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Raw Material Risks

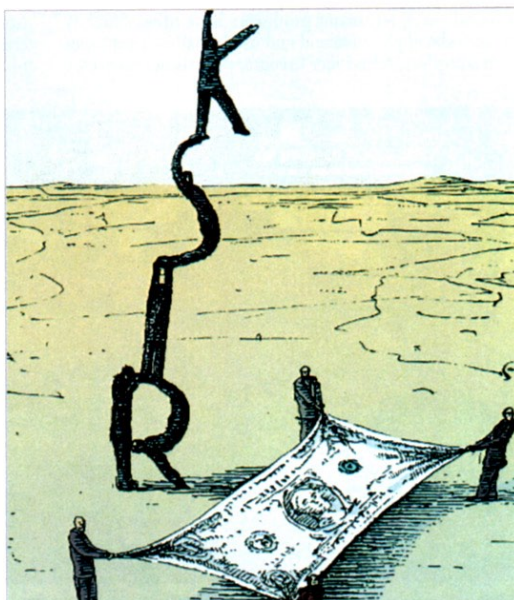
MANUFACTURERS MUST REMAIN VIGILANT AND AGILE IN THE FACE OF VOLATILE COSTS AND POSSIBLE SUPPLY SQUEEZES.

BY JILL JUSKO

IT HAS BEEN A WILD RIDE FOR RAW materials in the past 12 months, which can't have made U.S. manufacturers too happy. According to a number of studies, raw material concerns always have been and remain top of mind even in a less-than-robust economy. For example, a recent survey from buying consortium Prime Advantage showed that raw material costs were the top concern of 53% of manufacturers queried. And a quarterly survey from AMR Research named commodity price volatility as one of the top three supply chain risks (cited by 30% of respondents) worrying business executives.

It's not as though the worries are misplaced. For most manufacturers, materials costs (not just raw) make up the largest component of their cost of goods sold, even as labor costs seem to attract the greatest attention. Last fall, prices for many raw materials and intermediates soared to heights that left many manufacturers gasping. Then the economy collapsed, as did manufacturing, and many of those same materials costs deflated as well. Now, of course, the upward price creep is unmistakable as conversation about a recovering economy gains steam.

Meanwhile, in June the United States dem-



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on several raw materials, namely bauxite, coke, fluorspar, magnesium, manganese, silicon metal, silicon carbide, yellow phosphorus and zinc. China is a leading producer and exporter of these raw materials, which are key inputs for numerous products in the steel, aluminum and chemical sectors. European Union officials asked for WTO intervention as well.

"The United States is very concerned that China appears to be restricting the exports of these materials for the benefit of their domestic industries, despite strong WTO rules designed to discipline export restraints," said U.S. Trade Representative Ron Kirk in announcing the WTO case. Not only do the Chinese export restrictions limit access to the raw materials, but they also can "significantly" raise the world market prices for materials while lowering prices for domestic Chinese producers, according to the Office of the U.S. Trade Representative.

What should U.S. manufacturers be doing in the face of such raw materials volatility? Don't sit still, experts say. Rethink purchasing strategies, assess risk and consider changes to your production processes, such as those taken by manufacturer Anomatic Corp. Actions taken today can mitigate raw material risks in the future.

Expect Prices to Keep Rising

It's not simply growing demand that is starting to drive up prices, even as the manufacturing sector shows some signs of life and China appears to be restocking its inventories. Supply chain experts point out that in many raw materials markets, major producers have idled capacity in the wake of poor demand and used existing inventories to meet orders. "Producer inventory levels are now very

low in historic terms, and manufacturers are finally starting to ramp up production to meet orders. But given that some capacity was permanently idled and that inventory levels will take months to replenish, we are dealing with a diminished supply problem rather than an excess demand problem," states Patrick Furey, senior category manager for spend management solutions provider Ariba.

While many raw material prices are below year-ago levels, don't assume they will remain that way, or even fall back. Indeed, the best pricing is likely past. "For the most part, prices hit their low points in the first six months of this year and they have been on a steady climb since," says Furey. For example, he noted in mid-September, "Commodity plastic resins such as polypropylene and polyethylene are up 50% from their pricing lows earlier this year, but they remain down 30% when compared to last fall. Likewise, copper has doubled in the past six months, but remains 10% below last fall's price. Steel and aluminum are both up more than 30% in the past three months, but are down 50% and 20% respectively when compared to the fall of last year."

Furey says his company has been urging buyers to lock in direct material contracts for more than nine months. "If buyers and managers are sitting on the sidelines waiting for prices to drop again, they may be taking a hit by buying in the spot market while prices continue to increase," Furey says. He also urges companies to push for full pricing visibility to understand the cost drivers in the commodity being purchased. "If prices continue to escalate, suppliers will quickly come back to you and request adjustments—you need to be armed with market information and understand your supplier's cost structure so you can protect your company's

interests in future negotiations."

As a last measure of advice, the Ariba commodity manager points out that labor markets will lag as the market recovers. As a result, significant savings on indirect and service contracts still may be possible.

Get Holistic, Assess Risk

Raw materials purchasing decisions based on price alone bring their own risk, says Jeff Karrenbauer, president of Insight



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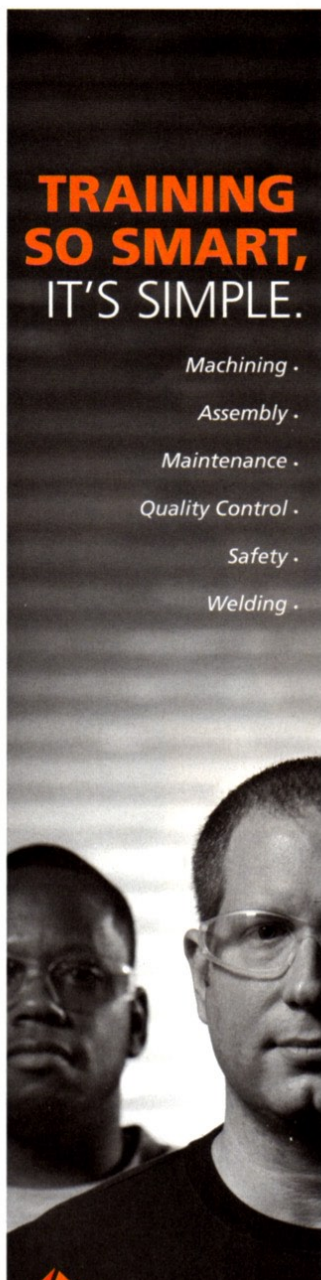
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tionally, people in procurement have worked on the basis of change—how can I get a better price—in isolation from the rest of the supply chain,” Karrenbauer says. One of the many dangers in that process is the potential for poorer quality materials that, for example, hamper the manufacturing process and dampen productivity. Yet many companies remain entrenched in silo management and silo metrics that reward purchasing for such decisions and place a black mark against manufacturing, Karrenbauer opines. “If we’re looking at this strategically, we should be looking at procurement and manufacturing in the context of the entire supply chain,” he says.

Indeed, focusing solely on the low-cost provider brings other risks as well. For example, Karrenbauer says, what if that low-cost provider, who is the sole source of a raw material that accounts for 30% of the finished goods by profit, is located in an unstable Third World country? “It puts a significant part of the enterprise at risk,” he notes. “That is just unacceptable. That’s just horrible management going for the lowest cost.”

Yet most manufacturers fall woefully short in assessing their supply chain risk vulnerabilities and developing Plan Bs, despite ample evidence that bad things happen. Note the number of suppliers that simply went out of business during the most recent economic downturn, the Insight president points out. “Industry is placing the biggest bet in the history of Las Vegas, and the bet is that nothing is going to happen,” he says.

Creative Cost Containment

Newark, Ohio-based Anomatic Corp. is no different than any manufacturer in that it is always looking for ways to reduce its raw material costs. One method the producer of anodized aluminum packaging uses to meet that

Anodizing aluminum is the company’s core technology, and the pedigree of the aluminum used is critically important, explains Mark Orminston the director of research and development. For certain finishes and in certain anodizing cells, virgin metal is an absolute requirement. “And virgin mill you never have to worry about,” Orminston says.

However, for other finishes Anomatic can and does use recycled aluminum, including mill scrap. The company began introducing aluminum mill scrap as an additional material source about 10 years ago, as a cost containment measure. Unlike virgin content, mill scrap already has gone through manufacturing sequences in an aluminum mill. However, the scrap is tightly controlled at the mill and its chemistry is well-known.

The cost savings in using mill scrap occurs primarily at the aluminum mill, rather than at Anomatic. However, those savings are passed along to the customer, Orminston says.

Recently Anomatic began introducing post-consumer aluminum as a second source of recycled aluminum—at the request of certain customers in their sustainability efforts. Because post-consumer aluminum once was used in another product, finding the right post-consumer aluminum for Anomatic’s processes was critical. “Finding a mill that could provide good post-consumer stock was the breakthrough,” Orminston says.

Today about 40% of the aluminum used at Anomatic is recycled (either mill scrap or post-consumer), estimates Orminston. Examples include one alloy that is 75% to 80% mill scrap, with the remainder being virgin metal. A new alloy contains about 65% recycled stock, 20% of which is “carefully selected” post-consumer stock.

Anomatic’s own sustainability initiatives also are helping drive down its processing chemical costs. For

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