

ADAPTING TO MARKET VOLATILITY

Dynamic product-cost models
in procurement processes

In a world where the only constant is change, the role of Chief Procurement Officers (CPOs) has become increasingly challenging.

The global business landscape, shaken by events such as wars, climate change, and political unrest, is more volatile than ever. This volatility is reflected in large swings in input factor costs such as energy, labor, industrial and food commodities necessitating rapid adaptation on the go. CPOs must transform regular planning and forecasting into agile, adaptive tools capable of responding swiftly and effectively to ever-changing market conditions.

The modern CPO grapples with a lack of cost transparency, making it difficult to predict and understand the fluctuating costs of commodities impacting their supply chains.

Their role has evolved beyond traditional responsibilities, now requiring them to steer their companies through turbulent times.

This includes managing a supply base marked by high volatility, providing accurate guidance on cost development and future expectations, and negotiating with suppliers with a clear understanding of input cost factors.

A critical aspect of this role is the use of should-costing and cost impact modeling. These models have gained prominence in successful supply chain management, providing insights into both current developments and future forecasts.



RISKS FOR CPOS

Without adopting sophisticated product-cost modeling, companies face significant risks. Planning becomes more challenging when procurement is misaligned with other departments due to a lack of clear cost insights. Decision-making suffers in the absence of transparency, leading to potential miscommunication and misalignment with internal stakeholders. This has direct implications on EBITDA, resulting in profit erosion.

Traditionally, CPOs have relied on static product-cost models, often managed through the files of Excel or procurement software. While these models are core in industries such as automotive, their application needs to expand to manage the volatility in other sectors, such as retail and consumer goods.



AI ADVANCES

The advent of generative AI marks a pivotal shift in this landscape. It enables the development of dynamic, more accurate product-cost models at a lower cost. By leveraging AI's capabilities, these models become not only more responsive to real-time market changes but also more cost-efficient to produce.

Dynamic should-cost models offer clear advantages. They provide rapid, clear cost analysis, tying indices automatically to price changes, thereby enhancing decision-making processes.

The use of AI in accelerating cost modeling generation is transformative. It allows the shift from a few high-effort models to many models created in a short period. Keeping models updated with real-time cost drivers and outlooks reduces effort significantly. Additionally, connecting these models to real-time risk monitoring sources enables a high level of automated risk assessment.

THE ALIXPARTNERS APPROACH

Building on these technologies, AlixPartners employs three key methodologies for cost modeling

1

TRADITIONAL (BOTTOM-UP) METHODOLOGY

This robust approach is utilized to develop sophisticated product cost models with a high degree of accuracy. It is most suitable for scenarios with a limited number of unique products that demand highly accurate, point-in-time pricing. The traditional method necessitates significant effort and time to gather either detailed raw material processing specifications or required information through product teardowns.



2

GENERATIVE AI METHODOLOGY

This method proves effective in handling a large volume of products with basic specifications, where cost models that are directionally accurate are deemed sufficient. It offers a scalable solution for rapid cost estimation across a broad product range without the need for intricate details. AlixPartners is able to use external data as well as own libraries of approximately 20K cost models that are used accurately calibrate and validate the models.

3

MACHINE LEARNING BASED SHOULD-PAY

This approach employs machine learning models to identify key attributes within a product family that influence pricing, making it ideal for products that share similar attributes but differ significantly in specific characteristics. It is particularly useful when there is an abundance of purchase order data available. The "Should Pay" methodology can provide insights for supplier negotiation strategies or predict prices. Similar to the Generative AI method, the "Should Pay" methodology demands a medium level of effort and time investment, also within a few weeks' timeframe.



CASE STUDIES

Our expertise in swiftly crafting detailed, dynamic should-cost models has helped many of our clients realize substantial returns on their investments:



SHIPBUILDING FOR CRUISE SHIPS

By employing Generative AI for should-cost modeling, a shipbuilder was able to develop detailed cost models for over 50 industrial components, revealing long-term cost trends and the significant commodities impacting costs. This enabled effective vendor negotiations, leveraging a solid factual basis to understand cost discrepancies and optimize pricing strategies.



BIG-BOX RETAILER FOCUSED ON VALUE PRICING

Facing a downturn in core operations, this retailer utilized Generative AI to quickly generate cost models for thousands of SKUs, integrating machine learning to optimize inventory levels and mitigate out-of-stock scenarios. The insights provided critical support during sales cycles, enabling scalable cost gap identification and facilitating negotiations to improve margins and counteract COGS inflation.



PARTY SUPPLIES AND NOVELTIES RETAILER

Emerging from bankruptcy with a goal to reduce COGS, this retailer showcased the capability of Generative AI in augmenting specifications from various data sources and developing cost models that informed the identification of alternative suppliers. The approach not only streamlined the supplier selection process but also initiated a proactive strategy for cost reduction through detailed RFI processes.

ADAPTING TO VOLATILE INFLATIONARY TRENDS

Regardless of how inflation is trending, companies can utilize dynamic product cost models to create value-driving negotiations with their suppliers. In fluctuating markets, dynamic should-cost models empower companies to adaptively manage supplier negotiations, leveraging real-time market data for both defensive mitigation of cost increases and offensive strategies to reclaim costs when prices fall.

FIGURE 3: PRODUCT (CATEGORY) COST DYNAMICS



Defensive approach to cost increase requests submitted by suppliers as underlying costs climb

Cost increases need to be **tracked closely with Cost Justification Forms (CJFs)** required for suppliers to populate to gather product costing information and increase rationale

Negotiation packs created to mitigate a portion (or all) of the increase based on the commodity trends, market data, and competitive positioning within the assortment

Offensive approach where companies are monitoring downward commodity trends and pursue the 'claw-back' of past cost increases based on market movements

Dynamic product cost models will enable companies to pinpoint which suppliers they should be engaging and, more importantly, when, based on product compositions.

Models will **'alert' or 'inform' companies** by forecasting market trends, enabling them to act accordingly via assortment optimization, hedging, forward buys, etc.

CONCLUSION

Dynamic product cost models can enhance negotiation leverage with dominant brands by uncovering the value chain, allowing for discussions focused on collaborative benefits and partnerships. This strategic insight shifts negotiations beyond mere cost to mutual value, even when dealing with brands that have a strong market position.

In today's environment, AlixPartners' offering extends beyond model creation to include guiding CPOs in adopting future-forward technologies and methodologies. The current market scenario makes it clear that dynamic should-cost modeling is not just an option, but a necessity to remain competitive. We encourage CPOs to review their current strategies and consider the benefits of adopting advanced modeling techniques, partnering with experts who can provide the necessary edge in navigating these challenging times.

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ABOUT US

For more than 40 years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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