Art Koch's Profit Chain® Tips

Modeling Piece Price Comparisons for Local and Regional Suppliers vs Low-Cost Country Initiatives

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The following article appeared in **Supply Chain Management Dojo**.

You can read the article here, but I've included it in full below.

Modeling Piece Price comparisons for Local & Regional Suppliers vs Low-Cost Country Initiatives **by Art Koch**

As a procurement officer, you've possibly been in the crosshairs of debate between sourcing locally and regionally versus from low-cost countries endorsed by many executive staff and boards of directors.

Every time I was requested to have a target percentage of our purchases from low-cost countries I felt a pit in my stomach. I worried whether I could successfully convey the message that even with the great prices, the total cost for the parts would be more than what it would cost to source locally or regionally. This led me to create the model described below.

If you graduated from a program focusing on supply chain management or completed professional certification in procurement, the coursework and educators always say that piece price isn't the total cost of ownership of the item purchased. Everyone agrees with this view, including executives and boards. The common phrase is: Cheap is expensive.

However, how do we move away from flying with a 20,000-foot-high opinion that nearly everyone agrees with – but doesn't follow – to create an analytical model that allows the organization to make an objective decision based on a known set of cost drivers? We need to understand all the individual incremental cost drivers and how to monetize their costs to compare each option's cost objectively.

An often-overlooked cost differentiator is hard versus soft cost. Separating these two costs fosters quicker analysis and buy-in.

HARD COSTS:

- Piece price
- Tariffs
- Shipping cost
- Cost of additional inventory to support longer lead times and supply variability
- The additional cost of maintaining suppliers in a foreign country
- Supplier quality (cost of inspection, sorting, rework, returns and scrap)
- Additional supplier delivery (cost of expediting and premium freight charges)
- Environmental compliance costs
- Currency exchange risk
- Labor market dynamics
- Infrastructure investment

For hard costs, the task simply involves working with accounting and operations to determine each item's discrete cost for each cost driver. Soft costs can be more difficult.

SOFT COSTS:

1. Supplier quality rating:

Platinum supplier = 0 percent added
Gold supplier = X percent added
Bronze supplier = X percent added
Unknown quality = X percent added

2. Supplier delivery rating:

Platinum supplier = 0 percent added
Gold supplier = X percent added
Bronze supplier = X percent added
Unknown quality = X percent added

3. Does the supplier have an outside professional certification?

Yes = 0 percent added
No = X percent added

4. Partnership potential:

Current partners = 0 percent added
High possibility = X percent added
Moderate possibility = X percent added
Low possibility = X percent added

5. Supplier innovation and technical capability / Engineering support, local technical support, CAD and design:

High = 0 percent added
Medium = X percent added
Low = X percent added
None = X percent added

6. Dual production site capabilities: (If required, can the supplier manufacture your part(s) at a sister location?)

Yes = 0 percent added
With some effort = X percent added
Not capable = X percent added

7. Resilience to disruptions / Speed of supplier responsiveness:

Fast = 0 percent added
Moderate = 0 percent added
Slow = X percent added
Very slow = X percent added

8. Supplier flexibility:

High = 0 percent added
Moderate = X percent added
Low = X percent added
Very low = X percent added

9. Supplier financial stability:

High stability = 0 percent added
Moderate stability = X percent added
Low stability = X percent added
Unknown stability = X percent added

10. Lead time:

Less than 1 week = 0 percent added
1-4 weeks = X percent added
5-8 weeks = X percent added
9-12 weeks = X percent added
More than 12 weeks = X percent added

11. Distance to supplier:

Less than 300 miles = 0 percent added
301-750 miles = X percent added
751-2,000 miles = X percent added
2,001-3,500 miles = X percent added
More than 3,501 miles = X percent added

12. Ease of international border crossing / International logistics performance index (LPI):

No issues = 0 percent added
Minor issues = X percent added
Higher than average issues = X percent added

13. Geopolitical issue potential / Likelihood of issues

None = 0 percent added
Low = X percent added
Moderate = X percent added
High = X percent added

14. Potential slave, child, or forced labor / Likelihood of issues:

None = 0 percent added
Low = X percent added
Moderate = X percent added
High = X percent added

15. Cultural and time zone alignment:

No issues = 0 percent added
Minor issues = 0 percent added
Higher than average issues = 0 percent added

16. Cyber security risk associated with suppliers in the low-cost region:

None = 0 percent added
Low = X percent added
Moderate = X percent added
High = X percent added

17. Cost of intellectual property management

None = 0 percent added
Low = X percent added
Moderate = X percent added
High = X percent added

I understand this is a lot of information, but capturing all the attributes to make the most informed decision is essential. For soft costs, I've found that outlining a list of three to five possible scenarios, applying an additive multiplier percentage to the base purchase price, and then summing the total produces reliable results that are easy to explain and support.

3 MISTAKES WHILE COMPARING PRICES BETWEEN SUPPLIERS:

Beware of these three underlying mistakes that organizations consistently make when comparing purchase prices between suppliers:

Limited Cost Drivers:

The most significant mistake is completing the analysis with only a few cost drivers – such as purchase price, shipping cost, and tariffs – which in the long term can lead to disastrous results.

Partial List of Hard Costs:

An additional mistake is only to assume a partial list of hard cost and little or none of the soft cost drivers. The different hard and soft cost drivers I've outlined involve a lot of information for an organization to absorb. However, it's necessary to dig deep and fully understand how the cost drivers will affect the total cost of ownership for an individual part when making such critical decisions.

Distrust Among Team:

A third common mistake is not trusting the procurement team with their analysis and overriding their recommendations because a decision has already been made. I've often heard, "If our competitors are moving their supply base to low-cost countries, we'd better follow or our margins will suffer." Just because others are doing it doesn't mean it's the correct business decision for your organization.

Don't let the complacency of incremental decisions define your long-term strategy. Amateurs ignore total cost models. Let this model serve as a road map to more precise decisions when selecting and sourcing parts.

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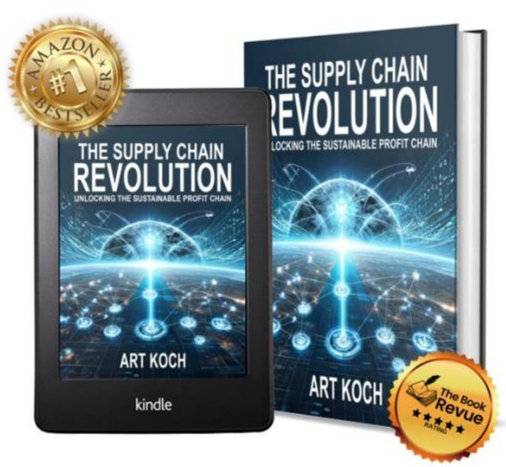
If you want to discuss this topic further and how it might impact your business, schedule a 30-minute call with Art here.

Carpe Diem!

- Art Koch



Find out more about "The Supply Chain Revolution" here.

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Art Koch's Profit Chain®

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If you have any questions or concerns about your operations and supply chain business strategy, please contact me by **e-mail** or at +1 (336) 260-9441.

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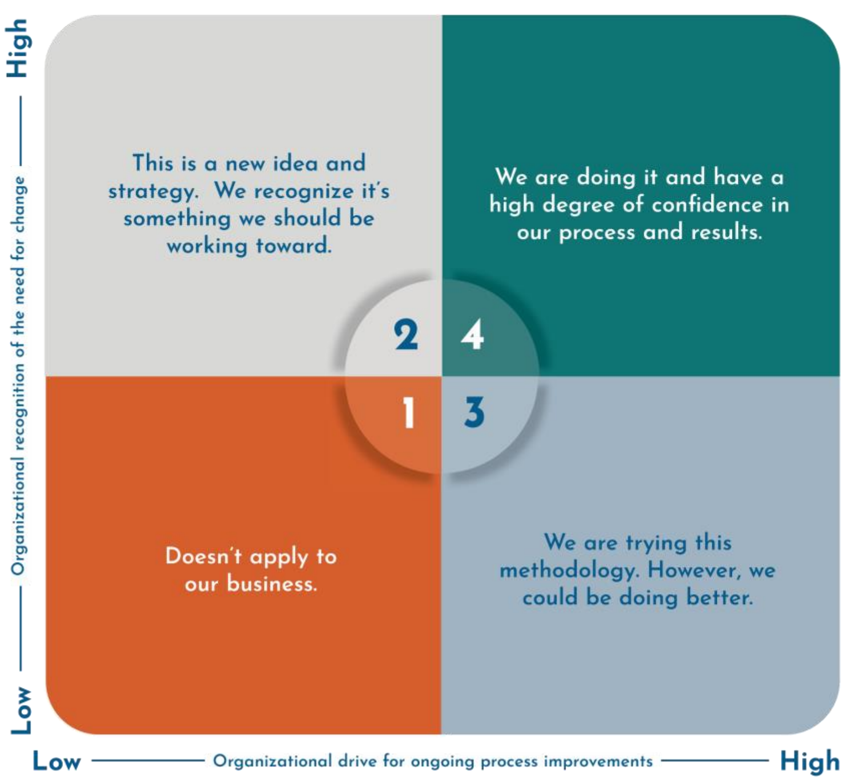
Self-Ranking - Pick one of the four questions below and fill in your comments relating to the current month's newsletter in the space provided.

1. Don't think this applies to your business or enterprise? (Write three to four reasons why it might not.)
2. A new idea and strategy; we need to work toward it. (Brainstorm the first steps.)
3. We can do better. We just need to modify our strategy, and now we are moving in the right direction. (What are the next steps to ensure success?)
4. Our team gets the time to keep their minds fresh, and we plan to live our dreams. (Comment on how you're ready.)



- ____________________
- ____________________
- ____________________
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Thanks in advance for your time and for being a loyal client.
Looking forward to helping you and your team again soon.

Carpe diem,

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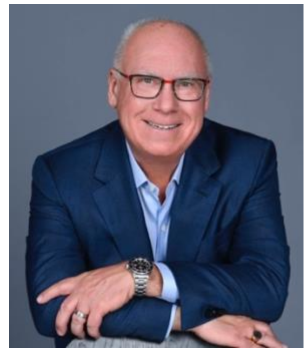

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Inventory Is Evil!™

in·ven·to·ry / ˈin-vən-ˌtȯr-ē / noun
Inventory is the term for the goods available for sale and raw materials used to produce goods available for sale.

in·ven·to·ry is evil! / ˈin-vən-ˌtȯr-ē is ˈē-vəl / phrase
"Left unchecked inventory has many negative unintended consequences to profitability. It hides problems; therefore, it delays fixing problems!"

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