Your supply chain costs have decreased by 12.2%

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The recession should have lowered your supply chain costs by 12.2% by now, and if your company is like most, that should lower your corporate cost structure by 5.9%, after taking into account inventory reductions at their cash equivalent value.

Your sourcing costs should have decreased by 9.7% due to deflation in raw material and component costs. If your purchased materials represent 50% of your cost structure that should lower your corporate cost structure by 4.8%.

Your inventory should have declined by 4.9%, which is worth about 0.5% on a cash basis. Last year inventories were full based on growing demand, but by now most companies have leaned down their inventories by 4.4% since this time last year.

Also, inventory carrying costs fell by 9.7% due to the deflation in the value of the purchased goods and another 2% due to the drop in interest rates (the rates for 2-year Treasurys fell from about 3% to 1% in the last 12 months), for a total of about an 11.7% reduction. Multiplied by the 4.4% drop in value, this yields an additional 0.5% savings on inventory carrying cost. Finally, shrinkage and obsolescence have decreased by a similar percentage due to the reduction of overall inventory levels and the carrying cost.

Your overall operations (assembly, production, and distribution) costs should have fallen due to declines in the cost of energy between last year's peak and this year's levels, yielding a 1.5% savings on total cost. For a company whose operating costs represent 80% of its costs, that should shave 0.1% off the corporate cost structure.

The net effect is that your supply chain costs should be 12.2% lower than they were at this time last year (9.7%+0.5%+0.5%+1.5%), and if your purchased materials represent 50% of your company's cost structure, that translates to a 5.9% reduction in overall costs (4.8%+0.5%+0.5%+0.1%). You may not see a small amount of this since this savings could be offset by the cost of excess capacity investments (which expanded by 0.5% more than GDP growth last year, and that excess investment was a bad one) made due to failure to foresee the downturn. At a 10% cost of borrowing, this may have added 0.05% to your costs this year. Nonetheless, you should see most of it, and be actively involved in making sure you realize the savings.

Supply chain costs are likely to continue to decrease by about 1.1% over the next 12 months. Depending on what you are buying, sourcing costs are likely to continue to decrease and you may pare excess capacity, relieving that cost burden. Using one industry that we are studying as an example, these costs will decrease by 1.6% over the next 12 months. On the other hand, inventory costs will increase and energy prices will rise again. The amount of inventory will need to increase, let's say halfway back to where it was, since we are in a completely destocked situation now. This will add 0.25% back to the cost structure. Furthermore, as the cost of government stimulus programs becomes apparent (somebody's got to pay for all that stimulus...), so the cost of holding inventory will increase. If interest rates rise enough to wash out half of the cost savings on the deflated value of inventory, that would increase inventory costs, adding back another 0.25% to corporate costs.

To make sure you capture the savings that your competitors are reaping, it is imperative to deploy world-class Rationalization programs. A complete Rationalization strategy consists of nine activities, including for example: strategic sourcing and outsourcing; lean sourcing and manufacturing; standardization and simplification of specifications and work scopes; lean transportation, including mode optimization, routing, rating, and cross-docking; and go-direct logistics that cuts out unnecessary middlemen and processing. These and other techniques are described in detail in Chapter 6 of the definitive Guide to Supply Chain Management, which has just been published by The Economist and was written by me, David Jacoby. The book, which is currently being printed, can be ordered through the publishers, Profile Books (UK) and Bloomberg Press (US), or purchased through www.amazon.com.

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