PRIVATE EQUITY EXECUTIVE SERIES

Conquering Direct Materials Procurement

A Playbook to Maximize EBITDA Improvement

Insight Sourcing

By: Luke Seibel, *Senior Manager*
www.insightsourcing.com

EXECUTIVE SUMMARY

For Operating Partners looking to maximize EBITDA improvement, procurement-driven value creation across Direct Materials should be a top priority, especially in the early stage of an investment. These are high stakes, as Directs have the power to significantly influence an organization's overall success.

Due to the heightened level of sensitivity around Directs spend, many executives face organizational obstacles including:

- A siloed approach to Direct Materials spend management
- Competing priorities of internal functions
- Limited organizational experience with non-price related sourcing levers
- Prioritization of near-term quick wins over long-term category strategy

Procurement provides an opportunity to overcome these obstacles, challenge the status quo, and drive down cost. The strategies in this guide will help you navigate these roadblocks to better enable procurement-driven value creation across your investment's Direct Materials spend.

INTRODUCTION

Early involvement of procurement in the investment process can be highly advantageous for private equity firms looking to increase EBITDA. Procurement can help identify risks and opportunities related to the supply chain, assess the quality and reliability of suppliers, and develop a plan for optimizing direct procurement processes, which can result in potential cost savings opportunities. These savings can be factored into the investment decision-making process, ultimately increasing profitability.

Procurement can also provide strategic guidance and support throughout the investment lifecycle, from due diligence to post-merger integration, identifying supply chain risks, evaluating supplier contracts, and assessing supplier performance. During the post-merger integration phase, procurement can assist in integrating supply chains, negotiate new supplier contracts, and implement cost reduction strategies, all of which can contribute to EBITDA growth.

In addition to cost savings, early involvement of procurement can help build stronger relationships with suppliers, leading to a more reliable and efficient supply chain. This can further increase the value of the investment, resulting in improved EBITDA and long-term success for the organization.

Overall, partnerships between procurement and private equity operating partners can be a powerful tool for driving cost reduction, increasing profitability, and rapidly improving EBITDA.

DIRECT SPEND MANAGEMENT

Direct spend is distinct from indirect spend because it directly impacts production of goods or services. Well-managed direct spend is crucial to success and often necessitates strict supply schedules to ensure the continuity of supply, the quality, and the quantity of materials. Additionally, the supply chain holds a significant opportunity for innovation through the direct materials procurement team's strong relationships with its supply base.

An advanced Operating Partner who is focused on increasing EBITDA will recognize the potential of direct spend programs as a unique and valuable lever available in the early stages of investment. In fact, procurement can be a critical factor in the success of achieving rapid EBIDTDA impact post-acquisition.

Procurement has a critical role to play in identifying cost-saving opportunities across the supply chain, while the private equity operating partners bring their expertise in operational excellence and financial management.

By working together, they can leverage their strengths to optimize direct spend procurement strategies, manage risk, and identify opportunities to achieve cost savings. This can lead to significant savings and increased profitability for the organization.

AGILITY DURING MARKET VOLATILITY

Market conditions are dynamic and evolve daily, with new challenges and opportunities emerging constantly. In this environment, it is essential for the operating partner to ensure the organization is agile and well-prepared to cope with any level of market volatility. This is especially true when it comes to direct materials, which can have a significant impact on an organization's profitability.

This requires a keen understanding of market trends, customer needs, and supply chain dynamics. By working closely with the procurement team to be responsive and adaptable to these factors, organizations can proactively identify and respond to changes in the market, mitigating risks and capitalizing on new opportunities.

- Material costs typically make up no less than 50% of the total Directs cost and any pricing shift in commodity indices and key input costs can quickly erode profitability.

The Midwest Premium for P1020 Aluminum Billet skyrocketed +200% from January '21 to April '22.

- Transportation costs are a contributing factor to total Directs spend and can rapidly reduce margin if unmanaged.

In September '22, the port of Los Angeles processed 700k TEUs, down 21% year over year. This reduced the cost to move a container from China to the U.S. West Cost by 93%, from over $20k to $1,300 per container in February '23.

- Geopolitical factors such as tariffs and duties can also impact your bottom-line.

In July '18, the U.S. government imposed a 25% tariff on many of the goods imported from China. And in February '23, the U.S. government imposed a 200% duty on aluminum articles and derivative aluminum articles that are the product of Russia.

Market conditions like commodities, transportation costs, or tariffs are beyond the control of any organization. However, a proactive approach to managing Direct Materials spend categories can help control the impact of these unpredictable factors. Failure to prepare for such changes may lead to supply chain disruptions, increased costs, and reduced customer satisfaction, resulting in rapid decline.

Overall, the constantly evolving market conditions present both opportunities for innovation for the prepared organization and risks for the unprepared organization. By remaining agile and proactive in their approach to direct materials, operating partners can help their organizations protect their profit margins, maximize opportunities, and achieve long-term success.

HOW TO OVERCOME DIRECTS SPEND CHALLENGES

To address Direct Materials spend as a top priority and navigate the related core challenges, evaluate and apply these strategies to your business.

1. **Replace the silo approach to Direct Materials spend management.**
   Many functions across companies tend to operate independently in their own silo. This traditional approach can have a detrimental effect on agility and the total value creation potential across Direct Materials spend. The strongest Direct Materials spend management approach is to regulate the end-to-end value chain, from designing, planning, sourcing, and manufacturing, through delivering the finished goods.

   Strategies:
   - Build an integrated approach to the end-to-end value chain that focuses on challenging the status quo by involving the C-Suite in close collaborations with cross-functional leaders within Procurement, Engineering, Commercial, Manufacturing, and Quality.
   - Invest in tools and market intel to bolster the organization's expertise and capabilities. For example, cost modeling is a capability that ensures key cost drivers are quantified and product design is optimized to meet target costs. Another example would be increasing and automating spend visibility across the organization at the supplier, category, and bill of material levels via technology solutions.
   - Harness the power of collaborating with your suppliers to discuss breakthrough innovations, identify win/win opportunities to lower costs for both parties, and share best practices.
   - Partner with procurement-focused consultancies who have experience successfully addressing Direct Materials in fast-paced manufacturing environments and who have the engineering knowledge to understand how products are designed and produced.

2. **Balance the competing priorities of internal functions.**
   Procurement is only one cog in the supply chain and savings aren't always a top priority for other functions across the organization. The Chief Procurement Officer must collaborate and build the trust of each functional leader, primarily Engineering, Manufacturing, and Sales. Keep in mind Engineering's influence on sourcing designs, Manufacturing's resistance to change (i.e., "if it's not broke, don't fix it mentality"), and Sales' management of customer expectations.

   Strategies:
   - Collaborate with Engineering to:
     - Secure Procurement's seat at the table during all stages of a product's lifecycle and especially the New Product Develop (NPD) phase.
     - Ensure Procurement owns the supplier relationship and all sourcing decisions are approved by Procurement.
   - Collaborate with Commercial Sales to:
     - Craft messaging for sales to justify a cost out effort with key customers that's primarily focused on the "insurance" of continuity of supply and a share in the cost savings.
     - Understand how contractual price change language between your suppliers and customers are defined to maximize cash flow and savings potential.
   - Collaborate with Manufacturing to:
     - Emphasize that piece price is only one part of the equation and that quality, lead times, and service levels are equally considered in the total cost of ownership approach.

3. **Navigate limited organizational procurement experience with non-price related sourcing levers.** Competitive Market Events (i.e., RFPs/RFQs) are the typical first choice for many Procurement professionals and are often considered an optimal sourcing strategy. However, a market event is only a medium to collect market feedback and is not a sourcing strategy. Deploying non-price related levers is an approach that can boost value capture potential.

   Strategies:
   - Explore Global Sourcing to take advantage of material, labor, and operational advantages that diverse regions across the world have to offer.
   - Develop advanced material purchasing strategies to navigate volatile conditions and improve cost position above and beyond traditional movement in commodity indices (e.g., spot vs. index vs. hybrid or Directed material buys).
   - Leverage cost modeling to assist in fact-based incumbent negotiations by setting your target cost as the should-cost, and exploring would- and could-cost opportunities that factor in improved purchasing decisions and design change opportunities (e.g., Value Analysis / Value Engineering).

4. **Prioritize long-term category strategy over near-term quick wins.**
   Optimizing Direct Materials spend can take up to 6-18 months depending on specification requirements, as well as business-specific supplier and product qualification requirements. Because of these timelines, many organizations are reluctant to opt in for sourcing levers that require changes in the supply chain. However, not only will allocating volume to a new supplier likely drive cost savings, this strategic supply chain change also ensures spend diversification to manages costs in an ever-evolving market.

   Strategies:
   - Hypothesize over the "art of the possible" through the lens of both cost and operations, above incumbent negotiations.
   - Balance the need to achieve quick savings with the proper category strategy development by pressure testing sourcing levers such as Make vs. Buy or Best Cost Country Sourcing, which drive incremental value.
   - Categorize suppliers into three buckets — Grow, Maintain, Exit — to develop a strategy that ensures you're developing partnerships with the suppliers that are the best fit for your unique business objectives.
   - Invest in tools and resources that enable Procurement teams to stay informed with the latest market conditions and trends. These investments will bridge information gaps to enable more informed supplier negotiations.

HOW TO NAVIGATE MARKET TREND FORECASTS

1. **Near-Shoring**
   - *Trend Forecast:* In the height of the pandemic, many executives explored the option to shift volume to supply sources in the western hemisphere to combat long lead times, tariff exposure, and increased freight costs. As supply chains start to settle, executives have challenged the notion of prioritizing volume shifts to countries like Mexico.

   - *Strategy:* Consider a hybrid approach to near-shoring to increase operational efficiencies and achieve the lowest costs. A hybrid approach balances the level of supply chain maturity in Mexico with the fact Asia is still competitive now that freight costs and supply availability have returned to the norm.

2. **Cost Modeling**
    - *Trend Forecast:* Cost modeling will continue to be a "hot topic."

    - *Strategy:* Invest in cost modeling as a capability. Cost modeling allows for increased transparency into discrete cost drivers that enable more informed negotiations with suppliers where switching constraints are both costly and timely.

3. **Supplier Collaboration**
    - *Trend Forecast:* You may have history with incumbents that spans years or even decades. This tends to lead to strong relationships and a robust understanding of how each company operates.

    - *Strategy:* Focus on long-term supplier collaboration over quick-win negotiations. Compromising long-term, strong partnerships by negotiating margin away from incumbents can lead to subpar value creation and will likely create an environment of hostility that questions the overall value that the partnership brings to the table.

    Instead of conducting competitive RFPs to reduce cost, shift away from near-term discussions and focus on long-term strategic conversations to identify initiatives that benefit both parties in a cost reduction effort.

    Examples of these long-term initiatives include:
    - Mutually investing in advanced equipment that increases manufacturing efficiencies and increases supplier capacity. Any increased capacity is often dedicated to the client who made the investment. This secures both lower cost and long-term supply availability.
    - Conducting a value analysis on the redesign of existing products or components, which would allow the supplier to manufacture product more efficiently and avoid design overcomplication.

A CASE STUDY IN NEGOTIATION

Industry: Pulp and Paper

Company Profile: $3B+, PE Backed, Manufacturer of Food Contact Safe Packaging Products for the Foodservice and Industrial Markets

Challenge: This company engaged Insight Sourcing to drive out cost and increase purchasing efficiencies across strategic spend categories totaling over $700M+ in annual spend. Directs categories of focus included Paper (Brown Commodity), Colorants & Additives, Inks, and Adhesives.

Results: Insight Sourcing achieved $70M+ (~10%) cost savings with most coming from incumbent negotiations.

- Paper: We captured 10%+ savings by leveraging market competition in a softening market and utilizing recent supplier machinery investments to guarantee demand for newly available capacity. We also optimized geographical landscape by increasing transparency and removing historically blended freight costs.

- Colorants & Additives: We attained 15%+ savings by establishing index-based pricing to capture market movements. We also secured a secondary source for critical big box retail spend.

- Inks: We achieved an additional 15%+ savings by consolidating the supply base and establishing preferred supplier programs at each facility.

A CASE STUDY IN SOURCING

Industry: Automotive

Company Profile: $1B+, PE Backed, Tier 1 Automotive OEM Manufacturer of Custom, Engineered, Technical Plastics and Lightweighting Solutions

Challenge: A private equity firm recently acquired this automotive component manufacturer, then engaged Insight Sourcing to drive cost out as part of the PE firm's value creation plan. Directs spend categories included Resins, Steel, Molded Components, Stampings, and Fasteners. In addition to achieving cost savings, the manufacturer needed to increase cost transparency with their supply base by developing robust bottoms-up should-cost models.

Results: Insight Sourcing achieved $13M+ (~8%) cost savings with most coming from incumbent negotiations and identifying global suppliers in best cost countries.

- Resins: We achieved $5M+ (~10%) cost savings by working in close collaboration with Engineering and Quality to define key specification parameters (must have vs. nice to haves) with the goal of expanding the number of suppliers who could participate in a competitive sourcing event. Through our analysis, we identified alternative specifications that met the functional needs, while adhering to critical quality standards, which informed pricing targets for incumbent negotiations.

- Steel: We achieved $3M+ (~20%) cost savings against the Client's yearly budget by renegotiating mill direct material pricing that leveraged softening market conditions. The material was used for the Client's Metal Stampings purchases.

- Metal Stampings: By leveraging bottoms-up cost models, we unveiled that the supplier was benefiting from a larger portion of the scrap value than originally anticipated. This led to the incumbent supplier sharing a larger portion of the steel scrap value with our Client. These savings tied to the Steel category impacted Metal Stampings, as the metal accounts for ~70% of the total cost.

- Molded Components: We achieved ~$1M (~7%) cost savings by identifying global alternative suppliers with Automotive experience in Mexico, China, and Vietnam.

CONCLUSION

Collaboration between procurement and private equity operating partners can be a powerful tool for increasing profitability and reducing costs. Procurement's expertise can be leveraged by private equity operating partners focused on maximizing their investments' value.

Having a strategic approach to Direct Materials spend management is vital for achieving the greatest impact to EBITDA. Through procurement-driven value creation, each recommendation in this guide provides a clear path to success.

Every organization faces obstacles when managing Direct Materials spend. Investing in an experienced procurement partner will help you overcome these challenges, while strengthening your organization with the strategy, resources, and expertise you need to achieve significant long-term cost savings.

MEET THE AUTHOR

Luke Seibel
Senior Manager

As the leader of the Direct Materials sourcing practice, Luke leverages procurement value creation to drive EBITDA growth in a range of industries. He has nearly a decade of experience in fast paced, high stakes environments and has delivered $100M+ in cost savings across raw materials, manufactured components, and contract manufacturing. His strategic sourcing experience is concentrated in Automotive, Pulp and Paper, Industrials, Oil and Gas, and Consumer Products. He is well versed in developing robust, long-term category strategies and deploying value creation levers such as best cost country sourcing, should-cost modeling, advanced commodity purchasing, and supplier negotiations.

Prior to Insight Sourcing, Luke was a consultant at Forsyth Advisors where he worked primarily with portfolio companies of private equity firms with a focus on delivering cost reduction to the lower middle market through strategic sourcing and supply chain initiatives. He lives in St. Louis, MO with his wife and son.

Education: BS in Business Administration, University of Missouri

DIRECT MATERIALS CENTER OF EXCELLENCE

Our Directs Practice has helped clients achieve an average of 5-10% in Direct Materials cost reduction in less than a year. We can complete Value Identification in an average of 4-6 weeks, followed by 10-16 weeks to execute Value Capture.

Our services include:

- Developing robust multi-year category strategies that outline feasible, calculated value creation levers that blend both cost savings and supply resiliency.
- Maintaining flexibility in strategic execution to ensure we achieve your critical business needs and objectives.
- Expanding your cost modeling capabilities by providing training and leaving behind bottoms-up cost build-ups that you can leverage to gain a better understanding of your unique cost structures.
- Identifying alternative competitive suppliers across the globe to diversify your supply chain, while maintaining a low total cost of ownership.
- Helping your organization collaborate cross-functionally by acting as the central nucleus of the supply chain. (For example, we'll harness the capabilities of Design and Engineering to conduct VA/VE efforts that reduce cost and complexity, while maintaining total value to the customer.)

ABOUT INSIGHT SOURCING

Insight Sourcing is the premier professional services firm in North America exclusively focused on strategic sourcing, cost optimization, and procurement operational transformation.

Founded in 2002, Insight's capabilities are designed to accelerate impact through the expertise of its 250+ procurement experts, its market-leading Category Center-of-Excellence model, and practices specializing in Private Equity, Supplier Diversity, Energy Management, and Sustainability.

Learn more about reducing your Direct Materials spend at www.insightsourcing.com.

Insight Sourcing

To learn more, visit
www.insightsourcing.com
or call (888) 973-0208 for a consultation.
info@insightsourcing.com