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Strategic Sourcing Scrabble

Getting maximum points from game plan variety

Through its recent rebranding as the Association for Operations Management, APICS better defines the broad application of the APICS body of knowledge, including purchasing and supply management. Embracing procurement is a good move because strategic sourcing can be as powerful a lever for performance improvement as lean manufacturing, total quality management, demand planning, and similar initiatives that have shaped manufacturing.

Strategic sourcing is re-engineering the supplier relationship in a way that achieves breakthrough improvement in cost or performance, enabling the company to reposition itself in relation to its competitors. It starts with a top-level view of a company's externally purchased goods and services—the spend. It prioritizes potential savings by category of spend and determines a sourcing strategy for important categories according to the magnitude of their spend and how hard it is to find, develop, and switch suppliers. The classic mechanism for realizing the savings has been to conduct comprehensive multistage requests for quotes or auctions.

As focus shifted from functional management (production, logistics, purchasing) to supply chain management, strategic sourcing became less rooted in competitive events and began to more fully encompass integrative scale- and value-based approaches to achieving breakthrough supplier cost and performance improvement.

In 2005, Boston Logistics Group focused its annual strategic sourcing study on the goals and the relative success that companies have had with 12 sourcing techniques as they relate to the largest category of external spend. The techniques are as follows: 1) requests for information, requests for quotes, and requests for proposals; 2) global sourcing; 3) auctions; 4) payment terms; 5) rationalization; 6) centralization; 7) group purchasing; 8) e-procurement; 9) long-term agreements; 10) supply chain integration; 11) purchasing cards; and 12) value engineering (including standardization and simplification of specifications).

Using the study, Boston Logistics Group seeks to quantify the benefits of alternative strategic sourcing approaches and to explain why some popular initiatives are not worthy of many companies' limited resources.

Each of the 12 strategies in the survey yields substantial benefit on its own. However, when combined into a strategic sourcing program, they can deliver a cumulative savings of 30 percent or more of acquisition cost. This magnitude of savings is what distinguishes strategic sourcing from tactical sourcing and is consistent with the savings obtained through similarly popular initiatives,

such as lean, especially when they are carried out in collaboration with suppliers.

Unfortunately, the typical company can focus on only 1.5 of the strategies at a time due to resource constraints, according to the study. Therefore, it is extremely important to know which strategies have the greatest payback.

Global sourcing: The "C" word

According to the 2005 study, global sourcing nets companies 12 percent of acquisition cost across major commodity categories. Savings on subcategories and specific items and services are often much higher. The savings have resulted in an increased focus on global sourcing, more imports, and more U.S. direct investment abroad.

The study also shows chief procurement officers will be putting nearly 40 percent more emphasis on global sourcing over the next three years than they did from 2000 to 2004. U.S. imports have risen by 8 percent annually and will continue to mount at about the same rate at least through 2010. Moreover, U.S. investment abroad has grown by more than 20 percent each year since 1980 and will continue to expand rapidly through 2009, according to The Economist Intelligence Unit.

Although global sourcing is not new, the case for it has become more compelling in recent years. U.S. labor costs, already among the highest in the world, are increasing due in large part to rising health care costs. Developing countries are graduating more technically capable students in engineering and other sciences. The cost of communications has dropped precipitously, and the U.S. dollar is strong relative to several key currencies, such as the Chinese yuan and the Korean won.

Knowledge of the Chinese supply market is essential to doing business anywhere else in the world due to its radically low cost structure. By U.S. standards, Chinese cost levels are eye popping. The average working wage is less than a dollar per hour in most areas, making Chinese labor cheaper than in most other capable, low-cost countries. China has so profoundly altered the economic landscape that one manufacturer in the study said "without China we'd be closing the doors." Korea, Singapore, and Malaysia are also popular manufacturing bases for many American companies.

Springfield Wire of Springfield, Massachusetts, is currently sourcing to China 50 percent of one of its product lines, and the company has set a goal to source 70 percent to 90 percent of its externally sourced product there. The only reason it is not shifting 100 percent of its production overseas is that logistics costs offset the per-unit cost savings on some product lines.

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Chinese labor costs just 3 percent to 5 percent of U.S. labor, says Richard Hundley, director of corporate purchasing at Springfield Wire. "The fully loaded Chinese labor rate is less than we pay just for workmens' comp in Massachusetts." He says the labor cost differential clearly exceeds the 25 percent to 30 percent unit cost savings needed to cover logistics costs.

One must be careful, however. A large portion of savings may be due to undervalued foreign currencies. The Chinese yuan is widely believed to be undervalued by 40 percent or more, and Western governments are currently pressuring China to revalue it, which would directly affect Chinese competitiveness. Those who have been involved in global sourcing for several decades have seen exchange rates swing sourcing decisions from one country to another and sometimes back again. In developing countries, exchange rate instability is part of doing business because those economies are more volatile than those of major industrialized nations. Remember the Polish zwoty, the Brazilian cruzeiro, and the Thai baht? Add the switch from a very strong dollar to a very weak dollar and exchange rate assumptions become a weak link in many long-term sourcing plans.

Many companies struggle with how to get started overseas. Qualifying suppliers and establishing reliable logistics pipelines are among the largest challenges. Companies that are new to offshore sourcing should consider the time frame to payback and make sourcing and investment decisions based on an informed assessment of the candidate countries' economies, exchange rates, and political risk. [See "Initial Steps in Offshore Sourcing" sidebar for a checklist of things to consider before cutting loose existing suppliers in search of greater gains overseas.]

Integrating acquisitions

Study results show centralized purchasing saves companies between 6 percent and 11 percent across their largest spend categories. Moreover, it is a platform for material standardization, which reaps another 7 percent in savings.

Centralized purchasing, which often starts with a spend analysis and supplier consolidation, provides the visibility needed for more strategic channel management. With increased visibility to the size of the total spend, purchases through distributors sometimes are renegotiated directly with manufacturers.

Initial Steps in Offshore Sourcing

1 Determine off-shore-ability.

- Is the activity strategic? Should it be outsourced at all?
- How much is the total cost of labor?
- What would you do if your intellectual property were compromised?

2 Start with a high-potential item, line, or category.

- Which ones have a high labor cost component?
- Which can have separate supply streams?
- Which have specifications that can be met by most suppliers?

3 Screen candidate countries and suppliers.

- Which countries have qualified suppliers who can meet the spec?
- What is their economic outlook and political and economic risk? Is there a promising domestic market?
- What is the landed cost after duties and logistics?

4 Understand channel economics.

- Is an agent (or agents) required?
- Does a trading company or joint venture partnership make sense?
- Should you build your own operations in the country?

5 Consider the total cost.

- What are the delivery lead times and reliability?
- How much re-work and inspection is needed to ensure adequate quality?
- How much communication and on-site supervision is required?

Centralized purchasing has become so important primarily because of the merger and acquisition boom that started in the early 1990s. Although the volume of deals slowed in the post-Internet boom, the value of deals has risen at a compound annual rate of 14 percent since 1990, and the emphasis on centralized purchasing rose at roughly the same rate over that period. Companies increasingly have centralized purchasing in order to digest the acquisitions and take advantage of the consolidated spend.

Ahold, a Netherlands-based holding company for grocery chains such as Stop & Shop, Giant, and Tops Markets, exemplifies the trend toward centralized purchasing. Since the mid-1980s, Ahold has acquired six grocery chains with sales in excess of $25 billion, as well as U.S. Foodservice, with an additional $18 billion in sales. To handle the complexity of sourcing for the group, Ahold set up a company called Braintree Sourcing. Braintree manages strategic sourcing, while the chains handle day-to-day purchasing. To date, Braintree has realized $220 million in annualized savings and more than $400 million in contracted savings through a highly structured strategic sourcing process, demand management, and enabling software.

The mission of purchasing councils is evolving. It is no longer limited to centralizing spend to get lower prices. Purchasing councils today are focusing on tapping the innovation that comes from involving suppliers in design as well as manufacturing processes, developing suppliers to be lean and to continuously improve, and fostering customized supply chains.

Here are seven steps to establishing an effective purchasing council.

1. Establish and document sourcing objectives.
2. Conduct a cross-divisional spend analysis.
3. Simplify specifications based on value analysis.
4. Standardize purchased materials and services.
5. Develop and manage the supplier portfolio.
6. Embed suppliers in product development teams.
7. Offer support services to internal customers.

Getting hitched

According to the survey, partnering saves 8 percent to 10 percent on major categories and yields a variety of noncost benefits, such as better product and information quality and availability, shorter lead times, and stronger engineering support. Because of the intensive supplier concentration that has occurred in many industries, the largest supplier now accounts for close to 50 percent of category spend in cases where there are 10 or fewer suppliers.

For an example of partnering, look at Menlo Worldwide, a UPS company. It supports its subcontracted carriers on routes where they have excess capacity and expects those carriers to support it on routes where it has excess demand.

"Partnering with carriers this way on a global basis mirrors the forwarder-shippers partnership at the retail level," says Hugh Cutler, vice president of global transportation at Menlo. The unit price on any given lane does not change, but the network functions more effectively and efficiently. This network "give-and-take" allows both companies to improve their asset use, thereby benefiting from economies of scope.

Partnering creates a ladder of increasingly symbiotic activities with core suppliers. At the lowest level are "transactional" suppliers; one level up are "preferred" suppliers, who have a record of consistent quality and price performance. "Project" partners share information and resources related to a specific goal or time frame; while "strategic" partners establish true mutuality of needs and vision, operate on an open-book basis, and routinely share resources.

Once a company has established project or strategic partnerships, it needs to determine how many suppliers to have for major spend categories. An optimal number of suppliers balances the benefits of lower prices against risks of inadequate quality, reliability, and availability.

Auction power

The strategic sourcing study shows, with a focused effort, auctions save an average of 9 percent across major categories. Companies that use them intensively save much more, and savings on individual contracts can be higher. However, most companies use auctions opportunistically and save less than 2 percent.

Many procurement professionals express grave concerns over auctions. They are apprehensive about eroding supplier goodwill that has been created over many years. Also, auctions risk driving prices up instead of down in a tight market, such as the current one for raw materials, whereas a request for quotes can be used for price discovery but abandoned if prices go the wrong way.

Auction providers have improved the technology and the process so some of the criticisms are less valid today. Alcoa, a Pittsburgh-based producer of primary and fabricated aluminum products, buys $1 billion per year through auctions, says Christie Breves, Alcoa's chief procurement officer. Alcoa uses auctions primarily for indirect materials and services, not for many materials that often involve strategic, long-term supplier relationships.

Thermo Electron, a maker of high-tech scientific equipment, conducts online electronic negotiations for commodity items and specialty make-to-print categories. Its software solution quickly analyzes bids and returns the best solution among those that are cherry picked, single sourced, and multiple sourced.

"Using this tool saves time for the buyers, which allows them to focus on strategic scenarios and total cost of ownership," says David Wohler, director of global sourcing for Thermo Electron. While some companies have not been successful with auctions, Thermo Electron has "achieved great results since we follow a well-defined strategy and a structured methodology," adds Nisreen Bagasra, manager of e-sourcing.

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Auctions can be very effective when used in the right situations. The key is determining where they can work well. The sweet spot is usually categories for which the product or service is standard or can be clearly specified, there are many suppliers in the marketplace, the volume and margin are attractive to suppliers, and there has been little or no previous strategic sourcing.

How long is long?

The strategic sourcing study showed long-term agreements save companies 7 percent of their acquisition cost on major categories. Respondents had a variety of success stories related to long-term agreements.

For example, United Kingdom-based Unisys required a high-speed upgrade to its communication links, involving underground cabling between its facilities. The distance between the two major sites was more than 100 miles. Even though existing links were used where available, the upgrade was substantial. Unisys opted for a five-year agreement instead of the typical three-year agreement for underground cabling between the sites. It saved the company 15 percent by amortizing the capital investment over five years instead of three and incurred minimal additional incremental risk.

Other companies sign 10-year agreements with their customers and suppliers. This structure hedges against fluctuations in material costs and allows amortization of upfront capital investment over an extended time horizon.

Integration surprise

The biggest surprise of the Boston Logistics study was that supply chain integration only saves companies 3 percent, compared to the 7 percent average savings across all tools. Yet companies focus on it more than other tools. Many companies direct all their energies on vendor-managed inventory and consignment and are missing larger supply chain opportunities, such as cycle time compression, working capital reduction, co-location, and Just-in-Time delivery. These methods allow Wal-Mart to sustain rock-bottom prices and General Motors in Brazil to build a car that sells for only $4,000 (depending on the exchange rate).

To get started, pick a strategy and commit to it. Companies that intensely concentrate on a sourcing approach get twice the savings of those that approach it with a moderate effort and four times the savings of those that hardly focus on it at all. Start now, and your company will see savings as soon as the 2006 fiscal year.

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