



REVISITING THE SUPPLY CHAIN

October 2020

1. Introduction

2020 will go down in history as a watershed year. COVID-19 has caused mammoth havoc and created unparalleled and profound challenges in unprecedented circumstances. For organizations, navigating this pandemic has necessitated careful consideration of a range of issues. Lockdowns were imposed all over the world of varying degrees, and probably the toughest in India at a fairly early stage of the pandemic, which curtailed economic activity. Almost overnight it became crucial to carefully consider and evaluate the disruption and its consequences upon business relationships. In India, as in the rest of the world, central and state governments were compelled to frame new policies almost daily and the overall lack of clarity of the situation caused tremendous ambiguity and anxiety. COVID-19 continues to create uncertainty globally across all business sectors, though, of course, 8-9 months later the position is slightly different. But even as we edge closer to the end of 2020 and seeing the fresh waves in many parts of the world, the trajectory of the virus is such that it shall inevitably continue to affect large and small businesses for the foreseeable future, at least, through 2021. As a consequence, there is a dire need to consider and plan forward and particularly in business verticals where the risk of potential recurrence is vast. Amongst the long list of disruptions to be managed, logistics and supply chain assumes great significance.

This newsletter focuses on the need to transform the supply chain with a focus on key selective areas.

2. The Lessons Learnt

Since the virus morphed into a pandemic, governments across the globe have been encouraging industries to evaluate their supply chain in an endeavor to develop both economic and strategic independence. The havoc to supply networks due to travel bans, export or import restrictions imposed on goods compelled companies to revisit their supply chains. The list of limitations have been endless – *for instance*, impact of absence of visibility over sourcing alternatives led to enhanced production costs; the inability to test and determine if the agreed specifications were fulfilled; challenge of insufficient quality-test capabilities, health risk to employees emanating from goods and people coming from high-risk areas, decreased productivity due to workforce absence – all have compounded supply-side issues. Companies had to review contingency arrangements and re-prioritize on the basis of several factors, be it inventory levels, cash flow to optimize technology, requirements of customers or end users. In the early days of the pandemic when the lockdown in India (as elsewhere) led to hoarding of supplies, from the simplistic perspective of a consumer, organizations had to suddenly monitor inventory levels so that there was better visibility. Entities focusing on one-country or one supplier had to assess risks and ability of limited suppliers to meet requirements. At such times, the ability of a supplier to supply within the agreed timeliness required a different strategy. In this process, it was

amply evident that there was a dire need to have sufficient visibility over sourcing alternatives to manage the supply chain. Using technology to create tools with potential to ensure ongoing supply chain visibility is critical to keep goods flowing and mitigating risk. Simultaneously, it was and continues to be of paramount importance for conglomerates to effectively communicate with suppliers and end customers to ensure absence of gap between expectation and reality.

According to a study by India Brand Equity Foundation and the Economic Survey of 2017-2018, the logistics sector is pegged at USD 215 billion and expected to attract investments worth USD 500 billion by 2025. Recognizing an increasingly changed consumer spending patterns and the role of logistics and supply chain to address changing needs, the 2020 budget speech of the government which preceded the pandemic in India contained several initiatives. Amongst others, this included viability gap funding for setting up warehouses, a new National Logistics Policy which will clarify the roles of the central and state governments and key regulators. Hopefully, as and when implemented, it will also obliterate red-tape and create the promised single-window e-logistics market, with an enhanced focus on employment and skills generation.

3. Face of a New Supply Chain

There is little doubt that things will not go back to what they were before. Businesses are looking to the longer term, including in respect of supply chain resilience, risk and its mitigation. Factoring in supplier and supply chain flexibility will be key to coping with uncertainty. And, the face of a new supply chain will have to consider many pieces, including alternative sourcing possibility, indigenization and essential contractual safeguards, compliance with regulations. Some of these considerations are outlined below.

3.1 *Understand Supply Chains Better:* Most companies know their major suppliers pretty well. They have a good idea of their critical dependencies, but many have not paid heed to their supplier's suppliers (and beyond), or properly evaluated their whole supply chain exposure. It is time to give much closer scrutiny to precisely how the total supply chain is constructed, where the dependencies lie, and negotiate contracts that give them a high degree of assurance and protection for the future.

3.2 *Alternative Sourcing:* As global supply chain networks come under increasing strain – the overnight disappearance of demand and loss of business, shutdown of operations due to implementation of measures designed to combat the spread of the virus – the pressure will increase to source alternative materials, components and ingredients in the production of industrial and consumer products to get around shortages and meet demand. If not done by now, businesses shall need to agree and implement codes of conduct between customers and suppliers for expected standards to manage risks and prevent disruption. This may involve auditing internal processes so that with a complete understanding of their total supply chain and risks emanating from them, one can put in place more effective contingency planning and mitigation strategies ahead of time.

3.3 *Diversity & Localization:* Companies will revisit where their supply chain comes from and passes through. Risk will only be spread if there is diversity in the supplies, suppliers and geographies. This is also the only way to reduce dependencies on one or two vendors, give greater flexibility and (hopefully) assure continuity of supply for future eventualities. Challenges will remain in ensuring consistency of quality, regulatory adherence and alignment, and partly in understanding geopolitical and other risks inherent in

dealing with particular geographies – assessing risks in jurisdiction, business practices, skills, logistics and transport. All of this will give a greater impetus to localization and building indigenous capabilities.

3.4 Contractual Considerations: It is imperative to understand and know both executed and future contracts better. This means evaluating enforceability of force majeure and material adverse clauses (“**MAC**”), when do they trigger. Incorporating them within contracts may prove useful in mitigating against risks, liabilities and penalties arising as a consequence of disruption to the supply chain.

Usually, contractual force majeure clause seeks to exclude the liability of contracting parties for events beyond their reasonable control. The clause contains **(a)** a definition of force majeure that provides for an inclusive list of events (such as fire, flood, etc.) and unspecified events, which are generally beyond the reasonable control of a party; **(b)** rights of termination in the event of non-performance for an extended period of time. So far, most provisions never provided for a disease or envisaged a pandemic. As a general principle, the non-performing party seeking to assert force majeure as a defense must demonstrate that it could not have avoided the contractual breach or, alternatively, that it took reasonable steps to mitigate its effect. It is, therefore, imperative for companies to take immediate efforts to limit the impact of supply chain troubles, shipping delays and labor shortages. A party seeking to excuse its performance is expected to use reasonable efforts to overcome obstacles. For instance, a company experiencing a delay in production could notify its distributor or explore alternative means of production. Moving forward, organizations that plan and implement immediate steps to mitigate will fare better than those that elect to do nothing.

When an event gives rise to a change which has a material adverse impact on the business, contracts contain MAC with materiality thresholds that usually provide for termination rights and ensuing consequences. The challenge remains while dealing with an unknown “enemy” i.e., there is no visibility on the duration and severity of the effects of the pandemic on business. And, consequently, the ability to decide to opt for termination shall require a detailed internal diligence. As COVID-19 has demonstrated, time is of essence and delays in decision-making could have wider ramifications on rights and liabilities of the parties. In any dispute, the effect of the pandemic and its impact on a material element of the contract will be a highly contentious issue. Additional exposure may occur where the risk may be that products may not meet required quality standards or technical specifications and the extent to which liabilities, including warranty claims, or other rights may also arise.

3.5 Others: While this is not exhaustive, but there are several other aspects to watch in the times to come. *Firstly*, monitoring compliance with both guidelines and policies assumes significance from a liability and risk perspective, particularly when goods are moved across national or domestic state borders. *Secondly*, watching consumer behavior is essential as change is likely to impact strategies around supply chain management and may require measures to adapt distribution networks accordingly. *Thirdly*, ongoing liquidity demands and access to finance are of critical importance in keeping organizations operational and the supply chain flowing which, as noted before, may require strengthening domestic capability and a resilient supplier base. *Fourthly*, plan for future shutdowns and other contingencies to avoid shortage of raw materials and components. Such planning should, hopefully, address and minimize the risk of possible substitute substandard materials by some suppliers.

4. The Board’s Role

In a fast-paced, evolving and uncertain regulatory and compliance landscape the board of directors have a greater duty to be particularly mindful. This is, perhaps, the best time to review all existing systems – information gathering, reporting, amongst others – so that the directors are able to steer as needed. At the same time, boards need to consider additional steps that may be required if the impact of the virus is prolonged and the feasibility of implementing new steps under different scenarios including limited resources, heightened health and safety regulations. Given the overall economic slowdown which preceded the virus, boards and senior managements need to perhaps play a more active role, than normal, see how the company needs to reinvent to be more resilient, and use technology to transform the supply chain.

Furthermore, it may be prudent for boards to constitute smaller committees to do contracts analysis, identify potential liability issues, triggers for defaults and termination rights so that they remain on top of potential future disruptions. A mere Plan B will not be sufficient; instead, the directors too need to be prepared for various different situations while juggling need to adhere to a heightened regulatory environment and manage employee health and safety issues at the workplace. At a time like this where small businesses and top conglomerates are impacted, logistics and supply chains management has assumed greater importance, even by the Board.

5. Conclusion

As noted, 2020 has brought its own set of mammoth problems in the backdrop of a recessionary environment. While things are slowly restoring to a “new normal” (whatever that may mean), but when both inter-state and international borders were completely sealed and with global travel restrictions, both domestic and international trade faced a massive slowdown. This was a reality. The lack of demand by the consumers and the consequent cash crunch in the economy hit the supply chain. It is imperative to ensure that India Inc. is equipped to handle such future restrictions on cross-border movement of goods and consequential shortage of resources and raw materials. The complexity of supply chain management cannot be undermined. The buzzword of the future is resilience, resilience and resilience. If not done already, it is high time to revisit the supply chain. This way, in the event interruptions do occur, organizations will not find themselves in a situation where they have to catch up after the event, which can obviously come at a cost of increased expenditure, exposure to legal liabilities and/or penalties and lost customers.

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