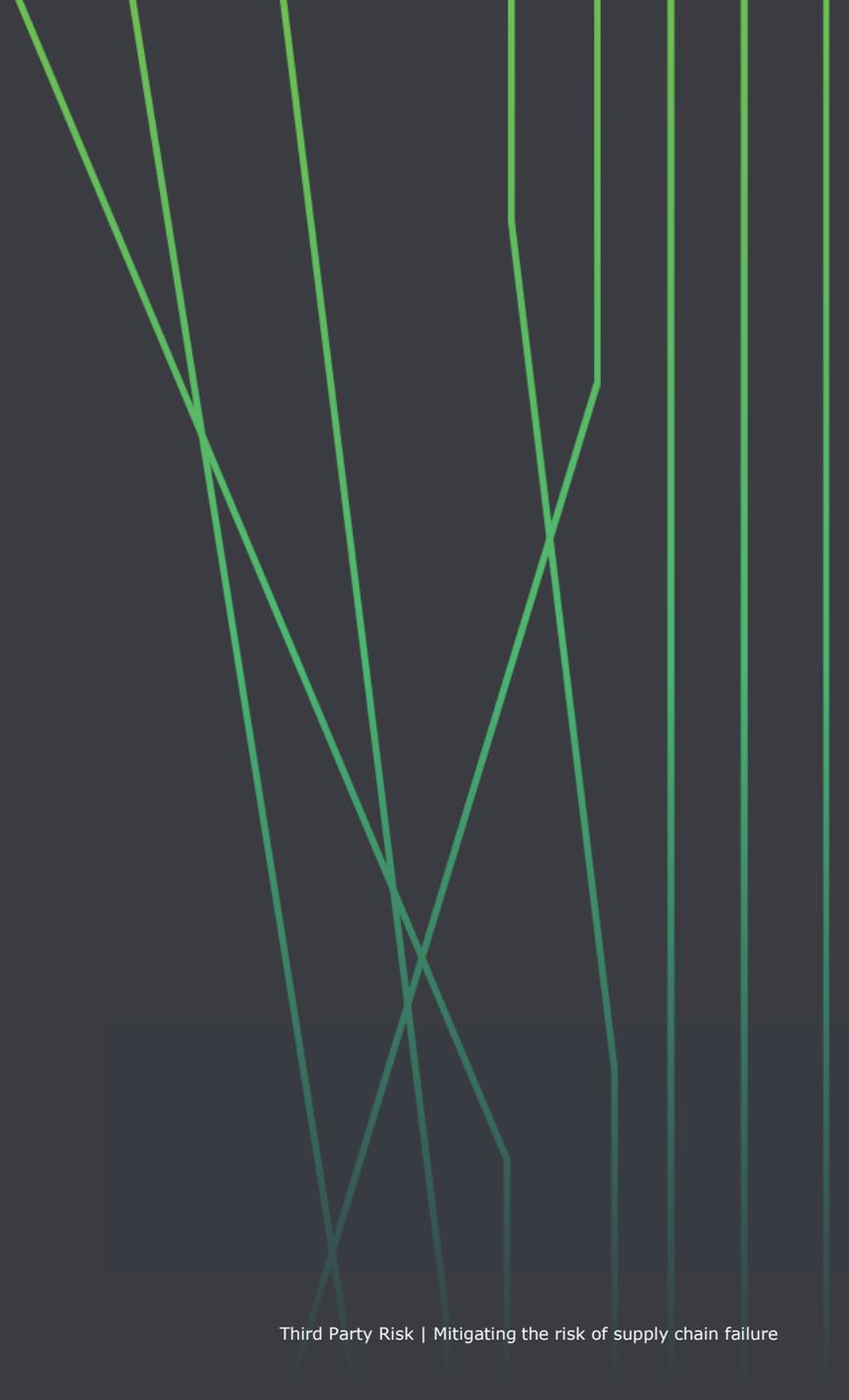


Third Party Risk:

Mitigating the risk of supply chain failure

A decorative graphic consisting of several thin, light green lines that cross and intersect in a complex, abstract pattern on the right side of the slide. The lines vary in length and orientation, creating a sense of movement and connectivity.

Supply chains
worldwide are more
vulnerable than ever

Vigilant monitoring and early risk identification are crucial to mitigating the impact of financial credit risk in corporate value chains.

As corporates increasingly seek to improve their margins through cost reduction amidst rising commodity prices and transport costs, suppliers are being caught in the middle. Moreover, failing business models and the impact of technology are driving whole-scale changes to many industries, resulting in widespread supply chain disruption. As the world braces itself for an economic slowdown, and as highlighted in our latest CFO study, the tension in supply chains is increasing.

“In 2019, business failures are set to rise for the third consecutive year (+6% y/y). The softening economic momentum, coupled with the global tightening of financing conditions, will drive up insolvencies in a majority of countries,” as stated by Euler Hermes, Insolvency Outlook, January 2019.

The failure of a single supplier even deep within the supply chain can trigger a production crisis. Yet in a recent Deloitte extended enterprise survey, over 1,000 senior executives from 19 countries acknowledged that they lack the skills and the resources to manage this risk effectively.

59% of OEM disruptions are caused by Tier 2 suppliers

30X the number of disruptions are caused by Tier 2 vs Tier 1 suppliers

60% of surveyed executives have little or no confidence in managing third-party suppliers

Growing financial pressure on suppliers is manifesting in failure as global insolvencies set to increase in 2019, placing many corporate value chains at risk.

Failure of a critical supplier can have huge financial, operational and reputational impacts on its customers

Reliance on third-party suppliers through complex cross-border value chains, just-in-time deliveries and faster production schedules all increase corporates' vulnerability.

Symptoms of stress are often financial, but can also be evidenced by operational issues:



Decline in operational performance

- On 'stop' with suppliers
- Reduction of credit insurance
- Difficulties fulfilling orders/delivering on time and to quality
- Management time taken up fighting fires/managing stakeholders



Changes to regulatory environment

- Short-term cost reduction programmes
- Trade wars
- IP protection
- Environmental tariffs
- Political risk
- Impact of reputational damage



Challenging markets

- Declining market share/product
- Increased competition
- Inability to pass on raw material price increases
- General consumption trends



Business specific

- Loss of key customers or overreliance on critical suppliers
- Significant or increasing staff turnover rates
- Large loss-making contract/material litigation
- Unsupportable debt structure/deterioration in security
- Off balance sheet obligations, including pensions

Identifying what critical goods and services are provided by third parties is the first step to a successful risk mitigation strategy. Having a robust monitoring approach around the key risks impacting these third parties will build supply chain resilience.

Questions C-level executives and their procurement teams should ask themselves:

- Have you identified all key third parties that provide you with a critical good or service?
- How often do you monitor the financial performance of these third parties?
- Are you satisfied that you receive timely data to be able to accurately monitor credit risk?
- Do you understand your suppliers' operating environments sufficiently to identify potential vulnerabilities? For example, customer concentration risk at their end, dependencies down the supply chain and changing industry dynamics.
- Do you maintain an active watch list of third parties that are perceived to be underperforming?
- Do you have in-house capability to rapidly intervene if a key third party is perceived to be at risk of failure? On site and abroad?
- What is your continuity strategy if one of your key suppliers fails?
- What other non-financial risks do you regularly monitor in your supply chain? For example, compliance with environmental and labor safety standards, cyber risk and regulatory risk.

Early engagement with suppliers facing financial challenges increases the chances of a successful outcome

By the time a business is at the point of financial failure, it is often too late to turn the business around without significant financial investment.

Early detection of credit risk can significantly reduce the impact of supply chain failure because:

- The earlier financial stress is identified, the greater the number of organic turnaround options available
- Businesses are more likely to still have access to funding to implement structural changes to their operating model
- Businesses may still be able to explore a regular M&A

Proactive intervention can provide suppliers with the support and clarity that they need to self-rescue. Typical corporate challenges for a business in financial distress include:

- Having the skills and resources to deal with the stress in the business
- Lack of clarity on options/way forward
- Conflicting workloads (firefighting)
- Need to make difficult decisions
- Pressure from stakeholders

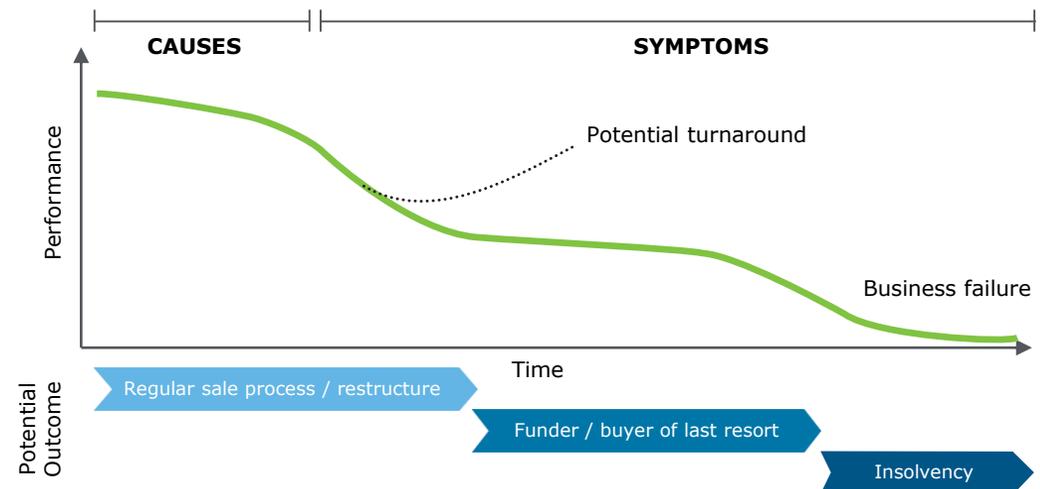
Risk of failure or serious disruption of the supply chain should be prevented at all times. This requires real-time monitoring with strong diagnostic analytics and the ability to anticipate risks with clear interventions to solve them. External advisers can bring global implementation support to help corporates quickly stabilize third parties.

Supporting a supplier through a turnaround phase is typically significantly less costly than having to fund continuity of supply once the business is insolvent.

Lessons learned: The failure of a tier one supplier in the UK automotive industry recently cost two OEMs £7m to secure ongoing continuity of supply in Administration. Had the risk been spotted earlier, there may have been more cost-effective solutions to explore.

Causes vs symptoms

Early identification increases the chances of a successful outcome



Deloitte's market-leading Third Party Risk team

At Deloitte we combine expert financial and operational restructuring skills with deep sector knowledge to deliver critical insights into the financial health of your key third parties. We draw on our experience of being the key advisor to companies in financial distress around the globe. We spot early signs of underperformance quickly and take action to protect your value chain.

We deploy situational skills focused on:

- Identifying suppliers and other third parties that are business critical
- Understanding a third party's financial position and the implications for your business
- Contingency planning to enhance supply chain resilience
- Implementing mitigating actions that minimize business disruption and brand damage

When it comes to supporting our clients, our work can be broken down into three main areas:

Risk identification and contingency planning

Do you understand where the business is reliant on third parties to deliver critical goods and services?

What does the business really value and want to protect?

Extended enterprise risk management

We help clients to understand which third parties they rely on, what they do for them, the risks posed and how they are being managed, ensuring that the right measures are in place to select appropriate third-party partners.

Contingency planning to build supply chain resilience:

For critical goods and services, we support putting clear continuity plans in place for third-party suppliers and will work with our clients' legal teams to ensure that appropriate contractual protections are in place.

Credit risk assessments and monitoring

Do you really understand the financial health of your third-party partners?

Credit risk assessments

We engage directly with your support network to conduct financial health checks to support procurement decisions, shape outsourcing strategies and perform interim health assessments.

Risk monitoring

We customize our screening and monitoring service, which has been applied by leading multinationals to screen and continuously monitor new and existing third-party suppliers.

Crisis response

Do you have the necessary skills and resources to respond if your value chain is threatened with the risk of failure?

Crisis response:

Where a third party is considered at risk of failure, we can mobilize experienced, professional restructuring specialists within 24 hours, leveraging our global network to quickly assess viability and options, identify a preferred action plan and lead effective engagement with stakeholders to minimize disruption.

Deloitte has the global reach, credentials and market-tested solutions to be your partner for Third Party Credit Risk

Our deep restructuring expertise helps to protect value through smart risk identification and rapid assessment of businesses at risk of failing. Deloitte’s ability to deploy financial and operational restructuring experts within 24 hours on a global scale enables us to be a trusted partner in volatile times.

Our global network applies operational, financial and business sector expertise to tailor effective solutions to supplier and credit risk issues, including:

| | | | | | | | |
|---|---|---|--|---|---|---|---|
|  |  |  |  |  |  |  |  |
| Screening and monitoring expertise | Business reviews | Performance improvement | Liquidity management | Implementation proficiency | Chief Restructuring Officer (CRO) and interim management services | Accelerated/distressed M&A | Administration/insolvency advice |

These and many other services make Deloitte an unequalled partner in helping to align suppliers, manage complex situations and secure the financial health of your supply chain.

Deloitte further helps clients manage credit risk with:

- **Dedicated risk advisory specialists and restructuring experts** capable of assessing inherent risk, control frameworks and supply chain resilience
- **Customized screening and monitoring service** to provide early warnings
- **Industry experts** providing insights and process know-how on the range of sectors most likely to be affected in a downturn
- **Seasoned restructuring specialist** to review prospects of business and options available
- **Situational experts** to quickly assess the financial viability of a supplier at risk of failure, implement interventions and support an effective engagement with key stakeholders to minimize the disruption

Case studies

Case study 1:

Quick action forestalls catastrophic business disruption

BUSINESS PROBLEM

An existing Deloitte client, a major global consumer goods company, became aware that one of its key UK trading partners was in severe financial distress and at risk of insolvency. Immediate insolvency would have jeopardized the client's business model in the UK, and resulted in significant financial implications.

DELOITTE SOLUTION

We quickly mobilized an expert advisory team, first helping to ensure the client was at the negotiating table with other stakeholders, and then supporting its interests throughout restructuring talks with the trading partner, which included:

- Discussion of new financing to prevent an unplanned insolvency and to stabilize the trading partner
- Monitoring the short-term cash performance of the business
- Contingency planning for a failure of the business, including a potential buy option and alternative delivery models

While the trading partner ultimately failed, our work supporting the attempted restructuring resulted in an extended period of stability, allowing enough time for the client to put an alternative delivery model in place and minimize the financial impact on its business.

KEY TAKEAWAY

Because Deloitte was already a trusted adviser, the client brought us into the situation early. Deloitte enabled the client to mobilize the right individuals very quickly, providing invaluable advice and temporarily stabilizing the situation while also embarking on other mitigation activities.

Case study 2:

Supply continuity preserved with innovative financial solution

BUSINESS PROBLEM

A component supplier to two large automotive OEMs was in serious financial trouble after the recent collapse of a sister company and exacerbated by a failure to diversify its business. The supplier continued to incur persistent losses, was unable to secure price increases and suffered from a disengaged shareholder. All restructuring and turnaround options had been exhausted.

DELOITTE SOLUTION

Deloitte was appointed administrator and quickly stabilized the business to provide a runway to formulate the best strategy to maximize the return to creditors. Ultimately a sale was not possible given the stage of model lifecycle.

Instead, we negotiated a funding agreement with the OEMs to ensure that production could continue, preserving supply continuity and delivering enhanced returns to creditors. During this period, we:

- Completed all remaining production for one OEM over a 14-month period
- Established an employee retention plan, which ensured that quality and capability was maintained throughout the period
- Reached an agreement with equipment providers to lease key assets until our exit from the site
- Minimized liabilities as we wound down operations
- Liquidated superfluous assets prior to the end of the period

The arrangement created a significantly enhanced return to creditors and allowed the OEMs to re-source and reach the end of planned model lives.

KEY TAKEAWAY

While the risk of failure was identified late in the process and Deloitte's engagement was subsequently delayed, even at this late stage, we were able to organize a creative solution quickly striking the correct balance between the interests of customers and suppliers.

"Getting an expert view on the financial and commercial status of key suppliers can be very reassuring for procurement teams when they are evaluating supply chain strategies."

— Fiona Kaufman

Case study 3:

Financial, operational and sector acumen key to solving new supplier woes

BUSINESS PROBLEM

A global OEM contracted with a German parts supplier to create and produce a new product line for integration into its product manufactured at an existing US plant. The supplier opened a new plant based in the US, close to the OEM's facility, but underestimated the complexity of ramping up a new manufacturing facility in parallel with developing a new product line. In addition, inaccurate timeline forecasts, technical requirements and operational inefficiencies contributed to the supplier ending up in distress.

DELOITTE SOLUTION

We quickly dispatched a seasoned restructuring expert to work on site developing and evaluating restructuring measures. These included a quick, initial financial analysis to gain transparency into the current situation as well as simulations of the effectiveness of potential measures on P&L, the balance sheet and cash flow. Deloitte created a specific action plan, leveraging its financial and operational expertise to define restructuring measures, manage negotiations and handle the turnaround, resulting in no production standstills and minimized financial impact.

KEY TAKEAWAY

Deep industry, sector, financial and operational expertise is a rare combination, but crucial to a positive outcome in complex situations like this. Deloitte's global reach, knowledge of supply chain operations and experience with SMEs made them a valuable partner in this situation.

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