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Managing from the Middle:

How to Improve Customer and Supplier Relationships Through Supply Chain Integration

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Middle-market companies often face daunting challenges within their supply chains. These challenges arise not because they lack capability but because they often lack the power to influence appropriate supply chain relationships.

Compared to their large customers and suppliers, middle-market firms have fewer financial and managerial resources, and less bargaining power. Those circumstances leave such firms at a disadvantage in their ability to structure and govern relationships with other businesses in their supply chains. Consequently, when large customers seek terms felicitous to their own cash flows, their smaller suppliers can't put up much of a fight. Payment schedules are among the most visible pain points. In April, Proctor & Gamble stretched the time it takes to pay vendors from 45 to 70 days. A week later, Mondelez, maker of Oreos, Toblerone, and other snacks, imposed 120-day terms. Other large companies have similarly squeezed vendors, particularly since the onset of the financial crisis.

But inventory is the more universal problem. It's a matter of basic economics: He who holds longest pays most. Powerful customers can pressure smaller suppliers to keep large amounts of costly inventory on-hand so they can snap into action when demand dictates. For middle-market companies, increasingly, "customer service" means taking a hit in carrying costs, which erodes profitability.

That same power differential bedevils middle-market firms dependent on large suppliers. Just because a firm is the customer, that doesn't mean it controls the relationship. Large suppliers also want to stay lean. If that means a customer—particularly a customer that accounts for only a sliver of the supplier's business—must wait on an order, well then, so be it. If that means a customer must order quantities larger than it needs, then the customer must swallow that as well.

Stuck between Fortune 1000 rocks and hard places, many middle-market companies turn to supply chain integration (SCI) to ease the pressure. Firms use SCI to connect, tightly couple, and dynamically synchronize their own operations with the corresponding operations of strategic suppliers and customers. It improves operational and logistical performance metrics: making deliveries more timely and accurate, raising quality, increasing operational flexibility, and lowering unit cost. And while SCI may not help suppliers get their money faster, the trusting relationships that arise from integration can decrease the chances that one firm will make unilateral decisions detrimental to another firm's financial health.

Virtually any mechanism that promotes transparency, efficiency, and coordination arguably falls under the SCI rubric. For most people, the term suggests information technology, specifically such tools as enterprise resource planning (ERP); electronic data interchange (EDI); technology-enabled ordering; and shared inventory-management platforms. But for middle-market companies, relationship-based integration can be just as important, if not more so. Such organizations must carefully consider their objectives when implementing SCI to determine whether they are better met through real-time software reporting or regular human contact.

To understand how middle-market companies incorporate SCI into their overall competitive strategies, M. Johnny Rungtusanatham, Matthew A. Schwieterman, Thomas J. Goldsby, W.C. Benton and Martha C. Cooper conducted a focus group study with participants employed by 39 business-to-business manufacturers with between $10 million and $1 billion in annual revenue. All participants were managers in positions with extensive knowledge of their firms' upstream and downstream integration efforts. Companies were asked how extensively they pursue SCI, what types of tools they use, the differences between their customer and supplier strategies, what obstacles they encounter, and which performance metrics they apply. Their responses provide a glimpse into how SCI plays out in middle-market companies.

MANAGING UPSTREAM AND DOWN

The overarching message from the focus groups was that middle-market companies feel squeezed. Demands escalate as corporations winnow their supply chains, expecting better and better service from their surviving vendors. "We have some customers that give us an order one day and need it shipped the next day," one manager from a middle-market automotive-products manufacturer told us. "They do this to reduce their warehouse inventory, but it can make things difficult. Many of our customers must think we are a bank."

"Lead times are my biggest issue," said the manager of one middle-market supplier of agricultural equipment. "[Our] suppliers are running lean and do not stock anything, so I have to stay ahead of their varying lead times and carry more safety stock."

Of course holding inventory is not, in and of itself, a bad thing. Particularly for middle-market companies boxed in by large customers and suppliers, the ability to quickly respond to orders in form (red, blue and green widgets) and quantity (50 to 1,000 pallets) can be a source of competitive advantage – if only a fleeting one. And in any supply chain someone, somewhere must hold inventory. If the total cost of doing so is lower for the middle-market firm than for its supplier or customer, then the middle-market firm may want to consider taking on the burden. In this regard, it may be helpful to think of the supply chain itself as a business. It is in the interests of companies in that supply chain to grow the business of the entire chain, even at some cost to individual members themselves. But the supplier that holds inventory should be compensated for its sacrifice, perhaps through premium pricing from its customer or reduced costs from its own suppliers or both.

That said, most middle-market companies understandably want to minimize the length of time they hold inventory, with the associated costs in money and space. If they operate in slow-growth markets, that desire is especially strong. Companies also want to maximize the speed and accuracy with which they fill customer orders, responding effectively to swells, troughs, and reconfigurations. Lack of such transparency and coordination can create major hiccups. "The biggest issue we have with our customers is a lack of communication when it comes to their production changes," one manager told us. "We aren't informed soon enough when there are volume spikes or drops. The result is production shut-down at the customer or build-up of inventory at our plant."

For companies facing such challenges, supply-chain integration could be the answer. The remaining question: how best to do it?

The efficiency of inputs naturally influences the efficiency of outputs, so a combination of upstream and downstream integration can provide the most benefit. Not surprisingly, SCI with customers often looks very similar to SCI with suppliers. In fact, for many of our focus-group participants, upstream integration and downstream integration appears to virtually mirror one another. One reason for such replication is the potential for increasing synergies throughout the chain. Another is that companies often begin SCI in one direction, and then use their newfound experience and understanding to replicate whatever works best in the other direction. We call this disinclination to reinvent what already exists "integration inertia."

There are, however, exceptions. For example, middle-market suppliers to large, powerful customers may be required to adopt particular flavors of SCI that require significant investment in technology. Those companies will not likely be in a position to turn around and impose those same requirements on suppliers larger than themselves, who probably exercise greater power in the relationship. For mid-sized companies' smaller suppliers, such integration may not be economically feasible.

TECH IS NOT ALWAYS THE ANSWER

Companies have one goal in pursuing upstream and downstream integration: to get the entities in a supply chain to act, react, behave, and move as one. To accomplish this goal, communication is fundamental. Enlisting customer participation in forecasting and production scheduling—or even monitoring relevant aspects of customer operations in real time--is a step in the right direction. Creating the same transparency in the mid-sized firm's own operations so suppliers can react quickly offers comparable benefits. As one focus group member noted, "Since customers have access to our Demand Planning system they can enter future orders and help us plan our production schedule."

Yet resource-constrained companies should remember that communication and technology are not synonymous. IT-based solutions are rarely the cheapest and may not even be the most effective means of coordination. Complex, expensive software systems can become a huge time and resource drain. Companies in fast-changing industries or that have numerous key customers and suppliers may find that maintaining integration via a technology solution becomes their de facto business. That does no one any good.

Middle-market companies may find they can serve customers better with daily or weekly meetings via phone, videoconferencing, or--ideally--at the customers' or suppliers' locations. There they can exchange information and synchronize operations to meet immediate and looming demands. Such personal communication is good for business because it establishes trust and deepens relationships in ways that software interfaces cannot. Organizations, after all, are made up of people, and bonds developed by employees with their trading-partner counterparts can be a significant strength for middle-market firms. Face-to-face coordination also provides opportunities for suppliers to raise sensitive issues, like those described above related to inventory. Reassured by the degree of commitment integration represents, middle-market suppliers may seek help, acknowledgement, and compensation from trading partners for disadvantages they assume in the interests of the supply chain overall.

Ultimately, the decision of how to integrate depends on what suppliers and customers hope to achieve. Do they want better information? Are they trying to mitigate the risk that uncertainty in supply and demand will hurt the business?

If the objective is to use real-time, dynamic information to speed up decisions on inventory or product offerings, then a technology solution makes sense. If the objective is to get truly closer to a customer or a supplier, then more face-to-face exchanges may be the better answer. In the end, technology facilitates information exchange. Personal communication deepens transactions into relationships.

Technology and other investments should also be considered in light of a company's trajectory. Some middle-market companies lack either the ability or the desire to grow much larger; others are rocketing toward $1 billion in revenues. Middle-market firms on their way to becoming large corporations may persuade their customers to support those growth ambitions by helping sync up their IT systems, for example. However those customers may, in turn, exert greater pressure on the middle-market companies.

In order to survive, slower-growth suppliers may have no choice but to push back against large customers mandating expensive, high-tech integration. If the requirements are too financially onerous or would distract the supplier from servicing other customers, it should be ready to walk away from the business. Saying no to one demanding customer that contributes 25% of revenue is hard. But if it is the only way to preserve good relationships with customers accounting for 75% of revenue, then it must be done.

BENEFITS FOR ALL

The means and ends of upstream and downstream integration are similar. Yet important differences remain, our focus groups told us. For example, middle-market firms often hold greater leverage with their suppliers than with their customers, particularly if those suppliers are smaller. Consequently, supplier integration may be more effective in reducing inventories. Suppliers motivated to improve service levels will help their middle-market customers maintain optimal lead times with their own customers.

Indeed, supplier integration has positive effects all the way up the chain. It helps middle-market firms buff their service as, for example, raw materials flow seamlessly into a middle-market OEM, which then delivers parts expeditiously to a manufacturer. The customer receives excellent service. The middle-market firm reduces inventory. The supplier maintains a healthy percentage of the middle-market firm's business. Everybody wins.

Benefits may be less direct for middle-market firms integrating with customers. Our focus groups talked about using customer SCI to improve forecasting and production schedules, and to avoid the kinds of bumps and disruptions caused by unexpected changes in demand. That means the middle-market firms must take the information made available by customers and apply it to their own internal operations in order to achieve improvements.

The thing to remember is that a supply chain is just that: a chain. When firms connect with one another to do business, individual links that act exclusively in their own best interest damage the interests of all. Forcing excessive inventory or technology requirements onto companies that can ill afford it risks putting them out of business and disrupting the flow of goods. Pursued sincerely and systematically, SCI allows companies to synchronize their operations and common interests for the good of the supply chain.