Supplier Relationships

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Introduction

- A vendor relationship is an intangible asset.
- Must be taken into account in purchase price allocations or impairment testing.
- Customer relationship to supplier

Introduction

- Takes different forms.
    - Contractual
    - More frequently from continuity
- Simple list or intricate web of documents.
- Normally valued by specialized Discounted Cash Flow (DCF) methods.

Types of Supplier Relationships

- “Contractual-legal" or "separable".
- Separability governed by industry or local practices.

Exclusions

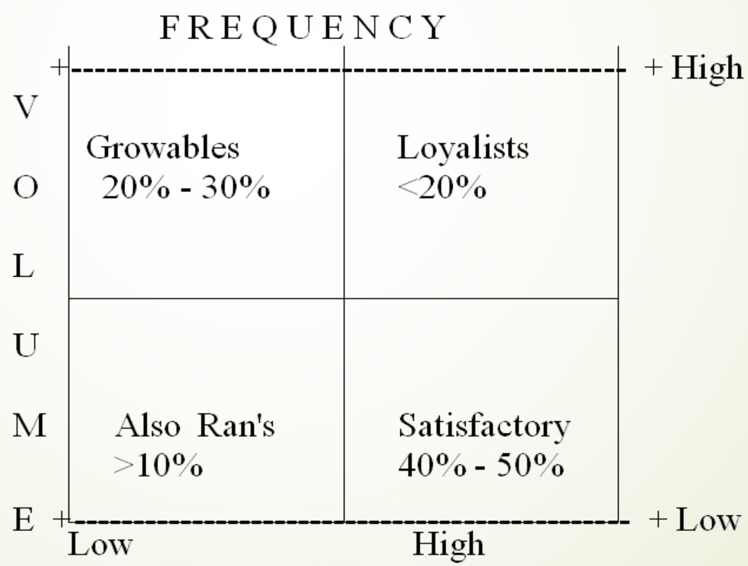
- Excluded from supplier relationships.
  - One-time sources few recurrences.
  - Former supplier, no business for a period, varies with nature of the entity.
  - Casual vendors lacking data.

Point of View of Suppliers

- You are a customer.
- The better customer you are the better the relationship.

Point of View of Suppliers

- Grouping customers.



Point of View of Suppliers

- Not all customers are created equal.
- 80:20 rule applies.
- Profits come from loyalists, the only one with value.
- “Growables” and “Satisfactory” keep the business alive.
- “Also Ran’s” may reduce profits.

Point of View of Suppliers - Customer Loyalty

- Loyalty determines profitability.
  - Satisfaction
  - Sentiment
  - Frequency
  - Services required
  - Size of order
  - Length of service

Point of View of Suppliers - Customer Loyalty

- Retention generates
  - Repeats
  - Higher volumes
  - Greater participation in a product line
  - Resistance to competitive pressures

Loyalty to Suppliers

- Not a new concept.
- 17th century English pubs agreed to a single supplier for local monopoly.
- Brewers got very rich.

Are you a profitable customer? - A

- Profitable customers - loyalists and "must-have-now's".
- Pay more for special treatment and service.
  - Retention Rate
  - Churn Rate
  - Maintenance Rate

Are you a profitable customer? - B

- Trends indicate success in retaining buyers.
- Unprofitable customers are dropped.

Are you a good or bad customer? - A

- Allocate revenues & costs to a customer
- Sales trends by customer
  - Seasonality
  - Product/service mix
  - Effective gross margins
  - Cost drivers - sales calls, orders, shipments, invoices, support, average receivable balances.
  - Determines credit for referrals

Are you a good or bad customer? - B

- Analysis allows a supplier to:
  - Discriminate by the level of service offered
  - See the evolution of the relationship
  - Single out customers from whom a positive return is unlikely at the level of service demanded

Are you a good or bad customer? - C

	Good		Bad	
	%	$'000	%	$'000
Sales				
Manufactured	75.0	900	60.0	1,080
Resale	10.0	120	30.0	540
Services	15.0	180	10.0	180
	100.0	1,200	100.0	1,800
Gross Profit				
Manufactured	33.0	297	33.0	356
Resale	25.0	30	25.0	135
Services	40.0	72	40.0	72
	32.7	399	32.7	563
Expenses	#		#	
Sales Visits	4	10	12	30
Orders	50	9	112	20
Shipments	50	18	210	76
Invoices	12	7	210	123
Support Calls	2	2	104	104
		46		352
Interest		2		5
Referrals		(2)		-
Other - Allocated by Sales	19.5%	234	19.5%	351
		280		708
Pre-tax Profit (Loss)		119		(145)
Margin		9.9%		-8.0%

Are you a good or bad customer? - D

- Bad customers divert corporate resources.
- Profitable relationships are cultivated.
- Don’t judge success by market share gains.
- Higher revenue is not always better.
- Watch mix & margins.

Lifetime value to Supplier - A

- Lifetime value studied by OEMs and Tier One Suppliers in auto industry since the late 1980s.
- LTV determined by discounting incremental cash flows based on customer retention and spending.

Lifetime value to Supplier - B

- Defections higher during the first year.
- Loyalty of remaining customers is better.
- They spend more each year.

Contributory Assets - A

- Other intangible assets - brand names (Intel inside), core technologies - are necessary to sustain supplier/customer relationships.

Contributory Assets - B

- For a retailer they include
  - Location
  - Display space
  - Inventory
  - Experience of employees
  - Financing

Contributory Assets - C

- Every element includes other intangible assets such as
  - Brand names (Intel inside).
  - Core technologies necessary to obtain business.

Contributory Assets - D

- Separate net cash flows from those attributable to the contributing assets.
  - Deduct an imputed return.
  - Use a percentage of cash flows based on industry experience.
  - Capitalize excess earnings over a "normal" margin.

Contributory Assets - E

- Estimate normal margins.
  - Average of the past
  - Guidelines
- Only a few have above average margins.
- If margins are more than Guidelines a large number is included
- The latter is correct.

Contributory Assets - F

- Account for employees.
- Assembled workforce is treated as goodwill.
- It contributes significantly to the fair value of customer relationships especially in service industries.

DCF Valuation Method

- Discounted Cash Flows (DCF) valuation methods used for supplier relationships.
- Specific cash flows are not directly reflected on financial statement.
- Five-stage process involves marketing and financial data.
- Results must be reasonable.

DCF Valuation Method – Stage One

- Stage one projects average number of customers.
- Requires analyses of retention and referral rates.
- Preferable for only "good" customers.
- Deal with the effects of "bad" ones separately.

DCF Valuation Method – Stage Two

- Stage two estimates future revenues giving a spending rate.
- Applied to the average.
- Peaks in third year.
- Slowly declines.

DCF Valuation Method – Stage Three - A

- Expenses related to customer acquisition and service.
- Direct costs of fulfilling orders.
- Acquisition reflects advertising and marketing costs for new customers.

DCF Valuation Method – Stage Three - B

- Direct costs
  - product development
  - Production
  - Delivery and selling
  - General and administrative
  - Not financial

DCF Valuation Method – Stage Three - C

- Direct costs decline in relation to sales.
- Service expenses re greater for new customers.

DCF Valuation Method – Stage Four - A

- Established contributory cash flows are allocated between
  - Customer relationships
  - Contributory assets
- Realistic returns on fair values of all contributory assets are determined and deducted from EBITDA.

DCF Valuation Method – Stage Four - B

- Acquisition and service expenses differ for new and existing customers.
- Income tax is deducted to determine the net customer cash flows.

DCF Valuation Method – Stage Five

- Present value over expected life without a terminal amount.
- Divided by the original number of customers gives Fair Value for each.
- Relationships last for varying periods.
  - Five to seven years is average
  - Can be only three years
  - Can be long as 25 years such as light training school serving major airlines.