

by

Simon Harper
harper_simon@bah.com

Laura Thompson
thompson_laura@bah.com

Buy Globally, Think Globally

Implications of Global Economics for Sourcing Professionals

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Throughout the airline industry's rough post-9/11 era, Southwest Airlines has led its peers in the U.S. in profitability again and again, staying consistently in the black even as a number of its competitors flew into bankruptcy.

Procurement managers buy globally, so it is essential that they take the wider economic and geopolitical conditions into account.

While there are many reasons behind Southwest's superior performance, a savvy procurement strategy has been a key factor. By hedging more than 80 percent of its fuel costs, Southwest avoided the turbulence many airlines suffered when jet fuel prices rose more than 60 percent between September 2002 and September 2004, and another 52 percent in the following 12 months.

Southwest's hedging strategy might seem like an obvious source of long-term competitive advantage. After all, people have been making forward contracts in commodities since the pyramids were built. Yet year after year in the first half of this decade, Southwest's fuel-buying program might as well have been a secret formula.

The kind of myopia shown by airlines that did not sufficiently hedge fuel risks might seem exceptional, but in procurement teams around the world this sluggishness to act on macroeconomic changes is

actually quite common. One case in point: In the very different industry of retail, the procurement teams of many European apparel retailers were apparently caught off guard by the "bra wars" in 2005, despite the fact that a trade war over importing cheap Chinese clothes into the European Union had been brewing for some time.

In fact, in many industries, procurement officers pay scant attention to important global economic and geopolitical factors when developing their strategies. Many are running their long, complex, 21st-century supply chains with a parochial, 20th-century outlook. Often, procurement managers don't stop to think about how an event such as a war or a change in tax policy in a distant part of the world could have a significant impact on the availability of a commodity or service their company needs.

These blind spots are good news for the procurement officer willing to do a bit of homework. Understanding the economic and geopolitical dynamics of the markets in which one buys can help identify many often overlooked opportunities.

In some commodities, a procurement manager can profit from knowledge of regular cyclical swings in price by locking in prices at the bottom of a cycle. At other times, understanding the market can help procurement see when a permanent shift in the market has occurred.

The price of sugar, for example, is now set not just by the demand for sugar for consumption but also by

the growing demand for sugar as a raw material for ethanol, thanks largely to Brazil's ambitious ethanol fuel program. As a result, where sugar once followed its own supply-and-demand cycles, now it tracks the price of oil—a fact that could be used to gain an advantage over competitors that still follow seasonal cycles.

Besides commodity price movements, currency fluctuations can also provide a source of savings. While the introduction of the euro has made currency management much simpler, it is still an important factor to watch. Does the U.S. dollar seem to be heading down? Maybe it makes sense to lock in a dollar price on Christmas stock early. Japanese yen seem too uncertain? You could hedge now and prevent an unexpectedly high price tag later on, or make sure the contract is denominated in your company's currency.

Sometimes a currency-related opportunity may exist even when one's direct purchases are mostly euro- or sterling-denominated. Disaggregating upstream suppliers' dollar-denominated costs can be one way to negotiate some substantial cost savings.

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If one of the key commodities used by an upstream supplier is priced in dollars, for example, it's easy to calculate the discount one should be able to negotiate if the dollar has declined against the euro and sterling.

The same divide-and-conquer gambit can also work well for uncovering other kinds of cost drivers. By disaggregating the value of the underlying commodities in the product, it becomes easier to see what the true cost should be. Vendors are all too quick to negotiate new prices when some of their cost factors go up but are understandably forgetful about calling back when those same prices go down again. A knowledgeable

procurement manager with access to a bit of price data might call the vendor and say, Hang on, why am I still paying the same as I did last month when sugar is down 3 cents per pound? Someone a bit less knowledgeable will let the opportunity slip.

As well as monitoring daily, weekly, or monthly fluctuations in prices, it's also crucial to understand trends in macroeconomic factors over the long haul. For example, spotting a trend of rising labor costs in a low-cost country where one currently sources could give the purchaser enough time to scope out more cost-advantaged locations before the existing agreement becomes uncompetitive.

Beyond enabling the company to get the best possible deal today, a little global foresight could also protect the company from losing out later due to a temporary blip in the supply chain, caused by a price spike or a shortage in a commodity. For example, some companies learned the hard way about China's long-term cardboard shortage, realizing the problem only after their orders arrived in weak, bulky boxes made of wheat or rice straw.

Such problems can often be avoided fairly easily. In this case, a quick search on the Internet would likely have informed the purchaser that non-wood fibers currently account for nearly 85 percent of the pulp China produces and that China faces a serious long-term shortage of harvestable trees. Knowing that, a buyer could arrange for alternative packaging — or seek to specify the grade of shipping material in the vendor's contract.

Nor are such problems necessarily far away. British retailers recently found themselves surprised by a battle with the European Union over a proposed tax on foreign-made plastic shopping bags. Something as nonstrategic and non-labor intensive as a plastic bag might not be expected to have a strong manufacturer's lobby. Even now, it is unclear whether retailers will be able to continue to import plastic bags from Asia. But analysts believe that if retailers lose this round in Brussels, the big four supermarket chains in the U.K. could lose as much as £60 million a year.

But what are the right factors to monitor? In a world where physicists believe that the flap of a butterfly's wing on one side of the world can lead to a storm on the other, perfect foresight is impossible.

However, asking four simple questions can go a long way toward preventing the kind of shock that many airlines suffered during the last oil price rise, and instead can help procurement managers take advantage of emerging opportunities:

1. Which categories within our spend are strategic enough to warrant close attention?
2. What are the economic drivers behind these key categories?
3. How would those drivers' movements affect the overall performance of our current sourcing arrangement?
4. How can my team best monitor changes in those drivers?

Getting answers to these questions can take time, but the information is generally not difficult to find. Within one's own organization, the legal, finance, and tax experts can flag relevant changes in economic and geopolitical conditions within their domains. The right answers can also be found by reading articles in newspapers and trade journals or by tracking down a commodity's industry Web site.

More surprisingly, blogs are becoming increasingly valuable sources of industry information. Even casual conversations with suppliers can be useful. If a vendor is moving its manufacturing from country X to country Y, a simple "Why?" asked in casual conversation can uncover deeper changes in the market.

It may sound great that a buyer was able to keep a price increase on a part to zero last year, but if the dollar is down 5 percent, the result begins to look less impressive.

For most spend categories, a little of this kind of knowledge can go a long way. There is typically no

need to install a Bloomberg terminal to follow hourly price movements, or to fly procurement managers to Brussels to follow every parliamentary debate.

Once the most important price drivers are identified, they can often be tracked relatively easily, by creating a simple online dashboard of commodity prices, or even by subscribing to online news alert services such as Google's.

When it comes to tracking the price of a major commodity, price quotes no more than a few minutes old are often available online for free, and most industries have newsletters and other publications that track price trends. Nor is this kind of data confined to raw materials. For almost any product produced in large quantities, even such high-tech goods as flat-screen displays and computer memory chips, it is almost certain that someone, somewhere tracks its price.

Of course, it's one thing to subscribe to a report or install an icon on a procurement manager's screen. It's another to make sure the information is properly used.

A good way to embed awareness of economic factors into the procurement team's day-to-day business is to set key performance indicators for the category, incorporating the appropriate macroeconomic factors. For example, if a particular metal is 30 percent of a part's cost and the entire product is priced in dollars, assessing the procurement team's contract prices against currency fluctuations will give a good litmus test of their performance. It may sound great that a buyer was able to keep a price increase on a part to zero last year, but if the dollar is down 5 percent, the result begins to look less impressive.

This kind of sourcing homework can pay off in surprising ways. A set of strategic insights can serve to identify opportunities for cost savings by showing the company that it has more buying power in a given category than it knew. Understanding the macro quantities that are traded in the global marketplace as well as more locally through some online research could reveal some surprising information, not least whether your current suppliers are really "in the game."

Occasionally, smart procurement can even create value, by enabling the company to capitalize on emerging customer preferences and a greater awareness among consumers of the global geopolitical landscape.

One of the few profitable grocery store chains in the United States, for example, Whole Foods Market, Inc., has succeeded in part because of consumer confidence that the foods in the store are all organic.

These kinds of preferences seem likely to proliferate in the future, so consider how a food buyer acting now might be able to capitalize on the geopolitical hot topic of climate change by sourcing not only organic food but also “carbon neutral food”!

For the globally savvy CPO, the opportunities may be as unlimited as the challenges.

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Simon Harper is a principal in Booz Allen Hamilton’s London office. He advises clients on procurement, operations strategy, and supply chain transformation topics across a wide variety of industries. He can be reached at harper_simon@bah.com.

Laura Thompson is an associate in Booz Allen Hamilton’s London office. She advises clients on all aspects of procurement from strategic sourcing through transformation across a range of industries. She can be reached at thompson_laura@bah.com.

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