ACHIEVE REMARKABLE VALUE CREATION WITH YOUR SUPPLY CHAIN

AVALTOS

Achieve Remarkable Value Creation with your Supply Chain

To understand how to increase a company's value, knowing how the value is created is a key factor.

There are three commonly-used ways to analyze a company's value.

1. For a publicly-traded company, market capitalization (market cap) is the value. The market cap is how much all the outstanding stock is worth at the current share price.

2. For a private company, the value can be estimated by using some multiplier, which is industry specific, times the earnings before interest, depreciation, and amortization (EBITDA). This gives an estimate of what most investors would think the company is worth.

3. Another way to value any company (public or private) is by calculating the economic profit. Economic profit is the profit less the cost of the capital used to create it. For comparative purposes, calculate the economic value-added (EVA), which is the net profit after taxes, minus the opportunity cost of the capital invested in the company.

Research conducted by Stern Stewart on companies that focus on creating EVA growth discovered that they usually outperform the market and competitors consistently, in terms of valuation. When the EVA of a company increases over time, the value also increases.

From an investor's point of view, even a company earning a profit may have an inferior EVA. For example, a company that has $100 million in capital invested and annual net profit after taxes of $8 million, has a 8% return on investment (ROI). If the investor has alternative investments with the similar level of risk that earn 10% annually and the company's net profit after taxes returns only 8% to the investor in value, this is not an attractive investment.

In this case, the opportunity cost of placing the capital with the company is 10%. The ROI of 8% is less the 10% opportunity cost. This creates a negative 2% EVA, which is not attractive. If the investor can, the investor should move investment money away from a company with a negative EVA to the investments with similar risks that pay the higher ROI. If the investor's returns exceed the opportunity cost of 10%, then there is a positive EVA and the investment is attractive to the investor.

The world's best value-added investor, Warren Buffet, amassed a fortune by hunting for companies that he could buy, which produced an EVA of 15% or higher. Buffet's value investing strategy is a buy-and-hold strategy of owning a company's stock forever as long as the company continues to produce a positive EVA.

Amazon's Supply Chain Model

Amazon has a market cap of $1.57 trillion (11-11-2020). The value of Amazon soared to new heights during the pandemic because of increased demand, which the company was able to handle with operational excellence. Even with global supply chain interruptions, which made many things unavailable, people wanted to buy a lot more things on online. Amazon had to hire 100,000 new workers, twice, to keep up with the demand. During 2020, Amazon's profits tripled.

Amazon's success comes from a consumer-first strategy driven by economies of scale, data and process mining, an intense focus on process efficiency and cost reduction, strategic acquisitions, and continual cash flow improvement.

The principle behind Amazon's success can be summarized in a single word, "relentless." In a PBS FRONTLINE documentary about how Amazon started, this word, relentless, is said to drive the company's founder Jeff Bezos as the company's key mission. At Amazon, there is a relentless pursuit of operational excellence.

Amazon became so efficient in managing the supply chain for value creation that it is now going to have to pay a big fine in the EU for antitrust violations. The allegations are that Amazon used its unique position of being both an online marketplace and an online retailer to take unfair advantage of its marketplace retailers. It does this through data and process mining when creating its own new products to sell at retail that compete with the other retailers selling on Amazon.

The antitrust allegations aside, all businesses can learn from the best practices used at Amazon to increase their company's value. However, you might want to stop just short of creating a global monopoly that competes with its own customers and attracts antitrust violations with massive fines. Or maybe not, since Amazon has plenty of money to pay these fines. What is a few billion in fines when the company is worth over a trillion and a half dollars?

Now that we have a clear metric to use with EVA as the valuation model and an example of the best practices in mind with Amazon, let's do a deep dive into how you can use advanced supply chain management techniques to build the value of your company or a company you invest in as a private equity firm.

How does the supply chain drive the company's value?

A company value is directly affected by the company's supply chain performance. Supply chain management includes operating in the most cost-efficient manner; however, if you want to maximize value, there is much more than just standard cost reduction measures to consider.

The supply chain is the company's circulation system; its lifeblood, of how information and materials flow from the supply side through the company to its customers. The traditional focus of supply chain management is procurement, manufacturing, warehousing, and shipping. Along with cost reduction measures, transportation logistics of how products get to customers are important. These are just some of the areas where possible improvements can be made in the supply chain for cash flow improvement to boost company value.

Here are four ways a supply chain can positively impact a company's valuation:

1. **Increased Revenues:** Supply chains, which operate with the best practices, create economic profit by enabling increase sales revenue supported by exceptional delivery of products to customers that encourages continued growth.

2. **Cost Efficiency:** An efficient supply chain controls 60% to 70% of a typical company's costs.

3. **Reduced Working Capital:** An efficient supply chain reduces capital investment requirements by lowering the inventory needed to be kept on hand and

increasing inventory turnover with the help of smoothly-operating transportation logistics.

4. **Asset Utilization:** An efficiently run supply chain makes maximum utilization of a company's physical assets such as manufacturing facilities, warehouses, and retail space in physical stores.

Increased revenues with lower costs increases economic profit. Use of less working capital and maximizing facilities use, reduces the investment needs and that also increases economic profit. These four factors above combine to improve a company's value over time.

The most impactful supply chain management considers the entire enterprise and its efforts in procurement, logistics, and operations to create a cross-functional alignment in the business that focuses on cost, cash flow, and growth. The goal is to produce the highest product availability at the lowest cost with the least amount of capital investment required.

A well-managed company wants higher revenue, lower costs, and to use less working capital to operate. Investors are very responsive to a company's ability to produce economic profit and value the company accordingly. Moreover, private equity firms have become extremely aware of the risks of supply chain interruption. They know how important the logistical and transportation companies and processes are to national and worldwide economies.

Supply Chain Disruption

A serious supply chain disruption can wreak havoc on a company's value, yet prior to the pandemic many companies operated without a formal strategy to manage risk in their supply chains.

The global pandemic clearly showed not only the financial risk of a supply chain disruption but life-or-death risk as well. COVID-19 testing was hampered by the inability of laboratories to get enough of the chemical reagents needed to conduct the tests.

The best practices for supply chain management have risk mitigation of supply chain disruption as a fundamental operational strategy. For example, supplier reconfiguration can reduce the number of vendors by working with consolidated partners and by using the techniques of cross-functional governance/cooperation.

Backup suppliers can be identified for critical components and a risk analysis made of continued availability. Just-in-time inventory management fails when a critical component is suddenly unavailable and orders cannot be filled. Inventory stock levels are managed for both the immediate need and the risk of components being unavailable.

The Relationship between Working Capital and Cash Flow

The best way to think about working capital is from an operational point of view. Increases in working capital reduce cash flow. To improve a company's value, the goal is to reduce working capital and increase cash flow.

Operating working capital is the value of inventory (raw materials, work-in-progress, and finished goods) plus accounts receivable minus accounts payable. Cash flow is the net cash from operations minus any increase in capital investments and minus any increase in working capital.

Working capital is the money that is tied up in things that are not yet converted into cash flow.

If a company lowers its working capital requirements, it automatically increases its cash flow because it frees up cash that was just sitting there doing nothing.

Companies that use supply chain efficiencies to reduce working capital needs and increase cash flow generate more economic profit. Ways to achieve this using supply chain management are to reduce finished goods inventory, raw materials, and work-in-progress.

Here are some helpful strategies to reduce finished inventory:

- **Manage Product Offerings:** Reduce the number of SKUs to manage the inventory of fewer, but popular, products. For slow-selling products, sell or liquidate the remaining stock, without producing more, and eliminate the SKUs.

- **Manufacturing:** Improve manufacturing flexibility to respond faster to changes in demand.

- **Inventory:** Use product segmentation as a strategy to reduce excessive inventory of slow-selling items and have more inventory of the fastest-selling items. Reduce raw material inventory and work-in-process inventory.

- **Planning:** Use a sales and operational planning process to manage any constraints in the supply change in alignment with product demand.

Here are some ways to reduce raw materials and work-in progress inventory:

- **Components:** Re-engineer products to reduce parts complexity.

- **Supplier:** Work with suppliers to lower the lead times for supplies.

- **Non-Production Materials:** Reduce inventory of materials not used for production, such as maintenance supplies.

- **Lean Manufacturing:** Implement lean manufacturing strategies for process improvements.

Using Supply Chain Management to Increase Cash Flow

Cash flow can be increased by holding on to cash longer by allowing account payables to increase and by receiving cash sooner by collecting account receivables faster. The problem is that if a company allows account payable to increase, this may disrupt important supplier relationships when the company becomes a slow-paying customer. Getting customers to pay accounts receivable sooner is quite difficult.
Supply chain management offers unique approaches for these challenges. It is possible to create a win-win situation by consolidating materials purchases and making long-term purchase commitments with a few key suppliers in exchange for increased time to pay their invoices. This allows account payable to expand and the company to hold onto cash longer.

For accounts receivables, it is possible to make customers willing to pay faster if the lead time for orders is shortened and the customers can carry lower amounts of inventory. This reduces their inventory carrying costs. Consider if it is possible to make these faster resupply arrangements with customers to get them to pay accounts receivables sooner. Alternatively, it is possible to factor receivables by selling them off for a discount to a third-party.

Achieving Supply Chain Excellence

A long-term commitment and the enthusiastic involvement of the top leadership in a company is required to achieve supply chain excellence.

For many years, Amazon continued to invest heavily in building out its infrastructure. It took a long time for the company to show a profit. The early investors in Amazon were major institutional players who have a very long-term investment time horizon. Even after Amazon went public in 1997, it was many years before the company showed its first profit in 2001.

However, once Amazon started generating profits, the profits expanded. Now that Amazon has the dominant market share of online retail sales, the profits are going up exponentially. Amazon is on track to make over $12 billion in profits for 2020. This is more than triple the previous year. The early investors got a fantastic financial reward for their patience when investing in Amazon's build-up of supply chain excellence.

Here are some strategic steps that companies can take to create supply chain excellence:

1. **Talent:** Hire the best employees available who are experienced in supply chain management, support their work efforts, and make supply chain improvements a critical part of the long-term business strategy. Enhance professional development of employees through cross-training and continuing education programs.

2. **Technology:** Embrace the newest technology and always keep updating systems. Supply chains are improved by both digital and physical innovations. Recent digital innovations include blockchain, IoT, 5G, cloud services, Big Data mining, artificial intelligence, cognitive analytics, facial recognition, and much more. Physical innovations include things like drones, 3D printing, autonomous vehicles, wearable tech, and robots.

3. **Collaboration:** Many supply chain improvements come from a win-win collaboration with suppliers and customers or by creating other collaborative business partnerships.

4. **Cross-Functional Governance:** Use an integrated business process with sales and operational planning to avoid functional silo problems. Provide excellent customer service by integrating all functions within the company that have customer touchpoints. Change from just serving customers to customer relations management.

5. **Meet Performance Benchmarks:** Follow the best practices strategies to deliver improved supply chain performance by successfully meeting the goals on-time and on-budget. Make sure to keep the focus on the bigger picture and not become overwhelmed with the granular details.

6. **Virtual Integrations:** Stay focused on core competencies and hire outside consultants and service providers by using the best practices for selecting third-party logistical solutions providers.

7. **Information Sharing**: Share information across the supply chain. Promote visibility form the suppliers to the customers. For example, have an online web portal where suppliers can see the dates that

their invoices will be paid and another portal where customers can see order fulfillment dates for refill orders.

8. **Agility**: Improve the company's ability to respond to the changing environment quickly and adapt faster than the competition.

9. **End-to-End Integration**: Understand how all the components fit together and work with the entire process to implement strategic cost savings, inventory management, cash flow management, working capital management, improved responses to growth opportunities, and risk mitigation. To do this effectively, requires end-to-end integration across all functions.

Megatrends Impacting Supply Chain Management

Value creation comes from tracking megatrends to make improvements in the supply chain that create operational excellence.

Increased Offers and Products

Supply chain management is consistently challenged to give customers more choices than ever before.

Shelf-Ready Product Packaging

Value-added services such as tagging items with prices and building retail displays that are shelf-ready help enable the process to get items on the store shelves and increase inventory turnover.

Improved Customization

Personalization is a megatrend that requires enhanced customization capabilities.

Emergency Preparedness

Supply chain management takes on a whole new level of importance in emergencies. The pandemic exposed major weaknesses in the global supply chain. Disruptions in the supply of surprising items like toilet paper were unexpected. At the same time as food lines were forming in the cities, which were many blocks long, food produced with no way to go into distribution, after the bars and restaurants closed, was rotting in the farmer's fields. This pandemic is not a once-and-done phenomenon. It is a permanent supply chain disruption risk problem that needs to be addressed on all levels, in every country, and made a part of every company's long-term planning.

Conclusion

Supply chain management is the key driver of creating company value because it takes into account the operating costs, cash flow, working capital, and has an impact on the revenues as well. Supply chain management involves all departments in a company. It benefits from having enthusiastic support from C-level management.

Once the logical connections are made between increasing company value and supply chain management, it is easy to see the importance of focusing on a long-term strategy for supply chain improvements to create supply chain excellence that dramatically increase a company's value. If you want your company to be the next one valued at over a trillion dollars, pay close attention to supply chain management.

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