As supply costs increase, a more comprehensive approach to procurement can boost margins and fund growth

A fresh look at procurement

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Content: Global Editorial
Layout: Global Design

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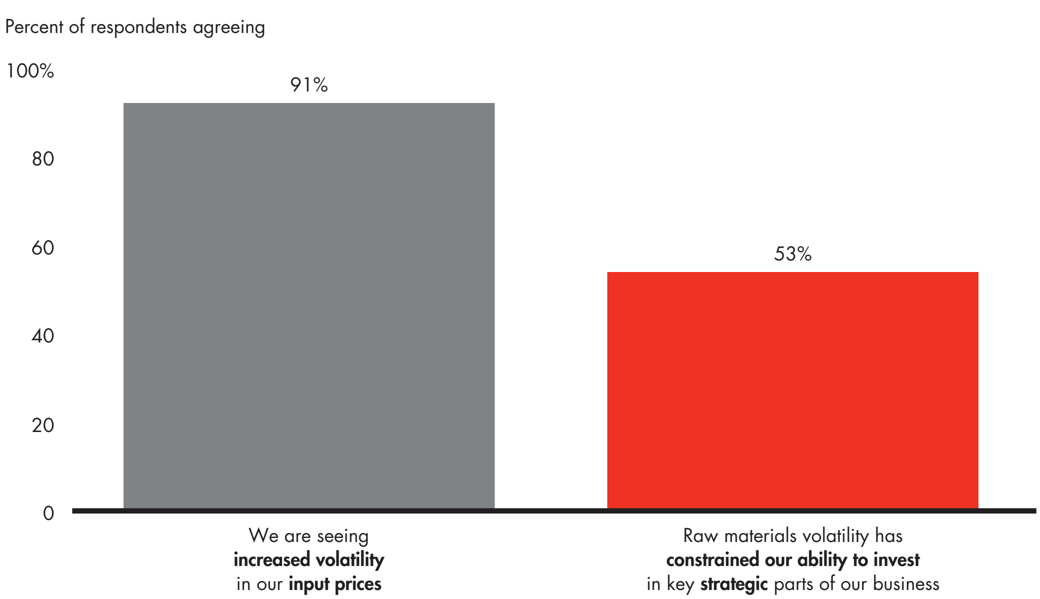
Rising commodity costs and volatility in input prices have become facts of life. Basic commodities are under pressure not only from their own higher demand but also from increasing alternate uses. Only a handful of commodities will likely result in real shortages and constraints, but no matter what business you're in, rising prices and volatility will become the norm.

Executives are feeling the pain. In a recent Bain & Company executive survey, more than half of the respondents told us that cost pressures constrain their ability to make strategic investments (see Figure 1). That is a big issue for nearly all companies, given that procured costs represent between 25 percent and 60 percent of a company's total costs, depending on the industry. We frequently find that procurement does not get a commensurate level of organizational investment.

When supply cost pressures increase, so does the opportunity to gain an important source of untapped margin. By taking a more comprehensive approach to what they buy and how they buy it, companies can free up cash and refocus resources to fund strategic priorities without the pain of layoffs. A comprehensive approach means deploying a broader set of tools to better negotiate prices or becoming more efficient at using supplies. It also means getting full organizational alignment—ensuring that roles, decision rights and incentives all work toward the goal of lowering procurement costs.

But doing it successfully is not easy. The evidence is clear that procurement is an area that's

Figure 1: Changing input prices are creating constraints for companies



Note: Does not include respondents who indicated they do not purchase raw materials
Source: Bain Procurement Survey, November 2011

ripe for improvement. We recently surveyed executives about their experience with past procurement management initiatives. While most reported annual gains in their efforts to save, 72 percent of the respondents believe that they could do substantially better (see Figure 2). Interestingly, this belief was held as frequently by the heads of procurement as it was by CEOs and CFOs.

That confirmed something we routinely see with clients: Most organizations under-manage this treasure chest. They lack a predefined, systematic playbook for reducing costs (see Figure 3).

For example, among respondents, 81 percent said procurement teams are able to influence price, but not the mix or consumption. The problem is, both are critical cost factors. Meanwhile, 77 percent of the executives said that their companies' procurement efforts are particularly weak in categories where decisions are fragmented across many buyers in the organization, demonstrating the need for tighter integration. Another finding involves the rate at which companies look at the total cost of ownership (TCO) in price negotiations. A TCO approach breaks down all of the costs that go into the delivered item—everything from supplier overheads to raw materials or even the distribution costs involved in final delivery. That provides visibility into what specific actions you and a supplier can take to further lower costs. It's a valuable tool for identifying ways of generating and sustaining savings, but only about one in three respondents reports that their teams regularly use TCO when preparing for negotiations with vendors.

Finding the flaw in your strategy

In our work with clients, we find that procurement organizations usually push to do the right things. However, we've found four common reasons that procurement improvement efforts typically fall short for the organization:

- They fly at 100,000 feet and do not get specific or focused on where to capture the savings. Many companies simply set blanket cost-reduction targets across spending categories. Sometimes they use high-level benchmarks to justify these targets. Their efforts go wrong because they fail to dig into the underlying factors of a given type of spending to assess which can have the most significant effect on costs. Thus, they tend to set targets too high for some categories, too low for others.

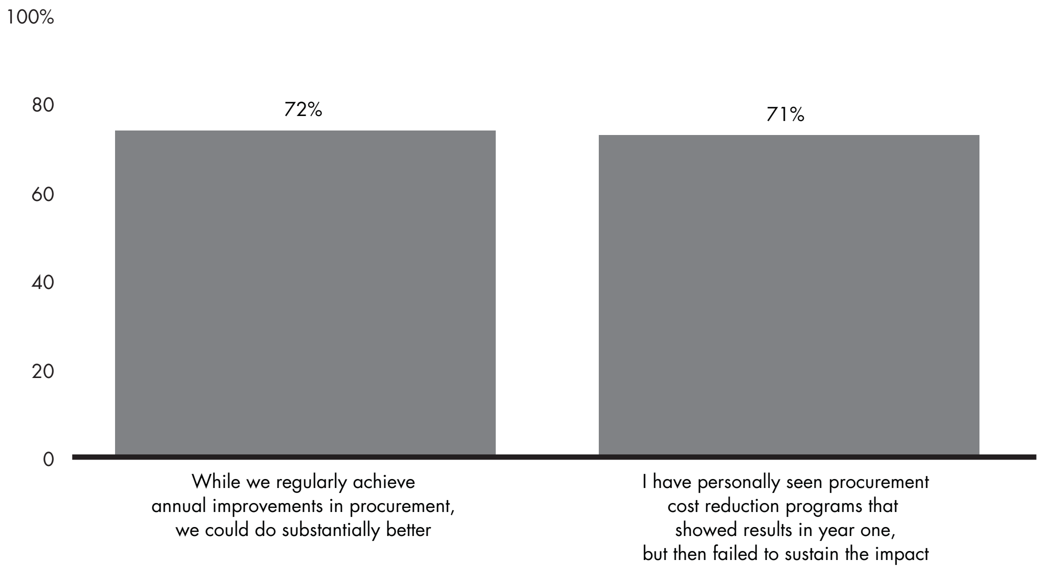
- They collapse under their own weight. The company tries to simultaneously attack 20 spending categories, changing policy and approach, and flooding the organization with more than it can reasonably absorb. People get lost in the sea of new policy prescriptions and initiatives. Behavior change fails to take root.

- Decisions are made in a vacuum. Too many companies delegate the improvement effort to the procurement department alone and don't involve the business and finance teams early and often. The key problem: All too often, procurement doesn't have a seat at the table in many decisions regarding the volume, specs and mix of what's purchased. As a result, these organizations focus too closely on the things procurement can more easily control, such as price, and leave significant money on the table.

- They are not set up for long-term success. After an initial flurry of activity, leaders move on to the next priorities, behavior reverts and there is no closed-loop process to sustain the progress. Traditional systems fail to generate appropriate metrics to track this slide. Within a year, the gap between actual behavior and the new procurement policy widens. And the effort is relaunched two years later, thick with cynicism of failed prior attempts.

Figure 2: Most companies believe they have a significant upside in procurement but have struggled to make past efforts stick

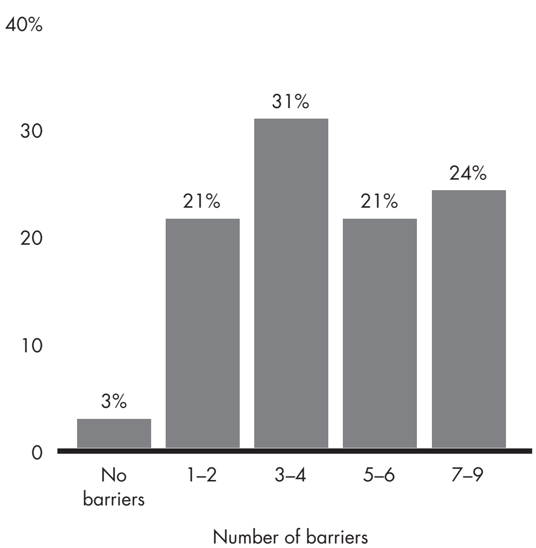
Percent of respondents agreeing



Note: Does not include respondents who indicated they do not purchase raw materials
Source: Bain Procurement Survey, November 2011

Figure 3: Every company will be different, but some subset of barriers exists in nearly every organization

Percent of organizations by number of barriers cited



Potential barriers respondents considered

- Procurement has difficulty influencing consumption and mix
- We rarely use total cost of ownership
- We struggle in categories where buying decisions are fragmented into many buyers
- Data is a big limitation to building effective category strategies and tracking impact
- We don't close the loop between policy and actual purchasing behavior
- We struggle to see savings show up in the financials
- We lack cohesion between procurement and the business
- We lack cohesion between procurement and finance
- Our procurement team does not have the right skills

Source: Bain Procurement Survey, November 2011

Getting it right

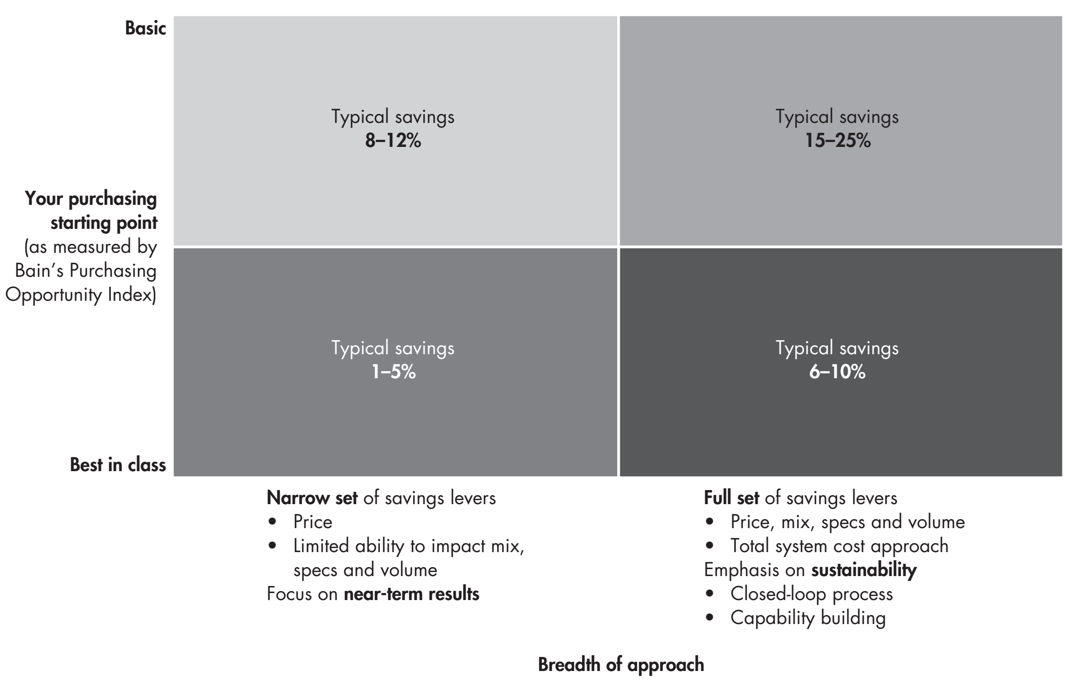
While our survey quantified the level of dissatisfaction with procurement reduction initiatives, our work with clients has helped us see what companies are doing to make those efforts succeed. And some are reaping significant, long-term rewards. The level of improvement depends on two dimensions (see Figure 4). First, there's a company's starting point: the capabilities it already has in place across a number of critical dimensions ranging from analytics to compliance to the overall integration of procurement with the rest of the business. The second dimension involves the breadth of tools a company is willing to deploy to improve. For example, companies with already sophisticated capabilities that want to just reap more savings on price tend to achieve 1 percent to 5 percent gains, depending on the category. Those that are somewhat underdeveloped in their capabilities and are willing to consider a broad range of actions can typically reduce spending by 15 percent to 25 percent or more across the categories they attack.

We've identified three steps that the most successful efforts follow:

Step One: Assess your starting point

The first step is to assess where you're coming from. We find the companies that reap the biggest rewards in these efforts ask a series of questions to help them clearly understand how they currently handle external spending reduction efforts (see the sidebar "Assessing your starting point" on pages 6–7)—and the gaps that exist. This checklist is part of Bain's Procurement Opportunity Index (BPOI), a quick and straightforward way to measure an organization's starting point. Taking this step enables management teams to see whether their companies deploy the full suite of behaviors of best-

Figure 4: The upside will vary, depending on the scope and the company's starting point



in-class companies. It also helps executives understand procurement's role in such important decisions as spec development for product inputs and policy development for indirect spending.

For example, the BPOI allows them to examine the extent to which they use TCO in price negotiations, track compliance, rely on supplier data and their ability to forecast and provide early warnings on potential supply chain risks. The exercise helps companies clearly see where they are leading and lagging in the required capabilities. It also provides a way to triage—identify the most likely categories for quick and sustainable procurement savings.

Step Two: Get to the root causes of your cost category by category

One of the most striking findings from our survey was the extent to which organizations fail to take advantage of all of the tools that can help them improve. Winners look everywhere. Among the best ways to generate lasting savings:

Look at the mix of what you buy. Comprehensive programs often unearth a string of valuable opportunities. When companies examine the mix of products across the organization, they find they can alter that mix and unleash savings, often without materially hurting the business. One healthcare company thought it was on the path to sustained savings in office supplies when it consolidated procurement with a single vendor. Then, a year later, it made a serious effort to look at its mix of products. It learned that employees purchased more than 13,000 different SKUs of office supplies, including more than 90 different types of computer mice. The company established two policies that led to dramatic savings: shifting heavily to the vendor's private label and narrowing the set of products that employees can buy.

Consider the way you spec and manage your own assembly. Looking across functions can yield big results—it can show you how your own internal processes and coordination add costs to what you buy. A building products company primarily relied on supplier negotiations to achieve price improvements. Oftentimes, this meant consolidating volumes with suppliers to get better terms through increased scale. But the recent homebuilding downturn caused the company to look even harder for cost savings. A procurement diagnostic helped the company see the significant opportunities it could gain by tightening integration across functions within the organization. For example, 50 percent of the items purchased involved external service providers for labor on the home sites. However, the coordination across those vendors was not being actively managed, resulting in high inefficiency. The company found that only 60 percent of the labor hours it paid were productive. For example, some workers arrived at the job site not ready to work—their tools may have been on a truck offsite—or late inspections resulted in rework. The company used TCO tools to pinpoint the opportunities where it could improve. It redesigned a few critical scheduling and inspection processes, changed organizational roles and aligned incentives to new metrics—all linked to reducing external labor costs. The procurement team worked hand in hand with the field to modify supplier terms and develop new metrics for tracking operational progress and linking it to savings. These and other improvements resulted in additional savings across nearly all categories of items purchased.

Take on fragmented categories. When the buying process gets fragmented, many companies find themselves struggling to rein in spending. In fact, in our procurement survey, 77 percent of respondents told us that they buy poorly when many people can make individual purchase decisions in a category. We've seen such fragmentation across industries. For example, one company performed a diagnostic and learned it had hired nearly 20 "Tier 1" (creative) ad agencies. Each sub-brand and sub-business was buying from its own favorite vendor. Based on this finding, the procurement department and a leader from each business formed a team tasked with evaluating and consolidating spending. Within six months the company reduced its Tier-1 spending to three agencies, and now expects to realize 10 percent to 15 percent savings that can be redeployed into additional marketing. In addition, service quality got much better, as the three agencies committed to add on-site project management.

Look at suppliers' input prices with a new lens. As commodity prices increase, suppliers come knocking, pushing through commensurate increases. But what happens when those same commodity prices fall? Too often, purchasers fail to get a break. Consider the situation of an aerospace and defense supplier. As key metal prices rose, the company grudgingly accepted its suppliers' price increases for machined parts. Trouble is, the company lacked good tracking data

Assessing your starting point

The Bain Procurement Opportunity Index (BPOI) helps companies take the first step in creating the capabilities that will deliver long-term procurement savings. Below is a subset of questions from the BPOI.

1. **How does your company tend to attack external spending reduction efforts?**
   a. Broad cuts to budgets, letting managers make decisions on where to cut.
   b. Procurement focused on price, rest of the organization encouraged to make their best efforts on consumption.
   c. Deep, analytic look at spending by category, with as much emphasis on consumption and mix as on price.
2. **In the last major procurement project you were a part of, how would you describe the results?**
   a. Interesting analysis, but not a lot of impact.
   b. Initial flurry of impact, but impact slipped over time as people focused elsewhere.
   c. Great impact that was sustained for multiple years.
3. **How would you describe procurement's role in spec development (for product inputs) and policy development (on indirect spending)?**
   a. Largely in a silo. Some early input, but procurement is mostly focused on negotiating price once specs and policies have been developed.
   b. Consistent input into specs and policy, but not a significant force if others have different views.
   c. Near-equal seat at the table. Often contribute to major recommendations on specs and policy.
4. **How regularly do you use Total Cost of Ownership (TCO) as part of the price negotiation process?**

on commodity indexes. So when commodity prices dropped, it failed to go back to the supplier to negotiate lower prices. When the company started closely tracking supplier input prices, it found a large, immediate opportunity to claw back savings from the supplier. It now has a commodity index dashboard tied to key inputs. Companies can use this approach to reap savings in categories as diverse as components, freight and temporary labor.

Step Three: Build capabilities for continuous improvement, not just one-time gains

There's an important lesson in the fact that 71 percent of our surveyed executives reported that their past efforts to take costs out of what they buy slipped significantly after only a year. As with any change effort, even the most proven tools will fail to yield results without a well-defined implementation program and a process

a. We use it rarely.

b. We use it in some categories, but we could use TCO much more regularly.

c. We use TCO in nearly all categories where it is relevant.

5. When new procurement policies are set, how good is your company at achieving compliance?

a. We have a pretty bad record on policy compliance—people tend to do what they want as long as they stay within their budget.

b. We track some categories rigorously and do well on those, but on many others we struggle with compliance because we just don't have the data to enforce policy.

c. We have an excellent closed-loop process across categories that regularly roots out and eliminates noncompliance.

6. How well does your organization manage and act upon supplier data?

a. We collect some performance data on suppliers, but it's mainly kept within the procurement organization.

b. Procurement uses supplier performance data to make supplier selection decisions, but the data is limited to what is observed by the procurement organization.

c. Supplier data is collected, reviewed and acted on by all representatives from the corporation who deal with a given supplier. The data is shared across organizational lines.

7. How developed are your organization's capabilities for forecasting and providing early warnings on potential supply chain risk?

a. We have limited capability for predictive risk. We find ourselves always being reactive to shortages or quality problems.

b. We track scorecard metrics, but still do not feel like we have a handle on all flavors of risk covering both price and supply reliability.

c. We conduct a full supply chain risk analysis, establish predictive metrics where possible and build in risk management contingencies for risk areas that are not easily predicted.

to close the loop between agreed change and actual behavior.

It goes without saying that you need to make sure you have the right level of talent in procurement. Best practice is to have A+ players in procurement and business units both open and eager to partner with procurement to increase savings. Organizational decision roles and incentives reinforce this.

Beyond talent, we find that there are four critical elements needed to get results to stick outside the procurement organization.

First, involve the right people from the start. If the effort is dominated by procurement people alone, it will fail. Create an organization-wide set of goals, and assemble a team of influential leaders across procurement, finance and the business. One approach that works well is to pair up "subject matter" experts from the business with procurement teams to help better identify potential opportunities and ensure the right process is followed to capture and sustain value.

Second, communicate changes both broadly and in targeted training. If you're no longer catering internal meetings, train the executive assistants who most frequently submit the catering orders.

Third, create a regular, simple dashboard across categories. Don't overwhelm it with more metrics than are necessary. Focus on actual dollars spent and the one or two most critical metrics of desired behavior. If you're consolidating R&D vendors, report how many different vendors were used in the prior six months.

Fourth, create a quarterly check-in process between finance, procurement and the business focused on dashboard metrics. Best-in-class companies focus on exception reports, creating the ability to take faster action on spending outliers. Profile spending trends, review categories where change is sticking and dig deep into those categories where results are slipping. Make sure targets flow into budgets, but also clearly show the business the bottom-line value and progress being made. When they know you are serious about the change, your team members will begin staying in preferred hotels, buying from preferred vendors and knowing when they should hold a teleconference instead of traveling to meet in person. This doesn't come for free. You will likely need to add analytical support within your finance or procurement teams to supplement the process (see the sidebar "A procurement team with new skills").

But the payback of sustained results makes it a high-return investment. As input costs continue to rise, so does the need to keep them in control. Succeeding at that challenge isn't easy, but it can spell the difference between a company that is able to make the strategic investments to secure its future and one that struggles to keep up.

A procurement team with new skills

One major dairy company redesigned its organization to create a more capable procurement team that was organized around key spending categories. It replaced its field-based, tactical procurement personnel with centralized teams whose category leads and analysts designed and executed against category strategies.

Where the old structure was 10 percent strategic and 90 percent tactical, the new organization was closer to a balance of 50/50. The new teams were a mix of dairy experts and outside hires with experience in a more strategic approach to spending and supplier management. The previous organization lacked the necessary analytical support to assist category leaders in designing and executing category strategies. Adding analytical capabilities helped category managers tackle a much broader range of spending. The chief procurement officer designed a procurement skills boot camp to help analysts from nonprocurement backgrounds learn the basics of procurement and supplier management.

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