Strategic Sourcing Implementation

Andrew Gager, CPIM

Purpose

Life Cycle Engineering (LCE) firmly believes that every client whether a single site or multiple sites, has the ability to leverage their spending to strategically position themselves for competiveness, cash flow improvements and bottom line profitability. This paper outlines the major steps taken to successfully implement a strategic sourcing operation. Once this approach is understood, interpreted and committed to, an organization will be better prepared for the challenges and ultimate rewards of strategic sourcing.

Why Implement Strategic Sourcing Processes

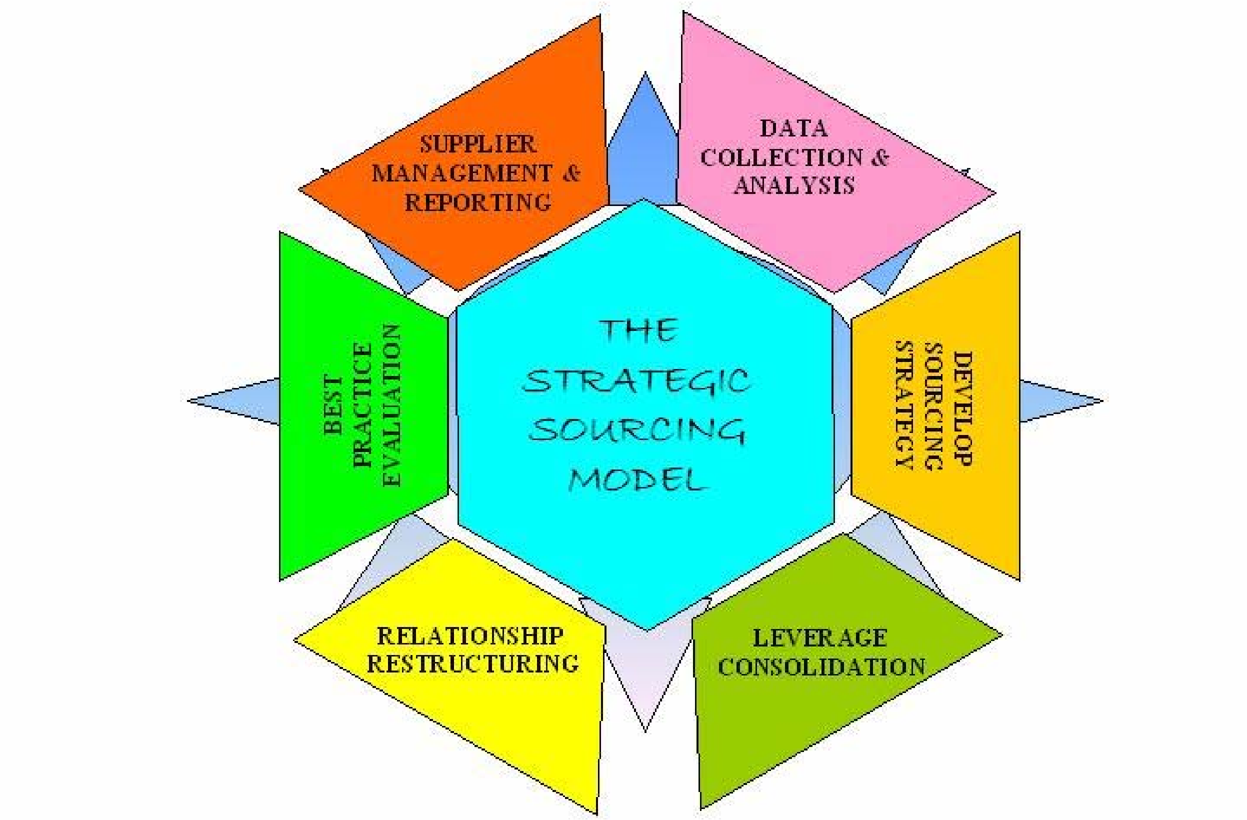
Estimates show that mid-sized US companies miss the opportunity for supplier savings in excess of $134 billion due to inadequate sourcing competencies (1). This much money left on the table could mean the difference between profitability and bankruptcy. There are two views on Strategic Sourcing. On the operational side we have benefits such as cost improvements, cycle time reductions, improved inventory turns, transaction reductions, higher service levels, inventory reductions, improved quality initiatives, etc. On the strategic side we have increased profitability, competitive positioning, improved reaction time to market conditions, utilization of supplier expertise, outsourcing possibilities, true partnering with suppliers, etc. World-class companies that have successfully implemented Strategic Sourcing recognize that a strong commitment internally, partnered with an innovative supplier base, are a valuable part of an organization that focuses on reducing waste, non-value added activities and costs.

The Strategic Sourcing Model

The Strategic Sourcing Model is based on a series of activities that must take place in order to be successful. Without following through all the necessary steps to discover where the spending trends are and where opportunities lie, we are simply purchasing in traditional ways. Companies that have implemented Strategic Sourcing policies report a reduction of inventories between 50%-70% (2)

© Life Cycle Engineering ®

The Strategic Sourcing Model



The six step Strategic Sourcing Model above links the entire process together from Data Collection and leveraging that data through Supplier Management & Monitoring. Each step has very specific needs and requirements that will be discussed below.

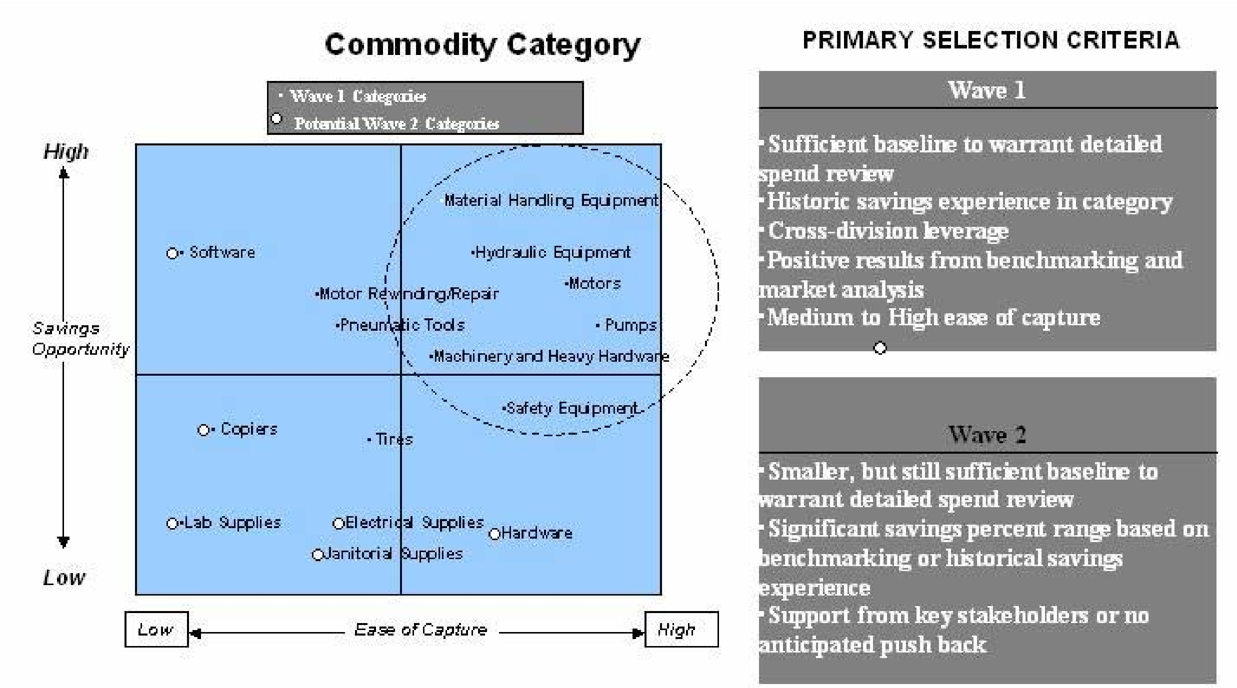
STEP 1 – DATA COLLECTION & ANALYSIS

At this step, the entire inventory is evaluated for similarities and broken down into commodity categories. There is significant "Data Scrubbing" at this initial stage. Part numbers must be accurate; part descriptions must be "Smart" coded for easy search criteria; obsolete materials identified and disposed of. Once this is completed then a listing of commodities is agreed to and the inventory is then broken down and placed in those "Buckets". In affect, the CMMS or ERP system must be cleansed before any other step.

After the "Data Scrubbing" is complete then a history or baseline can be developed. This is crucial in order to make informed and intelligent decisions going forward. The data can be examined to determine buying patterns, one-time purchases, high volume buys,

© Life Cycle Engineering ®

what volume is with what supplier, etc. From this baseline the needs can then be determined. Needs being where the biggest or greatest opportunities lie.



The above model can be used to decipher the data and examined to make decisions where to concentrate efforts. In the first cut or wave, certain criteria are used to determine the largest opportunities including whether enough data is available to make a business decision and if used across divisions or departments, can a business case be rationalized to move forward, etc.

Now we've identified the commodity, baseline data, opportunity and made a business case to support our efforts. The final step in this process is to clearly identify the specifications for each item in that product category. If we are to leverage our spending and negotiate preferential contracts, then we better understand what exactly we are buying. For instance, health and safety laws differ from county to county, state to state and absolutely, country to country. If the decision is made to purchase safety equipment from an offshore source, it must meet all country, state and local laws.

© Life Cycle Engineering ®

STEP 2 – DEVELOP SOURCING STRATEGY

After all the research, data analysis, specification development and commodity classifications, the next step is determining the sourcing strategy that will be used. The decision as to what to buy, where to buy and how to minimize risks is next. It's not as simple as finding a supplier with the lowest price. We need to consider total cost of ownership as well. Offshore sourcing is becoming a necessity in today's global economy. Companies must look at opportunities outside of traditional borders to maximize margins and profitability and assure no interruptions to the supply chain. If the decision is made to go off-shore for sourcing, know the supplier and the risks involved including current technology knowledge, communication, government stability, currency fluctuations, etc. Included in the total cost of acquisition and management of risks are:

Material Cost: Including unit price, set-up, tooling, transaction and other costs associated including currency fluctuations.

Transportation Costs Transportation, fuel surcharges and other fees included in a freight rate (F.O.B. shipping point or Dock?).

Inventory carrying costs Warehousing, handling, taxes, insurance, depreciation, shrinkage, obsolescence, and other costs associated with maintaining inventories, including the cost of money or opportunity costs.

Cross-border taxes, tariffs, and duty costs
Often referred to as landed costs, which are the sum of duties, shipping, insurance and other fees and taxes for door-to-door delivery.

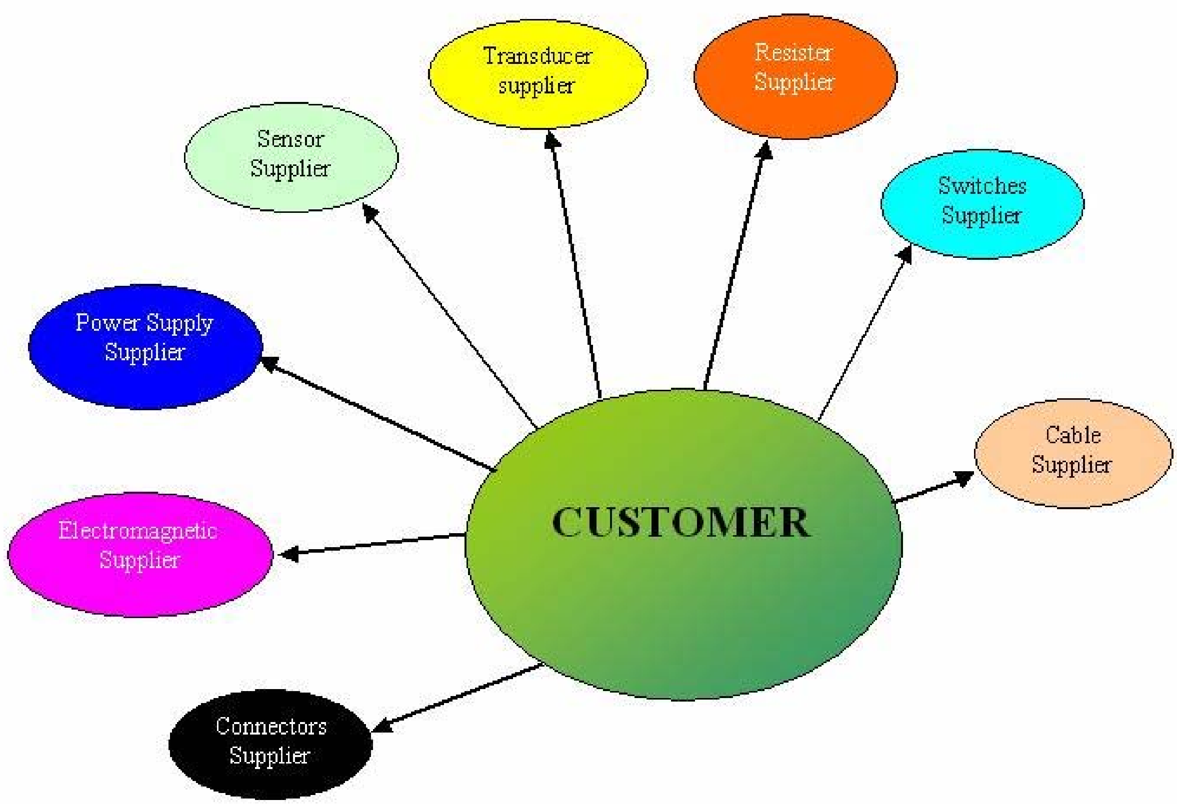
Supply and Operational Performance
The cost of noncompliance or underperformance, which, if not managed properly, can offset any price variance gains attained by shifting to an offshore source.

Supply and Operational Risks
Including geopolitical factors, such as changes in country leadership; tariff and policy changes; and instability caused by war and/or terrorism or natural disasters.

© Life Cycle Engineering ®

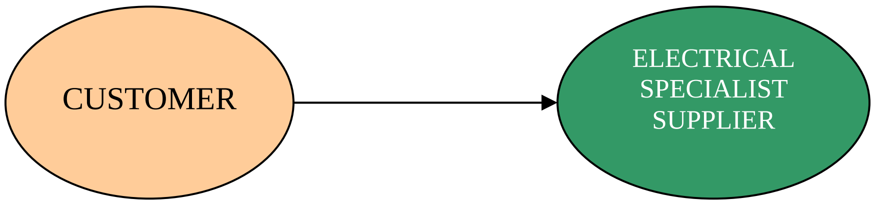
STEP 3 – LEVERAGE CONSOLIDATION

Leverage consolidation is simply taking the data that has been collected, analyzed, commoditized and identifying trends for family product lines, substituting like products for less costly ones, reducing supplier base, etc.



Having multiple suppliers provide what otherwise could be classified as a commodity is not strategic sourcing. This is the classic traditional purchasing model, many suppliers specializing in one focus area. Performing steps 1 & 2 above would yield this information. Data analysis would track how much we're spending on electrical componentry and amount spent with each supplier. By combining all electrical purchases across all divisions and/or departments we begin to see the benefits leveraging aggregate pricing discounts, transaction cost reductions, preferential payments terms, etc. Moving towards a single source supplier begins the process of true partnership. As they say: What's good for the goose……..

© Life Cycle Engineering ®



STEP 4 – RELATIONSHIP RESTRUCTURING

We've done the research, data analysis, specification development, and commodity classifications, determined the sourcing strategy and consolidated family products lines. Now we're ready to move into the bidding, supplier selection process and negotiations for a successful relationship. Successful strategic assessment will develop an understanding of the market. Strategic Professionals will therefore understand the true importance of the supplier, the balance of supply and demand, new entrants into the marketplace, consolidations, alternatives, supplier capabilities, and overall strategic alliances. Once this is achieved then the ultimate "Lowest Total cost of Ownership" will be achieved.

The package is put together for any specific commodity. It is time to send out for bidding. Today's electronic E-Commerce opens the door to a whole new world. The marketplace is no longer defined by geographic constraints. An operation in East Littletown, USA can compete with the world commerce on a level playing field with the invention of the Internet and E-Commerce now. Research to find the appropriate portal or B2B website for your specific needs. Below is a short listing of some useful starting points:

- http://www.exportbureau.com
- http://sources.sourcetool.com
- http://www.manufacturers.com.tw/
- http://chinasuppliers.alibaba.com

The identification of suitable suppliers is as critical as any other step. You can negotiate the best price, delivery, payments terms, etc but if the supplier isn't stable or in partnership then what good will great pricing do for your company? The following are suggestions for seeking out a suitable supplier:

- Strong commitment to environment, health and safety
- Lean manufacturing & 5S principles are in place and visible
- Cost competitive culture
- Financially stable
- Progressive management—clear and visible metrics
- Understands and uses Web-based paperless systems
- Registered ISO or QS certifications

© Life Cycle Engineering ®

- Actively seeks solutions to problems without your intervention
- Commitment to your organization’s requirements 24/7
- Willingness to share ideas and processes improvements

We’ve nearly completed a full 5S strategic sourcing exercise. All the steps have been taken to **S**ort, **S**tandardize, **S**trategize and **S**tudy. Now we’re ready to select the best **S**upplier. First step is to negotiate the total cost of product. Using the previous steps we should have a clear understanding of what we want at what price and when. Before the meetings between customer and supplier even begin some basic negotiating skills must be assured.

1. Do Your Homework- Know who you’re negotiating with prior to the meeting and know what you want.
2. Anticipate-The smart negotiator tries to anticipate what the other party thinks you want
3. Build Trust-Negotiation is a highly sophisticated form of communication. Without trust, there won’t be communication.
4. Know your BATNA-”Best Alternatives To a Negotiated Agreement”. Before you begin a negotiation, know what your other options are.
5. Know what a “Win/Win” situation is-Your both in the business to make money. If you can reach an agreement within your settlement range, that’s a Win!

STEP 5 – BEST PRACTICE EVALUATION

One of the most critical steps that companies fail to try is to renegotiate prices and payment terms. There is no harm in asking. You don’t get what you don’t ask for. Remembering that your supplier is in business to make money, squeezing the last nickel from them is not a best practice. There are other options that benefit the operation. Negotiate preferential payment terms. Change from FOB shipping point to FOB dock. Look at capitalizing on deliveries that best suit the operation not for their convenience. Measure total inventory value and break it down by costed inventory vs. consigned or Vender Managed Inventory (VMI). The higher the consigned or VMI is the better your managing your inventory. Freight is a very big cost because of recent increases in oil. Negotiate with your carriers on the fuel surcharge percentages. Clearly document the baseline cost the freight company is using for a gallon of diesel. Negotiate percentages from that baseline and discuss rebates. Have an open conversation with them and ask if they have other customers using the same lanes as you are and negotiate a “piggyback” fee instead of an LTL charge (less than truckload).

© Life Cycle Engineering ®

Issue credit cards for small MRO purchases instead of issuing a PO for each order. It makes good business sense to process one check for many low cost items as opposed to many checks for many orders.

Use on-line or e-commerce B2B portals to get best pricing and research a broader assortment of suppliers. More and more companies are using the Internet to do business. E-commerce decreases the cost of processing purchase orders and ultimately overall costs. The chart below reflects the trend of Internet usage for online purchase orders.

Average cost of placing manual PO:	$82.00
Average cost of placing PO via e-commerce:	$8.00

STEP 6 – SUPPLIER MANAGEMENT AND REPORTING

Track results and restart assessment ***(continuous cycle)***

- **Track % of total spending with your strategic suppliers (including capital expenditures)**
  This is a wonderful tracking measurement as it tells you whom you're spending your money with. This instantly communicates who your largest suppliers are and what percentage of expenditures are spent and where.

- **Track & trend total number of suppliers**
  This will indicate how successful you are at strategically aligning your buying power(leverage).

© Life Cycle Engineering ®

- **Track price increases vs. CPI (Consumer Price Index)**
  Are the price increases your supplier passing on to you higher or lower than the consumer price index (CPI)? This is a very good indication if your supplier is actively pursuing cost reductions, process improvements, self imposed strategic sourcing policies, etc. A bit of caution on this metric, prices may be increasing because of the current cost trends of raw materials. This should be taken into account and can be verified by checking the Wall Street Journal for current raw material pricing and trend analysis.

- **Purchase Price Variance (PPV) tracking.**
  Is what was quoted what was invoiced? Other than the obvious cost discrepancy there is additional cost to the business when the invoices don't match the purchase order. The process to correct intertwines from accounting to purchasing through the supplier. Few companies truly understand the associated costs with PPV's but costs many organizations in manual labor.

- **Track % of PO's manually vs. e-commerce**
  As noted earlier, this measurement is very important and can be tracked. Very few companies know how much it truly costs to place a purchase order. It simply is not placing an order over the phone. The real cost incurred from the time the need is discovered to when accounting matches the invoice with the PO and makes payment. IBM put a cost of $120 per order, Raytheon Corp an $86 average cost per order and Kodak justifies $102.00 a purchase order. Now all three average less than $10.00. As noted previously, the average manual purchase order cost is $82. After implementing a strategic sourcing and e-commerce based system that cost drops to $8.00. You can see the immediate cost benefits and reduction.

- **On-time delivery**
  One of the most important indicators of how well your supplier is performing is when the order hits your dock. Not only is it critical that your suppliers meet the expected delivery but the order quantity as well. The best planning can go south real quick if the order that you were expecting is late. It costs money to schedule the labor, equipment, contractors, etc. If the supplier fails to meet their obligation then there is a cost associated with that. Early shipments are just as bad. You're not in the business to pad your salesmen monthly numbers or for your supplier to meet their revenue goals by shipping everything before the end of the month. Same concept applies to quantity accuracy. If the order is for 100 pieces and your supplier short ships then there is a cost associated with that with regards to min/max levels, reorder points and potentially short shipping your customer. It also goes the other way as well. Over shipments are not acceptable. There is no quicker way to increase your supplier's sales by accepting anything over the order quantity. Accept the original order and thank your supplier for the extra samples. There is a high probability that your supplier will not over ship again.

© Life Cycle Engineering ®

SUMMARY

The six steps of implementing strategic sourcing has been outline above. There is work to be completed before the benefits are realized but once captured, has the ability to make a significant impact to the bottom line of an organization. Critical to the successful implementation starts with data collection and categorizing the products lines. After that has been completed a business decision can be made based on facts as to where the greatest opportunities lay. Selecting and negotiating with the identified suppliers is an integral part of the supply chain management and offer unique opportunities. Today's marketplace is not just based on who has the lowest cost but lowest cost of ownership. After the sourcing strategy decision has been made, where to go and with whom, the management of that decision must be tracked. Measuring the supplier based on performance benefits both parties and clearly defines the expectations of each. It is vitally important for companies to elevate the awareness and criticality of sourcing within the organization. Implementing the six steps of Strategic Sourcing will assure that organizations are proactively managing their operations.

References:

(1) www.purchasing.com/strategicsourcing/statistics
(2) www.purchasing.com/strategicsourcing/statistics

© Life Cycle Engineering ®