

Bridging the PROCUREMENT- SUPPLY CHAIN Divide

At many companies, there is a divide between procurement and supply chain operations that robs the organization of vital efficiencies. Companies that have recognized that gap and worked hard to close it now see sizeable financial benefits along with qualitative wins such as supplier-integrated contracts and streamlined processes. Here are the six factors that make a difference.

By Ashutosh Dekhne, Xin Huang, and Apratim Sarkar

Procurement teams are good neighbors with their counterparts in supply chain management. But they really need to become family. If they can find ways to interact more closely, they may find they can cut total inventory levels across the value chain by at least 15 percent—and lower overall supply chain costs in the bargain.

Although many companies have been focusing on improving the effectiveness of their procurement operations, relatively few have had much success with properly integrating suppliers into their supply chain operations. There's a mismatch: companies and their suppliers optimize their operations to suit their own environments. The consequences are far-reaching—everything from significant supply shortages and excess supply inventory to frequent write-downs and excessively long shipment times.

You don't need to look far for tell-tale signs of this

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misalignment. We know of a food processing company that stored excess raw material inventory while its packaging supplier was also burdened with finished goods inventory. There is a consumer packaged goods producer that suffered from shortages of a common raw material after it introduced a new product that shares the material with the company's old products. And we have come across a medical device manufacturer that moved to a local production footprint to improve the responsiveness of its supply chain, but then found that it had to ship raw materials around the world.

The misalignment is not the fault of one side or the other. Each has evolved naturally toward efficiencies that make sense for its immediate objectives, but not for the whole. But a root cause of the supplier-customer mismatch is the disconnect between the customer's procurement and supply chain operations. Procurement, the primary face to suppliers, usually takes a static view of business requirements to drive cost reduction while the supply chain operation's main goal is to deliver products and services that satisfy end-customer demand, which is dynamic by nature.

What is needed now is a cross-functional approach that embeds a total supply chain perspective in procurement's operations. Given the continued worries over global economic recovery—and the particular concerns



of business leaders about profitable growth amid signs of slowdown worldwide—we consider it imperative for business leaders to first recognize that there is a mismatch between procurement’s static perspective of supply-side interactions and the supply chain operation’s very dynamic view, and then to act promptly to close it. This article offers six ways to begin to do that.

A Closer Look at the Mismatch

On the face of it, a company’s supply chain and procurement functions should have a lot in common. They both act as primary interfaces between an organization and its suppliers, for example. And they are both incentivized to ensure that materials and components bought from elsewhere are available in the right quality, at the right time, and the right price.

Yet at many companies, procurement and supply chain processes don’t work hand-in-hand, but sequentially. At discrete intervals—during the development of a new product line, for example, or every few years after launch—the procurement function will launch a project to identify suppliers that are capable of delivering specific material requirements at the forecast volume and the required quality. It will then engage with qualifying suppliers to negotiate favorable terms and fix those terms in a robust contract. At that point, procurement hands over much of the management of ongoing supplier relationship to the supply chain function. Procurement staff will continue to monitor the situation at arms’ length, checking that suppliers are complying with contract terms, for example. But the detailed management of orders and logistics is left to their supply chain colleagues.

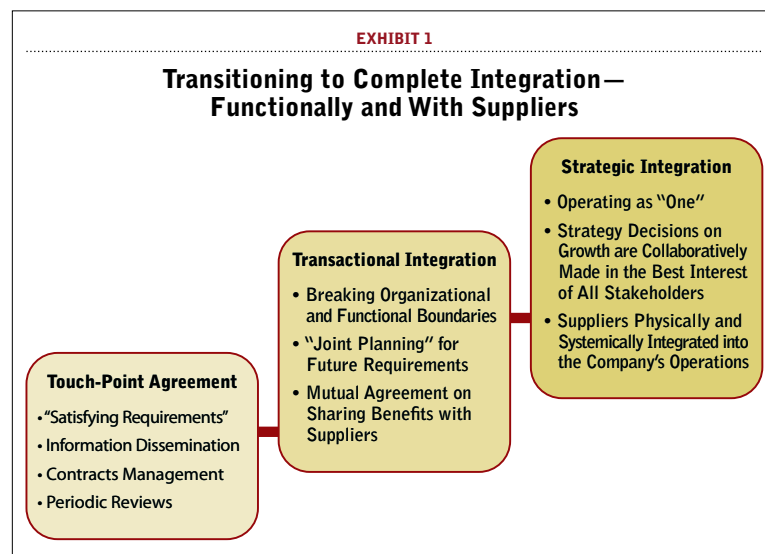
Working this way not only creates significant inefficiencies, but also ignores important opportunities to reduce costs and to add value for companies and for their suppliers. Inefficiencies arise because, even if overall demand meets forecast levels, the day-to-day detail of supply requirements can be highly dynamic. Seasonal demand variability, the introduction of competitive products, or promotional activity in retail channels can drive big short-term fluctuations. On top of this, any number of exceptional circumstances, from floods to product quality issues, can require rapid and significant action by suppliers.

If procurement staff aren’t fully aware of the dynamics of their organization’s supply chain requirements—usually because the supply chain function hasn’t made

them clear upfront—they may not take supplier flexibility into account during the qualification process or build appropriate measures into supply contracts and pricing. One consumer goods company aimed to make itself more responsive to customer demand by shortening its planning cycle from a month to a week, for example. The company’s manufacturing and distribution functions could accommodate the change, but such short lead-times had not been foreseen when many critical supply contracts were drawn up. Some of the company’s principal suppliers were simply unable to operate with lead-times shorter than four weeks, and the result was widespread raw materials shortages.

Some companies are seeking to overcome these issues by improving the collaboration between their supply chain and procurement functions. At its simplest, this approach involves procurement professionals gaining a full picture of supply chain requirements before negotiating supplier contracts. Such an understanding helps to ensure that potential suppliers are able to offer sufficient volume flexibility and sufficiently short leadtimes, for example.

Procurement and supply chain organizations share the responsibility of integrating between themselves and extending that integration outward, strategically, to their suppliers (see Exhibit 1). The benefit of this collaboration goes beyond preventing problems down the line, however. By considering both their own organization’s supply chain requirements and supplier organizations’ supply chain costs and capabilities during contract negotiation or renegotiation, procurement professionals also gain access to some important new levers they can pull to reduce total cost of ownership and improve the overall value of the supply relationship.



Six Ways to Close the Gap

Our experience, observations, and analyses of several companies have helped identify six specific ways beyond the basic touch-point agreements in which consideration of supply chain issues during the procurement process can identify opportunities for further cost savings, reduce supply risks, or allow the supplier relationship to contribute additional value to the business. (See Exhibit 2). We have seen that companies that strive for operational excellence not only embrace integration across the supply chain but also manage it strategically. Let’s look at each of the six factors in turn.

1. Demand Planning

The objective of focusing on demand planning is to create end-customer demand transparency throughout the supply chain and synchronize demand planning activities. Central to demand planning is the need to share with suppliers the stream of unfiltered demand data from end-customers and to leverage the strengths of both parties to jointly forecast demand.

It’s also crucial to synchronize and optimize the end-

to-end demand planning process—for example, order and replenishment activities, seasonal promotions, and the processes for handling exceptions, such as big spikes in demand, whether they are expected or not.

Demand planning also involves strict controls on manual adjustments to forecasts, production plans, and schedules. And it requires that people be held accountable for the accuracy of the data they key into the planning system in the first place.

2. Inventory planning

A renewed focus on collaborative inventory management can help to ensure the best balance and distribution of inventory stocking points across the supply chain—for example, helping to eliminate redundant inventory buffers between supplier and customer—and to create transparency for all supply chain partners. It will lead to alignment on inventory strategy on specific issues such as safety stock levels, inventory planning methodologies, and supply chain parameters. The use of multi-echelon inventory planning techniques can help to set safety stock requirements holistically, pinpointing the trade-offs between supplier inventory, client’s raw material inventory, and client’s stocks of finished goods.

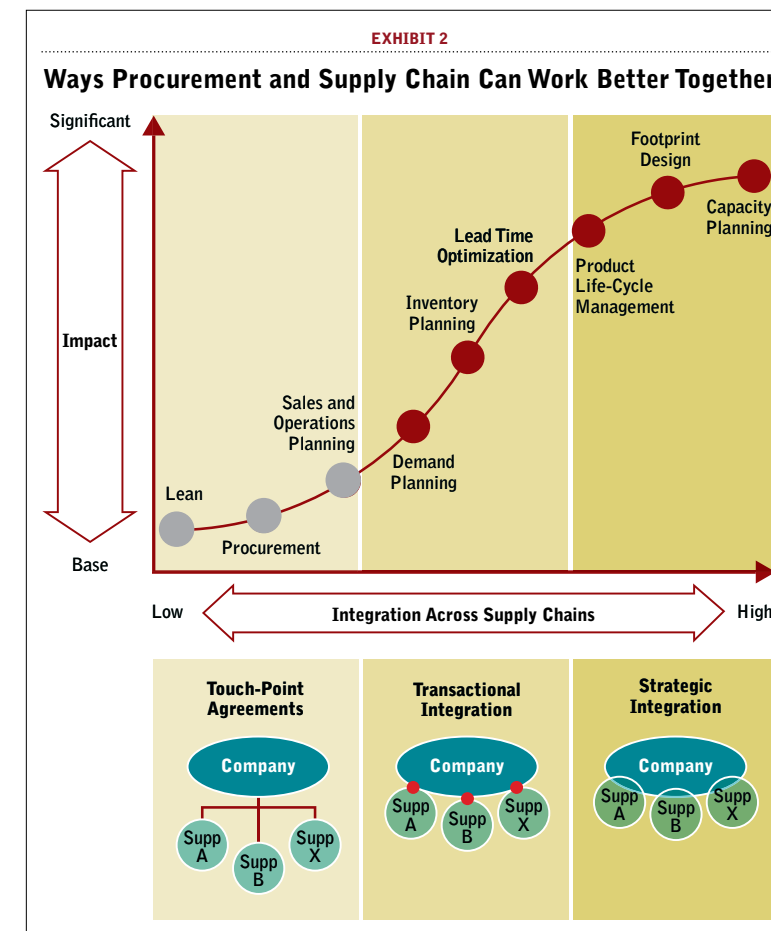
At one large retailer we know of, the joint development of a demand sharing and inventory planning strategy slashed the inventory of big-ticket items by about 60 percent—equivalent to a month’s stock.

3. Leadtime Optimization

Leadtime optimization puts the spotlight on quick responses to changes in demand from end-customers. It helps companies determine their optimal supply leadtime requirements holistically, using a segmented approach—for example, by aligning leadtimes across all components to support the supply chain strategy. It calls for trade-offs between logistics costs and leadtimes, makes use of lean concepts to identify bottlenecks at any point up and down the supply chain (and to devise cost-effective ways to get around them), and determines and enforces guidelines and processes for rush orders, based on cost and benefit trade-offs.

4. Product Lifecycle Management

The objective of this path is to ensure optimal support from suppliers during



product introduction and phase-out. Done right, product lifecycle management implies that the supply-chain partners can optimize end-of-product-life purchases (for example, last-time buys of components) using analytical models instead of “gut feel” decisions. It means that companies have to establish rigorous supply ramp-up and ramp-down processes with suppliers—communicating in detail about design nuances, bills of materials, and so on. There has to be close interaction with suppliers so they can increase capability flexibility to shift between new and old supply chains. And it is essential to leverage suppliers’ capability to drive product innovation and shorten the cycles for product development and commercialization.

A large industrial manufacturer that adhered to these practices saw a 6 percent pick-up in EBIT because its end-to-end product strategy and co-manufacturing approaches with suppliers enabled it to get new products to market in half the time of its competitors.

5. Footprint Design

The intent is to align each supplier’s footprint with the customer’s supply chain strategy. Proper footprint design makes sense of the mix of offshore and nearshore facilities, taking into account the trade-offs between purchase prices and supply chain benefits—for instance, responsiveness and logistics costs. It also helps to fine-tune the vertical supply chain collaboration/integration strategy—identifying the circumstances in which it is appropriate to set up co-located facilities with suppliers to increase supply chain flexibility. (The co-location supply chain strategy of one large high-tech manufacturer helped it cut inventory by about 20 percent and boost EBIT by roughly 6 percent.) At the same time, footprint design helps the company to optimize the transportation network strategy—the use of cross-dock locations, pool-points, and the best mix of third-party logistics service providers and internal logistics capabilities.

6. Capacity Planning

This factor is important in order to align long-term capacity plans between suppliers and customers, and to mitigate the risks of supply shortages. The bedrock point is that there has to be joint planning of capacity with suppliers. That activity will help to determine optimal excess network capacity based on the trade-off between the costs of

and benefits of risk mitigation approaches for handling demand spikes. Joint capacity planning will also help both sides to develop alternate sourcing strategies. The benefits can be rapid and immediate: we know of a consumer packaged goods leaders that realized a 2-3 percent uptick in EBIT after planning capacity in collaboration with its suppliers, and thus optimizing the capacity of its whole supply-chain network.

Benefits for Both Sides

In practice, supply chain levers are particularly useful for procurement functions because they typically offer genuine benefits for both buyer and supplier. Retailers can improve demand and inventory planning by giving suppliers access to point-of-sale data, for example. This can lead to smoother demand profiles than the periodic signals sent by store buyers. In turn, it allows suppliers to reduce their own finished goods inventories, or to run their production equipment more smoothly, creating important cost savings they can share with their customer.

In some cases, closer supply chain collaboration has allowed companies to build whole new kind of relationships with key suppliers. One company in the high tech sector used footprint design and leadtime optimization to do just that. The high-tech company wanted to dramatically reduce its service delivery leadtimes in order to improve the availability of its broad product range without the need to carry crippling high levels of finished goods inventory. The company’s supply chain group worked with its procurement function to find a way of

integrating the supply of critical components in the new distribution regime. The cross-functional group quickly recognized that it risked simply pushing large amounts of inventory upstream to suppliers, which would not ultimately deliver the impact it wanted.

To avoid this, the team sought suppliers that were willing to locate their own parts inventories in the same distribution center as the company’s, and to deliver parts to its production and configuration lines on a just-in-time basis. This tight integration allowed the suppliers to keep relatively low on-site inventories of parts, which the company could pull as required to assemble specific, highly configured finished goods in response to demand signals from its customers. (Although this arrangement seems similar to a traditional vendor-managed inventory (VMI) approach, the differentiating factor was that the setup was operated as a joint venture, requiring adequate process and management controls while ensuring a mutually agreed sharing of benefits from the arrangement.)

Building on the typical levers of procurement, the high-tech company’s strategic capacity planning and footprint design provided a construct to enable end-to-end inventory planning and leadtime optimization across the supply chain. The results were eye-opening: systemwide inventory fell by 19 percent, the company’s freight costs fell by 22 percent, and its suppliers’ freight costs ended up 14 percent lower. Average leadtimes approached zero; customer service levels improved from 68 percent to 94 percent. Operating as a joint venture meant that the company could take advantage of unified IT systems, which led to reduction in the headcounts of planner/buyers from 27 to 16. The company also experienced a significant improvement in EBIT—a testament to the impact of the cohesive integration of functional organizations. This example was by no means confined to the high-tech sector; it could just as easily have occurred in any other industry.

Real Impact on EBIT

In our experience, the combined application of all six supply chain levers in procurement has the potential to reduce total inventory levels across the value chain by 15 to 30 percent, while also producing overall EBIT improvement of 2 to 5 percent, as shown in Exhibit 3. Companies that apply them well enjoy a host of operational benefits too: they gain improved agility—such as greater responsiveness to changes in demand mix—simpler logistics processes, (for instance, transfer of ownership from supplier to customer without the need

to manually handle products), and smoother financial transactions with suppliers (as seen, for example, in the systemic generation and processing of invoice and related payments between the transacting parties).

Lastly, sustainable results will require a rigorous company-wide effort to ensure that capability-building and performance management not only are institutionalized within the organization’s culture but that they include suppliers’ organizations as well.

In our experience, many companies launch initiatives that rapidly achieve short-term value, but they fail to maintain momentum long-term because cross-functional support drops off, core players are pulled into other

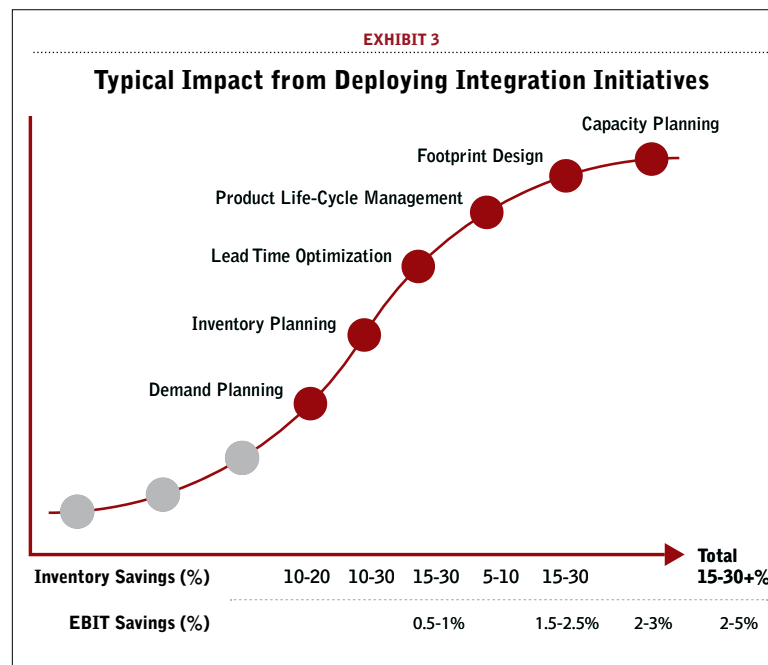
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initiatives, and new players are not trained in time. (See sidebar on the following page, “Why Procurement and Supply Chain Don’t Talk as Often as They Should.”) Companies that succeed over the long term tend to focus on both “performance” and “health,” with heavy emphasis on upfront training in new tools, processes, and approaches so they can build up a cadre of experienced managers who can sustain this effort far into the future.

Next Steps

We recommend three immediate actions for companies that want to permanently sync up the efforts of procurement and supply chain teams. Given that cross-functional collaboration is absolutely key in this process, the first step is to achieve alignment between procurement and supply chain leaderships on the necessity of such an initiative—followed by unwavering sponsorship from those leaders. While it may sometimes seem too prescriptive, it will be essential to obtain clear direction from those senior executives in order to achieve well-defined targets within the mandated timeframes. This will not only define a cross-functional objective but also provide a framework for alignment and engagement.

The second step is to conduct a rapid diagnostic, led jointly by procurement and supply chain, in order to size the potential of cross-functional collaboration, followed by vendor ideation sessions to underscore the benefits of that collaboration. (In our experience, the diagnostic typically takes a few months to complete.) The final step



Why Procurement and Supply Chain Don't Talk as Often as They Should

Intuitively, leaders understand cross-functional issues, but there are three key reasons why they don't succeed when attempting to address them.

1. Inability to address cross-functional trade-offs and maximize value. Often, senior managers lack the comprehensive perspective and pragmatic approaches needed to tackle cross-functional challenges. It's rare for them to have systematic methodologies with which to understand and arbitrate among inherent trade-offs. Too often, their fact bases are incomplete (for example, supply chain planners may order smaller batch sizes because they lack a clear understanding of the contracted volume discounts) and they have too few tools to make an impact—for instance, the kinds of sophisticated tools that can analyze total cost of ownership of products, including inventory carrying and ordering costs. Moreover, there may be only limited links between the business strategy and supply chain strategy, and between the supply chain strategy and the quality of supply chain implementation.

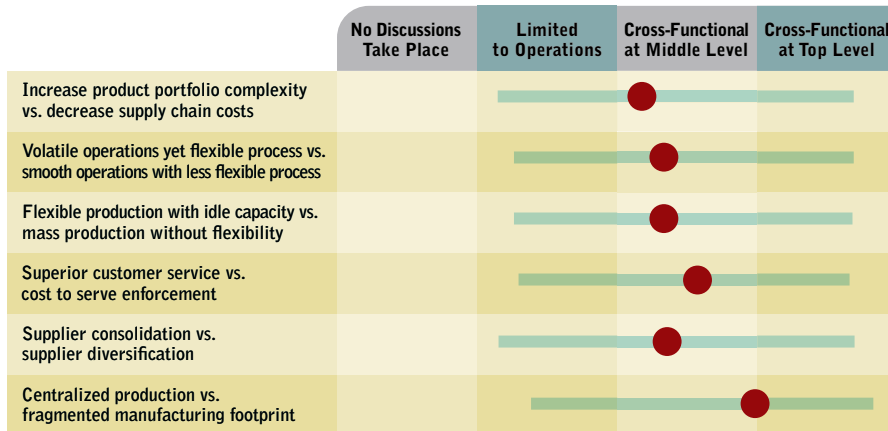
2. Dealing with issues in the wrong forums and without proper enabling elements. A recent executive survey shows that top cross-functional trade-off discussions still take place at the wrong organizational levels. (See Exhibit 4.) There is too little recognition of the factors that really enable change, and inadequate means to implement them even if they are recognized. It's common for there to be too little transparency, inadequate performance metrics, and too few incentives to drive true end-to-end integration. Worse: when middle managers attempt to resolve issues, they typically fight for what's best for the function and not to what's best for the company.

3. Incentives are often misaligned. Even if procurement and supply chain managers do talk with each other, their incentives don't often match the objectives that they should share. Procurement may be measured on savings from applying traditional procurement levers using a total cost of ownership (TCO) approach, while supply chain managers are

usually incentivized based on service levels, logistics costs, and inventory levels. A perfect example of such conflict was evident at a large retailer, where procurement defined volume-based supplier contracts that were executed early in a finite financial period whereas supply-chain operations only ordered as needed in order to minimize inventory levels. This resulted not only in increased procurement costs (higher logistics costs) but also in the loss, later on, of substantial volume discounts.

EXHIBIT 4


Cross-Functional Trade-off Discussions at Wrong Organizational Levels



Source: McKinsey Quarterly—website survey with over 400 executives/McKinsey+Company

is to plan for execution in multiple “waves,” targeting different parts of the supply chain and the vendor base. Depending on the complexity of the procured goods portfolio and the supply chain, these waves can take several months to more than a year to complete.

It no longer makes business sense for the procurement and supply chain organizations to keep acting independently of one other. In today's precarious and highly volatile global economy, companies need every edge they can get. It's clear that those that are finding ways to align

their procurement and supply chain objectives—and that know how to make alignment part of their organizational fabric—are already several steps ahead of their competitors. 

Sources:

“Bridging the supply chain divide: the power of procurement,” McKinsey & Company Operations Extranet, February 2012
 “Bridging the Supply Chain Divide,” Webcast recording, McKinsey & Company, October 2011