Procurement Revisited

“We are earning big bucks for doing almost nothing”. You might have heard this in the last century when many companies invested little effort and still achieved “rocket” sales. However, this is hardly the case in the current economy. Sustainable sales growth is increasingly perceived to be a major bottleneck in corporations. Business success and even survival requires a much more tangible managerial focus on costs, sometimes with the urgency of short time horizons. As various cost-cutting initiatives become the norm, the challenge is how to “get more bang for every buck” invested on such initiative. One of the most efficient and impactful cost reduction levers remains procurement optimization. In many cases, PE firms invest in mid-market companies whose size, history and managerial background do not usually guarantee the highest standards in terms of procurement practices. Procurement is a cross-functional process, which can significantly impact bottom line performance, and on which it is important to have a “steady grip”.

Over a period of 4-6 months, a procurement optimization program can deliver a quick but tangible P&L improvement and enhance the agility of the procurement process, which makes it one of the preferred levers amongst PE firms, particularly in the 2nd half of the investment horizon for growth deals. A target of 8-12% reduction in annual spend on goods and services is reasonable and achievable with fast, traceable impact on P&L, and therefore on the EBITDA.
Symptoms

Based on our experience, companies exhibiting one or more of the following patterns often benefit significantly from procurement optimization:

- Long-term relationships with few, local suppliers
- Order fragmentation across many suppliers and/or over time
- Lack of internal technical specifications or over-specification
- Low involvement in the buying process by users/limited control of the spending by the Procurement department
- Fragmented procurement functions across the company and buyers performing primarily secretarial role/activities
- Absence of formalized processes/procedures and limits on authorization
- Absence of forecast and procurement plans periodic/rolling (re-)elaboration

When facing such context, the benefits of procurement initiatives largely surpass the challenges related to their execution:

Going beyond “Buy the Same for Less”

The objective of a procurement optimization project may sound straight-forward – “buy the same for less”. However, it is never just about knuckling ten cents down with the favorite supplier or getting more cash-back at the end of the year. Instead, the project aims at realizing saving potentials in the short-term while re-constructing an efficient procurement organization (including processes and systems/tools) that guarantees recurrent profits for the longer term. Furthermore, the procurement optimization team needs to go far beyond the surface, reviewing internal spending patterns and the causes of malpractice, and also analyzing the detailed specifications.

Common goals of procurement initiatives are:

- Reduce the unitary cost of purchase
- Optimize the amount of Net Working Capital (NWC) – stocks, payment terms
- Review the minimum/optimal necessity (demand/volumes) for materials, external services, etc.
- Looking for opportunities to simplify the portfolio of procured materials/services
- Define, review and challenge technical product specifications/service level agreements
- Shorten lead-times, particularly for “critical” components
- Improve/redesign processes (e.g. “core” supply chain and budgeting/cost control)

Not all Spending Categories are Created Equally

In an ideal world, the joint team will have good quality data of past spending in order to perform quality analysis, execute rapidly and promptly come back with the expected result. However, a more common reality is that of limited data accessibility, lengthy data collection process, low data quality and difficulties experienced by staff when gathering information required for cross-checks, verifications and mistake explanation. Therefore, initial diagnostics are often coupled with extensive data verification, reclassification and cleansing to accelerate the tendering process and guarantee quality output.

Once we have clarity on spending buckets (baseline and patterns) and the specific project goals are determined, the first step is to define the procurement strategies and approach for each spending category identified. To structure an all-round procurement optimization project, 5 groups of levers are commonly adopted:

1 See the last page for more detailed description of improvement levers
There is no "one size fits all" approach. Levers should be customized in line with characteristics of each category, such as: size, purchasing pattern, industrial margins, degree of commoditization of purchased goods/services. For example, commodities management – including indexing and cost modeling – may be highly relevant for industrial manufacturing companies where the procurement of metal (e.g. steel, copper) makes up the majority of the spending. However, a procurement optimization project for a hospital network would focus more on demand aggregation, review on specifications, and tender process standardization. Larger or more complex categories often require a formalized tendering process with 2-3 rounds of negotiations, while small spending buckets could be tackled with a "quick and dirty", less formal tender or simple organizational adjustment (e.g., aggregate orders and appoint a central reference for small categories; eliminate unnecessary spending and corresponding roles, etc.).

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### Chart 2 – Main lever types and examples

<table>
<thead>
<tr>
<th>Traditional Procurement</th>
<th>Business Process Review</th>
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<tbody>
<tr>
<td>Scout new suppliers and expand the bidders list</td>
<td>Collect and share with Suppliers data on future demand and try to aggregate orders over time</td>
</tr>
<tr>
<td>Negotiate longer payment terms and discounts...</td>
<td>Implement periodic monitoring of consumption and recur to statistical analysis of spending...</td>
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</tbody>
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### Chart 3 – Sample approach to procurement optimization

1. **Initial Scoping**
   - Data requirements definition
   - High level spending baseline understanding
   - Commodities vs. added goods/services
   - Recent optimizations
   - As-Is procurement approach
   - Preliminary identification of opportunities
   - Definition of the financial target

2. **Data collection & analysis**
   - Data extraction
   - Analytical baselines definition (extensive re-classification likely)
   - Diagnostics, e.g.
     - Spending Map breakdown
     - Suppliers’ ABC
     - Orders frequency and Lead-times
   - Brainstorming with experts
   - Focus Categories definition/ prioritization
   - Validate list of opportunities to tackle

3. **Improvement levers implementation & Tender execution**
   - Market understanding
   - First 1-o-1 contacts with Suppliers
   - Tenders preparation
     - Technical Specifications,
     - Vendor Lists (incl. new suppliers)
   - RFI, RFQ
   - Indexes
   - Offers collection and negotiations
     - (1 or 2 rounds)
   - Technical verifications
   - Contracts closing
   - Benefits estimation and business case definition

4. **Follow-up and monitoring**
   - Benefits reconciliation with budget/inclusion in financial forecasts
   - Definition of monitoring mechanisms and responsibilities
   - First monitoring of P&L impact (actual vs. planned) and follow-ups

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There is no ready recipe for project execution in Procurement, but we have seen the following approaches work in many different industries:

- Ensure a thorough understanding of purchasing patterns in all locations and aim at maximum level of volume planning and aggregation that makes operational and financial sense (there could be instances when low volumes or irregular ordering do not merit volume aggregation)

- Work closely with technical staff, quality and R&D departments to simplify and optimize specification – there is always room for significant improvement and risks are more often than not perceived instead of real. Test aggressively for new specifications and suppliers. Think outside the box – think about alternative materials and applications, new recipe formulations, etc., Bench-mark internally – find the innovators within and transfer best practice across the network

- Source across the entire value chain, cutting earlier into it. Remove as many of the middle-men as possible. Consider “non-sources” from other industries and new partnerships of mutual interest – for example, in food industries someone else’s waste is your raw material, or they need only part of the product and you can utilize the rest. Join forces in R&D with suppliers and synergetic non-competitors

- Balance between aggressive price squeezing and long-term win-win partnership, which should be maintained by inviting current suppliers to contribute with cost-saving options on top of pricing (e.g., line audits, SKU rationalization, new specifications)

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3. Quick-hits refer to the opportunities that have a relatively large impact and can be tackled quickly and easily. These are different from the secondary spending categories – small baseline and require more additional effort – which are tackled after the main improvement levers.

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**Not there until seen in the P&L**

Despite the hard work on preliminary analytics, supplier extension and favorable bidding outcome – the project is only deemed successful when we are able to see the impact of the new prices and contracts in the P&L – that is, when first orders are delivered and put in use, invoices paid and supplier implementation is monitored successfully, as well as the quality of suppliers’ processes and delivered goods/services met.

**Show the money**

Introducing new suppliers, new specifications and materials is never easy – doing it in the heat of the high season, for much shorter lead times than the usual – that is what many of your employees will call “impossible”. The most successful projects are those that witness all team members “getting their hands dirty” – from personally transporting samples to the pilot plants to driving 4-5 hours to a new supplier site for a meeting. And what usually helps with speeding up supplier implementation is “showing the money”. Take the example of new product testing for packaging materials – plant managers are generally reluctant to schedule such testing as it disrupts their daily routine. However, once they are made aware of the € 500k annual savings potential from the new supplier, discussion is over and testing priority is set.

**Allow reasonable time for testing**

When we say testing, we do not mean only pre-contract testing – the supplier implementation phase is equally problematic. It is not uncommon to promise the moon on a tender and then deliver sub-par in reality. To avoid this situation, testing specialists should be well informed about the tendering process so that an appropriate testing time frame is budgeted. In fact, what dramatically slows down most tests is not the actual time the product is in testing (sometimes less than an hour) – it is the testing planning and coordination that is often unnecessarily complex and mismanaged. In many cases, external, “spot” auditing support could be helpful.

**Push further – specification de-complexity program**

As a rule, suppliers who provide savings while continuing to deliver to the same specifications will be the preferred choice. This helps avoid prolonged testing time and unexpected loss of savings if the end client does not accept the newly proposed specifications, despite the cheaper price (in the case of private label/OEM manufacturers). A specification de-complexity program can go on for several months after project completion and these savings are often considered to be “on top” of the project. In this phase, specifications will be examined and discussed with the marketing team to make sure the new sets meet end client requirements at lower costs. Such extensive savings can often be achieved by the unification of over-diversified specifications and the use of lighter materials or cheaper raw materials.

**Keep the pulse of supplier implementation**

Employees may think that a procurement optimization project brings disruption to their business and may then continue working in their old ways once the project finishes. To break this perception, a set of customized tools – such as contracts, price tables, guidelines for suppliers to use by category/sub-group/article, as well as more generic tools, such as contract templates, RFI/RFQ templates, offer comparison model, testing tracker – should be transferred during project hand-over. This not only helps employees autonomously implement the new procurement process but also guarantees sustainable P&L impact in the long-term.

**The Culture of Success**

Although many companies know roughly ‘what to do’, they quite often fail to achieve it. The most common hurdle is not knowledge or technology, but surprisingly – the mindset, culture and ability to change. A *hands-on approach and result-oriented mindset* is essential to the successful rollout of procurement optimization projects. Right from the kick-off of the project, the entire company needs to be aligned behind a shared goal that is tangible, broken down into manageable tasks and personalized to speak to the needs and capabilities of specific teams. *Ownership of the initiative* is a strong enabler and ensures sustainability of the improved practices in the long run. A number of practical *‘savings tracking’ tools* should be developed to not only track savings but also to reinforce ownership and responsibility. A good tracking tool is ideally easy to update, share and it provides key stakeholders with the level of detail needed to get a true pulse check of the project’s success. Buyers must
realize that their ways of sourcing and purchasing may be significantly challenged, relationships with loyal suppliers will have to be disrupted, new and untested materials will be introduced. They will, in other words, be pushed “out of their comfort zone”.

Quick Review

Do’s
- Challenge existing procurement practices and declared constraints (e.g. client validation of suppliers/materials employed, quality differences across geographies/suppliers)
- Review demand fragmentation (e.g. in terms of products ranges) and verify required specifications to identify opportunities for review/standardization (de-complexity)
- Anticipate new products/suppliers testing/validation (by clients) so as to accelerate implementation process while minimizing the impact on core processes (e.g. production interruptions)

Don’ts
- Don’t take for granted data received (e.g. price lists, annual quantity) without cross-checking with actual invoices (report and reconcile inconsistency among different internal data source)
- Don’t structure the RFQ before verifying the industrial common practice with suppliers
- Don’t accept verbal validation: ensure benefits blessings are written

Conclusion

Procurement is often more art than science – managing all the floating parts of the puzzle is certainly not easy but that is what makes it exciting and challenging. A joint procurement team, with strong commitment, passion and a positive attitude to break the status quo, is half the way to success. The most successful procurement teams we have seen have all displayed the following: they believed in the goal, they were systematic and willing to venture out of their comfort zone, and they worked well with the data – but most of all, they worked well with people, be it suppliers or internal teammates.

Procurement Levers: Zoom-In

<table>
<thead>
<tr>
<th>Type of levers</th>
<th>Examples of improvement levers</th>
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</table>
| Traditional Procurement | - Scout new suppliers and expand the bidders list (but limit the no. of suppliers awarded)  
- Consolidate “spending” across different suppliers/categories and company divisions  
- Negotiate longer payment terms (impact on NWC and discounts) |
| Strategic Sourcing Relationships | - Eliminate “spot” orders and setup frame agreements (securing the prices, delivery conditions, etc.)  
- Develop joint medium-term plans to enhance both parties’ efficiency and create “win-win” situations  
- E.g. Share volume & product mix forecasts, guarantee a stable share of the future demand, execute cost saving initiatives (better logistics/inventory levels, etc.)  
- Gain “preferred” client status from oligopolistic suppliers  
- Establish procurement alliances: team up with other players |
| Demand Management | - Review/standardize technical specifications  
- Rationalize required quantities/SKUs/SLAs  
- Balance the price-quality ratio  
- Eliminate budget “contingencies” covering inefficiencies |
| Internal Processes | - Share data on future demand with suppliers and aggregate orders over time  
- Implement weekly/monthly monitoring of consumption and recur to statistical analysis of spending  
- Review tendering/purchase approval procedures and enhance platforms (e.g. dynamic on-line tenders) |
| Supply Chain Redesign | - Review “make or buy” decisions  
- Assess the possibility of tapping earlier into the value chain/skip intermediaries |

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