

IBM Institute for Business Value

Sourcing in a demanding economic environment

Generating value in challenging times



IBM Institute for Business Value

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By *Karen Butner*

In a volatile economic environment, companies must dig deep across their supply chains for optimization and efficiencies to help combat the impact of a challenging economy. Sourcing of direct and indirect material continues to grow in emerging areas. To create a new roadmap for the supply chains of the future, today's sourcing and procurement organizations should adopt a strategic sourcing approach that includes initiatives designed to drive efficiency, productivity and – ultimately – business results.

The word volatile has been widely used by both the financial and mainstream media to describe our global marketplace. Due in large part to downward sloping production, disposable income, employment and consumer expenditures, worldwide gross domestic product (GDP) growth is forecast to be -0.8 percent in 2009.¹ Add to that the complexities of an increasingly interconnected and interdependent supply chain and several trends emerge:

- Foreign subsidiaries and transnational companies continue to be on the rise as industry looks to globalize.
- Supply chains are being extended outside company walls through collaborative partnerships, outsourcing and shared services.
- Products (and services) are in constant flux with new products and rationalization efforts driving turmoil across portfolios in the chase to meet customer demands.

This dynamic global environment creates opportunity for sourcing and procurement organizations to demonstrate leadership and deliver value. To do so, they must invest in the

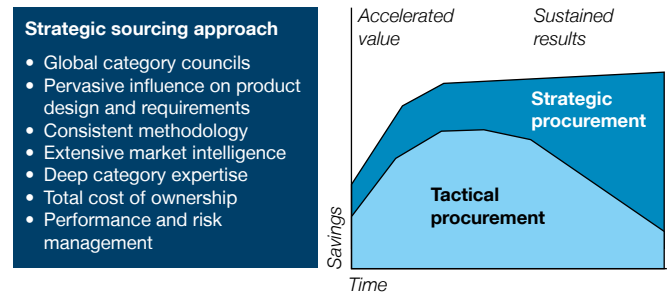
right skills, talent and programs to deliver a true competitive advantage. At the same time, they must look at their cost of doing business and create efficiency in their operating models.

Some of the proposals that procurement brings forward may not be popular, such as outsourcing noncritical missions that do not generate revenue or support profitability. Additionally, there are strategic make versus buy decisions in which procurement needs to be involved early to provide a critical, realistic analysis of the business decision. Procurement's interlock with key functions can provide the necessary path to successfully manage cash and expense for the company. As such, procurement has the ability to create real business value by reducing cost, reducing or eliminating expense, generating cash, managing risk and improving profitability. It's time for procurement and sourcing organizations to take a leadership role in driving business results. To do this, they must adopt a strategic sourcing approach that includes initiatives in purchasing, supplier health, risk management and supplier performance designed to improve efficiency, productivity and business results.

Strategic sourcing helps drive down costs, increase profit potential

To deliver sustained savings results, the sourcing organization must have a strategic focus. Creation of strategic sourcing commodity councils is often a first step in implementing a strategic sourcing approach (see Figure 1). A commodity council's responsibilities range from early involvement with key stakeholders to ongoing supplier relationship management. Its role extends far beyond simply negotiating with suppliers on price and delivery. Classical sourcing activities involve analysis of spend and the bidding, negotiation and selection of suppliers. However, strategic sourcing commodity councils expand the traditional role through the development of commodity strategies and implementation plans. A consistent methodology is applied – it begins with gathering customer requirements and demand management data and continues with market intelligence on trends, buying patterns and industry-specific data. Commodity managers lead cross-functional evaluation of new suppliers' capabilities, negotiate contracts and manage supplier relations. Also important is the ongoing communication of contract guidelines to all affected parties while closely monitoring supplier performance. A total cost of ownership (TCO) approach to evaluating the true product or service cost equation is preferred to a focus on price.

Many companies face challenges in reaping the benefits associated with effective strategic sourcing. A number of businesses lack accurate and timely information about their spending patterns or suppliers, and a significant portion of spend is untouched by the procurement organization. Many businesses lack proactive strategies to manage spend and, therefore, are constantly reacting to instability in the supplier marketplace, missing out on savings opportunities.



Source: IBM Institute for Business Value and IBM Integrated Supply Chain analysis.

Figure 1: Strategic sourcing approach and time to value.

The number of suppliers for a given spend category may proliferate due to uncontrolled local buying, resulting in loss of leverage and leading to higher prices, reduced quality and service issues. Innovation in sourcing and category management requires investment in skilled personnel and market intelligence sources that span the global supplier marketplace. Inconsistencies in sourcing processes, policies and management systems undermine a company's ability to implement sourcing strategies and gain savings opportunities and often result in unplanned buying activity within business units. And last, lack of tools and use of manual processes can cause sourcing professionals to spend time gathering information and handling administrative tasks rather than adding value through sourcing. All of these challenges can be addressed, of course, but a consistent methodology applied to all categories can help avoid them in the first place.

We recommend the below seven steps for developing a strategic sourcing approach.

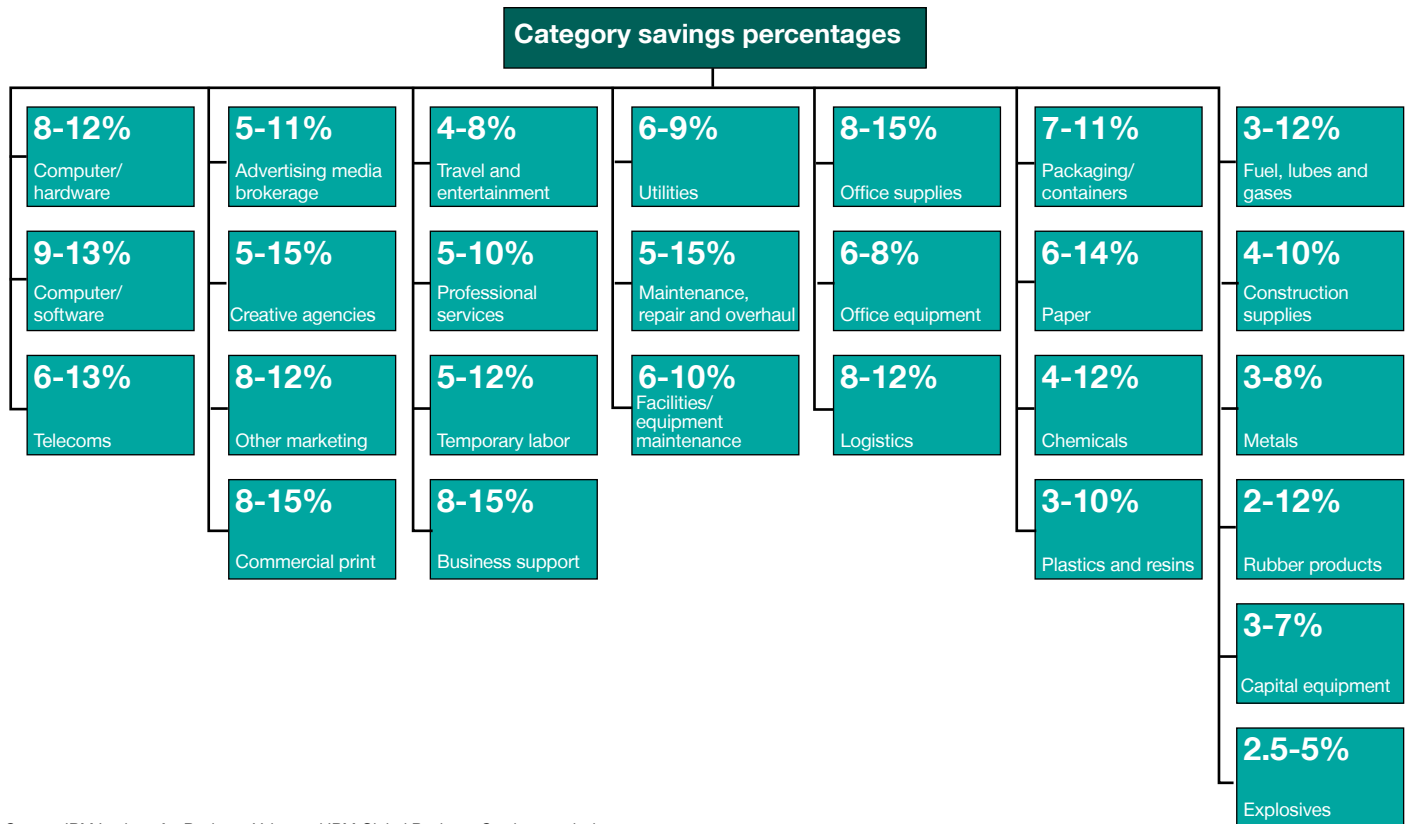
- 1) *Conduct spend analysis*: Collect and analyze category baseline spend data and then identify potential opportunities and re-evaluate project scope.
- 2) *Determine business requirements*: Assess current and future business needs, and challenge internal customer requirements to identify opportunities to reduce costs while sustaining – or even improving – quality and service.
- 3) *Conduct market analysis*: Understand the supply market in order to form category strategies that match business requirements with supply market capabilities. As the market place is constantly evolving, it is important to conduct market intelligence analysis on a regular basis.
- 4) *Develop category strategy*: Select the most appropriate go-to-market sourcing strategy for the category by identifying the potential strategic alternatives and analyzing each option. The supply market capabilities can be matched with the business requirements to recommend a strategy and priorities for the category that significantly reduce the total cost of ownership.
- 5) *Select suppliers and negotiate*: Provide a fair, consistent and structured approach to the identification, evaluation and qualification of suppliers, as well as the subsequent selection of suppliers that support business objectives. Above cost reductions, sourcing also has a critical role in negotiating competitive terms and conditions that optimize cash.
- 6) *Develop implementation plan*: Provide a structured approach to developing supply transition plans.

7) *Manage supplier performance*: Help ensure the performance of internal users and the supply base, the meeting of business requirements and contractual terms, and the capture of savings and benefits. In addition, deliver ongoing improvements to the supply relationships.

In addition to the above steps, creating commodity centers of excellence can also lead to potential cost savings, as well as greater efficiency and effectiveness. Utilizing commodity councils to create centers of excellence allows those involved to leverage expertise, share experiences and employ leading practices. This, along with a strategic sourcing seven-step approach, can lead to potential cost savings ranging from 2 to 15 percent (see Figure 2).²

“With the cost pressures mounting, the most prominent challenge for our company is to increase its sourcing from low-cost countries and transfer the existing sourcing from the relative higher-cost countries. It will be a challenge to do this while maintaining continuous material availability and without disruption of supplies.”

A European industrial products company executive



Source: IBM Institute for Business Value and IBM Global Business Services analysis.

Figure 2: Potential savings by commodity group.

An important leading practice involves interlocking the savings realized through global sourcing with financial plans. Without this closed-loop interlock, much of the benefit could be lost, as the savings could be spent on some unplanned need. The financial interlock covers three important areas: cost advantage, cash generation and expense. Key stakeholders and executive management need to be involved in the decision-making process and track the commitments to deliver value. There must be processes in place for resource and risk management to significantly reduce disruption to the business and unforeseen costs.

Implementing sourcing initiatives to help drive business results

Sourcing and procurement leaders undertake specific initiatives to better manage cost during challenging economic times. For example, some leaders leverage reports that contain the current status of all supply transactions with alert processes to highlight suppliers of concern. Others utilize weekly spend management reports with a review of open purchase orders. Another tactic involves establishing risk mitigation strategies and policies with action plans for troubled suppliers, such as

renegotiating contracts while being cautious not to damage relationships. Yet another tactic involves carefully rationalizing global supply bases to further supplier consolidation, while at the same time seeking new sources.

Sourcing and procurement leaders can positively impact business results in a number of ways by directing programs designed to increase efficiency and decrease cost. In a tough economic environment, we recommend they focus on initiatives in purchasing, supplier health, risk management and supplier performance.

Buying in a soft economic environment

A soft global economic environment presents many challenges. Against this backdrop, however, substantial advantages emerge for sourcing and purchasing groups. Purchasing strategies in a buyer's market differ significantly from those in the seller's market that, until recently, prevailed over the past few years. Obviously, the balance of power shifts in a downturn from sellers to buyers. Sellers are more likely to aggressively negotiate terms and pricing since they desire to keep capacity utilized and maintain revenue streams. Sharp buyers recognize this and typically will place more business up for bid, take actions to renegotiate contracts and seek out new suppliers. As always, buyers should recognize that markets change over time, and they should not do anything that would damage their buying position when it becomes a seller's market again.

“For us, it’s all about total cost reduction, inventory cost and transparent sourcing execution.”

Korean automotive manufacturer executive

Assessing suppliers' financial viability

In a volatile economy, many companies closely evaluate and monitor the financial and operational health of their suppliers. Within the framework of an overarching supplier management program, some key ratios can be assessed. The ratios below are industry benchmarks used in evaluating a supplier's financial stability and can be calculated from a supplier's financial statements.

- **Quick ratio:** Current assets less inventories divided by liabilities equals the quick ratio. This is a more conservative test of a company's liquidity than the current ratio (which is assets divided by liabilities).
- **Debt-to-equity ratio:** This is a measure of a company's financial leverage. Debt-to-equity ratio is equal to long-term debt divided by common shareholder's equity. Typically, the data from the prior fiscal year is used in the calculation. Investing in a company with a higher debt-to-equity ratio may be riskier, especially in times of rising interest rates.
- **Operating cash flow:** This is the sum of net profit, depreciation, change in accruals and change in accounts payable minus change in accounts receivable, minus change in inventories. Operating cash flow is usually considered a better metric of a company's financial health than net income since cash flow is harder to manipulate than net income.
- **Return on sales (ROS):** This ratio is widely used to evaluate a company's operational efficiency. ROS is also known as a firm's "operating profit margin." It is calculated by dividing net income (before interest and tax) by sales. This measure is helpful in providing insight into how much profit is being produced per dollar of sales.
- **Credit rating:** This is an assessment of an organization's credit worthiness based on its history of borrowing and repayment, along with the availability of assets and extent of liabilities. A company with a poor credit rating likely will have difficulty raising additional capital and will face increased interest rates.
- **Research and development percentage of sales:** This is the percentage of sales reinvested in the development of new products. This measures the commitment of an organization to innovation.

These ratios and metrics can also be applied to private organizations; however, depending on the size of the organization, additional analysis may be required. Also, various organizations (e.g., Moody's Investors Service, Hoover's and Dun & Bradstreet) provide information on a company's credit rating.

Sourcing and supplier management is the heartbeat of effective risk management

Supply chain risk management has taken center stage – and sourcing and supplier management are in the center.

According to our 2009 supply chain study, "IBM Global Chief Supply Chain Officer Study: The Smarter Supply Chain of the Future," risk management is the number two concern of supply chain executives worldwide and multi-industry. Thirty-eight percent of the company executives interviewed planned to evaluate and/or implement supply chain risk management technology in the next 12 to 24 months. While 46 percent of the companies surveyed identified supplier failure and continuity of supply as their top risk concerns, companies also identified nontraditional risks – brand and reputation issues, regulatory compliance, product safety and catastrophe exposure – as potential threats. Also, lack of standardized processes and data were concerns, with the most difficult inhibitor to effective risk management being the organization itself.³

Over the last several years, many companies have reduced their business costs and expanded their product lines through an aggressive sourcing strategy, which brings both benefits and risks. Low-cost country sourcing, multitiered supplier networks and business process outsourcing are among the supply chain initiatives that companies – large and small – have employed. The benefits of these initiatives are apparent – companies are able to reduce the cost of goods, develop new markets and free up resources to focus on core value-adding

activities. However, these benefits are often accompanied by greater supply chain complexity and exposure to new risks. Many companies experience supplier delivery issues in the form of unreliable commitments. Also, longer transportation distances with associated longer lead times often lead to capacity issues and elongate the cash cycle. In addition, quality issues are a growing concern, especially in consumer products with the traceability of product lifecycle status and ingredient components. Also rising to the attention of many executives are the mounting pressures for regulatory compliance and reporting.

The ultimate goal of an effective and comprehensive risk management strategy is to embed risk awareness into all core elements of the organization, from the C-suite through department heads across the various supply chain functions. Ideally, this goal can be accomplished through the construction of a formal, cross-function supply chain risk management team that offers a full cash-to-cash view of the supply chain's internal and external constituents. In today's marketplace, companies need well-defined strategies and policies across all of their supply chain activities with their constituents. When the supplier's plant fails to meet production schedules or there is a political, financial or other disruption, all parties need to have a flexible contingency plan and structure in place to expedite decisions and actions.

Keeping a keen eye on performance

Many companies manage supplier performance with service-level agreements, scorecards and ongoing dialogue. But in today's environment, both the scope and diligence of performance measurement need to be extended. Alignment with corporate strategies, building a business case with identified cost-saving opportunities and building business intelligence dashboards to closely manage all supplier management functions from an end-to-end perspective are all important.

Key measurements or key performance indicators (KPIs) to consider include:

- **Cash/liquidity**
 - Average payment terms (APT)
 - Supply chain enablement/inventory turns
 - **Profitability/effectiveness**
 - Total cost reductions
 - Procurement competitive advantage
 - Supplier quality and defects (overall)
 - Corporate innovation (revenue/labor cost ratio)
 - Transformation deliverables savings
 - **Asset management/efficiency**
 - Procurement efficiency
 - Global logistics service parts inventory
 - Business controls audit results
 - **Expense/debt management**
 - Global procurement expenses
 - Warranty expense reduction
 - Global logistics service parts cost and expense
-

Procure-to-pay outsourcing is an effective initiative to improve performance that is growing in popularity. Typically, the scope of outsourcing includes procurement operations, accounts payable operations and the underlying technology to support these processes. Benefits include operational savings, leveraging key skills and talent, and compliance improvement. We believe financial payback within a 12- to 18-month period is feasible.

Increasing communications with suppliers and having an ongoing dialogue is important. Seventy-nine percent of supply executives state that they engage in collaborative planning with suppliers on an on-going basis.⁴ Some are considering the use of advanced tools for increased collaboration and visibility and sharing of plans, commitments, shipment status and events. “Sametime” collaboration uses a multipartner platform to allow realtime discussions and sharing of information to facilitate exception management and quick decisions. If a supplier were unable to meet a commitment for delivery, for example, alternative sources could be identified and secured through sametime collaboration.

Also important to consider in managing the performance of global supply networks are emerging growth market opportunities. When formulating a strategic supplier development plan for growth geographies, there are several important actions to consider:

- Develop growth country sourcing strategies that are aligned with corporate strategies.
- Establish compelling business cases based on growth country sourcing strategies and identify cost-saving opportunities.
- Perform spend analysis and determine which categories should be sourced from growth countries considering optimum benefits and lowest risk levels.

- Identify the best matching growth country from which to source.
- Select the right suppliers that best fulfill the requirements.
- Perform cosourcing activities supported by (but not limited to) market intelligence, RFIs, RFQs, price and contract negotiations, and supplier qualification.
- Help protect intellectual property associated with growth country sourcing.
- Design and manage the extended supply chain to achieve the required supply chain visibility.
- Design and manage to local language and cultural challenges.

Sourcing and procurement can be a catalyst for generating value in growth markets by exploiting supplier base opportunities. Based on our analysis and experiences, sourcing and category management alone can lead to a five to ten times savings ratio versus costs, and a payback of six to twelve months is feasible.

“We’re using centrally defined and controlled processes (corporate direct report) but with local sourcing organizations that understand the local business and cultural needs.”

U.S. consumer products company executive

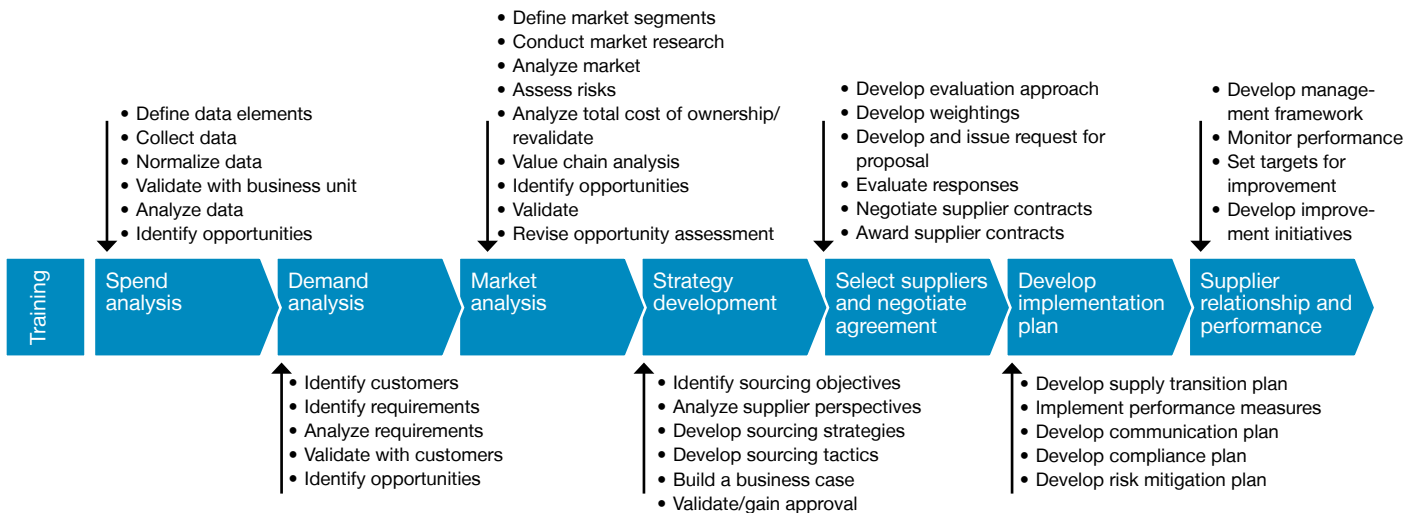
Key takeaways for generating value in tough times

A global financial crisis challenges every industry, but it is also creates unprecedented opportunities for sourcing organizations. As you develop go-forward plans to reduce your supplier exposure and investigate cost reduction programs, consider key questions in the following areas:

- Supply base: Who are the right suppliers?
- Commodities: What are the strengths and weaknesses in commodity coverage across growth countries?
- TCO: How can I help ensure sustainable TCO savings? How do I build a reliable business case and estimate risks?
- Quality and skills: How can I maintain quality levels? How do I attract and retain top-quality staff?
- Supply chain integration: How can I most effectively manage an extended supply chain? How can I help ensure competitive lead times and flexibility?
- Contracts and legal: What contractual and licensing issues should I be aware of? What are the import and export regulation requirements?
- Taxation: What are the benefits or pitfalls regarding local taxation? Should I buy in local or foreign currency?
- Language and local culture: How can I manage the local language and cultural challenges? How can I protect my intellectual property and prevent fraud?

Sourcing organizations must proactively demonstrate leadership and offer innovation that contributes to improving the bottom line. Optimizing strategic sourcing can bring improvements to cost, profit, cash position and overall company performance (see Figure 3). Sourcing and procurement must have a strong interlock with key stakeholders to provide visibility, avert risk and bring forward creative solutions. Opportunities in growth markets should be initiated now, not later.

For procurement and sourcing leaders, opportunities can be found amid the turmoil of a rough economic environment. Today’s leaders have the opportunity to create a new roadmap for the supply chains of the future. By adopting a strategic sourcing approach that includes initiatives in the areas of purchasing, supplier health, risk management and supplier performance, they can help drive efficiency, productivity and – ultimately – business results.



Source: IBM Institute for Business Value and IBM Global Business Services analysis.

Figure 3. Strategic sourcing framework.

Author

Karen Butner serves as the global supply chain management (SCM) leader for the IBM Institute for Business Value. In this role, she is responsible for research and thought leadership surrounding global SCM strategies and market insights. Karen is the architect and author of “IBM Global Chief Supply Chain Officer Study: The Smarter Supply Chain of the Future” and also served as an author and editor-in-chief for *Reshaping Supply Chain Management: Vision and Reality*, a book published in 2006. In addition, she is frequently invited to speak at national and international venues and is widely quoted in leading business and industry publications. Karen can be reached at kbutner@us.ibm.com.

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