White Paper

HIGH INFLATION

Uncharted Waters for Supply Management

Presented by

ISM
INSTITUTE FOR SUPPLY MANAGEMENT

A.T. Kearney

About Institute for Supply Management®

Institute for Supply Management® (ISM®) is the first and leading not-for-profit professional supply management organization worldwide. Its 47,000 members in more than 90 countries around the world manage about US$1 trillion in corporate and government supply chain procurement annually. Founded in 1915 by practitioners, ISM is committed to advancing the practice of supply management to drive value and competitive advantage for its members, contributing to a prosperous and sustainable world. ISM empowers and leads the profession through the ISM® *Report On Business*®, its highly-regarded certification and training programs, corporate services, events and the ISM Mastery Model®. The Manufacturing and Non-Manufacturing ISM® *Report On Business*® are two of the most reliable economic indicators available, providing guidance to supply management professionals, economists, analysts, and government and business leaders.

www.instituteforsupplymanagement.org

About AT Kearney

A.T. Kearney is a leading global management consulting firm with more than 3,600 people working in more than 40 countries. We work with more than three-quarters of the Fortune Global 500, as well as with the most influential governmental and non-profit organizations. A.T. Kearney is a partner-owned firm with a distinctive, collegial culture that transcends organizational and geographic boundaries — and it shows. Regardless of location or rank, our consultants are down to earth, approachable, and have a shared passion for doing innovative client work that provides clear benefits to the organizations we work with in both the short and long term.

With a long period of price increases possible, a proactive approach can help procurement professionals weather the storm.

A growing economy. A tight labor market. Two of the biggest telltale signs of inflation have been evident in recent months, and concerns have been further fueled by (1) tariffs and trade turbulence stemming from the Trump administration's protectionist policies and (2) supply chain bottlenecks due to rising transportation costs and continuing truck-driver shortages. The inflation rate in the U.S. for the 12 months ending in July 2018 was 2.9 percent, the highest such number since February 2012.

Prices for many commodities are already on the rise, and the dynamics are in place for a potential long-term inflationary environment that would be new territory for most supply management professionals, especially with trade-war speculation showing no signs of abating.

According to Merriam-Webster, the definition of economic inflation is "*a continuing rise in the general price level usually attributed to an increase in the volume of money and credit relative to available goods and services.*"

Historically, price inflation conditions have produced increases in costs for purchased goods and services that negatively impact how much we pay. Long periods of inflation can make it seem as though there's no limit to price increases. The last time western economies experienced double-digit inflation was more than 40 years ago, in the 1970s and early 1980s.

Merriam-Webster goes on to describe the financial definition of inflation as: "*the rate at which prices rise and purchasing power falls. It is why something that cost $1 in 1980 cost $2.37 in 2005.*"

Institute for Supply Management® (ISM®) and A.T. Kearney partnered to study how companies are responding to the current environment of increasing price inflation and likelihood of continued acceleration in inflation. An online survey was fielded to a sample of ISM customers and members from April 5 to May 18. In all, 304 usable responses were collected. (Among respondents, 54 percent were from manufacturing industries, 43 percent were employed by organizations with revenue of US$1 billion or more, and 66 percent were managers or higher.)

This inflation study integrates the practitioner network of ISM with the client experiences of A.T. Kearney to identify how companies are reacting and what a supply manager can do to mitigate the impact of inflation on the prices they pay to suppliers.

The Impact on Supply Management

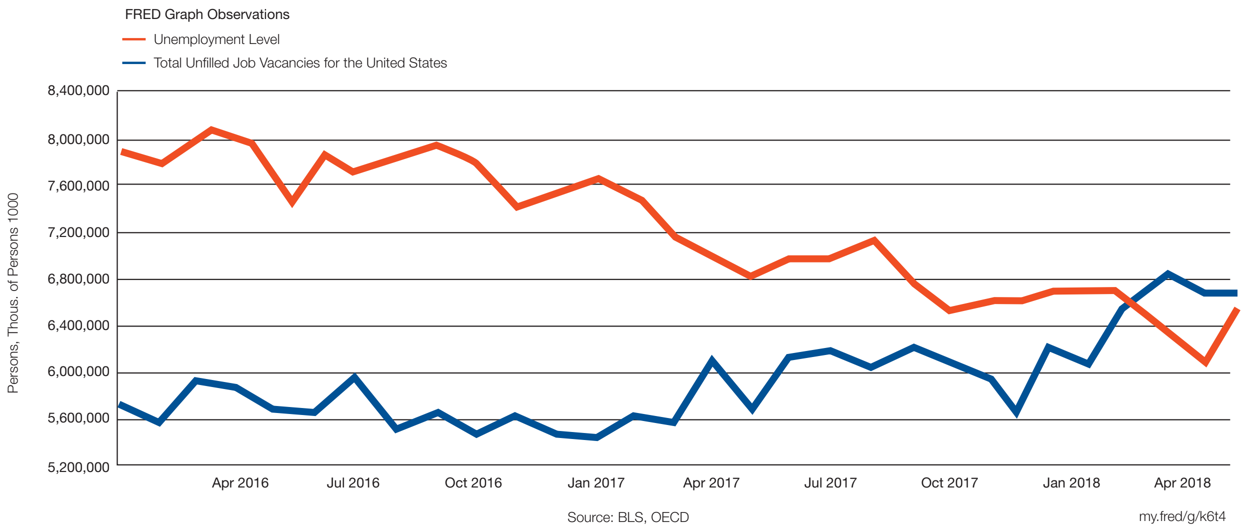
When supply management professionals evaluate how inflation will make their jobs more difficult, lost purchasing power is the primary concern. A long inflation cycle may be brewing, and many of today's professionals have never lived through the kind of double-digit inflation that could be coming. In fact, recent decades have provided low price inflation, and many industries (such as automotive and electronics) have seen price declines due to improved efficiencies and newer technologies. Pointing to clear bottom-line cost savings may become difficult when procurement success means avoiding price increases requested — or demanded — by suppliers.

Today, inflation is mostly driven by increasing commodity prices. The Manufacturing ISM® *Report On Business®* Prices Index has been above 70 percent since January. In 2017, the Prices Index dipped below 60 percent only twice and averaged 65 percent for the year. In May, the index reached its highest level (79.5 percent) since April 2011 and indicated price increases for 27 straight months.

Notably, the Manufacturing ISM® *Report On Business®* showed that, for May, hot rolled steel prices and aluminum prices increased 18 and 19 straight months, respectively. However, it may not take long until inflation impacts other types of purchases, including labor rates. We expect to see wages bid up as competition for workers intensifies. In 2018, for the first time in many years, the number of unfilled jobs exceeded the number of unemployed workers.

It may be wise to start planning for increasing inflation for the next decade or more. In fact, some theories claim that long economic cycles last 40 to 60 years (see Kondratieff and others).

Job Vacancies and Unemployment Level



The Signs of Inflation

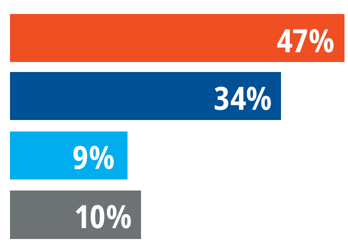
Inflation warnings are in the news, and the impact of rising prices is being felt by companies across many industries. A sampling of current articles highlights the severity of this concern, as there are daily reports on rising commodity prices, growing construction costs and a tightening labor market. Also, health-care costs are rising at a faster rate year-over-year.

Commodity costs are rising, and volatility is growing. Such factors as increasing demand among major and developing economies, geopolitical uncertainty, trade protectionism and climate change all create supply chain risk, increase costs and contribute to price volatility. For example: Chinese government shutdowns of factories that do not comply with environmental regulations, combined with U.S. tariffs, create upstream and downstream price pressures on steel and aluminum as supply constraints and import taxes increase. Today's trade environment is distinctly different from previous ones in breadth alone, and this is the first time companies have to address trade policy as a risk, as added costs cannot simply be passed off to consumers.

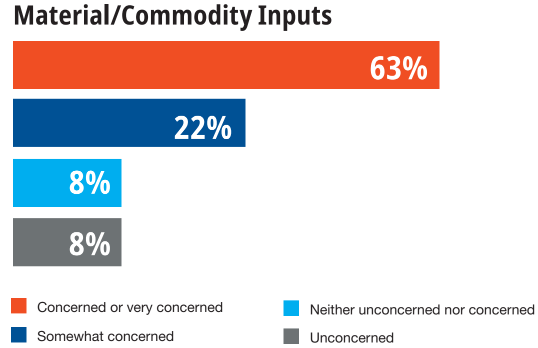
Higher prices impact procurement professionals in several ways. Inflationary environments make it difficult for buyers to determine price increases their suppliers need to offset inflation, compared to opportunistic price increases. This is especially true in commodity markets, where commodity producers have endured years of low margins and will try to recover in an inflationary environment.

Year-over-year reductions in (1) prices and (2) purchase price variance are not always possible. In such a situation, controlling price increases and showing value to an organization becomes the focus of procurement activities. Interestingly, at the beginning of long-term inflationary cycles, commodities play a key role. Our survey results confirm that primary concerns among business leaders are about price inflation for commodities versus non-commodities.

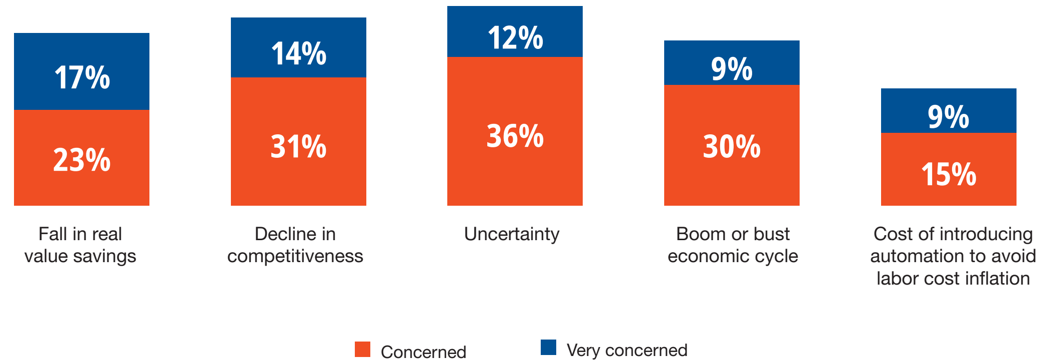
Level of Concern About Inflation in Non-Commodity Items



Level of Concern About Inflation in Raw Material/Commodity Inputs



Areas of Concern for Business



Uncertainty may come from (1) unclear direction of the U.S. government on tariffs and other international issues and (2) a lack of experience with inflationary economic environments among many supply management professionals. Among the recent reporting on these dynamics:

Mexico's President-Elect Balks at Including Energy Chapter in New NAFTA
— *The Wall Street Journal*, August 21, 2018

Trump's Fed Criticism Sends U.S. Dollar Lower
— *Financial Times*,* August 20, 2018

Starbucks Boycott? Nike Shutdown? China Holds Trade War Leverage
— *Bloomberg*, August 20, 2018

The World's Biggest Shipping Company Says Trump's Trade War Will Hurt America More Than Anyone Else
— *Business Insider*, August 20, 2018

Canada on the Sidelines as U.S. and Mexico Near an Agreement on NAFTA
— *The New York Times*, August 17, 2018

Trump Tariffs Could Reduce U.S. Exports, Says Fed
— *Financial Times*,* August 13, 2018

Trump Trade Blasts Send a Chill over Canada
— *Financial Times*,* June 7, 2018

U.S. Factory Orders Fall More Than Expected in April
— *Financial Times*, June 4, 2018

China Tariff Threat Deals Another Blow to U.S. Farmers
— *Financial Times*,* April 5, 2018

NAFTA's Biggest Challenge May Come After the Deal
— *Council on Foreign Relations*, March 1, 2018

Oil Companies Clash with Trump over NAFTA Changes
— *The Houston Chronicle* , May 11, 2018

The current political and economic environment could threaten what has been a seemingly inexorable march toward more integrated economies and more integrated global supply chains. A company's flow of goods and services are profoundly global and deeply dependent on a free flow internationally. Businesses are revising sourcing and distribution strategies that they relied on for decades. This diverts resources from other business activities, like new product development or expansion into new markets. Also, inflation may make it difficult for net cost savings to be seen on a company's bottom line.

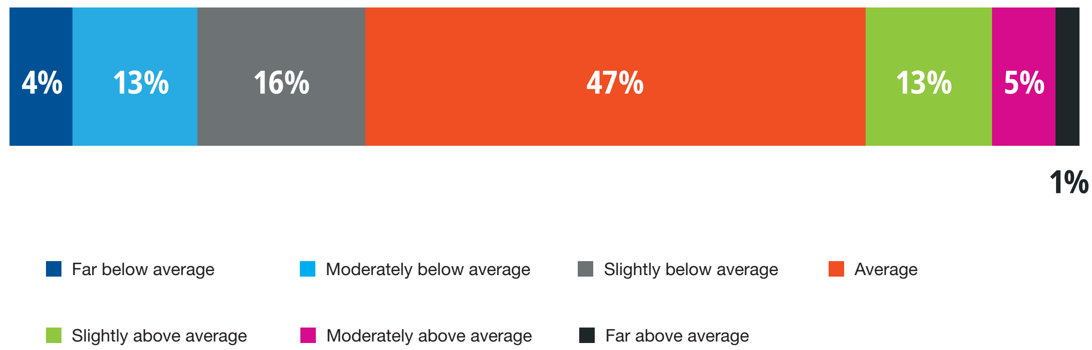
Additional Survey Insights

Survey respondents were also asked about their organizations' strength in areas necessary to navigate the high seas of inflation.

Supplier selection: Being prepared to handle inflation requires a company's suppliers to control costs. If not, costs are passed to your company in the form of higher prices, which can result in difficult supplier relationships if the supplier's profits dwindle.

*Must have a subscription to *Financial Times*

Level of Supplier Ability to Control Cost

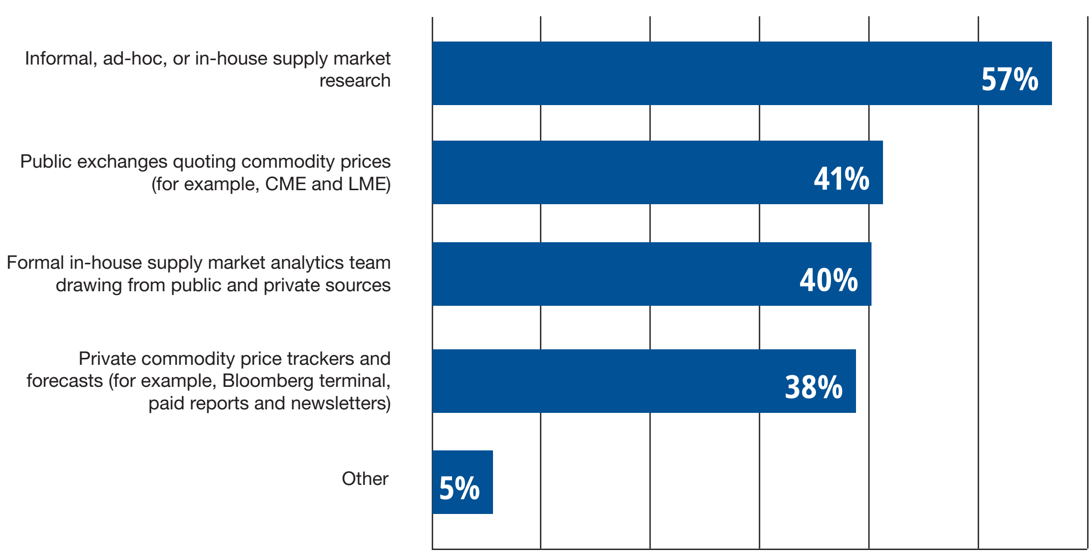


Most companies believe that their suppliers are only average or below average at controlling costs.

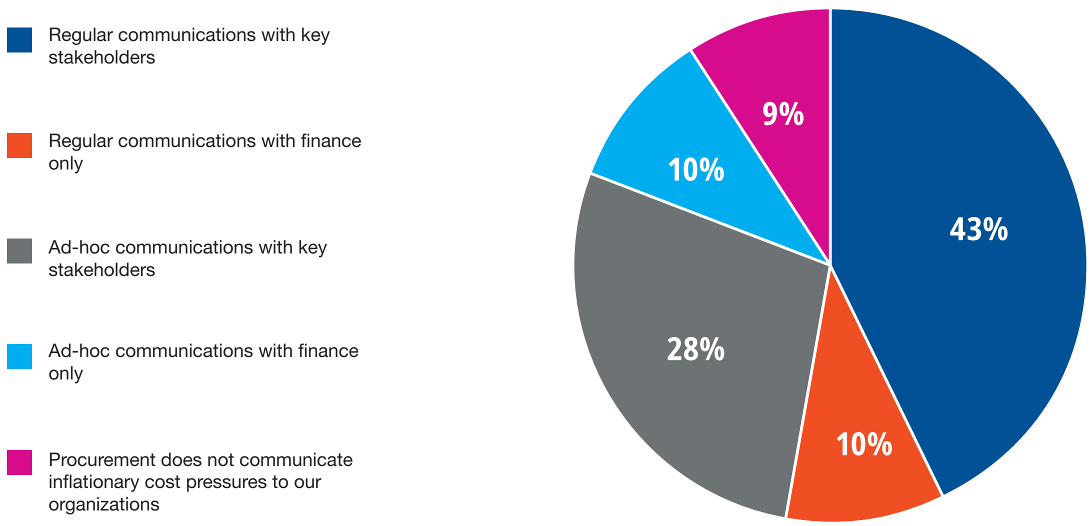
Most supply managers feel they are merely reactive to increasing prices. In an uncertain world and with insufficient experience (in general) with inflationary times, supply managers need to develop more proactive decision-making for increasing price inflation.

Market analysis: Our survey also indicates that the majority of companies do not have a formal market analysis program in place. This highlights a missed opportunity to extract more value from the supply base.

Tools to Monitor Market Changes



How Cost Pressures are Communicated Internally

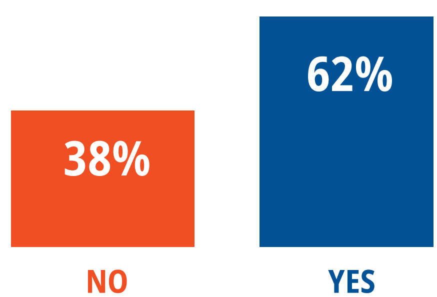


Internal communication: Stakeholder identification, engagement and crucial conversations are essential tools at all times — especially when changes occur. Increasing price inflation will alter the way we define procurement success, as cost saving may morph into cost avoidance.

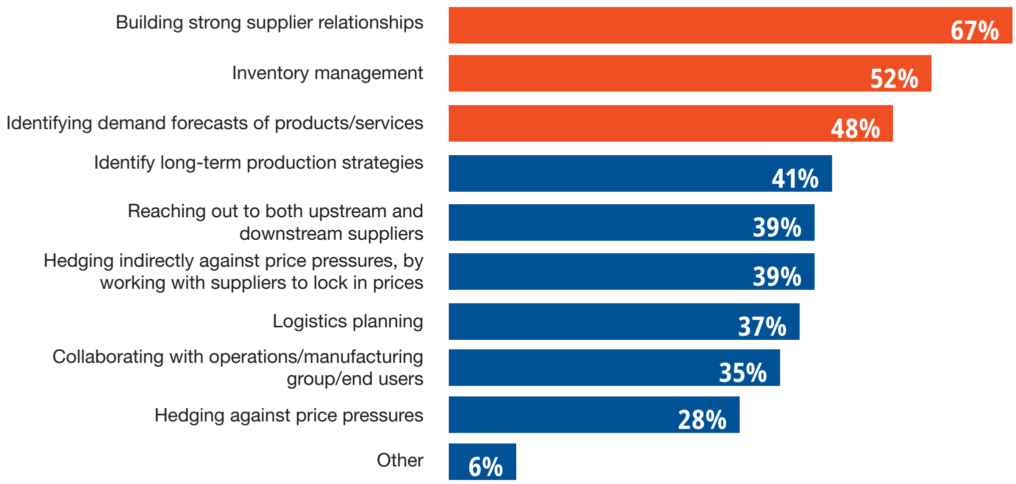
Most (53 percent) survey respondents indicate the importance of internal communication and stakeholder management. However, almost half of respondents report either no communication or only ad-hoc communication with finance and other stakeholders.

More formal structures for communicating internally will help supply managers during times of uncertainty and change. Supply management practitioners can take the lead in formalizing communication regarding responsibilities — and help provide accountability — as a company navigates unfamiliar waters.

Internal collaboration: Our survey found that 62 percent of participants partner with finance to assess implications and plan for purchasing negotiations. Finance can be a supportive stakeholder if open and active cooperation exists between it and procurement.



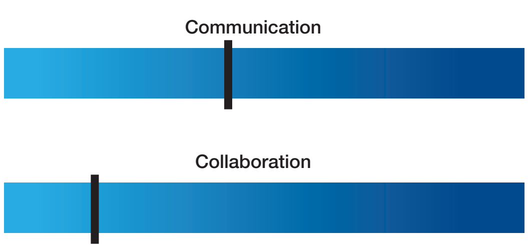
Top Approaches to Managing Cost Inflation



External collaboration: The majority (67 percent) of respondents report focusing on supplier relationship management to help identify approaches to jointly mitigate cost inflation. The survey also indicates an increasing focus on inventory management (by 52 percent of respondents), which can help free up cash flow as borrowing becomes more expensive due to higher interest rates.

Collaboration and communication are key drivers of stronger supplier relationships. But supply management professionals must realize that one is not necessarily tied to the other. A supplier may have a strong collaborative relationship with procurement on new product development but competing in other areas — a scenario that stifles open communication and the opportunity for gainsharing. Or a supplier may have excellent communication throughout the organization, while collaboration opportunities are limited because of differences in strategy or market focus.

Consequently, as supply management professionals focus efforts on increasing the strength of supplier relationships to reduce uncertainty and mitigate risk, they should be attentive to opportunities to improve communication and collaboration.



Inflation-Fighting Strategies

There are five battle-tested strategies to drive procurement success in inflationary times: block, transfer, hedge, deflect and operate. The ideal strategy depends on the situation:

- **Block:** While perhaps the most desirable option, blocking inflationary price increases is limited to scenarios with high demand power and more transactional supplier relationships. In this scenario, buyers refuse to accept the price increases. However, this plan is not ideal when demand power is low.
- **Transfer:** Instead of blocking, a company might transfer to or share the risk with suppliers by locking in prices for a longer period of time than normal and directing suppliers to hedge positions in advance. Don't employ this strategy if price forecasts are trending downward.
- **Hedge:** Sometimes, a supplier is unwilling or has poor/limited hedging experience. If it aligns with your firm's risk tolerance, you can hedge against future inflation. For example, most large consumer packaged goods companies apply financial hedges to such primary traded commodities as wheat, soy, corn, and sugar. If risk tolerance is low, take a different approach.

- **Deflect:** If you don't have an oligopolistic end market or high price elasticity, you can deflect the price increases and pass cost increases onto customers. Or, if suppliers do not own your specifications and your organization has sufficient internal R&D capabilities, consider creating new specifications that allow you to leverage lower-cost supply sources.
- **Operate:** Provided sufficient capital and capacity are available, inflationary risk can be managed operationally by building up inventory or making the product in-house.

The best inflation-fighting strategy depends on a company's overall strategy, risk tolerance, operational constraints, end-product market dynamics and supplier relationships, as well as the category. Indeed, you might employ multiple tactics in a given category with different suppliers. Weigh these internal and external considerations to ensure the right approach for your organization.

To help govern these strategies and gain full transparency and impact of price increases due to inflation, companies are implementing an inflation-management council. The council is made up of executives from across business units and functions of a company. Its objectives are (1) to manage a process for price increases and (2) be an escalation point for decisions that come out of the mitigating strategies.

MARKET FORECAST:

Transportation

Soft transportation markets in 2015 and '16 left most shippers unprepared for a rapid run-up in the cost of shipping goods in 2017. Short-term supply disruptions, including those from hurricanes in the U.S., were compounded by an improving global economy, leaving shippers with double-digit rate increases in road markets. For the rest of 2018, we expect further capacity tightening and higher costs in North America and Europe as carriers face inelasticity in driver availability. Also, we project additional price increases of 4 to 8 percent. With capacity limited in the short term, efficiency will be the biggest resource to combat transportation inflation. Leading shippers are implementing "shipper of choice" programs to calibrate capacity through better internal collaboration, changing demand, and increased collaboration with shippers. Furthermore, disruptive technologies are on the cusp of viability, allowing forward-thinking shippers to shape, implement and reset logistics cost structures in their favor.

MARKET FORECAST:

Packaging

Plastic-based packaging prices in 2018 are expected to be in the same range as in 2017. Even if such plastic resins as polyethylene and polypropylene experience a price drop of 4 to 6 percent from the heights achieved in 2017 — partly due to the impact of Hurricane Harvey on feedstock supply — a potential trade war and other geopolitical factors might lead to an oil price increase, which could push resin prices higher again. Paper-based packaging is likely to experience a 4- to 8-percent price increase due to an increasing gap between supply and demand. Demand for paper-based packaging is constantly increasing due to (1) regulations supporting sustainable packaging, (2) the growth of e-commerce and (3) demand for innovative packaging, driven by retailers and the food and beverage industry.

Conclusion

Higher prices are being felt across industry sectors. Anthony Nieves, CPSM, C.P.M., A.P.P., CFPM, Chair of the ISM Non-Manufacturing Business Survey Committee, said in June: “Inflation is here. It’s just not sharp inflation, but it’s here. … Prices are going up. We see it in the index; we see it in certain commodities.” Add the uncertainty of tariffs and trade turmoil, and it’s an environment that few supply management practitioners — regardless of age and experience — have seen.

However, supply managers can take a proactive approach — comprised of a formal market analysis, improved communication with stakeholders, effective supplier relationship management and strategies to lock in lower prices, leverage buying power or build inventory. When aligned with a company’s strengths and overall goals, this approach can help power procurement through inflationary times.