THIS REPORT IS BASED ON A RECENT PRIVCAP WEBINAR:

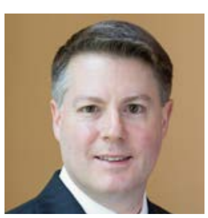
EXPERT DISCUSSION

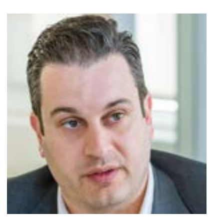
Winners and Losers in a Disrupted Global Supply Chain

Private equity value-creation experts are turning the supply chain and logistics crisis into opportunity for operations improvements. Topics of discussion include: reports from the front lines of portfolio companies that rely on the supply chain to fulfill orders, how the crisis is allowing companies to demand better service from shippers, the changing rules of inventory, and the disrupted interplay of rail and shipping.

VIEW THE PROGRAM HERE

FEATURED EXPERTS:





Marc Iampieri
MANAGING DIRECTOR
ALIXPARTNERS

Brian Nemeth
DIRECTOR
ALIXPARTNERS

Raz Khan
PRINCIPAL
PERMIRA

Privcap

EXPERT DISCUSSION

“How a shipper is treated today by a carrier—they remember and vice versa.”

- BRIAN NEMETH, ALIXPARTNERS

Privcap: How have disruptions in the global supply chain affected the ability of private equity-backed portfolio companies to deliver products to customers?

“

Marc Iampieri, AlixPartners: This is pretty broad-based - the challenges of moving goods internationally impact most companies. My focus primarily is on the North American market. We’re a very large importer from Asia as well as the Americas, but the trade from Asia to Europe has been a significant challenge going back to the beginning of this year, where there were expectations after the holidays that there would be a bit of a slowdown in demand. That didn’t happen. We didn’t have enough containers, and that created a challenge.

The supply lines were slower to get product here, so people compensated by ordering ahead and ordering more, which created more of a challenge. Then, the shutdowns at ports within the transportation industry brought a lot of this flow of goods, in some cases, to a grinding halt.

Certainly, there’s a cost impact like we’ve never seen before, with cost increases for ocean freight, and a significant shift to air freight where appropriate. A few companies have been able to get through this completely unscathed. Some have done better than others. But this is something we’re all dealing with as people in business, and as consumers as well.

“

Raz Khan, Permira: At Permira, we invest in companies that have strong, fast underlying growth, so this has been an acute issue for us. We have seen huge spikes in demand through Covid, these are all very relevant and acute issues for us.

Privcap: What are the root causes of the freight shortages and the cost spikes?

“

Khan: It’s broader than freight. It’s across the supply chain. The root causes we’re seeing are clearly labor shortages, both in skilled and unskilled labor. It’s being called the “great resignation.” A lot of people, for one reason or another, are either not showing up or changing careers as their initial career path has been disrupted.

Specific to our companies, we have resin shortages and chip shortages that everyone knows about. We have longer lead times across the board. With every supply chain disrupted, lead times are very long and getting longer. In some cases, there are even things as tactical as container shortages. If you can get a container, you’re lucky. We’ll pay whatever we need to pay. All of that combined is a lot. There’s also inflation on top of that, because there are shortages leading to an inflationary environment—hugely inflationary, in some cases. They also create opportunities, which we'll talk about in a bit.

> We have now started building more inventory than you normally would build."
>
> **RAZ KHAN, PERMIRA**

Iampieri: For many years, supply has not been significantly interrupted. In many cases, there's been an oversupply, whether it's for specific services or for particular goods. People are interesting creatures—after things work out well for a year, you nibble a bit and you try to take a bit more cost out. You extend the supply chain a bit further—you make it so fragile that it doesn't take much for it to break. We absolutely saw a break this year. Those cost-cutting decisions were made by a lot of experienced, educated, intelligent people. But the risk profile was probably not evaluated correctly of what the actual cost would be if it broke. In some of those cases, it's catastrophic. If you don't have the one component to complete your finished good, you can't have any sales. We're seeing that in many industries—auto is probably the most visible, but it's certainly impacting other durable goods and consumer prices.

Brian Nemeth, AlixPartners: There's a pile-on effect of these disruptions. Disruptions have been happening at such an increased frequency. You had Covid, you had shutdowns and large increases of demand. You had a vessel stuck in the Suez. Then, you had terminals closed in Asia for periods of time, which jammed up supply. Now, you have vessels waiting outside ports in China and L.A. to be able to unload these containers. This pile-on effect has exacerbated the whole situation.

Privcap: What can companies do to survive this new normal of supply-chain disruption? How can their private equity sponsors help them?

Khan: As I mentioned earlier, the disruptions have created opportunities. They have forced us to think differently about where we're working with our portfolio companies. Number one, we're thinking about creating vertical structures. Years ago, there was a huge push to only focus on your core competency and outsource everything else. In some cases, we are insourcing. In some cases, we are thinking about controlling our vertical supply chain.

We need control - we are paying for and getting paid for better and reliable, sustainable service. We're creating partnerships versus simply just beating up suppliers or squeezing every penny. We're looking for great partners, which perfectly fits into Permira's values of partnership and creativity, creating long-term partnerships with our suppliers and paying them for the service they provide. In turn, we get paid by our customers for the sustainable, reliable service we provide.

Then, we're simply not tolerating what we would tolerate before. Where there are substandard suppliers, we're not going to deal with them anymore. We're going to focus on the good ones and develop long-term relationships. Also, there is a huge opportunity for us to simplify our businesses, and in most cases, to simplify supply chains. Where there was reluctance or hesitancy in the past to rationalize products and suppliers, we're now doing that. In some cases, we rationalize customers. It's all about supply and demand. We want to invest in the best customers, best suppliers, best supply chains. So, it's been a huge opportunity to simplify businesses and to drive value.

Finally, we're also decoupling wherever we can decouple manufacturers or suppliers and supply chains, to not have single points of failures anymore and to have a lot of sustainable but repetitive supply chain.

Nemeth: Usually, supply chains and operations are the background, which creates a unique opportunity to pass costs through. Everybody understands what's going on right now. On a short-term solution, we can work with companies to say, "You've seen that freight has increased," or, "You've seen that raw materials have increased. We need to pass this along. Everyone has to absorb their share."

That's one tactic. The other is to use alternate supplier companies you might not have considered using before. Nothing's off the table anymore. Everyone is all about being creative and finding solutions.

Another area is planning. You used to buy a MOQ (Minimum Order Quantity) worth of a purchase order. Maybe you actually only need half of that purchase order and half of another purchase order. How do you find smart ways to consolidate or break up the product to get what you actually need versus what you want?

Communication is a huge deal—internally across functions, but also with suppliers and customers—being as transparent as possible so people understand what you're going through.

Long-term, there are a few other considerations, the most interesting being diversification and nearshoring. That's more of a 12-month to a two-year exercise, but because of what's happened, companies are starting to take a much more serious look than they have historically and saying, "Maybe I should shift a portion or a subset of my manufacturing to Mexico instead of Asia, so I can handle these disruptions more often."

Iampieri: Companies need immediate-term and near-term plans. There's so much uncertainty that we've seen more and more of our clients embrace the concept of a short-term control tower for aspects of the business that are acutely suffering from a pain point, whether it's a supply disruption or it's cost. And it's temporary to weather the storm. A lot of the things we're seeing we don't expect to be indefinite, but certainly could go on for another six to 12 months.

It's something that needs to be addressed now, but it's not permanent. Alternate network models are becoming top of the list of things to look at. We have to challenge the way we've done things historically, because oversupply caused too many to put eggs in one basket. Having all of your supply come from one country in Asia is a very risky proposition. How many companies formerly trading at high multiples have done that and are now paying the price? It's a lot more than we would've expected if we asked that question three years ago.

Privcap: Raz, you mentioned it's not the style of your firm to beat up on a supplier, to use that metaphor. But in these more challenging times, talk about what it looks like when certain partners, certain suppliers are not stepping up to the plate or being as communicative as they need to be, versus others that are stepping up with an innovative and a flexible mindset.

Khan: It's about getting into a discussion with them and understanding them. There's not a single supplier we deal with that wants to be difficult. It's trying to understand what their situation is and how we help them.

There are certain suppliers and parties who have solved their problems in a creative way. There are others that are struggling with geography, where they're located. It's not our style to beat up on anyone. We really want to be collaborative. Part of it is the data and forecasts we're giving to them. How good are we at communicating with our suppliers, whether they be great or they're struggling? It takes time. We need them to be successful because our success is tied to their success. It's about a partnership and trying to figure out how we collaborate and collectively solve the problems.

Iampieri: We're not going to be tolerant of waste, or of people making decisions that create an inefficient system. With the right data, and with things being so dynamic, you have to look at your suppliers and your customers. You look at the entire supply chain: where are the inefficiencies? Then, what can we do to make the whole system more

> We're not going to be tolerant of waste, or of people making decisions that create an inefficient system."
>
> MARC IAMPIERI, ALIXPARTNERS

efficient? Then we can negotiate who gets to share an equal or larger portion of that value. But that has to happen on a much more frequent basis than the annual contract review or even a QBR (quarterly business review), in some cases. That's definitely an area where you're not beating anyone up. You're working together collaboratively.

Nemeth: How a shipper is treated today by a carrier—they remember, and vice versa. The big companies are being taken care of by the big companies, but you have opportunities to work with small or medium transportation providers that are interested in obtaining new business and obtaining new partnerships. And they're taking advantage of this. These are some of the areas where you see better service levels through finding the right partner.

Privcap: I'd like to dive into a topic that is central to the supply chain question, which is the conventional rules of inventory: how have those changed? How do portfolio companies and their private equity backers need to be flexible with regard to the inventory rules that everyone learned in business school - rules that now seem to have been blown apart?

Khan: The business school rules are, you never want to tie up any more cash in inventory than you absolutely have to. That still is true, although we never want to miss a sale either, as growth investors and people that love and care about our customers and what their needs are. We want to have our products and services ready when our customers want them. For that, we have now started building more inventory than you normally would build. We would rather have more cash tied up in good inventory than miss the sales. Now, I'm very careful to use the word "good" inventory, because not all inventory is good inventory.

Although the basic rules have not changed, how we apply them have changed. We are creating real stratification of what the products and the raw materials look like, being very careful on what we buy and how we buy.

The work-in-process inventory, in some cases, didn't get enough attention. Now, it's getting a lot of attention. Where is the cash stuck? In the supply chain or in manufacturing? Because not only is it tying up cash, but it's also preventing us getting that finished product to the customers.

Iampieri: That focus on flexible inventory is on things that can be built modularly—you focus on the top components, on raw materials, on keeping product closer to the production site if you produce in market, because there's so much uncertainty where that demand is coming from next for deploying finished goods across your SKU portfolio and all the market. It's a recipe for markdowns and other issues.

Nemeth: We do a lot of work around the right SKUs—that's been one of the things most in demand with our clients: which of the SKUs are generating the most revenue, which are generating the most profit and traffic, whether it's foot traffic or online traffic? Really understanding that SKU and making sure the investment is in the right spot—it's become commonplace for us these days.

EXPERT DISCUSSION

Privcap: I'd love any anecdotes around flexibility in solving complex problems as a result of the supply chain disruption.

“

Iampieri: I'll share one: when looking at a complex manufacturing and assembly good, there's a whole universe of suppliers you need to work with and orchestrate all the supply coming in at the right time, given the move over the years to the just-in-time manufacturing we have here, at least in North America.

There is substitution from different suppliers of effectively the same component, which is a bit easier if they're already pre-qualified. The opportunity to fast-track the design process to potentially qualify a supplier has a slightly different approach. Then, there's approving spec changes and design changes a lot faster. There's a significant element of risk if you stop selling your goods, period. That is one area where we've definitely seen it from the supply side, on the sales side and the customer side.

The sales force can be very helpful in educating the customer and bringing them along into substituting. That will accomplish the need and, quite honestly, that's all that you have available.

“

Nemeth: Big companies are chartering vessels to get space. They're taking hold of their own supply chain. Owners of bulk vessels are reclassing their vessels just to handle containers. These are things you never would have thought of a year or a year and a half ago. Now, they're becoming the topic of the day.

“

Khan: The sales force can help where there are product lines with long tails and long lifecycles. Our sales force has really been helping and on the forefront of driving the conversion to the new products. In some cases, suppliers weren't supporting older products. So, it's been a huge opportunity to basically focus on the new versus the old long-tail life cycle.

Privcap: Have you heard any war stories from people in the shipping business?

“

Iampieri: I don't know if I'd call them war stories. I would call it the best year ever—the sound of corks popping out of champagne bottles is deafening right now. Companies are producing profits that they haven't produced cumulatively in decades. If you're able to produce profits that are double or triple what you've been able to do over the last 10 years, and you think you can lock them down for a couple of years, that's where the focus should be. Quite honestly, that's where the focus is. So, extension of contracts that were quarterly to multi-year are coming your way.

“

Nemeth: A few container lines have announced that they no longer are going to increase rates. It's capped off in a way. That's another signal to the market that we've achieved the peak. We might stay at that peak for a bit. This is as high as it goes. Two of the top five carriers have already signaled that this is it. They're going for image control, for not gouging the marketplace. At the same time, they need to capture this financial benefit for as long as possible.

Privcap: What are you seeing in the healthcare industry by way of supply chain disruption?

“

Khan: We're an active healthcare investor and we have a number of portfolio companies in the space. The shortages are much like everything else. Getting our products in and out has been an issue.

It is much harder to basically flex the supply chain. In some cases, you have to go back to the regulators. Those are the moats around the businesses. Nobody else can just jump in and start doing what you're doing.

But it's across the board. We've had raw material issues, just getting the raw materials for making a drug substance or a drug product. In some cases, we've even had issues getting vials to fill the finished product. It is a bit harder to switch suppliers because you have to go through the whole process of revalidation. This is where strategic partnerships really help—locking in supply and partnerships over the longer term.

“

Iampieri: The approval process is certainly a barrier, and it puts even more value on having a diverse supply base. It might be a very worthwhile tradeoff

CLICK TO LISTEN ON PRIVCAP.COM

to have geographic separation between certain suppliers, as well as substitutes with exactly the specifications that could work for the application, less so in pharmaceuticals, but more in equipment and disposable consumables—having some flexibility there is more valuable these days.

Privcap: What signs will you be looking for that will indicate a recovery or return to normalcy?

“

Nemeth: When I look at transportation, it starts with, can I even get on a vessel? Can I get a container? Now, we're currently at a point where there's a bunch of vessels anchored out at sea waiting to be able to access a berth to unload their containers. That's something I am following. We are seeing record-setting vessels at our anchorage in Southern California. There are 70-plus vessels, where normally it's none or a handful at most. How long are things staying at the port? Because that indicates two things: congestion, but also, when are warehouses ready to receive that product, and is there labor?

Hopefully, they're moving in the right direction.

“

Iampieri: I would challenge those that made predictions last year. Many got it wrong. Maybe it was wishful thinking that things would be better sooner. The best approach here is to have a couple of different scenarios modeled out. If this outcome occurs six months from now, here's what we're prepared to do, and be ready to do it and be quick to pivot. Even if we can get 100 experts to all agree on a date, there's still no guarantee. The best course of action is to be prepared.

“

Khan: I certainly don't have a crystal ball. But I'm looking at the people. To me, that's the number one indicator—both skilled and unskilled labor, engineers. In some cases, we don't have people in warehouses, in some cases we don't have engineers.

Privcap: Brian, what can you tell us about the state of rail freight?

“

Nemeth: If you talk to any of the terminal operators, they're all going to say, “I'm congested because the railroads aren't moving their containers off my property.” That's a huge issue. There's rail congestion at every major terminal. You have product that would have typically moved by rail. That's being trucked in order to get there. Rail is a huge unlock right now on the port congestion, which would help all those vessels that are waiting to berth.

Privcap: Are these challenging times a good opportunity also to strengthen the relationship between private equity sponsor and portfolio company?

“

Khan: Absolutely. In Permira, specifically, we hire great management teams, and where we've really collaborated is making sure, number one, that they have all the financial resources to double down and put in more equity to fuel the growth. Then, beyond the capital that we've invested, we've really spent a lot of time just tossing ideas back and forth and making sure we have a collective approach to problem-solving. We show our portfolio companies that we're real partners. Lastly, any sort of resource our portfolio companies have wanted, we've been able to provide. In a lot of cases, it's really opened up doors where there was a bit of a hesitancy to ask previously.

Our portfolio companies are relying on each other, as well. So, our CEOs and HR leaders are getting together in their own Zoom forums and saying, “This is the kind of issue I have. How do I solve it? What are you doing?” They get a very fast response from fellow practitioners and leverage best practices.