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## Supply: the critical thread

**There would have been brutal words exchanged at German auto giants Audi and Porsche in July when they were told they would have to slow production of their \$100,000 to \$300,000 automobiles because of a shortage of radio components. It seems their supplier of car radios had run out of microchips.**

They weren't alone. About the same time in Japan, Nissan was announcing a break in production for three days – reducing output by 15,000 cars – because of a delay in the delivery of auto-engine components by key supplier Hitachi. In turn, Hitachi blamed the delay on a shortage of integrated circuit chips from one of its suppliers. Call it a supply chain hiccup, but there is little doubt Nissan would have taken the news badly.

So what happened? It seems that as the world starts to emerge from the global financial crisis (GFC), we are seeing evidence of widespread supply chain failure. Counter-intuitively, it is as economic conditions improve that the precariousness of supply is revealed and the potential impact of supply chain failure becomes apparent.

In this article we will examine the impact of recovery on supply chains. We will look at how the failure of key supply-chain elements can damage the brands and fortunes of businesses large and small, threatening company failure, economic loss and irreparable brand damage.



### Destocking

Around the world as the GFC took hold, businesses engaged in “destocking” – running down inventories to ensure they weren't left holding high levels of stock at a time when they needed cash. In the circumstances, this was an appropriate response – particularly for companies engaged in electronics and computer peripherals, where stock held for longer than a few months quickly becomes obsolete.

But as economies began showing signs of recovery and businesses prepared to return production to pre-GFC levels, it became clear that changes made at various points in the supply chain threatened everyone else relying on that chain.

Failure in the supply chain is not intrinsically linked to the economic cycle, though weaknesses are often exposed during times of uncertainty and decline.

Supply chain woes can stem from anything from natural disaster to the death of a key staff member, or the malfunction of a computer system.

In 1999 American confectioner Hershey Foods suffered a meltdown in its order management and warehousing systems, which caused it to miss crucial Halloween shipments. USD150 million in revenue was lost, profit fell by 19% and one third was wiped off its share price.

In 2001, another American giant – Nike – discovered the risk of implementing an untried and unproven computer-based ‘intelligent’ ordering system. The new Nike system inexplicably duplicated production orders for slow-moving lines and cancelled orders on highly popular items. The result? A USD100 million hit to revenue and 20% share price slump.

## The Cisco experience

Perhaps it was a case of once bitten twice shy for US-based computer hardware giant Cisco Systems Inc., which was caught out in the tech crash of 1999 with excessive inventories when the bottom fell out of demand. It was forced to write off USD 2.2 billion of inventory and suffered a corresponding 50% share price crash.

A decade later, Cisco had completely reworked its supply chain based around contract manufacturers, primarily in mainland China. In the face of the economic downturn and a 20% reduction in sales, Cisco reduced inventory levels – a perfectly reasonable approach that helped shield the company from the worst of the GFC.

Perhaps Cisco's management wasn't expecting the height of hurdle as conditions improved.

Having been caught out before, Cisco wasn't about to move ahead of customer demand, so plans for restocking only swung into action once reinvigorated customer demand was demonstrated. It simply failed to anticipate the strength of the rebound – and the failure of its overseas suppliers.

In a statement released in October last year, Cisco noted that it had to temporarily extend the lead times for delivery on a number of products because of an anticipated lag between demand and “specific industry-wide capacity challenges”.

In other words, it knew that there would be a lag between demand resuming and being able to bring products to the market, but it was unwilling to risk stepping up production until there was a clear signal from consumers. And it fully expected its competitors would be in the same boat.

This resulted in lead times blowing out to over three months for the delivery of even simple components.

As a result, Cisco witnessed two worrying developments:

- 1 Customers placing multiple orders for the same goods from different distributors, then cancelling duplicate orders when the first shipment arrived.
- 2 Customers being handed the perfect excuse to seriously examine competitors' products. Anecdotally, Juniper Networks and Hewlett Packard experienced increased enquiries in relation to like products.

Fast forward seven years and the world was in the grip of the GFC. Australia may have been somewhat insulated from the worst of the crisis, but our businesses still engaged in destocking behaviour – running down their inventories as a precautionary measure. In the manufacturing sector, producers cut orders for components and, in turn, the component manufacturers cut production, implemented redundancies and mothballed production facilities.

We are now seeing businesses starting to judiciously increase inventories in reaction to improving consumer demand at the retail level and this is flowing through to wholesale, manufacturing, transport and logistics. As wholesalers and retailers re-stock, domestic manufacturers are driven to switch the machines back on and bring mothballed or underutilised production facilities back on line – similar trends are being experienced throughout Asia and around the world.

This is the point where fractured supply chains will be unmasked.

After a period of depressed consumer sentiment, some businesses have been reluctant to move ahead of demand, so we are seeing evidence of restocking starting only after consumer demand has resumed.

Breakdowns in the supply chain expose businesses on two critical fronts: short-term financial effects and longer term (and potentially irreversible) brand damage.

## Financial

In our experience, managers and executives commonly fail to anticipate supply chain difficulties when preparing forecasts for businesses in a recovery scenario. Often those forecasts and budgets are formulated (and in many instances cost-obligations incurred) based on business-as-usual instead of worst-case scenario assumptions.

### ■ Revenue

When production constraints bite, it can leave businesses in the unenviable position of having to

choose which customers to supply. This inability to achieve full revenue potential can be disastrous in cases where these constraints have not been factored into revenue forecasts – particularly where lending covenants have been built around such forecasts or around market capitalisation.

## ■ Cost overruns

Threats to revenue will typically capture the attention of management. Overreaction is common. Often, in desperation, businesses will turn to expensive options in order to maintain product flow. Air freight is a regular response to avoid shipping delays, regardless of the premium incurred for urgent freight.

According to data compiled by Transport Intelligence, air-freight forwarding volumes have increased 38 per cent in the first half of 2010 – faster than any other transport mode and a hint that businesses may, in fact, be resorting to air transport. This trend is expected to continue for the rest of the year, before inventory levels normalise. At Ferrier Hodgson, we have seen instances where air transport operators have charged a premium of 1,200% over the cost of sea freight.



Rarely are these additional costs built into the ultimate price, resulting in margin stress. In instances where additional costs are passed on, market share can be at risk.

For businesses operating on already tight margins, these costs, together with other recommissioning costs (things like maintenance and testing of plant, sourcing and quality control on raw materials and the time impost of dealing with agitated

customers), if not sufficient in themselves to push a business over the edge, are unsustainable in anything other than the immediate term.

## ■ Trade cycle

Resumption of orders with an overseas manufacturer who is unable to immediately restore pre-GFC volumes may result in an extension of the regular trade cycle. Where it may previously have been 90 days, it could blow out to 120 or 150 days to allow the manufacturer time to find staff and raw materials and to recommission mothballed machines.

Overseas manufacturers may still require a hefty portion of up-front payment, so financiers may well find requests for longer periods of trade finance funding.

## Brand

A longer-term implication of supply chain failure is the brand and reputational damage stemming from the inability to meet customer expectations.

Take the example of Intel. When introducing upgraded and new generation processors, Intel is often under pressure from major customers including Apple, Dell and HP for preferred access and supply. Prior to the GFC, Intel granted supply to Apple in preference to its competitors, meaning that Apple could offer a product to the market which the others could simply not match for performance.

As a consequence of their inability to source processor components, many of the competitors were unable to launch products with performance specifications to match the latest releases from Apple. Inability to source appropriate processing horsepower has resulted in a brand dilution for Dell and HP, and they are unable to make inroads into Apple's market share.

## Conclusion

Businesses and their financiers should be paying close attention to the assumptions underlying a recovery forecast.

Where a business is reliant on a supply chain, it should:

- Consider the capacity of its suppliers to resume regular production levels quickly.
- Consider existing banking covenants and talk to your banker if there is any risk of a breach as a consequence of an identified supply chain failure.
- Be cautious as to the assumptions around lead times to receive product.
- Consider the availability of alternative supply and look at locking in back-up arrangements.
- Identify any changes required to funding facilities given the potential for a temporary stretching of its trade cycle.
- Have a strong communication plan and particularly:
  - 1 Be ready to discuss with customers the possibility of short-term price revision for express orders.
  - 2 Actively manage key stakeholders (customers, financiers and investors), in the event that supply chain weaknesses emerge.

At Ferrier Hodgson, we offer a wide range of services to financiers and businesses, including:

- Assessment and quantification of the potential impact of the failure of a crucial linkage in the supply chain on a company's cashflow, profitability and funding arrangements.
- Review the appropriateness of banking covenants and recommend changes where appropriate.
- Due diligence reviews of potential supply chain partners, in conjunction with our network of Ferrier Hodgson offices throughout Asia and affiliates in Europe and North America.
- Testing cashflow assumptions and conducting business viability assessments under various funding scenarios.
- Identification and assessment of supply chain finance options.



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