Opportunities for Action in Consumer Markets

Procurement: An Untapped Opportunity for Improving Profits

THE BOSTON CONSULTING GROUP
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Deep inside every company is a procurement opportunity that offers immediate savings, higher quality, and greatly improved profits. Taking advantage of that opportunity is one of the most critical levers a company can employ in an economic downturn. Our experience suggests that by focusing on procurement spending, companies can reduce the overall cost of materials by 10 to 15 percent. To achieve those savings, companies must develop a systematic approach to purchasing that involves aggressively managing product specifications and negotiations with suppliers. This approach also requires new capabilities and analytical skills, and a senior management team that demands improvement.

Tracking Hidden Procurement Costs

When an overheated economy cools off, manufacturers often seek efficiencies in production to reduce costs. To be sure, rationalizing production processes should be an important source of savings, but such efforts usually involve detailed process reorganization, lengthy labor negotiations, and investment in new tools and technologies—all requiring time and resources before any substantial reductions are realized. For many companies, those savings can be too little too late.

Focusing on procurement, which is usually the largest portion of a company’s costs, can yield quicker and often easier savings. Yet when companies go after procurement costs, most of them either leave a lot on the table or discover that costs they thought they had
eliminated have mysteriously reappeared in such forms as higher payment terms, new charges, or reduced levels of service.

One reason procurement costs get out of control is that managers don’t review product specifications regularly enough to determine whether their costs are aligned with the value that is delivered to consumers or with their competitors’ costs. As a result, they often miss opportunities to find less expensive materials or needlessly end up giving one supplier a monopoly on their business.

Furthermore, although most managers think they are tough at the bargaining table, few approach negotiations as rigorously as they should. As a result, cozy relationships become entrenched over the years. To combat the status quo mentality, managers need to go into negotiations armed with supplier-cost benchmarking as well as a methodical analysis of the supplier’s cost structure. Managing these levers is crucial: more than 70 percent of the cost of most commodities is determined by product specifications and 30 percent by suppliers’ competitiveness.

**A Case of Runaway Costs**

Consider the experience of a large baby-food manufacturer that had been spending close to $800 million a year on procurement. Because the company was in a high-margin business, it wasn’t in the habit of monitoring procurement costs closely, and such scrutiny seemed unnecessary in a thriving economy. But as the economy started to cool and market growth slowed, the company realized that it had to make a greater effort to maintain its profit margins. Because procurement practices had not been watched carefully over
the years, they were an obvious place to begin track-
ing hidden opportunities for savings.

The company started with its spending on MRO (maintenance, repair, and operations) supplies and quickly decided to bring in a vendor to implement an electronic-procurement strategy. That move helped reduce costs by centralizing purchases and eliminating a good deal of administrative overhead. But in the final analysis, the reductions weren’t as large as the company had expected.

In search of greater savings, the company turned to its major commodities: ingredients, boxes, cans, and labels. It began by analyzing every element in its system that had an impact on procurement costs, including market forecasting, transportation, regional variations in product specifications, negotiating techniques, and relationships with suppliers. Deep into its investigation, some problems began to surface:

• The company’s negotiation practices were embarrassingly ineffective. Attempts to develop an approach for identifying the strongest bargaining positions were halfhearted at best, and there was little analysis of suppliers’ business economics or cost structures. As a result, procurement managers rarely challenged the status quo.

• Managers were in the habit of purchasing a variety of materials from one-stop, vertically integrated suppliers rather than finding the best supplier for each item.

• The company made little effort to compare its procurement costs with those of its competitors.

• The company lacked a mechanism for bringing the marketing and purchasing departments together
on a regular basis. That meant that there was no system for assessing the costs and benefits of the materials that marketing specified.

- Finally, even when managers found opportunities for cost savings, which might require changing machine specifications or shop-floor processes, they had difficulty getting the organization to execute those changes. Any adjustments to the system took considerably longer than they should have.

Once the company realized how much it was losing by not managing its procurement spending, it launched a full-scale attack on the problem. The company prioritized its commodities, conducted a series of cost-benefit analyses, and benchmarked its costs against those of its competitors across six drivers. The effort revealed a significant cost disadvantage in materials design, the number and type of suppliers the company was using, negotiating techniques, and transportation. (See Exhibits 1 and 2.)

For example, the marketing department’s specifications for packaging materials required a much thicker and more expensive paper than competitors were using, although the higher-grade paper provided no additional benefits. The company also found that the color processing of its cans involved passing over each can four times, even though a single pass would have been sufficient and obviously would have cost much less. Moreover, the company was using two labels (front and back) on its less valuable brands when one would have been adequate. And finally, because of multiple brands and SKUs, the timing of regional promotions, and different content configurations for labels in different regions, the company’s labels were being printed in short runs rather than less expensive long runs. In fact, as many as 80 percent of the company’s labels were produced in short runs, while its
major competitor printed 80 percent of its labels in long runs.

Because the company didn’t have a system to monitor the costs and benefits of specifications, managers had failed to realize that they did not necessarily need materials that were so expensive or involved costly processes. Once it had identified prospects for cost reduction in its specifications, the company then moved to bring the marketing, sales, and production people together regularly so that it could continue to seize those opportunities over the long term.

The next task was to develop a set of aggressive negotiating practices. This required a detailed cost and capability assessment of current and potential suppliers, including an analysis of suppliers’ cost structures.

For example, the company discovered that it was using the highest-priced supplier for one of its major ingredients. When it analyzed that supplier’s cost structure, it found that the supplier was in fact pricing as low as it could considering its own relatively high costs. The company then researched other suppliers’ cost structures—complex detective work that took into account the location of farms and refining facilities, the costs of electricity and labor, and the size of plants, among other factors. It discovered several suppliers whose cost structures put them in a better position to offer lower prices.

The company also looked more closely at one of its one-stop suppliers, which not only supplied boxes but also sourced the paper for the boxes and had it printed. After researching other paper and print suppliers’ costs, the company realized that it could buy the paper and have it printed for less than the box supplier was charging. When the company pointed this out in negotiations, the supplier was forced to lower its price or lose the company’s busi-
ness. Deconstructing the vertical supply chain to reveal discrete costs turned out to be a valuable negotiating lever.

As a result of these efforts, the company saved 12 percent of the value-added portion of its materials costs. The savings were split evenly between improved product specifications and smarter negotiating techniques.

A Strategic Approach to Procurement Costs

To rein in runaway procurement costs, companies need an overall procurement strategy that includes optimized specifications and tough supplier negotiations (see Exhibit 3). To support those objectives,
Companies must establish two continuous processes. The first is regular, comprehensive reviews of the costs and benefits of product specifications, including a breakdown of competitors’ products. The reviews should be coupled with a system for integrating procurement, marketing, sales, and production to align strategies and ensure that decisions on specification changes are quickly implemented.

The second process that is essential to a procurement strategy is one for managing negotiations on the basis of an analysis of suppliers’ cost structures and performance. In following such a process, managers must

- identify the issues to be addressed in negotiations
- determine objectives for cost reduction and improvements in quality and service levels

Exhibit 3. Fundamentals of a Winning Procurement Strategy

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<th>Commodity Strategies</th>
<th>Processes</th>
<th>Resources</th>
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<td>Aggressively review specs to ensure that costs are aligned with benefits</td>
<td>Ensure that spec changes and processes to qualify new suppliers are fast and effective</td>
<td>Provide the resources required to execute strategy</td>
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<td>Choose suppliers that offer the best cost, service, and quality</td>
<td>Integrate procurement, marketing, and sales to develop aligned strategies</td>
<td>Institute disciplined processes to manage negotiations with suppliers and monitor their performance</td>
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Source: BCG analysis.
• define points of leverage and a credible switching strategy

• choose a negotiating strategy based on the costs of switching, the number of suppliers, and the company’s confidence in its price reduction targets

• develop a step-by-step plan for negotiations, specifying when senior management should be involved

• ensure suppliers’ continual improvement by monitoring their performance at clearly established checkpoints

To determine whether your company’s procurement costs are as low as they can go, and to ensure that your negotiations with suppliers are as tough as they can be, ask your organization these questions:

• When was the last time we looked at alternative sources for our most important commodities? When was the last time we switched suppliers?

• Are our specifications consistent with the value they provide to consumers? Do they needlessly constrain the breadth of the supply base?

• Do we understand the cost structures, cost drivers, and profit margins of our key suppliers? Do we know how much they make by serving us? Do we know how important we are to them?

• Are our suppliers motivated to work with us to reduce costs?

In procurement, knowledge is power. Over and over again, we have found that a thorough assessment of product specifications and an accurate understanding
of suppliers’ cost structures can yield substantial savings in negotiations. With the prices of many raw materials rising and the economy in flux, now is a good time for consumer goods companies to get aggressive in their focus on procurement costs.

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