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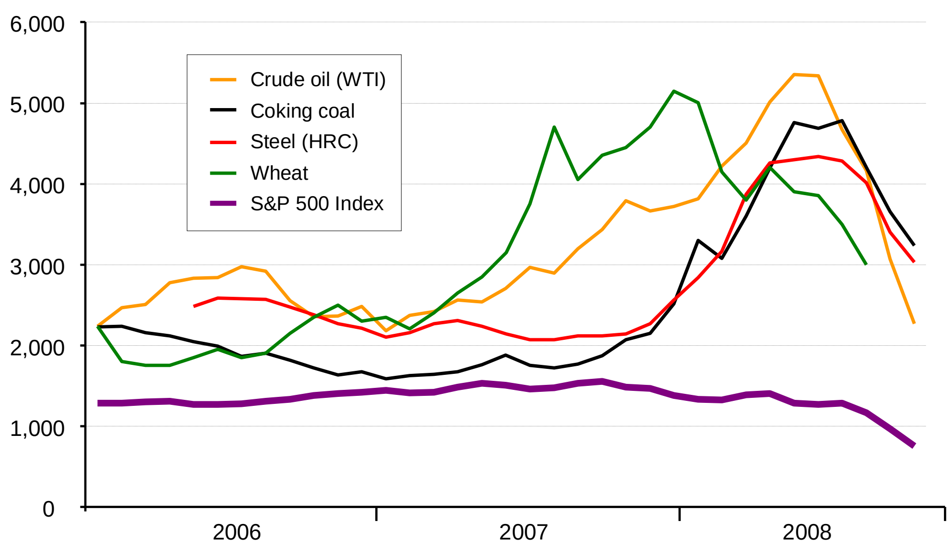
Buying Well in Volatile Markets

A large rock or two has been dropped in the world's financial pool. The ripples are spreading everywhere and more waves are coming. We should have a little time before the next ones reach us so it is worth taking a good look around and thinking about how to stay afloat.

Both price waves and supply waves are rolling through and they seem to be less connected to each other than economists would have us believe. So far the biggest waves have hit commodities as we can see from the recent peaks and falls in commodity prices.

Selected commodity prices compared with the S&P 500 stock index
(Commodity prices in US$ scaled to a common starting point in Jan 2006)



There is also a third type of wave which may outweigh the others – the wave of sentiment or market confidence. This measure has been trending downwards along with stockmarket indices like the S&P 500 despite lots of reassuring words and positive actions from our politicians and from senior bureaucrats like the head of Treasury and the Reserve Bank Governor.

All these events have consequences for those of us trying to source goods competitively and keep customers happy. Price disturbances are one thing but supply and demand disturbances can be even worse. In this paper we discuss how Australian businesses can mitigate supply risks and keep their procurement spend under control when waves of instability are rocking world markets.

We think it is worthwhile to explore

- Causes and consequences of current volatility
- Volatility risks for businesses
- Practical procurement responses for turbulent times.

Causes and consequences

Looking back at what seem like faraway times in the first half of 2008, the big news was the relentless rise of commodity prices, led by oil, coal and iron ore. Oil futures peaked on the 15th of July at US$147 a barrel, and then took only 4 months to fall below US$50 a barrel.

With the 20-20 vision of hindsight we can now see that the commodity price boom and bust of 2008 was energised by billions of dollars of speculative money from hedge funds and elsewhere desperately seeking the high returns that had stopped coming from financial instruments like repackaged mortgages. The combination of tight supply-demand conditions for many commodities and the arrival of a tsunami of funds chasing fast profits pushed commodity prices up into a bubble. Then all of a sudden the worsening financial crisis dried up global liquidity and the speculative money rushed back out of commodities and into the "safe haven" of US dollar and Yen-denominated instruments. One effect of the rush was to knock the Australian dollar down.

In the aftermath of the commodity price bubble we have supply and demand back in the driving seat . . . . or do we? What about the distorted exchange rate effects, the shortage of credit, recessions in country after country, bankruptcies and bailouts brought by the global financial crisis?

It is now much harder to predict what will happen next other than saying that things will certainly be volatile. This unpredictability and the run of financial bad news drains business confidence. Natural responses by apprehensive business managers are to run down inventories, buy cautiously, chase debtors and cut spending programs. As companies empty out their supply channels and cut back on spending is it any wonder that business activity measures are trending downward?

Paradoxically, emptying out supply chains will make the next business cycle more extreme because we are busily taking resilience out of the system. One role of inventories is to help damp down order spikes and allow businesses to handle the unexpected more smoothly. Lean Just-In-Time supply chains may be cost-efficient when running smoothly but they need stable demand and they will struggle to serve markets that can't make up their minds.

All indications are that the global financial crisis has by no means bottomed out. Consequences yet to come may include further jumps in exchange rates altering the balances between trading partners and the pricing of imports, especially if the US dollar starts to fall from its current heights.

Another factor affecting prices for traded commodities will be the importance of big players in these markets who do not provide transparent information. For instance commodity markets are in the position of constantly guessing about China's inventories, the intentions of China's bureaucrats, and so on. Delays getting information about supply and demand amplified by lack of transparency lead inevitably to more price volatility.

So there are plenty of reasons to expect increasing volatility in our future

- Ongoing financial crisis effects
- Stops and starts from emptied-out supply chains that want stability to run smoothly
- Price spikes upward and great buying opportunities downward as schizophrenic behaviour spreads – dumping excess stocks one day then charging scarcity prices the next day.

Volatility risks for businesses

Price volatility is the most easily observed and reported risk on the supply side. Fixed-price contracts and hedging are the standard defences. Southwest Airlines in the USA and Qantas in Australia are two airlines known to have done very well out of clever fuel price hedging during 2007 and early 2008.

Sudden price jumps in all sorts of industrial goods and commodity-dependent services like transport were widely reported during the second half of 2008 as the commodity price spikes flowed downstream. Now the price pain is being forgotten as oil prices plummet and steel prices readjust. The risk for businesses lies in believing that going down means staying down. To date the "lows" are still historically high ($50 a barrel oil compared with $20 a barrel during the 1990s), and price dips should be regarded as an opportunity to hedge against the next peak rather than an invitation to relax.

The second key risk threatening businesses is supply continuity. We can predict that supply volatility will worsen due to the bullwhip effect. With leaned-out supply chain inventories failing to provide much smoothing effect, each order from an end-user will tend to create larger and more sudden pulses of demand on suppliers and suppliers' suppliers, leading to more stockouts, backorders and supply failures.

Pity the poor procurement professional facing more delivery urgency and more spending uncertainty at just the moment his suppliers have prudently run down their stocks and cannot promise delivery dates or commit to prices. The bullwhip effect will amplify supply shortages, and is also likely to have roll-on effects into price volatility if suppliers try to price according to risk or scarcity or urgency or short production runs or airfreight costs.

Finally there is margin risk. Do your internal processes react fast enough to changes in input costs? Do you already use fuel levies or similar techniques to recover fast-changing costs? Or does higher buy price translate directly into lost margin because nobody at the sell end of the business gets to confront the reality of higher costs?

Business responses

Let's discuss specific steps that sourcing and buying teams can take to improve their chances of a smooth ride through these choppy and uncharted waters.

Our survival guide entails a four pronged approach, with the key themes being agility, creativity and collaboration in addition to strategic responses that safeguard lines of supply. The four initiatives are:

1. Agile governance and dynamic commercial models
2. Creative credit terms
3. Strategic supply chain responses and
4. Closer collaboration with your suppliers and customers.

Agile governance and dynamic commercial models

A critical response for companies in these volatile times is to stay alert and keep informed, speeding up monitoring, intelligence and analytics activities to ensure you are on top of important developments. Regular update bulletins or business news scans may be a good way of keeping your team informed and sharing market insights across your business.

Beyond this, corporate governance should be nimble – ready to make quick decisions to exploit opportunities or avoid pitfalls. Establishing decision making frameworks and / or 'guiding principles' may help encourage sound decisions rather than knee-jerk reactions. Nevertheless now is the time for action, with an external crisis providing the perfect opportunity to drive through tougher decisions.

If you have been putting off the review of long standing commercial arrangements or the challenging of 'accepted wisdom' in your organisation, now is the time to take a fresh look.

Ask yourself the following questions about your commercial partners (suppliers and customers):

- Is my commercial model dynamic enough to cope with the volatility whilst protecting or growing margin rather that eroding it?
- Have I synchronised my commercial model (and risk mitigation strategies) along the value chain (from customer pricing up to supplier's supplier) – making sure internal systems communicate changes in buy price directly through to sell price to avoid margin squeeze?
- Do I have the right commercial triggers and adjustment mechanisms in place, e.g. currency movements, key input pricing, fuel pricing, etc. to ensure risk is shared and margin maintained or improved?
- Is the commercial relationship fair and equitable to both parties? In these times opportunities will present themselves to exploit short term wind-falls. Ask yourself if exploitation is the best move for the longer term.
- Could my actions negatively impact my suppliers' viability and in turn risk security of supply?
- Am I a customer of choice for my suppliers – if there are trade-offs to be made from their side, will I be their first consideration?

Creative credit terms

Cash has always been King, however never more so than now. Luckily for us trade credit in Australia seems to be less affected than in other countries. We hear that some European banks have simply turned off the taps on all forms of credit. "What you don't lend, you can't lose" is the new banking ethic. In Asia the problem seems to be the drying up of the Letters of Credit needed to get exports off the wharves and onto ships. The economic consequences of these kinds of lending paralysis are potentially disastrous.

What we're seeing in Australia is less extreme, but still painful for those who are part of long value chains dependent on customers who have used market power to force long payment terms upon their suppliers. The original rationale of extended terms was to balance the lengthy sales-to-cash cycle at the front end of businesses. Now the availability of credit has become a major issue for many organisations, even those with healthy order books, and it is time for a rethink of payment terms in cases of hardship.

Developing and deploying creative commercial credit terms for customers and for suppliers/shippers should be a priority, especially those experiencing financial holdups such as inability to access Letters of Credit. If the current model is going to cause supply failures your better option will be to introduce exception mechanisms that support shared risk or faster cash settlement.

Deploy strategic supply chain responses

Regardless of any dips in demand, security of supply remains a critical issue and you may want to consider a range of strategies to shore up your supply chain. Some ideas include:

- Consider holding increased strategic safety stocks of critical imported and bought in items to cover supply variability and potential supply chain delays (credit and or capacity related)
- Activate alternate sources of supply even if they are higher cost
- Deliberately make your supply chain more redundant and resilient through maintaining or establishing excess capacity

Such responses as these may at first appear counterintuitive in an environment where cash and credit are scarce, however to ensure continuity of your own operations such insurance measures may prove invaluable.

Closer collaboration with your commercial partners

Do you know enough about the commercial health of your most important suppliers? There are several ways the financial crisis can be affecting supply chain partners depending on whether they are carrying debt, suffering revenue declines, or just apprehensive about their own suppliers. Now is a good time to renew supply chain relationships and check each other's situation and outlook.

Relationship building and collaboration along the supply chain with demonstrated willingness to share risk and pain can be a good investment of time and effort. Approach suppliers and customers on the front foot with a well constructed position statement outlining policies to navigate these volatile times. Request their support in a more open and collaborative way of working to communicate trade intelligence, jointly share risks and maintain the viability and prosperity of each business.

What to do today

Stable and predictable commercial environments encourage lean and mean "efficiency" players committed to wringing every last cent out of assets and inventories, suppliers and service providers. On the other hand volatile and uncertain environments favour the decisive, flexible and better-resourced players who have plenty of strategic options to fall back on and few points of exposure. Which type of hand would you prefer to be playing today?

Some decisions can be made right now. For instance:

- ✓ Change the way your team thinks about the supply market
- ✓ Put in place more frequent reviews of supply risks
- ✓ Go out and meet with your most vital suppliers to understand how they see things.

Other actions will take longer. For instance:

- ✓ Investment in some carefully chosen strategic inventories of critical inputs
- ✓ Developing a collaborative approach to credit issues
- ✓ Convincing your CEO to accept some added "inefficiency" costs that help build resilience and insure your business against potential supply problems.

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