Contracting:
Why Do We Keep Destroying Value?  Part I.
IACCM – Ask The Expert

January 14, 2016

Anne M. Kohler, EVP & COO
Dalip K. Raheja, President & CEO
Importance of Relationships
From Theory X / Y to Theory Z
Redefining the End Game
What Needs to Change
Importance of Relationships

“Poor Supplier Relations Costing U.S. Automakers Millions”

Rating is highly correlated to benefits provided by suppliers – first to see new technology, best personnel for support, best pricing, etc.
"Poor Supplier Relations Costing U.S. Automakers Millions"

<table>
<thead>
<tr>
<th></th>
<th>2014 WRI</th>
<th>8.76% Higher WRI than 2014&lt;sup&gt;2&lt;/sup&gt;</th>
<th>Estimated Increase in Operating Income per Vehicle</th>
<th>2014 N.A. Manufactured and Wholesaled Vehicles&lt;sup&gt;3&lt;/sup&gt;</th>
<th>Total Increase in Operating Income</th>
<th>Percent Increase in Operating Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>GM</td>
<td>244</td>
<td>265</td>
<td>$279</td>
<td>2,685,159</td>
<td>$750,197,626</td>
<td>11.4%</td>
</tr>
<tr>
<td>FCA</td>
<td>245</td>
<td>266</td>
<td>$285</td>
<td>2,317,521</td>
<td>$661,311,637</td>
<td>22.8%</td>
</tr>
<tr>
<td>Nissan</td>
<td>273</td>
<td>297</td>
<td>$276</td>
<td>947,558</td>
<td>$261,476,915</td>
<td>19.4%</td>
</tr>
<tr>
<td>Ford</td>
<td>267</td>
<td>290</td>
<td>$144</td>
<td>2,459,253</td>
<td>$354,327,079</td>
<td>5.1%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>$2,027,313,258</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Toyota’s WRI® improved 5.66% during 2014, Honda’s improved 11.86% for an average improvement of 8.76%
2. Indicates projected supplier working relations during 2014 if relations improved like Toyota and Honda average
3. Ward’s Automotive Group, Southfield, MI

Study conducted by John W. Henke Jr., PHD from Planning Perspectives, Inc.
Business Models are Changing . . . . . 

- Globalization
- Desire to enter new markets
- Suppliers drive revenue
- Customers drive cost
- Innovation is key
- Internet Of Things is here

. . . .and dependence on trading partners is higher than ever
Importance of Relationships

What do these Companies have in common?

These companies excel BECAUSE they excel at Trading Relationships.
Importance of Relationships

Just How Valuable are Trading Partner relationships?

Percent ROI Impact for Top 2000 global companies

![ROI Impact Chart]

Alliance impact on Percent Return on Equity for Fortune 500

![ROE Impact Chart]

Percent Profitability Improvement

![Profitability Improvement Chart]

Revenue generation a Percent of overall firm sales

![Revenue Generation Chart]

Source: Booz Allen Hamilton
How Valuable are Trading Partner relationships today?

Supply chain cost reduced by as much as 20%

Revenues increased by as much as 17%

On-time delivery increased by as much as 27% overall

Inventory levels reduced by as much as 50%

Inventory turns doubled

Stock outs reduced nine-fold

These downstream indicators are directly related to trading relationships

Source: Booz Allen Hamilton
Importance of Relationships

Extract Additional Value

Product Improvement Value

Process Improvement Value

Pricing Negotiation Value

Time

Value
The Only Value that increases over time is Relationship Value.
Importance of Relationships

From Theory X / Y to Theory Z

Redefining the End Game

What Needs to Change
Assumptions We Make about People Drive our Behavior

**THEORY X**
States that employees:
• Are inherently lazy
• Will avoid responsibility if they can
• Need to be closely supervised
• Need comprehensive systems of control

**THEORY Y**
States that employees:
• Find work to be a source of satisfaction
• Are self-motivated
• Seek responsibility or are willing to accept it
• Their full potential is not tapped in most organizations

This BECOMES a self-fulfilling prophecy

* Professor Douglas McGregor’s XY Theory
Theory Z

States that employees:
- Are motivated by long-term employment (commitment)
- Like collective decision making (collaboration)
- Have a moral obligation to work hard
- Like individual responsibility
- Like evaluation and promotion
- Like holistic concern for them as employees

If we change our assumptions and behaviors toward our trading partners might that change our results? Can you say Toyota? Honda?

* Developed by Professor Ouichi at University of California
The supplier holds the cards after the contract so I need to get what I can into the contract

If I tell the supplier about the decision process, he’ll try to work around it

The supplier will try to get all the money out of me that he can

The only thing the supplier won’t exaggerate is price

The supplier will not tell me any cost driver information

Does this Sound Familiar?

Common Buyer Behaviors – Theory X
Common Seller Behaviors – Theory X

Customer will beat me down in negotiations, so I will start high to have room to maneuver

Customer will talk about quality, but I’ll win on price

Some requirements will be hidden so I need to assume risk in my pricing

Customer will take advantage of any information I share

Customer wants absolute lowest price, doesn’t care if I make a profit

Sellers Think . . . .

Does this Sound Familiar?
Poll

Do the buyer and seller behaviors we described sound familiar?

Yes or No
## Moving from Theory X to Theory Y to Theory Z

<table>
<thead>
<tr>
<th>Theory X - Uneven Relationship</th>
<th>Theory Y - Cooperative Relationship</th>
<th>Theory Z – Collaborative Relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hierarchical</td>
<td>Holistic</td>
<td>Integrated</td>
</tr>
<tr>
<td>Power</td>
<td>Empowered</td>
<td>Empowered</td>
</tr>
<tr>
<td>Siloed</td>
<td>Cross-functional</td>
<td>Cross-company</td>
</tr>
<tr>
<td>Competitive</td>
<td>Cooperative</td>
<td>Collaborative</td>
</tr>
<tr>
<td>Exclusive</td>
<td>Shared</td>
<td>Inclusive</td>
</tr>
<tr>
<td>Command/control</td>
<td>Involving</td>
<td>Involving</td>
</tr>
<tr>
<td>Independence</td>
<td>Interdependence</td>
<td>Interdependent</td>
</tr>
<tr>
<td>Low morale</td>
<td>Higher morale</td>
<td>High morale</td>
</tr>
<tr>
<td>Poor behavior</td>
<td>Respect for some</td>
<td>Respect for all</td>
</tr>
<tr>
<td>NIMBY</td>
<td>Good practice sharing</td>
<td>Next practice sharing</td>
</tr>
</tbody>
</table>

### Is moving to Theory Y going far enough?
Poor Relationships - Long Term Value is Not Generated

<table>
<thead>
<tr>
<th>Buyer</th>
<th>Seller</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Longer buying cycles</td>
<td>• Loss of referral business</td>
</tr>
<tr>
<td>• Grudging vs. willing cooperation from supplier</td>
<td>• Loss of repeat business</td>
</tr>
<tr>
<td>• Loss of supplier focus</td>
<td>• Reduced purchase volumes</td>
</tr>
<tr>
<td>• Unreliable support / increased response times</td>
<td>• Increased cost of bid / longer sales cycles</td>
</tr>
<tr>
<td>• Loss of trust</td>
<td>• Loss of buyer focus</td>
</tr>
<tr>
<td></td>
<td>• Loss of trust</td>
</tr>
</tbody>
</table>

Reduction in Value Realization
Start with the end game in mind

Objectives for Both Sides:

- Increased savings/revenues
- Incremental value opportunities
- Reduction in buying/selling cycles
- Better trust
- Focus on relationship as core value
- Long term view
Importance of Relationships

From Theory X / Y to Theory Z

Redefining the End Game

What Needs to Change
Traditional Buying & Selling Process

- Define Requirements & Relationship
- Supplier Selection
- Contract
- RM - Value Generation

Step 1: Define Requirements & Relationship
Step 2: Supplier Selection
Step 3: Contract
Step 4: RM - Value Generation

The pre-nuptial

Commercial professionals have misidentified the endpoint

- End point is not the contract
- Buyer loses leverage once contract is signed
- Value is exchanged after the contract
With real end point in mind…

- Contract is an intermediate step, not the goal
- Everyone acts differently throughout entire process:
  1. Defining requirements & relationships
  2. Partner selection
  3. Negotiations and contract
  4. Ongoing Relationship Management
What Buyers traditionally do…

- Exercise their leverage up to signing the contract
  - Pressure sellers
  - Focus is to obtain best deal
  - Push risk onto the seller
- Pay less attention to value creation after the contract

“Mutuality of Interest” - Manage activities essential to capturing the promised “Mutual” benefits and to identify additional “Mutual” benefits of a partnership between a supplier and a buyer organization.
Importance of Relationships

From Theory X / Y to Theory Z

Redefining the End Game

What Needs to Change
Change the Faulty Assumptions of Buyers and Sellers to create Mutual Value with your Trading Partners!

Theory Z

- Focus on the relationship as the core value
- Create incremental value opportunities
- Increase savings/revenues
- Reduction in buying/selling cycle
Role of the commercial professional

The context under which they work – Theory Z

New required competencies

New approach and process
Change your Thinking

Better Relationships = Increased Value

Make your Commercial organization a competitive weapon by collaborating with your trading partners – Theory Z
Role of the commercial professional

The context under which they work – Theory Z

New required Competencies

New approach and process

Learn more by joining us on February 18th for Part II - “How to Build High Value Relationships Under Theory Z”
THANK YOU FOR ATTENDING!

By
Anne Kohler
EVP and COO
The Mpower Group
(630) 268-8963
www.thempowergroup.com
http://blog.thempowergroup.com