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Supply Chain Blues (Fourth of a Series)

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Even in the ordinary course of business, private equity sponsors pay ruthless attention to the cost structures of their portfolio companies. It is a time-tested tool in sponsors' kits and often on the first page of their due diligence playbook.

Covid has simultaneously raised the bar and challenged buyers in managing all aspects of companies' supply chains. An informal survey of clients highlighted some of the difficulties.

"Eighteen months ago, Covid was a top-line issue; now it's mostly a cost issue," one managing partner told us. "It's not that we can't pass price increases along, but our contracts require 90-day notice. The speed at which they're rising makes it hard to keep up."

Another source agreed. "We've been playing catch-up all year," he said. "Revenues are fine, but costs are out of whack. Which is surprising, since we began to experience these disruptions last summer. And here we are over a year later – we thought this would be fixed by now!"

Why is this such a challenge to resolve? "The variant has clearly extended supply chain issues," he answered. "Work force shortages are creating stoppages at every step of the process.

"Labor and product move together. Bottle-necks are being caused, not only from direct raw material or component sourcing shortages, but indirect ones. We're having a tough time getting the equipment that makes the equipment that makes the product."

As one consultant reported, bottlenecks of packaging materials such as plastic, aluminum and paperboard contribute to stocking shortfalls. That's forcing some companies to re-engineer product and packing materials, depending on commodity input availability.

Sponsors confirm that maintaining safety stocks inventory of certain raw materials have increased significantly, creating greater working capital requirements and impacting liquidity.

We mentioned earlier in our series that labor force constraints are fundamental drivers of higher prices. "It's not just retention and hiring, but training as well," a friend reported. "On-boarding is a huge time commitment. And keeping people is still tough. We need to bring on ten people per month, but we have to hire 20 since we'll lose half of them."

Worker availability is not only related to direct labor on the manufacturing floor. It's also affecting the white collar force. Management, back office, and administrative functions are being swept into the overall overheated labor market.

But despite these headwinds, sponsored M&A activity remains robust. As the managing partner put it: "Higher costs don't seem to be negatively impacting private equity buying appetite."

Next week we wrap up our series with an outlook for supply chains.