RIVER ROCK ADVISORS

WHAT'S YOUR TARIFF STRATEGY?

Developing a Proactive Approach to Inventory in a Changing Economic Environment



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CHANGE IS THE NEW CONSTANT

For the past couple of years, companies in the United States and indeed much of the rest of the world have been impacted by the ongoing tariff negotiations between the U.S. and China.

By this point, virtually every manufacturing and distribution company has already been impacted — in many cases, severely — by the tariffs, and yet the strategy needed to prepare for them was approached more reactively than proactively. It is for this reason that we continue to hear about companies filing for exemptions, struggling to find new suppliers, and even survive as their reliance on overseas manufacturing continues.

While much has changed and shifted throughout recent years, one thing remains certain: the tariffs aren't going anywhere. Just as one industry sees relief, another industry sees new tariffs going into effect. While it is next to impossible to know exactly what new tariffs are coming or to react to changing tariffs with sufficient notice, companies do have an opportunity to take a completely different approach to withstand this barrage of change.

In this white paper, we'll outline three steps supported by a number of recommendations that collectively comprise a new strategy for manufacturers and distributors to consider. Properly executed and managed, this approach can help companies achieve several key advantages despite the tariffs:

- Overall cost reduction
- More effective inventory management
- Adherence to service levels
- Scalability for when the tariffs are lifted
- A stronger competitive position

We hope this approach makes navigating today's complex tariff environment more manageable for your organization. Change is certainly needed in difficult times, but those who are ready to adapt and push through will reap the rewards in the end.

STEP 1: EFFICIENT DESCALING

WHAT'S BETTER: SCALING UP OR DOWN?

As more and more news comes in on the U.S.–China trade tariffs, it can be difficult to know what to expect — let alone plan for. Recently, both countries reached an agreement that provides some tariff relief, but the execution and ultimate impact remain uncertain. While this was a positive sign, manufacturers, distributors, and other organizations are left wondering how to respond to the tariffs, knowing that they can't base their inventory strategy and other operational decisions solely on the most recent headlines.

While the volatility of these trade negotiations has left many organizations with a feeling of uncertainty, it's important that companies do not become paralyzed as a result. Action is needed, but the question is, what should that action be?

While a common reaction has been to raise prices to account for the tariffs, this has shut down a great deal of consumer demand. For many manufacturers and distributors, demand is what drives volume. But with rising production and material costs and declining consumer demand leading to an erosion of margin and profit, how can they determine the appropriate approach to handling tariff challenges? This depends on whether they think that tariffs will increase or decrease in the future.

ACTION IS NEEDED, BUT THE QUESTION IS, WHAT SHOULD THAT ACTION BE?

Those that believe that the tariffs will increase or remain in effect for a long time are struggling with whether they should build up inventory now to avoid higher costs in the future. While this means more expense to the business now in securing inventory, operations can continue and profitability — hopefully — can be preserved. But this is a gamble in that the company may over-invest in inventory only to see the tariff decrease. And what happens if consumer demand doesn't pick up?

Those thinking that tariffs will decrease are holding off on bulking up their inventory to avoid the current tariff and maintain their profitability, but this comes with several challenges. Inventory will continue to decline — leading to potential shortages and potentially forcing the company to replenish their inventory at the higher cost they were hoping to avoid. Shortages can also mean service problems, which bring about their own costs and difficulties.

Both scenarios are incredibly difficult, and it's understandable that they would leave many companies feeling paralyzed. But in order to best know how to handle the tariffs, companies should first look to areas where they can reduce costs.

DESCALING THROUGH COST REDUCTION

There are two high-level areas where companies can look to reduce costs as a solution for how to handle tariffs: variable costs and fixed costs. Variable costs of course are costs that change with business output, whereas fixed costs don't. While it can be easy to put together a list of such costs that can be reduced, it's important that these reductions are done in such a way that organizations can quickly scale back up when needed.

VARIABLE COST REDUCTIONS

Variable costs are expenses that generally trend in relation to sales volume. As an organization sells more goods, it follows that other costs increase in order to meet demand and to help an organization get into position to increase sales even more. Examples of variable costs include basic raw materials, component parts, salesperson commissions, hourly labor, delivery and shipping charges, and advertising.

Adjusting variable costs is often the first step organizations take because those costs are directly tied to sales. If sales are down, the costs associated with the business must go down as well. Variable costs can also be adjusted more quickly than fixed costs. For example, canceling an advertising campaign or reducing orders of raw materials would not be as time-consuming as eliminating personnel or moving to a new facility.

If the tariffs were to increase, adjusting variable costs gives organizations a faster way to preserve their margin or at least withstand the immediate impact of the tariff increase while finding other ways to reduce costs and maintain operations. If the tariffs were to decrease, the very nature of variable costs means they can be scaled back up to meet increasing demand.

FIXED COST REDUCTIONS

Whereas variable costs are tied to business sales, fixed costs are expenses that are incurred regardless of fluctuations in sales. Sales supports these costs, but they will not change alongside reduced demand or higher production costs. Fixed costs are also more difficult to adjust because they are items that often have a longer-term (e.g., 6–12 months or more) commitment associated with them. Examples of fixed costs include facility payments, employee wages, equipment depreciation, certain technologies, and so on.

While not all fixed costs can be reduced right away in order to relieve the pressure on margins, some adjustments can be made that will have a positive impact over time. Making efforts to reduce energy usage and non-production-related materials, not hiring any additional staff (as opposed to eliminating personnel, unless the latter is necessary), and so on can help drive down costs while organizations wait on the outcome of the tariffs.

If tariffs increase and demand decreases, the ground made up in reducing fixed costs combined with adjustments to variable costs can help to preserve margin. If the tariffs decrease, companies can consider ramping the company back to where it was if desired. Often, fixed cost reductions are an ongoing effort, as such reductions would help a business increase its margin and profit regardless of tariffs. But, this is dependent on the organization and its goals.

When considering how to react to tariffs, the scalability of the cost reductions that are enacted is critical. Remember, while headlines seemingly change with each passing week, so too does the chance for the tariff negotiations to be concluded. When that happens, it'll be important to start scaling back to where operations were in the pre-tariff environment.

THE COMPETITION FACTOR

Finally, the choice between scaling up or scaling down and the related cost adjustments plays an important role in the competitive space. Not every organization is going to make the same decision as their competitor — or make a decision at all. Taking action to get into the most advantageous position possible not only helps to preserve margins and profits but also helps companies emerge from this challenging season ahead of their competition.

Remember, addressing the tariffs is not necessarily a gamble on whether to buy more inventory or sit on current inventory levels. It's about making intelligent decisions that preserve profit margins in such a way that companies can efficiently scale back up to pre-tariff operations when the circumstances permit.



STEP 2: DEVELOPING A SMART INVENTORY STRATEGY

MORE EXEMPTION REQUESTS, MORE DENIALS, MORE RISK

As the tariff battle rages on, it has never been clearer that companies need a reliable inventory strategy in place to protect themselves now and when the tariffs are resolved. And because that seems far off, companies are doing what they can to stay afloat. During a recent filing date for tariff exemptions, more than 8,700 requests were submitted by companies claiming they had no alternative options for their production needs.

Yet as the requests for exemptions increased, so too did the denials issued by the Office of the U.S. Trade Representative. In total, nearly 53,000 exemption requests have been filed since the first tranche of tariffs went into effect in mid-2018. In some instances, companies would have been crippled or ruined due to the inability to get certain parts and technology elsewhere. But in others, particularly those where materials parts were available from other sources, the denials were plentiful.

With companies facing more and more uncertainty every day, the need for a scalable inventory strategy must take precedence. In reality, such a strategy should have been developed and implemented a year and a half ago. But optimism, indifference, or lack of understanding can easily get in the way of being proactive. Here, we'll discuss the impact tariffs have on inventories and what your inventory strategy should be to ensure you're in the best position possible, both now and when the tariffs are lifted.

BUY LESS AND MORE FREQUENTLY — CONSIDERING ALL COST IMPLICATIONS

The impact that the tariffs have had on companies and their inventories is obvious. Supply chains are changing, companies are restructuring products and services from the inside out to adapt, and consumers are seeing changes and even delays in the products they rely on every day. For many companies, the tariffs have had effects well beyond just cost.

For example, not only are revenue and profit decreasing, but service departments are also struggling. When inventory is low, customers start calling — adding pressure to everyone to find a solution, though one simply might not exist. This pressure, coupled with any pre-existing operational or supply chain inefficiency, can quickly create a very painful and hard-to-fix bottleneck in an organization's ability to match consumer expectations.

While progress is being made in the tariff negotiations, the reality is that they're still very much ongoing. Specific markets and commodities, such as steel and aluminum, have even seen tariff increases. Much is still uncertain, but we appear to be at a point where one key inventory strategy is beginning to make more sense despite its potential downsizes: buying less inventory from suppliers, and buying it more frequently.

WHY THIS INVENTORY STRATEGY MAKES SENSE

An initial reaction to this recommended inventory strategy is that it will result in higher costs, and that would likely be accurate. The transactional costs and the per-unit costs incurred would certainly increase to some extent. However, there's a key benefit here — that it prevents your organization from becoming too heavily invested in inventory. If you were to order in significantly higher quantities, you could save on the per-unit price and could also save on total transaction costs over the long-term, but you'd logically have a higher average inventory that might not align with consumer demand.

IT MIGHT BE BETTER TO BE OUT OF INVENTORY TEMPORARILY AND LOSE SOME SALES THAN TO BE TOO HEAVILY INVESTED IN HIGHLY-TARIFFED INVENTORY WITH NO CUSTOMER DEMAND.

But what about stock problems? By buying in smaller quantities, even more frequently, won't that put you at risk of running low on stock — or running out entirely? There is potential for this to happen, but consider that it might be better to be out of inventory temporarily and lose some sales than to be too heavily invested in highly-tariffed inventory with no customer demand.

In the latter scenario, you've already spent the money and paid the tariff dues, and now the goods aren't being purchased for what little margin you have left. You're in the hole. In the former scenario, you ordered less, paid less on the tariffs, and sold through that stock. While you made less money overall, you've spent significantly less overall, too. Even if you have to expedite smaller orders to catch up, this inventory strategy could be worthwhile. Your margins may not be as favorable, due to higher per-unit and transactional costs, but it would minimize the risk of future inventory obsolescence.

KEEP CONSUMER EXPECTATIONS IN MIND

An important consideration with this strategy is demand. Consumers won't want to pay a higher price as a result of the tariff, so it's expected that demand will drop during a difficult season such as this, necessitating the inventory strategy we just described. However, if the tariffs were lifted, they would likely expect a price reduction (even though tariff costs weren't being passed onto them). In this instance, demand could suddenly return to pre-tariff levels, or in some instances, even higher based on a perceived opportunity to save money. In this situation, your organization might find itself in trouble.

Depending on your industry, what you sell, and who your audience is, your customers may have been experiencing a similar situation to yours. Perhaps you manufacture or sell parts that are just one component of a larger item. If demand for that item has dropped as a result of the tariff, only for the tariff to be lifted and demand returned, they might find themselves in a difficult situation had they not maintained a minimum level of inventory. As a result, they would begin pushing on you for your parts — putting you in backlog mode, which creates service problems.

BE INTELLIGENT WITH YOUR STRATEGY

If you're considering the inventory strategy we've outlined here, it's worth segmenting your inventory types to avoid becoming overinvested in lower priority items and investing appropriately in higher priority items. Spending too much in order to stock up on lower priority items as a response to the tariffs only puts your organization at greater risk of not being able to move that inventory to offset the initial order cost and tariff impact. This requires analysis to understand the demand for certain items compared to others.

For example, if you have three components that consist of 35%, 25%, and 15% of your orders over a given year (together comprising 75% of all orders), and numerous other products that account for the remaining 25% of your orders, you should do what you can to maintain adequate (not excessive) inventory levels of the first three items. These are the items where you have the greatest opportunity to preserve revenue and margins, keep up with order demand, and maintain a solid position for when the tariffs are lifted, which will be important for competitiveness in a post-tariff landscape.

IT ALL COMES DOWN TO BEING PROACTIVE

Now is the time to give careful consideration not only to your current supply chain and inventory strategy but also to world affairs. Whatever sources you use for information, monitor them closely and frequently. Be informed so you can make adjustments and plan for the impact of global matters accordingly.

STEP 3: PLANNING INVENTORY WHILE ACCOUNTING FOR COSTS

MAKING CHANGES WHEN NOTHING CHANGES

While both the United States and China have reduced the tariffs on certain subsets of goods imported on either side, other tariffs have been implemented and expanded. These include tariffs on goods that use steel and aluminum — not just steel and aluminum themselves. While deals have been negotiated and progress is being made, the situation doesn't show any sign of letting up anytime soon — making it difficult for companies that are accounting for tariff costs to make certain strategic decisions.

For many, the tariffs have become a guessing game. Should companies scale up inventories despite potentially lower consumer demand in the event that the tariffs conclude and demand returns? Or should companies scale inventories down, preferring instead to risk low stock, service issues, and customer frustration in an effort to save on costs? Whichever route a company chooses, how can it be done efficiently to minimize impact? When the tariff battle concludes, how can inventory be scaled back up?



RECAPPING OUR PREVIOUS RECOMMENDATIONS

Earlier, we explored the concept of accounting for tariff costs through efficient inventory descaling. This isn't accomplished through inventory itself, but rather by identifying reductions in variable costs and fixed costs. While the latter are often difficult to reduce and later reinstitute because they deal with longer-term needs (like buildings and employees), variable costs present a faster solution in that they are tied to sales and production. When production and sales are down, reorders of specific materials and other expenses like advertising can be reduced as well. These are often much easier to reinstitute as well, though, when it comes to certain parts and supplies, advance planning is necessary as they may take some weeks or even months to arrive.

While this approach does provide some relief for manufacturers and distributors, inventory strategy itself must still be addressed. Even if a company decides to scale its inventory up or down, some long-term approach is required to keep the company going. Ideally, organizations would take our recommended inventory approach by purchasing lower volumes of components, parts, or products at a more frequent rate.

THE BENEFIT OF NOT BEING OVERLY INVESTED IN INVENTORY IN A LOW DEMAND ENVIRONMENT OUTWEIGHS THE SHORT-TERM DOWNSIDE OF HIGHER TRANSACTIONAL AND PER-UNIT COSTS.

The thinking behind this strategy is that the benefit of not being overly invested in inventory in a low demand environment outweighs the short-term downside of higher transactional and per-unit costs. If companies were to scale inventories up, they run the risk of sitting on that inventory for a long time. By buying less but more frequently, companies can better match inventory to existing demand. Margins will shrink some, but this is still preferable to sitting on inventory that simply isn't moving out the door.

ACCOUNTING FOR TARIFF COSTS IN THE LONG TERM

Since we seem to be in a never-ending tennis match, it's now important to take this strategy a step further. These recommendations still hold their own, but as the headlines are proving with each passing day, the tariffs are going nowhere. So how can companies hedge against what they think will happen versus what might actually happen? In such an uncertain tariff environment, what matters most is placing the business in a position to protect what margins it can while maintaining service.

WHAT MATTERS MOST IS PLACING THE BUSINESS IN A POSITION TO PROTECT WHAT MARGINS IT CAN WHILE MAINTAINING SERVICE.

Let's jump back to our recommendation of buy-fewer-more-frequently. While this will shrink profit margins due to the absence of price breaks that come with larger orders, existing demand can be satisfied. Service levels can still be maintained because parts or products will still be coming in, though at more frequent intervals. Conversely, by buying more products or parts as a reaction without demand, precious resources are tied up in the warehouse. And because orders aren't being replenished as frequently, service issues could arise. Either the demand won't be there to consume inventory, or inventory will be consumed with far too much time between now and the next restock to maintain service.

PAY ATTENTION TO THE NEWS

Another consideration here is that the drawn-out nature of these negotiations means that companies must pay close attention to global matters. While many tariffs have already been implemented or expanded, as recent headlines have proven, any other type of tariff could become a reality in little to no time. That means companies must monitor market headlines and start accounting for tariff costs in their planning.

For example, if it starts to appear that a tariff on a specific material or good will not be decreasing from its current level, companies must be prepared to take action immediately. If the tariff were to increase unexpectedly, the financial impact to a company could be severe — and virtually immediate. In this situation, it might benefit a company to increase its inventory at the current tariff price rather than after the tariff increase. A tariff increase could reduce demand further but make it even more difficult for a company to replenish as that inventory ships out over time. It would be better to stock up ahead of the price increase to ensure sufficient supply, that service levels could be maintained, and to preserve the margin that currently exists on the part or product.

Conversely, if it appears that a tariff on a product or material will be decreasing, it makes sense to hold off on ordering new inventory to avoid paying the current price. However, there is a key strategic consideration here. With the tariff decrease could come an increase in demand from competitors for the same products or goods that a company is looking to reorder for its customers. This will put strain on the supplier and could result in each company that placed an order experiencing a delay, which could further impact sales and service. What companies decide to do in this situation should take their inventory levels into careful consideration. Companies should consider their runway for their existing inventory: will it last long enough to eventually place a reorder at a lower price? Or do we need to reorder now and accept the existing tariff price in order to meet demand?

CONSIDER OTHER SOURCES OF SUPPLY, BUT…

Another consideration for companies in this situation is to start evaluating other sources of supply. Perhaps another provider has solutions and processes for producing the goods needed at lower price points regardless of the tariffs. Not only might the per-unit price drop, but it might reduce enough to justify a reorder at the current tariff level, allowing companies to replenish inventory, meet demand, and preserve service. However, there is a dangerous pitfall here that is important to keep in mind.

With every new supplier comes costs beyond unit production costs. It will take the supplier some time to produce the new products, particularly if their production environment isn't already set up to produce it (e.g., if a mold needs to be built for manufacturing). It will also take some time to set up the distribution network between the company and their new supplier, which also adds to the lists of new costs incurred as a result of a new relationship. Any organization considering a supplier switch should conduct a cost analysis to determine if the lower part/product price is worth the time and cost of switching — and what the payback period or break-even point on the move will be.

PLAN YOUR TARIFF STRATEGY WITH CONFIDENCE

At River Rock Advisors, we understand that the strategy outlined here is not one to be considered or implemented lightly.

We have worked with numerous global organizations to help them solve their most pressing and complex inventory management challenges. Through our unique approach, we develop strategic recommendations that not only put your organization in a stronger position to succeed in the long run but also give you key advantages over your competitors.

Our advisory team consists of individuals with successful careers in supply chain optimization, operational strategy, business management, inventory performance optimization, and more. If you're looking to better position your organization for success, our team will work with you to understand your current inventory performance and objectives and develop a strategy that protects your business now and in the future.

DON'T NAVIGATE THIS DIFFICULT TIME ALONE. LET OUR TEAM CHART YOUR COURSE TO SUCCESS.

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