The Deal Room Podcast

Episode 154 – Why procurement should have a seat at the table in any acquisition

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Transcript

Joanna: Hi, it's Joanna Oakey here, and welcome back to the Dealroom P odcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal. Now today we have on the show JD otherwise known as Jonathan Dutton from JD consultancy, who is here to talk to us all about the role of procurement in mergers and acquisitions. In fact, we're talking about the role perhaps the procurement should have, rather than the role that procurement does have and in particular, we're driving to a discussion all about what the business benefits are that investors are after from an acquisition and why procurement is an afterthought in the M&A process. But why it's so important that they're not aftethought. JD shares some great stories of where he has seen this from the frontline himself, we discuss what role procurement can have in the due diligence process and what investors should really be looking for. And we also look at what else procurement can bring to the table other than just cost. Well, that's it. Buckle in. Here we go for a discussion with JD all about the role of procurement in M&A.

Joanna: JD, thank you so much for coming on board. I always enjoy having you on the podcast and I think today is going to be fascinating, interesting, full of lots of insights, as usual, as we talk about things together

Jonathan: Jo, we are going to talk about procurement and most people instantly fall asleep when they hear the P word and most people spell it wrong. There's two E's in procurement.

Joanna: Well, yeah, I mean, to be fair, most people think they're going to fall asleep when they when when they hear that someone's going to be talking about legal topics as a whole. So legal and procurement. Oh my goodness, we've got like the double

Jonathan: I've worked for an entrepreneur for five years and he used to say, procurements are for people that found the law too exciting.

Joanna: I love it, JD. Okay, well as if -- we're gonna have fun. I can tell. I can tell. Okay, so. So we've got an interesting discussion today because it's not, I guess, an obvious connection, the concept of M&A, talking about M&A and procurement. So maybe let's give a bit of the backstory, JD. How did we get here? Why are we talking about M&A and procurement.

Jonathan: In one of our conversations I mean, Jo, and I think I might have mentioned there's a number of business benefits to any acquisition, which the Big Cheese is always focused on. And they're always centered around developing a strategy for business vertically or horizontally integrating or just eradicating competitors, perhaps, or certainly enhanced profit. And one of the assumptions they tend to leap to is that we can cook the cost base of the company we acquire, or perhaps get some synergy between our cost base and theirs. In other words, or slash the cost. And they just assume that they can do that. And working as a head of procurement in several companies over a long time, I always ended up finding out afterwards that they've made that assumption and being given a target not agreeing a target. And in some cases, the acquisition lived or died or failed or succeeding based on our ability to cut costs. And nobody had actually done any real work or any thinking or any tests or any analysis of how we might be able to do that. And what that cost figure might be they just put two and two together and got five.

Joanna: But do you know what this is, I just want to highlight this point, because it is such a good point. Because, you know, there's lots and lots of statistics about at the moment, but they go somewhat likely somewhere between, you know, 50% to 75% of acquisitions are deemed a failure, whatever failure actually means, but you know, essentially not achieving the objectives that they set out to achieve. And usually this is for these, these factors relate to these statistics relate to larger organizations, like the type of organizations that have procurement divisions within them. And you're absolutely right, one of the success factors is around the amount of savings that are about that are able to be achieved by merging exactly.

Jonathan: Always on the list.

Joanna: And I guess what you're saying here is how often is procurement actually engaged? And we're hearing not very often. And, you know, maybe this is part of the secret sauce of why there is a high failure rate, I think we're onto something JD I

really, like this is cutting edge stuff, isn't it? You're onto it. We're onto it.

Jonathan: It's common sense really, I mean, most procurements are common sense, really focused common sense. But, okay, it's very difficult. And I understand that an acquisition process, especially where public companies are involved really has to be very confidential, you know, you're only going to spike the price if everybody finds out. And so it's necessarily a unique few in a room who have a closely guarded secret. So the assumption will cut costs as a primary driver of the benefit of an acquisition, certainly in the short term. Short term benefits rack up the winds, as far as shareholders are concerned in early days, although the longer term strategic benefits might be the real driver of an acquisition decision, but we overlook the due diligence. So above all, I think, a failure to consult your in-house expert, like on costs is a failure of due diligence. And of course, they don't do the spend analysis or come on to this perhaps, in the target company. Assume, a part of the assumption is hubris Jo, you know, it's, it's me, I'm great. Therefore, we must be right. And I'm great. So I'll be able to get to know a wonderful negotiator and get 10% of anything. And then, you know, 10% of adressed spend is very difficult target in the bond world. And so not a great deal of money when you're talking about big companies cost. So I guess my fundamental point is, you know, cost is a primary goal of an acquisition, but it's very rarely part of the due diligence process, and I fall victim to this a few times.

Joanna: And can you, I just love for you to paint the picture. If you can just, you know, go back to one of these examples, and just talk us through the example because you shared one with me. And I think it's a great story. I just love it, if you can share

Jonathan: I was young and I've been promoted in a big company, I was one of the group of 150 Top 150 managers in the company. I was number 147. So I was allowed to sit at the back. And we always got the briefing off the CFO at 11 o'clock in the morning, after you've done the analysts, after you've done the financial press, and we do a third presentation and that was for my managers. So we were third to find out what was going on. And of course, my good financial PR people have leaked all the news the day before. So I was literally, I came down in the morning, the newspapers, the old days, you know, the newspaper was on the doormat. In those days, not on an iPad, iPads or anything. I opened the newspaper and there was the CEO of the company saying he'd been personally shocked by the procurement scene that they would save 100 and 30 million pounds. And it was looking forward to heaven detail funds, answers to the analysts in the session the day before. And of course, I didn't know anything about it. I was just the head of procurement. choking on the gold flakes. And of course, I get ready for Derek's presentation at 11 o'clock to see yet again, another one of Derek's gaps agrees graphs always have a bloody great gap. And it was always a close the gap initiative in this case, the cost that he lost and the cost that should be and that's how the story worked really. So 130 million at Wells.

Joanna: And so JD, then you had to go and close the gap.

Jonathan: Where did the hundred and thiry come from? That was the first question and it was made up by an analyst. And it goes a bit like this, you know, I just pick round figures to make the point. And I'm not allowed to say it was a one of those guys, that was a billion dollars a year with a brain the size of a planet, it makes an awful lot of assumptions. And I actually met him at one point, he was really

struggling, really one of those guys where he's a lot smarter than you, you know, so you've been talking to him for five minutes, all of a sudden, it appears he knows more about it than you do. And it's your topic, you know? So, you know, just for the masses, I don't know, we were a $300 million company, and they're 100 million dollar company. And, you know, our cost base is 150, or something that is, I don't know, 50 or something. And we'll put the two together and say, 10%. Yeah, I'll be fine. I'm sure we can do that. Anyway. So then we got the staff base as well. What are we spending? I don't know, how many staff are we got? Again, if it was 50 million was that together? Okay. 10%? That's right, we'll make it 20%. And then they take a number. And let's say they're all on master the worked out of 30 million. So even if it was not quite enough, well, you really make it compelling because we couldn't put a dividend on that in year two. So let's just just round it up a bit. So make it 50 million, so 60, make it 60. All right. So 11% so they can do that. we can start with that person. And that's it. That's how we go.

Jonathan: That's how they did it. And of course that meant in my context on that in that job on that day. 100 and 30 million pounds of savings in the first two years to make the whole spreadsheet work and ready to justify in the short term, a person say an acquisition, which was driven for strategic reasons, not not for cost reasons, it was just the cost was used to justify the first two years. It was all based on the assumption they could cut the cost base by 11%, and stupid error and get that done by Friday. The reality what your face is quite different, of course, because there was no due diligence done at all, on the cost base, all the due diligence was done on the balance sheet, not asset stripping, but asset acquisition. I got the sales directors car, by the way, the company we acquired, that was going begging, so I thought, Man, I gotta give him the car, he was a shut me up. So anyway, you know, I got rid of my poxy little car and got this nice car loan by the sales director and, Paul, unfortunately, lost his job.

Jonathan: But what should have happened was, you know, again, we go back to it's a secret project, we can't do this in public. We can't do it in a way that reveals what we're doing. But what should happen is a spend analysis now you can nowadays, get a download on a memory stick from any P2P system, which will give you a basic granular spend analysis data, it's basically a list of everything you spend, listed by the amount by supplier. So descending list of, I don't know, 500 to 5000, suppliers, depending on the size of a business listed in order of annual spend. And so we can see our number one supplier in terms of spending the sum. So we spend, you know, four and a half million dollars a year with them on widgets, and you work down the list. And what you always find in procurement, always is operator. And so effectively 80% of your spend is with the top 20 suppliers or your top 20% of your suppliers. It's usually not 80-20. It's usually 70-30, or sometimes 60-40. And that depends on the nature of the business. You're buying direct goods and services or the raw materials, components, goods for resale. That's direct stuff, or you're only buying indirect and everybody buys indirect. There's typically 14 indirect categories. And these are the expenses that every business incurs, largest home that nobody wants to spend money on. It's office furniture, it's IT hardware, it's the telecoms bill, its travel insurance, or in categories that are the staples of every office, nobody wants to spend money on this stuff. I work my own business, JD Consulting. We don't want to spend money on this stuff but we do. Yeah, on every of the 14 categories. You do Jo. And so does BHP Billiton. You spend a lot more than those. So it's an easy target for savings. So

whenever procurement is addressed, one of these categories of indirect spend, we call it addressed spend, and unaddressed spend, the last bastions of spend best defended by their stakeholders, usually legal services spends in their job.

Jonathan: Their capsules are very good at passing away procurement. I'm the only person in the world qualified to decide which legal firms we'll use even though we're outsourcing contract leases, you know, taught some basic stuff. It's the same when the CFO defends the choice of auditors, marketing's another one. So these are areas where you've got powerful people in the C suite who defend their right to choose a supplier. And gradually they all lose in the end, in every debate that the market test, the choice of supplier and hopefully get some sort of reduction and other benefits as well. So the spending analysis processes is regimented nowadays. It's a desktop program, it's in the cloud. It used to be Excel based in the old days, few people do it, most people using Power BI or Tableau. They're desktop tools, you can do it yourself. Any semi competent, IT department can help and most of them are semi competent. And so even the smart kid in the office can do it. But you do need a bit of gray hair to ask the right questions. So once presented with the data, the kid in the office can't tell you why the data skewed that way. Oh, that's what the data says. Yeah. Well, why would that be so, son? And they can't tell you, the gray hair can spot that.

Joanna: So firstly, just rehashing for our listeners, the first thing is to do a spend analysis, which sounds fairly obvious, doesn't it? But I you know,

Jonathan: And it was quite easy as well

Joanna: But notwithstanding the obviousness of it is clearly missed in many instances. So firstly, do a spend analysis but secondly, make sure you understand what is coming out of the spend analysis right?

Jonathan: Well, the spending analysis will present contradictions. Why are we spending X on a category in this location and using certain suppliers and over here we're using one supplier and spending more. How does that work? So you do get a lot of presentations of curious solutions like that to solve on spend analysis. But what you're really looking for is the opportunity number. And the way that works is you pick a couple of categories you're spending a lot of money on, and you pull up a couple of purchase orders or credit card orders or whatever, verbal orders, the invoices, pick those invoices ring a few people from Google and see what they're charging the same thing. And usually you can find something cheaper somewhere. And yeah, just compare the price you're paying in that instance, with the price you got off some bloke rang up this morning, and times the gap by the volume and there's your opportunity. Now good people use that opportunity number like a lightsaber, you run around the business game, we could save $30 million, if only you'd let me by going to market on this category. And then you know, that basic process is the opportunity analysis is called and justifies the effort of procurement.

Jonathan: But in this case, you know, if you pick your top 20% of your spending items, that's where 80% of you spend always is, and sample test a few market examples you can see, gauge what's been addressed, what hasn't been and a quick conversation with the people in procurement there, I'll tell you what the got rounds and what happened. And from that, you can start to make assumptions that are a lot safer. So an unspent that has been addressed, is pretty rare to get good savings over

2 or 3% because you've already been out to market one every year, or two or three or several times, you know, your savings tend to zero over time. There's diminishing returns at work. However, in categories, which you've not addressed before, you've not had time, you've not got to it yet, you're only a small procurement team or the general counsel with letters, and all of a sudden you've got access, then 10 cents easy, double digit savings alone and your first go to market exercise for a new category. So, you know, obviously they average out but what you can't do is say let's just say 10%, across everything. That's got to be doable, well it isn't. And certainly not a big spend and that's a big number. And if that big number is used to justify an acquisition, certainly in the short term to pacify shareholders, or stakeholders that the instant success of an acquisition is there to see. And the strategic games are a bit more difficult bit more nebulous to see. And that's a risky strategy, I think. So that's why I argue procurement should be in the room for the due diligence process. And it can be, you don't have to declare how many and just say we'll give us a download in CXZ format, an Excel format of spend by supplier in descending order for the last year. And I could work with that. Give me that. And we can make a list of it from there. And that would be a lot safer than making blanket assumptions, which are usually let's say, 10% off, and that's where the hundred and 30 million number came from.

Joanna: Hmm. So we've talked about the analysis. But maybe let's talk about then what else it is that, where is it that you know, maybe savings can be found? So you've talked here about, you know, analyzing where the biggest spenders and understanding whether or not the best deal has been struck with those suppliers or whether there's other supplies around that might be able to provide

Jonathan: Well, that's a good question Jo, I mean, where the savings come from, or what people normally do is cut people headcount, their most instant savings, especially across the branch of the year, we can take the cost of departure in this financial year, an exponential years are massive saving against budget. And so that's what people normally do, because cutting everyday cost is actually quite difficult, stopping on a sixpence. And people tend to offer draconian rules, right 10% of every budget, and that's a terrible way of cutting costs, or, of course, abstinence, which is perhaps the most popular one, the travel freeze, the recruitment freeze, the training freeze, people pick

Joanna: And all of that being used right at this moment.

Jonathan: And no thought required. So you can be much more targeted. But you know, of course, the top management trust the middle management, don't they. You know, the middle management defends their bureau, defend their action, defend their budget. With that stupidity at the end of the financial year, where people are quickly spending the budget in case they don't get the same next year. And surprisingly, that still goes on. And it's a measure of an immature spending and procurement, an immature management culture that still lets that happen. But there are other benefits from procurement as well. It's not just about costs. And then we've seen a really good example recently, I think with the COVID crisis.

Joanna: Well, talk us through that. So what are the other benefits fact that procurement can bring?

Jonathan: You know, a lot of people saw on the TV during the crisis in the early days, the crisis, and we're seeing an ongoing basis here in Melbourne at the moment, shortages. And you know, where they come from is, of course, long supply chains. And, you know, Australia being at the tip of the global supply chain generally, and being a service based economy, we import a massive amount of things we depend on a lot of those supply chains started to break down and become and to some degree has been a victim of its own success. And what I mean by that is, we've become vulnerable because we've made perhaps one-eyed decisions in the past based on price. So there's several good examples. Recently, I'm on a series of roundtables with Chief procurement officers, CPOs, and they were confessing. In some cases, one guy had said that they sourced a vital component from the dominant Republic, which they assumed was Africa. But it's not of course, in the Caribbean, it's quite difficult to ship stuff from the Caribbean. Vital components. Why did they do it? Well, it was cheaper. And they got their global player, we're a global business, we took the global cheapest, and that's all well and good when you shipping it to Jalon.

Jonathan: Meanwhile, another manufacturer here in Melbourne produces bottles, and they source their bottle tops, particular shade of blue that the marketing assistant insisted on from Milan. So nothing came out of Milan for that first two or three months of the crisis. So perfectly good manufacturing process trucking away in Australia with no bottle tops. So that's a stop. And of course, everyone in manufacturing knows don't stop the line. The bottlenecks go on for years. And the cost of that goes on for years. So lots of examples were very vulnerable to little pieces of outside supply that they made on price decisions in the past or marketing decisions. And no one had stopped to ask for where's the risk in that. So what we're now seeing is a lot of procurement team scrambling very quickly, and to if you like, put their finger in that dike if you'd like to stop that problem. And that looks like building buffer stocks on shore here in Australia. It looks like reassessing their distribution and warehousing the stock, it looks like a dual sourcing, not single sourcing, it will keep the guy in the demonic Republic. That's all well and good. But her over here in WA, well sure, she can give us a good price. It's not as good, but it's a bit safer bringing it over across the number perhaps. And we're seeing people reshoring. And so we're not offshoring anymore, actually, we're bringing it back on shore, because it's just too precarious. Our business depends too much on that strategic supply line, we're seeing redefinitions of what strategic supply line is. My definition is very simple. If our business suffers within a week, because we've gone without that part or that supply line for a week, then that's a strategic supply line. And a lot of businesses in Australia have only got 20 or 30 rooms, you know, so you can be quite proactive in how you manage those 20 or 30 supply lines.

Joanna: Yeah, I think and I think this is a really interesting point that you make, because due diligence in an M&A environment is generally thought of as financial legal, obviously, technology, you know, certainly. And, you know, quite often people, but procurement, I can see not just we're not just talking about spend, and can we achieve the savings that we're hoping to by merging these two entities? What is the risk? Is there risk sitting in the supply chain of our target?

Jonathan: There absolutely is and COVID has shown us that. There's also dependency that in another way.So we talk in procurement about SRM. It's a strategy, a supplier relationship management, we positively and proactively build good relationships with suppliers we depend on and our principal strategy for our top 20 or

top 30 suppliers is SRM. And when you build a supply line across continents based on SRM, when the buyer changes, and acquirer comes in got ruined, because you never use us, we got a new one if deal with any future and that was all the time. And, you know, I guess the supplier faces a choice. They had a good relationship with JD, you fired him. And look, you know, to be honest, this business is a bit marginal for us. We're going to ship stuff over a long way. And we kept going because we felt loyal to the business but actually this has given us a chance to reassess this. So you can't just assume that strategic supply lines are static when you acquire a business and I think a more strategic perspective on the supply side is warranted certainly post COVID. Before you acquire a business, you've got to be clear on what the supply side implications are. And a short piece of work usually is enough to actually cast an eye over the supply side in terms of cost synergy, in terms of supplier risk and supply chain management.

Joanna: Okay, so JD, I have a question for you. Do you think that you can put together for our listeners, a really simple little checklist of the sorts of things that they should be thinking about from a procurement perspective when they're, you know, looking at acquiring a business.

Jonathan: Yeah, I can certainly do that. And I got a little download sheet actually, which I can let you have. And listeners can download, built around cost, stock and supply, three critical questions to ask yourself before you go into an acquisition.

Joanna: Absolutely fabulous. That sounds like a really valuable download. So we'll link through to that in our show notes. And I'll tell you a little bit later about how you can get that download. So okay, JD, summing up. Is there anything we've missed in this discussion? I think it's been a really great discussion about some areas that I think, you know, are overlooked, obviously, in the M&A environment.

Jonathan: There's three skills that procurement people can help any acquisition with. I think the first one is fairly obvious. They're practice negotiators. The second one is they're very good at supplier appraisal. So we got companies as potential suppliers. They've got to establish process and due diligence process for doing that. And that might help on any acquisition targets. And of course, they're pretty good at risk management grounds and risk profiles, which is part of something that falls out. That's a paraphrase and process. But as a takeaway message, Jo, I might offer the idea that most acquisitions are built on the idea of synergy two plus two, yeah, five. One of the assumptions that underpins that is the idea that the magnificent me can cut cost because I'm such a great negotiator. I'm quite objective about this. Surely, we can cut costs, but don't assume that two plus two equals three on the cost side. Just because you put two cost faces together doesn't mean you can cut a lot. And most people are building the assumption account. And I just argue that for a little bit of effort, you can test that assumption and get a much more accurate feeling for what the potential is, for two years saving on emerging in two cost basis.

Joanna: Brilliant. JD, I absolutely love it. If our listeners want to reach out to you to get some assistance in this DD and this analysis that they are now going to do. How do they find you?

Jonathan: On jdconsultancy.com.au or LinkedIn, Jonathan Dutton or on Twitter recently, but the website will do.

Joanna: I love it, JD. I love it. We will of course be putting links to JD in our show notes, and on our website, so make sure you check out the show notes if you want to link through to JD. JD, I just want to say a massive thank you for coming on to the Dealroom Podcast.

Jonathan: You're very welcome. And doing a podcast impresses my teenage daughter enormously. So I'll tell her know it's on Spotify, and she'll be very impressed.

Joanna: I love it. JD. I've run out. Thanks, JD.

Jonathan: Thank you very much, Jo.

Joanna: Well, that's it for this episode of the Dealroom Podcast, where we discuss what role procurement should have in mergers and acquisitions. If you'd like more information about this topic, then head over to our website at www dot the dealroom podcast.com where you'll be able to download the transcript of this podcast episode if you're one of those people who just loves to see the detail in writing. We also have a great download there for you that JD has put together all about the checklist in using procurement to analyze spend and potential cost savings in an acquisition and on that website. You'll also find details of how to contact JD and also how to contact our lawyers at Aspect Legal if you or your clients would like to discuss any legal aspects of sales or acquisitions. Of course, we've got a range of services to help guide businesses through acquisitions and through exits and we work with clients both big and small so don't hesitate to book an appointment if you would like to find out how we can assist.

Joanna: Well that's it for today. I hope you found this topic interesting. I certainly thought it was a really interesting look at an area that is clearly often forgotten in the acquisition process. And of course as usual, if you enjoyed what you heard today, don't forget to hit that subscribe button and leave us a review. Well that's it thanks again for listening in. You've been listening to Joanna Oakey and the Dealroom podcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal. See you next time.