

REV-UP YOUR PURCHASING ENGINE TO GENERATE GROWTH: CAPTURING THE REAL VALUE OF PURCHASING

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Summary

You have installed a powerful Purchasing team. They are delivering annual cost decreases across the board. You should be satisfied with their performance. Unfortunately, your key competitor has also invested in purchasing capabilities. Their cost decreases too and competitive pressures have forced you to pass most of the savings to your consumers. So, what can you do? Are you forever locked into a vicious circle? How can you differentiate yourself?

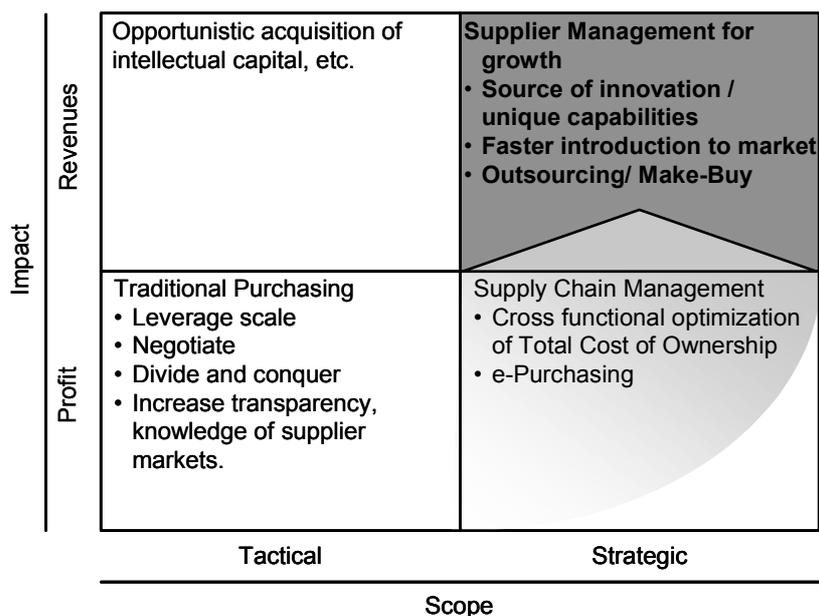
To create competitive advantages through Purchasing Excellence, you need to shift focus from cost reduction to using suppliers to create additional growth. Supplier development offers you three opportunity areas: capture of unique contributions from suppliers or supplier networks, leveraging suppliers to speed international expansion, and better sharing of knowledge from consumer to suppliers.

To achieve this without compromising the basics, you need to think about your Strategy for Purchasing, the Structure, the Suppliers, and your support Systems.

From Tactical Cost Cutting To Supplier Generated Growth: The Evolution Of Purchasing

Ten years ago, Purchasing was emerging from the dumping ground for failed employees, just good enough to administer Purchase Orders. It became an important field for management, offering abundant opportunities. By consolidating volume across plants and harmonizing specifications, you were able to pressurize your suppliers to give you better terms. You used consultants to speed up the process and build organizational skills, capturing an initial 15% cost reduction. You forced your suppliers to adapt and improve, or die. Some disappeared or were acquired. Your team's negotiation skills were creating value by lowering the cost of the Bill of Material.

Your company improved its profit margin for a few years, giving you the opportunity to invest in better systems, and attract good managers for your operations. Five years ago, your teams introduced strategic vision of the



entire supply chain. You gained insights on the Total Cost of Ownership and redistributed responsibilities to reduce it through cross-functional initiatives. More recently, e-Procurement solutions gave you an additional transaction cost reduction. Your best suppliers opened their books, discussed their cost structure and their ideas to optimize interface costs, set-up and management costs. You helped them by auditing their plants and introducing some of your best practices on lean operations.

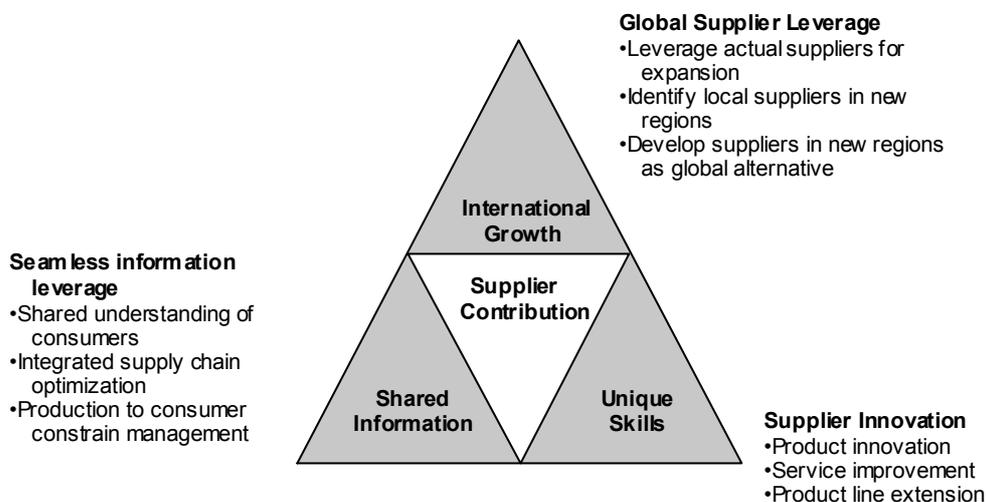
All those efforts have increased productivity significantly, but your profit margin has not changed much in recent years. Seemingly offensive moves kept you at the front of the pack, but did not move you ahead. Can Purchasing deliver more? The example above illustrates how Purchasing has evolved from its administrative role by impacting profit through tactical excellence in negotiation, leveraging the full scale of the organization. Then it was integrated into the operations. Strategic decisions on organization and cross-functional interactions drove a reduction of the total cost of ownership further contributing to profit. Today, all those initiatives are only leveling the playing field. Purchasing teams must focus on identifying and capturing strategic advantages, impacting revenues in addition to profit (See exhibit). Today, Purchasing must develop suppliers to exploit quickly their skills and isolate them from competition.

Purchasing contributes to shaping supplier's strategies to speed entry into new markets. Purchasing is about seamless transfer of information from the suppliers' development labs to the final consumers and back. That is the reason why Purchasing must understand the life-cycle value creation potential of an item, not only as a driver of the Total Cost of Ownership but, more importantly, as a driver of product pricing through the premiums provided by exclusivity, and market growth for the company.

This does not imply that traditional purchasing skills have become worthless, but that they are now "must have" components of a comprehensive purchasing strategy, solid building blocks that secure a place on the first line for the race to competitive leadership. Some purchasing categories will always be managed primarily through aggressive negotiation based on an in depth understanding of markets and supplier economics. A few deserve more.

Supplier partnerships have been used with varying degrees of success by the automotive industry, specially some Japanese manufacturers. At American manufacturers, executives have communicated the same vision, but Tier 2 and 3 suppliers rank the large US OEM much lower than their Japanese counterparts in their ability to create real "win-win" partnerships. For the rank and file purchasing organization, the measures of success stayed very much cost driven. Profit generation through capture of long-term competitive advantages is rarely one of the missions of the purchasing teams.

Beyond automotive, successful purchasing teams have applied those approaches. Frito-Lay is managing its seasoning suppliers to capture their best development skills, isolate them, leverage them to develop more impactful products at lower cost and make them available across a far reaching empire. Dell has used its relation not only with suppliers but also with logistics partners to create a manufacturing and distribution system that no one can match today. We can even find examples in the financial sector. What about leveraging purchasing of Property and Casualty loss items to create a new relation between the consumer and the supplier, binding them together through a privileged relationship that is exclusively provided via the insurance? In some countries, the



cost of setting up UMTS mobile telephony networks and resistance to the multiplication of antenna sites forces operators to consider sharing infrastructure. If coverage is not differentiating, will they be left with only image and pricing plans as tools of differentiation? Or will the smartest operators create exclusive relationship with software and service providers to increase their value proposition in a sustainable way? A World Class Purchasing can contribute significantly to that type of approach, working in team with Marketing and R&D.

When evaluating how suppliers can contribute to your growth ambitions, we look at three key opportunity areas: (1) exclusive capture of a supplier's unique skills and capabilities, (2) contribution to international growth and (3) leverage of shared information (see exhibit)

The Value Of Exclusivity: Capturing a Supplier's Unique Skills

Do you know the value of making your product stand out? What price premium can you extract from being better and more attractive? How much of McDonald's volume is driven by children deciding for their parents where to go for burgers, regardless of product offering, but because the chain offers the most desirable toy? Everything else being kept equal, a 5% reduction in the cost of food ingredients would increase net income by about 15%, while a 5% volume growth in a typical restaurant chain increase net income by 20-25%. Therefore the impact that Purchasing can have to capture unique supplier capabilities can be superior to the impact achievable via cost reduction. In an environment where Purchasing has not been optimized, a 5% cost reduction is easier to achieve than a 5% market growth. On the other hand, if Purchasing is already world class, like at McDonald, reducing the cost of purchased goods is more difficult than increasing revenue: McDonald's has grown system sales regularly (8% per year the last 10 years), while costs have not decreased as percentage of salesⁱ.

For McDonald, the sourcing of promotional items is a very serious matter. It must obviously attract children with a hot novelty. To achieve that, it has built relation with the major intellectual property holders like Disney to provide a continuous source of attractive themes. The toys are then designed to insure that they are extremely safe: with the volume distributed in every restaurant worldwide, a risk of one casualty over 10 million is not acceptable. McDonald has established a unique relation with a stream of partners helping its promotional efforts. ITS RAM, McDonald's Safety Consultant, for instance has developed for McDonald's safety toy program a "virtual child" and a "life-like" breathing mannequin to evaluate choking and suffocation hazardsⁱⁱ. As awareness of child labor increases, McDonald must also find low cost suppliers, usually in the Far East, that uphold the ethical standards of the Western world. Its competitors cannot match this chain of suppliers, from concept creators, safety consultants, to qualified manufacturing sites, working together in a sort of extended enterprise. McDonald maintains a grip on the burger market, squeezing competitors one after the other by delivering the promotions that attract the kids, while keeping their parents and Wall Street reassured about the associated risks.

At the other end of the spectrum, in the Luxury industry, premium pricing can be protected by access to exclusive sources of raw materials, skilled craftsmen, or other resources in short supply. As cost of good sold represents a small percentage of the revenues, purchasing should focus more on securing and isolating access to those resources, and delivering them in a timely fashion rather than on cost. But as cost is not so critical, few of those companies do it, and are content with a purchasing staff of the "first generation", administering procurement.

Stretching The Boundaries: Using Suppliers for International Growth

Ten years ago, Frito-Lay's international operations were a patchwork of systems, each of them with their own standards, designs, flavors, etc. Although Frito-Lay was by far the largest snack manufacturer in the world, it was not capturing its "right to win". Local players were not facing a nimble giant but acquired businesses that had kept their old habits. It all changed when Frito-Lay implemented a unified purchasing strategy, starting in 1995.

Once Frito-Lay had established a team of regional purchasing leaders with a global coordination team, they set their sight on the bigger price: build competitive advantage through an extended network of preferred suppliers that accelerate Frito-Lay's international growth and secure its dominance. Market research had identified opportunities to create a strong differentiation based on seasoning and packaging. Unfortunately, the capabilities of local suppliers in many countries were not sufficient to capture that differentiation. Import from the USA was neither practical nor cost effective. Therefore, the best suppliers serving the domestic operations were asked to shape their international development strategies around Frito-Lay's needs in Asia, Latin America and Europe. Seasoning suppliers and Frito-Lay teams worked together to make the winning US seasonings like "Nacho

Cheese” available to more and more countries without incurring the tax penalties of US exports. For packaging, Frito-Lay worked with converters and base film suppliers to introduce in Europe a new technology that preserves much better the freshness of its products. This was not a one-way street, from the USA to the world, as expertise and market intelligence developed in Europe was leveraged globally.

Those initiatives have driven Frito-Lay’s market share outside the USA from about 19% in 1996 to more than 28% in 2000ⁱⁱⁱ. Many competitors like United Biscuit or San Carlos have retreated to their home market.

The benefits of integration: Leveraging Shared Information

Dell has erected price advantage versus its competitors like Compaq, HP and IBM as a cornerstone of its strategy. While doing so, it has managed to remain profitable, while its competitors slipped (Amongst the top 6 US PC makers, Dell was the only one to report a profit for the first quarter of 2001^{iv}). Dell’s supplier management approach builds competitive advantages. For instance, to optimize its supply chain, Dell is communicating directly to its suppliers the status of its inventories and customer purchases, to help its suppliers optimize schedule and avoid costly overproduction or overtime runs. Recently, one of Dell’s suppliers was quoted mentioning that Dell was the only PC manufacturer with such a system. The next step for Dell is to move beyond collaborative planning to joint design and keep widening the gap with its competitors^v.

In a similar move, large retailers can give their suppliers access to point of sales information, allowing them to have instant update on sales and stock depletion to plan replenishment more effectively. They leverage their supplier knowledge of different retail formats to emulate them in their stores, improving appearance, product access, etc.

What It Takes To Succeed: Your Organization

This approach to supplier management may sound obvious to some. But, as we have seen in the automotive industry, there is a gap between the words of senior executives raving about “win-win” partnerships with their suppliers, and the actions of the purchasing managers under constant pressure to cut costs. Can the automotive majors master the latest tricks in metallurgy, electronics, plastics, performance components, etc.? Who drives innovation? Who drives differentiation? When you generate all your innovation internally, focusing on cost is fine, but when technology constantly brings opportunities to differentiate, improve your products, you must rely on strategic suppliers. So what does it take to enable your organization to capture competitive advantages through your supplier relationship?

Strategy

To achieve those results, Purchasing must participate in the agenda setting of the company. It must be viewed as the primary tool to develop suppliers, challenge demand and help other functions optimize their needs. It must have high aspirations aimed at shareholder value creation rather than pure cost impact. The Chief Purchasing Officer must be formally chosen, mandated and empowered to do so.

Supplier development is a building bloc of your long-term strategy. You would not stop investing in a high potential development to satisfy short-term objectives. Rather, you communicate the expected long-term returns. Similarly, your supplier development efforts are long-term investments in human resources and money. Evaluate them like an investment plan, with annual contribution tracking and demanding targets. To do that, you must set up the right measurement system to track supplier performance.

At least twice per year, Purchasing, Marketing, Operations, Sales and Product Development leaders must work together to identify potential sources of differentiation from suppliers. New solutions from suppliers are analyzed for their ability to create exclusivity; then Purchasing works to create a privileged relationship with that supplier and maintain that exclusivity as long as possible. New, unsatisfied market trends are discussed with Product Development, Purchasing, and privileged suppliers to develop new approaches that satisfy them. The supply of difficult-to-obtain raw materials is forecast based on expected company and market growth as well as specific competitor’s needs; Purchasing works on securing most favorable access to that material by collaborating with suppliers to isolate their joint relation.

During those discussions, products and services that have a high impact on consumer perception but are easy to obtain must also be discussed. There may be opportunities to extend the scope of the sourcing relation, considering supplier manufacturing and logistics, to change a product from a commodity to a differentiator.

Structure

To be able to act at the Strategic level, Purchasing must have a unified, central organization with responsibility over all strategic sourcing activities. Some functional leaders will argue that suppliers generating strategic advantages should be managed under their leadership. This would ignore the benefits of systematic supplier management, with scorecards, cost modeling, and other analytical tools that professional purchasing can deliver. It would also scatter purchasing expertise across functions and sites, preventing development and transfer of world-class supplier development expertise.

To apply the strategy outlined above, to make a central structure effective, its leaders must be “top-notch”. Who are the lead category buyers? Could they be promoted to a marketing or finance position, lead a business unit? Or are they trusted collaborators with limited potential? Do they lead a team of aggressive, creative associates or a team of under performers waiting for retirement?

Unfortunately, still today, many organizations do not staff their purchasing with their best and brightest. Purchasing must be credible when working in team with other functions. Some of the most promising staff, entrepreneurial, capable of selling ideas, understand marketing and operational constraints, should pass through purchasing and eventually lead purchasing.

The typical skills expected from top purchasing teams, like negotiation, attention to details and analytical skills are not sufficient. Capturing strategic supplier contribution requires internal and external networking capability. It requires a broad understanding of all the sources of competitive advantages that a general management executive can have. So the top purchasing team must understand Marketing, Financial Analysis, and others. They must be well rounded executives rather than technical experts.

The examples above show that supplier provided competitive advantages are always the result of a multi-functional approach. Marketing, Strategic Planning, or Supply chain teams work together to unlock the value of a supplier relationship. Therefore, Purchasing must be viewed by all functions as a contributor to profit improvement and competitive position by leading cross-functional and cross-organizational efforts. This means that the Chief Purchasing Officer is one of the most senior leaders of the corporation, participating in Strategy Development. The Chief Purchasing Officer is on par with the head of Sales and Marketing and other key executives.

Suppliers

Your Purchasing team is empowered, staffed with top talents, operating globally. But what about your suppliers? If they do not understand you, insist on treating all players in the market equally, or worse, have already a privileged relation with your competitor, your opportunities are limited. Watch for changes, as your supplier management team evolves, but focus your energy on other suppliers.

Both you and your supplier must believe in the benefits of a partnership. You are willing to analyze total value generated, focus on the levers that maximize it, and share the bounty according to resources invested. This should not foster complacency on either sides, but rather a long-term vision to generate above industry standard profits for both partners.

Purchasing must have a highly ethical approach to suppliers, to identify their potential as long-term partners. Focus your efforts on creating a community, an extended enterprise that shares your objectives and considers your competitors as their competitors, your customers as their customers. Partnerships are not developed on the golf course and in three stars restaurants, but by entrepreneur-minded, analytically driven teams. Keep the meal as a reward, to celebrate success. The game is played by investing volume and market knowledge with the suppliers to obtain rights to the advantages they provide, rather than investing capital in a vertical integration strategy.

System

Obviously, Purchasing must be enabled by a system that allows a global understanding of the spend and the total cost of ownership. It must include the monitoring of supplier performances along multiple criteria. Typical supplier evaluation focuses on price; it adds elements of service and quality, and then blends them with a weighing formula, to arrive at a composite result. To drive a program aiming at developing competitive advantages, you need a more rigorous translation of the need, vision, etc, into accurate measurements, quantitative, etc. that encompasses all the elements of the strategy. It must include assessment of the cultural fit, convergence of objectives, sustainability of the relation, etc.

Conclusion

Concentration in many industries and the lowering of trade barriers have removed the price umbrella provided by marginal players. Most likely, the remaining competitors have their tactical operation effectiveness similar to yours. So you must lead your operation teams to focus on capturing differentiating competitive advantages. Purchasing is the most promising area to capture a sustainable lead in your industry.

The principles illustrated in this article may appear simple. Nevertheless, after years of focus on cost, and in organizations where each function works too much in isolation, this transition is a challenge for the top executives of most leading corporations. Top executives must realize that focusing too much on price variance as the key metric of supplier performance will discourage broader, more strategic thinking. In this recessionary environment, it is a bold move, and a great opportunity. It is never too late to start, but in this field, it is difficult to catch up. Once the prime properties in the supplier leverage game have been captured, they rarely change hands. Today is the right time to make the capture of supplier provided competitive advantages a prime focus of your organization.

i McDonald annual report 2000

ii US Consumer Product Safety Commission, Release #01-144, May 7, 2001

iii PepsiCo 1996 and 2000 annual reports

iv Wall Street Journal June 8, 2001

v Wall Street Journal Europe, June 8, 2001