-departmental support is essential. In particularly serious cases, a cross-functional "war room" can be set up to capture the perspective of all key stakeholders.

Figure 3

Price increase requests from suppliers need to be addressed with a clear and singular message from the start



Sources: Kearney analysis

Risk position

The risk position for a company related to a supplier price increase request includes factors such as the current inventory and potential sales at risk. Inventory should be analyzed holistically among plants, warehouses, and business units, including any owned stock that is still at the supplier's site or in transit. In some instances, a company can "sit out" a market peak if it has sufficient inventory or if a smaller incumbent supplier is willing to commit additional volume for a chance to maintain a larger share of business post-shortage. Sales at risk defines how much revenue will be lost if there is a stock-out; this is particularly important for firms with a varied portfolio, as it could be a strategy to prioritize sourcing efforts and supplies on a smaller subset of the portfolio to maintain margins. Cross-functional teams help to provide a holistic view of the issues at hand. Understanding the risk position around a price increase request will help procurement understand whether a specific negotiation is about short-term supply security or medium-term cost position.

Cost structure

By working with engineering, procurement can come to better understand the cost structure of a product through a bottom-up cost calculation in order to argue against a price increase. Ideally, this analysis is performed on a bill-of-material level that takes all materials and their required production processes into consideration. While a detailed cost model is preferred, a breakdown of the four key cost components (material, conversion, SG&A, and profit) can suffice. The cost model can then be connected to market indices for key input factors such as commodity prices to obtain transparency into the real price effect of the commodity price increase. Figure 4 provides an overview of the cost breakdown process and its benefits.

Figure 4

Cost breakdowns support fact-based negotiations by estimating the should-cost through analysis of the full value chain cost structure

Cost components
Main categories

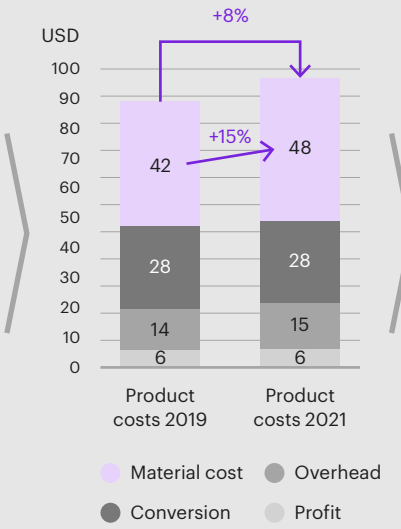
Material costs
Share of materials in the product divided up by every component/material

Conversion costs
Evaluation of each process step from the first step until the final product/assembly

SG&A overhead costs
Inclusion of all product-related costs to verify a holistic should-cost model

Profit
Depends on the industry benchmark and the supplier power position

Cost transparency
Breakdown by category



Benefits
Applying the method

— Increased **transparency of entire cost structure** (visibility into where value exists)

— **Enables identification of the right impact of market changes** or within the product

— **Determine target/fair** price level

— **Support fact-based negotiations** with suppliers

"A 15% material price increase does not justify a 15% price increase for the product."

Source: Kearney analysis

Market trends

Developing an understanding of the historic market development is also highly beneficial for negotiations. Creating transparency regarding the commodity price development since the last price agreement can deliver a powerful argument for procurement, particularly in combination with an understanding of the cost structure. By understanding at which price level in the market the standing contract was closed, and whether market relaxations have been passed since then, a request for a retroactive discount can often shorten a price negotiation. Furthermore, most suppliers have long-term contracts with their own suppliers, often with a markdown on specific indices, to cover forecasted demand for an extended period. Understanding the frequency with which a supplier makes commodity buys, and being able to show that a supplier had contracts in place before the temporary price hike and is thus unaffected by rising price levels, can be a powerful argument against price increases.

At the same time, the transparency achieved by market evaluation and cost analytics can be used to address additional price reduction arguments, such as gains in productivity by the supplier or increased efficiency in material usage. Once a cost model is developed and successfully negotiated, it should be updated regularly with market indices to reflect appropriate pricing at any given moment. This can then also be used as a basis for future price negotiations.

Bringing it all together in fact-based negotiations

Once procurement has a thorough understanding of the firm's risk position, the part's cost structure, and current market developments, it should engage the supplier in fact-based negotiations. The negotiation teams should be cross-functional in order to effectively present the prepared arguments, which requires internal alignment on each participant's role and the negotiation strategy. By using the evidence collected by procurement, combined with more traditional negotiation strategies and approaches, negotiation teams can often fend off price increases or get suppliers to commit additional volumes.

You cannot win them all

No matter how well a company prepares and leads the negotiation, at times the supplier will present strong evidence that a price increase is unavoidable (for example, by demonstrating that current pricing puts their margins below a sustainable level). In such instances, short-term solutions such as temporary surcharges that are renegotiated at a fixed date or at a fixed market level should be introduced to ensure the survival of crucial suppliers. The transparency from the cost calculations and market developments work can provide a basis to determine the size of the temporary surcharge. These surcharges should be added on a purchase order level (rather than reflected in the ERP info records) to ensure that renegotiations occur. While this process requires additional operational efforts by procurement, it promotes long-term price stability and comes with the additional benefit of being able to report the commodity price increase cost separately.

Alternatively, a price adjustment clause that is updated regularly can be utilized to enable transparent and fair pricing for strategically important categories or product groups. While somewhat complex to negotiate and set up, price adjustment clauses appropriately reflect ongoing market developments in the long term. No matter which of these two solutions is chosen in a specific situation, procurement should link a market-related price increase to conditions and concessions in order to bring balance to the negotiation results.

Switching to offense

After defending against the price increase, procurement must get back on the offensive as quickly as possible to reduce the long-term bottom-line impact. The product cost structure understanding and the underlying market knowledge gained during the defense phase can be used in three ways: to reassess internal demand, to try to pass on cost increases to customers, and to holistically optimize products and their cost structures (see figure 5).

First, the current situation can be used as a catalyst to reassess internal demand. The zero-based-budgeting-plus (ZBBplus) approach provides a proven framework to target demand reductions in a structured way. An important first step is the creation of transparency; here, the information collected in the defense effort can be used. ZBBplus execution is based on the development of spend policies and the definition of and alignment around the right spend level. Once those two steps are completed, cost reduction can begin via quick wins based on selected sourcing levers. A new governance model needs to be implemented to sustain the optimized spend and demand, supported by spend tracking.

Concurrently, in the case of price increases, procurement should partner up with the sales team and try to pass on the now-transparent cost increases to customers using the rationale developed for the fact-based negotiation as a starting point. Here, it is crucial to take pricing history into consideration as well as the currently existing cost transparency toward customers. Be aware that transparency can turn into a disadvantage if used incorrectly; utilizing public sources such as market indices has proven to be effective and enables the sales team to establish common truth with the customer.
It is usually beneficial to keep cost transparency to a minimum and focus on the change to base costs. Once shared, cost transparency and "open book" calculations cannot be taken back in subsequent customer price negotiations, which significantly weakens a firm for future negotiations.

Figure 5
From a strategic perspective, disruptive procurement levers are required to stay ahead of the market



Source: Kearney analysis

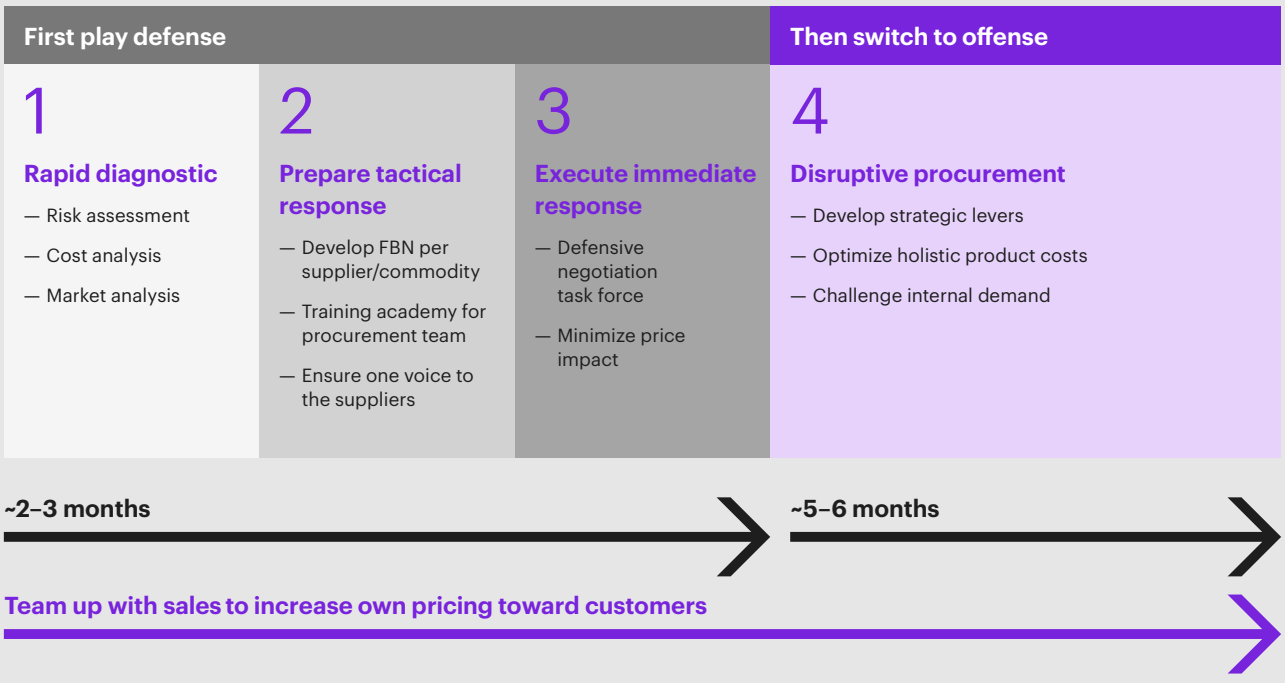
As a third, highly effective midterm possibility, we recommend optimizing products and their cost structures holistically. Disruptive procurement is based on strong, interdisciplinary collaboration that can be used from the shared experience in the cross-functional war room and the resultant fact-based negotiations: by working closely with procurement, other departments can get a better understanding of procurement's goals and become sensitized to cost drivers. Conversely, the procurement team benefits from a deeper technical understanding of the product and an extended perspective of customers' key needs. Based on this deeper understanding, a cross-functional team can now conduct an analysis of the product functions and the related cost drivers, allowing them to tailor the design to fit the customers' needs while also improving the firm's sourcing and cost position. Further using the improved cost understanding, the team can compare functional fulfillment and subsequently customers' willingness to pay for specific functions. This enables the team to develop new, optimized product concepts, focusing on mismatches between the willingness to pay and incurred costs on a function level. Furthermore, these collaborations can bring technical and market understanding to the same table, and drive innovation so that a product need not rely on a scarce or volatile commodity.

Defend, attack—and ultimately disrupt

The current market situation presents a challenging business environment for all manufacturers. While shortages and line stops threaten sales and the top line, price increases, spot market premiums, and expedite fees harm the bottom line. In short, current commodity prices will put significant pressure on manufacturers' margins, and not all have the luxury to pass along price increases. Thus, we recommend the above-mentioned approach, which is summarized in figure 6.

The good news is that the current trend is based on external shocks rather than a systematic supply shortage. Accordingly, raw material prices will normalize in time. However, in the near future commodity pricing and material scarcity will continue to keep procurement busy and become a more prominent topic for the C-suite to address.

Figure 6
Defend current pricing, then go on the offense to reduce costs



Source: Kearney analysis

As an immediate response to market conditions, strong purchasing teams are required to proactively and systematically defend against price increases and guarantee supply security. These teams need support from functions such as engineering, sales, and supply chain. The first, most crucial step for this team is to establish consistent supplier communications addressing the issue. Subsequently, a risk analysis by category and supplier needs to be conducted, followed by the establishment of bottom-up cost transparency, which needs to be linked with market history and current market developments. Based on this exhaustive research, the cross-departmental teams can then engage suppliers in fact-based negotiations to fend off or reduce the impact of price increases.

However, every crisis also presents an opportunity to learn. As soon as price increase requests have been resolved or absorbed, and supply security reestablished, procurement should shift to the offensive and use the current markets to their advantage. With the momentum and understanding gained in the short-term defense, as well as the increased C-suite attention, procurement has the unique opportunity to establish itself at the center of cross-departmental teams and task forces. This can mean, for example, that where a price adjustment was necessary, procurement can aid sales with compelling arguments and hard facts to pass price increases through to the customer base and protect margins.

This elevated position can also be used as an opportunity to carry disruptive procurement approaches into the wider organization. These cross-functional procurement levers include intelligent questioning and optimization of internal requirements, use of cost transparency to proactively hand through price increases to own customers, and the use of advanced procurement methods for holistic optimization of products, supply chains, and business models. By proactively positioning and driving these ideas, both the procurement department and wider organization can grow with the challenging market environment and emerge strengthened from the current crisis.

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