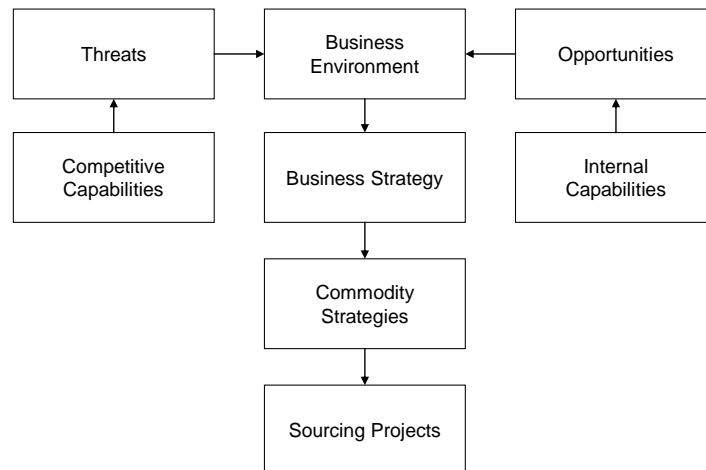


Lessons Learned: Ten Ideas for Effective Strategic Sourcing

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Abstract. Effective Strategic Sourcing must be supported by an enabling infrastructure of processes, analysis, staff involvement and participation, and strategic focus. Based on a cross-industry review, ten specific areas for evaluation and improvement are offered that could add five to ten percent net savings to an organization's bottom line. Each finding is reviewed and actions are recommended if gaps exist.

The role of Supply Management is primarily to leverage and improve the supply base and the supply chain. Over the past ten years, supply management has provided substantial benefits to organizations in terms of cost improvement, quality enhancement, delivery and inventory success, and a more responsive supply chain. There have been a number of factors at work that contribute to these successes. One of the more significant factors is the use of strategic sourcing processes. Normally begun by a concentrated assessment of spend, suppliers, processes, customer needs, measures, business strategies, and performance, commodity strategies drive the number and extent of sourcing projects. The word "strategic" is used to describe these sourcing projects because the projects themselves are linked to the business and commodity strategies. Total alignment can occur. The juxtaposition of the sourcing projects can then be portrayed as follows:

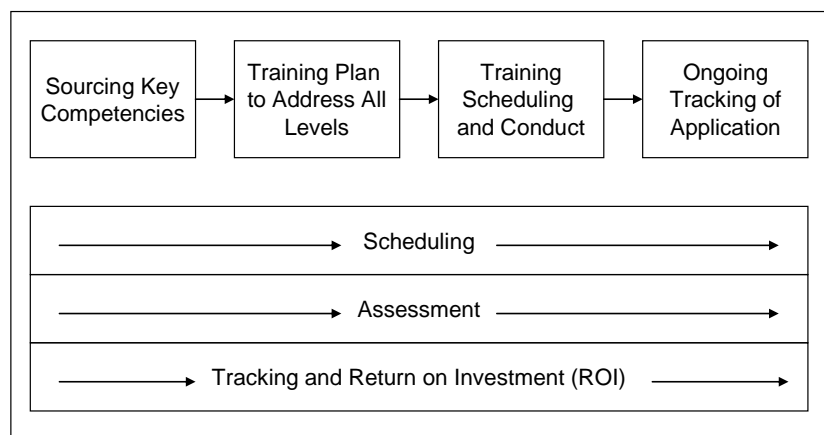


This alignment must occur to provide direction to global, regional, and local sourcing terms both the context and the extent of these sourcing activities. The infrastructure for executing the strategic sourcing projects must be established to ensure effective results.

For the past ten years, organizations have developed an infrastructure to support commodity and sourcing strategies. Some have fallen short of expectations due to common reasons. This paper describes these shortcomings, and together with an internal assessment, could aid the

supply management function in improving its results over the long term. These areas include training and development, fully deployed commodity strategies, fully developed and deployed e-procurement, management of indirect-spend decision making, contract compliance for indirect purchases, properly developed market analysis, fully integrated cross-functional involvement, total cost implementation, market-rationalized pricing, and supply chain integration.

Training and Development. Most supply management organizations do not have a deployable training plan. The elements of the strategic sourcing process are assured to be capably managed by experienced staff. This simply can't be justified in my opinion. Team management processes are consistently applied, market research is not thoroughly conducted, price and cost analysis not fully accomplished, and negotiation strategies not appropriately developed. These are key activities of the sourcing process. A training plan and schedule to address key competencies in the following areas is needed:



Linking training to refresh or develop core competencies in sourcing could add 2 - 3% of additional savings.

Fully Deployed Commodity Strategies. A strategy is easy to create. To deploy it requires significant effort and coordination, and sometimes deployment just doesn't happen effectively. One of Calyptus' clients, a large Fortune 200 company, only achieved 27% of the benefits envisioned by the regional contracts. The best performance in this area that Calyptus has come across achieves approximately 85%. So what are the reasons for low percentages? Reasons range from lack of buy-in, poor communication, inadequate team management, reduced expectations / demand overall, competing supplier pressure, inadequate planning, and changing markets. Although these reasons can probably be defended, strategies are not fully deployed across the organizations and millions of dollars of potential savings are lost.

Some key guidelines to address deployment problems are:

1. Get total subject matter expertise on the commodity team
2. Tie strategies to critical-to-quality characteristics
3. Know and address the market
4. Get the right, committed, and authorized cross-functional and cross-divisional personnel
5. Develop templates for commodity strategy formulization
6. Develop and implement an effective communication plan

7. Get buy-in from all key users prior to contract signature
8. Align sourcing projects to the plan

These and other tasks are necessary to increase the use of signed contracts.

Fully Developed and Deployed e-Procurement. E-Procurement applications and usage have been growing exponentially over the last five years. A few key players remain (Ariba, Emptoris, Perfect Commerce), but these applications still don't provide all the features needed to manage the full supply chain. Spending estimates for the period 2005-2008 are increasing at a promising level. Many supply management directors are planning for improved data availability, lower administrative costs, and a higher degree of customer satisfaction. E-Procurement is not the savior of poorly developed supply chains. E-procurement solutions provide tools for productivity improvement.

Supply management still needs an overall strategy, and only with the strategy, a map that shows the linkage of e-procurement to the achievement of goals must be constructed. The core of e-procurement applications should provide accurate spend information, e-auction applications, automated acquisition and purchase order placement, and risk management. If systems aren't effectively providing functions that track to supply management goals, expected results and ROI will not be reached.

Management of Indirect Spend Decision Making. First, the direct material spend associated with manufactured goods was addressed using strategic sourcing. Over the last three to five years, companies have addressed indirect spend. United Technologies has saved more than \$500 million using a concentrated strategic sourcing effort for indirect spend. Financial institutions, insurance companies, software organizations, and diversified service firms are following suite by mounting a strategic sourcing effort for indirect materials, which is essentially addressing all of their spend with third parties.

While these companies have clearly made in-roads in the traditional indirect spend categories such as travel, office supplies, office equipment, MRO, telecommunications, temporary labor, packaging, and transportation, less input has been made to address non-traditional indirect categories such as:

- Advertising
- IT
- Benefits
- Insurance
- Marketing Communications
- Professional Services

Most strategic sourcing successes in the above areas have been anecdotal. The reason is that the using departments are still "calling the shots" on sources, sourcing strategies, contract terms, and supply relationship managements. At one Fortune 50 customer of Calyptus, IT spend is still controlled by the IT department, amounting to more than \$800 million per year. This represents the loss of at least \$40 million in savings. Supply management groups should redouble their efforts to address the non-traditional categories in order to bring on additional savings opportunities.

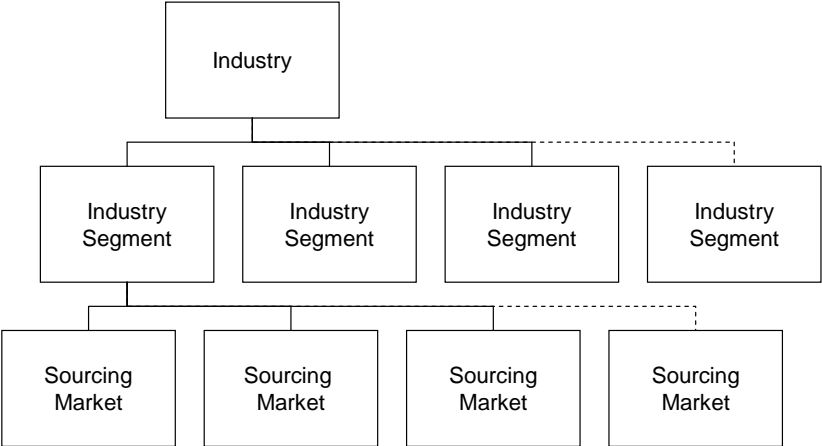
Contract Compliance for Indirect Purchases. Once contracts are established, companies can expect that the organizational units requiring services and goods would use existing contracts. As mentioned previously, 27% to 85% of the time, these contracts are utilized. At one Calyptus client, the primary travel agency was not being utilized because they couldn't service a specific region of the world. At another client, no one was using the car rental agency due to poor quality and high rates. At still another Calyptus client, MRO suppliers proliferate despite having integrated supply agreements in place with two U.S. companies.

At the essence of this situation are these factors:

1. The selection of ill-suited suppliers, sometimes selected on the basis of cost only.
2. The lack of buy-in at the time of contract signature.
3. The lack of implementation control practices, plans and procedures.

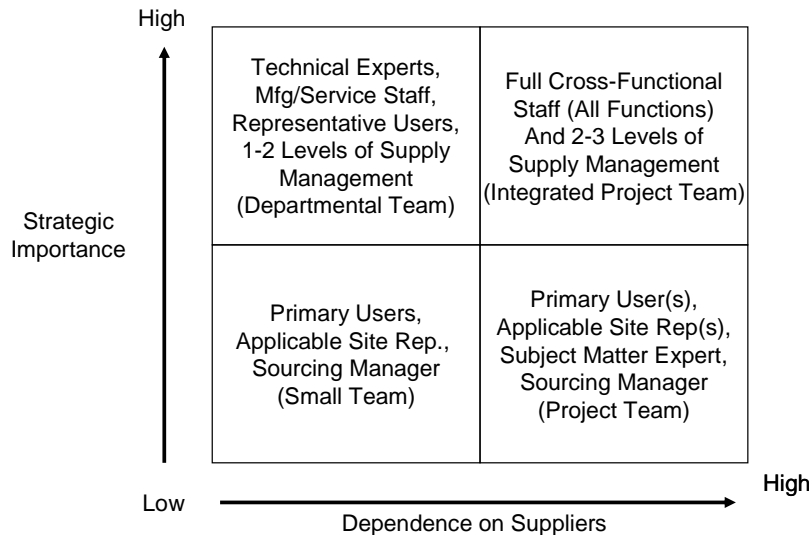
These are sequentially important issues. The “buy” proposition is usually based on a lowest cost, without adequate consideration of customer service and turnaround time. The contract approval process is sometimes ill-supported or supported by inappropriate managers having little power or spend. Last, implementation processes are largely ignored as companies simply expect people to comply. Measures of implemented spend by contract should be initiated, tracked, and results communicated to the CFO and CPO within the organization. For every expenditure that qualifies for inclusion in a signed contract, companies lose 5-8% in cost savings benefits.

Properly Developed Market Analysis. Market analysis provides insight into the present and future conditions of an industry and market. Many tools are available to assist supply management in completing market analysis tasks such as Michael Porter's Five Forces, SWOT analysis, Boston Consulting Group's Product Segmentation Matrix, and resource models. Further, online resources available through Gale, ProQuest, Wilson, and Emerald can provide information on market status and trends along with investor analyst opinions from the major financial services companies. Ultimately, the result is an assessment of the market under which the strategic sourcing project will be pursued. Results may dictate length and timing of contracts, pricing trends, selection criteria, underlying new material trends, offshoring / outsourcing, and profit levels. The parts of the analysis link up as follows:



Global, regional, and local economic status and supplier capability can be factored into the sourcing project. A comprehensive market analysis should be conducted yearly as a way to validate commodity plans and sub-markets should be evaluated for every strategic sourcing project.

Fully Integrated Cross-Functional Involvement. Just how much involvement does the strategic sourcing team need to complete the implementation of its sourcing project? The extent of resources depends on the geographic scope, complexity of product or service, number of sites, strategic importance of the project to the firm, and the size of expenditures. The following matrix could aid in determining how extensive the involvement should be based on strategic importance and market complexity.



Supply Management usually establishes the team for strategic sourcing events. Key questions to ask include: Who must be included in scoping this project; who should make the decisions; and who will approve implementation efforts? Major risks remain if the wrong or inappropriate mix of staff participate. Involve the project champion if stalemates occur, but involve the key players even if you don't expect full, complete and supportive involvement!

Total Cost Implementation. Many supply management groups use the notion of "total cost" as an indicator of best practices. Total cost management is a best practice only when it is used and practiced in identifying, selecting, and managing suppliers. The chief question that must be answered always is "Can we justify an award to other than the lowest price supplier?" Internal customers in highly competitive industries will not readily support the award to a higher bidder unless there is qualitative analysis performed to demonstrate best value to the organization.

Numerous models exist for the calculation of total costs. For example, Pratt & Whitney uses delivery and quality factors. Calyptus uses a 25 factor analysis that considers financial, quality, delivery, complexity, lean, and supply chain costs. Companies that want to use total cost should develop their appropriate model and keep it updated. Consistent practices should be established, refined and documented to ensure that the full cycle of total cost is implemented to ensure the achievement of best practice.

Market Rationalized Pricing. The best embodiment of market rationalized pricing occurs as a result of a reverse auction event. These events provide an opportunity for suppliers to compete in terms of setting the market price for a specific “lot” of goods and services. Commodity markets for oil, sugar, eggs, coffee, resin, and paper all work in a similar fashion. In most organizations, only a small percentage of purchases are completed using commodity-based or reverse auction pricing. Although this percentage is expected to grow due to the use of reverse auction techniques, supply management groups must achieve the same effect in their sourcing projects. To do this, consider incorporating the following items in your request for proposals / quotes and as a dimension of your evaluation criteria:

- Marginal costs
- Currency rates
- Supplier efficiency
- Capacity utilization
- Supply chain costs
- Market timing
- Length of proposed contract
- Volume fluctuations
- Supplier relationship desired

So what is a satisfactory market-based price? One that is a result of perfect competition (companies compete with equal knowledge) and is set below the general market due to extraneous factors such as those listed above.

Supply Chain Integration. Companies don't necessarily compete with each other; their supply chains compete. Supply chain improvement occurs when companies have information, resources, data, and goals with the members the chain. Too often, the integration of the supply chain is tied to computer systems or integration is attempted once the contract has been signed. Neither of these situations will provide the level of integration required to turn a company's supply chain into a competitive advantage. Much has been written about the supply chains of Wal-Mart, Dell Computer, and Honda. These companies have effective chains because:

- They share goals with suppliers
- They establish future goals for suppliers
- They require the suppliers to work in collaboration with them
- They insist on integrated planning, execution, and performance evaluation

The level of supplier integration should be established as part of a specific commodity strategy. Sourcing projects should implement the integration goals of the applicable commodity strategy. Full integration starts at product / service design and continues through to service to the ultimate customer or end user.

Conclusion. In conclusion, by assessing your supply management organization in relation to these ten areas, and by developing a gap analysis and improvement plan, your company can improve its supply chain results. Estimates of an additional 5 – 10% net savings are possible, depending on the starting point and the size of the gaps in current status or performance.