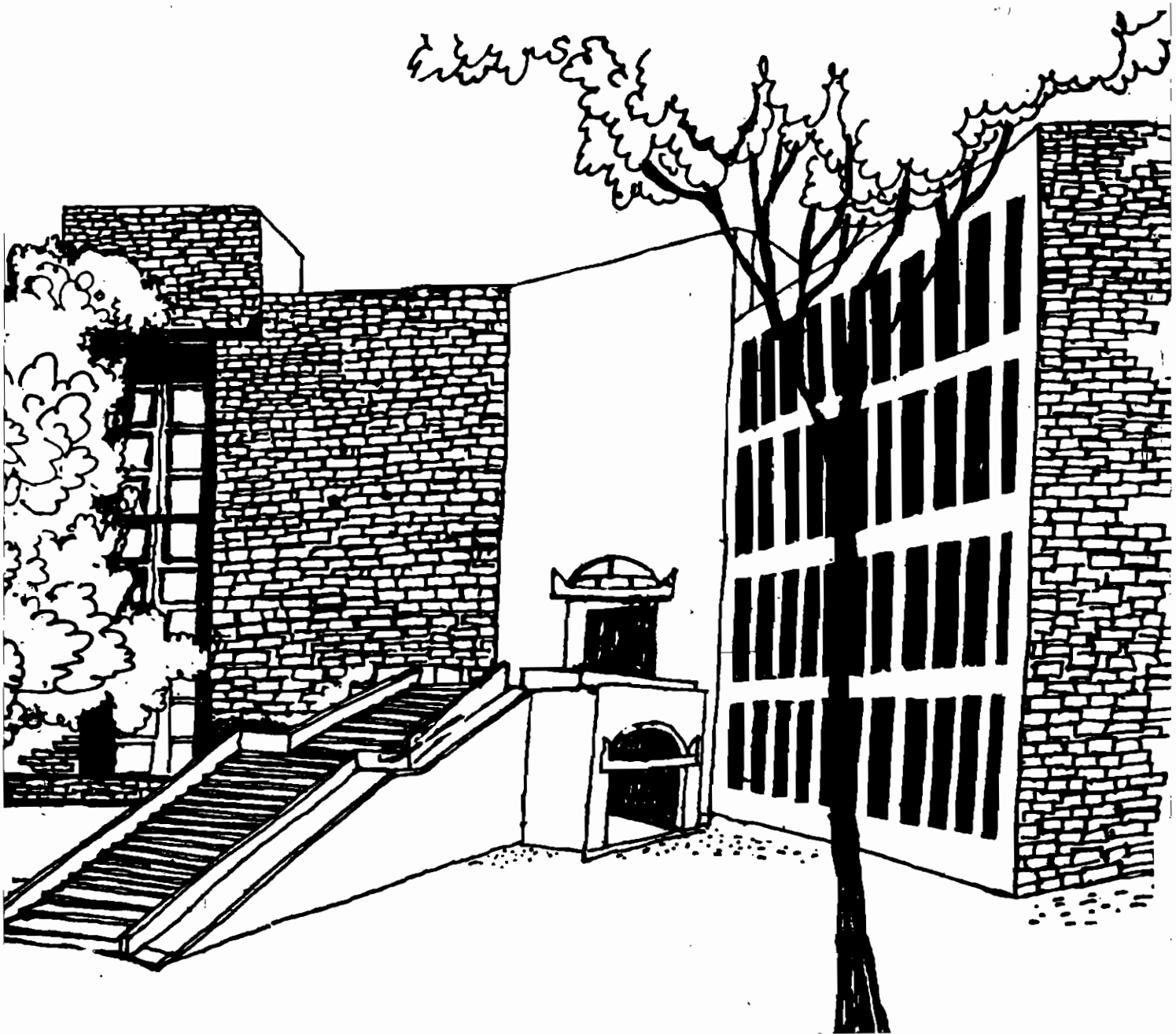




# Working Paper



**A Value-Based Approach for Sustainable Supplier-Customer Relationships: The Case of the Indian Steel Industry**

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## **A Value-Based Approach for Sustainable Supplier-Customer Relationships: The Case of the Indian Steel Industry**

By

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### **Introduction**

The Indian steel industry has been at the receiving end for the last several months, as the unabated stream of media reports indicate. The steel industry, which has endured years of mediocre performance, due to a supply glut and consequent depressed world prices, has suddenly appeared on the radar screens of most companies, and even retail customers. With a widening demand-supply gap, and greatly increased input costs, especially over the last about one year, prices have firmed up. Customers, for many of whom steel is an important raw material, are finding that the steel prices continue their northward climb without any let-up. Many customers feel that the steel industry is making super-normal profits in the process, and using the situation opportunistically to their advantage. In this article, we seek to understand the current situation that is perhaps best characterized by simmering supplier-customer distrust. We then explore ways of building sustainable supplier-customer relationships in the context of business markets. While the case of the Indian steel industry is discussed, the lessons are more widely transportable to business markets in general. Although the steel industry caters to both consumer (B2C) and business (B2B) markets, our focus will be on the business markets, which constitutes over 80% of the Indian steel industry. )

### **Suppliers and Customers of Steel in Business Markets**

Typically the B2B customers purchase steel from large steel producers in the country, for further processing. The array of industries that use steel as a key raw material is indeed staggering, including automobiles, white goods, two wheelers, appliances and many more. Some of these customers manufacture products used by consumers, who are the public at large. These consumers buy products such as ceiling fans, scooters, cars, washing machines, etc., for their own use. Other customers of steel in business markets such as steel fabricators, make products such as switch gear panels, cabinets for computers, etc., which in turn are supplied by them to their customers further downstream in the value chain. There are seven major steel manufacturers in the country (SAIL, Tata Steel, ISPAT, Essar, JVSL, Lloyds and RINL, which together account for about 22 million tons per annum finished steel capacity. There are many other smaller mills, which together account for about 21.75 million tons finished steel. These smaller units use raw material from some of the larger plants to make finished steel. Thus the total finished steel capacity in the country is 43.64 million tons per annum.

### **Forces at Play on the Indian Steel Industry**

There are many forces at play in the Indian steel industry, which we briefly examine in the following. Many of these forces are more generally at play on suppliers in other industries as well.

### **Relentless competition in consumer markets and their transmittal upstream**

With almost unlimited access to information that end consumers for nearly all products have, enabled by the miracles of the internet and modern communication technologies such as mobile telephony, television, etc., companies catering to consumer markets face incessant competition. These companies vie with each other for the end-customer's rupee. The consequent relentless price pressure in the consumer marketplace is a reality that few companies catering to consumer markets can ignore. This causes a 'laddering up' effect of price pressures at every stage in the upstream value chain in the relevant business markets.

### **Volatile Global Raw Material Markets**

Indian steel manufacturers face volatile prices with regard to supply of raw materials for the steel industry. This is especially true for those manufacturers who source bulk of their raw material requirements externally. It is less true for those steel manufacturers who have their own captive raw material sources. The increased volatility and upward price pressure in the raw material prices stems from China's recent enormous appetite for steel (about 260 million tons last year).

### **Present Imbalance of Supply-Demand in the Global Steel Industry**

As a consequence of the sudden uptake of huge steel quantities by China, the world is presently passing through a supply-demand mismatch. However this is not a new phenomenon, as steel has long been recognized as a cyclical industry, characterized by a cycle of about three years duration. This cyclicity arises from the nature of the industry, which needs large investments, and requires considerable time lag for capacity build-up and likewise for capacity build-down.

### **Seeking to get more and more for less and less**

There are clearly two opposing forces at play in B2B markets. On the one hand, we see severe price pressures in consumer markets and the escalation of these pressures all the way up the value chain into corresponding B2B markets. On the other, there is increasing pressure on suppliers in B2B markets to provide more and more value to their customers, and thereby try to differentiate themselves from competition. They do this with the hope that this will bring them out of the commoditisation trap. They also do this to gain an increasing share of wallet of their customers. Thus, there is simultaneous existence of both downward price pressure and increased demand for value delivered by the supplier. Customers in B2B markets seem to be saying: 'give me more and more for less and less.'

### **Perform or Perish: The Heat is on the Managers**

Managers across various functions in customer companies have to demonstrate strong bottom-line performance of their companies, month after month, and year after year. For managers in the procurement function, this translates into aggressive control on input costs. Their bonuses, career graphs and their very continued existence is contingent upon obtaining aggressive prices in all their key procurement activities.

### **Companies in Cyclical Industries Face the Brunt**

In cyclical industries such as steel, the forces described above combine to create complex supplier-customer relationship dynamics. During a downswing in the supplier's industry, the power shifts to the customer, as suppliers vie with each other for a share of customer

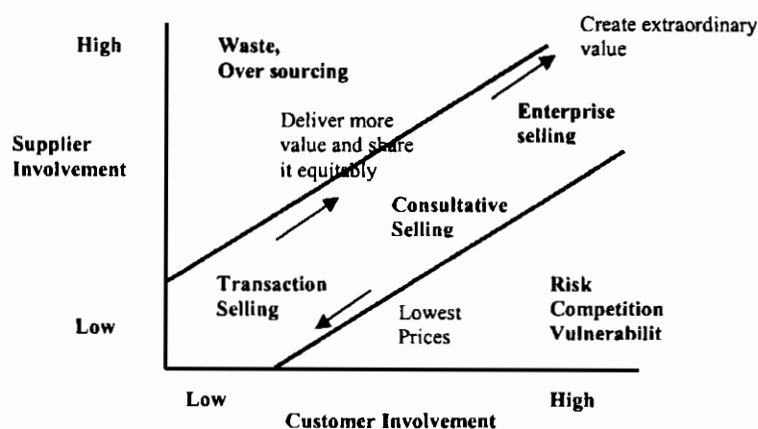
business. Suppliers are ready to bend backwards to satisfy the customer, at any price demanded by the customer. This is time for customer euphoria. In an upswing, as has been the case of the steel industry for the last one year, it is retribution time for the supplier. The customer perceives this to be opportunistic supplier behaviour.

## A Conceptual Model to Understand Supplier-Customer Relationships

Companies in business markets endeavour to create more value for their customers and in this way attempt to escape the commoditisation spiral (Figure-I and Table-I). They do this through their market offerings, which consists of the package of products, services, systems and programs that they take to market for various customer segments. They embark on various product augmentation strategies, technology enhancement programs and relationship building initiatives; create value through channels; bring out new market offerings; etc. They seek to move select customers from transaction selling, to consultative selling and eventually hope to move some of them to enterprise selling mode. In transaction selling, the basis of obtaining the sale is lowest price. In consultative selling, the goal is to minimize customer's total cost of usage of their market offering, and the focus is on helping to solve the customer's problems. In enterprise selling, the supplier seeks to deliver extraordinary value for the customer and derive equitable returns.

The off-diagonal positions are unstable for the customer and / or the supplier. The nature of the supplier-customer relationship depends first on the supplier's industry. Some industries such as packing material are not easily amenable for high intensity relationships. It next depends on the propensity of the supplier and customer to enter into high engagement relationships. Thus, within the same industry, we may find one supplier seeking to move up diagonally along the relationship spectrum in Figure-I, while another supplier shows no interest to do so. Finally, for a supplier company, its relationships with its different customers will span all the three categories, depending on the customer, mutual fit and desire of both to move up the relationship chain, business potential in the relationship, etc. Specifically, it would not be possible for a company to have all its customers in the higher end relationships such as enterprise selling relationships, as the supplier simply would not have adequate bandwidth to be able to service all these customers with the intensity that enterprise selling calls for. In the steel industry, if all supplier-customer relationships were mapped, we would find that some suppliers operate almost totally in the transaction-selling mode. Some others will be operating in all the three different selling modes.

**Figure-I: Relationship Spectrum in B2B Markets**



(Source : Rackham & De Vincentis)

**Table-I**  
**Key Features of Different Types of Selling Situations**

	Selling Situation		
	Transaction Selling	Consultative Selling	Enterprise Selling
<b>Basis of obtaining the sale</b>	Lowest Price	Lowest Total Cost	Create Extraordinary Value
<b>Alternate Terminology</b>	Intrinsic Value Selling (All value is embedded in the product or service and the selling process adds no additional value.)	Extrinsic Value Selling (The selling process adds considerable value to the customer, through a process of dialog with the supplier's sales person, whereby the customer's problem is first unearthed and then a solution is jointly evolved.)	Strategic Value Selling (The supplier and customer enter into a high-engagement relationship, whereby the supplier provides a product or service of strategic importance to the customer. The two organizations ideally synchronise their working at a strategic level.)
<b>Trust What?</b>	Trust the Product or Service	Trust the Person	Trust the (Supplier) Organisation
<b>To do What?</b>	To fulfill a need	To solve a problem	To enable the customer to focus on his core competency, and let the supplier provide a product/service of strategic importance
<b>Selling Mantra</b>	Find ways to deliver the product / service at lowest cost in a hassle-free manner	SPIN Selling through a series of questions (Situation, Problem, Implication and Need Pay-off questions) to help solve customer's problems	Build strong, wide, and deep relationships across both supplier's and customer's organizations
<b>Supplier's Objective</b>	To obtain a sale quickly: Always be closing (ABC)	To obtain customer commitment for advancement to the next step in the selling process	To build long-term relationships of strategic importance to both companies
<b>Type of Negotiations</b>	Distributive (The pie is limited in size, so the customer and supplier haggle over who gets what share of it)	Integrative (expand the pie and share it equitably)	Integrative (expand the pie and share it equitably)
<b>Predominant Mindset</b>	Value pie is limited, and so customer and supplier each try to grab the maximum share of the value pie	The value pie can be increased, and shared between the supplier and customer in an equitable manner	The supplier and customer seek to continually look for avenues to create value, eradicate value drains, and equitably share the value so created.

(Source : Rackham & De Vincentis)

## **Genesis of Supplier-Customer Acrimony in the Indian Steel Industry**

The Purchase function in many organizations is primarily driven by the financial imperatives. Often the effectiveness of a purchase manager is judged by the percentage compression in price (or a nominal price increase if that is inevitable) year-on-year (YOY). This is where suppliers in cyclical industries get into a tight spot. The upswing we are witnessing in the steel industry today is after many years of depressed markets, where the industry had to endure less-than-satisfactory returns. This is a well-known fact, as Table-II reveals. This has restricted the availability of surplus funds for capacity creation. The nature of the industry does not allow easy access to equity capital on favourable terms, as it is perceived by investors to be an 'old world' industry, with a cyclical behaviour to top it up. Lenders are also wary of extending large loans to cyclical industries, and when they do, it is often on terms that are unfavourable and / or difficult to fulfill. Hence the main source of capital for capacity augmentation per se has to be through internal generation. Due to the indifferent performance of the steel industry worldwide over the past several years, there has not been significant capacity augmentation, except the massive government-backed capacity build-up in China, to cater to their very ambitious infrastructure creation schemes. Table-III provides a snapshot of last year's global steel production and consumption region-wise.

The current buoyancy in the world steel markets is undoubtedly catalysed by an upsurge of demand in China. This has also put enormous pressure on prices of raw materials for the steel industry, primarily iron ore and coking coal, as well as on international sea freight rates for shipment of these materials. Some domestic steel manufacturers depend to a large extent (as high as 80% in some cases) on purchasing many of these raw materials from international markets and consequently have to deal with the realities of commoditised raw material markets. Such suppliers are therefore much more vulnerable in their ability to control their cost of manufacture. Some industry experts suggest that with the slow-down of Chinese demand for steel over a few years, post-Olympics 2008, the pressures on raw material prices of the steel industry will ease. They argue that at that time the Indian steel industry will revert to normalcy, from its current 'super-heated' state.

### **Diagnosis**

#### **Customer Exposure as a Determinant of Customer Perception**

Customer companies that are used to operating in international markets, including large multinational corporations (MNCs), understand the existence of these upward price pressures on steel in the Indian market that the industry is facing today. Such companies are open to benchmark and assess the performance of their purchasing departments based on the purchase price of steel in the domestic market vis-à-vis prices in international markets, rather than comparing their procurement price of steel in the Indian market on a YOY basis.



**Table-II**  
**Performance of Indian Steel Industry over the Last Ten Years**

PAT/Net Sales	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03
Bhushan Steel & Strips Ltd.	10.65	11.21	12.20	11.06	8.91	6.00	5.33	4.92	4.03	4.85
Essar Steel Ltd.	22.30	22.30	22.03	0.52	0.98	-21.96	-24.00	-13.73	-31.55	-48.02
Ispat Industries Ltd.	8.60	9.57	7.36	5.68	3.83	1.81	0.26	-15.87	-24.09	2.71
Jindal Iron & Steel Co. Ltd.	14.65	16.85	7.16	6.28	2.99	0.96	0.74	-6.95	-6.57	7.77
Jindal Strips Ltd.	8.42	9.11	8.11	5.50	6.54	3.64	5.25	4.13	3.27	14.67
Jindal Vijayanagar Steel Ltd.					-19.22	-5.40	-18.35	-4.28	-20.31	-4.42
Kalyani Steels Ltd.	2.09	38.46	9.45	-25.90	12.08	-2.82	38.66	-69.19	79.31	1.73
Lloyds Steel Inds. Ltd.	35.29	16.43	11.47	0.05	-4.74	-24.31	-54.29	-89.93	-78.76	-39.60
Mukand Ltd.	2.22	3.90	4.00	1.57	1.01	-4.63	0.81	-6.01	-17.14	-20.35
RINL	-28.90	-17.13	-9.61	-11.38	-13.73	-29.58	-20.77	-9.28	-1.65	9.58
Steel Authority Of India Ltd.	4.56	7.81	8.72	3.50	0.88	-10.18	-11.63	-5.00	-12.14	-1.74
Tata Iron & Steel Co. Ltd.	4.77	6.08	9.66	7.39	5.01	4.50	6.93	8.09	3.05	11.61
<b>Steel Industry-PAT/Net Sales</b>	<b>2.57</b>	<b>6.33</b>	<b>6.63</b>	<b>2.09</b>	<b>-0.35</b>	<b>-8.42</b>	<b>-7.52</b>	<b>-5.77</b>	<b>-9.72</b>	<b>-0.29</b>

Source : CMIE

**Table-III**  
**Region-wise Global Production and Consumption of Steel (2002 and 2003)**  
**(Million Tons)**

Region	2002				2003			
	Crude Steel Production	Crude Steel Consumption	Finished Steel Production	Finished Steel Consumption	Crude Steel Production	Crude Steel Consumption	Finished Steel Production	Finished Steel Consumption
EU (15)	158.7	151.2	142.6	135.5	159.8	152.2	143.8	137.0
CIS	101.1	32.2	91.0	26.2	105.9	33.8	95.3	30.4
US	91.6	118.2	82.4	107.4	91.4	117.9	82.2	106.1
S.Korea	45.4	45.4	40.9	43.7	46.3	46.3	41.7	41.7
Japan	107.7	72.8	97.0	71.7	110.5	74.6	99.5	67.2
China	181.7	244.2	163.5	211.2	220.1	295.8	198.1	266.2
India	28.8	33.4	25.9	29.0	31.8	36.8	28.6	33.1
Others	187.9	240.2	169.1	209.2	179.4	229.4	161.5	205.6
World	902.9	937.6	812.4	833.9	945.2	986.8	850.7	887.3

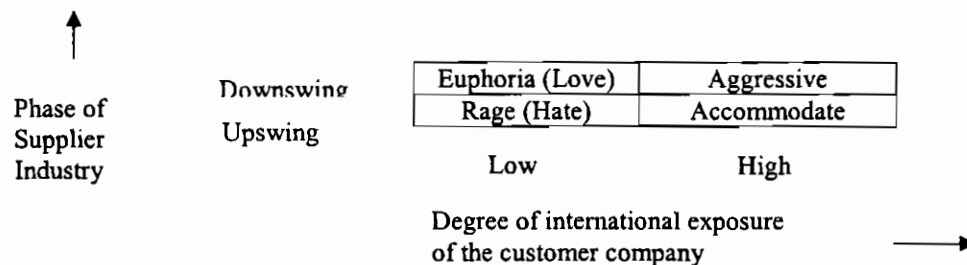
Source: IISI actual published figures till 2002 and MRG estimate for 2003

For companies with a more local focus and relatively localized span of influence, the metrics clearly are YOY prices, and hence in an upswing, these are the companies more prone to a high degree of rage. Figure-II depicts the euphoria – rage cycle that closely

tracks the business cycle of the steel industry. Customers with a high degree of international exposure would be aggressive in a downswing, as they have access to low-cost material from global markets, should they choose to exercise this option. In an upswing, since they are aware of the global price realities, they tend to at least give a patient hearing to the supplier, and so long as they get a domestic price better than the landed price of steel from international markets, they would tend to accommodate requests for price increases. They would of course also expect the supplier to demonstrate value to justify the premium price being sought.

In contrast, customers with a low degree of international exposure tend to love the supplier during a downswing, as they can extract dream prices (from the perspective of the customer). In an upswing, since they tend to operate on YOY benchmarks, these customers tend to get into a rage when customers seek higher prices. They see the supplier's requests for prices as unreasonable. Instead of realizing that the supplier is making profits after a dry spell, the usual reaction of such customers in this situation is to perceive the supplier as being mercenary and opportunistic. This is what we are seeing today.

**Figure-II**  
**Behaviour of Customers as a Function of Exposure and Supplier Industry Phase**

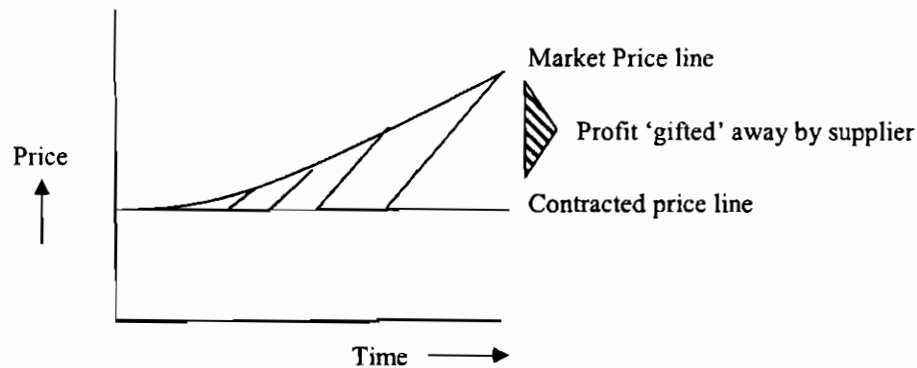


Customer-supplier relationships operating in the 'transaction selling' mode are more prone to the love-hate or euphoria-rage cycles depicted in Figure-II, than relationships that are further up along the relationship spectrum. However in the current scenario of the Indian steel industry vis-à-vis their customers, it is only a matter of variation of intensity, since all supplier-customer relationships appear to be reeling under the spell of this syndrome. In this article, we examine how the supplier and customer can strive to convert this inherently adversarial relationship into a win-win situation for both.

### **Case for Deploying the Concept of Futures into B2B Supplier-Customer Relationships?**

There have been examples of mutual self-interest in supplier-customer relationships in the Indian steel industry. In such situations, both the supplier and the customer have been willing to enter into medium-term contracts for the supplier's market offering. In such a situation, the steel company would enter into a 3- or 6- or 12- month contract relating to pricing of its market offering for that customer. Figure-III illustrates the price behaviour in an upswing, where clearly the customer wins. Since the supplier has entered into a contract, he faces an opportunity loss, in that he could alternately have skimmed the market.

**Figure-III: Contracted vs. actual price behaviour in an upswing**

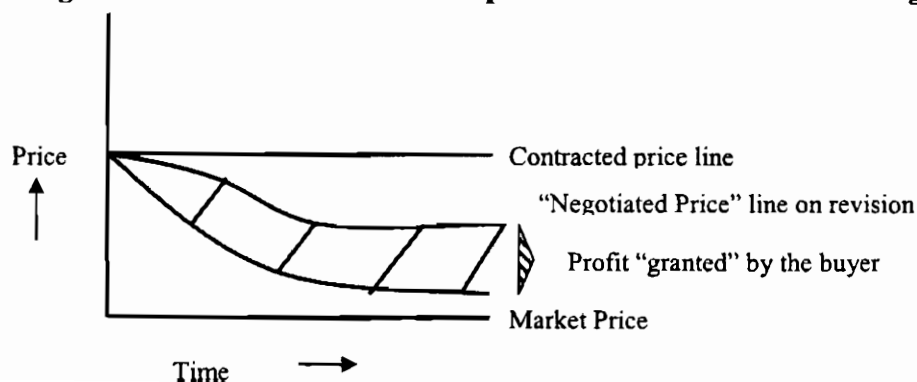


In Figure-III, the area between the market price line and the contracted price line can be translated into profits 'gifted away' by the supplier to the customer. The customer would be averse to any move by the supplier to raise the price above the contractually agreed price levels. In this situation, it would naturally be the customer who would reiterate the sanctity of the contract. However from a supplier's perspective, the customer owes the supplier a return favour at some future point of time.

Figure-IV shows the situation in a downturn. Here is when the customer is likely to get into a situation of 'amnesia'. There would be a tendency on the part of the customer to 'initialise' the relationship with the supplier, and exert enormous pressure on the supplier to lower the contractual price on a real time, month-to-month or even on a day-to-day basis.

As against situations in developed nations where the same person (in the supplier and customer organisation as well) would typically continue to hold the relationship over relatively longer periods of time, the ethos in Indian companies is to rotate people over relatively short time intervals (a few years at most), to give them wider exposure, and in some cases, to prepare them for taking on higher managerial responsibilities in the future. This is the classic divide between specializations that one sees in the developed countries, versus creating generalist managers that has been a significant trend in India. Job-hopping, which is not uncommon in India, further compounds the problem. These factors impede establishing continuity of relationships over the long-term. They also do not permit using the psychological 'IOUs' that were implicitly understood and exchanged on an earlier occasion. The fact that organizational discipline to mutually document such IOUs also contributes to short-term memory of both supplier and customer.

**Figure-IV: Contracted vs. actual price behaviour in a downswing**



There is a strong case of extending the concept of 'Futures' that we find in certain markets, to specific supplier-customer relationships, to bring in a modicum of stability into the industry. This is an initiative that both the supplier and customer must take. We will address some aspects of how this concept can be implemented later in this article.

### **Internal Skepticism**

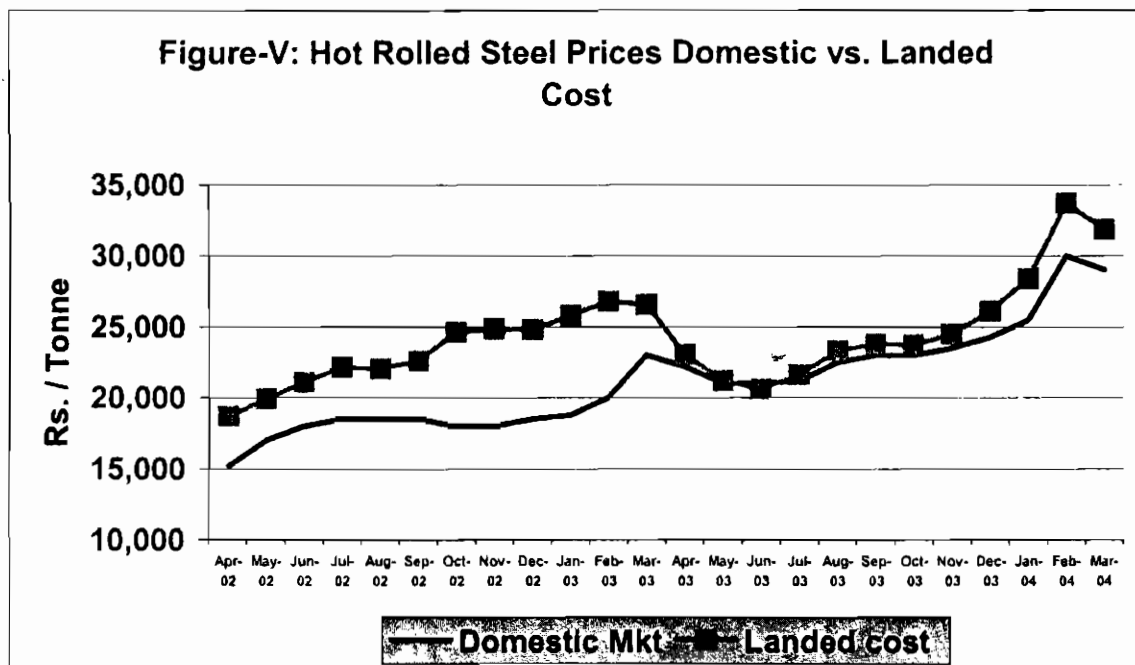
The supplier company also has to reckon with skepticism of their own marketing team while attempting to seek higher prices during an upswing. Typically, the supplier's customer account managers (CAMs) consider themselves to be ambassadors of customers. Often, during an upswing, they find the prices suggested by their companies to be unreasonable, since like the customer's purchase managers, their basis for price fixation is essentially on the basis of YOY. However this is a less formidable hurdle to cross for the supplier firm. Experience suggests that if the facts are properly presented, the supplier firm's CAMs can be convinced to seek the higher target prices. For this, the supplier company must have a tracking mechanism of the PAT figures of the customer firm as well as their own PAT figures, over the long-term (ten or more years). They can then use this to demonstrate visibly to the CAMs that over the years, it is in fact the supplier firm that has appropriated a lesser share of the value created, and that the customer firm has had a greater share of the value created. Far too few suppliers take the trouble to track this information however. Most supplier firms only complain that they have been unfairly treated by the customers, and that the customers do not value the sacrifices they made during the downswing. There is thus a strong case for suppliers to assiduously track not only their profitability over the years, but also that of each of their customers, as also of their own industry and that of the industry of each of their customers, to make meaningful inferences on value appropriation over the years. Moreover, a move to value-based approach to marketing, which is discussed in this article, would also greatly help in convincing both customers and the CAMs in the supplier companies.

### **Some Ground Realities**

Contrary to what one may tend to believe, the reality (Table-IV and Figure-V) is that Indian steel prices are broadly in line with global prices. One of the myths is that the Indian price of steel is much more than the price of steel in international markets. It may be noted that India has not seen a flood of imported steel. The proponents of this myth would then argue that the Chinese manufacturer in the same industry thereby has an undue advantage, which will result in dumping of Chinese made goods (such as white goods, automobiles, etc.) into the country, unless the Indian steel manufacturers are reined. They would use this in industry forums and as a rallying point with the government, with the implicit demand that the government should intervene and do something to reverse the impending non-competitiveness of these Indian manufacturers. There are a few other aspects that we need to understand. The import duty on steel is currently at about 24% (15% customs duty and 8% countervailing duty), so that landed prices closely mirror international prices. Secondly steel constitutes in value terms only a small percentage (typically 5 to 7%) of the cost of manufacture of items such as automobiles, white goods, etc.

**Table-IV**  
**Comparison of Domestic Price of Steel with Landed Price of Imported Steel**  
 Source: Crisinfac

		Domestic Market Price	Landed cost
2002	Apr-02	15,200	18,717
	May-02	17,000	19,906
	Jun-02	18,000	21,089
	Jul-02	18,500	22,127
	Aug-02	18,500	22,046
	Sep-02	18,500	22,593
	Oct-02	18,000	24,646
	Nov-02	18,000	24,865
	Dec-02	18,500	24,806
	Jan-03	18,800	25,805
	Feb-03	20,000	26,800
	Mar-03	23,000	26,563
2003	Apr-03	22,200	23,027
	May-03	21,000	21,183
	Jun-03	21,000	20,596
	Jul-03	21,200	21,617
	Aug-03	22,500	23,315
	Sep-03	23,000	23,801
	Oct-03	23,000	23,736
	Nov-03	23,500	24,507
	Dec-03	24,250	26,120
	Jan-04	25,500	28,398
	Feb-04	30,000	33,745
	Mar-04	29,000	31,861



The irony is that during the downswing, the government did not intervene to provide any succor for the steel industry. For instance, not much was done to bolster the infrastructure so essential for a large-scale industry like steel. It was essentially left to fend for itself. Now that the country has been having an upswing in the steel industry for the last one-year, the customer industry lobbies are clamouring for 'restraining' the steel industry. This is significant for various reasons. Given that we are well on our way towards globalisation, this is also an ominous trend. There is a history of government price control on steel. There is always the threat of imposing the 'essential commodities act'. Finally we must realize that large steel plants rely much more on the country's infrastructure like ports, railways and roads, all of which are controlled by the government.

### **Government Intervention is Clearly not the Solution**

Is government intervention then an appropriate solution? Looked at from various angles, this would be a retrograde step. The government must continue to ease any remnants of barriers to free trade, in line with the negotiations of WTO, etc. Decision makers at the government must realize that at the end of the day, steel is essentially a commodity product, widely available from various sources worldwide. Of course, despite this, or perhaps precisely for this reason, supplier companies need to constantly seek to create more value to their customers through additional services, systems and programs, and thus enhance their market offerings. Yet any attempts by the government to artificially regulate or intervene during either an upswing or downswing are likely to result in unintended consequences such as those that we witnessed during the 1970's and 1980's. Businessmen will always find ingenious ways to circumvent any roadblocks, to maximize their objectives, which could have undesirable consequences at a national and societal level. The government's proactive role could be in strengthening the steel base of India. One can clearly see that the demand for steel will grow fast in India, with the rising aspiration levels of the masses. The steel industry must be made attractive for private investment. Otherwise, a natural resource-rich country like India will have to resort to large-scale import of finished steel products.

### **The Futility of Contracts in Volatile Markets**

In the scenario described above, it is clear that a typical Indian customer would react differently to situations when the prices are on a ramp-up, vis-à-vis a situation when they are on a climb-down. Clearly, when the prices are heading up, the customer would be pleased to enter into an yearly contract to hedge his bets. On the other hand, when the prices are plummeting, he would be very hesitant to enter into any long-term contracts. He would like the supplier to recalibrate the prices downwards on a daily basis! Therein lies the paradox. In such a circumstance, what sort of planning on cash flows or profitability projections can the supplier firm do? We see clearly see how this process, over a ten-year period would only further widen the chasm in the supplier-customer relationship. The supplier will not have the financial muscle left for making worthwhile investments for technology augmentation or future capacity build-up. The customer wants the supplier to give more for less, as the competitive pressures in his markets further intensify. It also leads to mutual cycles of recrimination while the supplier and customer end up labeling each other mercenary depending on the stage of the cycle that the supplier industry is in. In some of the developed countries, these relationships have

now entered a more mature phase, where three-year supplier-customer contracts are not uncommon.

### **Undervaluing the Cost of Providing Services**

As a nation, we are yet value the cost of providing services. We see this manifestation in many different arenas. We are happy to pay the asking price for a piece of hardware, which is tangible and physical. We are reluctant to pay for software. Perhaps this stems from our general impression that manpower is cheap, and so we have a right to expect services 'for free.'

Contrast this to a situation where a large global steel manufacturer services a large automobile manufacturer. The former could typically sell 4 million tons per year steel to the automaker. This single account in volume terms is about 12% of India's steel capacity, and would be the size of a typical major steel plant in India. Naturally in this situation, the global steel supplier would provide some of its best resources to support this customer. In India, a typical customer, who may procure 50,000 tons per year steel from a steel manufacturer, would expect the steel supplier to provide the same level of service that the global steel maker would provide to the automaker in the above example.

In the context of B2B markets however, where increasingly suppliers are under pressure to provide more and more services into their market offerings, first to get their 'foot in the door' of the customer, and later to 'increase the share of customer wallet', this results in a peculiar situation of wanting 'enterprise selling' level of service and value provision, at 'transaction selling' prices. Clearly this is not sustainable!

Given the nature of the steel industry, there are huge costs in managing customers, improving supply chains, investment in R&D, and many more. There is a cost associated with supplying steel on a 'Just-in-time' basis to the customer. Clearly these costs would not be there if the supplier had the luxury of making his supplies at his convenience. A customer would expect his key supplier to supply a new specification of steel at short notice, and would not take 'no' for an answer. This costs money. Surely someone must pay for this! A situation of long-term sub-normal profits of the industry will be at the peril of all. Unless a more holistic and system-level perspective is taken, it is likely that our industries will limp from one crisis to another, and end up living in the ICU (Intensive Care Unit) for the long haul. Coming out of this downward spiral calls for enlightenment on the part of both supplier and customer. It calls for balancing service provision and price of the market offering. Table-V shows the profitability of major Indian steel manufacturers and also the profitability of the top ten world steel manufacturers over the last ten years. Table-VI shows capacities of these plants. Clearly, the Indian steel industry has not made any super-normal profits, contrary to what most customers would tend to believe.

**Table-V**  
**Profitability (PAT) to Sales Figures of Large Indian Steel Manufacturers and Top**  
**Ten World Steel Producers over a Ten-year Period**

10 BIGGEST PAT CO's Profitability - Net Income to sales (Percent)											
	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
AUSTRALIA BHP STEEL	10.4	9.7	7.6	-12.0	-7.0	2.0	5.5	6.9	7.8	7.5	3.6
SOUTH KOREA-POSCO	9.4	7.4	14.0	14.5	10.1	7.5	7.4	10.2	5.2	4.3	3.0
TAIWAN-CHINA STEEL	14.0	9.0	13.3	7.3	13.3	15.4	18.6	16.8	18.5	8.8	16.8
SOUTH AFRICA-ISCOR	34.2	-13.6	3.7	0.9	3.7	-6.1	6.7	7.4	5.6	-0.8	4.0
BRAZIL-GERDAU	20.0	15.1	14.1	16.4	12.9	9.5	na	na	na	na	na
INDIA-TISCO	10.3	2.7	7.1	6.1	4.5	5.0	7.4	9.7	6.1	4.8	3.8
GERMANY-THYSSEN KRUPP	0.6	1.7	1.4	0.9	5.0	5.3	0.9	2.0	0.3	-3.0	1.0
RUSSIA-SEVERSTAL	9.1	-26.1	21.8	11.9	-12.4	0.2	na	na	na	na	na
US- NUCOR STEEL	3.4	2.6	6.5	5.9	6.1	6.8	6.8	7.5	7.6	5.5	4.9
JAPAN-SUMITOMO METALS	1.6	-15.4	0.7	-10.2	-2.2	0.2	1.2	1.5	-2.7	-3.3	0.0
INDIA-SAIL	-1.6	-11.0	-4.5	-10.6	-10.5	1.0	3.8	9.4	8.3	4.8	4.3

Figs. For SAIL is calculated from 92-97 from Ann. Rpt

SOURCE: WORLD STEEL DYNAMICS

**Table-VI: Capacities of Large Indian and Global Steel Makers (2002)**  
**(Million Metric Tons)**

Country	Australia BHP Steel	South Korea-Posco	Taiwan-China Steel	South Africa-Isco	Brazil-Gerdau	India-Tisco	Germany-Thyssen Krupp	Russia-Severstal	US-Nucor Steel	Japan-Sumitomo Metals	India-SAIL
Crude Steel Capacity	7.4	28.3	11.0	9.1	4.2	4.0	17.5	9.6	14.1	20.9	12.0

SOURCE: WORLD STEEL DYNAMICS

## **Towards Discovering a Cure**

### **Breaking out of the Myopia**

What then needs to be done? Our industry captains would do well to understand the wisdom behind the 'enlightened self-interest' approach that we see in the customer-supplier relationships in the steel industry in the developed countries. We must recognize that pricing is a long-term issue and not a short-term, opportunistic phenomenon. Both supplier and customer must have a long-term view on pricing, although mutually they may decide, through transparent dialog and clear rationale, that for particular periods of time, they will make operational short-term contracts, while still retaining the spirit of their long-term view.

The supplier needs to realize that he must direct investments through a process of dialog with his key customers and not embark on investment decisions autonomously. The supplier also needs to have a long-range plan spanning multiple cycles, on what he needs



to do in terms of capacity and capability build-up, while simultaneously realizing that financial resources for this will be generated in a cyclical fashion as well. The customer should not grudge the supplier making what appear to be super-normal profits in the upswing, because he also realizes that in a downswing, the supplier is essentially surviving on oxygen. This is perhaps a peculiar feature of cyclical industries, the reality of which has not yet dawned in the Indian business market customer's mindset. If such enlightenment had dawned in the supplier-customer relationships in the steel industry a decade ago, we may not be finding ourselves in the present situation. For several years preceding the current one-year old upswing in world steel outlook, the global steel industry was literally down and under. Now that the steel industry is on a roll, the customers grudge the steel companies what they see as obscene profits. Table-VII shows industry profitability of various Indian industries over the last ten years. Clearly the Steel Industry is in the bottom quartile in terms of profitability.

**Table-VII: PAT/Sales (%) of Various Domestic Industries over the Last Ten Years**

	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03
Aluminium & aluminium products	8.7	10.5	18.2	25.0	19.6	17.7	14.3	16.9	17.6	15.7	11.6
Automobile	-1.1	0.6	5.1	6.3	8.6	5.9	5.8	3.4	-0.5	2.8	5.1
Automobile ancillaries	3.5	4.2	6.1	7.4	5.4	4.4	3.1	4.3	2.1	3.6	5.7
Cement	0.1	0.2	5.7	7.4	0.3	-1.5	-2.4	-6.5	-2.1	-1.2	-1.2
Chemicals	2.5	3.4	4.8	4.7	3.4	2.9	2.7	2.2	1.5	1.9	3.9
Computer software	9.1	7.9	13.0	13.3	11.8	13.5	17.2	21.7	24.5	18.1	15.2
Construction	4.2	4.0	7.9	7.6	4.2	3.8	2.7	2.7	3.6	3.1	3.5
Drugs & pharmaceuticals	4.8	6.5	9.7	9.8	7.2	4.7	3.5	7.2	7.4	9.4	11.0
Finished steel	0.8	2.1	6.3	6.8	3.0	0.0	-7.8	-7.2	-4.3	-9.2	1.7
Housing construction	8.3	9.2	17.4	15.9	7.4	-0.1	-4.3	-1.2	-2.0	-2.4	3.4
Petroleum products	2.8	3.1	3.0	3.3	2.9	3.9	3.7	2.8	2.5	2.1	4.1
Plastic products	2.6	8.4	9.4	7.2	1.2	-3.0	-6.8	-4.7	-5.8	-3.0	0.1
Telecommunication services	12.2	9.6	12.0	12.4	12.7	12.6	11.6	4.0	11.2	7.9	2.8
Textiles	-0.1	3.9	5.0	2.6	-0.7	-4.3	-6.5	-7.8	-7.0	-6.8	-3.0

Source: CMIE

## Some Supplier Specific Hard Constraints

This is not to say that all is well with the steel suppliers in India. They of course need to get their act together, and fast. However a recognition of the specific hard constraints that they face as well as some specific to individual companies, would be a good starting point for our discussion on what needs to be done to come out of the present situation

### **Company-specific factors**

The operating environment of each company is different. A company that has a large dependency on raw materials from international markets displays behaviour that is quite different from a supplier that has access to captive raw material sources. Their operations are very sensitive to international raw material prices, which have gone through steep increases in the last year due to the Chinese factor. These include key raw materials such as iron ore, coking coal and steel scrap. The propensity of such companies to enter into long-term contracts with their customers may be low. On the other hand, companies that source their raw material requirements from captive sources would have a higher propensity to enter into long-term contracts. Another dimension of the past history is the amount of debt that a steel supplier carries. Companies that have large borrowings in their source of funds will have different business imperatives than some others that have low or negligible debt. The operational market behaviour of the high-debt carrying companies will be driven by cash flow considerations.

### **Width of Offering and Global Marketing Footprint**

The width of offering, which is a resultant of the manufacturing geometry and configuration, also impacts a supplier's relative flexibility and consequently vulnerability. Another dimension is the geographic spread of the supplier's markets. Some of the larger steel companies in India operate across a wide spectrum of product offerings. They have both flat and long products. Within each, they have multiple product lines. They also operate in both domestic and international markets. Such companies with wider product range and larger global geographic spread can play a 'balancing act' and at least have some flexibility in picking and choosing more profitable markets.

### **Irrational Behaviour of Suppliers at the Time of Capacity Augmentation or New Entry**

Every time a new entrant to the domestic steel industry starts operation, or when an existing player makes significant capacity augmentation, one can expect irrational behaviour by that supplier. In such situations, the Key Result Areas (KRAs) of Sales & Marketing team will focus on pushing the product into the market at any cost. There is likely to be a tendency to 'scavenge' the market. On achieving the KRAs, usually at 70% or more capacity utilization of the new or augmented capacity, the supplier will likely revert to a more rational behaviour.

## **The Myth of Cartels**

### **The Reality**

Based on recent price increases in steel, a vast majority of business customers to the steel industry believe that the steel suppliers have formed a cartel to jointly squeeze the customers. Let us look beyond the obvious to understand the situation better. For the first time in the history of the Indian steel industry, the Indian Steel Alliance (ISA) has been formed, representing only five flat steel producers, about a year ago. Given that the industry is about a hundred years old, this surely does not substantiate the claims by customers of existence of cartels. Many other industries such as ACMA for automobiles, NASSCOM for software, and many other similar industry bodies have been around for much longer. Moreover, given the generally depressed scenario of the global steel

industry, with each supplier struggling for existence, as was the case over the last several years, it is the most unlikely condition for formation of a cartel.

Cartels are formed when one or more of the following conditions exist. When the customer base is shifting, each supplier tries to poach another's customer. Given the differences in the operating realities of each of the steel suppliers in India, this is unlikely to be the case. For instance, the segments occupied by a company with captive raw materials sources and low debt may be of little interest to a supplier who is burdened with high debt or excessive dependence on bought-out raw materials. This is not to say that competition is benign or gentlemanly. On the contrary, the customer also has the choice of imported material from multiple sources, and even in the domestic market, the customer has choice of suppliers. Another situation when a cartel may be formed is when there is a sudden and huge capacity entrant into the industry, when the existing players may join together and find ways to 'accommodate' the new entrant, rather than spoiling the market. So rather than industry-wide cartels, there may be the possibility of 'understanding' between suppliers who are servicing particular large customer account, to jointly come up with tactics for resisting price pressures from the customer. For instance, if two suppliers are servicing a customer who needs a total of 10,000 tons per year, which is a relatively small requirement, the two may agree to share the customer's requirements equally (5,000 tons per year each), and evolve joint tactics to resist attempts on the part of the customer to lower the price. However, this would be on a case-to-case basis and restricted to a local level.

Discussions between suppliers are also likely to occur with a view to understand each other's price positions. For instance, one supplier may have a quarterly basis for setting prices, and another may be more comfortable in taking a monthly price position. While they may discuss together to come up with a shared understanding, given the differing realities of each, they may end up agreeing to disagree. This is hardly the basis for us to conclude the existence of strong cartels. In fact, one would wish for more cooperation among suppliers, to improve the performance of the system as a whole at a national level.

### **Supplier Myopia**

Rather than a steel cartel at work in India, what clearly appears in reality is the myopia of suppliers, resulting in overall sub-optimisation. Examples of such myopia abound. The industry will most likely have chronic shortages for the next few years. Each company will seek to ramp up its capacity independent of the others, with little coordination. In a few years, this will result in a condition of glut, and the seeds for another down-cycle would have been sown.

Currently for instance one of the large steel plants in the country is in the process of commissioning a new blast furnace that will result in additional 400,000 tons per year hot metal production. However they do not have balancing downstream capacity to take up the increased output (hot metal) of the blast furnace. So they would end up having to export low value added ingots, at least in the short run. Surely, there is no denial that India will need much more steel than the product of a small blast furnace. During the growth period, there will be periods of surplus and deficit. What needs to be ascertained is that the investments are made keeping in view issues of long-term sustainability.

## Remedies

There are no quick-fix solutions to the multifarious issues raised above. One can clearly recognize the need for all to put their heads together to find solutions to these vexing problems. We can also see clearly that if there was more holistic understanding from a long-term perspective, we would not be experiencing some of what we are witnessing today. If the steel industry was financially healthier for example, they may have invested in more capacities (which take a long lead-time to build up), and perhaps the industry would have had additional capacity of several more million tons, mitigating the possibility of today's supply-demand gaps. In the following we discuss some possible remedies.

### **From Myopic to Pan-Industry Collaborations**

It is clear that there is a need for customers and suppliers in business markets to expand their range and depth of vision and dialog. There is need for more transparency in dealings and in communications. Understanding, creating, delivering and documenting value by the supplier to the customer has become more important than ever. Such a value-based approach to marketing, advocated in the recent past by business market academia is imperative on the part of suppliers and customers. Rather than each industry body looking after its own turf, and lobbying with the government to rein in players in another industry, there is a clear case for industry bodies of affected industries to engage with each other in meaningful and on-going dialogs, to proactively anticipate problems, and circumvent them. These dialogs should foster long-term relationships and sustainable win-win situations for both supplier and customer.

Another very important source of remedy to the current malice is embarking on a path of aggressive innovation. This can happen within and across industries. It may call for a significantly stronger collaboration between supplier and customer firms, than what we as a country are used to. The term steel does not refer to one product. Even flat steel is not one species. It is a generic term. It is possible to produce and purposefully use steel of much higher strength than what is commonly used in the country. Such steel may for instance be used to produce a lower weight automobile, as it will require the use of less steel. Consequently it will be more energy efficient. Another pathway to innovation could be that the automakers can guarantee certain number of years of corrosion-free cars, which can be a great boon to car owners. They can do so by using appropriately coated steel sheets. Lamenting, which is currently rampant, cannot however be a solution!

At the final reckoning, all players must focus on what is best for the end consumer. This will greatly mitigate the current atmosphere of acrimony and bring sanity into the super-charged atmosphere that we are witnessing today in the steel industry. If the end consumer's interests are vividly kept on the radar screens of all players, the propensity to collaborate for long-term benefit of all will take precedence rather than indulging in perpetual management of individual crises of each company.

### **Modifying our Interpretation of Contracts and Respecting their Sanctity**

We need to move from interpreting contracts opportunistically, to giving them respect and sanctity that they deserve, based on mutual trust. Nations such as Japan practice this to the hilt. Most businesses in India have a steep learning curve in this regard. Trust is a two-way street, with equal onus on both supplier and customer. We must understand that in a situation of oversupply, contracts deal with price. However in a short supply situation such as the present steel scenario, a contract embodies both price and quantity. When the supplier puts this into practice however, the customer is prone to read the supplier as being arrogant and opportunistic. More intense collaborative working among competing suppliers and active pan-industry collaborative forums can also help address these problems. Suppliers must understand that they have the onerous responsibility of keeping the customer's operations going, by ensuring through various mechanisms, steady availability of raw material. They must earn the right to grow from their customers. In turn, customers must respect the supplier's right to grow. Both need to inculcate long-term memory. Only such a symbiotic relationship will result in win-win for both and improve overall prosperity.

### **Consumer Education**

Manufacturers catering to consumer industries, in attempting to justify price increases of their products to end consumers, tend to attribute this to raw material cost increases. For instance, an automaker might seek to justify price increase citing increase in steel prices. The reality however is that although steel is the conspicuous input to a car, in value terms, it is about 5% of the price of the car. In this situation, seeking to justify car price increases by attributing this to steel price increases is erroneous. However, the consumer, in the absence of any substantive data, would tend to believe the story. This has an inadvertent consequence of the steel industry being seen as a villain in the eyes of the general public. This points to the need for concerted effort by steel manufacturers or their industry body to systematically educate public in a proactive manner.

### **Strategy-focused Organisations**

All this will not mitigate the need to run the company with a strong focus on strategy. Some of the steel companies in the country that have practiced this. Consequently, despite the current pressures on the industry, they have been able to wade through the troubled waters. Needless to say, this calls for a visionary management, creating the right cultural context in which the mental energies of everyone in the organization is harnessed to address the various issues of the company, and many more ingredients that together ensure success. It calls for timely, well-panned, proactive and courageous investment in manufacturing assets, infrastructure, people and processes. Above all, it calls for having a clear strategy and implementing it, while watching out for conditions and changing realities that may necessitate fine-tuning or even re-examining strategy.

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