McKinsey&Company
Operations Extranet

End-to-end supplier management: the next challenge in purchasing

Companies are starting to exhaust many of the conventional purchasing levers, while the proportion of their value chain outsourced to external suppliers continues to rise. The time has come to fundamentally rethink the nature of strategic supplier relationships

by Ashish Kothari, JehanZeb Noor, Frank Scholz and Jeff Shulman

October 2011

This article is based in part on survey data. Readers are encouraged to participate on behalf of their organizations; please see the end of this article for details.

The majority of the value chain in most industries today is found outside the walls of the manufacturer or brand owner. In consumer-packaged goods, for example, an average of 70 percent of product value is added by external suppliers. In automotive, the industry which pioneered the extended manufacturing supply chain, that figure is as high as 80 percent. Some companies have even built highly successful value chains in which their entire production and distribution value chain is outsourced to contract manufacturers and third party logistics service providers. Even in traditionally vertically integrated industries like pharmaceuticals, the percentage of value outsourced to suppliers is rising: up from around 20 percent ten years ago to 40 percent today.

Companies have very good reasons to outsource aspects of their operations to contract manufacturers or enter into joint production ventures with external firms. Such agreements can deliver important cost savings, by allowing companies to access low cost production sources, for example, or other sources of cost advantage based on scale, expertise or access to particular manufacturing technologies. Outsourcing also helps to reduce capital expenditure, allowing companies to turn fixed costs into variable ones, something that is highly desirable in an environment of unpredictable demand.

The rising importance of suppliers has driven a corresponding increase in the status, capabilities and performance of purchasing organizations. Today, leading companies have developed highly sophisticated skills in the evaluation and selection of suppliers and in the negotiation of supply contracts that ensure on-going improvement levels in quality, price and delivery performance. Their purchasing organizations have increased their internal influence too, working with other functions to optimize specifications, control demand and minimize total cost of ownership.

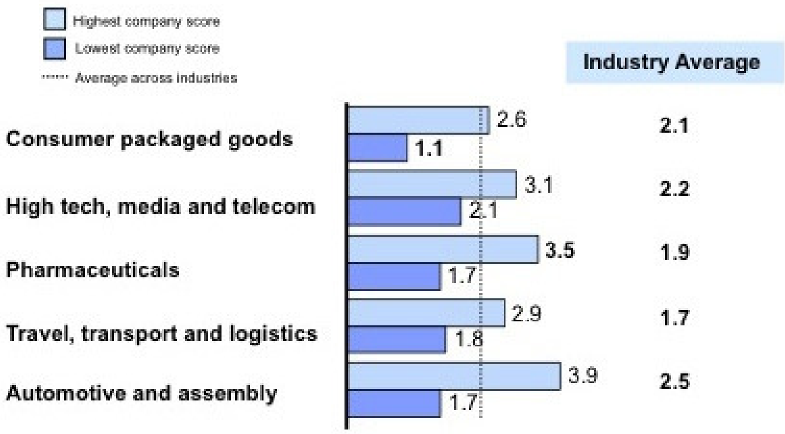
Now many of these companies are finding the next level of performance difficult to achieve. Once you have selected the most capable supplier, negotiated a tough but fair contract and instilled internal discipline, what else can you do?

To better meet customer needs, and to improve their own competitiveness, leading companies across the consumer products and high-tech sectors are increasingly collaborating with suppliers on cost improvement, innovation and agility. For instance, we have seen several companies achieve 10 to 20 percent reductions in material costs alone in some categories. They do this using a structured approach that unlocks opportunities through improved demand transparency, design and specification optimization and bottom-up costing, combined with the development of lean manufacturing at suppliers to improve operations, and the optimization of supplier-plant interfaces.

The supplier management gap

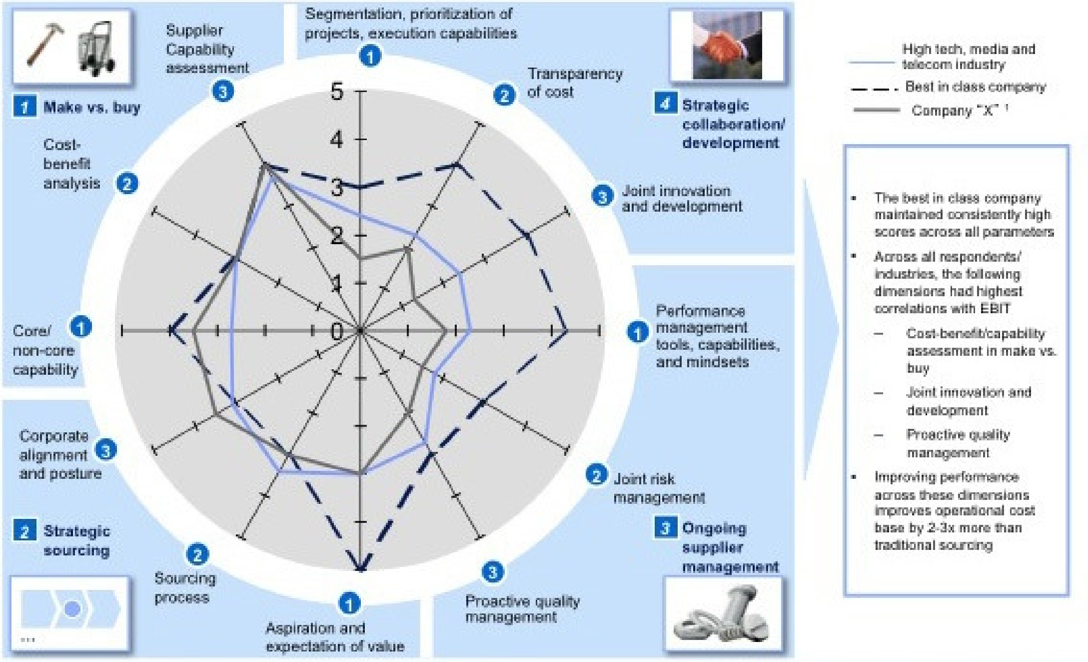
Few companies do this well today. We recently looked at the supplier management practices in use at more than 40 companies we know well in a supply management excellence (SME) survey. We rated their current practices across a range of important dimensions on a scale of one to five, with five being world-class performance. The results of the survey confirmed our hypotheses. As shown in Exhibit 1 below, while there was room for improvement everywhere, performance varied significantly between industries. (Automotive companies in our survey had an average score of 2.5 across all the dimensions measured, for example, while pharmaceutical and travel, transport and logistics companies lagged behind with average scores of 1.9 and 1.7 respectively.) The overall differences were even larger between individual players in the same industry, however. Average scores for consumer packaged goods companies ranged from 2.6 to 1.1, for example.

Exhibit 1: Supplier management scores by industry



When we looked at companies' relative performance across different levers, however, we found a remarkable degree of consistency. Exhibit 2 demonstrates the score for one company across dimensions, and the picture for most cases was directionally similar. In general, companies were strongest in the more upstream aspects of the supplier management process. The processes used to conduct make vs. buy decisions, for example, had the highest scores overall. Companies in the survey had an average rating of 3.0 out of five for these dimensions, which include the evaluation of their own core and non-core capabilities, the assessment of supplier capabilities and cost/benefit analyses prior to outsourcing decisions.

Exhibit 2: Scores of best in class company vs. TMT (high tech, media and telecom) industry vs. an average performing company



1 Company X represents a poor performer in the high tech, media and telecom industry

SOURCE: Interview analysis

McKinsey & Company | 1

Close behind came the 'traditional' strategic procurement levers: the status and strategic alignment of the procurement organization, its functional processes and companies' expectations that sourcing will deliver real value. The average score for these dimensions was 2.9, while the highest performing company scored 4.2. Across industries, High tech and telecom companies were the strongest performers. Surprisingly, automotive companies did not feature in the highest scorers on these dimensions, despite their strong reputation for aggressive procurement strategies. Of the top 10 highest scoring companies, only 1 was an automotive company. The top 10 scores across industries ranged from 3.3 to 5, with 70% of the companies being from the high tech, telecom or pharmaceutical industry.

When it came to ongoing management of supply, companies were weaker, but most good performers had the basics in place, with strong scores for ongoing management of supplier delivery performance (average score 2.7), but weaker ones for quality management and processes for jointly identifying and managing supplier risks (average scores 2.2 and 2.3 respectively). The overall average score for these dimensions was 2.5, while the highest performing company scored 3.8. Across industries, automotive companies were, unsurprisingly, the strongest performers, closely followed by hi-tech companies.

The weakest dimensions for the organizations we surveyed, however, were those that companies can use to evolve and maximize the value delivered by their ongoing supplier relationships. Few companies have formal processes in place to identify which of their suppliers have the most strategic importance, for example. Still fewer had any kind of systematic process for engaging with their suppliers to help them improve those capabilities. Likewise, few companies had attempted more than ad-hoc projects to ensure that the methods they used to interact with suppliers, including forecasting, scheduling, and logistics processes, were optimized to minimize end-to-end cost. The average score for these dimensions was 2.1, while the highest performing company scored only 3.0. Across industries, automotive companies were, once again, the strongest performers with their key strength being management behavior and organizational culture.

Finally, as more of the value chain moves out to suppliers, supplier knowhow and innovation will become ever more important in driving improvements in product and process performance. Advanced products like Apple's iPhones would not exist without technologies and innovations sourced directly from suppliers.

Yet, few companies have systems in place to effectively evaluate and integrate supplier innovations: the average score for supplier development and innovation across industries was 2.2, lower than all the other levers in our survey. Still fewer have closed the loop entirely – revaluating their basic make or buy decisions based on their evolving understanding of supplier capabilities to deliver true end-to-end supplier management.

The supplier management imperative

The relative weakness of companies' more advanced supplier management capabilities should be cause for concern. Our work with companies in a number of sectors has shown that for high performing purchasing organizations, supplier management is the single most powerful lever in reducing costs and improving performance across an extended value chain. Supplier development activities have the ability to bring about a 35 to 40% reduction in total costs in the case of Toyota for example, while improved collaboration between a large retailer and one of its key suppliers allowed them to reduce overall supply chain costs by 15 percent and inventory costs by 20 percent, while simultaneously increasing revenues. The downside of poor supply management is equally costly. Half the cost of product quality and delivery issues we analyzed at a chemicals client could be attributed directly to supplier problems.

What they need

If companies are to reap the full benefits of their supplier relationships, they will need to fix these gaps in their capabilities and supplier management processes. Doing so will require changes to contracts that encourage suppliers to play the most useful role they can in the value chain. It will also need robust performance management systems to ensure that they do this. Purchasing functions will have to change too: really effective supplier management will require professionals with cross-functional skills, who can discuss engineering and manufacturing decisions alongside commercial priorities. Effective supplier management requires the use of skills that are always in short supply, so the most successful companies segment their supplier base and prioritize the management of their most important suppliers■

* * *

In forthcoming articles in this series, we'll look at what companies have to do to make end-to-end supplier management work, and what they can achieve when they do. Our next article will examine the theme of supplier collaboration and development.

If you would like to benchmark your organization on the e2e supplier management journey, please click on the link below to take a short survey. The survey should take just a few minutes to complete and all participants will receive a summary of their company's score vs. industry and best-in-class benchmarks

http://esurveydesigns.com/wix/p3481303.aspx
Username: survey
Password: password

About the authors:
Ashish Kothari and JehanZeb Noor are consultants in the Chicago office, where Frank Scholz is a Partner. Jeff Shulman is a partner in the Dallas office.

The authors would like to recognize Ankur Goel, Tanya Singh, David Ressa, and Naman Maheshwari from the Operations Practice for their contributions to the research carried out for this article.