From Purchasing to Strategic Sourcing – A Road Map

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In many traditional non-manufacturing firms the Purchasing function has long-been relegated to the corporate back-40 with little visibility and little consideration of its impact on the bottom line. By contrast, in a number of more innovative firms, purchasing has been renamed Procurement or Sourcing to imply both an expanded scope and role, has adopted significantly improved processes, and has become an important strategy for profit growth. This article presents a summarized road map for the journey from Purchasing to Strategic Sourcing.

First, why embark on this journey? Simply answered, the impact of improved sourcing is often greater than any other profit lever in management's arsenal. For example, the purchase of goods and services can range from 30% of total revenues (for services companies) to a high of 80% (for PC or auto manufacturers who largely integrate sourced components). By following the road map described below, savings in purchasing these goods and services of 10 to 20% should be achievable. These savings fall directly to the bottom line and can have the same impact to a corporation as a 50 to 100% increase in revenues.

1. Determine your spend. Quantify the following for every major expense category from office supplies to legal services: (1) How much was spent?, (2) Who spent it?, (3) Where and how was it spent?, and (4) What specifically was it spent for? When you complete this analysis you may be shocked to discover that:

- Your total expenditures in the category are significantly greater than you thought (30 to 50% greater is not uncommon)
- The number of suppliers you are purchasing from is much greater than you thought (at times more than 1,000)

- The range of prices you are paying for the same or similar items is incredibly broad (200 to 300% ranges are not uncommon)
- The number of "untrained" and unmanaged buyers is quite large (especially in decentralized organizations)
- The size of the average purchase (typically less than $500) seldom justifies the cost of processing the Purchase Order and other paper work (typically $100 or more)

At first, these discoveries might seem discouraging. However, they represent tremendous opportunities for both operational and economic improvement.

2. ***Prioritize the spend categories.*** Prioritizing is straightforward and involves looking at the size of the savings opportunity compared to the degree of difficulty in actually achieving the savings. The degree of difficulty is determined by such issues as organizational turf, complexity of the product or service itself, and the complexity of the actual sourcing process (e.g., vendor selection, vendor certification, RFP, negotiations, etc.) It is always best to go after the "low hanging fruit" first by selecting the high savings opportunities that can be achieved with little difficulty. Then attack the other categories based on the availability of knowledgeable people to serve on the various category teams.

3. ***Form category teams.*** These teams are small groups of people with the charter to examine the sourcing options for the category and to make recommendations to senior management. Ideally, especially in a decentralized organization, you would have representatives from each of the key business units on the teams to obtain diversified inputs and to build consensus.

4. ***Develop a sourcing strategy for your categories.*** Each category team needs to develop a basic strategy to source its category. These can range from joint ventures with suppliers when the product or service being sourced is highly technical, critical to your business, and only a few suppliers are capable of meeting the specifications (e.g., jet aircraft engines), to very competitive bidding situations when the product is simple and widely available, like office supplies. Other issues to consider in putting together the strategy are your product and service specifications – what they should be and how both you and the supplier will measure them. Also, understand the pros and cons of your current

procurement practices for this category. Then, what opportunities for improvement will be pursued? For example, do you plan to leverage purchase volume across the organization to achieve better pricing, work with the supplier to better manage or limit demand through pricing and other methods, and/or promote joint efforts to mutually save costs, like changes in delivery method or frequency? Finally, what can you do with the supplier to simplify your internal processes or reduce your costs of operations, e.g., does the supplier have systems to simplify order entry, better track usage, interface with your payables system, etc?

5. ***Perform the RFP process and make the final selection.*** Identify a list of potential suppliers, starting with your current suppliers. The members of the category team should reach consensus on the basic ground-rules for awarding the business (e.g., a national contract for ***all*** of the corporation's office supply purchases) and just what criteria (e.g., prices, rebates, breadth of offering, delivery frequency and options, order entry system, etc.) will be used to select the winning proposal. It is extremely important to reach consensus on these issues ***before*** sending out the RFP. In crafting the RFP, clearly state your assumptions about volumes of business to be awarded, service levels, etc., explain the selection process and criteria, and outline how you intend to measure both your and the supplier's compliance to the terms of the contract. Point out the potential increase in business that winning the contract would mean. Send out the RFP and then make your preliminary decision based on your ***pre-established*** criteria and use your best negotiating skills to come up with a final choice.

If the decision is a substantial change from prior practices, e.g., all business units must buy from a single national supplier rather than buy from multiple sources, you will need to present your basic business case to senior management. This business case should stress the trade-offs between the current purchasing practices and those envisioned under the contract. For example, the business case would deal with the expected cost savings for each of the business units, the mechanics of placing orders, changes expected in average order size and frequency, changes in basic terms and conditions, etc. If the category team has done its homework and is united in its recommendations, senior management's acceptance should be a forgone conclusion.

6. ***Manage the supplier relationship aggressively.*** Supplier management is the area of Strategic Sourcing with the greatest opportunity for both success and failure. Too many companies just sign the contract and forget about the relationship until contract renewal time. To make the relationship a real success and to ensure that the benefits you and the category team fought so hard to achieve are sustained, both parties must be actively involved in monitoring results, reviewing pre-established performance metrics, partnering on creative ways to mutually lower costs, ironing out any contract or performance disputes, etc.

7. ***Provide feedback to both suppliers and senior management.*** Give your suppliers feedback on both successes and failures. Make them feel a part of your overall Strategic Sourcing process. Similarly, keep senior management informed about what you and the category teams have accomplished. Present an annual plan to them that recaps savings achieved during the year and planned activities for the following year. Finally, be a missionary for Strategic Sourcing by trumpeting the successes of the program and carrying the message throughout the corporation.

Strategic Sourcing Success Stories

Using the seven-step process outlined above (or something similar), some remarkable successes have been achieved. Below are just a few of the successes that have been made *public*:

- At CNA Financial Services, consultant-led client teams developed and adopted Sourcing "best practices", built economic business cases for various Sourcing alternatives, leveraged the entire enterprise's buying power, and dealt with various organizational and implementation issues. Teams examined categories ranging from office supplies to legal services and identified savings ranging from 12% to 18%. Total savings are projected to be $ 200 to $ 300 million annually.

- A large building products company ($ 4 billion in annual revenues) achieved its target of a 20% reduction in costs when it applied a strategic sourcing process to its IT and maintenance procurement functions.

- At Sears an internal effort to reduce the cost of purchased goods and services used for internal use (sponsored by the CEO and led by the SVP of Purchasing) reduced annual procurement costs by $ 1 billion in the first 18 months. These savings were achieved primarily by better processes and by centralizing supplier management and negotiations.

- An electric and gas utility ($ 1.5 billion in annual revenues) reduced the number of services providers it used for utility line clearance and storm drain damage repair from many to one. As a result, it reduced its costs by 15%.

- Another utility ($ 2 billion in annual revenues) reduced its inspection and repair costs by 30% annually by implementing a strategic sourcing process.

- AMR Corp, the parent company of American Airlines, hired its first Chief Procurement Officer in *1995.* He was given the charter to use procurement to enhance AMR's bottom-line. Just a few of his accomplishments since that time: (1) the number of suppliers was slashed from over 17,000 to 2,000, (2) increased the percent of purchasing staff with college degrees from 55% to over 90%, (3) eliminated more than 230,000 POs , and 600,000 invoices annually, (4) forged sourcing partnerships with a number of key suppliers including Boeing, AT&T, and a number of the major fuel suppliers, (5) negotiated with 70% of the spare parts suppliers to carry the inventory and operate emergency depots in AMR facilities, and (6) added $250 to $ 500 million annually to AMR's bottom-line.

- In 1990, Chrysler adopted an aggressive program to work with its suppliers to mutually reduce costs by improving processes and consolidating volume whenever appropriate. The program is credited with savings to Chrysler of $ 2 billion by 1995. It is further credited with helping Chrysler to cut model development time by up to 40%.

- An electronic switch manufacturing firm with annual revenues of $ 3 billion used cross-functional teams, including customer and supplier personnel to reengineer its overall procurement process. It reduced costs by 15%.

- Owens Corning, a $4.5 billion global fiberglass materials and building products company, had seven separate business units with P & L responsibility and with separate sourcing activities. Raw material purchases accounted for *50%* to 70% of revenues. Several years ago it undertook a corporate-wide strategic sourcing study which resulted in a "matrixed" sourcing organization and in annual cost reductions in the range of 3% to 7%.

- Milliken Textiles reduced its "time-to-market" from 36 months to 6 months by aggressive supplier partnerships and management.

- First Chicago National Bank instituted a centralized procurement function headed by a SVP that achieved some notable success in the first few years, including: (1) sourcing approximately $ 500 million annually, (2) saving about $ 100 million annually or 20%, (3) and instituting standards, metrics, and a number of improved processes across the organization.

- United Technologies recently outsourced its non-production procurement to IBM Global Services. Among UT's objectives in outsourcing was to force standards and best practices by centralizing with IBM. The CEO of UT has committed to his shareholders that this move will result in annual savings of $750 million by the year 2000.

- BankBoston established a centralized procurement function in 1993 with the mission "to save money; reduce business risk; and make management's lives easier." By 1997, the centralized group had (1) reduce invoices by 11 % while the business itself actually doubled, (2) reduced overall cost of purchasing by 13 %, (3) increased its spending influence/management to $400 million annually, and (4) achieved savings of $80 million annually.

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