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Quick Cash Meets Competitive Purchasing

Boost your bottom line and your buying acumen

BY CARLOS NIEZEN AND WULF WELLER

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 trouble is, in economic downturns, most companies are doing a balancing act of finding short-term cash and building long-term capability. Do they generate fast cash through measures such as restructuring supplier agreements or invest in broader purchasing capabilities that will make them more competitive?

Too often companies think they need to choose between these two goals or find themselves swerving from guardrail to guardrail. There is another way: Meet both short- and long-term needs by addressing four critical questions about the value of purchasing.

Limited View

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 purchasing. However, when acting under pressure, companies often take reflexive actions to cut costs 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 shortsighted, 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, and using electronic auctions—and then estimate how much they can save by using them. Afterward, 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 U.S. automaker, currently struggling to stay afloat. It reduced costs by continuously squeezing 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 to retain the business. In fact, it priced its products to the automaker at cost. But the supplier compensated by increasing its prices in the aftermarket. The main buyers of the aftermarket products were dealers and consumers, so although the automaker succeeded in lowering vehicle prices, its cars earned a reputation for having higher maintenance costs and thus a higher total cost of ownership.

[Key Takeaways]

- Cash is king in an economic downturn, and a ready source is the proceeds from short and sharp cost cuts in purchasing. The problem is that quick fixes do little for the company's strategic outlook.
- It is possible to find quick cash injections from purchasing and enhance your long-term business prospects by addressing four key questions.

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

1. 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 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 it 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 1990s—and had run out of targets in its largely consolidated industry. An alternative strategy it pursued was to improve earnings by using its scale to strike more favorable deals with suppliers, standardize purchasing items, centralize wherever possible, and 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 formulated an experience curve, performed make-versus-buy analyses, and used broad benchmarking—looking beyond its company and industry for benchmarks—to set real targets. In only eight weeks, FoodCo not only strategically set saving targets for purchasing in one of its most critical categories but also turned around supplier negotiations in its favor.

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

Once they size their savings, service levels, quality, and cost targets, strategic supply leaders typically look inward for places to cut demand.

Control demand for internal use and costs

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. Generally speaking, companies have the most options for shrinking demand volume for indirect supplies—everything from travel to office equipment to janitorial service.

This is also the time to reduce unit prices for indirect supplies by eliminating off-contract buying, driving down purchase prices with reverse auctions, and substituting for lower-cost items such as printers. In some instances, with the right suppliers in place, price negotiations to immediately close cost gaps can begin.

While shrinking demand and unit prices for indirect costs, companies should pursue per-unit cost reductions for direct supplies, those that are integral to a company's product or service.

3. 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-versus-buy analysis, which should help to determine targets—and can generate quick hits. Many companies evaluate suppliers primarily based on short-term price. By 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 research and development capabilities and ability to innovate, quality of management, service levels, industry position, and willingness to collaborate across critical fronts.

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. Applying the same make-versus-buy analysis to overhead functions can help a company determine whether it is time to outsource noncore business processes. Purchasing should fully support the outsourcing decisionmaking process. And pay particular attention to opportunities for collaboration with the right suppliers.

For example, retailer Macy's and a supplier jointly developed an alternative supply chain to speed time-sensitive products to stores. Macy's also collaborated with a supplier to develop three separate apparel items at price points the retailer was confident would sell extremely well—and did.

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Consider total cost of ownership

When comparing suppliers' costs, many companies place too much emphasis on invoice price. This 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 European 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 at around 100 euros if the equipment is used for 2,000 hours and 20 euros 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 from 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. Organizations often overlook the potential savings of "upstream" levers, such as design simplification, in favor of "downstream" activities, such as 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 are passing on raw material price movements to customers; implementing margin-sharing with suppliers; 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 financial tools such as forwards and options to hedge risk—delivering benefits to both the profit-and-loss statement as well as the balance sheet.

4. 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 there is a clear owner for each key decision and that decisions are made swiftly, at the right level, and with the right inputs. 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.

Lafarge, the worldwide building-materials maker, revised its decisionmaking 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, and 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 make sure purchasing savings materialized into the business units' profit-and-loss statement and cash flow.

Such careful attention to decisionmaking 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. ◆

Carlos Niezen is a Bain & Co. partner based in Mexico City, Mexico. He can be contacted by e-mail at carlos.niezen@bain.com. **Wulf Weller** is a Bain & Co. partner based in Munich, Germany. He can be contacted by e-mail at wulf.weller@bain.com.