

Sourcing: Realizing the Value



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The Booz·Allen & Hamilton
Sourcing Team

Despite record gains in productivity and ever increasing customer choice, most companies today fight hard to retain prices, differentiate their products, and improve their margins. Many solutions—from downsizing to business process redesign—have been offered and tried with varying degrees of success. Over the decade of the 1990s, however, corporate executives have increasingly recognized that their companies' purchasing practices hold enormous potential for creating value and improving their bottom lines.

Why it has taken so long for purchasing to reach the CEO's agenda is somewhat puzzling since outside purchases of materials and services account for so much of a company's total cost. In fact, as early as 1982, Peter Drucker declared: "Nowhere in business is there greater potential for benefiting from...interdependence than between customer firms and their suppliers. This is the largest remaining frontier for gaining competitive advantage—and nowhere has such a frontier been more neglected."

While many companies have identified their sourcing functions as a key element, if not the linchpin, in creating value and improving their bottom lines—and some, in fact, have benefited significantly from enhanced sourcing practices—most have not realized their full sourcing potential.

This *Viewpoint* explores the reasons some companies have fallen short and why others have achieved some measure of success. It also distills those experiences in a set of six key lessons learned for optimum sourcing.

Finally, it presents a short self-assessment questionnaire to help readers think about where they stand on the continuum of tapping into sourcing's value creation potential and offers a set of principles to help guide the development and structuring of a strategic sourcing initiative.

The Gap: Sourcing's Potential and Realized Savings

Too many companies, when assessing their own sourcing programs in the light of best practices, assert: "We're already doing that." While they may honestly believe they are "doing that," empirical observation suggests that many lack a complete understanding of the full dimensions of sourcing's potential or they have not executed well enough to realize the full value.

The result is usually a large gap between the potential and what has actually been achieved. Even companies that claim significant cost savings through sourcing improvement programs, frequently bring only 20 to 30 percent of the identified opportunity to the bottom line. By exploring the full dimensions of sourcing, we can better understand why some companies have fallen short and others have succeeded.

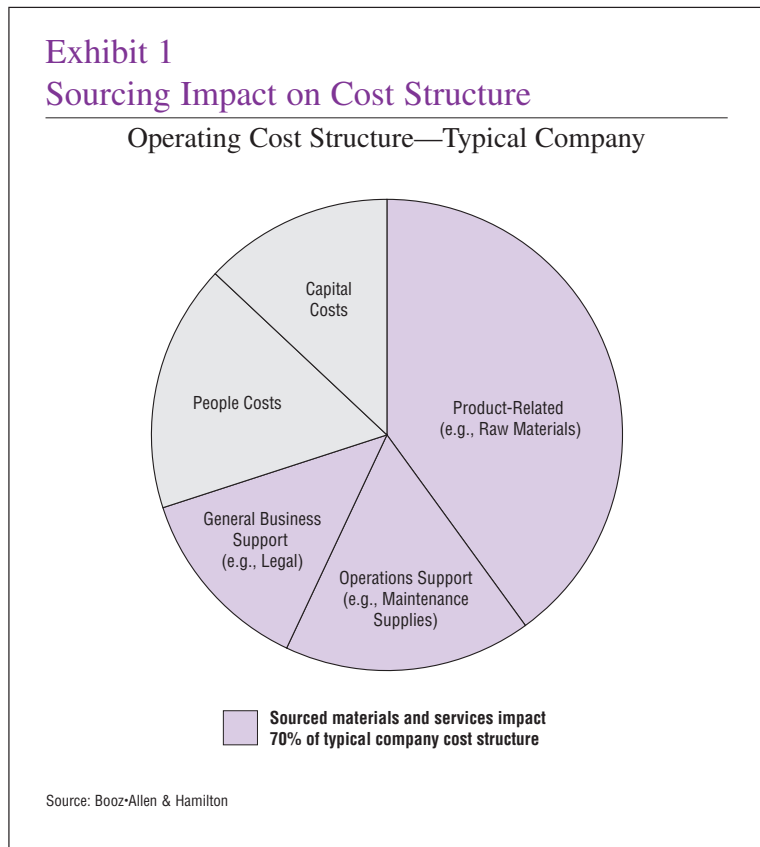
Sourcing Scope

The gap between sourcing's potential and the results achieved can often be traced to focusing on too narrow a set of sourcing objectives—driven perhaps by misaligned performance measures or other organizational priorities. For example, many companies have addressed product-related sourcing opportunities by rationalizing their supply base for raw materials and components that go into the end product. These companies have saved significant amounts by better leveraging their volume across fewer suppliers and reducing transaction costs. Product-related sourcing, however, often represents only about half of a typical company's outside purchases (Exhibit 1).

Companies that do not aggressively address sourcing opportunities in non-product related areas miss tremendous opportunities. In one client example, Booz•Allen assisted a global corporation in realizing sourcing potential in non-product related areas that ranged from operations support materials and services, such as maintenance, to business support services, such as legal services. The total non-product related spending, which had not been universally subject to sourcing disciplines, was more than \$7 billion worldwide. Through improved non-product related sourcing practices, the company is currently pursuing a \$1 billion savings, which is being delivered to the bottom line—with no major disruptions, such as layoffs or massive restructuring. Additionally, service to internal customers of these products and services are realizing improved levels of support, dispelling the concerns that the exercise could cut costs but also disrupt business.

The failure to look at sourcing broadly is often driven by the fragmented nature of accountability for non-product sourcing, which is usually spread over many departments and budgets. For example, one company’s non-product related purchases of more than \$3 billion were spread across fifteen business units and three continents.

This occurs for a variety of reasons. One seems to stand out in particular: internal customers do not become fully engaged in the process. They see sourcing



initiatives as a purchasing issue, not an overall organizational responsibility, which greatly limits any sourcing program’s ability to realize its full potential.

Bottom Line Results

Another factor that contributes to the sourcing potential gap is the failure of top management to insist that identified opportunities be delivered through to the bottom line. In several companies where substantial sourcing savings have been achieved, the “owners” of the “businesses” that achieved the savings have simply used the “surplus” generated from sourcing on other activities. This obviously results in no bottom-line savings.

Companies that do see bottom-line results, however, ensure that the business unit managers build projected sourcing savings into their budgets and are therefore highly motivated to meet—or beat—the targets. Often it’s not until the CEO insists on addressing these issues that significant value has been realized. One CEO, after working with internal experts and Booz•Allen & Hamilton to assess the potential, demanded double-digit budget reductions for non-product related expenses. Business unit heads, who initially tried to fight the target unsuccessfully, were surprised at the results achieved simply by challenging their organizations to deliver.

Supply and Demand

Another reason some companies do not achieve full sourcing value is their focus on finding savings opportunities exclusively by trying to squeeze suppliers. Although they achieve results through rationalizing the supply base and leveraging volume, they do not address opportunities on the demand side. Much of the cost of sourced materials and services is locked in by internal requirements and specifications. Simply rationalizing suppliers fails to address the full range of factors that can drive costs down. For example, one company demanded that only experienced lawyers could perform certain types of work, although the industry practice was to use paralegals at a much lower cost. Even though the company had rationalized the number of law firms it used, it did not realize greater value until it challenged its own demand requirements. In many cases, modifying these company “demand side” activities delivers 50 percent—or more—to the full savings potential.

This one-sided supplier orientation also misses opportunities to truly optimize sourcing across the entire supply chain. When sourcing is viewed mainly as squeezing money from suppliers, companies can miss opportunities to better balance value-added activities between themselves and their suppliers. Automotive companies have generally learned how to determine which activities they should perform and which are better done by suppliers. For example, instead of placing specific orders for components with suppliers, many auto companies share vehicle production schedules and let the supplier decide exactly when to produce component parts. This greatly reduces inventories and eliminates numerous other inefficiencies across the supply chain.

Proven Sourcing Techniques

Many companies lose sourcing potential when they do not apply proven sourcing techniques effectively. For example, when setting objectives for sourcing, many companies employ cost-based or price-based targets rather than value-based targets. Price-based costing simply compares a supplier’s offering to others and sets targets based

on the lowest price offered. However, lowest offered price is not necessarily the optimal price. Different specifications, different suppliers and different working arrangements can all lower total costs in addition to prices.

Cost-based targeting, made infamous by government “cost-plus” targeting, has been evolved within many open-book relationships so that companies and suppliers jointly pursue cost-reduction opportunities. While effective and appropriate in many cases, these cost-based approaches may yield only incremental improvements.

Value-based targeting, on the other hand, has generated tremendous value in many situations, though few companies appear to do it well. This approach sets the target based on the value of a supplier’s contribution to the end customer. For example, the original Swatch used a plastic casing for its watches because many customers planned to discard the product when the battery died, and thus would not value a more expensive but longer lasting metal casing. Value-based targeting is only one example of the many leading-edge sourcing techniques that, when applied properly, can generate significant results.

Leveraging Supplier Capabilities

Supplier capabilities are rarely fully utilized to deliver maximum value. Companies that do leverage suppliers have realized significant benefits—in their end product/service value, time to market, and cost reduction. For example, one Booz·Allen client quadrupled cost savings in product redesign by leveraging supplier input (Exhibit 2).

Successful companies define and implement systematic efforts to appropriately integrate suppliers into product development activities. They also sell supplier input in areas not related to product design or production. This is particularly valuable in areas where suppliers' expertise is deeper and broader than the company's.

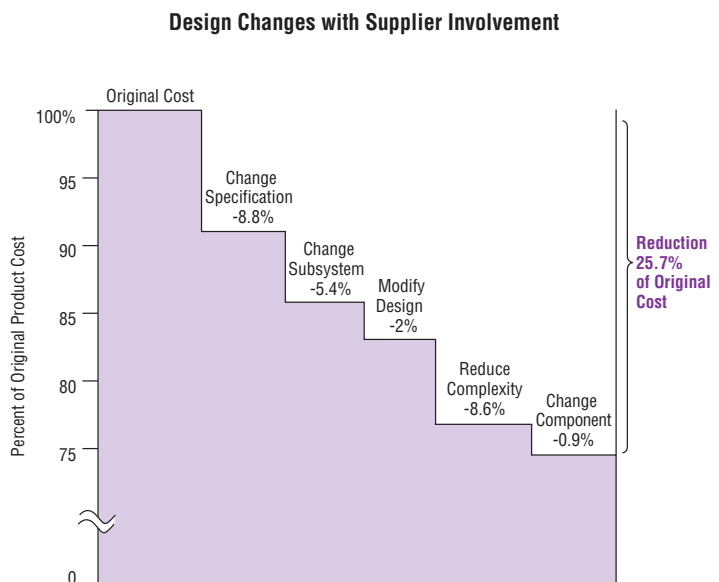
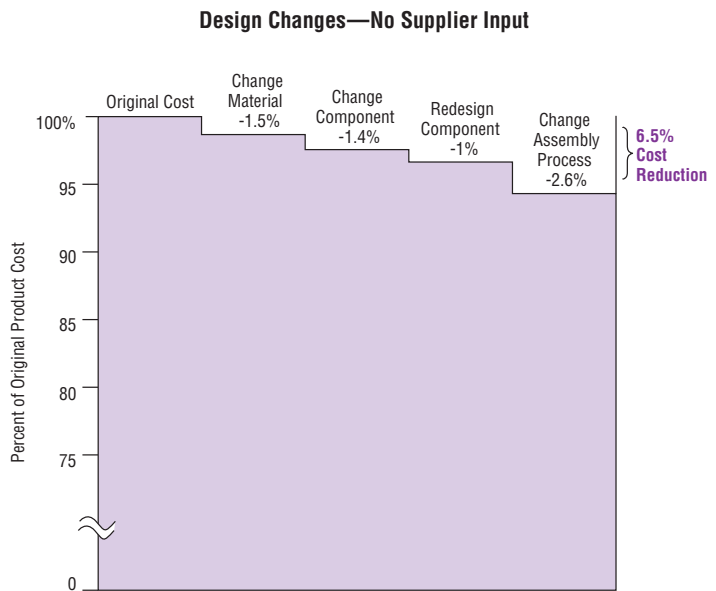
For example, many companies in the United States look to facilities and real estate management firms for advice on helping internal customers select appropriate solutions to their needs.

Allowing suppliers to contribute fully yields significant reductions in cost when using the right suppliers in a business relationship that ensures goal congruency.

Leading companies are also creating global networks of current and potential suppliers to support worldwide operations and to ensure access to the breadth of capabilities needed. Traditionally, companies have developed a supplier base that is local or regional, and occasionally global if dictated by

Exhibit 2 Cost Savings Through Supplier Integration

Booz·Allen Client Example



market needs. Proactive global sourcing allows companies to engage with current suppliers in continuous improvement, while exploring opportunities for new supply bases.

Sourcing Capabilities

Companies who fail to realize sourcing’s full value often do not understand the need to invest in and build internal sourcing capabilities. Many have conducted “strategic sourcing” or “supplier reduction” projects, which generally result in one-time savings—savings which usually slowly erode over time.

In order to capitalize on the potential value of sourcing, companies must nearly always upgrade their internal capabilities by building and sustaining new organizational skills, business processes, and information management resources. While the need to enhance organizational skills clearly includes the purchasing function, it also extends to broadening and improving skills in many other areas—design, engineering, and manufacturing in particular.

Based upon client experience and research, Booz•Allen identified a set of six organiza-

tional capabilities that leading companies use to ensure a broad, organization-wide approach to sourcing (Exhibit 3).

Some of these capabilities are universally applicable in any industry, while others—the “differential” skills—are critical only for certain companies or industries. When fully developed and applied appropriately, these skills create what we refer to as “Balanced Sourcing.”

Key business processes for sourcing must also be in place to sustain leading-edge performance. Many companies have addressed their “transactional” sourcing processes—such as placing purchase orders and processing invoices—but many still have not redesigned the more strategic processes including:

- Aligning sourcing priorities to business objectives
- Ensuring broad organizational engagement in sourcing activities
- Developing specific category—or commodity—strategies
- Maintaining an appropriate supply base-global as needed.

Another major obstacle to ensuring sustainable sourcing results is lack of effective information. While many companies have automated the transactional purchasing process, few have successfully built information management capabilities to support more strategic activities. Without these, the ability to monitor progress, identify further opportunities, and successfully leverage suppliers is virtually impossible.

Exhibit 3 Balanced Sourcing Organizational Skills

UNIVERSAL SKILLS

- **Modeling Total Cost**
Underpins the entire sourcing process.
- **Creating Sourcing Strategies**
Drives the critical shift from tactical purchasing to strategic sourcing.
- **Building and Sustaining Relationships**
Focuses on the cooperative dimension of the Balanced Sourcing model.

DIFFERENTIAL SKILLS

- **Integrating the Supply Chain**
Ensures rapid delivery of goods and services with minimal waste.
- **Leveraging Suppliers in Innovation**
Derives maximum value from suppliers in terms of technology and product development.
- **Evolving a Global Supply Base**
Expands scope beyond the home market to find low-cost suppliers or to support global expansion.

Source: Booz•Allen & Hamilton Sourcing Practice

Lessons Learned

Booz•Allen’s sourcing work with clients and our observations of other companies who have not been totally successful in realizing sourcing’s full potential can be distilled into six key lessons learned (Exhibit 4).

Those who do not take these lessons to heart cannot fully realize the value from sourcing; companies that understand them and push forward in all these areas can achieve tremendous results.

Measuring Up Against Your Sourcing Potential

Probing for clear answers to the questions in the condensed “Sourcing Self Assessment” (Exhibit 5) can provide an initial indication of remaining sourcing opportunities.

An in-depth calibration of a company’s sourcing practices determines how completely the sourcing potential has been tapped. This in-depth calibration may require two weeks to two months, depending on the company’s size and scope. Though potentially time-consuming, the time spent in a full calibration can be quite valuable. For example, when applied at one company that was “already doing sourcing,” the identified gaps translated into savings opportunities three times the company’s current target.

Exhibit 4 Achieving Value from Sourcing

Lessons Learned

- 1 Expand the scope of sourcing—cover all areas including product-related and non-product related.
- 2 Demand bottom-line results—make sure the “money on the table” becomes “money in the pocket.”
- 3 Address sourcing activities broadly—look to suppliers as well as internal activities for opportunities.
- 4 Employ appropriate best practice techniques—e.g., value-based targeting.
- 5 Leverage supplier capabilities fully—in product development, for example.
- 6 Build necessary capabilities to sustain results—not just in the sourcing function but organization-wide.

The condensed Sourcing Self Assessment focuses on the first three key lessons learned: breadth of scope, bottom-line impact, and span of activities examined. Calibrating the remaining three elements—employing best practice techniques, leveraging supplier contributions, and building sustaining capabilities—requires closer examination to get a good sense of where a company really stands.

The first Self-Assessment topic—breadth of scope—starts with what seems a simple exercise, adding up the total dollars spent annually on sourced materials and services. Most companies can quickly calculate a number for the product-related category based on manufacturing, purchasing or cost accounting data. However, if this data is not

readily available, this potentially indicates a lack of clear understanding of product-related expenditure—which typically implies a significant savings opportunity.

Calculating the non-product related (NPR) spending is usually more problematic, as it includes a broad range of areas—from plant maintenance to legal to Information Technology services and capital projects. One quick way to estimate this NPR spending is to subtract product-related purchases from the total annual accounts payable volume. While this may overstate the NPR amount because of other items in the accounts payable system (e.g., financial transactions), it provides a starting point. Again, as with the product-related category, a lack of good

Exhibit 5 Sourcing Self Assessment

Objective: To determine if the company is realizing full value from Sourcing

1. Breadth of scope

- How much do we spend annually on procured materials and services?

Product-Related:⁽¹⁾ \$ _____

Non-Product Related:⁽²⁾ \$ _____

Total: \$ _____

- What specific sourcing **actions** have we taken in each segment in the past 1–3 years?

- How much **value** did this generate?

	Product-Related	Non-Product Related
1 Actions	_____	_____
Value	_____	_____
2 Actions	_____	_____
Value	_____	_____
3 Actions	_____	_____
Value	_____	_____
4 Actions	_____	_____
Value	_____	_____
5 Actions	_____	_____
Value	_____	_____
6 Actions	_____	_____
Value	_____	_____
Total Value Created:	\$ _____	\$ _____
Other Value: (e.g., Enhanced Service, Product Features)	_____	_____

2. Demanding bottom line impact of sourcing initiatives

- *What savings level were budgeted last year for sourcing results?*

	Budgeted Savings	% of Baseline⁽³⁾
Product-Related:	\$ _____	\$ _____
Non-Product Related:	\$ _____	\$ _____
Total:	\$ _____	\$ _____

- *What savings were actually delivered last year?*

	Budgeted Savings	% of Baseline⁽³⁾
Product-Related:	\$ _____	\$ _____
Non-Product Related:	\$ _____	\$ _____
Total:	\$ _____	\$ _____

3. Broad look at activities

- *Which of the actions described in "Breadth of scope" heavily impacted suppliers (number of suppliers, contracts, pricing, etc.)?*

- *Which of the actions described in "Breadth of scope" heavily impacted our internal activities (e.g., modifying specifications)?*

(1) Sourcing of materials and services that are direct input into the company's end product.

(2) Sourcing of all other materials and services — A partial list of categories/areas would include: advertising/promotion, capital projects, facilities, information technology, maintenance, repair and operating, telecommunications, and transportation.

(3) Baseline = prior year's spending in this category.

NPR information suggests potential savings opportunities.

Once you have a sense of baseline spending in each category, the next step is to assemble a list of recent significant sourcing effort. This exercise may yield several insights. For example, no major readily identified actions over the past one to three years suggests that a more in-depth look may be warranted. If most of the actions are only in one category (e.g., product-related), then sourcing activities may not be as broad in scope as necessary. Even within a category—say NPR—the actions should span a number of specific areas. Rather than concentrating sourcing activities in one area such as information technology—each year, leading companies muster resources to attack at least several areas.

In companies striving for major sourcing results, the total value of these actions should be significant—running two to five percent of the baseline annual spend in the category. Companies who excel deliver three to five percent per year from sourcing initiatives, so results lower than that level should be cause for further probing.

The second part of the Self-Assessment addresses the issue of bottom-line results. Too often sourcing initiatives promise major savings, which fail to appear on the bottom line. The first question to explore is whether or not sourcing results were actually budgeted, a clear indication of whether the business units sourcing “savings” are spent elsewhere. While re-allocation

of sourcing savings may be appropriate, it should be done explicitly rather than simply absorbed elsewhere in the budget. Many companies completing this Self-Assessment find that little of the value claimed in section one of the assessment ultimately hits bottom-line results.

Finally, section three examines the breadth of opportunities explored—a particularly important issue in early wave sourcing initiatives. Sourcing activities often focus predominantly on the supply side—better leverage, for example. However, realizing the full value usually requires examining and changing internal policies and practices. For example, consolidating advertising agencies saves money, but even greater value can come from better integrating internal marketing processes with agencies to eliminate duplication, speed up the process, and better leverage supplier capabilities. Few significant internal changes in section three indicate that additional review is warranted.

This Sourcing Self-Assessment is meant as a first-cut guide exercise for senior management. Part of its value is testing the familiarity of senior executives with sourcing, impact, potential, and current state within their own companies. Many senior executives are surprised to discover how much of their cost structure is based on procured materials and services. This revelation alone often causes many management teams to charter a sourcing review to current sourcing capa-

bilities, strategies, and execution. If this Self Assessment and the dialogue it generates raise questions about potential untapped opportunities, like others you may conclude that a more in-depth calibration exercise is needed.

In Conclusion

A few companies have deeply tapped their sourcing potential by attacking on a broad front, and driving for deep results. Unfortunately, many companies have conducted sourcing programs that deliver some value, and then declared victory without realizing the full potential. Quickly calibrating your company’s sourcing situation may lead to uncovering those areas where you have further sourcing upside.

Booz•Allen & Hamilton is a global management and technology consulting firm committed to helping senior management improve the performance of their organizations. In more than 75 countries, in hundreds of the world's leading industrial, service, and governmental organizations, our team of nearly 8,000 professionals has one common goal—to help our clients achieve and sustain success.

We help clients in Sourcing by combining our firm's broad business strengths with exceptionally deep Sourcing capabilities. Our industry practices provide a clear understanding of the client's industry dynamics and the client's positioning. Our truly global organization works together seamlessly to support our client's needs throughout the world. Furthermore, our approach to client services focuses on transferring knowledge to build the capabilities for sustainable results.

Our Sourcing capabilities span the breadth of sourcing segments and types of programs.

We have assisted major global clients address sourcing opportunities in all three segments—from Product-Related to Non-Product Related. These programs have encompassed a variety of approaches to improving sourcing—from business process redesign to innovation. We have developed a series of sourcing service offering modules and tool kits to be accessed as needed by the joint teams, and we deliver these services with experienced professionals. Finally, our practical experiences in sourcing ensure leveraging “lessons learned” to provide assurance of achieving results.

Booz•Allen & Hamilton's sourcing capabilities are integrated with our overall service offerings, enabling us to deliver the appropriately tailored approaches and teams. We draw from our wide range of methodologies and techniques to tailor programs to a company's particular situation. We believe that true success occurs when our clients feel ownership for the joint work-product and are committed to sustaining the change over the long term.

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