Evaluate Vendor Risk to Control Cost in Times of Economic Uncertainty

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Initiatives: Sourcing, Procurement and Vendor Management Leaders and 1 more

Economic uncertainty presents pressure on sourcing, procurement and vendor management leaders to reduce expenditure on technology vendors. Evaluate vendor solvency and their strategic importance to differentiate your vendor cost management strategy.

Overview

Key Challenges

- The financial stability of your business-critical vendors is directly related to your own organization's financial and business risk.

- Cost-cutting efforts rarely consider the financial position of strategic vendors, which may accelerate the risk of vendor failure or compromise strategic relationships when the vendors are under financial pressure.

- The goodwill of vendor relationships is a strategic asset that can be leveraged in times of financial crisis, however SPVM teams risk missing potential savings by adopting shortsighted cost-cutting tactics.

Recommendations

IT sourcing and procurement and vendor management leaders responsible for vendor risk management should:

- Determine the importance of each vendor by assessing the criticality of their products and services to the SPVM leader’s business operations and recovery strategy.

- Evaluate the level of risk associated with each vendor by defining and monitoring against a specific set of financial health and qualitative risk indicators.

- Differentiate the approach to vendor cost optimization during economic downturns by modifying the SPVM leader’s approach depending on vendor solvency and their criticality to operations and recovery strategy.

Introduction
Economic downturns challenge most organizations experiencing a decline in revenue. SPVM leaders are often asked to meet aggressive and immediate cost-cutting targets. Cost cutting is a challenge at any time, but a financial downturn presents an added risk of vendor insolvencies, mergers and acquisitions, as the fundamental market dynamics adjust to a new norm. Furthermore, some vendors are critical to your organization’s business operations or recovery strategy, so an empathetic approach is required.

As outlined in Figure 1, SPVM leaders must determine which vendors are critical to their business (horizontal axis) and assess vendor solvency risk (vertical axis) to determine the most appropriate vendor-specific strategy for their organization.

Figure 1: Assess Vendor Solvency Risk and Criticality to Maintain Cost Control

Assess Vendor Solvency Risk and Criticality to Maintain Cost Control

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<th>Vendor Solvency</th>
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<td>Identify Alternate Vendors to Consolidate Supply and Terminate Nonessential Services</td>
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Analysis

Determine the Criticality of Your IT Vendors to Your Business Operations and Recovery Strategy

In times of economic uncertainty, SPVM leaders must have a solid understanding of the vendors that are critical to their business operation and recovery strategy, so they can prepare to respond to crisis-mode decision making.
In a changing economy, investments and priorities are likely to change — so you must redo segmentation analysis for each of your vendors.

A foundation of effective vendor management is the segmentation of vendors to know which vendors are critical to your organization, both in terms of vendor risk to critical operations as well as the ability to execute on the organization's strategy. In a changing economy, many organizations will see a rapid change in their organization's strategy that may impact the relative importance of some vendors. Gartner's “Toolkit: A Model to Segment Technology Vendors to Determine Relationship Impact and Business Value” provides the ability for you to quickly assess and segment vendors. Consequently, SPVM leaders must undertake two tasks:

- Review and modify questions and weightings in the segmentation toolkit to ensure the risks relevant to your organization are being assessed.
- Engage with IT and business owners to determine which vendors are important to achieve current or evolving business priorities.

The resulting analysis will uncover the importance of vendors for your organization, which will help you determine the vendor importance (horizontal axis) as presented in Figure 1.

**Evaluate Financial Health and Qualitative Risk Indicators**

Gartner's “Understanding the Methodology Behind Gartner's Financial Statement Scorecard for Public Companies” focuses on several financial metrics that can help evaluate the current financial viability of any vendor. In this methodology, a scoring system is used to reach an overall view of the vendor. Because we focus on ratios using all of a company's financial statements, the feedback is not driven by any one particular metric, but uses a balanced approach. For example, high-growth companies may have trouble turning a profit. Similarly, seasoned, highly profitable companies may struggle to generate growth. The methodology provides a way to compare such vendors on a relatively equal scale.

The five ratios we recommend examining are:

- Trailing twelve month (TTM) total revenue growth — This metric gives insight into whether a company has been expanding successfully to acquire greater market share, or is growing slowly or declining in an attempt to maximize profitability and cash flow. Where appropriate, always review longer periods, like TTM, which tends to smooth out fluctuations related to one strong or weak quarter.

- TTM net income as a percentage of total revenue — This particular metric assesses the vendor's ability to generate profit from its business. This can be highly correlated to cash flow generation, but can differ for a number of reasons.
All of these metrics are based on historical results, and you may notice they do not factor in forecasts, estimates or even company guidance. The art of predicting the future can be extremely valuable when assessing vendor risk. But even in stable times, this remains very difficult. During times of upheaval, it is nearly impossible, and perhaps even foolish to try.

This is why looking at what a vendor has done to this point is a great way of assessing its financial status. Above all, during turbulent times, those vendors with large cash balances that also generate strong cash flow will be the most reliable. Vendors that are cash rich may make adjustments to keep that condition steady, but they are reacting from an initial position of strength. On the other hand, vendors with very large debt balances may face difficult hurdles ahead, as investors of debt frequently require certain financial strength to be maintained.

All of the metrics discussed above are available for vendors that are publicly listed.

**Private Vendors**

Private vendors typically do not need to disclose these metrics, so getting them could be difficult. For such vendors, request the ratios themselves rather than the actual amounts. For example, a vendor may disclose that it grew revenue by 40% for the period, but may, for competitive reasons, choose not to disclose the details of that revenue. If no data or metrics are provided, the vendor should be considered a high risk.

One class of privately held vendors is inherently at greater risk due to its debt load. When companies are acquired by private equity, the privatization transaction is typically done via a leveraged buyout (LBO). This is usually accomplished by taking on large amounts of debt to finance the transaction, which then becomes the responsibility of the vendor to service. During
times of economic downturn, declining revenue could cause the vendor to breach the conditions of its loans. In addition, the financiers may require changes to the vendor’s operations, which may directly impact the services provided to its clients.

Qualitative Distress Signals

SPVM leaders must evaluate other factors relevant to the vendor, including its size, its scale and the primary industries it serves — which may impact its overall resilience or ability to contribute to your cost control program. Other observations may also indicate financial distress, including:

- Declining service levels or missed milestones
- Vendor staff turnover, especially if the staff are not replaced
- Declining maintenance schedule, or slippage of enhancement schedules.

SPVM leaders can also use their relationships with vendor staff to ask them how the vendor is performing through the economic downturn — often a direct and empathetic approach can be the most revealing. The analysis of vendor financial risk will enable SPVM leaders to determine vendor solvency (vertical axis) of Figure 1, enabling the categorization of the vendor into one of the four quadrants.

Differentiate Your Vendor Strategy Based on the Vendor’s Financial Solvency, Strategic Importance and Relationship

SPVM leaders can combine the segmentation of vendors and their financial health to determine the appropriate cost-cutting strategy outlined in Figure 1. This section provides recommendations and considerations in implementing the following four approaches.

Partner

Collaborative, constructive relationships with financially strong and critical vendors are essential to driving the best possible outcomes for your enterprise, in terms of short-term cost savings and midterm recovery. The partnership approach is based on an acknowledgment that success or failure is shared. Work with IT and business teams to uncover the evolving strategy for recovery and then work with your partner vendors to determine creative or innovative ways to pursue cost savings as well as recovery initiatives. Depending on the strength of your partnerships, you may want to do this as a collaborative exercise or workshop with the business, IT and strategic vendors to really think outside the box. This may involve amending payment structures, consolidating supply, or retiring or changing products or services to realize transformation.

Watch Out

The greatest challenge will likely come from a vendor that is critical but under significant financial stress; such a vendor may not survive. Alternatively, it could change its product and services to
pivot away from your current and future needs. Make a careful examination of the options you have and the likely outcomes:

- Can you help to save this vendor or the relevance of its products or services, if you are the one who makes concessions?
- Is the value of its product or services sufficient to justify investment, or are there viable alternatives?
- If the vendor fails, would purchasing the vendor assets or absorbing its resources (or in extreme cases, acquiring the vendor) be an appropriate course of action to ensure that your business needs are met?

All these actions are worth considering in an open, transparent way with vendors that you know are at risk but that you identify as critical. Your particular action will be dictated by your own financial situation and strategy. As such, you should bring this to the attention of the relevant executives, such as the CIO and CFO. Contingency plans should be prepared in the event the vendor fails, or fails to provide critical products or services (see "Develop Contingency Plans for Your Critical Suppliers, or Risk Business Disruption").

**Exit**

Transactional vendors that are financially stressed present a potential opportunity to either save money or consolidate supply as negotiation leverage with an alternate, stronger vendor. SPVM leaders should work with enterprise architecture and the business to rationalize and standardize products and solutions, which can also reduce the cost overheads of managing multiple vendors. Work with legal to understand the termination provisions in at-risk agreements. Where termination is not an option (or unattractive), continue to monitor the vendor’s financial health and qualitative distress signals that might necessitate termination if the vendor’s performance fails contractual undertakings.

**Negotiate**

Those vendors that are financially strong and are not business-critical provide an opportunity to seek cost cutting — either through canceling contracts, reducing consumption, renegotiating rates or seeking cash flow relief in return for goodwill or an extended term. Care must be taken to fully consider the consequence of well-intended but poorly executed negotiation that does not fully account for risk. Below are examples of issues that can arise when overenthusiastic negotiation puts your agreements with vendors at odds with your real needs:

**Hardware**

If lower-cost options require compromise with respect to product specifications or component quality, hardware life cycles may be shortened or reliability impacted. If diminished levels of
support are chosen in exchange for lower cost, be certain that the increased response times, lower availability of spares and the like are acceptable to the business.

Software

Contraction of a software environment or a contentious, cost-focused negotiation can be an invitation to an audit or true-up even when relationships are generally positive. Ensure that software/subscription entitlements and consumption/use/access are properly tracked and in order prior to seeking financial relief. If lower levels of support are negotiated, make sure that these levels still satisfy the needs of your enterprise.

Services

Savings negotiated on the front end of a deal risk being sacrificed in the long term when the vendor is not able to provide resources of acceptable quality in light of the pricing it accepted when the deal was done. This is especially the case when negotiations take place during difficult times and quality resources begin to turn over once recovery begins — when quality resources may be at risk (or wholly unavailable) due to pricing below what is realistically sustainable.

Evidence

1 In Gartner’s “Leading Through COVID-19: 10 Rules For Rapid IT Spend Reduction” webinar, 70% of respondents indicated they had made IT budget cuts, while 63% said they were likely to make more (n = 202 IT Leaders, on 22 April 2020 and 27 April 2020).


3 “We Need Mission-Focused Risk Management Programs to Adapt to Changing Circumstances.” Nextgov.

4 For instance, Gartner’s client inquiry database indicated that, from 1 January 2020 to 30 April 2020, Gartner analysts fielded an increase of 110% client inquiries related to remote working.

5 “How to Reevaluate Strategic Vendors Acquired by Private Equity”

Recommended by the Authors

Take Immediate Action If Vendor Risks Are Disrupting Your Business
Develop Contingency Plans for Your Critical Suppliers, or Risk Business Disruption
How to Drive Immediate IT Infrastructure Cost Savings
Key Actions to Reduce Costs of Managed Workplace Services in an Economic Downturn
How to Cut Software and SaaS Costs and Quickly Improve Cash Flow in Times of Crisis
Five Ways to Immediately Cut or Optimize Mobile Costs in a Suddenly Weakened Economy
Cost Optimization and Productivity Strategies in Application Services for Short- and Long-Term Returns

Navigating COVID-19 Impacts on M&A Buy or Sell Decisions

Recommended For You

Case Study: Client-Centric Technology Implementation Protocols (ATB Wealth)

Consider Your Purpose: Reinventing Your Way Out of the Crisis

Innovation Insight for Event Brokers

Innovation Insight for Event Thinking

Drive Revenue and Customer Satisfaction by Building Trust

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