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Turn Your Suppliers into Cost-Cutting Allies

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Turn Your Suppliers into Cost-Cutting Allies

Demanding nothing but price reductions from your suppliers is a zero-sum game. Instead, focus on bringing some creative juice back into negotiations.

BY JONATHAN HUGHES

PROCUREMENT GROUPS HAVE PLAYED a key role in meeting their companies' ambitious cost-cutting targets over the past several years. Through recurring negotiations with suppliers, buyers have achieved repeated discounts. But as deals with suppliers have matured, negotiators are finding it increasingly difficult to replicate earlier wins. As buyers face continued pressure from their companies to continue to drive down costs, they are increasingly resorting to high-pressure tactics to squeeze more concessions out of suppliers.

For some companies, this zero-sum approach continues to deliver the goods (at least for now), but for many, such tactics are failing. Too often, they result in time-consuming, highly contentious meetings that sour relationships without producing significant or sustainable savings.

A less adversarial approach is needed, one that views suppliers strategically, as valuable assets of the extended enterprise rather than merely cost centers. This is particularly important for noncommodity suppliers that have more to contribute than low-cost products or services.

Indeed, developing more robust relationships with certain suppliers may well help firms return more to the bottom line than hard-line negotiations ever could. To cite one example, research by the Boston-based Aberdeen Group found that integrating suppliers earlier in the product design process yields additional reductions of 3% to 15% in product cost and can drive improvements of 10% to 20% in quality and time-to-volume cycles.

So how can procurement groups forge more productive relationships with suppliers, particularly when current cost-cutting programs are bogged down? Try the following strategies for rejuvenating supplier relationships and putting the creative juice back into negotiations.

Shift from an emphasis on reducing costs to enhancing competitive advantage

Just as revenue is rarely the only goal of a customer relationship (margins, cost of sales, use of a customer as a reference, supplier's contribution to total sales, and market share all matter to varying degrees), minimizing costs should not be the primary goal of every supplier relationship. Before initiating any cost reduction negotiation, analyze what you need most from that supplier. Dell Computer works with suppliers to increase supply chain velocity—a key driver of profitability and competitive advantage in an industry in which prices fall rapidly and product life cycles are short.

Focus the negotiations on taking costs out of the supply chain, not the supplier

Many suppliers hear "cost reduction" and immediately think "price reduction" or "margin erosion." Try reframing the discussion to focus on improving the efficiency of the overall supply chain. Explore changes in materials requirements, product specs, and business processes (including your own). Looking for opportunities across the entire supply chain will produce larger and more sustainable savings than extracting price concessions or new efficiencies from individual suppliers.

Chrysler's SCORE (Supplier Cost Reduction Effort) program took this more constructive approach by soliciting ideas from suppliers for innovations in design, materials, and processes. In its sixth year of operation, the program delivered annual savings of more than $1.7 billion as well as profitability gains through improved quality and faster product development. A core element of the program was gain sharing with suppliers. (For more information, see Jeffrey Dyer's article "How Chrysler Created an American Keiretsu," *Harvard Business Review,* July–August 1996, Reprint # 96403.)

Create an attractive role for your counterpart

Consider initiating negotiations by asking for your counterpart's help instead of pressuring him to deliver cost reductions. The supplier will naturally resist such demands—especially ones that feel unfair or arbitrary—and may well respond in kind. At the very least, high-handed treatment of suppliers is almost guaranteed to discourage the kind of creative thinking necessary for continued cost reduction.

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BUILDING DEEP SUPPLIER RELATIONSHIPS

Toyota and Honda enjoy the best supplier relations in the U.S. automobile industry. In an alien Western culture, they've replicated the supplier webs they built in Japan: close-knit networks of vendors who continuously learn, improve, and prosper along with their "parent" companies. This kind of partnering isn't easy. It takes time, and it unfolds through the disciplined application of the following six principles:

1. **Understand how your suppliers work.** Observe suppliers' operations, cultures, and capabilities firsthand. One Honda engineer spent 12 months getting to know a potential supplier.
2. **Turn supplier rivalry into opportunity.** Spark competition between vendors with your existing suppliers' support. Toyota encouraged the formation of a new seat supplier with the blessing of its existing suppliers.
3. **Supervise your suppliers.** Regularly assess suppliers' performance on agreed-upon metrics, responding to problems immediately. When a supplier can't find the root cause of a problem, Honda sends engineers to troubleshoot.
4. **Develop suppliers' technical and product-development capabilities.** Toyota teaches suppliers how to collect precise data on equipment tolerances so they can design products appropriately.
5. **Share information intensively but selectively with suppliers.** Toyota shares proprietary information on certain components with suppliers—then has them develop the parts on its premises.
6. **Conduct joint improvement activities.** Honda's U.S.-based engineers lead continuous-improvement events and create model product lines at suppliers' factories.

The payoff is well worth the effort. For example, Toyota and Honda design new cars in just 12 to18 months—versus U.S. automakers' two to three years—and are known for their high quality.

This sidebar presents a summary of ideas originally published in "Building Deep Supplier Relationships," by Jeffrey K. Liker and Thomas Y. Choi, Harvard Business Review, *December 2004, Reprint # R0412G.*

A large aerospace company achieved only limited success over many years by demanding annual cost reductions from suppliers. When the company found itself in financial crisis, procurement teams insisted on even steeper cuts. When their demands were met with flat refusals, a top executive stepped in and met with key suppliers. He expressed a commitment not to solve his company's problems on the backs of the suppliers, but explained that his company could not solve its financial problems without their help.

One supplier offered to share ideas for redesigning key parts in a way that would deliver enormous savings. All the supplier wanted was to share in the gains. Amazed, the executive asked why they had never shared the ideas before. The response was disheartening: "We've tried for years to tell your people, but they always dismissed us and told us they didn't need us to tell them how to run their business."

Balance carrot and stick incentives

Too many companies negotiate through coercive leverage at every opportunity (even with suppliers that they depend on for much more than the lowest price) and explore alternative approaches only when they are desperate. Others rely simply on threats (explicit or implicit) to take the business elsewhere or on other negative incentives, all of which are unlikely to maximize cost reduction and other forms of value. A balance of positive incentives and negative consequences for subpar performance almost always produces better results than a pure-carrot or pure-stick approach.

Taking a more balanced approach does not mean companies have to be lenient with their suppliers. Since the mid-1990s, Harley-Davidson has achieved tens of millions of dollars in real cost reductions—along with major improvements in product development time, quality, and distribution—through closer, more collaborative relationships with key suppliers. Suppliers know, however, that Harley-Davidson will replace them if they consistently fail to meet rigorous quality standards or deliver continued cost savings—but only after working closely with them to improve performance. Suppliers that perform well earn more business and share in Harley-Davidson's growth and success.

Between 1996 and 2000, the company reduced the cost of goods and services sold by $37 million and cut inventory from 15 days down to as little as 6.5 days—and its 70 top-performing suppliers have prospered from this success by receiving 80% of Harley-Davidson's supply purchases. ◆

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