

Overview

Thorough analysis of a target acquisition's supply chain is critical during any due diligence process, especially as most middle market companies have expanded their supply chains to a global level. Understanding the areas of risk and opportunity for improvement within a supply chain can be critical in the evaluation of the business to reduce risk and help support the deal hypothesis. This becomes even more applicable when a strategic or financial investment firm is looking to integrate the target acquisition's supply chain to create economies of scale and increase the combined assets' purchasing power. But how can you possibly expect to evaluate a companies' supply chain in its entirety, in a matter of a few weeks or, if you're lucky a few months?

The most successful firms will tell you that you must have a process – a process for evaluating both the supply chain, and the suppliers themselves. Having a process that outlines critical areas of focus enables the investment team and their outside consultants to know where to look, and how to capture the data they will use to analyze the supply chain in a short time frame. The following article will help outline some of the areas of focus that can be useful to help make the most informed decisions. In the paragraphs that follow, you will find useful information that can be used to evaluate the internal processes, as well as the external suppliers. This holistic viewpoint should provide guidance to investment professionals that face these challenges every day.

Supply Chain Due Diligence

Supply Chain Due Diligence means different things to different people, especially across various industries. However, one thing that remains constant is that all supply chains consist of four critical elements – Sourcing, Procurement, Quality, and Logistics. All four elements must be evaluated during diligence as all four play critical roles in the performance of the factories they support. While these four elements remain constant, every supply chain has unique suppliers, geographies, stakeholders, processes, management teams, and products. All of these unique aspects require analysis and understanding. To address this need, it's important to have a systematic evaluation process that looks at the various components within a supply chain and that can uncover valuable data that enables strategic decisions to be made by the investment team.

Sourcing

Evaluating a company's sourcing process is the first step. Without the ability to properly and effectively evaluate suppliers and source raw materials, components, and sub-assemblies, you do not have a sustainable business. It is critical to ensure that any target acquisition has a robust, formalized sourcing process that supports internal operations. Below you will find several examples of questions to consider during the sourcing diligence process:

1. Does the company have a formal sourcing program?
2. What is their process for identifying and qualifying new vendors? How robust is their audit process?
3. What percentage of spend comes from LCRs or Low Cost Regions?

4. Is the sourcing team capable of extending sourcing to new geographies?
5. How many critical suppliers do they have? What are their current performance metrics?
6. How often is the sourcing management team assessing supplier factories in person?
7. Are they sourcing export controlled items and what is the process for managing risk there?

Procurement

Procurement is the second critical function. Increasing globalization of supply chains, coupled with the impact of legislation like the Foreign Corrupt Practices Act has elevated procurement analysis to a strategic area of focus for diligence teams. Ensuring that a company's procurement group not only has robust processes, but also complies with all local and international laws and regulations is of utmost importance. Below you will find several examples of questions to consider during the procurement diligence process:

1. Is the procurement team using long term agreements or LTA's?
2. Is there a formal proposal process in place?
3. What sustainability and/or diversity initiatives are currently under way? Are these customer driven or internal projects?
4. Does the procurement group make use of available on and offline procurement tools?
5. Does the group utilize a detailed cost analysis process for price comparisons?
6. Is this a government regulated industry in their market source? What is the threat of FCPA violations?

Quality

Managing Quality is critical to every business. A target acquisition must not only have great confidence in their supply chain's ability to deliver a high quality product, but they also need to understand the impact of quality and know how to measure supplier quality performance. Ensuring that there are systems in place to avoid catastrophic production interruption or brand damage is critical to the success and performance of the business, and ultimately the investment. Below you will find several examples of questions to consider during the quality diligence process:

1. Does the Supply Chain group regularly post Key Supplier Performance? How often are these results communicated to management?
2. What is the process for incoming inspection?
3. What type of Quarantine measures are being taken to prevent defective product from entering the production line?
4. Do they measure quality in PPM?
5. Do they have a Supplier Quality Management system or process?

Logistics

Logistics is often an undervalued, even overlooked part of the diligence process. However, in an increasingly competitive marketplace, a robust logistics strategy and process can create unique competitive advantages. In addition, leveraging best-in-class logistics policies and procedures can improve overall operating performance by supporting vendor managed inventory initiatives as well as just-in-time delivery programs. Below you will find several examples of questions to consider during the logistics diligence process:

1. What VMI or Vendor Managed Inventory programs are currently in place?
2. Is there a strategic logistics plan and technology roadmap?
3. How does the company work with logistics vendors to reduce risk and reduce costs?
4. What natural or political disasters could potentially have a significant negative impact on delivery of supplies?

In short, there are many questions to consider when evaluating supply chain processes and procedures. Spending time to understand the critical elements of a company's internal and external supply chain procedures and processes is critical. Equally important however, is evaluating the actual supply chain itself. Understanding the capabilities of the supply chain itself, will provide investment professionals with valuable insight and outline areas of risk and opportunity.

Supplier Diligence

Just as it is critical as evaluating the internal systems, processes and management team skill sets, it is equally important to look upstream at the suppliers themselves. In a time when "Know Your Customer, Know Your Supplier" is becoming increasingly more important, it is critical to look at the supply chain itself for areas of risk and opportunity. Understanding the limitations of critical suppliers, their geographic profile, and sometimes even their management teams can give diligence teams a comprehensive overview of the chain itself.

When dealing with global supply chains, this becomes increasingly more important, but it is too often overlooked. In China, for example, 2008 and 2009 were exceptionally difficult years for many manufacturers, particularly in the textile and toy industries. As credit markets froze and orders from US importers declined rapidly, many Chinese firms operating on thin margins fell on hard times. According to data released by the Chinese government released data and reported widely by newspapers like the LA Times, hundreds of thousands of factories shut their doors during these tough economic times. As we move into 2010 and watch the global economy slowly recover, we must make sure that conducting adequate analysis of overseas supply chains is viewed as a critical risk mitigation activity. To assist us with these activities, we must leverage every available technology as well as consider the benefits of conducting global supply diligence activities. It is the financial and strategic investment professionals that understand the value of conducting these activities that will provide a more stable and sustainable return for their investors in the long term.

Foreign Corrupt Practice concerns also stimulate added focus on supplier business practices. With every contracted supplier, consultant, or agent having the ability to potentially threaten every company doing business overseas, it is becoming increasingly more important to understand FCPA regulation, and areas of risk present in a company's supply chain and beyond. As we enter into our 3rd decade in the Digital Age, the potential for risk and exposure of such illegal practices continues to grow. Diligence teams must consider all of these issues when analyzing a target company's supply chain.

In Conclusion

As outlined above, all four elements of the supply chain including the suppliers themselves, must be evaluated during diligence as all four play critical roles in the performance of the factories they support. With supply chains continuing to span the entire globe, diligence teams definitely have their work cut out for them. As investors renew focus on operations and operating performance, it will be those who understand the intricacies of the operations of their target acquisitions who will outperform their competitors and have the most sustainable returns.



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