DELIVERING ON PROCUREMENT'S POTENTIAL

Introduction

Chief Procurement Officers in the 21st century face a triple threat of challenges making their job one of the most daunting in the enterprise:

- ***Boardroom expectations*** to increase procurement's contribution to enterprise financial performance in a marketplace where globalization and other competitive forces have limited the ability to increase profits through sales and marketing

- ***Increased supply risk*** resulting from the complexity of global supply chains, the need for increasingly aggressive supply management strategies to meet cost reduction goals, and the impact of natural disasters and other geopolitical events

- ***Capability gaps*** in organization, processes and technology that must be closed to meet the boardroom expectations and manage the increases in supply market risk

CPOs that overcome these challenges will make real and measurable contributions to business value. In doing so they will help to position procurement as one of the most strategic functions in the enterprise and banish once and for all the image of purchasing as a corporate backwater.

So how do CPOs overcome the triple threat and deliver on procurement's potential? One of the most widely supported strategies for driving increased value from procurement is to increase the amount of spend under management. Aberdeen*Group* defines spend under management as the portion of corporate expenditures sourced and controlled by the procurement organization or by procurement-derived policies and procedures[1]. Spend under management is more likely to pass through best practice procurement processes on a consistent basis, resulting in an increased probability of achieving cost savings, quality and service goals. Organizational and technology capabilities such as cross-functional teaming and e-sourcing, both demonstrated to result in superior sourcing results, are also more likely to be applied to spend managed by procurement. In addition, supply risk can be managed and mitigated more effectively if variation in supply management strategies and processes can be controlled across the enterprise by having all spend managed by a single function.

This white paper presents an innovative and pragmatic approach that procurement leaders can use to increase spend under management and, more importantly, manage that spend to create sustainable enterprise value. The latter point is important because simply increasing the amount of spend administrated by procurement, for instance by channeling purchasing transactions through an e-procurement system, is not enough.

Similarly, successfully persuading stakeholders to transfer sourcing decision making to procurement will not in itself deliver bottom line value. To positively impact corporate financial performance procurement must, after accepting responsibility for the increased spend, apply best-in-class supply management practices to that spend in order to generate measurable and sustainable benefits.

By applying the principles described in this white paper CPOs will be able to identify opportunities and design strategies for capturing untapped value in the spend base. Guidance will also be given on how to implement internal marketing programs that succinctly communicate to all stakeholders the benefits of procurement having authority and responsibility for the management of all spend with external suppliers. Lastly, an implementation approach will be presented that sets in place a sustainable spend management framework able to consistently deliver tangible bottom line value even in the most competitive and uncertain business environments.

How Spend Management Creates Value

For the purposes of this white paper, enterprise value is defined as the present value of the enterprise's future free cash flows. This definition is used instead of some of the more commonly encountered ones (such as the sum of market capitalization and net debt, market value of assets, or earnings multiples) because it allows the most granular analysis of the potential impact of spend management on enterprise value.

The components of free cash flow are shown in Figure 1 below. Enterprises employing best-in-class spend management practices understand that five of these eight components – revenue, cost of sales, operating expenses, working capital and fixed assets - can be directly influenced by the procurement function through approaches such as those described below:

Revenues can be increased by leveraging cross-functional procurement teams and strategic supplier relationships to deliver increased value to customers in areas such as quality, service, performance, innovation, delivery reliability, reduced stock-outs through supply chain responsiveness and supply risk management, reduced product returns, faster time to market for new products, and involvement of procurement in sales and marketing planning.

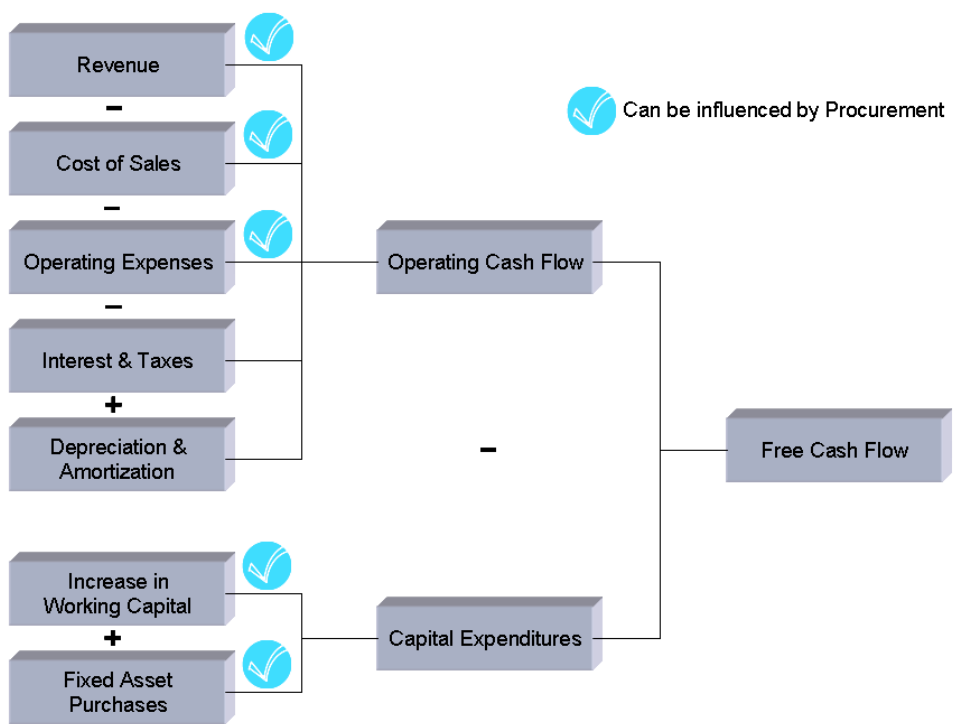
Cost of Sales can be reduced by involving procurement and suppliers early in the design process to provide visibility of key cost drivers, implementing an ongoing and collaborative value engineering/analysis program with suppliers, pursuing parts reduction & standardization, utilizing global and low cost country sourcing, working with suppliers to improve yields, extending cost management best practices to suppliers through training & development, negotiating raw material contracts for your suppliers, and applying strategic sourcing to freight.

Operating Expenses can be reduced by improving visibility of spend across the enterprise, getting involved in non-traditional categories such as marketing, making full use of buying leverage for high spend/low complexity purchases, implementing e-procurement and contract management systems to drive high levels of user and supplier compliance, utilizing outsourcing where appropriate, and reducing the cost of the procure-to-pay process.

Working Capital requirements can be reduced by improving payment terms with suppliers, aggressively managing receivables and working with suppliers and operations to implement lean inventory policies.

Fixed Asset costs can be reduced through programs such as asset recovery, total productive maintenance, life cycle cost management, asset pooling/sharing and strategic sourcing of capital equipment.

Figure 1 – The Components of Free Cash Flow for the Enterprise



Best-in-class enterprises also realize that the surest way to successfully implement approaches such as those described above is to bring as much spend as possible – preferably 100% - under the control of procurement. In other words, *to bring all spend* *under management*. One of the best examples of this is United Technologies Corporation (UTC), winner of Purchasing Magazine's 2006 Medal of Professional Excellence. The central procurement group at UTC manages every dollar of the company's $16B annual spend through cross-business commodity teams, each team led by a senior executive sponsor.

Enterprises like UTC and others like them who have brought all (or close to all) spend under management *and kept it that way* have been particularly successful in five areas:

- Achieving enterprise spend visibility
- Developing value creation strategies for high opportunity spend categories
- Upgrading the capabilities required to execute the above strategies
- Capturing the support and involvement of key stakeholders
- Implementing a sustainable business model to lock in benefits

Success Area 1 – *Achieve Enterprise Spend Visibility*

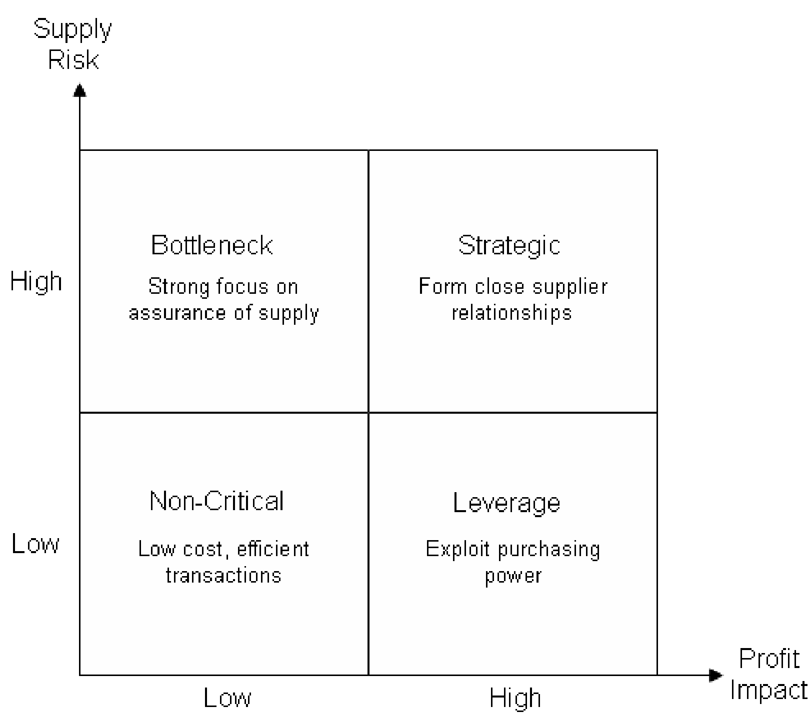
Spend management leaders understand that the first step in bringing more spend under management and managing it more effectively is to understand who is buying what from whom across the enterprise today. Without this visibility of total spend the CPO does not know where the value creation opportunities are, how the value will be created, or which stakeholders will have to be approached for procurement to become involved. To accomplish this critical first step a spend analytics system and process must be in place to extract, normalize, cleanse, classify and report all enterprise spend data. Only then will procurement be able to conduct an assessment to determine which categories present the most attractive value creation opportunities in terms of driving increased free cash flow.

Success Area 2 – *Develop Value Creation Strategies for High Opportunity Categories*

The approaches for increasing enterprise value through free cash flow described on page 4 cannot be employed in a "one size fits all" way to any spend category or enterprise environment. For example, automotive gearboxes and food produce require very different spend management strategies to increase revenue. Best-in-class procurement organizations conduct a spend analysis and then segment enterprise spend categories into families with distinct sourcing characteristics. They then apply the appropriate value creation strategy to each spend category. One segmentation method commonly adopted is the Kraljic Matrix[2] that places spend categories into one of four quadrants – Strategic, Leverage, Bottleneck or Non-Critical – based upon the profit impact and supply risk of the category (see Figure 2 below). Enterprises using the Kraljic method segment their spend categories into the four quadrants then match the sourcing strategies to each quadrant. Returning to the automotive gearbox and food produce examples, the former would fall into the "strategic" quadrant (high profit impact, high supply risk) and the latter into the "leverage" quadrant (high profit impact, low supply risk). Revenue increase strategies for a strategic purchase like a gearbox would involve collaboration with suppliers to enhance performance and reliability of the end product (an automobile).

Conversely, the correct approach for a leverage purchase like food produce would involve working with vendors to reduce shelf stock-outs through supply chain management best practices, thereby increasing sales to the supermarket's customers.

Figure 2 – Kraljic Matrix*



*Slightly adapted for the purposes of this white paper

Success Area 3 – *Upgrade Capabilities Required to Execute Value Creation Strategies*

Having developed value creation strategies, many CPOs are faced with the problem of lacking certain of the capabilities required to execute them. Some examples of missing capabilities include sourcing skills for high opportunity spend categories, an effective procurement organization structure, technologies for enabling key procurement processes such as spend analysis and e-sourcing , or best practices such as low cost country sourcing and supply risk management. The important thing for the CPO to realize is that she does not need to address every missing capability in her organization – only those that are necessary to act upon the most attractive value creation opportunities. The CPOs creating the highest value for their enterprises will be those that successfully identify and address the most important capability gaps corresponding to each identified opportunity.

Success Area 4 – *Capturing the Support and Involvement of Key Stakeholders*

With programs and investments defined the CPO must now present the argument for procurement taking a leadership role in delivering the results. Depending upon the nature of the planned programs, procurement may be 'stepping on the turf" of certain stakeholders (e.g. when proposing for example that procurement become involved in the sourcing of non-traditional spend categories such as marketing) and a strong case will have to be made that clearly shows the benefits to the stakeholders of working more closely with the procurement group. Best-in-class procurement organizations accomplish this by working through the following steps

Step 1: Identify the affected stakeholders
Step 2: Confirm stakeholder objectives
Step 3: Define the impact of the planned programs on stakeholder objectives
Step 4: Define the impact of the planned programs on stakeholder roles, in particular how they will work differently with procurement and which activities previously performed by the stakeholders will now be performed by procurement
Step 5: Develop the internal marketing plan required to garner stakeholder support and participation

Success Area 5: *Implementing a Sustainable Business Model to Lock in Benefits*

UTC's procurement organization has been delivering bottom line value for over five years with no sign of the enterprise reverting back to the old way of doing things as has happened with many companies' procurement initiatives. The explanation for the sustainable benefits enjoyed by UTC and other organizations showing similar results lies in the implementation of a procurement business model that "locks in" the processes responsible for positively impacting the components of free cash flow described in Figure 1. This business model exhibits a number of features including

- A high strategic positioning for procurement
    - CPO reports to the CEO or President
    - Procurement strategy is integrated with corporate strategy
    - Procurement metrics are aligned with corporate financial metrics

   - Clear procurement objectives are shared across the enterprise
   - Executive sponsorship exists for all cross-functional procurement programs, initiatives and processes

- High performing procurement organization
   - CPO has strong leadership skills and high credibility
   - Structure is either centralized or center-led
   - Highly effective cross-functional teams are in place
   - Procurement professionals are highly educated with good people skills
   - Knowledge development is focused on leadership, best practices and use of enabling procurement technology

- Best practices are in place that support procurement's strategic objectives
   - Sourcing analysis & strategy
   - Strategic sourcing, customized by category as necessary
   - Supplier collaboration & management
   - Contract management
   - Supply risk management
   - Procurement outsourcing
   - Capital cost management, e.g. asset recovery, working capital reduction
   - Performance measurement & management focused on business value

- Full coverage of enabling technologies
   - Spend analysis
   - E-sourcing
   - E-procurement
   - Optimization
   - Contract management
   - Supplier performance/relationship management
   - Collaborative design

Case Example: Staying with UTC, Figure 3 shows how many of the features of the sustainable business model described above are present. Procurement was recognized as strategic function from the beginning of George David's tenure as CEO in 1994. Strong CPO leadership, senior executive involvement and highly effective use of sourcing best practices and enabling technologies all contributed towards the delivery of over $1.5 billion of savings from 2001 through 2006. The savings program is still in place today and continues to contribute sustainable value to the enterprise on a recurring basis.

Figure 3 – Selected Key Features of United Technologies Corporation Procurement Organization

Strategic	Organizational	Processes	Technology
• Procurement reports to CEO • Clear board-level mandate to drive savings across all business units and functions • Procurement held in high regard by enterprise	• Strong procurement leadership • Center-led structure with executive sponsorship • Cross-functional, cross-business unit commodity teams each led by an executive sponsor	• Procure-to-pay outsourced to third party • Standard sourcing & contracting processes modified by category as needed • Compliance enabled by executive sponsor policy-setting and spend data visibility	• Spend analysis • Reverse auction • E-procurement • Internal web marketplace for surplus assets

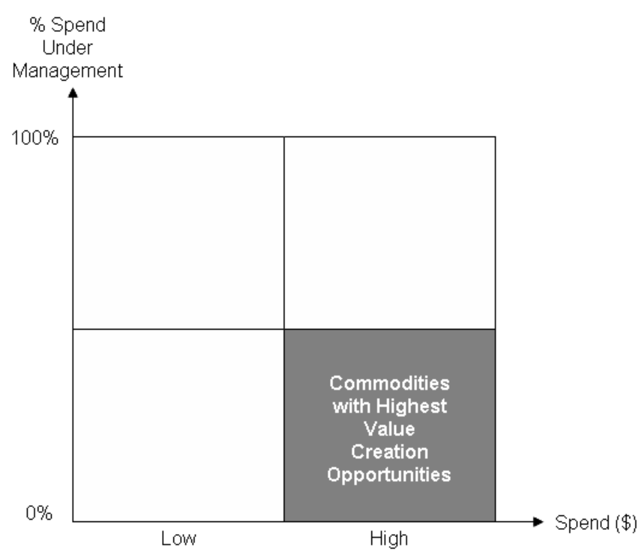
Six Steps to Delivering Enterprise Value through Spend Management

What steps can you take to bring more spend under management and deliver tangible value to your enterprise? We recommend you employ the following approach:

Step 1 – *Understand the Opportunity*

Conduct a spend analysis to develop a single consolidated picture of spend by commodity across the enterprise. Then estimate the percentage of each commodity's

Figure 4 – Opportunities for Bringing Spend Under Management



spend that is currently under the management of the procurement function. Identify those commodities with the highest dollar spend and the lowest percentage of spend currently under management (the bottom right quadrant in Figure 4). These represent your highest opportunity commodities for creating value by bringing them under procurement management and applying spend management best practices.

Step 2 – *Position High Opportunity Commodities in the Kraljic Portfolio*

Assign each commodity in the bottom right quadrant of Figure 4 to the appropriate quadrant of the Kraljic Matrix in Figure 2 according to its profit impact and supply risk. Some examples of the type of commodities that fit into each of the Kraljic Portfolio quadrants are provided in Figure 5.

Step 3 – *Match Value Creation Strategies to Commodities and Identify Programs*

Match value creation strategy to commodity based upon which Kraljic Matrix quadrant a commodity resides in. Use Figure 5 as a guide for determining which value creation strategies are most appropriate for each commodity. When you have determined the correct value creation strategy you are now in a position to define specific programs, e.g. identify, select and implement back-up sources for a defined group of critical spares.

Figure 5 – Value Creation Strategies by Kraljic Matrix Quadrant

Value Creation Category	Kraljic Portfolio Matrix Quadrant			
	Strategic e.g. high value engineered components	**Leverage** e.g. food and consumer packaged goods	**Non-Critical** e.g. office supplies, janitorial supplies	**Bottleneck** e.g. critical spares, long lead time custom parts
Revenue	Supplier partnerships focused on service, quality and performance.	Drive vendors to produce high supply chain performance (fill rate, delivery, etc.)	N/A	Assure supply to prevent shutdowns - back-up sources, monitor market closely, maintain buffer inventories
Cost of Sales	Supplier partnerships to reduce life cycle costs built in during design	Reduce suppliers, standardize, utilize global & low cost country sourcing, reduce freight costs	N/A	Assure supply but control cost by optimizing sources, inventory and transportation
Operating Expense	N/A	Reduce suppliers, standardize, improve contract	Reduce transaction costs, (e.g. e-procurement, p-	Assure supply but control cost by optimizing sources,

		compliance, take on non-traditional categories	cards), improve contract compliance	inventory and transportation
Working Capital	Supplier partnerships focused on supply chain inventory reduction	Utilize Vendor Managed Inventory (VMI) and favorable payment terms	Standardize/reduce user options to reduce inventory requirements; utilize VMI	Assure supply but avoid excessive increase in inventory
Fixed Assets	Supplier partnerships focused on total lifecycle asset cost	Reduce suppliers, standardize, improve contract compliance	N/A	Utilize asset pooling and/or scheduling to assure availability

Step 4 – *Identify Capability Gaps*

Review the capabilities of your existing procurement organization in the areas described earlier, asking such questions as

- Is procurement positioned strategically in your enterprise and does strong executive sponsorship exist for all procurement programs and initiatives?
- Is procurement optimally structured to take advantage of cross-organization spend leverage while also meeting the needs of local users and customers?
- Do you have the right people with the required technical, leadership and teaming skills?
- Does procurement employ best practices in key areas such as strategic sourcing, supplier collaboration, and supply risk management?
- Does procurement have full coverage of all key enabling technologies such as spend analysis, e-sourcing, and contract management?

Based on your answers to these and other questions develop an inventory of gaps in current capabilities that prevent you from successfully executing the strategies you identified in step 3 above. Each of these gaps will correspond to a required investment in organization, process and/or technology (see step 6 below).

Step 5 – *Develop Stakeholder Marketing Plans*

Identify the stakeholders who will be affected by the value creation strategies you have developed. Define the impact of the strategies on each stakeholder's objectives and their roles. Include both the direct impacts of programs and indirect issues such as the need to secure sponsorship and funding from senior executives. Ultimately, decide what specific marketing messages will be required to win the support and active participation of each stakeholder individual or group. Some examples could include:

- Securing the sponsorship of the CEO through the development of a financial business case linking program success to measurable improvements in enterprise profitability and cash flow
- Obtaining approval from the CFO for funding of required investments (e.g. new hires, enabling technologies, etc.) by showing how each investments will directly enable the capture of benefits from the planned programs
- Bringing more marketing spend under management by showing the marketing group how best practice sourcing of commercial print can free up funds to deploy in other areas such as market research and media buying
- Communicating the benefits to manufacturing of procurement and suppliers having improved visibility of short, medium and long range demand forecasts as opposed to the current situation where procurement is an order placer for parts
- Successfully integrating suppliers into the product development process by showing designers how visibility of key supply-related cost data can lead to lower cost designs that still meet all form, fit and function requirements

Step 6 – *Implement a Sustainable Spend Management Business Model*

The last step is to implement a sustainable business model for procurement that locks in the value opportunities you have identified. The key features of this model are a strategically positioned procurement organization, widely adopted best practices, full coverage of enabling technologies and an effective center-led structure (see Figure 6). Early and sustainable benefits can best be realized by implementing each of the value creation opportunities through dedicated teams while simultaneously setting in place the business model elements needed to generate recurring benefits over time. The key steps in this approach are:

- Implement your stakeholder marketing plans from the CEO down to secure support, involvement and funding for all programs and investments defined in steps 3 and 4 above

- Draft a Spend Management Charter laying out the mission, objectives, strategies and performance metrics for a center-led, cross-functionally driven procurement organization

- Communicate the Spend Management Charter enterprise-wide with sign-off from the CEO and all other key senior executive stakeholders (CFO, COO, Heads of Engineering, Manufacturing, etc.)

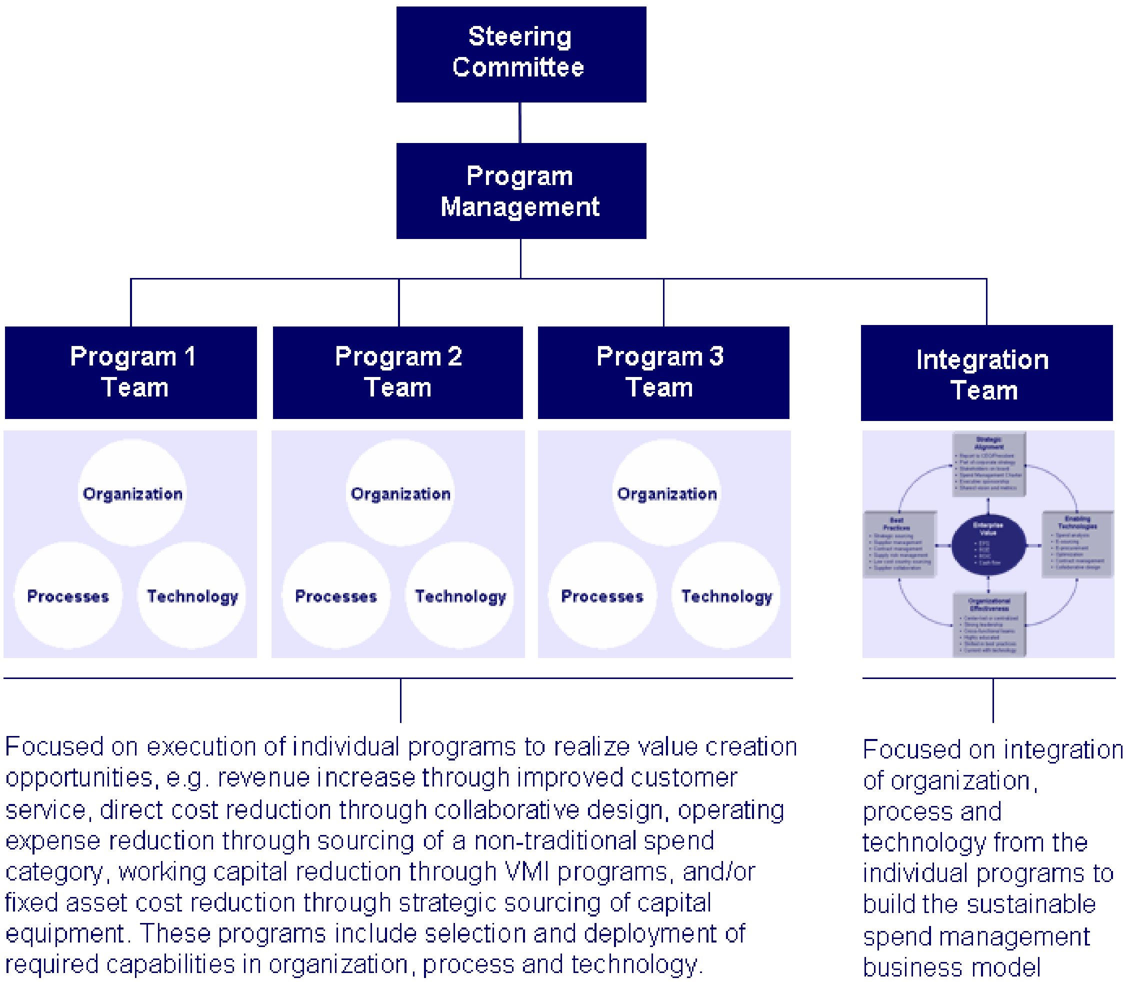
- Develop detailed program plans for each of the identified value creation strategies that clearly define the activities, resources and investments required in organization (e.g. re-structuring, hiring, setting up cross-functional teams, etc.), process (e.g. acquiring best practices) and technology (selecting and implementing vendor solutions)

- Mobilize an implementation organization that includes individual program teams, overall program management, a steering committee of senior executives, and an integration team to design and implement the permanent business model that will enable the delivery of sustainable, recurring benefits (see Figure 7)

- Track the progress of the procurement organization in meeting the objectives and performance metrics laid out in the Spend Management Charter, and make adjustments and course corrections as needed

Figure 6 – Sustainable Spend Management Business Model

Figure 7 – Implementation Organization for the Sustainable Spend Management Business Model



Your Call to Action

In deciding your course of action after reading this white paper, we recommend that you return to the three challenges discussed at the beginning of the document and ask yourself the following questions

- Is my procurement organization currently meeting boardroom expectations for contributions to enterprise financial performance?
- Is my team identifying and managing all sources of supply risk in a timely and effective fashion?

- Are all of the organizational, process and technology capabilities in place to ensure that procurement delivers significant and measurable business value on a sustainable basis?

If you can answer yes to all of the above questions then congratulations! Your procurement organization is clearly an example of spend management best practices in action. By continuing along this path your board and shareholders can rest assured that procurement will consistently deliver meaningful enterprise value even in the most challenging business environments.

If however you answer no to one or more of the questions then we recommend that you consider employing the principles and approaches discussed in this white paper. Start by doing a spend analysis to uncover the size of the opportunity. Understand what strategies are required to capture the benefits. Then be honest about what organizational, process or technology capabilities you are missing in order to deliver those benefits and how much investment it will require to put the missing capabilities in place. Go to all the key stakeholders with a clear message about what is in it for the enterprise and for them. Then, with everyone on board, implement! Within a short amount of time your procurement organization will be delivering sustainable bottom line value to the enterprise and its shareholders and you will be heading a function that is a constant and integral component of corporate strategy.

References

1. **Center-Led Procurement – Organizing Resources and Technology for Sustained Supply Value**. Aberdeen*Group*. November 2005.

2. **Purchasing Must Become Supply Management**. Peter Kraljic. Harvard Business Review, September-October 1983.