

# Lost supplier trust, ...how Chrysler missed out on \$24 billion in profits over the past 12 years

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By any measure, Chrysler is on a roll. Sales are strong with double-digit improvements over previous years. Following the merger with Fiat, the automaker is making money, contributing substantially to Fiat's overall profits, and enabling the improvement and expansion of Chrysler's manufacturing plants in the United States. Talented Chrysler personnel are working well under the leadership of Sergio Marchionne, chairman and CEO of the new Fiat Chrysler Automobiles N.V. Together they have developed a comprehensive plan for Chrysler's long-term success.

Marchionne has publicly stated that Chrysler's future success now comes down to the execution of their well-developed plans. Chrysler's history, however, suggests that Chrysler's plans should not be considered complete. Conspicuously absent is any mention of Chrysler's suppliers and how they will be viewed going forward.

That could be a mistake. With Chrysler suppliers providing goods and services valued at approximately 70 percent of revenue, the time may be right for the automaker's leadership to review Chrysler's 20 year checkered history of supplier working relations. If they do, they will find strong evidence that the more trusting the supplier working relations, the greater the suppliers' contribution to Chrysler's profitability.

Why is this important? Because both our studies

# lost profits

**Most companies are missing out on an important opportunity for improved profitability simply because they are unaware of the profit contribution their suppliers can bring.**



Thomas Barwick

and others have proved quite conclusively that companies with the most trusting supplier working relations are the least adversarial and reap the greatest benefits from their suppliers. For instance, in a 2009 *Marketing Letters* article and a 2010 *Sloan Management Review* article we and our co-authors, respectively, discuss research that shows supplier price concessions and supplier-related non-price benefits, such as suppliers' willingness to share new process and product innovation ideas, increase as trusting working relations with the customer increase.

We base those conclusions on 20 years of ongoing studies we have conducted on the working relations between the six major U.S. automotive manufacturers and their hundreds of Tier 1 suppliers (See sidebar "Our Research" for details on our methodology). These studies enabled the comparison of the automakers' supplier relations in relation to one another, and across commodity areas and other groups within each automaker. Our results are not unique. Over the past several decades a multitude of studies, including many published in *Supply Chain Management Review* going back to 2005, have tied trusting supplier rela-

tions to a plethora of customer-related benefits.

The one thing missing in these studies is the impact of supplier trust on customer profitability. After several years of research we have determined how to calculate the economic impact of supplier trust on a customer's profitability. The impact on the bottom line is staggering. Using Chrysler as an example, we calculate that poor—or low trust—supplier relations have cost Chrysler \$688 of profit on every light vehicle they have manufactured and sold in the U.S. since 2001. This translates into \$24 billion in lost operating profit (EBIT and extra-ordinary expenses) over the last 12 years.

The methodologies we have developed enable us to determine the financial impact of supplier relations for virtually any company. For this article, however, we are focusing on Chrysler to show how supplier trust of a customer is related to the customer's profit.

There are two reasons for selecting Chrysler. First, Chrysler's supplier relations and profitability have been the most volatile of all the North American major automotive manufacturers over the past 20 years. In addition, co-author Thomas Stallkamp is a former vice president

## Our Research

Since 1992 we have conducted Annual Studies of Tier 1 production suppliers to the six major North American automotive original equipment manufacturers (OEM): Chrysler, Ford, General Motors, Honda, Nissan, and Toyota. The objective of the surveys is to understand the suppliers' perception of working with each of the OEMs.

Suppliers answer the survey questions as they relate to supplying specific goods, e.g., braking systems, wiper blades, audio systems, tires, and castings, to a specific OEM. As a result, we have obtained information from hundreds of suppliers on thousands of specific buying situations, spread across the six OEMs for 1992–2012.

In 2001–2012 the survey results included supplier provided financial data on the price reduction demands of each OEM and the subsequent supplier price concessions provided each OEM at the buying situation level.

The working relations data and price concession data from these surveys were complemented with 1992–2012 financial performance information from OEM-related annual reports, 10-K reports and other publicly available financial reports. Financial data were also made available to us directly from the various owners of Chrysler. This extensive array of data, as it applies to Chrysler, is the basis of our study. Profitability is standardized to operating profit (EBIT and extra-ordinary expenses)/vehicle to enable comparison across years and among OEMs without concern for unit

production and sales differences.

The initial research activities focused on determining which Working Relations Characteristics and OEM Financial Performance are most closely related. The 1997–2012 time period was used because public financial data relating to the North American operations of the three foreign domestic OEMs, Honda, Nissan, and Toyota, as well as Chrysler, as part of the DaimlerChrysler organization, were not available prior to 1997. The OEM data was corrected to include revenue for only domestic produced and sold vehicles (Ward's Automotive Group, Southfield, Mich. provided the production and sales data), because several OEMs imported vehicles for sale in the domestic market and also included non-sales automotive-related revenue in their revenue figures.

Using these data we were able to estimate a series of standardized econometric models for the overall industry and for each of the OEMs. As a result, we were able to identify a statistically significant relationship between supplier trust and financial performance, specifically Operating Income (EBIT and extra-ordinary expenses)/Vehicle. Additionally, using these estimates, we were able to calculate the annual supplier financial contribution for each OEM, which when coupled with the price concession data from our Annual Studies, enabled the determination of the supplier price concession contribution to OEM profitability and supplier non-price benefits contribution to OEM profitability.

of procurement, and former president and member of Chrysler's board of management. In addition, he became vice chairman of DaimlerChrysler Corporation in 1999. Under his leadership, Chrysler developed the Extended Enterprise concept and introduced the Supplier Cost Reduction Effort (SCORE) we discuss below. During his tenure, Chrysler achieved the highest profit per unit of any major automobile manufacturer. We contend that this success was a direct result of supplier trust.

Chrysler's experience, which mirrors what we have found at Ford, General Motors, Honda, Nissan, and Toyota, provides a strong lesson for every company. Building trusting supplier relations is more than a company feel good exercise. It is a prudent company activity that can contribute substantially to a company's profits. To prove this point the article presents an overview of 20 years of Chrysler's supplier working relations and related profitability. Chrysler's history provides direct evidence of two incredibly important managerial lessons. One is that a company's actions toward its suppliers substantially affects the suppliers' contribution to the company's profitability. The other is that it is folly for a company to take an adversarial approach when pressuring suppliers for price concessions.

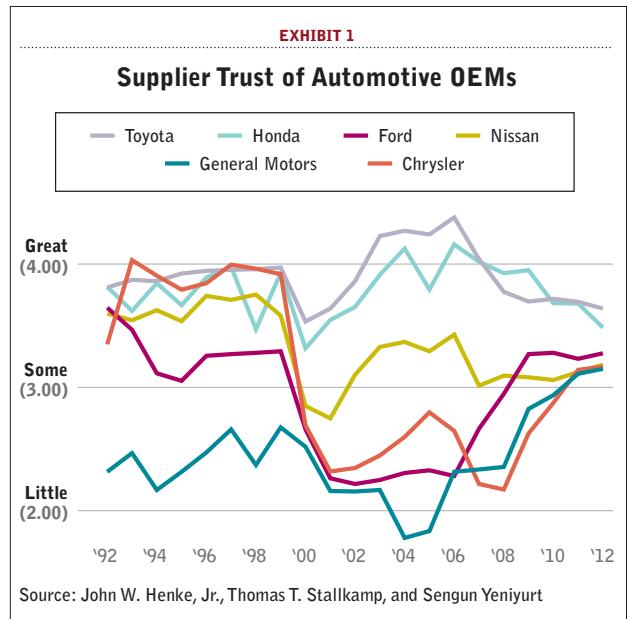
These findings are compelling evidence that justify why CEOs, CFOs, and heads of purchasing in every industry should give far greater attention to their firm's supplier relations. In fact, we believe that readers will conclude, as we have, that if top management of any company does anything less than work to ensure that their firm has trusting supplier relations, they are mismanaging the company.

But first, some background on Chrysler's recent history of supplier relations.

### Chrysler: Lost Trust = Lost Profits

Despite the company's strong performance since the recession, Chrysler's road to profitability hasn't always been smooth. From 1992 until 2012 Chrysler experienced considerable volatility in supplier trust and profit per vehicle as it underwent a succession of owners. According to our research, this volatility was unmatched by any other North American automotive original equipment manufacturer (OEM) (Exhibit 1).

During the 1990s, an independent publicly-owned Chrysler Corporation developed and implemented a unique approach to supplier relations that produced significant advantages for the firm. Known as the Chrysler Extended Enterprise™, the strategy was based on the belief that more collaborative supplier relationships would reduce costs and improve supplier working relations. The Extended Enterprise™ program emphasized strong, coordinated collaboration between Chrysler and the



companies that comprised its vast supply chain. Every production goods supplier, regardless of size, was treated as an equal member of the Chrysler team.

The Extended Enterprise™ program focused simultaneously on strengthening supplier working relations as measured by supplier trust of Chrysler, while achieving greater supplier price reductions. This was contrary to the common domestic automotive industry belief that increasing supplier trust and getting greater supplier price reductions were mutually exclusive activities. (This belief, which persists today, is typical in most manufacturing industries.) While the other automotive OEMs were constantly changing their policies toward suppliers, the various Chrysler supplier interfacing functions (primarily procurement and supply, engineering, and manufacturing) treated suppliers in a consistent and predictable manner that established and maintained an environment of mutual trust.

The Extended Enterprise™ program created an environment in which Chrysler and supplier behaviors consistently matched the expectations of the other party. The result was an atmosphere in which common goals and mutual effort brought Chrysler and its suppliers closer together than ever before. This trusting environment enabled Chrysler to develop its highly regarded Supplier Cost Reduction Effort (SCORE) program. As described by our co-author Stallkamp in his book, *SCORE! A Better Way to Do Business: Moving from Conflict to Collaboration*, SCORE followed the collaborative philosophy of the Extended Enterprise™ program by encouraging suppliers to submit suggestions that would reduce their cost of doing business with Chrysler, whether these cost reduction opportunities were to be found at the

suppliers' facilities or within Chrysler. Most importantly, Chrysler structured the SCORE initiative so that suppliers kept a portion of any realized savings for themselves to improve their own profit margins. This was contrary to the usual industry practice of the OEM taking all of the savings from supplier cost reduction ideas. As a result, Chrysler and its suppliers both benefited significantly under these conditions.

Concurrently, the other domestic OEMs began implementing cost reduction programs, but in an extremely adversarial way. For example, under the direction of the infamous J. Ignacio Lopez de Arriortua, General Motors purchasing announced in October 1992 that it would break any contract it considered unfavorable to GM with only a 30 day notice. This ignited a fire storm of negative industry press, causing GM's senior management to eventually "clarify" that contracts would be canceled only over quality concerns. Such behavior toward suppliers, even after Lopez left GM, caused supplier trust of GM during

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the 1990s to be by far the worst of all OEMs (Exhibit 1).

The combination of the unusually equitable SCORE program and the lower supplier trust of GM and Ford resulted in Chrysler increasingly becoming the OEM to whom suppliers would bring cost-saving ideas and new innovation for both products and processes. By sharing the savings with suppliers, the SCORE program became self-sustaining with greater contributions to Chrysler's bottom line occurring in each succeeding year. As publicly reported, SCORE produced in excess of \$5 billion in material and operating cost savings for Chrysler from 1991 until the 1998 merger with Daimler-Benz.

By following a coordinated strategy that involved defining the goals suppliers were expected to achieve, measuring the achievement of those goals at both the individual supplier level and the supply base in total, and through the public recognition of individual supplier achievements, Chrysler divorced itself from the decades-old adversarial approach to supplier relations. Most importantly, Chrysler's behavior created a level of supplier trust that was rivaled only by Toyota and Honda

during the mid-1990s (Exhibit 1). In fact, in his book, *The Toyota Way*, Jeff Liker reported that Toyota, which had the most trusting supplier relations of all OEMs at the time, was quite concerned that Chrysler would ". . . soon become the world's most profitable car company in terms of profit per vehicle—not the biggest, but the most profitable per vehicle... Up to that point, no U.S. company had shown signs of getting it right and developing a culture that could compete with Toyota."

Toyota's concern was justified. During 1997-1999, the only comparable years during the Chrysler Extended Enterprise period for which Toyota financial data is publicly available, both Chrysler and Toyota experienced equivalent trust of their suppliers (Exhibit 1), with Chrysler realizing, on average, \$2,456 operating income (EBIT and extra-ordinary expenses) per vehicle, while Toyota realized \$1,784 operating income (EBIT and extra-ordinary expenses) per vehicle.<sup>1</sup> This was all to change at the close of the decade when difficulties with the Daimler merger peaked.

At the time of the 1998 merger, Chairman Jürgen Schrempp publicly stated that one of the reasons Daimler-Benz approached Chrysler with the merger proposal was to gain access to Chrysler's organizational and supplier relations philosophies. Unfortunately, Schrempp's attitude toward Chrysler's capabilities was never taken to heart within the Daimler-Benz organization. Chrysler's collaborative approach to suppliers was truly foreign to the Mercedes purchasing and engineering personnel, who had long followed a command and control approach to managing the Mercedes supply base. As a result, Mercedes personnel involved in the day-to-day activities with suppliers showed little regard for Chrysler's supplier relations philosophy.

In the end, the stronger Daimler culture overwhelmed that of Chrysler. By 2000, many of the senior Chrysler leaders who had led the transformation of the firm during the previous decade had left DaimlerChrysler, either voluntarily or through outright firings, and had been replaced by Mercedes personnel. This new Chrysler management team began implementing Mercedes' adversarial policies and procedures, which rapidly obliterated the successful Extended Enterprise™ model. Subsequently, supplier trust of DaimlerChrysler showed the greatest single year drop ever measured in the industry, falling from an average rating of 3.7 in 1999 to 2.6 in 2000 (Exhibit 1).

The worst was yet to come. Facing a dismal economic future, Chrysler's Mercedes-bred management brought in outside consultants from Germany to review the company's purchasing practices. Failing to understand

the value of the Extended Enterprise™ program, the consultants concluded that Chrysler, on the basis of piece price alone, was paying too much for its production parts. Influenced by the studies, the management team approved a new Material Cost Management (MCM) program.

On December 7, 2000, the MCM program was announced to a disbelieving supply base. The two-phase program began with all suppliers being given three weeks notice that their prices and purchase orders were being arbitrarily reduced by 5 percent on January 1, 2001. Suppliers were told that cashing the first Chrysler check that reflected the price reduction would indicate their tacit approval of the price reduction. Phase 2 involved Chrysler procurement and engineering personnel collaboratively working with suppliers to reduce Chrysler's total purchasing costs by an additional 10 percent by the end of 2001. An unfortunate, but predictable, result of these events was the continued drop of supplier trust of Chrysler to an average rating of 2.3 in 2001. In 2003, Chrysler procurement began to slowly improve its supplier relations and, subsequently, its profit as the company attempted to work more closely and in a more trusting manner with selected strategic suppliers. But another change was about to hit.

In 2007, Daimler sold its interests in Chrysler to the private equity firm Cerberus Capital. The sale, which resulted in a several billion dollar loss for Daimler, seemed a natural outcome of the 2000-2006 years of Daimler management of Chrysler, during which time Chrysler realized an average operating income (EBIT and extra-ordinary expenses) per vehicle of only \$110. This is in comparison to the average operating income (EBIT and extra-ordinary expenses) per vehicle of \$2738 during the 1993-1999 Chrysler Extended Enterprise years.

To rapidly improve profitability, Cerberus management focused on cost cutting, including a particularly adversarial approach to reducing supplier costs. This chapter of Chrysler's history, which included the lowest levels of supplier trust and profitability since 1992, was short lived. In January 2009, Cerberus was forced to obtain Federal government assistance for Chrysler to avoid certain bankruptcy.

The terms of government assistance required the replacement of the Cerberus-appointed management, which included replacing head of purchasing with a Chrysler manufacturing veteran who had worked closely with suppliers. Even in the depths of the Great Recession, the collaborative approach resulted in improved supplier relations and increased profitability (Exhibit 2).

Chrysler weathered the 2008–2009 industry downturn with the help of government loans and Fiat investment, a bankruptcy to clean-up its books, extensive restructuring to be a more efficient manufacturer, a return to its roots of

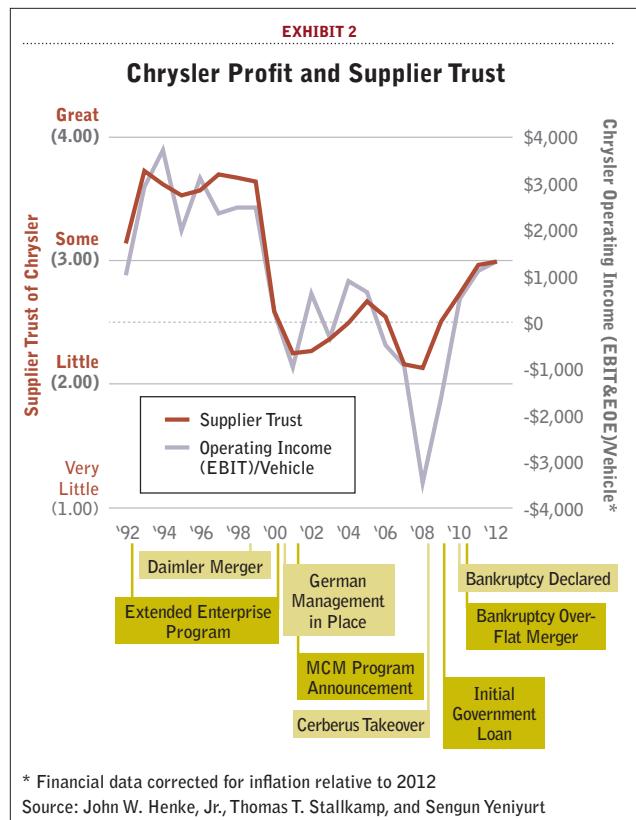
collaborative trusting supplier relations, and a subsequent merger with Fiat. As a result, Chrysler returned to profitability, realizing \$528 operating income (EBIT and extra-ordinary expenses) per vehicle in 2010, \$1086 in 2011, and \$1336 in 2012 as suppliers' trust continued to increase (Exhibit 2). But supplier trust of Chrysler was still among the lowest of the six major North American OEMs (Exhibit 1).

### Suppliers' Contribution to Chrysler's Profits

The two decade story of supplier trust and Chrysler's profits (Exhibit 2) indicates a strong correlation between the two. While correlation does not imply causation, our 20 years of annual supplier relations data, the availability of annual OEM financial data, and annual N.A. automotive production and sales data, coupled with numerous governmental annual econometric data, enabled us to go where other researchers could not to show how supplier trust affects customer profit (see "Our Research" sidebar on page 26).

We initially found that OEM profitability results from two sources: managerial capabilities and suppliers. Critically, our 20 years of data enabled us to determine the annual percent contribution managerial capabilities and suppliers make to the profits of each OEM.

Managerial capabilities of an OEM are comprised of such diverse characteristics and activities as management



skills and talents, manufacturing capabilities, workforce skills and dedication, labor productivity, product quality, marketplace acceptance of its vehicles, and sales incentives, to name a few.

Suppliers contribute to the profits of their customers in two areas. The most obvious is supplier piece price reductions, while the second area is related to non-price benefits that suppliers provide, on their own volition, to customers. These latter “soft” benefits include the level of assistance a supplier may choose to provide a customer, supplier sharing new product and process innovation, supplier providing support beyond contractual obligations, and supplier providing “A Team” rather than “B Team” support when support is needed. Each of these soft benefits contributes to the efficiencies and effectiveness of the customer’s operations, causing the customer to reduce its costs of operation.

**Overall supplier financial contribution.** At this point in the research we had three of the four variables needed to fully understand the annual supplier contribution to profits for each OEM. As shown in Exhibit 2 for Chrysler, publicly available data enabled the determination of the annual operating profit (EBIT and extra-ordinary expenses) per vehicle. The research we subsequently conducted resulted in the determination of the percent of annual operating profit that could be attributed to suppliers for each OEM.

Finally, the relations and price concession data from our Annual North American Automotive OEM–Tier 1 Working Relations Index® Study enabled the determination of the third variable, the annual supplier price concession contribution to the profits of each of the six major North American OEMs for 2001-2012. The fourth variable, the supplier non-price benefits contribution to annual profits, could now be calculated. By multiplying the supplier profit contribution percentage times the annual profit per vehicle we had the total annual supplier contribution to operating profits per vehicle for each OEM. We then subtracted the annual supplier price concession contribution from our Annual Study to get the annual supplier non-price benefits contribution for each OEM.

Exhibit 3 shows the results of these calculations for 2001-2012 for Chrysler. The results are limited to 2001-2012, because these are the years for which we have price concession data. As seen with total operating profit (Exhibit 2), suppliers’ financial contributions to Chrysler profits are strongly correlated with the level of supplier trust and, most importantly, are quite substantial. In fact, if it were not for the annual supplier contributions (Exhibit 3), Chrysler’s annual operating income (EBIT and extra-ordinary expenses) would have suffered even greater losses (Exhibit 2).

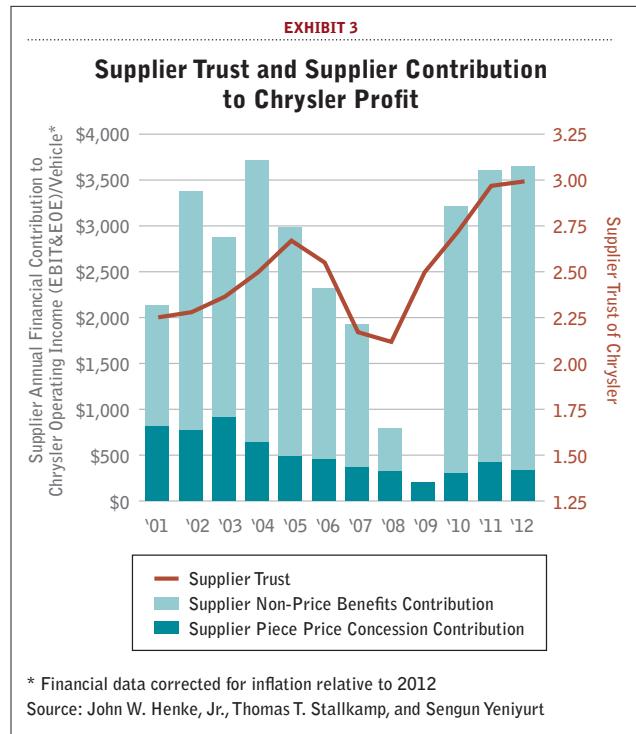
During the Daimler years of 2001-2005 supplier trust was low, but slowly increasing year over year. Concurrently,

supplier contributions to profits also generally increased. In 2006-2009, the waning and increasingly adversarial years of Daimler and Cerberus ownership, supplier trust dropped precipitously, as did suppliers’ annual total profit contribution. The supplier benefit contribution for 2009 is not included because it is negative, which we believe is indicative of the highly unusual Cerberus financial machinations that took place leading up to and during 2009, and preceded U.S. government intervention and bankruptcy.

Also, the steep increase in supplier trust in 2009 and Chrysler’s lowest supplier price concession over the 2001-2012 time period is reflective of our Annual Study timing. The increased 2009 trust number is indicative of the “legacy” trust suppliers had of the new “old Chrysler” management that was in the process of taking over from Cerberus, while the profit data is the result of the Cerberus management prior to declaring bankruptcy.

The years 2009-2012 began with the federal government showing the door to Cerberus and its management team. Fiat was then brought in and “old Chrysler” personnel moved back into key management positions. The combination of these events resulted in supplier trust increasing in 2011 to its highest level in a decade from its lowest level in 2008. The suppliers’ contribution to Chrysler’s profit shows a concomitant increase in 2010-2012.

**Supplier price concessions.** The most obvious OEM benefit of supplier price concessions is the immediate



reduction of the cost of goods. This results in a corresponding direct and immediate increase in operating profit.

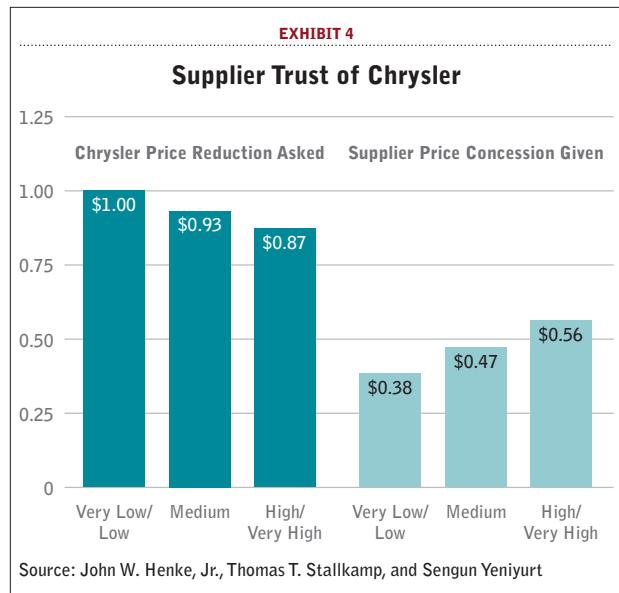
This rationale is used by companies in search of more profit to justify the use of an adversarial approach to getting price reductions from suppliers, as was the case with the Daimler and Cerberus management teams. In reality, the adversarial price concession approach results in lower supplier trust, which in turn reduces supplier price concessions—the opposite of what management expects and needs in challenging times (Exhibit 4).

These contrary results occurred at Chrysler. The data show that as supplier trust of Chrysler increased in the 2001-2005 and 2009-2012 time periods, suppliers were more likely to give Chrysler greater price concessions. And when supplier trust decreased, 2006-2009, supplier price concessions also decreased. In fact, the lowest supplier price concessions occurred in 2008 and 2009, when suppliers were confronted with the adversarial behavior of the Cerberus purchasing head. As a result of their naive actions, Cerberus purchasing management's adversarial behavior caused suppliers to give Chrysler their lowest price concessions at a time when Cerberus was in need of its suppliers' greatest financial support.

**Supplier non-price benefits contributions.** An equivalent relation occurs between supplier trust and the soft benefits suppliers provide their customers. The more a supplier trusts a customer, the greater is the supplier's willingness to support the customer. Our annual automotive studies and other client supplier studies have consistently found that, regardless of industry, companies most trusted by their suppliers realize the greatest benefits. These benefits, which can contribute significantly to the efficiency and effectiveness of a company's operations, include:

- increased supplier willingness to share new product and process innovation ideas with the customer;
- increased supplier willingness to invest in customer specific new product and process innovation in anticipation of future customer needs;
- greater supplier willingness to allocate greater resources and the most qualified personnel to support the customer; and
- more open and honest supplier communication with the customer.

Unlike supplier price concessions, the financial contribution of the increased managerial efficiencies and effectiveness that results from these non-price benefits is buried among the various line items of the customer's income statement. It is the challenge of quantifying this financial contribution that has eluded academics and practitioners. However, as previously discussed, the publicly available OEM financial data and industry production and sales



data, coupled with the price concession data from our Annual Studies enabled us to determine the annual financial contribution of the suppliers' non-price benefits to each OEM's profit/vehicle.

When applying this methodology to Chrysler we found that the financial contribution of the soft benefits suppliers provide Chrysler are, like supplier price concessions, highly correlated with supplier trust. In addition, the value of these non-price contributions greatly and consistently exceeds the monetary value of the suppliers' price concessions. For example, in 2010, 2011, and 2012, as suppliers became increasingly convinced that Chrysler was moving back to more collaborative ways of working with them, the suppliers' increased non-price benefits to Chrysler. The increased supplier non-price benefits contributed to more efficient and effective operations within Chrysler that resulted in lower operational costs. These, in turn, resulted in supplier-related profit contributions of up to eight times the price concessions suppliers' gave Chrysler. Even in 2008, during Cerberus' most adversarial relations, suppliers provided benefit related financial contributions that were slightly more than the monetary value of their price concessions.

These outcomes suggest that companies that pressure suppliers in an adversarial manner to obtain greater price concessions to improve their bottom line are, in fact, doing themselves a great disservice. They are, instead, consigning their firms to be second class customers who will be treated in an adversarial manner by their suppliers.

### What Lessons Have Been Learned?

Today, Chrysler's improved supplier relations have resulted, once again, in suppliers providing substantial financial

contributions to Chrysler's profitability. So, why the concern about what Chrysler should do next? Because history often repeats itself.

Even with the recent improvement, Chrysler's current supplier trust is substantially below the trust levels of the 1990s that are associated with Chrysler's highest levels of profit-per-vehicle in the past two decades (Exhibit 2). Also of concern is the flat-lining of trust improvement seen in the last year. The lack of trust improvement suggests that Chrysler's top management, like the majority of CEOs, CFOs, and heads of purchasing, are grossly underestimating the importance of allocating the resources and supporting the effort needed to create and maintain a working environment that will increase suppliers' trust and the subsequent supplier contribution to their company's profits.

In fact, if the 2012 level of suppliers' trust of Chrysler had been present since 2001, our calculations estimate that Chrysler would have gained an additional \$688 of profit on every light vehicle manufactured since 2001. This additional profit/vehicle would have resulted in Chrysler realizing a total gain of almost \$24 billion in additional operating income (EBIT and extra-ordinary expenses) over the 2001-2012 time period.

This estimate, coupled with Chrysler's supplier and related financial experiences of the past two decades, provides two convincing lessons for every company. First, working to build and maintain trusting supplier working relations is a prudent, financially responsible activity for every company to undertake. Second, by working to build and maintain trusting supplier working relations, the opportunity for purchasing to achieve meaningful and substantial supplier price concessions and other supplier-provided benefits is maximized.

It takes a lot of effort and resources to be an adversarial customer. Hopefully, this story of 20 years of Chrysler's supplier relations and profitability is a convincing argument as to why every company would be much better off applying its effort and resources toward building and maintaining trusting supplier relations. ☺☺☺

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#### **End Notes**

1 All automotive OEM profit data discussed in the article is operating income (EBIT and extra-ordinary expenses) per vehicle, corrected for inflation relative to 2012, for light vehicles (automobiles, pick-up trucks, and SUVs) produced and sold by the OEM to car dealers and fleet owners in North America.