SPEAKING OUT

Mitigating high raw material prices


David Jacoby

The recent raw material price volatility has hit manufacturing companies hard.

Prices of metals, wood products, paper, packaging, and fuel—just to name a few commodity-based raw materials—have all increased markedly in the last 18 months. The price of flat rolled and galvanized steel more than doubled, imported coke is up 110%, iron ore freight is up 105%, scrap 47%, and ore 28%. And, with oil rising to more than $50/barrel in November, the prices of most petroleum derivative products have spiked in the last 12 months. Polystyrene, polyethylene, and PVC prices all nearly doubled, peaking late last year. Chemicals and natural gas have risen a 'more modest' 12% to 17%.

Some observers feel that a combination of factors may reduce the price pressure somewhat. However, there is no clear sign that the fundamentals will change this year. Global cost differentials are large—boosting trade flows and encouraging continued offshore investment. China's strong internal consumption is driving world market prices up, and the country continues to be a magnet for foreign investment, largely due to its unbelievably low cost of labor. The weak dollar continues to take a toll on U.S. purchasing power, and accounts for about one-third of the steel price increases, according to a variety of steel suppliers. Strong U.S. demand is keeping production pumping, and the war in Iraq and the general threat of geopolitical instability has certainly taken contributed to higher oil prices.

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Even, our own lean thinking has exacerbated the price increases. In the spirit of lean manufacturing, we are holding fewer inventories. Because we have slimmed down the supply base and now deal with fewer trading partners, we are sometimes captive to sole suppliers who can make themselves whole after years of price concessions. And a collective failure to invest in capacity since 9/11 is delaying rapid price relief.

Organizations with less advanced supply chain processes and organizational disconnects are particularly feeling pain. Absent or limited spend analysis and market forecasting has impeded visibility to price trends, and resulted in higher average prices for companies whose reactive contracting succeeded only in locking in rates at the peak. Uncoordinated corporate functions and lengthy strategic sourcing cycles have the same effect—the price rises before the bid cycle concludes.

The jury is out whether and how long the current cycle will continue. Many see Chinese demand and the American economy staying heated for the next several years. In the meantime, most bulk and process manufacturing companies are absorbing some of the price increases and offsetting the balance with savings in services and other materials buys. The finished goods producer price index ended 2004 up by 6%, a fraction of the price of the raw materials increases. But that doesn't make buying any easier.

Hedging the Risk

What reasonable steps can a buyer take when it seems like rocks and hard places are becoming your comfort zone?

On the surface, there doesn't appear to be much that raw materials buyers can do except wait out the current price cycle. Even the time-honored practice of using preexisting long-term agreements to provide shelter from the worst increases doesn't always work because when demand is so high—as in the case of steel—that mills and service centers sometimes renege on contracts or put customers on allocation rather than absorb losses.

Here are the three steps I'd suggest you take to mitigate much of the pressure caused by rising raw materials prices.

First, assure supply through an anchor supplier and strategic inventory. Be important to at least one supplier by building a stable, trust-based relationship—trust and goodwill goes a long way toward ensuring product availability in a tight market. Negotiate capacity, not just price, and share information if you want information in return. Keep strategic inventory reserves at the supplier, at your plants, and in finished goods, to guarantee availability.

Second, keep your options open by building flexibility into agreements. Set up contracts that are long enough to satisfy production plans but short enough to permit adjustment if prices start to decline. Share the risk by indexing prices and setting alert bands and trigger points. And hedge the remaining risk with futures contracts relevant to the commodity and currency you are buying.

Third, plan ahead to anticipate cost trends and establish internal expectations. Compile a formal supply market analysis and update it every six months. Incorporate intelligence from industry experts and your own international antennae, such as strategically located international procurement offices, sales offices, or plants. Establish two to three-year forward projections and model them in your budget to test the impact of price scenarios as well as contracting, hedging, and inventory strategies.

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