# Shoulder Pads and Supply Chains

By Mariko Gordon
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I'm not quite sure how I found myself watching the first few episodes of *Star Trek: The Next Generation* over winter break with my older son Haden. For all I know, he might have been feigning an interest in order to con me out of something later on.

In any case, I hadn't watched the show since... did that show really first air in 1987?! I actually *remember* how excited all of us Star Trek nerds were about the show, and how cool we all thought everything was - the costumes, the sets, the new improved Klingons. It was so much less cheesy than the original show.

Except, with the benefit of 25 years of hindsight, it really wasn't.

The 80s are writ large all over the futuristic costuming, not to mention (for those characters who had any) the hairstyles. Somehow, futuristic imagining can't ever seem to achieve escape velocity from the present in which it's being imagined.

But it did remind me of something. Just a few weeks earlier I had another brush with the late 20th century, this time in the guise of a company we were visiting. Apparently, one of its vendors had observed that striking a deal with them was, "like doing business in the 80s." Here, and unlike my Star Trek experience, it was meant as a good thing.

Let me explain.

Right around the time Next Generation premiered in 1987, a man named Jose Ignacio Lopez took over parts purchasing for Opel, one of General Motors' European brands. He was hired because he was a change agent, as you can see here in this excerpt from The Independent from July of 1993:

*Lopez's innovation was to turn the pricing principle on its head. Prices were no longer to be set by production costs. Rather, production costs had to be tailored to the prices that clients would accept. Having established such a price, he would then take a margin for the supplier - 'since obviously they must make a profit' - and whatever is left is production costs plus the car company's own profit. This did not imply a drop of 5 or 10 per cent, but 20 to 30 per cent or more.*

*'I do not want to hear any more that prices are already down too far and you are making no profits,' Lopez told suppliers. 'We have to change our attitudes. No more excuses. (...) The Spaniard was unforgiving - either his exacting requirements were met, or the suppliers were cut off.*

Lopez became the symbol of a new paradigm between vendors and customers, one that spread like a pandemic across businesses worldwide.

To put it very simplistically, something that had been largely an amicable partnership of a vendor marking up its costs and passing them along to its customer, who did the same all along the supply chain, became ruthless and antagonistic, seemingly overnight. This included not just the cost to manufacture, but other costs to do business, as well. Things like electronic data interchanges (EDI) or just-in-time supply management. (Wal-mart was another big player in the "squeeze your vendor" movement.)

Many things contributed to this zero-sum game of big business: Excel (or another blast from the past, Lotus 1-2-3) gave finance types the creative superpowers with which to wring better profits and cash flow; return on invested capital as a financial metric became favored by Wall Street (with its intense focus on manufacturing and sunk costs); shareholder value became the measure by which stock options and compensation for the C-suite would be determined; to name just a few.

And yet today, we are seeing glimmers that this approach is looking as dated as a Star Trek production set - more than one company of late has told me that its competitive advantage lies in precisely *NOT* optimizing its purchasing efforts Jose Ignacio Lopez style.

Consider the throw-back to the 80s company I mentioned earlier. They're a specialty retail company whose business practices are built for speed and nimbleness - something they achieve by being easy and non-demanding to do business with (just like in the good old days).

When vendors don't have to factor in costs like paying a third party to fulfill via EDI, or know they don't have to pony up so much as a dime in markdown money or promotion allowances, and they get paid right away, then guess what? These same vendors also don't factor into their price the frictional costs inherent in doing business with the 800 pound prima donna elephants.

Instead of a relationship between vendor and customer being one of every man for himself, this company has shifted back to an earlier time: a relationship based on symbiosis and mutual benefit. As a result, it sells product at a great value to its customers while enjoying above industry gross margins.

(Memo to the C-suite: Keep this in mind the next time some guy in finance wants to stretch out your days payable and squeeze your vendors harder. He may only be making it easier for your competition to thrive by driving your best vendor relationships into their arms.)

What's all this have to do with picking stocks?

The retailer in question is heavily shorted. Why? Well, one part of the bear thesis centers around the unsustainability of its margins - the very margins that come from it doing the exact opposite of today's textbook wisdom regarding how to run a business. The bears cannot believe that such margins are possible without funny business, because their view of vendor relations is as outdated as shoulder pads and leg warmers.

Happily, this particular company is not the only retailer we've come across that's taking a more enlightened view of its vendor relationships - and to great competitive benefit - a trend that gives us confidence that something new is afoot in the world of supply chains gone wild. It gives us what we think is a cheap stock too, though only time and reported earnings will tell if we are right and the shorts are wrong.

But of this, I don't need time to tell me that I am right: If, as an investor, you cannot see that the world is always changing, that pendulums always swing back the other way, and that new business models and approaches unseat the old, you will pass up a lot of intriguing investment opportunities.

Live long and prosper (sorry, couldn't resist)!

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