Managing costs during inflation

Organisations continue to face inflationary pressures, coupled with persisting supply chain challenges. In the face of continued economic turbulence and uncertainty, organisations need to proactively work with suppliers and internal stakeholders to rein in costs and prevent disruption to operations.

> **"Inflation is at its highest levels in decades across many parts of the world."**

Inflation is at its highest levels in decades across many parts of the world. Global financial markets are in turmoil with the Russian/Ukrainian conflict expected to fuel further inflation through increased energy and food prices and continued disruption to trade routes. With existing supply chain constraints and sustained demand, inflationary pressures are expected to continue at least through 2022.

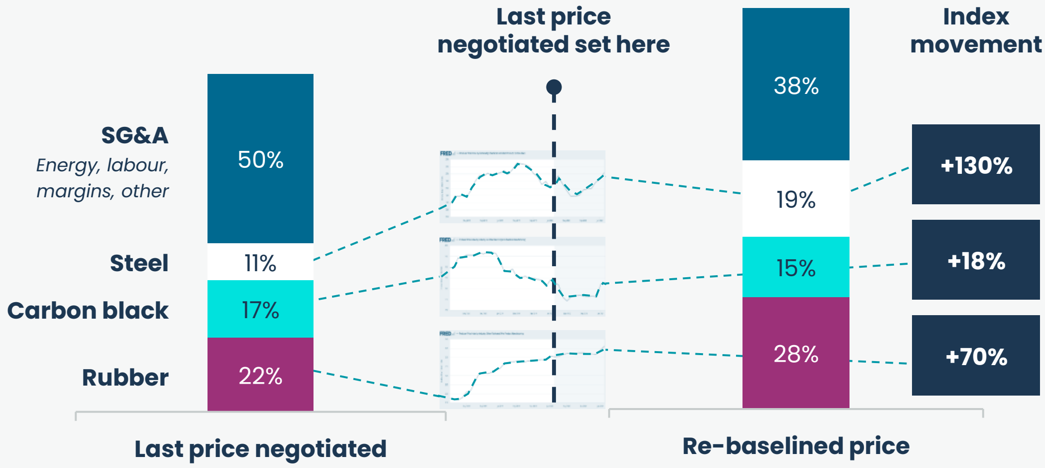
As increased prices and supply shortages cascade through the supply chain, organisations can explore opportunities in four areas to control their cost base and avoid stockouts.

1. Agree fact-based, dynamic pricing mechanisms

Many suppliers are now using inflation as a reason to negotiate price increases. When a supplier comes knocking, it can be hard for the buyer to determine the degree to which a price increase is warranted. Often, procurement managers do not have the skills to negotiate in an inflationary and supply-constrained environment and may end up agreeing to disproportionate price increases in the hope of securing supply. While it is difficult and time consuming to work out reasonable price adjustments across all purchases, it is important that price negotiations are grounded in facts, and mechanisms are put in place that bring prices back down once inflationary pressures decline.

We helped an organisation develop a mechanism to agree a fair price increase with their suppliers. This included identifying the main cost components for tyres (e.g. rubber, carbon black and steel), agreeing a verifiable, third-party price index for each and scaling each cost component accordingly. This then translated into a new reasonable price based on the actual underlying movement in cost of the supplier. This formula was then embedded into an automated price adjustment mechanism to avoid unnecessary acrimony in repeated renegotiations.

Example: Adjustment mechanism for price for tyres



2. Tightly manage suppliers to contract

It is critical now more than ever to ensure that suppliers are meeting their contractual obligations. Organisations that do not closely monitor supplier performance in terms of cost, quality and supply, risk leaving significant value on the table. Enforcing rebates and penalties and running regular reviews where suppliers and buyers discuss performance issues and problem solve can go a long way in driving the right behaviours and ensuring suppliers are continuously incentivised to perform to contract.

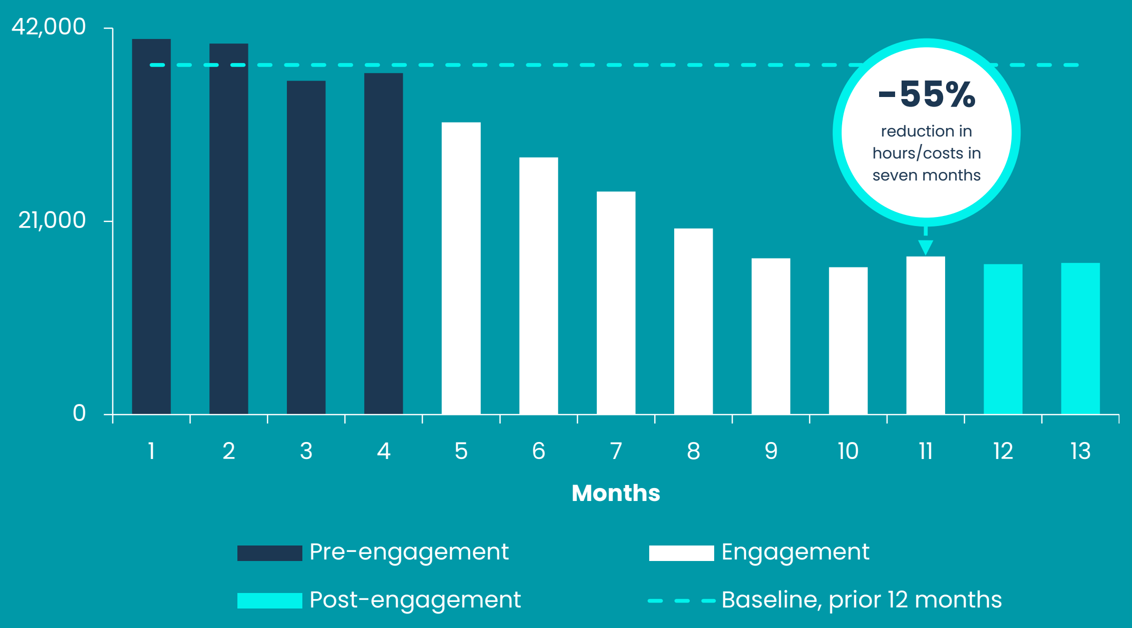
3. Embed disciplines to manage usage and optimise demand

When faced with price shocks, most organisations will also step up efforts to reduce discretionary (non-essential) spend. This is the first step to creating a strong cost-focused culture where people spend money as if it were their own. This requires clear visibility of costs and active management of stakeholders – without single point accountabilities for cost KPIs, agreed action plans and a cadence of regular reviews, it is easy for progress to stall, reducing cost savings.

However, this is only the first step to reduce usage. With rising costs, new and innovative solutions to address costs become more attractive. Organisations can look at reverse engineering and optimising purchases based on specific supply market conditions. This should be done with the intention of maximising total value of ownership. For example, in a tight parts market, organisations can consider intelligently increasing service intervals, reviewing procurement strategies such as using remanufactured parts instead of OEM or introducing alternative/innovative components with improved performance characteristics. In many cases, such substitutions will yield significant value that may more than offset any underlying price increases.

Example: We worked with a client to implement improved reporting and tighter controls, achieving a ~55% reduction in contractor spend – $26m total savings sustained after we left site

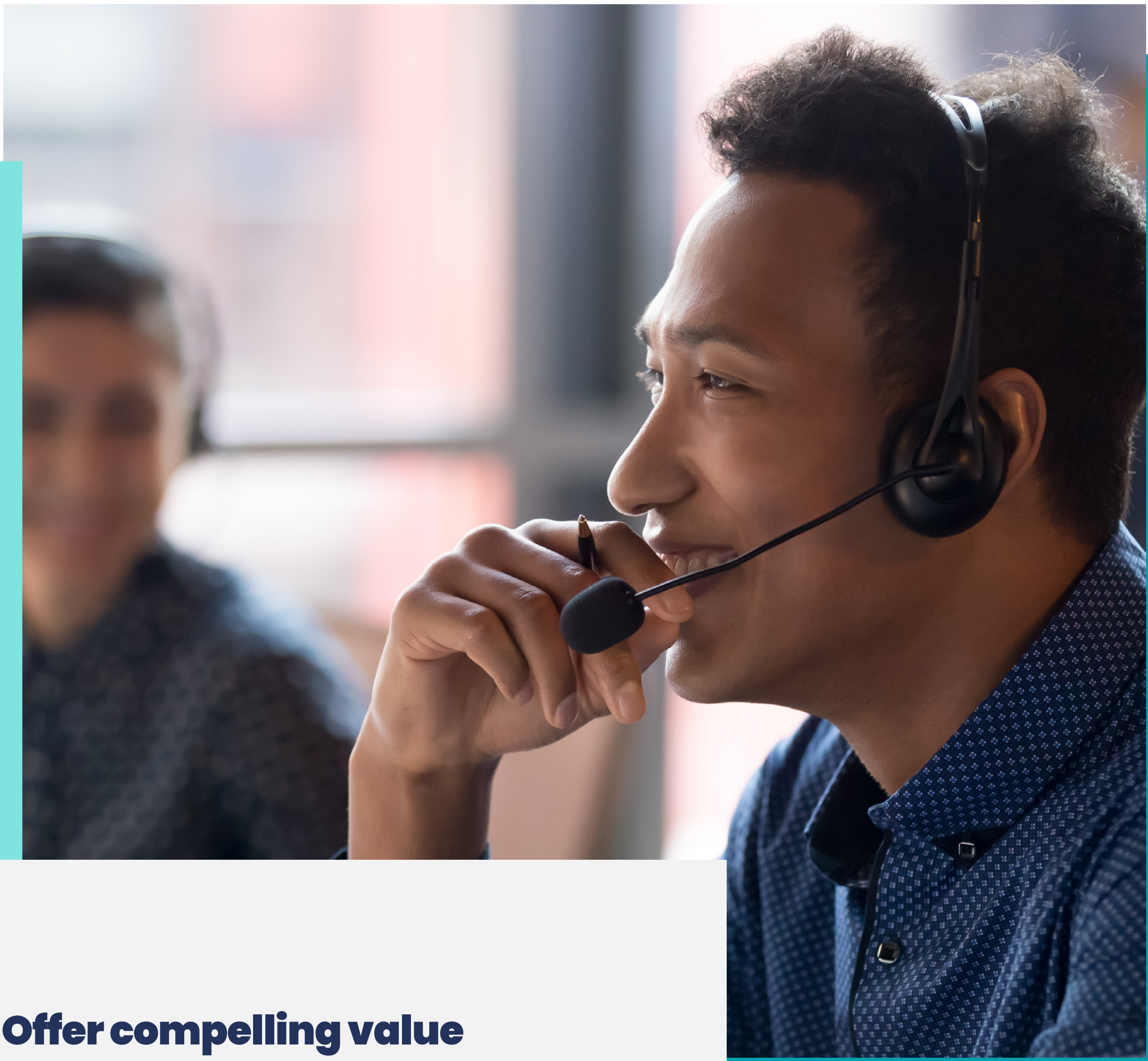
Total contractor hours on site



4. Bring your key suppliers further into the fold and increase collaboration

In many instances, the instinct is to run adversarial price negotiations with suppliers (who are also facing cost pressures and supply uncertainty). This will almost certainly lead to a deterioration in the relations with your supply chain partners and may even jeopardise attempts to secure supply in a tightly constrained market as is presently the case in most sectors and industries.

A more successful strategy can be to collaborate more closely with key suppliers to find value and create lasting win-win scenarios (beyond short-term profiteering during this unusual period). Value can be found by improving data-sharing, optimising operations to reduce complexity and improve speed to market as well as joint developments on quality, products and business development. A successful collaboration will allow both buyers and suppliers to reduce costs, increase efficiency and productivity and improve competitive advantage through a streamlined process or the introduction of innovative products.



5. Offer compelling value

With inflation persisting, many organisations are considering passing price increases through to customers, yet increasing prices can affect your relationships with customers.

If you have a strong and distinct value proposition which is clearly understood by customers, your organisation will be much better placed to maintain both custom and margin.

Engage closely with customers to build understanding of potential price increases and proactively communicate your organisation's unique value proposition. This will enable you to cement stronger customer relationships, potentially creating opportunity to grow margin relative to your competitors with less compelling offers.

Conclusion

Given the unpredictability in today's markets, organisations need to create a strong value-focused culture across all levels within the organisation. Developing an agile, innovative approach – with tighter cost controls and closer collaboration with suppliers – will allow the organisation to realise immediate benefits, while also establishing a strong foundation to weather future disruptions.

About the authors

Michelle Daniel

Manager

Michelle Daniel manages our global Procurement and Supply Chain Practice, and has delivered successful sourcing and performance improvement engagements globally.

Tom Sonnen

Director

Tom Sonnen leads our global Procurement and Supply Chain Practice. Tom has over 25 years' experience as a consultant and has led major business improvement and transformations globally.

Mitzi Campbell

Partner

Mitzi is a Partner in the Procurement and Supply Chain Practice. She has close to 30 years experience in operational improvement driven through sourcing and procurement.

Allen Makamure

Partner

Allen has 15+ years experience in building high-performing organisations through operations improvement and external (sourcing) spend reduction.