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Taking the Sequester Bull By the Horns

By Bridget McCrea *Apr. 25, 2013*

With the federal budget sequestration in full force, effective supply chain management is more important than ever.

Air traffic controllers aren't only ones feeling the impact of the federal budget sequester. In effect since March, the sequestration – defined as mandatory cuts to federal programs – is already taking its toll on the supply chains of firms that work directly with Uncle Sam and trade goods and services with government agencies.

Passed as part of the Budget Control Act of 2011, the sequester impacts both domestic and defense programs and includes a total of $85.4 billion in spending reductions. According to *Bloomberg Businessweek's* The Sequester's Hidden Risks for the U.S. Economy, the drop in government spending will result in 750,000 fewer jobs and a 0.6 percent contraction in the U.S. economy. Defense spending reductions (through contract cessation and contract extension elimination) and federal employee furloughs make up the bulk of the spending cuts.

Measuring the Impact

Media outlets nationwide are already reporting negative supply chain impacts inflicted by the sequester. In Boulder, Colo., for example, the cuts have put the state's aerospace industry in limbo, according to the *Boulder County Business Report*. Based on research from George Mason University, the article states that, "more than 2,000 Colorado jobs could be lost this year in the civil space industry alone. The impacts are not just to the aerospace and defense companies; the flow-down effect to its supply chain is significant, given the high rate of subcontracted work."

Arizona firms are also feeling the squeeze, according to the recent *Politico* article In Arizona, sequester starts to hurt, which stated that about 2,000 companies with Arizona ties received contracts from the Department of Defense last fiscal year for a total of about $13 billion. "The general feedback from the supply chain in our market…is some of them have not seen an order for a year and a half from the larger OEMs, and they're burning through their last contracts," said Barry Broome, president and CEO of the Greater Phoenix Economic Council, "so the government is cutting off their business."

Is the Glass Half-Full?

Guy Morgan, managing director and global advisory group lead with BBK in Southfield, Mich., has a slightly more optimistic view on the sequester and says commerce in the U.S. has yet to feel any significant impact of the sequester. "We speculated some potential effects for our heavy industry clients as some manufacture widgets for the defense industry," says Morgan, "but no negative effects have been brought to the forefront yet."

Those firms that *are* feeling the pinch would be wise to focus on cost-related issues, according to Morgan. "Volume will be adversely impacted, and once it is, it is critical that suppliers first address all quality, cost, and delivery issues associated with reduced capacity," he advises. Next, companies should focus on growing their business in other markets as much as possible. Flexible electronics suppliers, for example, can move existing technology and capabilities from government-oriented products to other industries i.e. computer, auto, or consumer, thus lessening the negative impact on their supply chains.

"Exploring other business segments includes examining their product portfolio to see which products, if any, can be placed into other industries," says Morgan, noting that when the auto industry faced its downturn in 2008, "many suppliers looked outside of automotive to try and meet minimum capacity levels in order to sustain operations."

Dealing with Ongoing Uncertainty

At Veterans Trading Company (VTC) in Park City, Utah, John Pierce says the uncertainty of the sequester is having the biggest impact on supply chains right now. With no resolution on the immediate horizon, for example, firms can't effectively plan their sales *or* their procurement activity for the remainder of the year. "Companies know that they're going to be impacted," says Pierce, executive vice president for the third-party logistics provider, "but they don't really know *how* it will impact them."

VTC, for example, has several government contracts in effect – some of which won't be active until 2016 – that have already been funded and, as a result, aren't affected by the sequester. The overall slow decision and activity rates within the defense industry, however, could create supply chain delays and holdups for firms that rely on Uncle Sam for shorter-term contracts.

"Defense is a very conservative industry as far as the supply chain is concerned and decisions aren't made very quickly to [begin with]," says Pierce, who advises suppliers not to take their eyes off the prize and to continue over-performing and hitting their matrixes despite the uncertain environment. "Maintaining quality, on-time delivery, and supply chain efficiency are more critical than ever."

The Dollars and Cents Of It

Developing a smooth-running supply chain is challenging enough in a "normal" environment. With the sequester adding new layers of complexity to the task, companies have to work a little harder to make sure their supply chains remain fluid, visible, and optimized. Pat Ross, a partner with Irvine, Calif.-based CPA and business advisory firmHaskell and White LLC, says firms should focus on good inventory management while remaining flexible and agile.

Maintaining open lines of communication (both with suppliers and customers) about the sequester and its impacts is also important, says Ross. In some cases, for example, vendors may be willing to extend terms in exchange for short-term pricing increases. "If you're on 45-day payment terms and you need 60-day terms because your own A/R payments are being held up, now is the time to talk to your suppliers about the problem and enlist their help in managing it," says Ross, who also advises firms to start talking to banks and other lending sources *now* rather than later. "Don't wait until you absolutely need that $750,000 loan to cover your business operations; start talking to your bank about it now."