

## **NEVER WASTE A GOOD CRISIS – BUT WHY DID IT NEED COVID TO RECALIBRATE A RISKY SUPPLY-CHAIN?**

by Dr. Dirk Schneider

**A EUR 300 million company, supplying customers in heavy and light machinery had expanded its manufacturing footprint to include European, Asian and North American sites. Over time, engineering, procurement and manufacturing had successfully driven down supply-chain cost while optimizing lead-times and increasing on-time delivery. Increased single sourcing primarily in Asia, reliance on global transportation networks and reduced customer intimacy had, however, generated some uneasiness on Board- and C-suite-level but not enough to trigger risk mitigation. Only direct financial threads arising from the China/USA trade war and the COVID-19 induced supply-chain interruptions triggered then hasty and in part sub-optimal emergency measures.**

**The following article recaptures these developments, asks why Board and C-Suite did not act on early warnings and discusses potential way to overcome these shortcomings.**

A privately held company, supplying customers in the heavy and light machinery industry with electric and electronic components and modules, had steadily grown into an international business with more than EUR 300 million in revenue. With headquarter functions and engineering still in Germany it had built regional manufacturing and distribution centers in Eastern Europe, China and the USA.

Recognizing the insufficiency of their historically Europe-centered supplier base, the company had globalized its supplier network as well with a stringent focus on cost efficiency and delivery performance. Over almost 20 years and without significant noise or undue hick-up central engineering and procurement had in close cooperation with regional purchasing and manufacturing driven down supply-chain cost while optimizing lead-times and increasing on-time delivery.

With a solid market-position and a highly competitive cost-base, the company could take full advantage of strong demand growth between 2015 and 2018. Top- and bottom-line developed as planned or better.

### **Beginning uneasiness**

In 2018, during a Tour d'Horizon the Advisory Board and Management reviewed

the operational footprint and the broader supply-chain. While most tracked performance indicators continued strong, the discussion created an emerging uneasiness regarding selected aspects of the supply chain not covered by the company's performance indicators.

First, mapping the supply-chain 2000, 2010 and 2018 demonstrated that the supplier base had become significantly more global. This globalization, however, did not mirror the globalization of manufacturing and distribution. While manufacturing and distribution had followed customer markets, i.e. had expanded from originally Europe to include sites in Asia and Northern America, the supplier base had primarily moved from Europe- to China-centered. Lower cost of materials and continuously improving service levels were strong advocates of this change. The share of materials and service sourced in the region of use, however, had declined from 74% to 46% thereby increasing the reliance on global transportation networks significantly. Furthermore, there was almost no visibility beyond tier-1 suppliers in China.

Second, over the last 20 years the share of single-sourced items had increased from 28% to 61%. Together with a closer integration of suppliers, this had reduced cost of materials and increased service levels.

At the same time, however, the company became more dependent on fewer suppliers with limited visibility of their supply chain beyond tier-1. Anecdotal evidence suggested that some suppliers had eliminated redundancies as well thus making themselves more vulnerable for any kind of disruption.

Together, this increased reliance on global transportation networks and increased dependence on potentially vulnerable single source supplier put supply-chain resilience somewhere on the radar. But strong overall financials and lack of a quantified downside combined with a general sense of potential risk-mitigation cost kept any concerns at the edge of visibility.

Then, beginning of 2019, a new Chief Commercial Officer joined. New analyses showed that innovation drivers had changed significantly between the 1990s and the 2010s. 20 years ago most innovation had been product related, e.g. increased service life or improved IT-interconnectivity and had often been developed in cooperation with suppliers and customers. More recent innovations had focused on process improvements within the supply chain. Shorter lead times and improved delivery performances had still increased customer value but previously existing intimacy with customers and suppliers had suffered.

This added to the already existing uneasiness. But with financials still strong, with operational performance indicators still within target and without an imminent downside, the discussion remained subdued and failed to trigger specific actions.

### **Operational and strategic recalibration**

Limited operational recalibration was triggered in the second half of 2019 when trade tariffs between USA and China, certainly an unexpected development, became real. Facing immediate tariff threats of initially 10%, then 25%, the company

shifted sourcing of components for their US-business from largely China-sourced to new suppliers in Vietnam and the Philippines or to already existing suppliers in Europe. These emergency adjustments did minimize the financial impact of new tariffs. At the same time, however, these unplanned adjustments also reduced IT-integration along the supply-chain and led at least in some cases to sub-optimal contractual agreements.

Broader and more strategic recalibration was triggered in early 2020 when the again fully unexpected and almost complete COVID-19 lock-down in China interrupted major parts of the supply-chain. With the Asian business entirely, and the European business largely dependent on China, these businesses faced immediate and easily quantifiable risks. The American business, depending on Vietnam, the Philippines and Europe was uncertain as well. Combined with earlier concerns like increased share of single sourcing and reduced level of customer intimacy, this imminent threat triggered a more thorough assessment of the global supply-chain on Board- and C-level.

With the objective to minimize the impact of imminent short-term risks and to increase general supply-chain resilience, the Board and Management decided on major adjustments.

First, supplier networks were regionalized to mirror manufacturing centers in Asia, Europe and Northern-America. While relatively easy for Asia and Europe with existing networks, this posed major and still ongoing challenges in Northern America without existing networks.

Second, regional and cross-regional redundancies were systematically increased. Again, what was relatively easy in Asia and Europe posed an enduring challenge in Northern America.

Third, the company started to supplement regional manufacturing centers with small, customer focused engineering groups to facilitate closer intimacy with supplier and customers in the region.

Detailing and implementing these adjustments under time pressure and under active COVID-19 restrictions was challenging. Identify additional suppliers and the transition itself were certainly more costly than they would have been with better preparation and several new arrangements, usually hastily negotiated, remain less than satisfactory. General supplier intimacy had suffered as well.

### Lessons learned

In the end, the company recalibrated their global supply chain successfully and with a strategically sound vision. Several adjustments, however, were carried out in a hurry and without sufficient planning thus producing avoidable transition pain and at times suboptimal solutions with lower supplier integration. This raises at least two questions regarding the overall preparation and decision-making process.

Why did Board and C-suite not respond to its early uneasiness and did not push more forcefully for robust preparation? Could organizational and process adjustments avoid similar shortcomings in the future?

Board and C-suite reviewed frequently and in a well-structured process a broad set of financial and operational performance indicators. Any deterioration there would

trigger immediate mitigation measures or, at the very least, the development of specific “What-if-plans”. These would be backed-up by specific measures, timelines and milestones. Occasional Tour d’Horizon-discussions, on the other hand, were not designed to lead to specific initiatives but rather to identify potential long-term threats or opportunities, often at an abstract level. Against this background it is not surprising that still strong performance indicators did smooth over any potential uneasiness without any impact on performance indicators.

More structured Tour d’Horizon-discussions could avoid such shortcomings. In 2018 the general supply-chain discussion could have been substantiated through, e.g., specific scenario planning. Modelling shorter- and longer-term supply interruptions and rolling these into projected performance indicators would have led to quantifiable risks. With these risks clearly visible, specific mitigation scenarios could have been evaluated and pre-planned if appropriate. This would have made later adjustments smoother and financially less costly.

Obviously, there is a trade-off between additional upfront preparation and potential later benefit. But whenever risks (or opportunities) could be significant it might be good practice to go this extra mile. In such an environment, a sufficiently strengthened Board with well-structured processes and adequate resources should pay off quickly.

\*\*\*



*Dr. Dirk Schneider is an independent interim manager / management consultant with a strong track-record in change-of-ownership, restructuring and value enhancement work where he has led comprehensive balance sheet restructurings, strategic repositionings and operational improvements in advisory and management roles.*

*Before Dirk has been with McKinsey & Company where he has worked on strategic acquisition or divestment strategies, financial valuations, privatizations, acquisitions, divestitures and post-merger-integrations in a variety of countries and industries.*

*Dirk holds a Ph.D. in Molecular Biology from the Philipps-University in Marburg, Germany and an MBA from the Darden Graduate School in Charlottesville, Virginia, USA*