Delivering Real Value Through Strategic Sourcing

ENSURING SOURCING SAVINGS HIT THE BOTTOM LINE

A well-designed supply chain coupled with strategic sourcing can produce huge savings for organizations, but too often, those savings fail to hit the bottom line. Fortunately, when savings do not materialize, the root causes are predictable and can be avoided.

In a recent leadership meeting we participated in, the head of strategic sourcing said to the Chief Financial Officer (CFO), “We’re going to save 10 percent on freight this year.” The CFO’s response? “If you saved as much money as you’ve promised every year, freight would be free by now.”

This scenario, where identified savings from strategic sourcing initiatives fail to yield real bottom-line results, is all too common.

In some instances, projected savings can be overstated or understated if we do not have a clear understanding of the total cost of the item.

In other cases, savings never hit the bottom line because the organization fails to track and hold people accountable to achieving them. In order to truly deliver value, the total cost of ownership (TCO), not just the acquisition cost, must be considered, and the entire organization, from the front lines to the C-suite, must be held accountable in order to realize, measure and sustain improvements in EBITDA.[1]

FOCUS ON THE TOTAL COST OF OWNERSHIP

For many businesses, the acquisition cost for direct materials represents roughly 40-60 percent of the TCO, or total cost to serve, of a given item or service. While “traditional” buyers focus primarily on price, “strategic” buyers think holistically about TCO, which includes warehousing costs, inventory carrying costs and operating costs, just to name a few (Figure 1).

While this concept is not new, most companies still struggle to evaluate TCO comprehensively – including some, but not all, key cost drivers in the equation.

The more advanced, "big-picture thinking" sourcing professional does not limit the scope, but considers all facets of cost and the margin by which the company stands to profit for each product. Then looks at all of the opportunities to improve the bottom line including:

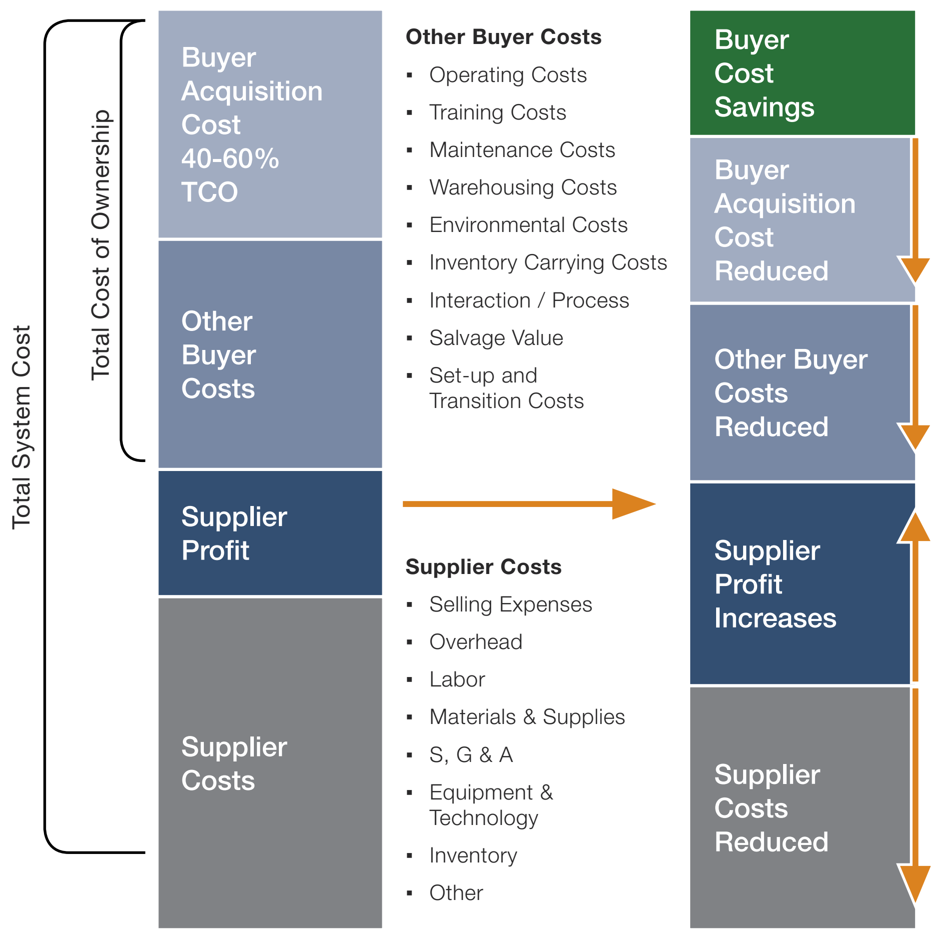
- Negotiating lower acquisition costs
- Hosting supplier workshops to collaboratively develop plans for lowering supplier and buyer costs while sustaining and/or improving service for mutual profit gain
- Considering reverse engineering opportunities to develop product specifications that meet "fit for use" requirements at lower costs
- Optimizing product portfolios to remove unprofitable products through frequent analysis of margin contribution by product, customer, market, etc.
- Improving sales, operations and demand planning processes (S&OP)
- Improving inventory practices to reduce warehousing and inventory carrying costs and product scrap
- Clearly defining internal and external metrics and governance to monitor and drive results

FIGURE 1

TOTAL COST OF OWNERSHIP AND TOTAL SYSTEM COST

TCO is calculated individually for each product type. It contains the acquisition cost as well as setup, shipping, training and ongoing maintenance related costs.

The Total System Cost (TSC) model focuses on working with suppliers to identify savings within their supply chains that can then be shared with buyers by managing total internal cost.



COST DRIVER ACTION PLAN

- Identify costs and key commodity cost drivers to manage the TCO.
- Understand the supplier's costs and determine actions that can be jointly taken to lower TSC.
- Establish cost and service improvement goals, develop strategies internally, and align with key internal stakeholders and suppliers.
- Prioritize cost saving drivers including initiatives such as warehouse, freight and distribution costs.
- Collaborate with internal cross-functional teams and suppliers to optimize costs to include value engineering where applicable.
- Develop internal and external key performance indicators (KPIs).
- Measure and track cost savings and EBITDA improvement.

CASE IN POINT

A client in the food distribution industry had more than 5,000 different products in its portfolio. The company had negotiated competitive prices with suppliers but was still not nearly as profitable as it thought it should be. When taking into account the TCO (rather than just prices), A&M's assessment indicated the company was losing money on 40 percent of the products it was selling.

Armed with the detailed data analysis from the assessment, leaders made changes to pricing, product mix and their overall portfolio to more favorably position them in the market and increase EBITDA by three percent.

CASE IN POINT

A fuel distribution client was losing market share among high-population, metropolitan areas. Upon evaluating the company's cost to serve these segments, A&M identified that these metropolitan customers paid the same price for fuel as rural customers that could live as many as four or five hours from a delivery hub. In this case, the company had defined prices based on an average cost to serve – a price that was too high to remain competitive with sought-after metropolitan customers and too low when one considered the true cost to serve its rural customers. Providing the data gave the client visibility into what its total cost to serve was and helped leaders make better, more strategic pricing decisions to improve market share and EBITDA.

DRIVING SOURCING SAVINGS TO THE BOTTOM LINE

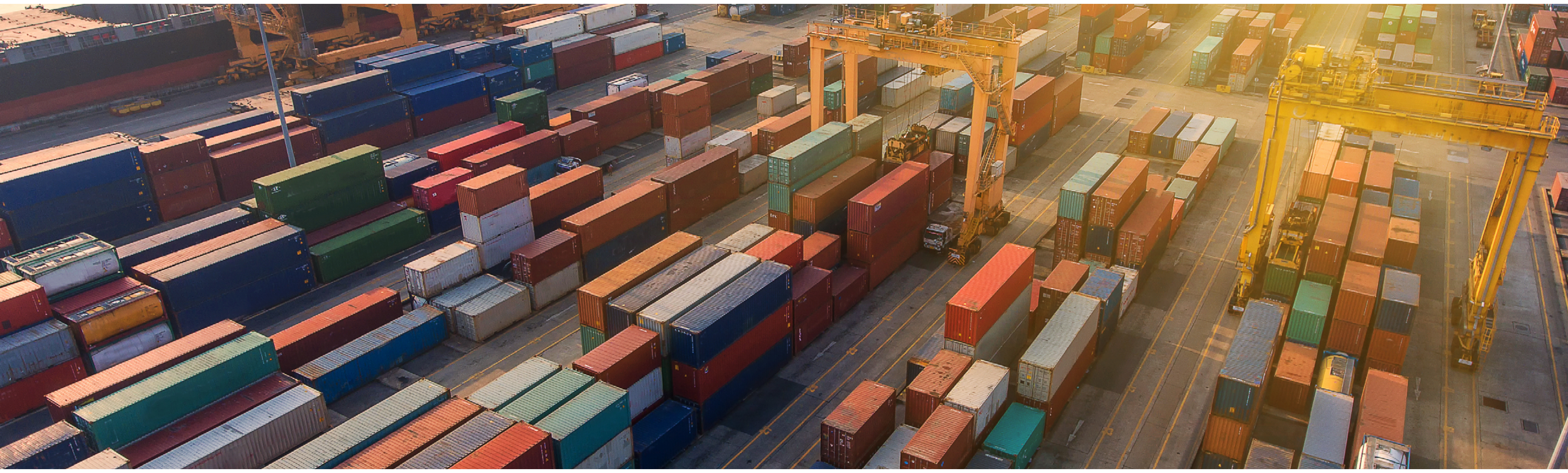
Accurately identifying savings opportunities is critical; however, even organizations that do so are not always successful at capturing real results. Below we share a few tips for driving sourcing savings to the bottom line.

Create consensus around what the savings are and how to achieve them

Make sure leadership and business partners agree to identified savings and the strategies for achieving them. Collaboration in this process is critical. Identify and validate each of the stakeholders who contribute to the EBITDA equation – engineering, sales, marketing and suppliers. Understand their objectives and where shared goals and action can drive profitability.

If savings will require adherence to new contractual terms, make sure impacted departments are aware and committed to adhering to the terms. If new pricing strategies need to be developed, involve sales and marketing as early in the process as possible. If warehousing and transportation changes are in order, spend the time up front to help teams understand why the changes are necessary and what the real impact to their day-to-day jobs will be.

Ultimately, everyone should be aligned on specific goals and how they are going to achieve them. This type of collaboration takes time and is predicated on having relationships that transcend functional silos, but without consensus up front, the likelihood that savings will materialize is low.



Take the savings out of the budget

Nine times out of 10, if projected savings are not formally reflected in departmental budgets, savings leakage will occur. Work with both the impacted departments and with the CFO and the finance organization to formally adjust the budget and devise a practical governance structure to ensure teams adhere to any new contracts and programs developed to support savings. When budgets are impacted, collaboration will be more important than ever. Leaders will be (understandably) sensitive to relinquishing allocated funds, but will feel better about doing so if they have a full understanding of how savings will be achieved and the benefits to themselves, their teams and the company as a whole.

CASE IN POINT

A major retailer had tried multiple times, unsuccessfully, to achieve EBITDA improvement through sourcing. Each department was given a clear target of reducing indirect spending by 10 –15 percent. Everyone had good intentions, but again and again, savings failed to materialize. A&M helped establish a process by which leaders and sourcing agreed to targets during formalized decision meetings. Then, once finalized, the CFO took the savings out of the respective departments' budgets. The details of the savings initiatives were jointly reported to the CFO and his finance team to ensure reporting and tracking could be established correctly.

Incentivize and measure the results you want to see

You need to define, up front, how savings will be measured, where progress will be reported and what incentives will be provided for achieving savings goals. It is important to remember what you measure and incentivize drives behavior and will ultimately be where you see results. Therefore, metrics should directly tie to the bottom-line impact and EBITDA improvement.

Having a clear measurement and reporting plan and governance to support it allows an organization to identify risks to achieving savings goals before they become issues. For instance, how will you monitor and/or enforce proper use of new contracts? Capture demand management? How will you track savings? Who will review progress? How often? There needs to be a formal structure and process for reviewing progress, and the organization has to apply rigor and discipline to monitoring and achieving that upon which it has agreed.

SUMMARY

To add real, bottom-line value to an organization, strategic sourcing organizations must do more than negotiate the lowest price and write contracts. Today's sourcing and procurement professionals need to fully understand the cost drivers and the sourcing levers they can use to impact them, work with stakeholders and finance teams to reflect those savings in the budget, and have accessibility to the highest level of decision makers and/or influencers in the organization.

Remember:

1. It is about more than just buying something. Acquisition cost is only one component of the equation. When you assess the opportunity, consider all of the expenses that make up the total cost of ownership or total cost to serve.

2. Create consensus around what the savings are and how to achieve them. Start building the relationships you need, now, to make collaboration easier in the future. Before going after identified savings, make sure all the stakeholders impacted are on board. Make sure all the stakeholders on which you will depend to achieve the savings know what is expected of them and commit to the goals.

3. Take the savings out of the budget. If you don't take the money out of the budget, nine times out of 10, it will be spent.

4. Incentivize and measure the results you want to see. Define how you will incentivize, measure and report progress against your goals. Designate who should review progress reports and how often.

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Julie Diehl is a Managing Director with Alvarez & Marsal with more than 30 years of supply chain leadership experience. Julie joined the firm after serving in several senior management positions with Pennzoil - Quaker State Company, including Vice President of Global Strategic Sourcing, Vice President of National Account Sales and Brand Manager. In 2004, Julie led the development and launch of Alvarez & Marsal's Supply Chain Practice, with the mindset of combining industry-experienced practitioners with problem-solving consultants to share knowledge and train clients so that performance improvement is sustained long term.

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