Strategic Sourcing versus Traditional Purchasing:

And the Impact on your Bottom Line

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Introduction

Recently, after hearing the positive — yet unexpected — outcome of a transportation strategic sourcing effort, a senior executive asked the project leader a million-dollar question:

> *How in the world did you get 15 percent savings from a supplier we've been using for more than 15 years, let alone more than 25 percent from their biggest competitor?*

While the results were compelling, the executive in question was surprised and somewhat angry that a long-term supplier he viewed as a partner had been willing to yield such significant savings.

The answer to his question was simple: process. Specifically, the **Strategic Sourcing** process used to deliver these savings was vastly different from the process in place for decades prior at this multi-billion-dollar manufacturer.

The Key Differences

Strategic sourcing blends science, art and heavy data analytics with the use of a comprehensive methodology designed to explore all viable avenues in pursuit of total cost reduction and overall quality/service parity or improvement.

Strategic sourcing differs from traditional purchasing in a myriad of ways.

Poor procurement data often hinders traditional purchasing. By contrast, strategic sourcing professionals are willing to perform the "pick-and-shovel work" to get the data necessary to achieve best-in-market results.

For example, a $2 billion multi-division company embarked on a sourcing campaign across five indirect spend categories, but it lacked visibility into total spend levels and line-item detail collectively and even at the divisional level. An exhaustive data collection effort yielded:

- 8 AP system reports with hundreds of thousands of lines of data
- 13 contracts (of which 8 were expired)
- 29 PDF reports with 745 pages

- 6 supplier-provided reports in Excel
- Almost 3,000 pieces of paper

Although it took another monumental effort just to analyze the data once it was in hand, the resulting clarity enabled $12 million (20 percent) in cost savings.

Executives should ask themselves: do I fully understand where we are spending the company's money? Spend visibility is surprisingly elusive, and you cannot effectively manage what you cannot track and monitor. Given that many companies spend 30-80 percent of revenues on the purchases of materials and services, a more effective sourcing process can truly be strategic.

In traditional purchasing, the typical mantra is 'get three bids and go with the lowest.' Strategic sourcing assesses the supplier market and internal needs, develops multiple sourcing strategies, identifies qualified suppliers regardless of location, and engages in a rigorous Request for Proposal (RFP) effort.

Next, a fact-based, multi-round negotiations process is launched, which results in a comprehensive contract and smooth implementation. As many as 30 suppliers might be screened and included in initial assessments if the spend volume warrants it.

As an example, a large restaurant chain decided to apply strategic sourcing to its uniforms spend. An analysis of current costs and requirements was performed. After rationalizing the mix of items that had evolved over time into a more consistent set, a two-pronged sourcing strategy was developed and executed.

The team sought bids from traditional uniforms providers, including incumbents. However, the initial assessment revealed that the value added by the supplier was limited—they were effectively receiving product and then distributing it to the thousands of locations on demand. There were no laundering or other complex services provided.

So, the team examined the supply chain and decided to source the uniforms directly from Pakistan along with a third party logistics provider (3PL) in the U.S. as one thread of the effort. This served the dual purpose of offering an alternative and revealing the likely margins the large uniform providers were making. Risk and complexity were mitigated by having the 3PL take title to the goods and handle imports.

In the end, the incumbent was convinced its customer intended to implement this alternative strategy and offered a last minute bid adjustment that yielded 22 percent in savings without any changes. This type of pressure is not generally found in a traditional purchasing process, and therefore, neither are these results.

Traditional purchasing uses volume as the primary price lever. Strategic sourcing, on the other hand, explores more than 20 different sources of leverage (including volume) to craft the most appropriate strategy to achieve best-in-market total costs.

For example, one company saved 30 percent of its packaging costs by determining that its "cost-to-serve" characteristics for the supplier were far more favorable than a typical customer of its size. After a rigorous sourcing process reduced costs by 20 percent, leveraging this attractive profile drove an additional 10 percent in savings with a former backup supplier, replacing a 15-year incumbent. Aspects of the attractive customer profile included a low number of box SKUs (enabling longer supplier production runs), a 'drop and swap' delivery (where the supplier dropped off a full trailer and picked up an empty one without unloading), and the fact that the plant and the customer were located off of the same interstate requiring literally one turn during the delivery. This 'milk run,' as we termed it, deserved better pricing than other similarly sized customers, and the strategic sourcing process secured it.

Traditional purchasing processes are often designed to 'keep incumbents honest' and are not viewed by competing suppliers as objective. This results in a loss of best-in-market cost visibility as incumbents do not believe they will lose the business and competing suppliers do not feel they can really win. As a result, competitive sales people often will not invest their limited internal equity to put their best pricing and terms on the table.

In the packaging example above, the winning supplier was the previous back-up supplier. When the customer's CFO asked the supplier why they were willing to lower their costs 30 percent after years at the old price, the answer was essentially tied to 'process.' In the past, the backup supplier never believed they could win the business and felt they were being used to put pressure on the long time incumbent. Once a professional strategic sourcing process was employed, they believed in its objectivity and pulled out all the stops.

In traditional purchasing, RFPs are either high-level or so onerous as to be nearly punitive. In strategic sourcing, however, RFPs are designed to engage suppliers and to provide them as much clarity about the opportunity as possible. This way, they do not have to "hedge" when making proposals and can be as aggressive as possible without fear of the unknown or interpretations of ambiguous requirements.

Supplier concerns are addressed upfront, and punitive elements (such as negative contract language) or long lists of granular questions, are not included in the first round unless they are critical to the down selection process. This is done out of respect for the suppliers' time and to enhance supplier engagement.

Further, the process is supported by deep analytics which includes a tight bid format to enable comparative bid analysis and to eliminate ambiguity. Many suppliers are highly appreciative of this approach, feeling that they have lost bids they should have won due to inaccurate bid analysis or through pricing gamesmanship by their competitors.

Results

The proof that these differences exist is in the end results. Across all industries — from airplane manufacturers and mutual fund companies, to apple-pie makers and entertainment companies — strategic sourcing can generate recurring cost savings of 10 to 50 percent.

For example, one $500 million manufacturer improved its profitability from $60 million per year to $84 million per year—a 40 percent increase—purely through the results of world class strategic sourcing.

Getting Started with Strategic Sourcing

So how do you make such a meaningful impact on profitability? How do you begin? It starts with support from senior executives. Next, in order to build support from all stakeholders, it is important to have compelling data to support the need for strategic sourcing.

For the $500 million company, the process began with a Spend Analysis and a rapid Assessment. This included a detailed look at one year's worth of expenditures and interviews with key stakeholders from the top executives to engineers to operators on the shop floor. This identified multiple opportunities and $120 million in expenditures were targeted for strategic sourcing. These included most indirect expenditures such as freight and telecommunications as well as many direct materials (cost of goods sold items) such as tooling, plastic molded parts, metal plating, machine shop services, and others.

The assessment demonstrated that some expenditures were fragmented across multiple, similar suppliers. In other cases, the spend was consolidated, but there was a low rate of supplier turnover from previous years along with other signs of potential supplier complacency. In some other cases, competitive bids had been undertaken regularly, but the relatively limited depth and rigor of the process suggested money was left on the table.

A project structure was established with supplier selection teams formed among relevant stakeholders. The processes used over the next 12 months, to drive $24 million in cost from the $120 million in historical expenditures, leveraged the full strategic sourcing process.

For example, the assessment noted that the 30 machine shops used by the plants tended to be within an hour or two of the locations to enable close collaboration. The sourcing process posed the following question: What are the odds the world's best-in-class and low cost suppliers are located within a few hours of each plant? Even if a world class sourcing process was used previously and razor thin margins were negotiated, what if the regional supply bases' cost structures were higher than average?

The team looked more broadly, both domestically and globally. In the end, suppliers were selected from areas known for machine shop excellence (and excess capacity), such as Detroit and the auto belt. Even after considering the cost of freight and the potential need for regular site visits, the savings were almost 20 percent on a $15 million cost. In addition, just as importantly, quality improved.

Strategic sourcing is not limited by conventional wisdom. In this example, one of the Detroit suppliers offered to use its own vehicles to ferry samples and finished product to each plant on a JIT basis at no extra cost. Yes, there are times when it would be nice to have the supplier down the road, however, in those few instances, the manufacturer could rent a private jet or a car and driver and still come out far ahead.

Many of the company's employees were concerned about changing from long time suppliers and did not initially support the process. However, a world-class sourcing process is designed to address all of the concerns and risks in a comprehensive manner, and it relies on facts and logic rather than emotion and historical anecdotes. In the end, even those who initially resisted the process became excited about the potential once they began to see the new prices and the high quality of the new suppliers. Subsequent projects had greater and greater support.

Conclusion

Purchasing has been an area of underinvestment by businesses for years. Purchasing is often understaffed and the resources are pulled into day-to-day tactical activities, leaving precious little time to focus on strategic sourcing. In other cases, true sourcing skills and expertise do not exist within a company.

The good news is that historical underinvestment means the opportunities are rich, and have the potential to make a significant EBITDA impact for companies that choose to embrace strategic sourcing.

About Tom Beaty

Tom is the founder of ISG and has over 20 years of strategic sourcing and management experience. Early in his career, Tom led the turnaround of a 120-employee construction company, converting substantial losses to profitability in under a year—primarily through cost optimization. This experience contributes heavily to his focus on delivering measurable results and high ROIs for clients.

Tom founded a business in 1994 that resulted in the creation of an early Internet portal. After selling it in 1997, he went on to work with Deloitte Consulting and later was a Director with a 500-person procurement services firm, ICG Commerce.

Tom founded and leads the non-profit Witness to War Foundation (www.WitnessToWar.org) which is dedicated to preserving the oral histories of combat veterans. In that role, he and his team have interviewed over 800 combat veterans, primarily from WWII. His efforts have been featured in *Inc.* magazine, on CNN, Fox News, on CBS Evening News with Katie Couric, and in cover stories for the Boston Globe and the Atlanta Journal-Constitution.

Tom has been awarded a Top '40 Under 40′ award from the *Atlanta Business Chronicle (2007)*, and has been named a 'Pro to Know' by *Supply & Demand Chain Executive* Magazine from 2008-2012. In 2009, he was selected by the Institute of Supply Management to lead a four hour televised session on Negotiations.

Tom received a Bachelor's degree from the University of North Carolina at Chapel Hill and later received an M.B.A. with honors from the Goizueta Business School at Emory where he was awarded the Woodruff Fellowship, Emory's highest honor.

About Insight Sourcing Group (www.insightsourcing.com)

Insight Sourcing Group, Inc., is a management consulting firm focused exclusively on strategic sourcing, spend analytics and procurement process transformation. Founded in 2002 in Atlanta, ISG has delivered an impact of 10 to 30% earnings (EBITDA) for many companies by driving down the cost of the materials and services they already buy. ISG has delivered over a 800% one-year average ROI for their clients, resulting in a significant earnings impact. ISG also created SpendHQ (www.spendHQ.coom), an innovative spend visibility solution.

ISG has been recognized as one of the "Fastest Growing Private Companies" by Inc. Magazine for five years in a row, has been a "Supply & Demand Chain Executive 100" annually since 2008, has been recognized as one of the "Best Places to Work" by the Atlanta Business Chronicle every year since 2008, and recognized as the 2012 "Supply Chain Company of the Year" by The Atlanta Metro Chamber.

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