



Strategic Supply Management Alignment: The Itinerary for Your Next Level Supply Management Journey Part III

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Introduction

In the first part of this series, which is the sequel series to Sourcing Innovation's white paper on "Taking the First Step on your Next Level Supply Management Journey", we defined what strategic supply management alignment is and what the essential organizational requirements are to obtain it, and how your Supply Management organization puts together a plan to get aligned.

We started by discussing the 6 Ts -- talent, technology, transition management, tracery, topography, and trail -- that are necessary to achieve strategic supply management alignment and advance the organization to strategic business enablement, and how they combine, through tracery, into a unified tapestry that unites the organization on a collective, strategic, journey.

This journey will be full of trials and tribulations because while the average Big 6 consultancy will try to trick you into trusting that the journey from where the organization is today (A) to where it wants to be (B) is a straight line from A to B that can be accomplished in an orderly linear fashion in seven simple steps, which that consultancy can deliver to your organization as soon as you hand over the check, nothing could be further from the truth. This is the real world, and just like the real-world has mountains and active volcanoes, deep valleys, foreboding jungles, forked paths into dark forests, fog, bogs, quicksand, and mountain passes prone to avalanches, sometimes your organization will have to go around the unclimbable mountainous that block your way and other times your organization will have to avoid the quicksand and quagmires that trap it in inefficient processes. Sometimes your organization will have to choose the dark and foreboding path through the forest (as it's the only way to get out of foggy valley and into the fields of light) and other times it has to take the rickety rope bridge across the chasm, as scary as it is.

Despite the trials and tribulations, if properly planned, the journey can be a successful, productive, and rewarding one. The key is to do the right steps in order, step back and take stock on a regular basis and, most importantly, get all of the key stakeholders on board before starting. This last requirement is crucial, and it involves more than just getting an edict handed down from on high. Projects are always more successful when stakeholders buy in then when they are forced in.

In the first two parts of this series we walked you through the process required to plan, execute, monitor, communicate, and get stakeholders on board with your journey to strategic business enablement. In this third and final part of our series, we are going to switch gears from what your organization needs to do get to strategic business enablement to what your organization needs to do to maintain strategic business enablement, because it's much easier for a strategically aligned Supply Management organization to get there than it is to stay there.

Strategic business enablement, the third and final stage of an organization's next level supply management journey, is not an organizational state, but an operational state. An organization that identifies an end state as strategic business enablement and declares success when it reaches that state has not truly mastered strategic business enablement. The organization is operationally excellent and has the basic capabilities required for strategic business enablement, but it is not truly soaring because soaring requires a commitment to perpetual process improvement and constant transition management. The only way to continually enable the business and provide constant value is to regularly find new opportunities for savings, identify new methodologies that will speed up tactical processes, work with potential partners to deliver free value-add, etc. The journey never ends. When a plateau is reached, the process starts all over again and the organization plans how to reach the next plateau.

In order to soar, an organization has to complete three critical objectives. What are they? Read on to find out.

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Take Flight and Soar

First the Supply Management organization mapped the topography and then it traced the trail and weaved the tapestry so it could cross the chasm. And the organization was rewarded with an outcome that closed the gap between its goals, strategy, and philosophy and that of the organization. As a result, Supply Management performance was improved overall. As far as the organization is concerned, it's reached the third and final stage of its supply management journey. Right?

Wrong. Strategic business enablement, the final stage of any organization's supply management journey, is not an organizational state but an operational state. A Supply Management organization that has achieved true strategic business enablement doesn't stand still. Such an organization is constantly exploring its surroundings looking for new opportunities, identifying new trails that will speed the journey, and making new weaves that will allow it to don its next generation flight suits and soar to even greater heights.

In order to soar, an organization will have to do three things, as will be detailed in the sections that follow.

Benchmark the competition and the market and identify gaps

The organization needs to do three critical kinds of benchmarking.

Benchmark its cost vs. market cost vs. should cost

For example, let's say the organization is a computer hardware (re)seller that assembles and sells high-end computer graphic workstations in North America to engineering, architecture, animation, and other companies that do extensive 3-D modeling. Let's also say that the typical configuration is 32 GB of memory; 2 TB of high-speed storage, 10,000 RPMs or faster; a quad-core processor at 3 GHz or better; a dual-monitor 64-bit video card with at least 8 GB of on-board RAM; a GB motherboard capable of supporting the configuration; a mid-tower case with at least 2 fans and a 750W power supply; and two 23" or better high-resolution monitors.

Let's say that after doing some research into the prices being charged by its top three competitors, and their expected margins to determine their cost, and into the average component wholesale prices the organization discovers that:

Organization's Cost:	Market Cost:	Should-Cost
Avg. Cost: 5100	Competitor A: 5300 Competitor B: 4900 Competitor C: 4600	Avg. Memory Price: 400 Avg. Storage Cost: 600 Avg. Processor Cost: 500 Avg. Video Card Cost: 900 Avg. Motherboard Cost: 600 Avg. Case & P.S. Cost: 200 2 * Avg. Monitor Cost: 1600 TOTAL: 4800

Then the organization knows that while it is beating competitor A on cost, and based on the should-cost, should be beating competitor B on cost, it is not. It also knows that based on the should-cost, it probably should continue to charge more than competitor C as the should-cost model indicates that while it is possible that C negotiated a better deal, it is more likely that either C is not making the margin it thinks it is or is using inferior components that will cost C's organization significantly down the road in warranty-related repair costs. And at the end of the day. It should be able to reduce costs by almost 6%.

Benchmark its sourcing strategy vs. its competitors' sourcing strategies

Let's say that while doing its market research it discovers that while it goes with a single wholesaler and locks in prices for six months at a time, competitor B uses up to three different wholesalers and only locks in prices for three months at a time. Competitor C spot-buys on the open market, which might be another explanation for their slightly lower cost over the past year, but the organization has been burned in the past with that strategy as every time a fire happens at a major memory plant, hard drive plant, video card plant, or processor plant, market prices sky-rocket and the organization has to raise prices to cover the costs and, as a result, loses sales.

This analysis should indicate to the organization that it either needs to lock in prices for a longer time or (be willing to) use multiple wholesalers at one time. Given that prices typically drop on every new product release, and on the release of a non-manufacturer equivalent clone product from a third-party, locking in prices for a longer time probably isn't the solution. On the other hand, a willingness to coordinate orders between multiple wholesalers to get the best price is probably the sourcing strategy the organization should be adopting.

Benchmark average price paid against market prices for commodities

For example, let's say when the organization plotted the average price it paid for copy paper over the past 12 months and compared it to the average price paid for paper in the public sector (based on publicly available public contracts) and the

average market price for paper from the top office supply firms (based on public web-site data), it produced a graph as follows:



In this case, the organization is paying less than the average listed market price, but more than the average price being paid by the public sector. This says that the current strategy being employed by the organization is not appropriate and that the organization needs to either lock in a good contract, or, if one is in place, make sure that it is being adhered to and that maverick spend isn't causing the savings to evaporate.

Once the organization has completed the appropriate benchmarks and identified where it is overspending or not performing to market expectations, it will need to

Identify the Root Causes of the Gaps and Potential Strategies to Solve Them

In our last section, we examined an IT buy and a paper buy and determined that in both cases the organization wasn't doing as well as it could be.

In the case of the IT buy discussed in the last section, the organization needs to understand why it is spending more than Competitor B when the should cost model says it should be paying less. The initial market assessment indicated that the likely reason for the cost differential was over-reliance on a single wholesaler when the competition used multiple.

But is this the root cause of the gap? Is there any reason why multiple wholesalers could be more competitive than a single wholesaler when most of them have access to the same inventory from the same distributors? Especially when distributing the order volume decreases the volume leverage?

The problem might not lie in the strategy of single-sourcing to a preferred wholesaler, but in the selection of the wholesaler in the first place. Let's say that the typical sourcing strategy is just to negotiate with the preferred, local, wholesaler using market prices and, as a result, two of the three suppliers competitor B regularly uses are never asked to quote. In this case, the root cause of the gap is the sourcing strategy, and in this case the sourcing strategy needs to be to increase the competition base for the award.

In the case of the paper buy, which is not being centrally managed, the organization needs to investigate what is happening. After doing so, it realizes that some offices are just buying at the office supply store down the street that is offering 10% off of list price, and other, smaller locations, are just buying at the cheapest vendor they can find once a month with no contract, negotiation, or auction.

In this situation, the organization needs to centrally manage the paper category and negotiate master contracts for each office location to buy off of. While paper may not be that important at each office location, with one hundred offices each spending over \$1,000 a month on paper, that's over \$100,000 a month and \$1,200,000 a year. Over-spending by 10% amounts to a \$120,000, and that's just over-spend against market averages. The organization is big enough to negotiate better discounts and might even by over-spending by \$200,000 a year.

The real gap here is in spending oversight. A six-figure savings opportunity that is so easily identified should not have gone overlooked for so long. So what is the root cause of the spending oversight? It typically boils down to a few situations. Lack of a central P2P system that centralizes spend for analysis. Lack of a good spend analysis tool. Or lack of people to do the analysis to identify the top n savings opportunities and go after them.

If the organization does a root-cause analysis and finds the reason for this over-spend was that off-contract spend doesn't go through the e-Procurement system, often being put on corporate P-Cards, employee cards and expensed for one-off purchases, or just paid by check as part of a monthly payment agreement, then the organization needs to either force more spend through the e-Procurement system or, if the system can't handle it, get a better e-Procurement system.

While it will typically be easy to identify the gaps, as it was in these examples, identifying the root causes won't always be so easy. For example, let's return to our IT example and the situation where Supply Management is analyzing the warranty and return costs for the gaming machines the organization is selling and has identified that the organization's warranty claims are averaging 18% while its competitors' warranty claims are averaging 9%, 11%, and 14%. Considering that each warranty claim costs the organization at least three times as much as the profit margin being made off of each machine, then the organization has to get this cost under control to keep its costs in line and maintain a healthy margin.

But why are the warranty costs so high? Is it any particular component? Is it the assembly process (that is damaging some components)? Are the users fiddling with the machines and causing damage when something doesn't work (when in fact the problem was a driver, and not a hardware, issue)? Are the users overclocking the machines and burning them out?

In order to figure this out, a detailed analysis of claims is going to have to be made to determine what the primary causes are. If a significant number of claims can be pinned to a specific component or a set of components from the same supplier, then the primary reason for the gap is clear and the organization needs to stop using those parts from that supplier because it has no leverage as it does not do direct supplier negotiations, only the wholesaler does. And as long as the customers are buying, the wholesaler isn't going to care.

But if the failures are spread across components, unless the support department keeps good notes on what the IT department finds, it might not be possible to determine the primary reason for failure. So, what does the organization do?

It analyzes the end-to-end process. How are the components being shipped? Where are the machines being configured? How are they being delivered to the consumer? How are they being used? What happens when they are brought in for a warranty claim? What process does the repair shop follow for diagnosis? And for documenting their diagnosis and repair?

The problem could be a host of issues. The components could be shipped in inferior packaging and arrive to the assembler damaged. The assembler could be a low-cost assembler with no knowledge of high-end graphic machine components and, while it can plug and play the component pieces, it doesn't know how to correctly install the drivers and software. The delivery courier to the end customer might not handle the machines with care. The customers might not be plugging them into UPS systems and subjecting the delicate graphics cards to dirty power, causing the cards to blow. The support department might be running the wrong suite of tests and incorrectly diagnosing the issues as hardware issues when they are software issues.

In order to resolve the gap, the sourcing team will have to identify the primary cause. They will need to put processes in place to record and capture all of the information associated with shipping, assembly, and diagnosis to determine what it is. If it is shipping, then Supply Management will need to work with the wholesaler to select better packaging or change carriers to one that handles fragile packages with more care. If it is assembly, they will need to source a better assembly shop. If it is diagnosis, Supply Management will need to source a better repair shop. And Supply Management will also need to see who the competition is using because, obviously, the suppliers of the competition are doing a better job.

However, this is still easy compared to what an automotive or aerospace company has to deal with when a significant number of engines fail. Is it the component, the sub-component, the sub-component parts, or the raw material? It might be easy to pin-point the transmission, but what's the root cause? If it's the converter, is it the turbine assembly, or the stator assembly? If it's the turbine, is it the turbine or the clutch assembly? If it is the clutch assembly then was the part not built to spec, or is it poor raw material quality.

If the organization doesn't have visibility beyond it's first tier, all it will know is that it's the turbine. This is a situation where the only way the organization is going to identify the root cause is if it has multi-tier supply chain visibility into its supply base and knows the quality testing and failure rates of the transmission components its supplier gets, the quality testing and failure rates of the sub-components the turbine supplier gets, and the quality testing and failure rates of the clutch assembly raw materials the clutch assembly supplier gets.

However, this isn't the only reason an organization would need multi-level supply visibility. Another reason it would need multi-level supply chain visibility is if it wants to change the game. For an organization to really soar, the organization will have to:

Find Ways to Change the Game

An organization that is soaring is a forward looking organization and always thinking about what it could be doing with optimization, analysis, advanced supply chain design, visibility, etc. if it was advanced enough on the sourcing maturity curve.

Instead of focusing on how the organization can identify the sourcing projects that could be applied to close the identified gaps, a leading organization focuses on what game changing sourcing projects could look like, once it was aligned, to do even better than it can do today. It's constantly whetting its appetite for ways that it can use its newfound alignment to apply new processes and technologies that will allow it to change the very nature of sourcing and perform better than it could previously have envisioned. What might these projects look like?

Change the Game

Multi-Level Analysis and Advanced Category Management

One of the first things an aligned organization looking to soar will do is to create a should-cost model for each and every product in each of its high-spend categories and analyze raw material usage and costs across the entire category. Then the sourcing team will look at the amount being spent on the raw material by the suppliers, the current market price, and the expected leverage the organization could bring to the table if it bought the raw material on behalf of its suppliers.

If there is a considerable opportunity to take cost out of the equation by buying the raw material on behalf of the supply base and then reselling it to the suppliers at cost, then the organization does just that. For example, an automotive manufacturer will often source catalytic converters, outer panels, engine blocks, etc. separately from different suppliers but if they are sourcing parts that are all based on (stainless) steel, then it might make sense to buy the steel on behalf of the suppliers.

Catalytic Converter	Outer Panel	Engine Block
Steel	Steel	Steel
Ceramic Monolith	Plastic	Aluminum
Silica	Machining	Machining
Alumina	Labour	Labour
Machining	Overhead	Overhead
Labour
Overhead		
...		

However, a leading Supply Management organization doesn't stop at the raw material costs, it also looks at the energy costs, labour costs, and overhead costs. If the energy costs are too high, it will work with the supplier to determine if the energy costs are too high because the process is sub-optimal and/or the machines need tuning and energy is being wasted or because the supplier is paying rates that are too high. If the energy rates are too high, then, provided the supplier's factory is located in a state or province where there is not an energy monopoly, it will help the supplier set-up and run an appropriate sourcing event so that it may obtain better energy rates. Alternatively, it will work with the supplier to see if it should be constructing its own power plant.

If the supplier's overhead costs are too high, it will try to help the supplier identify potential efficiency improvements that will bring the costs down.

Finally, if it turns out that a detailed analysis indicates that no significant reductions can be obtained using any of the above methods, but costs have to come down for the company to be competitive, the sourcing team will work with engineering to identify (a) potential product redesign(s) that use alternate materials that might be producible at a lower cost by the supplier or an alternative supplier.

TVM Optimization w/ Collaborative Sourcing

The next thing an organization that wants to soar does is to upgrade its sourcing events from landed cost, even if landed cost contains all import and export tariffs and not just unit cost and transportation cost, to true total cost. In addition to unit, transport, and trade tariffs, the organization will also take into account (supplier) switching costs, utilization and waste costs, expected failure and warranty costs, and any other costs related to the buy. Plus, in a true total cost model, the organization also looks at the entire product (or service) lifecycle and if there are any future costs related to product reclamation, recycling, or disposal (because local regulations or laws requires it), these costs will be included as well.

And then, once it has reached true total cost modeling, it moves on to total value modeling or TVM. What is the difference between total cost of ownership and total value modeling? In total value modeling, in addition to capturing all of the costs, the sourcing analyst also models in qualitative and quantitative value. For example, if reliability, delivery time, or excess production capacity (in case a primary plant goes down or customer demand surges) are valuable to the organization, then the sourcing analyst will include qualitative constraints that insure a minimum (average) reliability, a maximum (average) delivery time, or a requirement that a supplier have at least two production locations and can produce 50% more than it is being contracted for. This will insure that the organization makes an award to suppliers with characteristics that are valuable to it.

However, if the organization is offering co-marketing, free value-added services, or design services that have a quantifiable monetary value to the organization, then the organization will assign a value to each of these services and model it as a discount associated with selecting the supplier. In the end, a complete cost model that captures all relevant costs and associated value, as well as restrictions limiting awards to suppliers that meet organizational needs, is created. Then the supplier bids are analyzed against this model, typically with a strategic sourcing decision optimization model, and the award is made accordingly.

An organization that does true total value management modeling and optimization will often find that the award changes substantially from the award generated using a total cost of ownership model that isn't much more than landed cost.

For example, let's say the organization has the option of out-sourcing a custom manufactured high-tech component to China or Brazil. Let's also say that the expected defect rate from China is 6% and Brazil is 9%, because the plant in Brazil is newer and less experienced. A quick landed cost model might put China 3% cheaper. But returns aren't bulk shipments that spread the transportation costs over thousands of units to make such costs competitive with transportation costs from Brazil, which also has significantly lower return costs. When the expected costs of returns are factored in over the three-year contract, it could easily be the case that Brazil is 3% cheaper.

Sourcing Opportunity Identification

A leading supply management organization that is preparing to soar above the competition will be regularly monitoring spot-buys and categories with off-contract commodities to identify prime new sourcing opportunities. On a regular basis, which may be monthly or quarterly, depending on the turbulence of the commodities in the category in question, it will look at the average price per unit against the current market price (obtained from on-line marketplaces, commodity indices, and/or should-cost models), and if the difference is substantial enough to indicate a savings opportunity that would exceed the cost of chasing it, then the commodity, and maybe the entire category it belongs to, will be added to the list of short-term sourcing projects.

This might happen if a new supplier enters the market, shifting the supply/demand balance (considerably) in the buyer's favor, if one or more suppliers' energy costs drop significantly and they can sell the product at a lower price and still make a profit (because a new renewables plant opened in the region), or consumer demand stagnates due to economic uncertainty or a recent increase in the unemployment rate and suppliers, desperate to not lose money, begin to sacrifice profit margins.

Re-Sourcing Opportunity Identification

Similarly, a sourcing team that is proactive and on the ball will also be tracking market cycles and prices of products and commodities under contract to determine if it should be considering an early extension to a current contract. For example, if the price of a commodity that usually increases a few percentage points when the standard contract is re-sourced every two years suddenly drops 10% because of new competition in the marketplace and/or increased supply, it might be wise to attempt a renegotiation with the current supplier which would lock the lower price in for an extended period of time, even if the organization is only six months into the current contract.

When an organization combines these first four techniques: multi-level analysis, total value management, sourcing opportunity identification, and re-sourcing opportunity identification, it will find that it doesn't have to attack a 100M spend to find savings, it can use sourcing opportunity identification to identify small chunks of spend in the 1M to 10M range, find savings, and, in the end, possibly find more opportunities than if it just attacked a 100M spend.

Optimal Re-Sourcing in Emergency Situations

What does the Supply Management organization do when an earthquake puts the factory of the organization's key strategic supplier out of commission for at least a year only one year into a three year strategic supply agreement for custom manufactured parts? At this point, the organization needs to quickly identify an alternate supplier and cut a new contract to prevent a critical supply interruption.

In this case, the proactive supplier organization will consult market indices and compare them to historical market indices at the time of the last sourcing event to predict expected supplier bids based on historical supplier bids and changes in market indices. Based on this information, the sourcing analyst will select the top previously qualified suppliers that are likely to give the best bids and jump right to the RFQ phase to accelerate the sourcing process. This is because, even if the list of previously qualified suppliers may not contain the current best supplier, a stock out of the critical product will be much more costly than possibly paying a few percentage points more as a result from the shortened sourcing process.

Continuous Agent-Based Analysis, Optimization, & Predictive Analytics

A soaring organization focuses on the art of the possible and potential future states for a Supply Management organization on a journey to become a true world-leading best-in-class organization.

In this type of organization, the monthly or quarterly sourcing and re-sourcing opportunity identification processes will be automated. The average unit price for each commodity over the period will be automatically computed, benchmark data will be pulled in automatically from relevant sources (and, if appropriate, should-cost models computed), and the sourcing analyst alerted if a price differential or potential savings opportunity crosses a pre-defined threshold set by the sourcing analyst for the membrane.

Moreover, because the process is automated, the frequency of the analysis will be increased and every week the analysis will be run over the past month or quarter's worth of data to allow potentially opportunities to be identified continuously and addressed as fast as organizational resources can get to them. The organization is constantly on the look-out for new opportunities and grabs them as soon as they come into its grasp.

Summary

In the first part of this series, which is the sequel series to Sourcing Innovation's white paper on "*Taking the First Step on your Next Level Supply Management Journey*", we defined what strategic supply management alignment is and what the essential organizational requirements are to obtain it, and how your Supply Management organization puts together a plan to get aligned.

In the second part of this series, we walked through the process of taking a high level plan and converting it into an executable action, implementing that plan, and identifying, and dealing, with unexpected, or unwanted, situations that resulted from the implementation. We stressed regular, and careful, monitoring against the measuring outcomes and noted that if an organization washed, rinsed, and repeated the key activities against each action, it would transform from a tactical, paper-pushing Purchasing organization into a strategic, forward-thinking, Supply Management and Planning organization.

Then, in this part we noted that just because an organization successfully executed its multi-year action plan and achieved all of its goals, that does not mean it has reached the Supply Management plateau of strategic business enablement. It will have achieved operational excellence and may be strategically aligned, but strategic business enablement is an operational state, not an organizational state. This is because the only way to continually enable the business and provide constant value is to constantly find new opportunities for savings, identify new methodologies that will speed up tactical processes, work with potential partners for free value-add, etc. The journey never ends. When a plateau is reached, the process starts all over again and the organization plans how to reach the next plateau. That's strategic business enablement, and that's something that only an organization with true strategic supply management alignment can delivery.