



HOW TO SPOT—

Current economic realities make one thing clear: today's business continuity needs cannot be met by using yesterday's risk-management approaches. That's especially true when it comes to your suppliers, who should they falter have the potential for derailing your operations. Supply chain managers need new mechanisms to spot "at-risk" suppliers—and proven processes for intervening to reduce the impact of those suppliers' problems.

and HELP—an AT-RISK SUPPLIER

By Foster Finley

“Dear Customer: We are liquidating and are unable to fulfill our current orders on file for you...”

With little advance warning, supplier communiqués like this are becoming increasingly common in an economic environment that saw 2008 bankruptcy filings in the United States jump by 54 percent from the prior year. Even if your key suppliers are not filing for bankruptcy or ceasing operations, you may be still confronted with actions that disrupt the continuity of supplies or significantly affect your finances—actions such as take-it-or-leave-it price increases, demands for faster payment terms, delivery of less-than-ordered quantities, and longer delivery lead times.

The impact is global and affects nearly every industry. Edscha, a German manufacturer of sun roofs, door hinges and other car parts, filed for insolvency in early February 2009. The production interruption forced a key customer, BMW, to make undisclosed incremental payments to Edscha to support the supplier’s continuing operations so the automaker could meet a planned product launch.

Similar scenarios are playing out elsewhere. In the U.S., the challenges faced by automotive Tier One supplier Delphi have been front-page news. The Chapter 11 bankruptcy filings of storied brands such as packaging producer Smurfit-Stone Container and industrial equipment and chemicals maker Milacron have added

Foster Finley is a managing director at AlixPartners LLP. He can be reached at ffinley@alixpartners.com.

to a growing list of distressed businesses that appears in nearly every industrial sector, regardless of the size of those businesses.

Raising Your Risk Management Game

The impact of supplier vulnerability has made it doubly critical to safeguard supply continuity. That concern has brought two imperatives to the fore: The need for supply chain managers to spot financially “at-risk” suppliers and the importance of intervening to stave off or plan around those suppliers’ problems.

Unfortunately, we have observed few supply management functions that are skilled at assessing the financial viability of their suppliers—particularly the viability of small private enterprises. We recently reviewed a request for proposal from a highly respected global manufacturer that was 130 pages in length. The RFP required respondents to provide specifics about: local product content, diversity programs, management structure, and environmental responsibility. However, we could not see a single question that addressed the supplier’s financial viability.

If few supply-management functions are adept at identifying financially distressed suppliers, even fewer are equipped to intervene when a supplier encounters financial distress. Mounting economic pressure has undermined the viability of many companies—customers and suppliers alike that took on debt during better times and structured themselves for business levels that never materialized. So more suppliers are facing difficulties while too few of their customers have adequate processes for detecting suppliers’ problems early enough to take preventative measures. Consequently, many procurement groups are discovering suppliers’ distress at advanced stages of “metastasis,” when the costs of main-

taining supply continuity are at a premium.

The following example puts the dangers for customers in sharp relief. Following more than 10 months in bankruptcy, automotive supplier DriveSol announced that it was liquidating its U.S. operations at the end of 2008. The company's announcement to its customers acknowledged their inability to re-source DriveSol's products on short notice and indicated that their requirements would be met with a shift to DriveSol's continuing European operations.

As global supply chains become more complex and expansive, it becomes increasingly evident that today's needs cannot be met by using yesterday's risk-management approaches.

However, DriveSol's notice also indicated that supply continuity would require a substantial surcharge, prorated across the customer base, to be collected over only three months. It also stipulated 10-day payment terms on all orders. Customers were given just a few days in which to accept these requirements. While most customers were aware of DriveSol's financial distress, many were caught off guard by the financial implications of its spot demands. Few were in a position to pass on the additional costs to end customers; for some customers, the extra cost burden raised the threat of having to shut down production lines.

Most supplier risk management processes across industries simply have not anticipated these kinds of events. As current economic realities disrupt more and more global supply chains, it becomes increasingly evident that today's needs cannot be met by using yesterday's risk-management approaches.

What's needed now is a fundamental shift in the processes and mechanisms for monitoring suppliers. Effective supply management functions must incorporate structured, routine, data-supported ways to assess their suppliers' financial viability—in addition to many of the traditional supply management activities. Today, best practice in supplier risk management (SRM) must blend assessment of the supplier's financial viability with other relevant metrics for a composite rating that can be weighted and adjusted to suit the business environment. This monitoring process might include: product quality ratings, on-time service performance, or a qualitative assessment of a supplier's management team. Such a composite score continually prioritizes the riskiest of the at-risk suppliers.

Inclusion of a supplier's financial viability can prove invaluable far beyond the current downturn. It now must

be developed as a core competency—as a competitive differentiator with which to safeguard supply continuity.

Identifying the High Priority Suppliers

A first step in practicing effective SRM is to highlight the true priority suppliers. Fortunately, many supply management functions already maintain some form of prioritized supplier listings, and these may provide a helpful starting point. These existing processes may be based on metrics such as overall portion of procurement spend, historical delivery performance, indirect vs. direct products, threat of labor interruptions, or product quality variations, for instance.

However, while these are all relevant considerations for highlighting priority suppliers, they fail to address

the underlying question of overall dependence upon any given supplier. Even small and medium-sized enterprises have hundreds and sometimes thousands of suppliers. Moreover, the goods and services acquired from those suppliers will vary dramatically in terms of how essential they are to ongoing operations. When we discuss the topic of high-priority suppliers with supply chain leaders such as chief procurement officers, we find four mindsets that distract them from properly pinpointing criticality:

1. *A focus on price escalation or commodity volatility:* Many companies are reliant on commodities such as oil, sheet steel, copper, and aluminum. And given the meteoric rise and subsequent fall of prices of those commodities, it's easy to understand why so many companies spend so much time and attention on budget forecasts, market outlooks, hedging positions, and customer surcharge management. But most often, the risk is borne proportionately across the customer base so it is less often linked to the potential failure of any one supplier.

2. *Siloed organizational structure:* Category specialization can make global comparisons difficult because different groups of supply management specialists focus on discrete pockets of information. It is not uncommon for the supply management function to be organized by, say, direct materials, indirect materials, capital expenditures and services—with further subdivisions within each category. While informed purchasing professionals and buyers are equipped to describe their most strategic or difficult-to-replace supplier, making organization-wide comparisons in search of critical suppliers is very difficult.

3. *Adherence to the Pareto principle:* There is a natural tendency to interpret a supplier's criticality in terms of relative annual spend, or of units or weight of a product

purchased. Financially, it makes sense to lavish attention where the most money is spent. But in many companies, this is a poor proxy of true criticality because it fails to take into account either the business importance or the relative difficulty of re-sourcing a supplier of a product that accounts for a large spend. For example, a transportation-intensive shipper could rightly point to its reliance on a particular less-than-truckload (LTL) carrier as a proportion of its spend base. But it would be much harder to declare that that carrier was critical because of the relative ease of finding alternate LTL carriers.

4. *Focusing on the “tallest nail”*: Every company has one or more problem suppliers that consume disproportionate amounts of managerial attention. Product quality issues, lack of responsiveness, unreliable delivery, aggressive pricing, or just the most recent “one-time issue” all provide rationales for meetings and resolution. Except in the most unusual cases, customer and suppliers reach an accord over time—or they part company. But, time-consuming suppliers are not de facto critical suppliers.

These four mindsets are fundamental to good supplier management, and we do not intend to diminish their importance. But satisfying the demands of the here and now—of day-to-day supplier management—can obscure the more fundamental question of overall supplier criticality and risk management. The starting point is to isolate the suppliers without which key production lines or service capabilities would grind to a halt in very short order. The central question is this: “If this supplier failed in the next few months, what would be the impact on my business?” More specific questions to test reliance include:

- Are the supplies sole-sourced and are there viable alternative sources?
- Who owns the production tooling? Can tooling be relocated to other suppliers?
- What is the current inventory position and how much more consumption can it support?
- Is product engineering or redesign necessary in order to relocate supply?
- How lengthy are product qualification cycles? Must customers approve supplier changes?
- What is the risk of interruption of raw materials to the supplier?
- Do geographical distances or local regulations impact control?

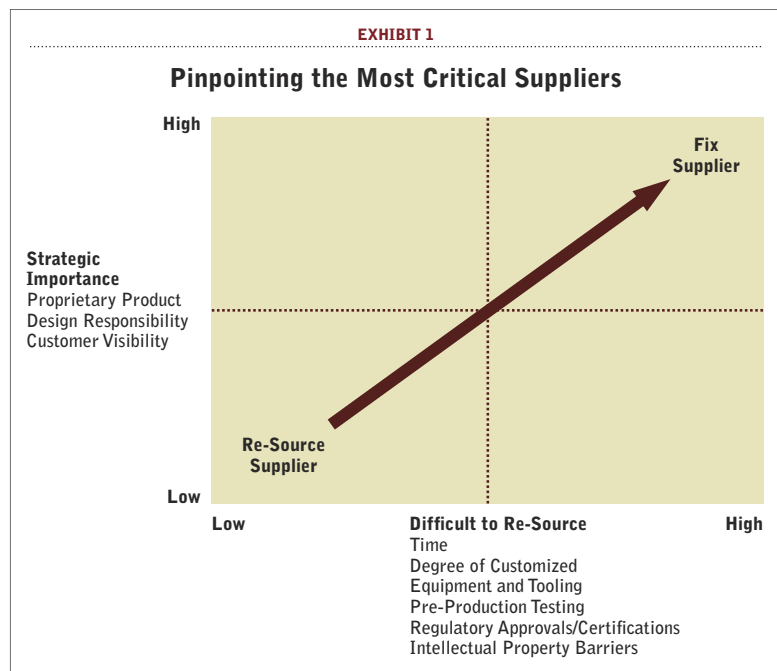
Both quantitative and qualitative considerations go into these assessments. We have found that a practical and time-effi-

cient approach involves ranking suppliers in even quintiles from most strategic to least strategic (so as to avoid the occasional tendency to discover that nearly all suppliers are “highly strategic”). This approach requires that if there are, say, 100 suppliers, no more than 20 can be in any individual quintile ranking. The output from this analytic step is used to stratify all suppliers along the dimensions of strategic importance to the business; the same approach is then applied along a continuum of difficulty to re-source the goods or services provided. Specifically, we seek to prioritize those suppliers that fall into the upper right quadrant, denoting high strategic importance and high switching difficulty. (See Exhibit 1.)

After a supply management executive in the printing industry conducted this analysis on his supply base, he was surprised by the degree to which the truly critical suppliers differed from his previous perception of what “critical” meant. For example, this manufacturer had always regarded one chemicals supplier as critical since it had long been a sole source producer of proprietary compounds. However, closer scrutiny of the supplier’s performance, followed by competitive sampling, made it clear that there were viable alternatives and suppliers to meet production needs. Conversely, the process highlighted a few suppliers that had previously been considered inconsequential—prompting a much closer focus on their status and performance.

Assessing Financial Distress

Once you have identified your high-priority suppliers, the next step is to assess their financial viability.



For many supply management functions, this can be a daunting task. Commonly available supplier financial reports typically fail to adequately reveal the supplier's overall liquidity position, which is an all-important measure of any company's ongoing sustainability. Moreover, suppliers that are privately owned often reveal little or no financial information.

There are many valuable and comprehensive sources of financial data with which to assess suppliers' financial viability. However, we have seldom seen all the collected data, across the multitude of suppliers, successfully translated into cogent indicators of financial distress. In one case, a customer kept a detailed and up-to-date "key suppliers" folder. In addition to internal reports on supplier performance, the folder contained the annual reports, 10-Ks, 10-Qs, sector coverage reports from several investment analysts, chronological transcripts from the earnings calls as well as reports purchased from financial information bureaus. Most buyers could readily describe suppliers' metrics such as recent stock price performance, executive compensation, the fiscal calendar, key competitors, and whether business was growing or declining. However, nobody with whom we spoke at that company could quantify supplier liquidity beyond subjective quotes from analysts' reports—much less rank suppliers by the extent of financial distress.

If needed information is publicly available, or if your privately owned supplier is willing to share details, the Altman Z-Score can be applied as a general predictor of financial distress. This reliable metric was introduced in 1968 by New York University Professor Edward I. Altman. The lower the score on a 0 to 5 scale, the greater the likelihood of distress. The Altman Z-Score equation comprises five financial ratios: Working capital to total assets; retained earnings to total assets; earnings before interest and taxes to total assets; market value of equity to book value of total liabilities; and sales to total assets.

The Altman Z-Score can certainly help supply chain managers to quantify and rank suppliers with more rigor than they may have done previously. However, it is only a general predictor that varies dramatically based on factors such as asset intensity or industry structure. Over the past decade, we have used a proprietary Early Warning Model (EWM) tool. The EWM analyzes a number of company-specific financial factors and produces a likelihood of distress, on a scale of 0-100 percent, over a forward-looking, two-year period. The higher the value, the higher the likelihood of distress.

Context—such as comparisons within peer or industry groups—is vital to interpreting the condition and extent of distress. In Exhibit 2, the deterioration (red line) of a process-industry company is apparent, leading to the company's bankruptcy filing. At the same time, two other producers in the same industry (blue lines) are exhibiting clear indications of stress, while the remaining peers (green lines) are all tracking below the 15 percent level. It is easy to spot the prospective suppliers that should be cause for concern. Moreover, by periodically monitoring each company's absolute distress level, one-time increases in distress, and period-over-period deteriorating trends, it is possible to flag at-risk suppliers just as the first distress signs appear.

It is not unusual for suppliers to be surprised when their financial viability is first challenged. However a fact-based conversation dispels emotions, facilitates a constructive dialog, and can lead to early preventative actions among receptive suppliers. For recalcitrant suppliers or suppliers on a deteriorating path, the advance warning can provide supply chain managers with an early jump on alternative plans—thus avoiding the premiums associated with crisis responses at the last minute.

We have learned that many companies exhibit early signs of distress when there are months, if not years, of lead time before they hit crisis levels. It is possible to monitor average distress levels of tracked companies that filed for bankruptcy protection, contrasted with the number of months prior to filing, during each of three calendar years: 2007, 2008, and 2009 (through April). (See Exhibit 3.) The data suggest that in the cases of suppliers that cross a 40 percent probability level of crisis, there is, even in the worst cases, more than a full financial quarter in which to take corrective action. While a 40 percent-plus rating is no guarantee of failure, it implies that proactive intervention or contingency planning significantly improves customers' chances of uninterrupted supply or crisis response, much as early detection of a disease can help forestall its worst effects.

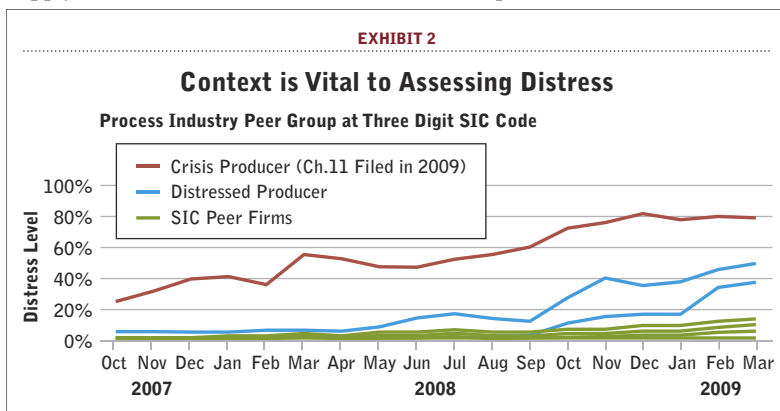
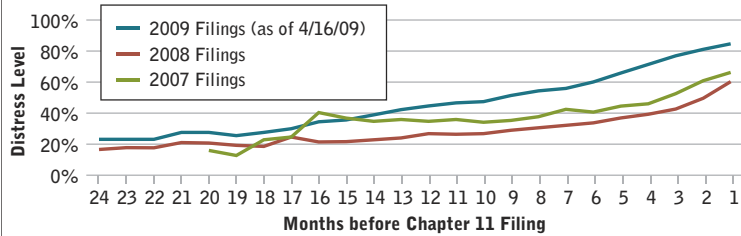


EXHIBIT 3

Spotting the Warning Signs of Distress

Average Level of Distress Before Chapter 11 Filing*



* Publicly traded firms with sales >\$250 million (>\$500 for retail firms) and assets >\$100 million

In our experience, it is essential to open confidential dialogs with high-priority suppliers whose probability of distress exceeds 40 percent. This gives supply chain managers an opportunity to assess the circumstances first-hand and judge whether the supplier's distress level is a financial anomaly or a signal of mounting distress. Constructive intervention at the earliest stage also means that there are the most degrees of freedom remaining to reverse the course—which is in the best interests of both supplier and customer.

Intervening with At-Risk Suppliers

Highlighting “at-risk” suppliers is only the first, and easiest, part of the SRM process. Once you have recognized that a priority supplier is financially at-risk, it is time to suspend the business-as-usual approach until stability is restored—or until you no longer rely on the supplier. To be sure, many supply management functions have instituted cost take-out programs or other structured mechanisms to contain costs, and these are certainly appropriate ways to ensure competitiveness over the duration of a relationship.

However, during periods of financial sensitivity, aggressive supplier negotiations can inadvertently serve as the *coup de grâce* for a supplier and heighten the likelihood of supply disruption. Consider this recent example from Chrysler's experience. Prior to its own bankruptcy filing, the car maker sought 50 percent price reductions from some of its suppliers, including Aradco Management, a Tier 1 supplier of stampings, modular assemblies and welded parts. With more than 90 percent of its business dedicated to Chrysler, Aradco could not withstand the additional loss of income inferred in Chrysler's proposal. Failing to reach an agreement, Chrysler attempted to move all of its business away from Aradco. Even after obtaining a court injunction granting legal rights to Chrysler for Aradco's parts and tooling, Chrysler was turned away by a union blockade at the Aradco plant in Windsor, Ontario, severing flow to production lines.

To resolve the question of supply continuity, we have to triage at-risk suppliers into two groups based on how badly a supplier's financial picture has deteriorated. Broadly, we categorize them into “distressed” and “crisis,” with each category implying different levels of intervention. Let's get into more detail on each:

Dealing with a “Distressed” Supplier.

In such cases, the fundamental objective is to improve the supplier's cash flow in order to reduce or reverse its distress level. A good example is the recent case of an interven-

tion at a privately held freight provider. This company was exhibiting early signs of financial distress; its customers were worried about its viability. At the same time, its owner was worrying about how to secure a major cash infusion to tide the company through the economic downturn.

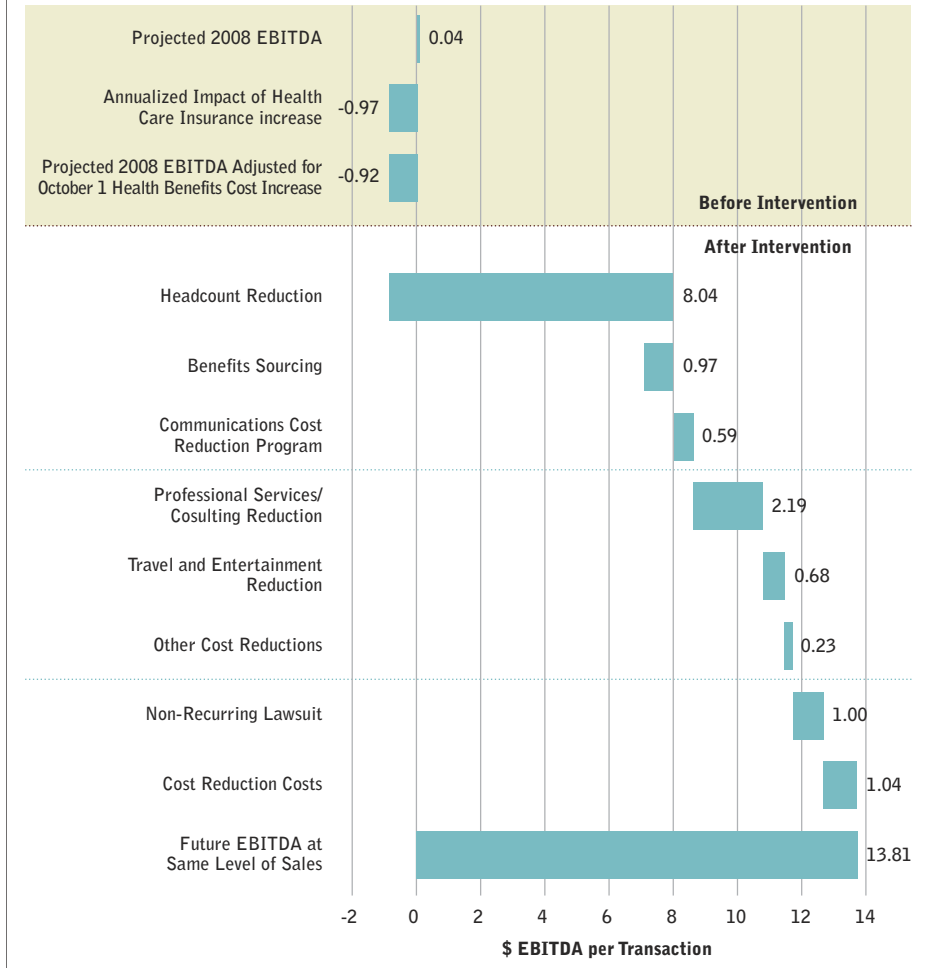
The initial meeting between the supplier's executive team and AlixPartners centered on a detailed review of the company's financials. It was agreed that the company would give priority to immediate and steep cost reductions, which included a freeze on new hires and on planned salary increases, and the appointment of the chief financial officer (CFO) as the “cash czar” to control all discretionary expenditures. The initiative also involved a company-wide program to dramatically improve earnings before interest, taxes, depreciation and amortization (EBITDA) per transaction, by:

- Executing one-time employee severance pay-outs for selected employment contract-based executives whose employment contracts had been thought to be too costly to terminate.
- Implementing a 26 percent staffing reduction to bring operational capacity in line with the business outlook.
- Shutting down services provided by all non-employee contractors whose total costs came at a premium compared to those of full-time employees.
- Eliminating and not replacing non-recurring costs, including ongoing litigation expenses.
- Replacing a health insurance plan that was due for renewal at a higher cost with another provider's more competitive plan that better suited the needs of the new business structure.
- Immediately cutting travel and expense costs for all but essential business purposes.
- Reducing communications costs.

Exhibit 4 shows the relative impact of these key actions over time. After just four weeks, the changes listed above led to a \$15 per transaction positive swing in EBITDA, reaching full run rate after 60 days. The

EXHIBIT 4

Rescuing a Distressed Supplier



supplier’s CFO noted that had it not been for the intervention, the supplier’s liquidity crisis would have necessitated a bankruptcy filing or massive equity infusion by the end of the year.

This case provides a clear example where advanced intervention—well before the onset of a cash crunch—allowed orderly and sustaining improvements with no disruption to service. What is also notable is the contrast between “a plan designed to improve cash flow” vs. a “typical” supplier-development action plan resulting from a customer’s visits. In our experience, supply management functions are rarely equipped to engage constructively with suppliers to address issues such as SG&A reduction or health insurance negotiations. Rather, they tend to be oriented toward product quality, service levels and cost containment. Certainly all of those factors are critical, but during periods of acute financial sensitivity, they are

insufficient to meaningfully improve supplier liquidity. Exhibit 5 shows a continuum of supplier financial distress along the dimensions of timeframe, focus, actions, and skill sets.

Coping with a Supplier in “Crisis.”

Typically, a “crisis” supplier has already run out of cash or is about to run out, which cuts short the debate over the need for intervention. Suppliers can be at great risk: It is quite possible that payroll cannot be met or the supplier’s suppliers have not been paid. The supplier may be about to default on its obligations, resulting in an involuntary bankruptcy filing. Once a company has filed for restructuring, it operates under the protection of the court and in the interests of its debtors. The objective of restructuring is to restore the business to ongoing financial viability. Implications for customers can include: renegotiating contracts and the associated terms; selling, liquidating or shuttering business units to

raise cash or stanch financial underperformance; encumbering assets, including parts, tooling and equipment; and even reclaiming cash or assets exchanged during a defined time period prior to the filing.

When a crisis does occur with a priority supplier, it is usually too late to re-source the goods. If supply continuity is in jeopardy, there are several undesirable but prospective steps that a customer may undertake to fill immediate needs. Suppliers’ cash flow can be temporarily improved by paying your supplier’s supplier directly for the raw materials or inputs for your products. If tooling is controlled under a bailment agreement, it may be possible to relocate it to a different supplier. There are even circumstances in which resources from your organization may run the endangered supplier’s production equipment in order to obtain output. Of course, none of these kinds of moves should be more than temporary.

EXHIBIT 5

Supplier Distress Continuum

Supplier Status	Business-as-Usual Supplier	Financially Distressed Supplier	Crisis Supplier
Timeframe	Ongoing	<3-6 months	Immediate
Focus	Product-based (e.g.): <ul style="list-style-type: none"> • Cost Containment • On-time Performance • Product Quality • Supplier Capability 	Supplier-based (e.g.): <ul style="list-style-type: none"> • Cash Flow Improvement • SG&A Reduction • Product Profitability • Working Capital Improvement 	Supplier-based (e.g.): <ul style="list-style-type: none"> • Cash Generation • Debt Reduction • Monetize Assets from Balance Sheet • Restore Profitability
Required Actions	Periodic audits and performance monitoring, supplier/site visits, development plan management	Confirm supplier's understanding of situation, assess turn-around plan(s), accelerate/execute contingency measures	Work with supplier or creditors to maintain supply or obtain parts/tooling Restore supplier profitability High-speed re-sourcing of parts and services

detection and prevention of financial distress—or toward re-sourcing “at-risk” goods and services while there’s still time to do so.

The skill sets, competencies and approaches best suited for these situations are defined as those of a turnaround professional. The recognition of the role of “turnaround professional” is relatively recent. Organizations dedicated to this discipline include the Turnaround Management Association (www.turnaround.org) and the Association of Insolvency & Restructuring Advisors (www.airacira.org). Both organizations offer rel-

In one recent case, a mid-sized apparel supplier could not cope with its crushing debt load. After notifying senior lenders that it was unable to meet its debt repayment schedule, the company moved to focus on generating cash, restructuring its manufacturing footprint and supply chain and restructuring its debt.

Specifically, the apparel supplier implemented a 13-week cash flow forecasting model to quickly manage and forecast profitability, established a disciplined cross-functional approach to accelerate collection of overdue accounts receivables from customers, and dramatically reduced working capital tied up in slow or over-stocked inventory. The industrial restructuring focused on three key drivers: (1) reducing the supplier’s manufacturing footprint by consolidating the number of production sites; (2) shifting to a more effective and efficient distribution network to reduce costs and simplify the paths for product flow; and (3) increasing scrutiny on discretionary spending such as travel and expenses. The actions taken to preserve cash delivered significant accounts receivable benefits, solid inventory benefits, and a 10 percent reduction in manufacturing and discretionary spending—in addition to a new business plan aligning the objectives of the owners with those of the management team.

Some supply management organizations have the competencies needed to help distressed suppliers. But most lack the skills necessary to turn around a supplier in crisis. So should they develop internal turnaround competencies? In our experience, the incidence of crisis suppliers is not high enough to merit doing so. Instead, their time and energies are better directed toward advanced

evant training and certification programs. Enterprising supply management professionals can dramatically expand their conversancy and familiarity with the field of crisis management and turnaround work through these and other programs. While they do so, there is still no substitute for harnessing experienced turnaround capabilities if they are forced to deal with a supplier in crisis—which of course is what truly effective supplier risk management can help them avoid in the future.

The Financial Viability Factor

In today’s world, where continuity of supply is so critical, supply-management professionals must be able to embed financial viability in the overall function of supplier risk management. Specifically, they have to have the data and the analytical methods to be able to highlight the most critical companies in their supply bases. They need to be able to critically monitor and engage any critical suppliers that are showing signs of distress. And they must act to mitigate supply risk by decisively re-sourcing the relevant goods or services or by intervening to support the distressed suppliers.

The skills required for this kind of monitoring and supplier intervention are new for most supply management functions and their professionals. But now they must view these accumulated skills as a long-term competency.

Supplier failures will remain a fact of life, but supply disruptions need not be. We all look forward to a time when we can decrease the weight given to financial viability as a factor in deciding what to source from which suppliers. But for now, we don’t have that luxury. ☹☹