Flexible Strategies for Managing Uncertainty in Manufacturing Supply Chains

Article By
Vanessa L. Miller
Nicholas J. Ellis
Foley & Lardner LLP
Insights/Publications

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In 2022, manufacturers still face many of the same issues that bedeviled the industry throughout 2021, as well as a host of all-new challenges, including the impact of the war in Ukraine, labor shortages, and unprecedented inflation. Unfortunately, as with many aspects of pre-pandemic life, the relative stability in the global supply chain that industries enjoyed for many years is unlikely to be restored any time soon. Manufacturers and their suppliers must be agile to adapt to these new and continuing challenges.

This article highlights several key areas of focus for companies looking ahead, including seeking greater flexibility and risk sharing in pricing, warehousing/inventory, and managing freight costs. Among other strategies, companies should consider updating many of their traditional operational and contracting practices in order to enhance flexibility in a more unpredictable world. While the changing landscape presents challenges, it also presents opportunities for growth. The companies that adapt quickly will be the companies that are best positioned to thrive going forward.

With full Commission oversight of antitrust investigations rescinded, there may be “less accountability and more room for mistakes, overreach, cost overruns, and even politically-motivated decision making,” according to FTC Commissioners Phillips and Wilson in their dissenting statement of September 14, 2021. Whether and how this lowering of the threshold for the FTC to launch antitrust investigations could affect automotive industry participants is unknown, but it does reflect a change worth considering. As both the FTC and DOJ have authority to review and challenge consummated deals — even deals that were notified and received HSR clearance — one possible outcome of these resolutions is to increase the number of investigations of consummated transactions.

1. Manufacturing Supply Chain Challenges for 2022

For many companies, and for manufacturers in particular, 2021 was a year defined by shortages, increased costs, and other unprecedented supply chain challenges. The lockdowns of 2020 quickly gave way to shortages of many raw materials and components, as supply could not keep up with surging demand. While the global shortage of semiconductors may be the most well publicized of these issues, many companies also faced difficulty in obtaining other materials, including lumber, steel, resin, and foam. In keeping with the Law of Supply and Demand, these shortages quickly turned into rapidly escalating costs for many companies, with hefty price increases that were not contemplated in the seller’s original quotations and, in many cases, are not expressly covered by their long-term supply contracts.
In addition to difficulty obtaining materials, many companies faced significant operational and logistical hurdles. They encountered and continue to face difficulties in obtaining sufficient labor to keep their operations running at full capacity. Companies also had to contend with myriad logistical challenges, including port delays, the Suez Canal blockage, a dearth of containers, a scarcity of truck drivers, and massively increased costs for shipping. The cost of shipping containers from Asia to the United States soared, increasing over 500% as compared to just a year earlier. Companies also faced surging labor costs. Under the burden of these significant challenges, the manufacturing supply chain exchanged a fresh wave of force majeure declarations and notices of commercial impracticability. Unlike the situation in 2020, when many manufacturers shut down in unison, such declarations often were the subject of significant disputes as parties wrangled over responsibility for costs to maintain operations and timely deliver products.

Compounding these difficulties, many companies’ efforts to manage their supply chains were further complicated by unpredictable (or unmanageable) demand. Some companies were caught by surprise when demand for their goods surged in the face of COVID-19 instead of falling off, as the worst predictions of economic devastation largely were avoided. This has led to significant misalignments of demand and capacity throughout the manufacturing supply chain. Some manufacturers have been left struggling to meet demand from their customers, while others have seen their sales drop, or get deferred, as their buyers have to reduce production due to shortages or delays in obtaining other components needed to manufacture the final products. In a global manufacturing system that for decades had been predicated on ever-increasing efficiency — having exactly the right goods in exactly the right place at exactly the time they were needed — these problems all have contributed to significant inefficiencies that are now contributing to surging inflation.

Unfortunately, 2022 already has proven to be another difficult year for many manufacturers. Analysts predict that the raw material shortages and other supply chain disruptions will continue into at least 2023, even if there are some signs of gradual improvement. COVID-19 remains an ongoing threat to disrupt supply chains. While there appears to be little appetite for a return-to-lockdowns in the United States, lockdowns remain a possibility in many other countries. In particular, China has hewed closely to a “zero-COVID” strategy and recently re-imposed lockdowns in a number of cities. Faced with an expanding outbreak of the Omicron sub-variant BA.2 in March and April, China imposed lockdowns in Shanghai, a city of 26 million people. As a result, many manufacturers were forced to shut their production facilities or only managed to maintain production through drastic measures of having their work force effectively live at the factory. Continued spread of the outbreak may threaten production in other regions.

On top of the continuing challenges posed by COVID-19 and existing material shortages, many manufacturers must now contend with the impact of the war in Ukraine. Companies with operations in Ukraine have faced the obvious and significant disruptions that come from an ongoing armed conflict. Companies with operations in Russia, or whose customer base or supply chain are tied to Russia, have been left scrambling as they comply with both the legal and ethical hurdles to continuing such relationships, including the ever-expanding list of sanctions. Even those companies whose operations are not tied directly to Ukraine or Russia are being affected, as the war and sanctions affect both the prices and availability of numerous commodities, including for example energy, wheat, neon, and aluminum. These disruptions and shortages (and the next disruption around the corner) are likely to continue causing headaches and financial uncertainty for manufacturers and will continue to drive up costs.

2. Strategies for Approaching the Changing Circumstances in the Global Supply Chain

For most of the last two years, many manufacturers have operated in some form of crisis management mode as they waited for the return to “normal.” Unfortunately, it is rapidly becoming apparent (to the extent it was not already apparent) that there will not be a return to the conditions that existed before the pandemic any time soon. COVID-19 will be with us, in one form or another, for the foreseeable future and the fallout from the war in Ukraine (including many of the sanctions imposed on Russia) is likely to continue. The era of minimal inflation that has prevailed in much of the world for the last decade appears to be over. For these and a variety of other reasons, companies likely face a period of greater instability and volatility in the global supply chain. So how can companies shift out of crisis management mode and adapt their business practices to survive, and even thrive, in the new environment? This article presents four key strategies that companies should consider, from the contracting stage through operations.

A. Focus on pricing provisions and parameters triggering pricing relief — For many years, in many segments of
the manufacturing industry, long-term contracts at a fixed price have been the standard practice. In some cases, contracts may even require that a supplier provide annual price reductions (year-over-year costs savings or price downs). Provisions allowing a supplier to increase prices are relatively rare, with the exception of contracts for certain raw-material-intensive components. Both buyers and sellers alike, having lived through repeated cycles of spikes and declines in raw material pricing, recognized that long-term fixed price contracts for such components often proved to be untenable and utilized various forms of indexing or other flexible pricing for such components. In the current environment, with inflation and significant pricing volatility, companies are rethinking the traditional structure for supply contracts. Long-term contracts at a fixed or even declining price may no longer be practical. As has been the case in the past with raw material intensive components, companies should focus on implementing greater pricing flexibility into their contracts to account for changing costs, whether through some form of defined indexing, a periodic opportunity to renegotiate and market test, or other creative approaches.

B. Warehousing and inventory banks — For decades the traditional model for many manufacturing companies has been lean, just-in-time (JIT) inventory management, as companies have maintained only minimal levels of inventory. This was historically an incredibly efficient model — as long as everything was running smoothly and on time. However, as the pandemic and supply chain issues have laid bare over the last two years, once all of the proverbial “fat” has been stripped out of the system, there has been nothing left to cushion any shock to the system. Buyers and sellers both must now weigh the potential benefits of lean inventory against the risks posed by a supply chain that is far less stable and predictable than it was two years ago. Many companies have incurred significant costs for expedited freight, overtime, shutdowns, and other expenses that have far outstripped any savings and efficiencies realized from trying to maintain a lean inventory. As a result, many companies are looking at ways to mitigate these risks. In addition to looking at re-shoring and shortening supply chains (which primarily are long-term strategies with little capacity for short-term relief), many companies are rethinking their inventory models and moving to implement warehousing and larger inventory banks as a shield against shortages and disruptions. While this approach can be an effective strategy, it is not without its own added costs. Companies must think carefully when implementing such a strategy (either on their own initiative or at the request of their customers) to ensure that the costs are properly apportioned and accounted for.

C. Stress-testing, dual sourcing, and contingency planning — In many industries, the drive toward minimizing cost, as well as the expense associated with qualifying a new supplier, have driven a trend toward single sourcing material and component suppliers. In the new, less-predictable world of the global supply chain, companies that have not done so already should review their supply chains to understand where potential risks exist and whether a single-source strategy still makes sense. This often requires digging into the details and understanding where all levels of the supply chain are sourced. For example, a company purchasing components from two separate suppliers, one of which is located nearby, may feel that it has mitigated its risk. However, if both of its direct suppliers are obtaining 100% of their raw material from the same sub-supplier, the company still is exposed to risk based on the sole source. Even if companies do not actively dual source components, it is prudent to have a contingency plan and understand what alternative sources are available if necessary, and how quickly a new supplier can be engaged, in the event of a disruption to the current supplier.

D. Shifting risk for freight costs — For many companies, freight costs have taken on outsized significance over the course of the last two years, both due to increased need for expedited freight and to rapidly increased costs (and delays) for ordinary shipping. Traditionally many buyers have treated most shipping costs, including costs for expedited freight (even in cases of force majeure and commercial impracticability) and costs to ship components from lower-tier companies, as something for which their suppliers are responsible. However, many companies are questioning this structure and pushing back. Numerous companies have struggled with increased costs for shipping, particularly those needing to obtain components from Asia. As discussed above with respect to pricing and costs more generally, companies should look for ways in which to share some of the burden and risk of these costs with their customers. Many companies also have struggled with a need for frequent (and for some periods, near constant) expedited freight in order to compensate for delays in the supply chain. As most companies know, costs for expedited freight can rapidly become exorbitant and threaten to surpass their profit margins on a program for an entire year or even longer. In recent years, buyers and sellers have treated costs for expedited freight as a zero-sum game, with buyers demanding that their suppliers pay the entire costs for expedites and suppliers often balk and refusing to pay such costs (even if otherwise obligated to do so under the applicable contract/law). Given that the challenges in the supply chain show no sign of alleviating soon, companies should consider possible new approaches in which both buyers and sellers each share some of the risk for expedited freight arising out of issues that are outside of their control.

3. Conclusion

The global supply chain has changed, and manufacturers must adapt to the new circumstances. The challenges faced by manufacturers in 2021 have continued into 2022, and many show no signs of abating. If manufacturers have learned anything from the last 18 months, it is to expect the unexpected and apply the "lessons learned" to navigate challenges going forward. These challenges will require companies to reevaluate many of their contracting and operations, including their approach to managing the risks inherent in pricing, warehousing/inventory, and freight costs. More volatility in the supply chain requires that contracts be more flexible in order to allow for a bend-but-don’t-break approach to resolving challenges as they arise.