Cost Savings: Is Your Organization Aiming High Enough?

Today's procurement officers are paying more than the market dictates they should. The Institute of Supply Management (ISM) in the United States asked purchasing managers how much they expect prices to change in 2015: a startling 59% of respondents believe that prices will increase this year. Just 18% of respondents see prices falling, and of those, the expected decline is just 4.6%. These responses remain in stark contrast to the reality of the average 50% price decline that has transpired across a representative group of core industrial commodities. What level of visibility and insight do purchasing managers have when it comes to the costs behind their key buys?

Most organizations started the year with cost savings targets below 5%, content to allow multi-year lows in material prices pass by without extracting the full value of their suppliers' declining costs. Best-in-class organizations, on the other hand, lean on econometric models and market insights to trace cost declines through supply chains to achieve optimal timing and cost savings. Models that fail to track the movement of cost savings through supply chains provide little value in low-price environments. Quantifying changing costs in the categories you buy can mean the difference between 5% savings and over 20% savings. An organization that pushes for a 10% price cut rather than being content with 5% will save an extra $50,000 on every $1 million of spend.

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Why Are Greater Cost Savings Achievable Now?

After years of ever higher peaks, the last 12 months saw commodity prices suffer their sharpest declines since the global economic recession. Many are now back to levels seen 10 years ago. Copper prices were among the first to skyrocket, taking the elevator up 163% from early 2005 to mid-2006; but copper has also been riding the escalator down since 2011, with steady declines accumulating to 43%. Until 2005, oil prices barely ever rose above $50/bbl, and for a decade they rarely fell below that level, that is, until June 2014.

The volatility that accompanied higher prices has also lessened as those prices have come down. Higher prices brought higher fluctuations. Volatility in ethylene prices doubled between the decade leading up to 2005 and the following decade.

In short, commodities have reset to levels of 10 years ago, completing the super-cycle that has gripped markets since the final stage of China's industrial rise in 2005. Now, companies must set about the task of clawing back the cost increases that have plagued procurement departments – nimbly balancing between maintaining supplier relationships and their own bottom line. As price declines filter through supply chains, many organizations are struggling to answer the question: "Are we aiming high enough for our cost savings in 2015?"

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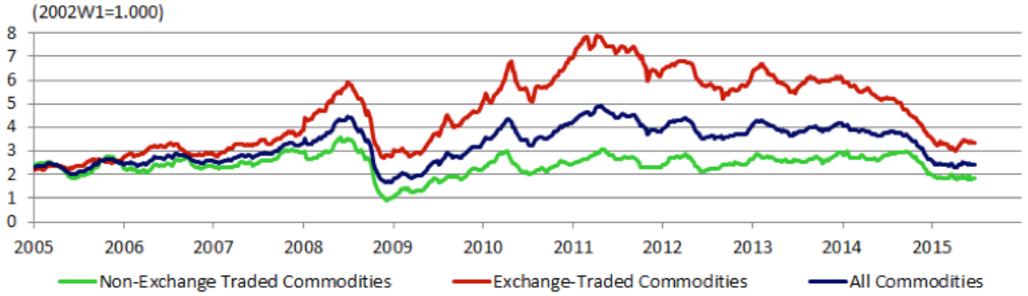

Source: IHS

Targeting the Right Costs

Although costs are falling across the board, procurement officers should focus on product costs—those costs that can be traced or assigned to a specific good or service. Product costs differ from period costs—those costs that occur proportionately and are more difficult to trace to a specific good or service. Product costs are also the most common to be included in a price negotiation; after all, companies pay for products from other companies, they don't pay for marketing or inventory management costs. For further simplicity, this analysis will focus on direct materials, traditionally the source of 50% or more of the total cost and the volatility.

* The standard deviation of the weekly percent changes in ethylene was a shade below 4% in the decade leading up to 2005, but for the following ten years volatility would wreak havoc to the tune of a 7.0% weekly standard deviation

Past as Prologue: Prices Come Full Circle

Falling commodity prices have already pushed prices lower in many key categories, setting a floor for cost savings at the next negotiation. However, for many categories, this is just the beginning. IHS forecasts significant price cuts will occur for a number of key material and equipment categories. The timing and magnitude will vary based on the key materials in the industry and one's location in the supply chain, but the broad-based nature of the price declines should offer hope for all.

Cost declines for suppliers have not stemmed solely from lower commodity prices. Intermediate goods, such as metal stampings (-26.6%), steel pipe (-19.2%), and industrial valves (-3.6%), have already shown steep declines in their direct materials bill. Finished goods, such as mining machinery (-6.6%) and aircraft engines (-1.0%), are not far behind. The graphic below illustrates historical data movements for key price and cost measures at different supply chain levels, from their recent peak price through the first half of this year, highlighting the breadth and depth of declines and the range of savings opportunities that already exist. The IHS forecast for total 2015 savings raises the bar to even higher levels.

Peak to Trough Declines through May 2015 in Key Categories throughout Supply Chains

Hot-Rolled Steel Sheet	Total Direct Materials:	-38.5%
	Scrap:	-41.4%
	Coal:	-3.6%
Metal Stampings	Total Direct Materials:	-26.6%
	Hot-Rolled Steel Sheet:	-32.6%
	Galvanized Steel Sheet:	-26.0%
Steel Pipe	Total Direct Materials:	-19.2%
	Steel Plate:	-29.1%
	Iron and Steel Foundries:	-1.6%
Valves	Total Direct Materials:	-3.6%
	Iron Foundries:	-2.0%
	Copper Foundries:	-6.1%
Mining Machinery	Total Direct Materials:	-6.6%
	Bar Steel:	-12.1%
	Iron and Steel:	-15.0%
	Speed Changers:	-0.4%
Aircraft Engines	Total Direct Materials:	-1.0%
	Forging and Stamping:	-1.5%
	Iron Foundries:	-2.0%

Raw Materials → Intermediate Goods → Finished Goods

Sources:IHS

Price Declines by Industry

Energy

The energy industry has faced the stark reality of falling oil and gas prices in advance of relief for the costs to produce those fuels. However, the second half of 2015 offers a chance for oil and gas operators to reverse that trend: key spend categories in the energy industry are among the weakest and show steep declines in our forecasts. Each supply chain stage is weakening: coiled tubing (-21.7%), stimulation chemicals (-8.0%), and well completions (-1.9%) are all expected to pull back, bringing production costs closer in line with energy prices. These declines come after years of constant increases and present a reversal of fortunes for energy procurement professionals in negotiations with their suppliers. The former will need to shift their focus from dulling the impact of increases to extracting the full value of recent price declines.

Iron Steel Pipe & Tube USA	Share	2015 Forecast
Direct Materials	62.8%	-15.1
Steel Plate	40.1%	-23.2
Iron and steel Foundries	22.7%	-0.8

Sources: IHS Pricing and Purchasing 2015Q2 Forecast

Automotive

After having suffered with metals and plastics prices plateauing at a high level since 2008, the automotive industry is finally ready to recover. Steel prices are dropping across the board: hot-rolled steel sheet (-25.2%), cold-rolled steel sheet (-22.5%), and galvanized steel sheet (-20.6%). Moreover, the savings extend beyond steel products into raw material categories such as rubber (-11.0%), benzene (-41.9%), and finished goods such as automotive seats (-10.9%). Automotive procurement professionals can lock in prices at the 2015 trough to enjoy a reprieve from the usual volatility and price escalation.

Metal Stampings USA	Share	2015 Forecast
Direct Materials	45.5%	-20.9
Hot-Rolled Steel Sheet	22.4%	-25.2
Galvanized Steel Sheet	16.8%	-20.6
Primary Nonferrous Metals	3.5%	-8.7

Sources: IHS Pricing and Purchasing 2015Q2 Forecast

Chemicals

The chemicals industry stands with the energy industry in seeing falling selling prices for their goods without similar declines in production costs (outside of oil and gas itself, of course). However, capital equipment prices have now stabilized and in some cases will be lower in 2015. Compressors illustrate this point: costs have shown substantial declines due to high metal intensity and pay present and opportunity for price declines.. Categories such as turbines (0.3%) and fluid power equipment (0.7%) are also showing their slowest price escalation in many years. In contrast to purchasing officers in other industries, chemicals procurement professionals would do best to delay purchases as the bulk of price declines are still to come.

Air & Gas Compressors USA	Share	2015 Forecast
Direct Materials	35.40%	-3.8
Iron and Steel	12.10%	-11.1
Integral Horsepower Motors and Generators	8.10%	-0.3
Fabricated Structural Metal	5.70%	-0.3
Industrial Valves	4.90%	1.6
Other Fabricated Metal Products	4.60%	-0.8

Sources: IHS Pricing and Purchasing 2015Q2 Forecast

Aerospace and Defense

The aerospace and defense industry is among the more concentrated in nonferrous metals and has struggled with the volatility that comes with the territory. For now, a buyer's advantage exists: titanium prices will continue their slide to end the year 4.8% lower, joined by key rare earth metals such as lanthanum oxide (-17.8%) and cerium oxide (-29.5%). These price declines are hitting finished goods as well. Aircraft engines, a product that only rarely dips in price, might prove less expensive in 2015 as direct material prices drop 1.1%. At the very least, intermediate goods will pull back as a result of lower prices in the broader metals markets.

Aircraft Engines & Engine Parts USA	Share	2015 Forecast
Direct Materials	53.2%	-1.1
Forging and Stamping	15.2%	-1.9
Iron Foundries	13.9%	-1.6
Metal Fasteners	8.5%	-0.3
Other Fabricated Metal Products	8.0%	-0.8
Nonferrous Metal Foundries	4.3%	-0.1
Carbon Fiber Products	2.0%	0.4
Fluid Power Equipment	1.3%	0.6

Sources: IHS Pricing and Purchasing 2015Q2 Forecast

Technology

The technology industry is no stranger to falling prices, but cost-side reprieves are perhaps more rare. The greatest benefit for the industry comes in the form of falling chemical and industrial gas prices. Industrial gas prices are expected to drop for the first time since 2010, with a 4.4% decline translating directly into a reduction in direct materials costs for semiconductor manufacturers. Industrial inorganic chemicals will merely tick 0.3% lower, but these savings will build upon the declines from 2013 (-4.2%) and 2014 (-2.8%); in other words, peak-to-trough declines for the category will measure 10.2%. Purchasing managers need to be vigilant: chemical prices are extremely volatile, and it would be easy to miss the declines by always buying on the upswing.

Semiconductors USA	Share	2015 Forecast
Direct Materials	37.6%	-1.6
Industrial Inorganic Chemicals	17.9%	-0.3
Industrial Gasses	11.0%	-4.4
Other Fabricated Metal Products	1.9%	-0.8
Electricity Measuring and Testing Instruments	1.0%	0.2
Electrical Machinery and Equipment	1.0%	0.2
Other Electronic Components	0.7%	1.1
Plastics Materials and Resins	0.7%	-5.4
Printed Circuit Assemblies	0.6%	-0.3
Bare PCB	0.5%	0.5
Current-Carrying Wiring Devices	0.5%	0.9
Flat Glass	0.5%	1.5
Copper Rolling Drawing and Extruding	0.5%	-3.5
Corrugated and Solid Fiber Boxes	0.4%	0.7
Capacitors	0.2%	-0.7
Resistors	0.2%	0.1

Sources: IHS Pricing and Purchasing 2015Q2 Forecast

Other Manufacturing

Other manufacturing industries are also benefiting from the price reset. Categories vary from nonferrous metals, where aluminum (-2.7%) and copper (-12.4%) have dropped; and building materials, where lumber (-13.8%) is plummeting; to transportation logistics, where trucking costs (-2.1%) are moving lower. Procurement professionals should aim high and broad when they are targeting cost savings; categories, such as equipment and transportation costs, where declines have been rarer, present a better bargaining opportunity than in years past. One of the greater challenges for procurement officials in this category will be to achieve the optimal level of price cuts in categories for which they lack supplier cost intelligence, creating the possibility they will leave savings on the table.

Industrial Valves USA	Share	2015 Forecast
Direct Materials	45.7%	-3.6
Iron Foundries	10.2%	-1.6
Other Fabricated Metals	7.9%	-0.8
Copper Foundries	4.5%	-4.1
Nonferrous Forgings	4.5%	0.0

Sources: IHS Pricing and Purchasing 2015Q2 Forecast

Retail

The retail industry's broad needs leave its purchasing managers at the whim of several different price cycles. However, nearly all of those cycles are currently at or near their cyclical bottoms. Materials as differentiated as hot-rolled sheet (-25.2%) for shelving, paint (-1.9%) for shelving and walls, as well as paper (-0.2%) and plastic (-2.3%) packaging costs are declining. As such, procurement professionals in the retail industry need to be mindful of the broad savings available to them. While it will often be the case that the biggest savings come from tough negotiations on the largest categories, it is especially the case in the retail industry that significant savings can accumulate from successful price negotiations across multiple, smaller categories.

Plastic Packaging USA	Share	2015 Forecast
Direct Materials	46.10%	-6.6
Plastic Materials & Resins	36.90%	-5.4
Corrugated and Solid Fiber Boxes	3.50%	0.7
Industrial Chemicals	3.00%	-15.7
Fuels and Related Products and Power	2.70%	-22.1

Sources: IHS Pricing and Purchasing 2015Q2 Forecast

Summary

- Procurement officers are not fully taking advantage of 2015 commodity and intermediate good price declines to negotiate lower purchasing costs. While a representative sample of core commodities shows a 50% decline in prices, procurement managers have kept their cost savings targets below 5%.
- An organization that pushes for a 10% price cut rather than being content with 5% will save an extra $50,000 on every $1 million of spend.
- Because commodity prices are falling less rapidly in the energy (with the exception of oil and gas) and chemicals industries, purchasing executives in those segments might delay purchases until the bulk of price declines occur.
- IHS can help your purchasing department trace cost declines through supply chains to achieve optimal timing and cost savings.

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