RAPIDRATINGS®

# How to Evaluate Supplier RISK

## A Practical Approach to Global Supplier Risk Management

In today's disruptive business environment, your suppliers' risks are your risks. It's time to develop a comprehensive risk management program that protects your brand, customers, and bottom line in a world where global supply chains are symbiotically intertwined and interdependent.

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# Introduction

Building supply chain resilience has become a strategic imperative for organizations of all sizes and across all industries in today's disruptive business world. With new worries and threats lurking around every corner, geopolitical issues, natural disasters, and data breaches are just a few of the potential hazards pushing the number of supplier failures to new heights.

Fraught with potential challenges, today's global supply chains are also symbiotically and strategically intertwined, thus increasing the number of companies impacted when just one small, Tier 3 supplier of parts runs into financial problems, goes out of business, or is hit by a natural disaster.


## The threat is real:

In our recent benchmark survey, **one in three respondents (33%)** experienced a significant supply chain disruption during the last 24 months, yet **just 24% of those companies** reported having a clear strategy in place to manage all types of supplier risk. This shows that while companies realize that there are potential threats in all links in their supply chains, most of them aren't taking the proactive steps necessary to thwart or manage those potentially-disruptive issues.

In this eBook, we explore the increased prevalence of supplier disruption, show how it's impacting companies across all industries, and outline the key steps organizations should take to create a comprehensive, effective supply chain risk management program.

**4 steps to create a comprehensive supplier risk management program:**

1 **Develop the plan.** Understand your organization's key risks. Part of this includes deciding what risks your organization can mitigate, and defining which suppliers are critical to your business along with the level of analysis they should be evaluated with.

2 **Implement the program.** Decide on which data and tools will be necessary to evaluate the risks you've identified as the most important for your organization.

3 **Take risk mitigation action.** Understanding risks is not enough; a successful program includes a defined action plan, broad communication, and clear accountability.

4 **Conduct ongoing evaluation and monitoring.** Monitor the overall risk levels of your suppliers and ensure you monitor healthy companies on a regular cadence for any deterioration.

# Making Business Continuity & Resilience a Priority

**The best companies in the world leverage all that the global supply chain has to offer - understanding what they do best, and where they need to call on another's expertise to fill in the gaps. Engaging in our now agile global supplier ecosystem, however, is a challenge that requires a more holistic, strategic approach than years passed to handle the increasingly complex networks that can span multiple entities across multiple countries to create just one product. For instance, to remain efficient, many companies have put a lot time and energy into creating "leaner" logistics operations that are both responsive and cost-effective. They've learned to operate with very low levels of inventory—a plus that many are starting to understand could impose real risks on their supply chain, if implemented alone.**

*A sound supply chain management system, however, can bridge the gap of major business functions such as logistics, sourcing, and procurement within and across companies into a cohesive and high-performing business model.*

# Supply Chain Disruption Lurking in the Shadows

## Case Study:
## Hanjin Shipping

Just one supplier insolvency can quickly turn a lean operation into one that's scrambling to find alternate sources of supply. For example, Hanjin Shipping's bankruptcy a couple of years ago caused over $14 billion in cargo to be stuck at sea. The first shipper to go bankrupt in over 30 years, Hanjin was responsible for shipping over 100 million tons of cargo annually. Many major retailers were affected, with their cargo stranded right before the holiday season, but didn't find out about the problem until their merchandise failed to arrive. This single event showed how it's not just Tier 1 suppliers that can cause disruptions in your supply chain; disruption in a Tier 2 or Tier 3 supplier can also create severe negative impacts.

Read more about Hanjin Shipping ›

Even if you're not running a multi-billion-dollar, multi-national company, your supply chain could still be at serious risk. In fact, it's often the small to midsized (SME) companies that suffer most in the face of supplier disruption or supplier insolvency because they simply don't have the cushion to absorb a disruption for any length of time.

> *"SMEs often do not have the tools, support, and methodology to quantify what a supplier disruption will do to their business,"* Zurich's Linda Conrad told *Risk & Insurance.* *"Most SMEs have an 'all hands on deck' scenario in trying to be profitable, but no resources to measure potential loss. Yet, the supply chain is their economic lifeblood."*

Of course, less consequential disruptions occur in supply chains every day, and range from deterioration in product quality to disruptions in delivery and fulfillment schedules to the inability to access inventory or services when a supplier goes bankrupt. Over time, however, these and other events can bring your business and your brand to its knees.


The good news is that by making supply chain resiliency a priority, organizations can be prepared for supply risk. And it's not too late to roll out this type of initiative. Doing so gives organizations options, strategies, and solutions to leverage when an interruption occurs.

> *"By ensuring their suppliers are equally prepared, they will have critical products and components available when they need them,"* Sue Doerfler, of *Inside Supply Management*, reports. *"Their customers will be satisfied. And there will be minimal impact to the bottom line."*

# How Evolved is Your Approach to Supplier Risk Management?

Many companies are already using ***some*** form of supplier risk management in their day-to-day operations. Depending on the business and how evolved that risk management approach is, the company may be either managing supplier risk events in isolation (i.e., one at a time as they surface) or it might already have a broader, enterprise-wide strategy in place.

The companies with the most evolved risk management processes are examining a range of risk factors, communicating those risk factors across the entire enterprise, and effectively leveraging predictive risk analysis. In other words, they're not "waiting around" for disruption to happen. They're getting out in front of it by leveraging robust technology platforms to identify and mitigate problems ***before*** they happen, maximizing positive business outcomes in the process.

Other organizations aren't quite as far down that path, and still have just one person or one group managing their supplier risk management activities. Where they may be using technology tools to get the job done, they're probably not storing, accessing, and reviewing the data in a very efficient manner. They're also not sharing pertinent supply chain risk data across the enterprise—a critical step in being able to effectively mitigate risk throughout the lifecycle As a result, while they might be able to build resiliency and maintain business continuity, the task isn't being handled very efficiently, nor is the company getting the best possible return on investment (ROI) for its risk management processes.

Regardless of where your company stands on the supplier risk management spectrum right now, the need for program maturity will vary based on current exposure levels, what's already being done to identify and mitigate risk, and your firm's future growth plans. If, for example, you are just beginning to work with global suppliers and partners after being largely focused on the domestic market for decades, then now would be the perfect time to implement a more robust supplier risk management approach.

# Managing Supplier Risk: Complex and Nuanced

While many organizations intuitively understand the need for solid supplier risk management strategy, the actual act of managing risk is often complex and nuanced. Historically, supplier risk was based on whether or not a vendor could deliver the designated goods or services within the appropriate timeframe and in a quality manner (or not). That definition expanded and contracted according to the actual operations in question, but, overall, supplier risk management was extremely operations and logistics oriented.

**As supply chains became leaner and leaner, the risks grew exponentially because the traditional "time cushions" and other security blankets suddenly disappeared.**

Fast-forward to today and that definition has changed considerably based on an increased complexity in the global supply chain and focus on the financial burden associated with supplier risk and supply chain disruption.

*"A decade ago supply chain risk was primarily focused on supplier failures, commodity price volatility, and component shortages. Mitigating these threats was possible with closer supplier cooperation, collaborative planning around upstream constraints, and dual sourcing," SCM World's* Kevin O'Marah writes. *"The playbook was essentially about identifying potential weak links in the chain and shoring them up with shared ownership of supply continuity."*

This is no longer enough, according to O'Marah. *"Where once we worried about localized mistakes or oversights upstream, now we worry about cataclysm, potentially at the hands of actors bent on destruction. The new world of supply chain risk means preparation for widespread, systemic disruption in our immediate future."*

As the definition of supplier risk has evolved, it has come to incorporate everything from identifying potential suppliers to securing alternate sources of supply to better understanding one's own supply chain and how that entity fits into the larger scheme of things. To accommodate this expanded definition—and the activities that comprise good supplier risk management—the number of tools, platforms, and data sets has proliferated exponentially and is helping companies more successfully address risk.

Concurrently, supply chain and procurement professionals have become more aware of the potential risks and are learning how to effectively avoid and/or mitigate them on a daily basis. These professionals are looking at financial, cyber, compliance, and other risks with a more discerning eye—from the earliest stages of the relationship and straight through to the ongoing monitoring of a supplier.

# Focused Supplier Risk Assessments

Early conversations around risk management are usually focused on the specific risks that the organization is (or, could be) facing. Because risk can come from pretty much anywhere in the supply chain, it's usually impossible to list all of the potential perils. However, this list can serve as a good starting point for any organization.

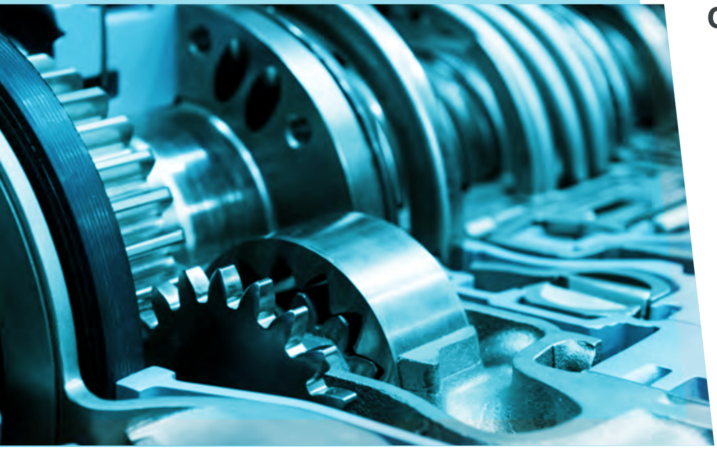
## Potential risk areas to consider in your supply chain:

- IP Protection
- Sole or single source
- Financial
- Geopolitical
- Environmental
- Market conditions
- Cybersecurity
- Regulatory
- Reputational
- Quality
- Delivery & fulfillment
- N-tier supplier risk
- Business continuity

While companies may face many of the risks on the previous list, and then incorporate those risk metrics into their programs, the most focus should be on these **two types of risk:**

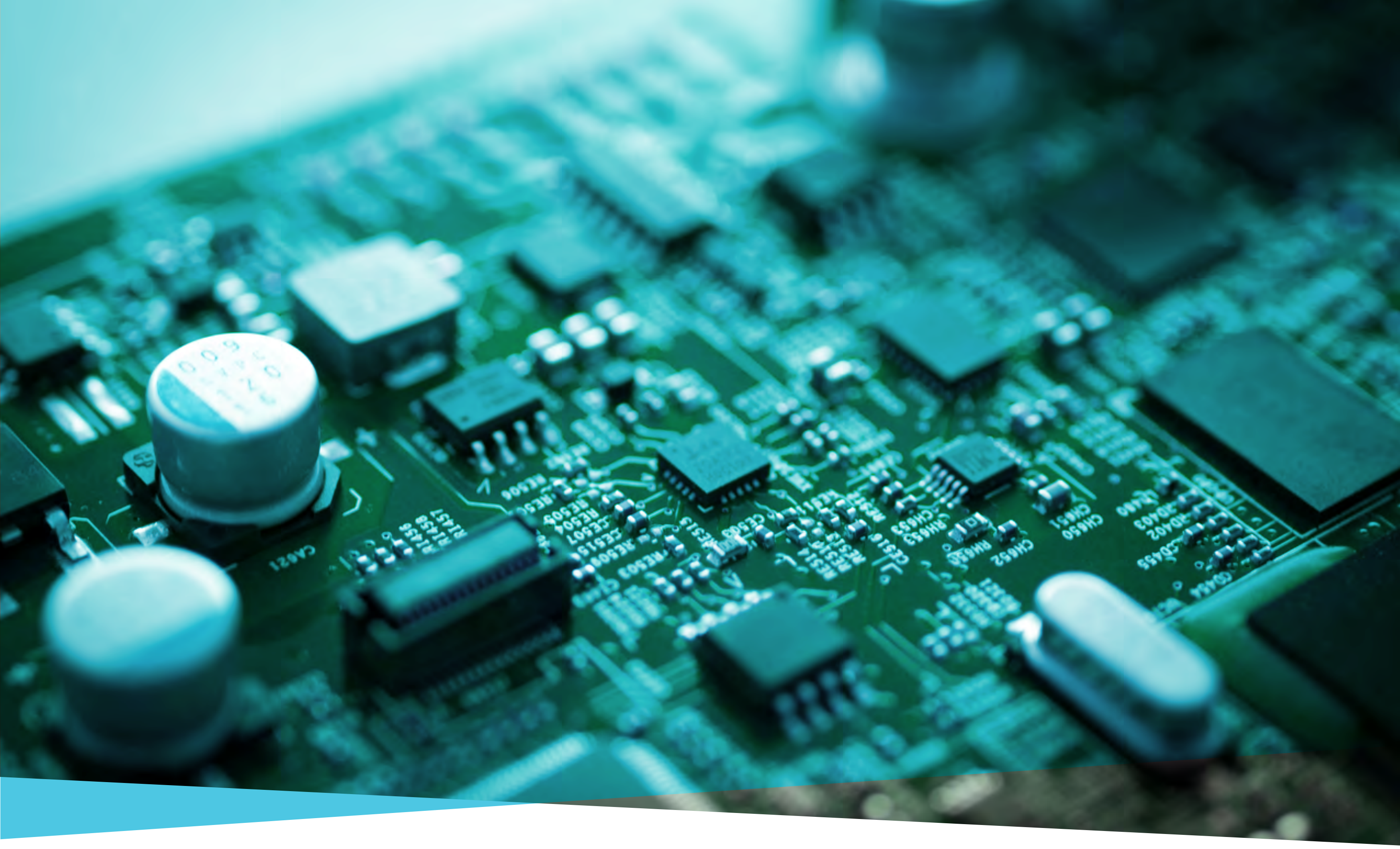

**Financial Health**

Financial health goes beyond whether a company will go bankrupt or default on payments. Understanding financial health allows you to peer deep into your supplier's strengths and weaknesses. A strong company financially may be able to weather storms they can't control, such as natural disasters or a weak market, and may be able to invest in more programs, such as R&D, cybersecurity, or the quality of their product.



**Operational Risk**

Two of the most important factors in managing a supply chain are having a quality product and having that product delivered in a timely manner. Poor product or delayed deliveries can affect both brand reputation and bottom line. Suppliers need to perform at a certain standard, and poor performance is often linked with poor financial viability.



When developing a robust supplier risk approach, you'll also want to factor in other organizational- or industry-specific risks that could impact your company. For example, retailers may be more focused on potential cyberattacks, while banks and healthcare organizations must factor in regulatory changes.

> *"Supply chain risk is everywhere, waiting to cause the next million-dollar disruption. It could come from an earthquake in Japan, a hacker in Ukraine, or even from a disgruntled employee or former partner,"* Edwin Lopez, Editor at *Supply Chain Dive*, points out. *"It could come at any time, too — so supply chain managers must always be prepared."*

# Is Your Global Supply Chain at Risk?

If you're experiencing any of these problems in your supply chain right now—or even if they've been prevalent in the past—then developing and implementing a supplier risk management strategy should be a top priority:

- Unexpected transit delays or missing components
- Production problems from Tier 2 or 3 suppliers
- Financial issues including cash flow problems or bankruptcy
- Cost increases in raw materials, services, and project costs
- High debt levels, high interest rates, or an inability to access capital
- Product contaminations or recalls
- Critical technology failures or cyberattacks
- Exposure to a Tier 2 supplier that services multiple Tier 1 suppliers
- Legal non-compliance, regulatory lapses, or vendor fraud
- Any suits, liens, or judgments filed against the vendor (i.e., OHSA violations, environmental pollution, etc.)
- High dependency ratio - % of your business that is the supplier's total revenue

By thinking and acting proactively, companies can effectively shore up their supply chains and ensure their own longevity and continuity. It starts with identifying the main sources of potential risk.

These are just some of the key points RapidRatings' strongly encourages companies to understand and assess. As the marketplace becomes even more turbulent and volatile, addressing these issues early in the supplier relationship will become even more important.

# Your 4-Step Journey to Managing Supplier Risk

It’s imperative to get buy-in from the impacted business groups and from senior management, both of which will play critical roles in the implementation and orchestration of a good supplier risk management approach.

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# Develop the Plan

*Before you start drafting your plan, it's imperative to get buy-in from the impacted business groups and from senior management, both of which will play critical roles in the implementation and orchestration of a good supplier risk management approach.*

Regardless of which elements are put in place, without a commitment to following through on that operational plan, the plan is sure to fail.

Once you have the appropriate buy-in for your plan, the goal should be to create a centralized, coordinated effort that encompasses the entire enterprise. And while many companies choose to ignore this step, a decentralized program misses out on the coordination of information and analytics that a centralized program thrives on.

***Determining, managing, and acting on Key Risk Indicators (KRI's) is much easier when it's done across the enterprise, with information shared with all stakeholders.*** Centralized information-sharing allows for optimal decision-making – from spotting correlations in the data to extracting the valuable insights that come from it, whether that's correlating financial health risks to cyber risk or quality to delivery risk and beyond.

## Supplier Segmentation

Determining which suppliers are most important from a risk mitigation standpoint is a crucial step in the supplier risk management process. Whether a supplier is sole-sourced is one such key consideration during this process, as any "blip" in that vendor's supply chain will create significant impacts on your supply chain. During the supplier segmentation exercise—which should be ongoing, and not a "one and done" exercise—you'll also want to ask yourself questions like:

**What level of spend or concentration does my company have with the supplier?**
And, what proportion of our overall spend is focused on that supplier versus that company's overall annual revenues? If you have heavy exposure with any specific vendors, you'll want to look at those relationships and exposures.

**Is the supplier aligned with a particular commodity group?**
In today's volatile business world, a supplier that's aligned with a specific commodity or commodity group could be a potential red flag.

**Does the company need a special component or proprietary part to make its products?**
If that company's alternative sources of supply are limited, then that supplier could present high levels of risk.

**What are the relationship nuances?**
For example, if the supplier has close ties to your customer, then any risk-related event could have a major impact on your brand and reputation.

Understand that the riskiest supplier relationships may not be as obvious as you think:  when Facebook experienced a major data scandal a just this past year, third-party consulting firm, Cambridge Analytica, was responsible for harvesting the personal data from millions of Facebook users without consent.

## Developing a Master Supplier Portfolio

Using the answers to these questions, you can begin tiering suppliers in terms of importance. At RapidRatings, we help clients do this during the implementation process—right at the very start of a new relationship—which shows just how crucial the supplier segmentation process is for effective supplier risk reduction.

Once you've started down the supplier segmentation path, you can start building out a master portfolio for these vendors and then use that data for good decision making going forward. It's important to note that this step is important for companies of all sizes. We continue to see even very large organizations that can't readily access their own supplier data (i.e., lists of suppliers and their contact information), which show that even entities with plentiful resources are lacking in this area.

By creating a framework to segment your supplier base you can prioritize which supplier relationships need to be evaluated and which risks are most important to your organization. The most strategic and critical suppliers need to be evaluated in-depth for financial viability and performance metrics, while the least critical can be measured against a baseline assessment.

Your supply chain risk plan is not just a starting point; it's part of a continuous management process that should be iterative, and continually improved upon as risk evolves and as supplier relationships expand or contract.

# 2 Implement the Plan

At this point, you should understand how to segment your supplier base in terms of criticality and some of the key areas of potential risk within your supply chain. Now it's time to actually collect all the data, assess your risks, and understand where the issues are. Building out this database is imperative.

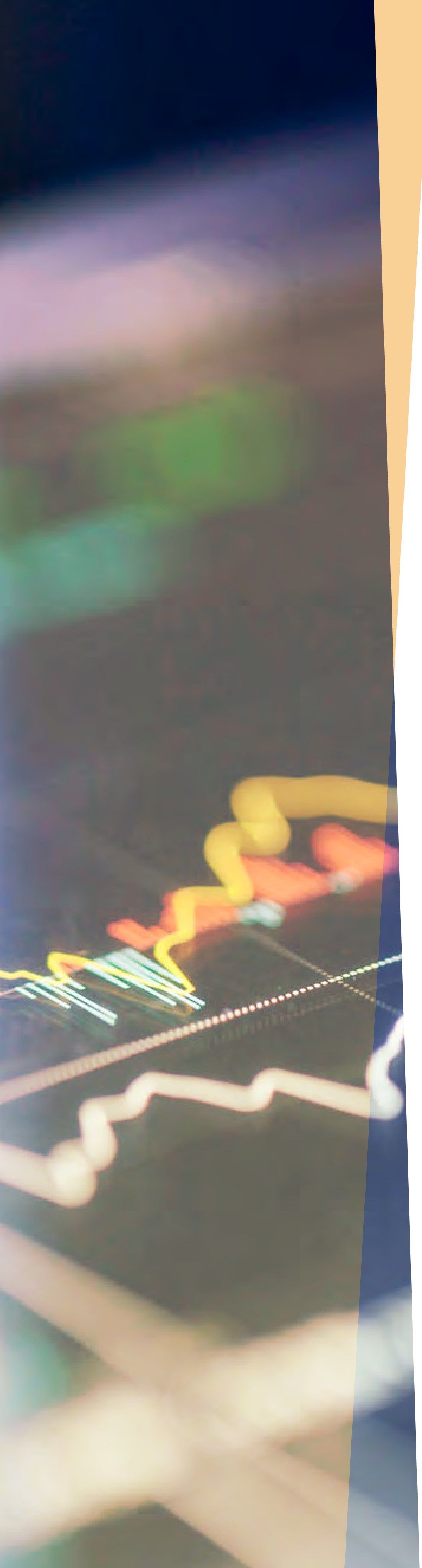
**Your Supplier database must at a minimum include:**

Spend

Revenue associated

Contact information

After compiling your list, select the data, tools, and software you'll use to evaluate the risk. You can use scorecards to monitor supplier performance and trends in your Key Risk Indicators (KRIs), which are important to understanding how your entire supply base is performing and if there are any significant shifts overall. Scorecards are also an excellent method to ensure you are looking at all the important indicators for each supplier.



**Some of the KRIs to monitor could include:**

- Demand shortfalls
- Customer losses
- Pricing pressures
- Regulation changes
- Management change
- Poor financial performance
- Earnings shortfalls
- Poor operating controls
- Employee issues/fraud
- IT & cyber security issues
- Industry-specific crises
- Natural disasters
- Geographic or political issues
- Socioeconomic problems

At this point, focus on your KRIs and select the data and tools based on your overall program goals. You may need a supplier management tool and additional third-party data. For example, to assess financial health you can use RapidRatings' Financial Health Rating (FHR®), an analytic measured numerically on a 0-100 scale that represents the financial viability of public and private companies, globally.

Request a FREE FHR Report ›

## When Should You Assess Suppliers?

If possible, start by evaluating all suppliers. This will help you develop a baseline for each supplier, regardless of your exposure and/or relationship with them. Use the following as guidelines for when and how often to evaluate suppliers:

New suppliers should be evaluated in the pre-contract due diligence process

Existing suppliers should be evaluated on a set cadence throughout their lifecycle, depending on the criticality and risk level, as determined in the planning phase

Critical suppliers and high-risk suppliers should be evaluated regularly, such as monthly or quarterly

All other suppliers should have their risk rating reviewed at least annually

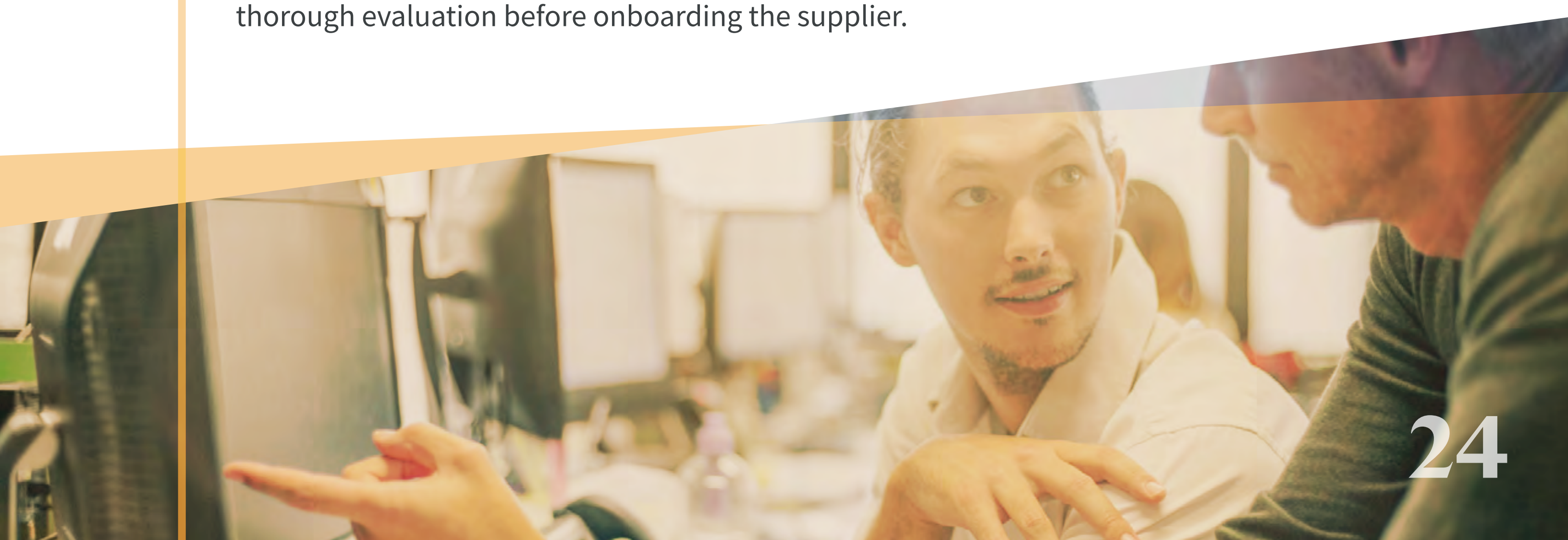
When a supplier is high risk, the last thing you should think is that it means the relationship needs to end. By understanding the supplier's issues, you can work together to help mitigate the risk.

## 3 Take Risk Mitigation Action

Let's say a prospective supplier is being endorsed by a warehouse manager who really wants to work with that particular vendor.

The procurement department conducts an evaluation of that supplier, finds that it meets the minimum criteria to be onboarded (based on conflict checks and other compliance areas), and that it also meets the minimum threshold of financial health and cyber risk. The supplier comes onboard and the category manager starts placing orders for its products.

But let's also say that the finance team and supply chain risk teams noticed something unusual about this vendor—maybe that it had experienced financial deterioration over the last three quarters. It was still considered "safe" and of medium risk, but there was a marked deterioration. If the procurement team had known this in the first place, it could have done a more thorough evaluation before onboarding the supplier.



And vice-versa, if the supply chain risk management team had known that the supplier was being considered, it could have alerted procurement to the problem earlier in the process. When all stakeholders are working from the same playbook, the cadence of evaluation going forward might be different than it was in the past.

This is just one simple example of how difficult it can be to put risk assessment plans into action without complete buy-in and participation from all enterprise stakeholders. ***The companies that are most successful at mitigating risk make accountability a priority across the organization.*** A committee of subject matter experts (SMEs), for example, can assist in the risk mitigation process. Often, this committee is made up of high-level colleagues from different departments, including:

- finance
- technology
- operations
- legal
- compliance
- sales

# Risk Committee Helps Your Organization to Take Action

Present the committee with information you have about the supplier's risk to this group and then gather perspectives and ideas on how to address the risk and what may be the best solution. Pose questions like:

1. Should we reassess our payment terms?
2. Should we buy materials and inventory in advance?
3. In light of long-term risk, is our contract short-term (making the level of risk acceptable to your organization)?
4. Just how much risk are we willing to deal with?

In many instances, your organization can help your supplier get out of its rough patch by buying additional inventory, easing payment terms, or even investing in the company to help them through difficult times.

It's important to note that communication is key to building a lasting and profitable relationship with your suppliers.

**Other Risk Mitigation Actions:**

- Watch and wait
- Ease payment terms or conditions
- Provide price increase
- Purchase inventory early or increase inventory to weather a storm
- Find alternate sources
- Invest in the supplier in cases of highly critical and valued relationships
- Exit the relationship, usually only in the most extreme cases

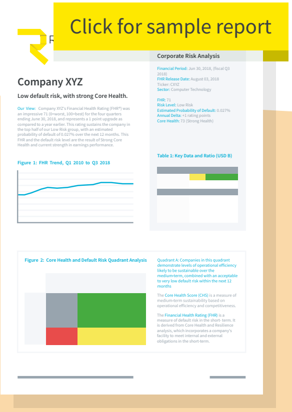
In the case of high-risk suppliers, talking about the issues they face is paramount because it helps bring transparency into the relationship. It also allows you to better understand the strategy, plan, and direction of the company.

Engage directly with your suppliers; an in-person meeting or phone call can provide great insight into the future plans of your supplier. This helps to create a very collaborative, two-way communication stream in a world that demands it.

# Creating a Dialogue with Your Suppliers to Strengthen Relationships

Many RapidRatings clients leverage Financial Dialogue, a report that identifies and prioritizes the most relevant financial questions companies should be asking their suppliers. Using key financial health questions as a foundation, Financial Dialogue helps organizations digest this critical information, assess its potential impact on their operations, and efficiently manage supplier risk.

Leveraging RapidRatings' Financial Dialogue, companies can ascertain a supplier's strengths and weaknesses—both of which should be addressed with concern—while also garnering actionable responses to key questions and following up and requesting written answers to improve accountability.




**Armed with the Financial Dialogue, companies can:**

- Enable procurement, supply chain, and finance professionals with various levels of financial expertise to engage confidently in a financial health review
- Substantially decrease time spent analyzing financials and preparing talking points for these reviews
- Create a trusting and collaborative relationship with suppliers
- Providing a balanced agenda of targeted key concerns while acknowledging notable strengths

# 4 Ongoing Evaluation and Monitoring

After the arduous task of evaluating high-risk suppliers, communicating about strengths and weaknesses, and operationalizing a plan to mitigate the risk, the last thing you want to do is end the process. An ongoing and evolving process, risk mitigation revolves around continuously addressing and taking steps to mitigate risk surrounding your supply chain. This builds both resilience within your organization and a competitive advantage within your respective industry, but only when a regular cycle of monitoring progress to improve or mitigate risk is put in place.

Once the steps outlined in the mutual action plan have been completed, have follow-up conversations to understand the changes your supplier has made. In assessing the status of the mutual action plan and following up with your supplier, **consider these key points:**

- Adjust schedules and requirements for site visits and supplier reviews
- Follow up on action plans that impact operating activity (e.g., changes to inventory coverage and inspections)
- Refresh or add new supplier ratings

At a high level, the most important "win" your company will see from its commitment to supplier risk management is a more resilient supply chain. You'll be able to weed out the weakest companies and also get ahead of other issues by working directly with suppliers to solve those issues. Put simply, having real-time, robust supplier ratings doesn't mean that you have to switch vendors to move out of the "danger" zone; it simply means that you know about the problems before they turn into real debacles. And, you understand how to align your supply chain with the strongest potential suppliers right out of the gate (versus finding out later that they're problematic).

By putting a supplier risk management program into place, you put your company in a position to work with suppliers that have the elasticity and the agility to grow with your business, make it through difficult times, and capitalize on the commercial opportunities that come along.

That's a resilient supply chain, and it's driven by a sophisticated and dynamic supply chain risk process.

# The Window of Opportunity is Closing

**The business world isn't getting any less complex, and the world's supply chains aren't getting any less sophisticated. With more companies doing business overseas, more political disruption in the cards, and more market volatility ahead, being able to fully grasp the strengths, weaknesses, and trends of your key business relationships is only going to become more important.**

For example, companies have had cheap and easy access to capital over the last 10 years, creating an environment where even the weakest companies have been able to stay alive by refinancing their debt over and over, masking underlying operational inefficiencies. In the coming years, however, this advantage will start to disappear as interest rates continue to rise, leading to more failures as refinancing is no longer an option. Right now, supply chains are riddled with companies that will be affected by these and other disruptive issues. If supply chain managers aren't identifying risk hotspots in their supply chains now, it'll be too late when those entities blow up. The window to adopt sophisticated programs ahead of these and other disruptive trends is closing.

Whether you're working with public companies that are required to publish their financials, or private firms that keep that information close to the vest, the RapidRatings' FHR brings transparency to your business relationships, giving insight into the business integrity of all of your third-party partners, suppliers, vendors, and customers. Every decision is better informed when you have a clear picture of financial health to guide you.

# Key Takeaways

1 Building supply chain resilience has become a strategic imperative for organizations of all sizes and across all industries in today's disruptive business world.

2 Global supply chains are symbiotically and strategically intertwined, thus increasing the number of companies impacted when just one small, Tier 3 supplier of parts runs into financial problems, goes out of business, or is hit by a natural disaster.

3 Companies have created "leaner" supply chains that are responsive and cost-effective, but that can turn problematic when supplier disruption happens.

4 The companies with the most evolved risk management processes are examining a range of risk factors, communicating those risk factors across the entire enterprise, and effectively leveraging predictive risk analysis.

5 Good supplier risk management is based on four foundational steps: develop the plan, implement the program, take risk mitigation action, and conduct ongoing evaluation and monitoring.

6 With more companies doing business overseas, more political disruption in the cards, and more market volatility ahead, being able to fully grasp the strengths, weaknesses, and trends of your key business relationships is only going to become more important.

7 By thinking and acting proactively, companies can effectively shore up their supply chains and ensure their own longevity and continuity.

RAPIDRATINGS®

## About RapidRatings

RapidRatings® is transforming the way the world's leading companies manage enterprise and financial risk. RapidRatings provides the most sophisticated analysis of the financial health of public and private companies in the world. The company's analytics system provides predictive insights into third-party partners, suppliers, vendors, and customers. Every business conversation becomes more productive, transparent and efficient with the FHR®.

**Want to speak to someone on our team about incorporating the Financial Health System into your risk management process?**

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