Finding quick cash or building purchasing capabilities: Let business strategy be your guide

Purchasing power: finding quick cash and building long-term capabilities

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Finding quick cash or building purchasing capabilities: Let business strategy be your guide

As the effects of the turbulent economy spread across virtually every industry, companies are looking for cash. There's no easier way to generate quick cash without painful layoffs than to find cost savings in purchasing. The purchasing of goods and services is one of the largest, if not *the* largest cost category—for most businesses it represents up to 50 percent of their total expenses. And the savings can be substantial. In our experience, companies taking a systematic approach can save 5 percent to 30 percent from the addressed cost base.

The trouble is, in economic downturns most companies are doing a balancing act of finding short-term cash and building long-term capability. Do they devote their efforts to generating fast money through measures like restructuring agreements with existing suppliers? Or do they opt for investing in them to build the broad purchasing capabilities that will help the company come out of the recession with a stronger competitive position? Too often companies think they need to choose between the two. Or they find themselves swerving from guardrail to guardrail—devoting too much energy first to one, then to the other.

Acting under pressure they often take reflexive actions that end up damaging them in the mid- to long term. They fail to align their purchasing strategy with their corporate strategy. They grab whatever costs they can for short-term gain (in some instances even driving promising suppliers to the brink of bankruptcy), when slightly more effort would deliver better—and lasting—results.

Where do they typically go wrong? Based on our observations, companies instinctively take a short-sighted, bottoms-up and transactional approach to identifying savings targets. The question is often: "How much money can we squeeze right now from our suppliers in each category to meet this year's cost reduction targets?" Limited by their experience, they'll determine which of the purchasing cost-saving levers they haven't used—renegotiating contracts with suppliers, ordering larger volumes, using electronic auctions—and then estimate how much they can save by using them. Afterwards, they will implement these tactics. But costs eventually creep up again since they have failed to implement any sustainable measures to ensure that these benefits stick.

Consider the example of a US automaker, currently struggling to stay afloat. In an effort to reduce costs, the company continuously squeezed prices from key suppliers beyond what the suppliers could really afford. One of the main suppliers of shocks and struts acceded to the pricing pressure in order to retain the business. In fact, it priced its products to the automaker at cost. But the supplier compensated by increasing its prices of shocks and struts in the after-market. Not surprisingly, the main buyers of after-market products from this supplier were the dealers in the automaker's network and the consumers. In the end, the automaker was able to price its cars out of the factory lower than competitors'—but those cars earned a reputation for having higher maintenance costs, and thus a higher total cost of ownership.

Companies can take a more effective, fact-based and strategic approach to purchasing while also achieving quick savings. The process involves addressing four questions:

- What cost reductions, service levels, quality and innovations should purchasing contribute in the support of the company strategy?
- What can purchasing do to generate cash for the business within three to four months?
- What can purchasing do to improve the company's competitive position beyond three to four months?
- How do you ensure the results achieved don't erode over time?

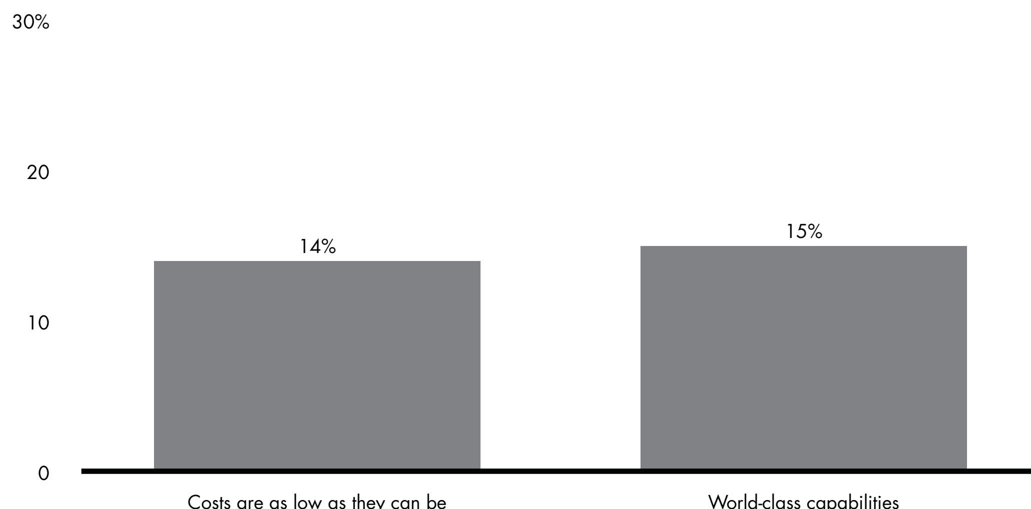
This definitely is an area where companies stand to make gains. Most companies readily admit they lack the ability to optimize their purchasing costs by selecting the most competitive suppliers or striking agreements that deliver maximum value. When Bain & Company surveyed 60 executives from a range of industries, 85 percent said their companies lacked best-in-class purchasing capabilities. (See figure 1.)

We've identified an approach that allows companies to build supply-management capabilities while also addressing their short-term needs for cash and profits:

Sizing the opportunity: What cost reductions, service levels, quality and innovations should purchasing contribute in the support of company strategy?

When it comes to purchasing, most companies instinctively think about how to quickly generate cash. Some companies think about how to boost their long-term purchasing capabilities. Strategic supply leaders consider both—using the company's overall strategic goals as a starting point for defining targets or strategies for their purchasing departments. For example, a company focused on bringing innovations to market might be more interested in speed, service levels and innovations coming out of the supply base. A company

Figure 1: Companies readily admit they can improve purchasing capabilities



intent on being the low-cost leader in its industry would be most interested in suppliers that offer the lowest cost, regardless of other considerations—typically large and less-flexible suppliers.

In either case, sizing—and understanding—the opportunity for purchasing gains is the first objective of strategic purchasing.

As a CEO, how can you objectively determine how much of your cost-saving targets can be delivered by purchasing—and link them to strategy?

Consider the approach taken by a company we'll call FoodCo. The company had grown through acquisitions—more than 40 since the early '90s—and had run out of targets in its largely consolidated industry. Therefore, it wanted to use its considerable size and continue generating earnings-per-share growth—something of a challenge given relatively flat overall growth for one of the company's major products, and a decline in per-capita consumption. The company's chairman set his sights on using FoodCo's scale to create a cost advantage, starting with developing purchasing capabilities its competitors couldn't match. His mandate was to make the most of the company's volume to get supplier deals, to standardize purchasing items—centralizing wherever possible—and to run efficient processes.

The company used some outside-in metrics to determine the size of the purchasing performance gap in important product categories. Key to its success was FoodCo's quantitative approach: the company quickly conducted experience curve and make-vs.-buy analyses, and used broad benchmarking—looking beyond its company and industry for benchmarks—to set real targets. Thus, FoodCo was able to not only strategically set saving targets for purchasing in one of its most critical categories but also turn around supplier negotiations in its favor. (How did they do it? See sidebar "*Finding free cash in plastic bottles.*")

Quick hits: What can purchasing do to generate cash for the business within three to four months?

Control demand for internal use and costs

Once they size their savings, service levels, quality, and cost targets, strategic supply leaders typically look inward for places to cut demand. Instead of just looking to suppliers for price cuts, the first thing a company can do is to look internally and quickly identify means that are entirely within its immediate control. Even though there are quick opportunities across the company, generally speaking, companies have the most options for shrinking demand volume for indirect supplies—everything from travel to office equipment to janitorial service.

When it comes to shrinking demand for indirect costs, everything's on the table for consideration. Companies can rapidly control demand and reduce waste through such measures as tighter expense policies and approvals, more usage and cost awareness and accountability—such as publicly posting travel-expenses and cell-phone-usage accountability. Other options include limited use of corporate purchasing cards and zero-based budgeting. Often the right policies and contracts already are in place, but compliance is not—in tough times, just enforcing compliance can make the cash register ring.

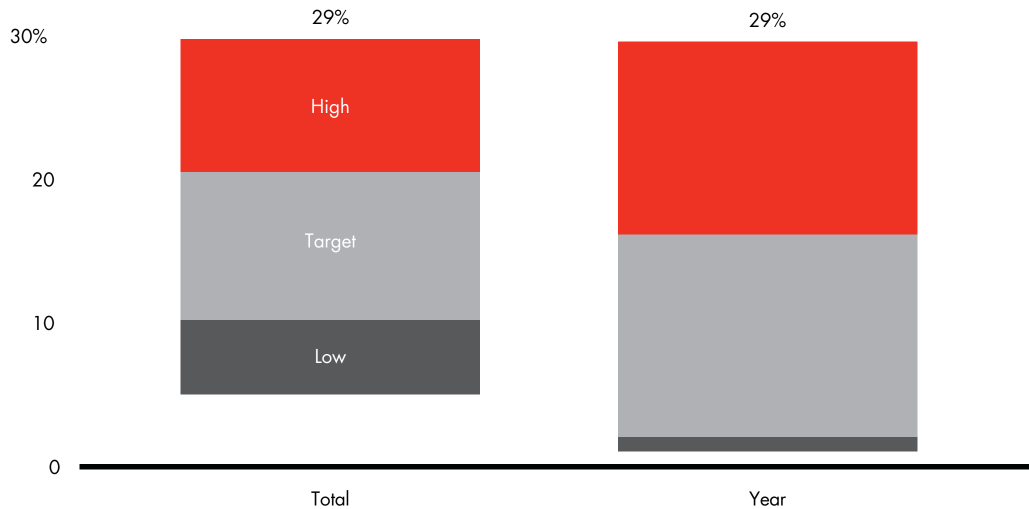
Companies can cut travel for internal meetings in half by using videoconferences. They can increase 14-day advance purchases, use a lower tier of hotels, enforce compliance with preferred

hotel vendors and reduce daily meal allowances. They can put in place stricter approvals for staffing services—and analyze the top 20 percent in terms of cost with the aim of driving those contracts down 60 percent to 80 percent. They can save on facilities costs by renegotiating leases with less than three years remaining, trading lower rates for lease extensions. For owned buildings, they can apply for property tax reassessments—with the help of firms that work on contingency. They can cut back on janitorial and landscaping, standardizing specs or re-bidding with local contractors. One US bank was able to save $3.1 million within a year through such means. Other tactics to quickly unlock savings from indirect purchases: stopping all non-essential purchases and revising permission criteria.

The next step is to reduce unit prices for indirect supplies. To achieve such savings, companies can eliminate off-contract buying, drive down purchase prices with reverse auctions and substitute for lower-cost items like printers. In some instances, with the right suppliers in place, it is possible to begin price negotiations to immediately close cost gaps. But it's always important to balance short-term and long-term considerations. Squeezing quick cash out of an important supplier generally isn't worth it if it will come back to haunt you. Consider the automaker that saved on the cost of shocks and struts but wound up with a reputation for selling cars with high maintenance costs.

While shrinking demand and unit prices for indirect costs, companies should take on the challenge of pursuing per-unit cost reductions for direct supplies—those that are integral to a company's product or service. (See figure 2.)

Figure 2: Companies can achieve 10% to 20% savings through purchasing initiatives



*Of addressed costs
Source: Planet Retail

On firm footing: What can purchasing do to improve the company's competitive position beyond the first quarter?

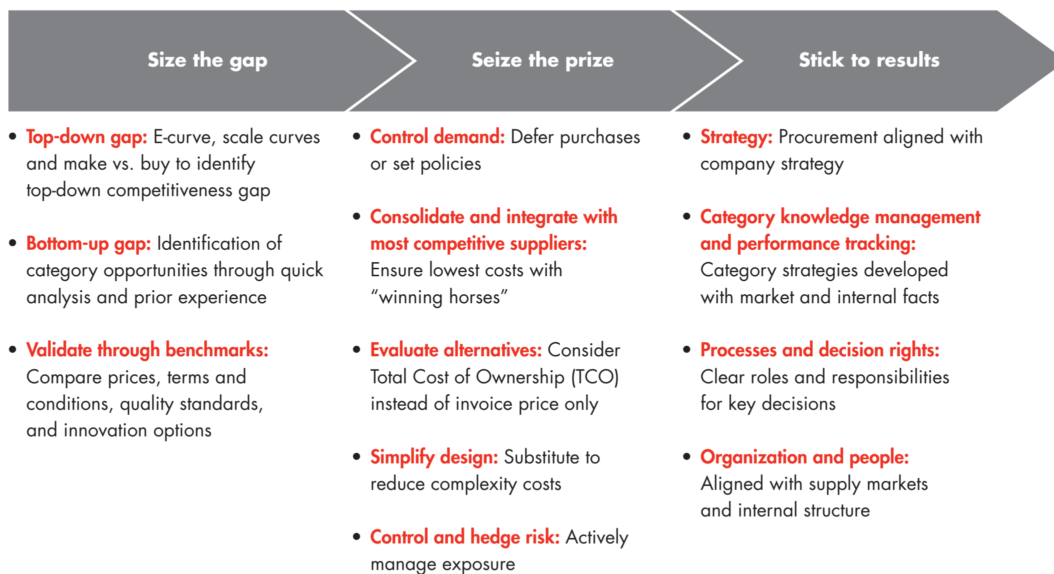
Consolidate and integrate with the most competitive suppliers

A downturn is the time to consider whether you are sourcing from the right suppliers to support your strategy. If your company is sourcing from the right suppliers, then it is important to ensure that you're consolidating volumes for maximum savings. This can be done by evaluating the supplier's performance against experience curves or a make-vs.-buy analysis, which should help to determine targets—and can generate quick hits. If your company is not sourcing from the right supplier, based on the experience curve and make-vs.-buy analyses, then it is time to search for new suppliers. In addressing the question above, many companies evaluate suppliers primarily based on short-term price. In contrast, leading companies will pick long-term winners by assessing total cost of ownership instead of invoice price. They also consider several additional factors in the selection process, such as R&D capabilities and ability to innovate, quality of management, service levels, industry position and willingness to collaborate across critical fronts. (See figure 3.)

The relative importance of each of these factors should depend on a company's strategic goals. If your company wants to be a low-cost leader, total cost of ownership will be a key selection criterion. If your strategy is to be first to market and on the leading edge of innovation, other factors may trump total cost of ownership in importance.

Finally, the strategic supply function can make an important contribution in the way a company thinks about its indirect-cost structure.

Figure 3: Our approach to procurement transformation



Applying the same make-vs.-buy analysis to overhead functions can help a company determine whether it is time to outsource non-core business processes. Outsourcing can improve both efficiency and effectiveness through such gains as better controls and more-consistent results. When considering outsourcing, purchasing should support the business case, statement of work definitions, vendor assessment as well as the Request for Information and Request for Proposal processes. In most cases, it takes more than six months to achieve gains from outsourcing.

When a company chooses the right suppliers capable of serving its strategic goals, collaboration could spell the difference between building long-term purchasing capabilities that competitors can't match and suffering the ill effects of sending a supplier down the path toward bankruptcy. If you have the best suppliers, there's no point in alienating them or driving them out of business by forcing them into a lower price bracket. So there is an important question to ask: Is there a way to negotiate for key products that puts us in a win-win situation?

By placing value on suppliers that are willing to collaborate, retailer Macy's is able to both achieve quick infusions of cash and form supplier relationships that are mutually beneficial for the years ahead. For example, Macy's and a supplier jointly developed an alternative supply chain to speed time-sensitive products to stores. It also collaborated with a supplier to develop three separate apparel items at price points the retailer was confident would sell extremely well—and did.

Consider total cost of ownership

When comparing suppliers' costs, many companies place too much emphasis on the invoice price. That oversight paints a notoriously inaccurate picture of the cost impact. Instead, leading companies look at the total cost of ownership. That means considering quality, service levels, lead times and how the purchase fits into a bigger scheme of things. For Korean construction company SK Engineering & Construction, looking at the paid invoice price without taking into account probable fines for delayed deliveries would lead to the wrong sourcing decisions. For worldwide building-materials company Lafarge, determining the total cost of ownership means considering how many hours a piece of equipment will likely be in operation. The total cost per hour is estimated from around €100 if the equipment is used for 2,000 hours to €20 if the equipment is used for 14,000 hours or more. The company compares suppliers not at the invoice price, but at the estimated overall cost of ownership assuming the optimal lifetime.

Simplify the design, the product and the supplier base

We can't emphasize enough the long-term benefits to be gained by actively managing the level of design and sourcing complexity. We find time and again that companies involve purchasing too late in the game in the product development process, and fail to consider the cost impact of their design decisions. Take the case of a cardboard-box maker that waited until after it had selected a supplier to call in the purchasing department to negotiate the contract and try to save on costs. Had purchasing decisions been considered at the design stage, the company would have had a better chance at assessing design trade-offs, with a greater impact on costs. For example, the team could have considered using two colors instead of three, and a different printing process. One important insight we have seen over time is that organizations often overlook the potential savings of "upstream" levers like design simplification in favor of "downstream" activities like switching suppliers.

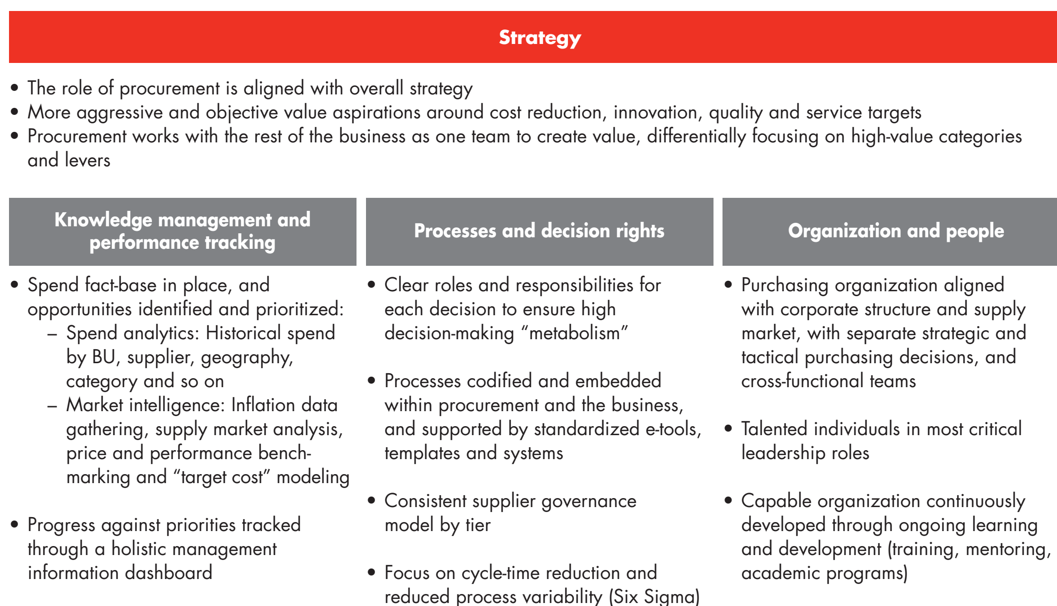
Control or hedge risk with customers, suppliers or third parties

Companies with world-class purchasing capabilities understand their level of exposure by type of risk and their preferred level of risk tolerance. Based on that knowledge, they rely on different hedging mechanisms to keep exposure in check—using corporate strategy as their guide. Among the measures they can use: passing on raw-material price movements to customers or implementing margin-sharing with suppliers. Or when appropriate, vertically integrating, deploying flexible production schedules to meet supply contracts, shifting to input substitutes when supply is short and building inventories when prices are favorable. They also can postpone capital investments and use such financial tools as forwards and options to hedge risk—delivering benefits to both the profit-and-loss statement as well as the balance sheet.

Sustaining benefits: How do you ensure the results achieved don't erode over time?

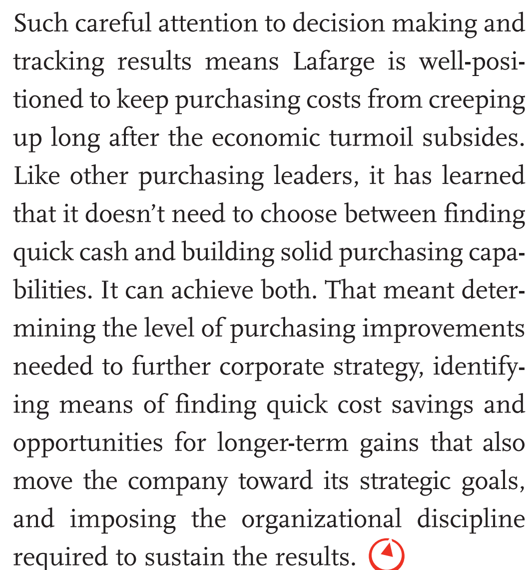
With multiple business units, functions and processes coming into play, most companies face the issue of managing purchasing organizations that become increasingly ineffective as they grow in complexity. This not only precludes continuous improvements but also reverses gains attained in focused efforts. To keep the benefits coming, leading companies ensure that there is a clear owner for each key decision, and that decisions are made swiftly, at the right level, and with the right inputs. (See figure 4.) And once decision rights are established, they install a higher caliber of purchasing talent—and implement the right targets, tools, and metrics to manage performance. As with every other element of purchasing strategy, what you choose to track and measure—and how you compensate purchas-

Figure 4: World-class procurement organizations



ing talent—should be dictated by your corporate strategy. Even though purchasing often is responsible for managing up to 50 percent of a company's total cost structure, too often companies fail to make the necessary investments to hire top talent, support them with the necessary tools, and clarify accountabilities.

Lafarge, the worldwide building-materials maker, revised its decision-making process by putting in place a new organization aimed at helping it sustain savings from all categories of purchases (Capex, energy, industrial goods and services, indirect purchases). It defined what decision rights belonged above and below the business unit line, and reinforced cross-functional input on key purchasing decisions. Once decision rights were set, the company established a process to ensure all stakeholders were involved at the right level at the right time, and that it had the right tracking mechanisms to measure compliance and performance. Setting up the right tracking mechanisms was key to reinforcing purchasing credibility and making sure that purchasing savings were materialized into the business units' P&L and cash flow.



Such careful attention to decision making and tracking results means Lafarge is well-positioned to keep purchasing costs from creeping up long after the economic turmoil subsides. Like other purchasing leaders, it has learned that it doesn't need to choose between finding quick cash and building solid purchasing capabilities. It can achieve both. That meant determining the level of purchasing improvements needed to further corporate strategy, identifying means of finding quick cost savings and opportunities for longer-term gains that also move the company toward its strategic goals, and imposing the organizational discipline required to sustain the results.

Finding free cash in plastic bottles

When FoodCo learned that the supplier of the majority of its plastic bottles was raising prices for many of its SKUs, the company calculated the price increase would add $7 million a year to its costs. FoodCo was considering accepting the proposed price increases. But first it decided to conduct experience curve and make-vs.-buy analyses—a typical step taken by companies with solid purchasing capabilities, conducting a category-by-category search for savings.

Experience curves (e-curves) show how unit prices should decline as volume grows. Our internal analysis of more than 100 products with data that goes all the way back to 1946 shows that experience curve costs and prices typically decline 20 percent to 30 percent for each doubling of experience in a particular good or service. Experience curves can be generated for an industry or for an individual company using internal purchasing data or external market data. Companies use the analysis to determine their own performance gap and that of their suppliers. E-curves provide a valid picture of what companies should be paying for each unit they buy and what their suppliers should be charging. Experience curves also provide a guide for long-term contracts, and help determine what the supplier should be able to charge in the future. While many companies look for across-the-board discounts, leading companies differentiate what they ask for based on the specific economics and experience curves of each supplier industry.

Purchasing leaders also use make-vs.-buy analyses to quantify cost targets. The objective is to compare the cost of purchasing a good or service vs. producing it in house. The exercise sheds light on a company's ability to achieve cost savings and helps pinpoint the true costs its suppliers should be charging. It is particularly useful for companies facing unstable, monopolistic or oligopolistic sources of supplies.

At FoodCo, the e-curve analysis indicated that rather than increasing its prices, the supplier should be dropping its prices by 0.76 percent per year, based on its ability to more efficiently produce plastic bottles each year. Meanwhile, the make-vs.-buy analysis found that by in-sourcing all the bottle production of this supplier it could generate a net present value of $50 million. With this information, the CEO of FoodCo communicated the results to the supplier, but gave them one more chance. Faced with the quantitative evidence, and the prospects of watching FoodCo make its own bottles, the supplier decided to *decrease* its costs rather than increase them. The end result: FoodCo slashed costs by $7 million per year.

Purchasing leaders like FoodCo also evaluate their ability to achieve their targets by benchmarking their purchasing capabilities against best-in-class competitors and, often times, against other industries. And when sizing targets, these companies will benchmark a range of factors in addition to unit price, such as quality and service levels.

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