



## **Global Commerce Management – The Executive Business Case for Operational Excellence**

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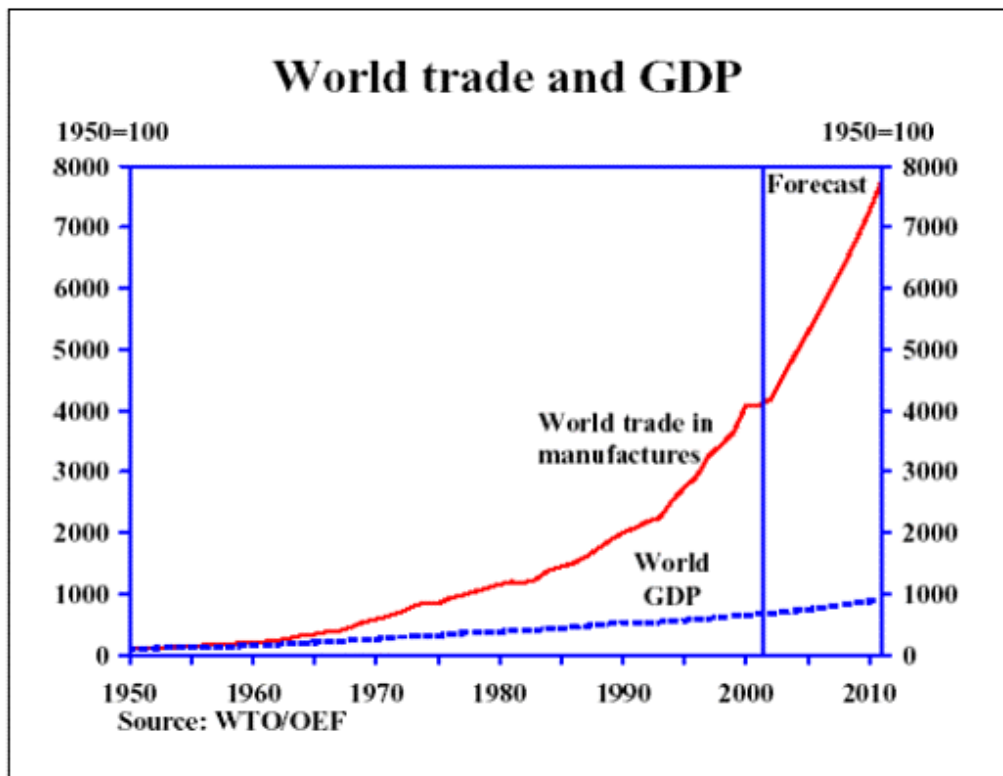
# Global Commerce Management – The Executive Business Case for Operational Excellence

## The Global Commerce Imperative

In virtually every industry, companies must operate their supply chains on a global scale in order to compete. For many corporations, global sourcing has become a critical element of their overall operations strategy.

Anecdotal evidence is clearly supported by the facts. As illustrated in the chart below, world trade (imports and exports) continues to grow at a much faster rate than overall GDP.

FIGURE 1 – GROWTH IN GLOBAL TRADE IN MANUFACTURES



Most executives understand the need to both buy and sell in world markets. The tremendous growth in the level of offshoring and outsourcing by North American manufacturers, retailers, and distributors has certainly been well documented. The overall trends pushing companies towards lower-cost international sources of supply have recently been accelerated by the explosive growth of China as a world manufacturing power and giant consumer market.

The overall drivers of global sourcing are clear, though each vertical industry has its own pressures and supply chain considerations. In general, however, the following pressures and opportunities are driving increased use of global sourcing:

- ❑ Intense global competition
- ❑ Opportunities to reduce per unit costs, often as much as 20% or more
- ❑ Improved product/component quality – the best sources of supply are often found outside the home country
- ❑ Opportunities to reduce corporate asset requirements
- ❑ Elimination of fixed costs in favor of variable costs
- ❑ Opportunities to create profitable growth

For many companies, the need is even more basic – it's a matter of corporate survival. The Wall Street Journal, for example, detailed the story of Viasystems, a multi-billion dollar manufacturer of electronic circuit boards. At its peak, it operated 34 plants in eight countries, including many in the U.S. and Europe, but became increasingly uncompetitive in the price-dominated electronics industry. It now plans to maintain just one plant each in those two main markets, while moving all other production to China, where it employs tens of thousands.<sup>1</sup>

The world of commerce is at a crossroads, and many of the old rules and assumptions no longer apply. Whether companies know it or not, their customers are global. Industries are all in a world-wide quest for lower costs, which is dramatically reconfiguring trade structures and relationships.

While different industries and companies are moving at different speeds, global sourcing strategies are rapidly evolving for most from being a source of potential competitive differentiation to simply a requirement for market competitiveness. Achieving these potential benefits of global sourcing, however, often means overcoming significant supply chain challenges. The effectiveness with which global commerce strategies are executed can in turn have a significant impact on corporate profitability, working capital, revenue growth, and ultimately shareholder value.

## Global Sourcing Adds Complexity

While the strategy of global sourcing holds much promise, the reality is that it also adds a substantial amount of complexity. Many of these complexity drivers are summarized below:

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<sup>1</sup> Wall St. Journal, Dec. 5, 2003; "Viasystems' Salvation," page C7.

<b>Impact of Global Sourcing on Supply Chains</b>		
<b>Factor</b>	<b>Domestic Supply Chains</b>	<b>Global Supply Chains</b>
Cycle time	Short	Long
Total landed cost	Clear	Ambiguous
Number of parties involved	Few	Many
Inventory risk	Low	High
Regulatory risk	Moderate	High
Intellectual property risk	Low	High
Overhead costs	Low to moderate	High
Information availability	Moderate to high	Low
Processes	Well defined	Less defined
Internal Company Expertise	Moderate to high expertise	Moderate to low
Security and risk	Low to moderate	Moderate to high

Failure to effectively manage this complexity can easily mean that the expected benefits of global sourcing are substantially lost. Consider some of the following examples, each of a company that:

- ❑ Believes it is achieving savings on a per unit basis but is in reality losing most of those savings when overall logistics and supply chain costs are accurately considered.
- ❑ Decreases per unit costs but at the price of substantial increases in inventory costs, as inventory buffers and inventory obsolescence increase significantly as a result of the longer and more uncertain lead times.
- ❑ Incurs massive expediting charges to get goods from overseas in time to meet production and distribution requirements.
- ❑ Loses sales opportunities or fails to hit promotional schedules due to failure of offshore goods to arrive on time.
- ❑ Incurs substantial overhead costs associated with global sourcing operations and staff.
- ❑ Consistently misses budgeted financials due to a mismatch between expected landed costs and actuals.
- ❑ Cannot accurately reflect its true financial exposure due to hidden purchase commitments through international suppliers.

Could any of these scenarios characterize your company? Do you have the tools and metrics available to know in fact how well your global sourcing operations are really performing, or to understand the potential impact on financial results?

The reality is that traditionally, senior executives, especially those outside of supply chain management, have not been particularly involved with global sourcing strategies and initiatives. Many do not yet fully understand or appreciate the exceptional potential impact of global commerce and trade excellence on the company's total financial performance and shareholder value.

This is changing. Companies are starting to realize that as they globalize their supply chains, it can really impact their working capital efficiency. The Chinese, for example, prefer to get paid up front. When you are procuring or distributing around the world, and you are paying up front, this can truly hurt the balance sheet. Effectiveness in global sourcing and commerce management has become a discipline in which the potential value and competitive advantage can be won or lost, with a significant impact on company financials depending on the level of this effectiveness.

This effectiveness comes from the right operations strategy, together with the right integration of people, process and technology. Above all, it requires senior management leadership. To provide that leadership, company executives should clearly understand the significant impact of global commerce effectiveness on corporate financial performance and ultimately shareholder value.

## **Bottom Line Benefits of Global Commerce Excellence are Substantial and Often Underestimated**

For many companies, a substantial percentage of the cost of goods sold is related to sourcing of goods overseas. Many of these same companies have substantial overhead costs associated with global sourcing operations, both in the home country and abroad.

Global sourcing effectiveness will have a material impact on such as:

- Per unit total delivered cost
- Total inventory levels
- Corporate SG&A, related to overhead for the sourcing function

The difference in performance between leaders and laggards in these categories can easily add up to millions or tens of millions of dollars even for mid-sized companies with substantial global sourcing activity. The dramatic changes in global sourcing have also created interest in newer financial metrics, such as cost of obsolescence, and the trade-offs of ocean time vs. market responsiveness. In addition, those companies with high performance global sourcing operations will frequently achieve additional, less easy to quantify benefits:

- Increased sales and top line growth through competitive advantage in cost/selling price, and reduction in sales lost due to unavailable inventory
- Increased supply chain and operational flexibility to respond rapidly to emerging market and customer requirements

- ❑ Improve regulatory compliance and reduction in associated overhead costs, especially with regards to new Sarbanes-Oxley rules and emerging security regulations
- ❑ Increased operational visibility and predictability

How are these benefits achieved? By integrating the strategy of global sourcing with execution excellence. This requires a combination of process improvement, improved information availability and flow, and the coupling of physical supply chain processes with related financial flows and information.

Specifically, companies with high performance global sourcing operations are characterized by the following:

- ❑ **Automation to increase effectiveness the many manual processes still used by many global sourcing operations:** This process enabling impacts such areas as: offshore vendor quoting and selection, purchase order management, logistics management, and customer service (internal and external).
- ❑ **Accurate information to estimate true total delivered costs:** Ensures sourcing decisions consider all cost factors among different alternatives.
- ❑ **Reduction of uncertainty through improved information flow across the long global supply chain:** This results in substantial reduction of safety stock inventories as well as expediting costs.
- ❑ **Accurate, detailed performance measures:** Missing in many global sourcing operations, these metrics are necessary to look for additional cost savings opportunities, improve negotiating power with global vendors and service providers, and drive continuous improvement in global sourcing operations.

*We believe that few companies and their senior executives fully understand the real economic impact of global sourcing excellence, or can well assess how their companies stack up in performance versus their peers in the industry or what can be achieved.*

## Example Impact on Company Financials

To demonstrate how substantially global sourcing excellence can impact key corporate financials and shareholder value, let's consider a composite company we'll call Action Apparel. While Action Apparel is a fictitious company, it is based on a composite from a number of companies in the apparel industry, such as Russell, Kellwood, and Phillips-Van Heusen Corporation, to estimate key ratios (e.g. cost of goods sold, sales, general and administrative expense, and inventory turns).

Action Apparel has sales of \$2 billion, cost of goods sold at 68% of total revenue (\$1.36 billion), SG&A costs of 26% of sales (\$520 million), and net profit from operations of \$120 million, or 6% of sales.

**Action Apparel Summary Income Statement\*\***

<b>Revenue</b>	<b>\$2000</b>
<b>COGS</b>	<b>\$1360</b>
<b>Gross profit</b>	<b>\$640</b>
<b>SG&amp;A</b>	<b>\$520</b>
<b>Operating income</b>	<b>\$120</b>

\*\* All figures in \$000's

Action Apparel also achieves six inventory turns per year, a figure extrapolated as a rough average in this sector based on the 2004 annual working capital report from CFO magazine.<sup>2</sup> With six turns per year, Action Apparel would have an average inventory level of \$226 million, based on inventory cost (\$1.36 billion divided by six). As an apparel designer/distributor, we also assume that 100% of Action Apparel's product is sourced offshore.

Action Apparel is an average performer in its industry in term of global sourcing efficiency. This results in an estimate of sourcing overhead of five percent of COGS, or \$68 million.

As an average performer, Action Apparel has the opportunity to reduce costs in several critical areas. Our estimates for this example are shown in the following table.

<b>Estimated Savings Potential for Action Apparel</b>			
<b>Area</b>	<b>% Improvement</b>	<b>Dollar Impact</b>	<b>How Result is Achieved</b>
COGS	0.5%	\$6.8 million	Objective total landed cost calculation, reduced transportation and expediting costs
Inventory Reduction	16%	\$32.4 million inventory reduction	Increasing of inventory turns from 6 to 7 per year based on lower buffer inventories due to improved visibility
SG&A Reduction	15%	\$10.2 million	Process improvement and automation of core tasks reduce overhead costs from 5% to 4.25% of COGS

<sup>2</sup> CFO magazine, "Off the Shelf: 2004 Annual Working Capital Survey"; September, 2004

To calculate the impact of these improvements on company financial and stock performance, we will also use a real inventory carrying cost of 19%. This number reflects the combination of non-capital inventory costs (warehouse, obsolescence, shrink, damage, taxes, etc.) of 10%, and a cost of capital of 9%. While each company calculates the inventory holding costs differently, the numbers we use here reflect a synthesis of the thinking presented by Dr. Stephen Timme, an expert in supply chain financials and president of FinListics Solutions. It is adapted from an article by Dr. Timme in Supply Chain Management Review.<sup>3</sup>

In total, this results in a dramatic impact to the income statement and bottom line. Total operating costs are reduced by almost \$30 million.

- ❑ COGS reduction from improved sourcing decisions and processes: **\$6.8 million**
- ❑ COGS reduction from reduction in inventories: **\$6.15 million** (\$32.4 million in inventory reduction times 19% inventory carrying cost)
- ❑ SG&A reduction: **\$10.2 million**
- ❑ Total operating expense savings: **\$23.15 million**

The total impact on the income statement is shown in the table below.

***Revised Action Apparel Summary Income Statement\*\****

	Current	With Global Sourcing Improvements
<b>Revenue</b>	<b>\$2000</b>	<b>\$2000</b>
<b>COGS</b>	<b>\$1360</b>	<b>\$1347.05</b>
<b>Gross profit</b>	<b>\$640</b>	<b>\$652.95</b>
<b>SG&amp;A</b>	<b>\$520</b>	<b>\$509.80</b>
<b>Operating income</b>	<b>\$120</b>	<b>\$143.15</b>
<b>Dollar improvement</b>	<b>NA</b>	<b>\$23.15</b>
<b>Percent improvement</b>	<b>NA</b>	<b>19.20%</b>

\*\* All figures in \$000's

With a net profit margin of 6%, this \$23.15 million total cost decrease has an equivalent bottom line impact of over **\$385 million in top line revenue growth**.

In addition to the substantial improvements in the bottom line available to Action Apparel, equally dramatic results can be realized in terms of cash flow and ultimately shareholder value.

<sup>3</sup> Supply Chain Management Review; "The Real Cost of Holding Inventory"; July/August, 2003

To better understand this impact, we turned to Gerry Marsh of The High Tech Analyst Group.<sup>4</sup> Mr. Marsh ran the financial improvements Action Apparel generated through global commerce excellence through his firm's proprietary model that calculates the impact to cash flow from operational improvements, such as increasing inventory turns and reducing the cost of goods. The model then calculates how that improvement in cash flow drives increases in stock valuation.

As can be seen in the box below, the net presented value of the increased cash flows from these operational improvements is \$104 million, which in turn results in a \$175 million increase in total market capitalization, or a 22% rise in stock price.

Whether reviewing the income statement, cash flow, or stock price, it is clear that the potential for improvement is of a magnitude that should pique the interest of most company executives.

### A Shareholder Value Analysis of Action Apparel

The margin expansion and inventory reduction attributed to a step-up in Action Apparel's Global Trade Excellence may strike some as modest. Looking at these same benefits through a Shareholder Value Analysis (SVA) lens however, reveals an opportunity to boost stock valuation some 22%. This equates to a \$175 million increase in Action Apparel's market capitalization, as shown in the table below.

<u>Improvement Area</u>	<u>Performance Tracking</u>			<u>Free Cash Flow</u>	<u>Market Cap</u>
	<u>Metric</u>	<u>Current</u>	<u>Future</u>	<u>Improvement</u> (\$ millions)	<u>Increase</u>
Revenue Growth	Growth Rate	5.70%	5.7		0.0%
COGS	% of Sales	68.00%	67.66	\$28.4	3.6%
SG&A	% of Sales	26.00%	25.49	\$42.6	5.3%
Corp. Tax Rate	WW Eff Tax	34.50%	34.5		0.0%
Receivables	DSO	60	60		0.0%
Inventory	Turns	6.0	7.0	\$104	13.0%
Payables	DPO	45	45		0.0%
Working Capital	Investment Rate	19.1	17.5	\$104	13.0%
Ann Capital Exp	Investment Rate	2.0	2.0		0.0%
		Total Benefits*		\$175	22%
	Mkt Cap @ 0.4 Price/Sales			\$800	

High-Tech Analyst Group  
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The right investment to improve Global Trade Excellence can generate an additional \$175 million of shareholder wealth. This is in addition to the increased protection from high downside risk inherent in a serious supply chain disruption.

## **The SVA Approach to Evaluating Operational Improvements**

The estimated \$175 million or 22% boost to intrinsic stock price comes from a proprietary DCF (discounted *free* cash flow) stock valuation model developed by the High-Tech Analyst Group.

*Buy Side* analysts have been using DCF valuation models for several decades now. More recently, *Sell Side* analysts have turned to these models to estimate intrinsic stock price or the fair market value of a company's stock.

The market does reward executives for improved management of free cash flows – not just for EPS growth. Earnings and revenue growth – plus the working and fixed capital investments required to generate the profit and support the growth – are completely captured in a free cash flow approach to managing the wealth creation process.

## **Unusually Valuable Insights**

The SVA approach can prove some surprising and extremely valuable insights about the high leverage opportunities that operating executives have within their grasp. Look again at the table, and note the relative stock price impacts of margin expansion benefits vs. working capital efficiency improvements. Who would have thought that going from 6 to 7 turns would be more valuable than expanding operating income margin by almost one percentage points?

Remember, the results of SVA are highly company specific and can vary significantly depending on a company's business, operating, and financial models.

These figures do not include other potential benefits, such as increased sales, reduced compliance overhead, and other factors.

Clearly, each company's opportunities for savings, improved financial performance, and increased shareholder value are dependent on many factors: their current size and global sourcing performance, actual operating ratios and inventory turns, percent of goods currently being sourced offshore, etc. As with all improvement, these savings will be achieved over time, as the impact of process and technology change take hold, before reaching their full potential.

But as the above analysis should indicate, even when discounting these factors, or discounting the savings a company believes it can legitimately achieve over a given time period, it is clear that for companies with any actual or planned levels of global sourcing that exceed 25-30% of total purchased components or materials, the savings opportunities are likely to be in the millions of dollars, and have a material impact on operating income, cash flow, and shareholder value.

## Security, Regulation and the Terror Threat Must Also be an Executive Concern

In the past, logistics related regulations and risks rarely rose to a level that concerned corporate executives. Since Sept. 11, 2001, however, risks and regulations associated with global commerce have grown to a level that require the attention of senior executives. This environment suggests that in addition to the substantial financial and shareholder benefits of global commerce excellence discussed above, improved technology and processes should also be considered to address related security and regulatory challenges. These challenges and risks include:

- ❑ **Regulatory Compliance:** Though still largely in their formative stages, we expect Homeland Security-related regulations for tracking, audit trails and electronic communications related to goods sourced overseas to increase dramatically over the next several years. Failure to address these requirements effectively may mean large fines, high costs for compliance and damage to the company and its brands through public “black eyes” from compliance failures.
- ❑ **Brand Protection through Improved Supply Chain Security:** A company unfortunate enough to have their inbound goods used as a vehicle for terrorist activities will likely have serious damage done to its brands. As one executive from a Fortune 50 company recently put it: “If an act of terrorism was committed using one of our containers, we believe it would be a company-ending event.” Given the scale of the risk, companies clearly must take strong steps to protect their companies and brands from the possibility of terrorism-related activities.
- ❑ **Supply Chain Agility:** A company’s individual supply chain, or the global supply chain as a whole, could be dramatically affected by an act of terrorism (e.g., an attack on a major global or U.S port). While the effects of such an event would likely be substantial for most companies, some supply chains will be much better prepared to react to those disruptions than others. For example, some companies will be able to quickly understand where all of their inbound goods are across the extended supply chain. Others will spend days trying to ascertain that information. Some companies will have the ability to quickly evaluate alternative product sources and logistics routes, and their comparative costs, while others will have little information upon which to respond.

In total, the risks to the corporation are substantial, and in many cases beyond the scope or focus of global logistics managers. Protecting the company against these potentially devastating risks requires senior level leadership by executives who see the big picture of why the company must protect itself from supply chain related security threats. Global supply chain managers need the strategy and investment appropriate for process improvements and information to minimize that risk.

## What Does It Take To Get There?

Like most operational strategies, capturing the substantial economic benefits from improved global commerce management will require a combination of process and technology change.

Companies should first assess their current and planned level of global commerce, and the opportunity for bottom line improvements. The reality is that this is an exercise that relatively few companies have formally undertaken. As described in the main body of this paper, many companies will discover that there are substantial opportunities for bottom line, cash flow and shareholder improvements from achieving global commerce excellence.

Re-engineered global sourcing processes will almost certainly be required to capture this potential value. Executives leading this transformation may encounter some internal resistance, as the real benefits generally come from making changes across functional domains, such as purchasing and logistics, which are used to acting independently.

It is likely that this assessment and process engineering will identify the need for improved technology support. The reality is that there are many types of software solutions, from ones that address a single area, such as sourcing or transportation, to more comprehensive solutions that address the entire scope of the problem.

Global Commerce Management technology may provide support for some or all of the following areas:

1. **Sourcing and Merchandising:** Decision-support for the processes associated with defining product requirements and appropriate global vendors.
2. **Purchase Order Management:** Capabilities that enable creation of international purchase orders and management of the entire PO execution process.
3. **Logistics Management:** Management and control of the international transportation and logistics processes, and communication with third-party logistics providers.
4. **Security and Regulatory Management:** The ability to assess the capability of suppliers and service providers to meet the security and regulatory requirements of government agencies and ensure that all supporting documentation meets the import requirements.
5. **Financial Management:** Management and control of the financial aspects of global sourcing and logistics.
6. **Performance Management:** The right metrics to monitor and control International supply chains for overall company and shareholder value.

The needs of every corporation will differ depending on many variables, including their level of global sourcing, number and type of SKUs, current application portfolio, organizational maturity and other factors. Solutions in this area have matured greatly over the past few years, and have demonstrated a proven ability to improve financial results.

## What About ERP?

Once executives understand the opportunities for improvement in global commerce management, the next question is often: “Can I get the required software capabilities from my ERP supplier?” This is a natural response, as most companies naturally hope to leverage their existing investment in enterprise software.

In general, the answer to that question is No, though of course the company’s specific requirements, its incumbent ERP provider, what version of software the company is on, etc., will all impact this assessment.

The reality, though, is that global commerce management software requires a level of sophistication and detail that ERP companies have not yet attained. Most of these applications have been very focused on the internal needs of the corporation (order management, financials, manufacturing) and not really designed for cross border, cross company execution processes.

While companies will naturally look at their current ERP provider to evaluate solution capabilities, we strongly recommend that they also review the capabilities of specialized ‘best-of-breed’ providers to ensure a full understanding of the capabilities that are available and how they deliver value. Best-of-breed providers also tend to bring more domain expertise regarding global commerce and supply chain management, which can be an equally important element of the choice.

We note that in the global commerce management arena there are a wide variety of providers, ranging from those who focus on a specific area (such as visibility or regulatory compliance) to those that offer a more complete solution across several or all of the functional categories discussed above. As always, the company business requirements should determine the best solutions.

## Summing It Up

We operate in a global economy, and many companies already source a substantial level of their components, materials, and finished goods from global sources. Many others are aggressively moving down this path.

As a result, the effectiveness of a company’s global sourcing and commerce management will be an important determinant of the corporation’s overall success. It is therefore an area that should receive commensurate executive attention.

The impact of global commerce excellence can often have a substantial financial impact, as we've demonstrated in this paper. While this specific impact for any individual company will depend on many factors -- including the level of global sourcing activity, types of products and components being sourced, and current level of sourcing excellence and process maturity -- it is also clear that improvements in sourcing operations provide an untapped potential for many corporations to substantially improve net income, cash flow, and shareholder value.

## About the Authors

**Gene Tyndall** is the founding partner of Supply Chain Executive Advisors, and was formerly EVP and Leader of the Global Supply Chain Solutions Business at Ryder System, Inc. He is currently a contributing editor at SupplyChainDigest.

Prior to this he was a global leader of the Ernst & Young Supply Chain Management Consulting Practice, where he led breakthrough supply chain projects for dozens of leading global corporations. He is co-author of "Supercharging Supply Chains", one of the most influential books on how to manage supply chains. Mr. Tyndall continues to work with executives across the globe in all industries; is a frequent speaker at industry conferences; and is a well-known author and thought leader.

**Dan Gilmore** has over 15 years experience in the logistics and supply chain industry. He is currently editor and president of SupplyChainDigest™, the industry's premier on-line newsletter and web site devoted to supply chain topics. Prior to that, he was Sr. Vice President of Marketing and Strategy at a leading supply chain execution software provider, and was head of the supply chain practice at META Group, a leading research and advisory group, where he worked with dozens of clients on supply chain issues. One of the industry's most frequent writers and speakers, Mr. Gilmore has also held management positions at NCR and Pitney-Bowes.

## About The Report Co-Sponsor: Blinco Systems/3rdWave

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Blinco Systems' ([www.blinco.com](http://www.blinco.com)) 3rdwave™ provides the most comprehensive global commerce management solutions available on the market today. It has a proven ability to help companies improve operating profit, cash flow, and shareholder value through reducing cost of goods, sourcing and administrative overhead, and total inventories. It is a powerful enabler of global commerce excellence.

3rdwave helps companies achieve global commerce excellence through integrated functionality for sourcing and procurement, logistics, security and regulatory compliance, and financial management. The solution provides managers the information they need to make better decisions in as real-time an environment as required.

3rdwave easily integrates with existing ERP and legacy systems, and is available in flexible deployment options.

Blinco also provides the depth of domain expertise in global trade and logistics processes necessary to help companies adopt best practice and get the most value out of a global trade solution.

3rdwave provides exceptional global supply chain visibility. 3rdwave's comprehensive data repository, when integrated with other disparate corporate enterprise systems (ERP, CRM, SRM, SCE), captures item level details and enhances them to meet the demanding reporting, compliance and documentation requirements of global sourcing and logistics. It provides execution and visibility capabilities around the RFQ, Purchase Order or global logistics moves, validates the information and makes it available to all users in one authenticated view. This data warehouse capability insures that product information is captured, normalized and made available in real-time to operators that are mandated with the execution tasks.

Supported with flexible workflow tools, 3rdwave enables users to establish and monitor product events and generate exception reports if critical events are not executed to plan.

Blinco System (BSI) has been developing global sourcing and logistics solutions for organizations for over 15 years. From its inception BSI has focused on enabling companies that operate in the global economy to streamline their sourcing and logistics processes to increase on-time delivery execution while reducing total landed costs. BSI provides solutions for synchronized control over the entire supply chain - from the suppliers' suppliers to the customers' customers - through totally integrated execution, compliance, workflow, reporting, costing and visibility tools.

Understanding that successful global supply chain solutions cannot be cobbled together and maintained from disparate point applications, BSI continues to focus on successfully developing, delivering and implementing fully integrated solutions that allow its clients to take advantage of their enterprise technology investments and support their ability to totally manage their supply chain and focus on their core competencies.

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