

FOUR ELEMENTS OF Successful Sourcing Strategies

It's not enough merely to partner with a supplier in the hopes of getting the best possible price. Today, commitment and coordination with a cost-analysis mindset are needed to maximize the supplier-customer relationship.



BY PETER GRITTNER

For many years, companies made decisions about where to buy parts, supplies and services based on one factor and one factor only: price. They were essentially comparison shoppers—soliciting bids from several suppliers and choosing the lowest one. Purchasers often switched from supplier to supplier in search of a better price. They

even shopped work out to several suppliers simultaneously to intensify price pressure and “keep suppliers on their toes.” The relationship was frequently adversarial, often short-term and—as most companies learned—shortsighted.

To meet the challenges of boosting profits, increasing market share and enhancing competitive position in an increasingly global and cost-conscious mar-

BRIEFCASE

Purchased goods and services often account for more than half of total product costs, yet partnering often has meant little more than asking suppliers to open their books or to fill out cost structure questionnaires.

Distinguishing between controlling price and cost is an important first step, but cost analysis goes further. Cost analysis starts with the view from the factory floor.

ketplace, many companies have been rethinking their whole approach to purchasing. Rather than focus on price alone, purchasers are scrutinizing more closely whom they buy from, what they buy and how they order, as well as what they pay. They are looking at suppliers, not as adversaries, but as partners in cost-reduction programs. By partnering with key vendors to reduce costs, some companies have managed to shave millions off their bill for purchased goods.

"Supplier partnerships" has become a hot

corporate slogan, and "supply chain management" an increasingly important approach to reducing costs, particularly in manufacturing. Most manufacturers now spend 50 percent or more of their revenues on purchased products and services, and that amount has been growing since the '80s as companies have outsourced more and more work.

Still, partnering relationships with suppliers have met with mixed success. Some companies find that anticipated savings aren't realized, or that new approaches don't hold. In other cases the so-called "preferred suppliers" wind up disgruntled, feeling that for them "partnership" has meant little more than opening their books to a customer, only to be told: "cut here." Other companies find that while they do realize savings from vendor partnerships, the savings are marginal or are "one-time hits" that can't be replicated year after year. Why the mixed results? What are the key ingredients to a successful sourcing strategy?

Based on our studies for General Electric, Corning, Amoco and Whirlpool, it's clear that partnering with key vendors is an important piece of the cost-reduction puzzle, but it isn't the only piece. Partnerships need a strong foundation to work and sustained momentum to last. The most successful sourcing strategies are built around four key elements: competitive suppliers, commitment, coordination and a cost-analysis mind-set.



COST-ANALYSIS MIND-SET

What is a cost-analysis mind-set? It is a broader, more strategic way of thinking about supplier economics: what drives their material costs, production cycles and staffing patterns, what affects their inventory and other carrying costs, and how manufacturers' product specifications and sourcing practices influence those costs.

Distinguishing between controlling price and controlling cost is an important first step, but cost analysis goes further. Rather than looking at cost from the line-item perspective of accounting, cost analysis takes the view

STORY ONE

A New York equipment manufacturer decided to introduce a more analytical approach to its supply-chain management, with the goal of reducing procurement costs of filters, an important but expensive component. The New York firm was happy with the quality of its supplier's product, but felt it was paying too much for the part.

A team of experts and managers was put together, visited the supplier and explained the study goal: to better understand the functions, activities and demands that added cost to the filter they built, and to explore potential avenues for reducing those costs. Based on a commitment from the manufacturer that the supplier would be a partner in the strategy and would share in any cost-savings measures that emerged, the supplier agreed to cooperate.

The team toured the supplier's operation, tracking each step of the production process: raw materials cost, direct labor, equipment usage, set-up time, order processing, production planning and overhead costs. It became obvious that the direct-manufacturing costs were a fraction of the total product costs—about 30 percent. The other 70 percent was buried in the contribution margin supporting the indirect functions of marketing, developing, engineering, testing, packaging and shipping the New York firm's filter. But which indirect functions added the most cost, and why?

To answer that question, the team met with engineering staff, production managers, quality inspectors and other personnel—including top management—involved in servicing the New York company. They learned that much of the indirect costs were attributable to two factors: erratic and inefficient ordering patterns, and excessive and redundant post-production specifications for quality measurement and testing.

By making long-term volume commitments, improving forecasting, coordinating order size and altering quality specifications that were inefficient or overlapping, the team was able to reduce total product costs from \$7,300 to \$4,000, a 46 percent savings.

from the factory floor, focusing on manufacturing and design technologies, production planning, workshop-level loading, product-mix scheduling and other drivers that determine the total cost of production, from the supplier's shop floor to its customer's shipping dock.

When sourcing strategies are driven by an understanding of the total cost of the supplier-customer system, manufacturers can begin to think of their suppliers as extensions of their own manufacturing process and to collaborate on everything from design specs to production volume planning to ordering patterns. Potential savings from this approach are far greater than the 2 percent to 3 percent annual reductions that incremental approaches usually achieve: Cost-focused sourcing strategies can lead to total system redesigns or product reengineering that produces savings on the order of 10, 20 or 30 percent—sometimes even more. The case on page 42 demonstrates how a cost-analysis mind-set can help manufacturers and their suppliers isolate previously “invisible” cost drivers, and by doing so target opportunities for reducing costs.

As this case illustrates, the cost-analysis mind-set holds out the promise of significant savings in the supplier chain, but it doesn't work in isolation. Suppliers have to be vested as full partners, and sourcing practices have to evolve from shared knowledge about the economics of both firms, shared understanding of cost drivers and shared commitment to implementing new approaches. Top management has to endorse the strategy and to facilitate the necessary changes in policies and practices.

To many purchasing managers, the risk seems high. But by combining a cost analysis with competitive supplier partners, by cementing those partnerships based on mutual commitment and by implementing strategies based on cost-focused coordination, a company can actually minimize risk by better understanding—and better controlling—the supply chain from start to finish.



COMPETITIVE SUPPLIERS

Maximizing volume economics is often an essential driver to lowering overall costs. When a company sources goods and services from a few preferred suppliers, rather than squandering potential volume efficiencies by spreading purchases among many suppliers, it often can buy more for less. Working with a small number of select

suppliers—or even a sole supplier—is not only possible, but smart. This understanding has driven many firms to reduce supplier numbers in search of better price, better product and greater consistency from the “chosen few.”

But relying on one or two suppliers for what used to be purchased from five or six also increases a company's risk, especially if it doesn't choose well. To evaluate suppliers, simply use the same criteria one would employ in considering an acquisition candidate:

- Is the company competitive? Where does it rank in its industry?
- Can the supplier meet our needs?
- Is the partnership an “easy fit,” or do business approaches clash?
- What is the company's success rate, and what is the quality of the management team?
- Does it have in-house engineering or technology expertise that can add value to my product?

The importance of carefully selecting suppliers positioned for the long term is illustrated

STORY TWO

A Wisconsin manufacturer makes scientific instruments with internal electronics. The firm outsourced the stuffing of its electronic boards to a built-to-print house with efficient, low-cost manufacturing and assembly capabilities. The supplier had no design or engineering resources, but the Wisconsin company wasn't looking for engineering help; it was looking to get electronic boards outfitted cheaply. The design specs included an industry-standard capacitor, which the supplier was able to buy from one of three sub-suppliers at 50 cents each.

As industry standards changed, two of the capacitor makers moved on to different products, leaving only one sub-supplier. In one year, the cost of the capacitor shot to \$2 each, which the supplier had no choice but to pay in order to build the Wisconsin firm's product to spec. By the time the Wisconsin company took notice, the price of the obsolete capacitor had increased to \$10 each and then was discontinued altogether. Without electronic boards, the manufacturer's production came to a halt. It was unable to ship product for six months.

A California-based competitor in the scientific instrumentation business also outsourced the stuffing of its electronics boards, but it selected a value-added supplier. Though the supplier quoted a higher initial price, it had a design and engineering team of more than a dozen people. The California company felt it was worth a small premium to do business with a supplier that had people trained and experienced to think about design and obsolescence issues in electronic components.

It was right. When the number of capacitor suppliers fell from three to one, the value-added supplier predicted that the part would soon be obsolete and redesigned the board to accommodate a newer capacitor, priced at 50 cents. The design modifications were minor and inexpensive, and the California company's boards remained in continuous production at a competitive price, even when the original capacitor was discontinued.

There's a big difference between simply knowing a supplier's costs and really understanding them.

by the example on page 43 from a firm in the scientific instruments business.

As this case proves, reducing the number of suppliers has marginal benefit if price is still the overriding factor in selecting vendors. Particularly in fast-paced, technology-sensitive industries, suppliers have to be able to function as contributing partners able to recognize and adapt to changes in design and product mix, whether driven by market demands or technological advances. When commodity-type suppliers are entrusted with value-added responsibilities, they can't always deliver, and the manufacturer pays the price.



COMMITMENT

The biggest cost-reduction opportunities often rest within the supplier's organization, but the responsibility to find and exploit them isn't the supplier's alone; it also rests with the manufacturer. Developing sourcing practices based on an in-depth understanding of a supplier's cost drivers can, as illustrated, yield significant cost savings for both the supplier and the manufacturer. But in order to get inside the supplier's shop and explore more fully what drives its costs, and to allow the supplier to develop the same understanding of its cus-

tomers' economics, a basic commitment between supplier and purchaser is essential.

This is easier said than done, especially given the contentious approach that has characterized vendor-customer relationships for so many years. Commitment can involve trusting the supplier with proprietary technology and other sensitive information, an uncomfortable proposition for many companies, to say the least. It can require short-term investments based on the promise of long-term payoff. But as the case from an electrical goods company described on this page illustrates, commitment is a choice that can offer high return.

When a manufacturer makes a real commitment to its supplier, the supplier then can be encouraged to make a commitment in return by investing in the manufacturer's business and its product. And whether that commitment is in people, machinery, technological upgrades or some other form, when a supplier makes a direct investment to better service a key customer, both can enjoy sustained competitive advantage as a result.



COORDINATION

Most cost-analysis studies result in cost-savings recommendations based on better coordination between a manufacturer and its suppliers. Yet surprisingly few companies have fully embraced the cost-savings potential of true, integrated coordination with their suppliers; many companies still pass orders over the fence with little regard for how order size, ordering patterns, product design and varying product specifications affect a supplier's operation and efficiency and, hence, its costs.

Therefore, the final building block—and in some ways the linchpin—for a successful sourcing strategy is coordination: developing cross-functional teams that work together to eliminate frictions and inefficiencies that add cost unnecessarily. Teams should comprise staff from both the supplier and the manufacturer and should focus on volume consolidation, dependable forecasting, product design, parts standardization and other overall cost-savings strategies that arise when a supplier and manufacturer sit around the same table as partners with a cost-savings or performance-enhancing goal. Involving these teams and their recom-

STORY THREE

An Ohio manufacturer purchased processed nickel for use in its lighting products and changed suppliers year to year based on the lowest bid for its product. During one stretch, it changed suppliers once a year for four years straight, confident that with each switch it was paying the lowest price for the product.

A Massachusetts competitor took a different approach. After selecting a competitive supplier it felt comfortable with, it worked with the supplier to build an exclusive, long-term relationship. The Massachusetts firm promised the supplier 100 percent of its volume and a contract with no time limit, provided cost, quality and service didn't slip. The supplier, for its part, invested \$19 million in a modernized furnace to provide its Massachusetts customer with state-of-the-art nickel processing. The new furnace allowed for faster annealing and wider nickel strips, and production costs fell dramatically. The manufacturer and its supplier shared in the savings.

The Massachusetts competitor sustained a 16 percent cost advantage over the Ohio manufacturer over a period of six years, even though the supplier didn't have the new plant operational until the fourth year.

STORY FOUR

A Kentucky engine manufacturer orders pumps from its supplier on an almost hourly basis, constantly changing scheduled orders and requiring fast expedition of the new order. As a result of the firm's erratic and piecemeal ordering practices, the supplier has to produce pumps in smaller, inefficient runs.

A Connecticut competitor that buys from the same supplier better understands the supplier's manufacturing system—it produces pumps in economic lot sizes of 100 units, holding inventory at the component level before final assembly—and dependably forecasts larger orders based on optimal run lengths. The Connecticut firm also makes fewer adjustments to its orders once placed.

The result? The Connecticut competitor pays \$9,500 per unit versus the Kentucky firm's \$10,700, enjoying a 13 percent savings per unit. By simply coordinating pump orders in larger quantities with a 90-day lead time, the Kentucky manufacturer could save \$2.6 million per year.

STORY FIVE

A Midwestern manufacturer of medical systems buys \$12.2 million worth of fabricated sheet metal from 35 vendors, purchasing metal pieces separately from lowest-priced vendors. This methodology is actually penny-wise but pound foolish: Its competitor coordinated with one supplier on design, resulting in fewer metal parts bundled in a 16-part kit.

The competitor's better-engineered product used less metal due to fewer parts and reduced scrap based on the better fit of the designed kit. The simpler design also cut the vendor's labor costs: It required less time for assembly and eliminated welding steps.

The result? While the Midwest manufacturer paid \$550 per cabinet, the competitor paid \$430, a 28 percent cost difference. By coordinating with a single-source supplier on cabinet design, the manufacturer would be able to realize annual savings of \$2.4 million.

mendations early in the process starts the manufacturer-supplier relationship out on the right foot, devising sourcing practices that optimize efficiency while still meeting the manufacturer's product requirements. Two brief cases described on this page illustrate the point.

As these cases suggest, developing a closer, more collaborative working relationship between buyer and supplier at the outset can lead to better coordination for optimal manufacturing efficiency, and the cost-savings potential of such coordination is enormous.

Implementing the Strategy

Each step in a 4C sourcing strategy seems straightforward: Select a competitive supplier, establish a commitment to that supplier, analyze the complete manufacturing process with a cost-analysis mind-set and coordinate with the supplier early and often to maximize cost-efficiency. Sounds simple.

In reality, implementing such a strategy often involves a complete reorientation in the way a company does business—in the way it staffs the purchasing operation, approaches suppliers, operates across different units and measures overall performance. Like any major organizational change, implementing a suc-

cessful sourcing strategy needs support and direction from top management, new training and reward programs for purchasers, and facilitators to help validate and guide the change in practice.

Outside facilitators can be useful to help isolate areas for improvement and dimension potential savings—often an important sweetener for investing top management in the new strategy. New policies and partnerships can be arrived at informally, but should then be articulated clearly in writing, both as a training tool and as a new statement of corporate commitment. Such a statement is crucial for the refocused purchasing team; if they are told to look at sourcing differently on one hand, but are called on the carpet if they don't achieve annual 2 percent reductions on the other, partnerships will disintegrate quickly as purchasers reclaim their role as hard-driving price takers. ■■

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