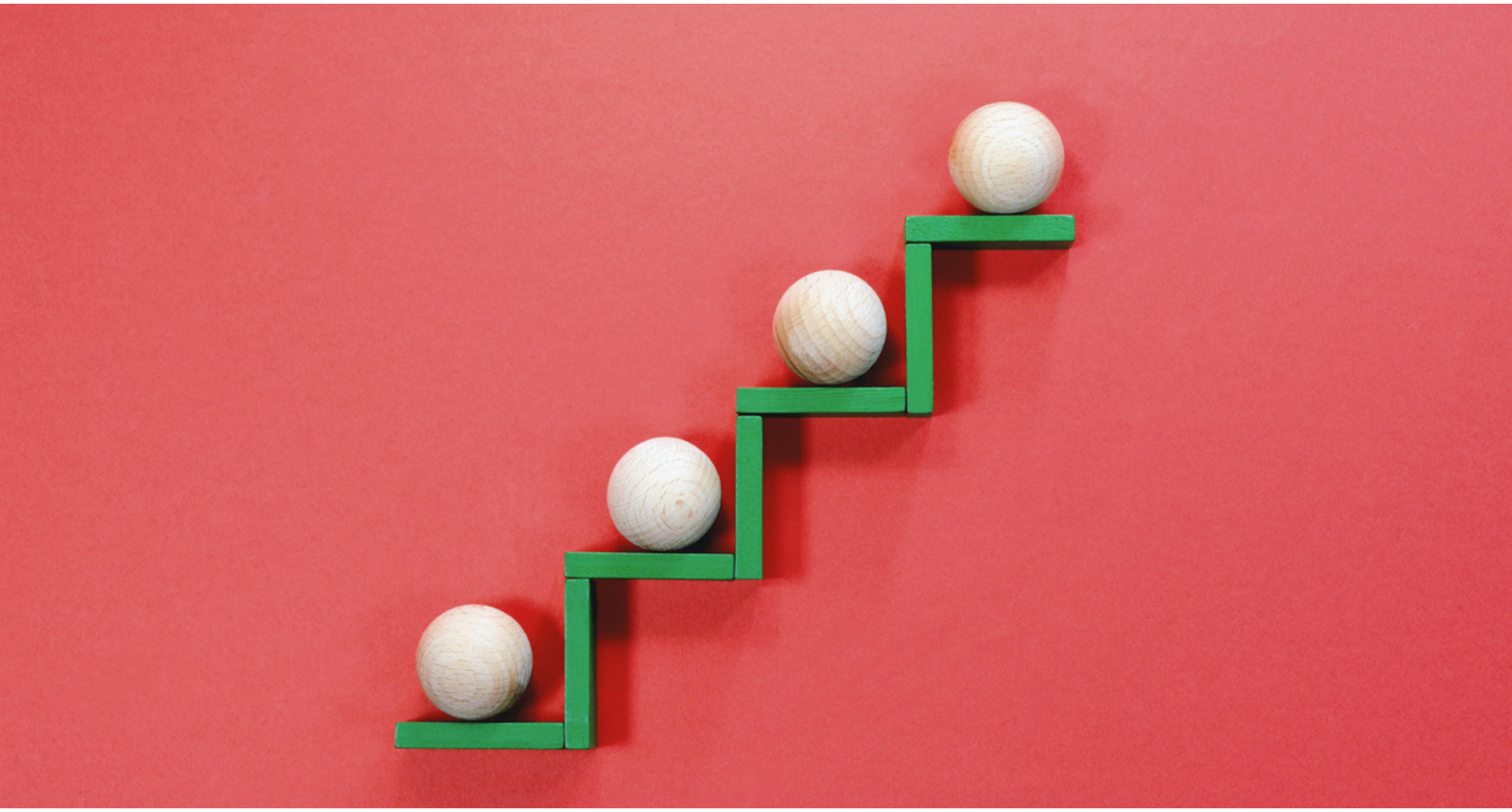
McKinsey Analytics

Indirect procurement: Insource? Outsource? Or both?

A more thoughtful balance between homegrown capabilities and outsourcing can help companies generate more value from an often-overlooked opportunity.

This article was a collaborative effort by Chetan Ghatge, Patricio Ibáñez, Samir Khushalani, Peter Spiller, and Henrique Teixeira, representing the views of the global Product Development & Procurement Practice.



November 2020

For many organizations, indirect procurement—purchases of services and supplies that support business operations—is a source of tremendous untapped value and savings. But even though indirect spend can represent ten, 15, or even 18 percent of revenue in some industries, it typically isn't fully managed by a single function or business owner, and is frequently overlooked as "noncore" spend.

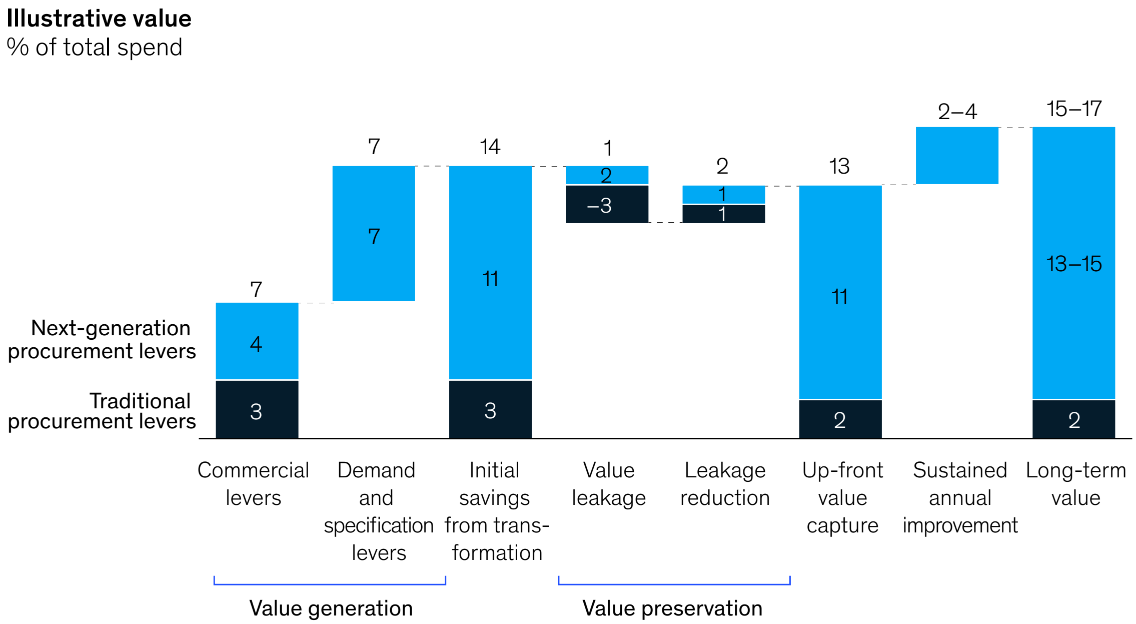
Because many companies lack the necessary capabilities to address all of the potential opportunities and capture full value from optimizing indirect spend, outsourcing can sound like an appealing option. Indeed, outsourcing providers can bring important capabilities and assets to bear, such as domain and functional expertise, knowledge of the market, process discipline, and updated sourcing technology.

But outsourcing raises important risks as well. Over time, it can weaken the effectiveness of the procurement function as a whole, without producing the sustained impact leaders may have hoped for. Instead, companies may find that the value captured in the first one or two years of outsourcing falls, before plateauing at a relatively low level. Moreover, a lack of strong relationships within the client organization can impede collaboration, while the transactional focus of many outsourcing relationships tends to inhibit a more strategic approach to optimization.

A few companies, however, have found that the most effective way to optimize indirect procurement is not simply outsourcing it, but instead transforming the procurement function into a strategic, value-generating arm of the organization. Such a transformation requires introducing rigorous management practices, changing deep-rooted mind-sets and behaviors, and building new, next-generation capabilities in areas such as digital procurement. Yet done correctly, it can yield an initial cost reduction of about 15 percent (Exhibit 1)—which translates to a bottom-line improvement of roughly 1.5 percent.

Exhibit 1

Indirect-procurement optimization can reduce costs by 15 to 17 percentage points.



Companies can capture most of these gains within 12 to 18 months, and continue to capture annual cost reductions of about four percent after the transformation. Our work suggests that completely outsourcing indirect procurement, on the other hand, captures only about a quarter of the full savings opportunity—and can prevent companies from building internal capabilities that can become lasting advantages and sources of resilience.

The expected benefits of outsourcing indirect procurement

Extracting the full value from indirect sourcing requires a well-thought-through, integrated approach (see sidebar, "Value generation, preservation, and enablement in indirect procurement").

Some companies realize they lack the talent, expertise, systems, or infrastructure to pursue such an approach, so they must make a critical choice: develop the capabilities internally, or outsource some or all of the indirect-procurement function. Outsourcing may look attractive, given that the benefits indirect-procurement business-process outsourcing (IPBPO) providers can offer include:

Category expertise. IPBPO providers have access to specialists with substantial domain and functional expertise.

Market intelligence. Providers may be able to generate superior insight on market dynamics, suppliers, cost, and pricing, together with pricing benchmarks as they share information across clients. In some cases, this insight provides leverage that allows for better-than-market pricing and catch-of-the-day opportunities.

Process discipline. Tried and tested, fully integrated source-to-contract (S2C) and procure-to-pay (P2P) processes, along with the discipline to preserve savings (such as by limiting maverick spend, ensuring contract compliance, and deploying catalogs), helps organizations increase procurement productivity.

The latest sourcing applications and technology. Many providers have both proprietary and industry-standard sourcing tools that a client company would otherwise find itself deploying independently. Although this capability has become less of a differentiator as advanced sourcing applications have become more accessible, it nevertheless is often seen as an enabler for value capture for the outsourced categories.

Risk mitigation. In certain regulated industries, having a third party or other intermediary involved in procurement serves to mitigate risks, or pass the risks associated with sourcing those categories onto an entity better able to understand and manage them.

Cost advantages. Outsourcing providers can offer scale and cost advantages that can be particularly important in transactional sourcing activities.

The expectation is that these value-adds can result in faster time to impact, increased spend visibility and compliance, and reduced operational cost.

Where outsourcing can fall short

Relationships with IPBPO providers frequently focus on improving basic sourcing practices, capturing low-hanging fruit such as pursuing volume discounts by consolidating spending. It's much rarer to attempt more-sophisticated approaches, such as should-cost analysis, highly structured negotiations, or advanced request-for-quotation (RFQ) strategies. Consequently, outsourcing frequently runs up against a series of limitations.

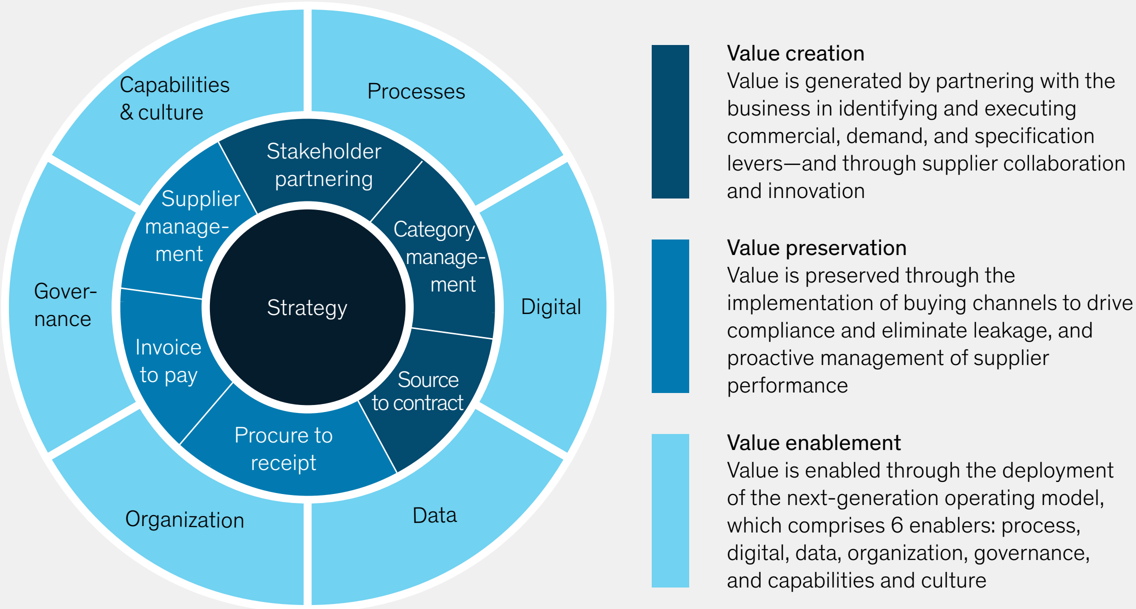
Overemphasizing commercial levers. Exhibit 1 illustrates that even when done well, commercial tactics—such as switching suppliers or sharpening price negotiations—typically represent only about 40 to 50 percent of the full potential value from indirect-procurement optimization. But these levers are the ones that outside parties can readily pursue.

Value generation, preservation, and enablement in indirect procurement

We've identified three main value objectives that indirect sourcing serves (exhibit).

Exhibit

Three value objectives help indirect procurement achieve its full potential.



1. *Value generation* uses commercial management and demand management to inform strategic sourcing. Commercial management matches the best suppliers to different business needs at the best possible prices and through the best available channels (including e-auctions and RFQs based on cost breakdowns). Commercial management also uses tools such as should-cost analyses and total-cost-of-ownership models to negotiate with suppliers.

   Demand management involves optimizing what the company buys (carefully distinguishing essential—and nonessential—solution features through techniques such as design to value), how much it buys, and when. Effective demand management requires deep knowledge of both products and diverse stakeholders within the organization. Knowing stakeholders' interests helps them make decisions that optimize indirect procurement, but it's difficult to achieve, which is why most indirect-procurement organizations don't work much with demand management.

2. *Value preservation* ensures that up-front savings from value generation flow to the bottom line. Leakage can occur in the form of maverick spend (spend outside authorized channels or through nonstrategic suppliers), mismatched purchase orders, supplier noncompliance and a lack of preauthorization. Value is preserved through a robust procure-to-pay function and programmatic management of supplier performance.

3. *Value enablement* maximizes both value generation and value preservation through streamlined processes; broad adoption of digital tools; and clean, classified data, together with predictive analytics, effective governance, advanced capabilities, and a culture of continuous improvement.

Barriers to developing strong business relationships. The rest of the potential value from optimization comes from strategies such as demand management: influencing stakeholders to common configurations, or reviewing specifications to find opportunities for simplification and substitution. Yet these sorts of interventions depend on internal relationships that are difficult for external providers to develop. Moreover, their absence can make even routine business operations more cumbersome, further weighing on value generation (see sidebar, "Q&A: A Fortune 200 organization's experience with outsourcing indirect procurement").

Reduced cost and capability advantages. Savings can be eroded by cost and availability constraints on the IT, talent, and management resources that the IPBPO provider can deliver at any point in time. Ensuring that the services meet agreed-upon standards may also require additional (and perhaps unbudgeted) administrative support on the part of the client.

Misaligned incentives. IPBPO contracts may create incentives to achieve quick wins at the lowest possible cost, with the unintended result of sacrificing service in the name of speed. Total cost of ownership tends to be less of a focus; likewise, there may be few incentives for continuous improvement or innovation. As a result, most of the impact typically arrives in the first couple of years of a relationship, after which savings plateau.

Indirect-procurement outsourcing in practice

Our research confirms that most companies that decide to outsource indirect procurement achieve moderate initial benefits: total cost reductions of four to six percent in the first couple of years, followed by year-on-year additional cost reductions of a further one to two percent. But companies that take back control of indirect procurement and launch full transformations can achieve savings of more than 12 percent, even after the function has been outsourced for a few years.

For example, a semiconductor manufacturer outsourced its indirect-procurement function, establishing 3.5 percent annual savings targets. After three years, the outsourced functions seemed disconnected from the company's business needs, and the savings were difficult to confirm. The manufacturer chose to bring category management back in-house, while identifying a new outsourcing provider for transactional activities and tail-spend sourcing—achieving 10 percent savings on targeted categories.

Likewise, a consumer-goods company spent five years transitioning all indirect procurement to an outsourcing provider. Three years after completing the outsourcing project, the company brought indirect sourcing back in-house, citing poor fit with company culture and missed savings targets as the reasons for its reversal.

An international retailer that outsourced all indirect spend to a third party found that in the first year, the arrangement captured savings of about four percent, which fell to two to three percent in year two. In later years, savings stagnated at less than one percent per year. Although the provider executed well on the contract, it had difficulty building the close functional relationships necessary to make demand-management strategies possible; it also lacked channels to challenge business leaders. These constraints kept the provider from developing deep fluency in the client's business problems, and led to perceptions that it lacked credibility across all categories and focused mainly on achieving the lowest prices.

Consequently, the retailer left the provider in charge of smaller and smaller projects. With ROI dwindling, the retailer chose to take back control of its indirect spend and introduce an analytically driven, fact-based sourcing transformation. In a little more than a year, in-house management of indirect procurement yielded additional cost reductions of more than 10 percent. About two-thirds of the benefit came from complex demand-management tactics, such as aligning the marketing organization across the business to standardize elements of advertising campaigns and relationships with outside agencies.

Q&A: A Fortune 200 organization's experience with outsourcing indirect procurement

We sat down with a leader who led the outsourcing effort at a large company's indirect-procurement organization to learn about the decision behind the choice, and the subsequent experience.

What drove the decision to outsource indirect procurement?
At the time of the decision, indirect procurement wasn't viewed as a strategically important function. The provider made a compelling case to manage both our transactional and strategic procurement functions. I led the outsourcing and was part of the small team left to manage the provider.

How was the experience?
From a financial perspective, we successfully delivered against our business objectives. But the "how," in terms of the quality of the strategy and implementation, started to suffer. For the simpler categories, such as office supplies, the provider could focus almost entirely on price-based negotiations and have success. But, lacking internal relationships, they really struggled in the more complicated and critical categories such as marketing.

What drove your decision to insource again?
My business partners grew to question the outsourcing experience during the duration of the contract. Over time, the business partners and other users started to run their own sourcing events to drive savings, and leveraged the provider just to administer the process.

The contract incentivized the provider based on savings, so its people were happy to play this role. The savings were still achieved, but the business was doing more of the work. Part of the provider's scope of work was collecting and reporting benefits, but we gradually realized that this activity could be done through a system owned by the business to manage procurement-related savings centrally.

At the end of the contract, we decided to insource all strategic portions of indirect procurement while keeping the transactional elements with the provider. We had to rebuild our team, but ultimately that division of labor, with our strengthening our own capabilities, has generated even more value for us.

When outsourcing can help

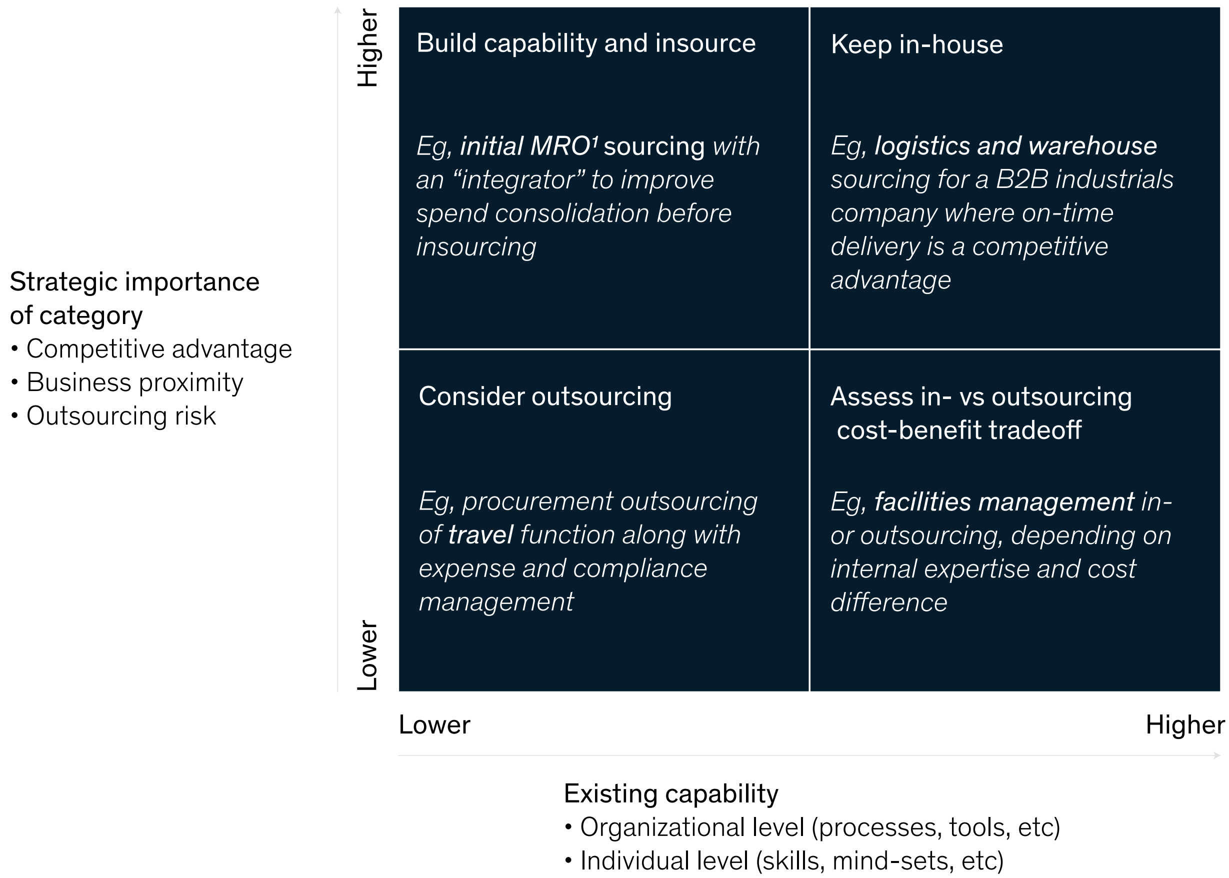
The decision to outsource indirect procurement is not all-or-nothing. Indeed, outsourcing non-strategic procurement can free up stakeholders to focus on systemic improvements that ultimately bring more savings. The key is to understand how to derive the most value from the outsourcing relationship. The considerations may differ depending on whether decision makers are considering outsourcing procurement that creates value, or that preserves value.

Whether to outsource value-creation activities depends on two main factors: the strategic importance of the category, and the depth of internal sourcing capabilities. "Strategic importance" usually is a question of whether the category creates competitive advantage and requires close involvement of the business—or, conversely, whether outsourcing would generate substantial additional risks. Once that determination is made, the organization can assess its internal sourcing capabilities by analyzing the skills, mind-sets, and maturity of the indirect-procurement processes and tools that they have in-house (Exhibit 2).

Likewise, the decision to outsource value-preservation activities should be based on whether an organization has internal economies of scale

Exhibit 2

For value creation, indirect-procurement outsourcing decisions depend on internal capabilities and category importance.



[1]Maintenance, repair, and overhaul

and the capability to effectively run this functions (Exhibit 3). The outcomes of these assessments create four possible approaches to balancing outsourcing with building internal capabilities.

Build own capabilities, consider outsourcing temporarily

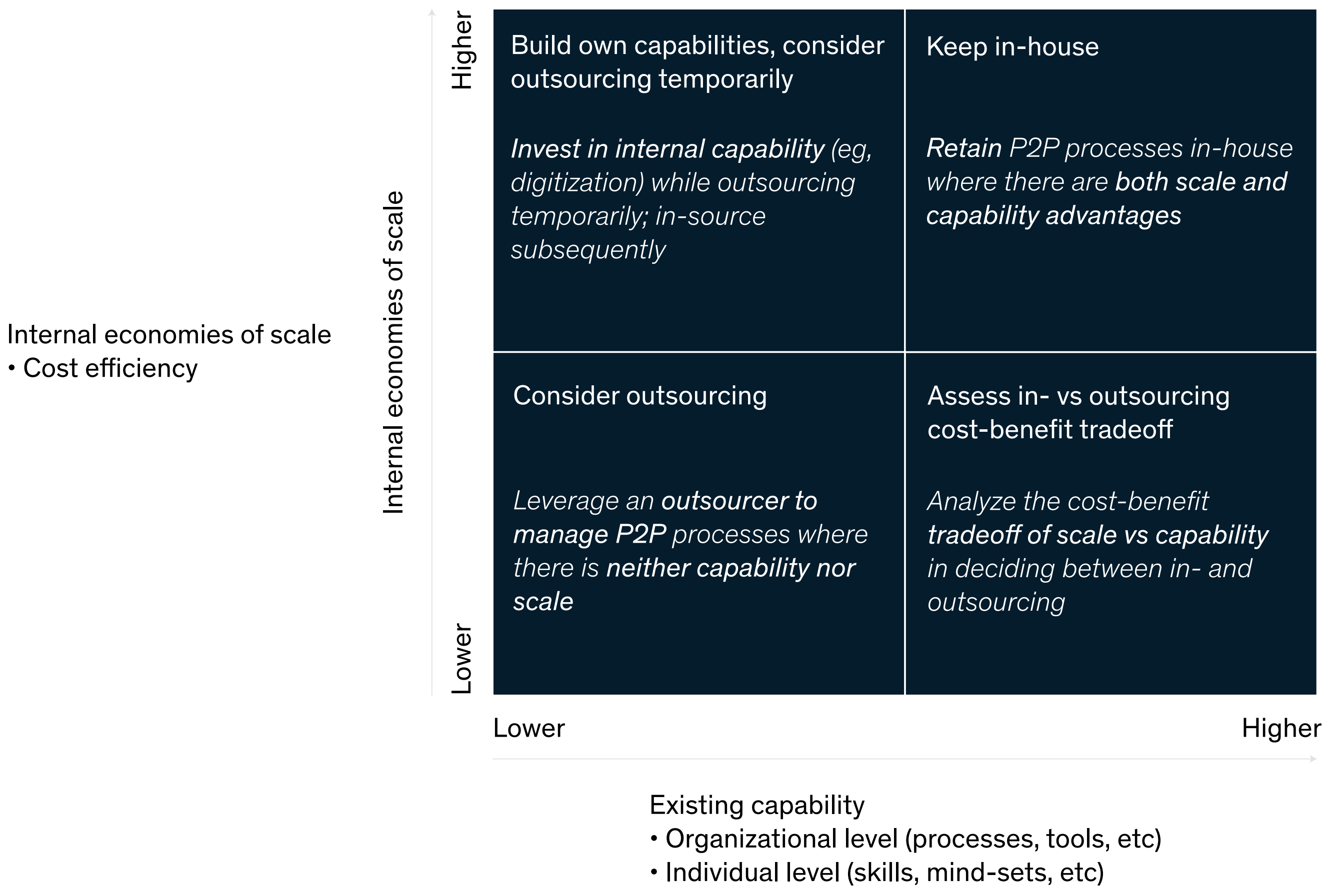
An organization can outsource a process to capture short-term benefits while building in-house capabilities. For example, maintenance, repair, and overhaul (MRO) might be managed by an external integrator. This short-term approach can be especially helpful when spend management is not centralized, master data are poor, information on specifications and prices is limited or unpredictable, and suppliers are fragmented.

Integrators can use their tools and knowledge to collect MRO specifications, identify duplicate products, and consolidate the supplier base. Because external aggregators are likely to struggle to unlock the next five to eight percent of value, organizations can bring indirect outsourcing in-house after building their own capabilities, and use internal relationships to better manage demand.

One method to assess when an organization is ready to insource is through a structured strategic-sourcing assessment. These types of tools help identify both readiness as well as curricula to build capabilities.

Exhibit 3

For value preservation, indirect-procurement outsourcing decisions depend on internal capabilities and economies of scale.



Keep indirect procurement in-house
Organizations that already act on commercial and demand levers (running frequent RFPs, implementing preferred-supplier models, and managing specifications or implementing catalogs) can handle indirect procurement internally. When meeting certain performance indicators is strategically important—such as on-time delivery—stakeholders may want to keep that category internal as well: for example, choosing the right logistics partner may be too critical to a company's competitive advantage to leave that decision to a sourcing provider.

Similarly, an organization can keep activities in-house if it can execute procure-to-pay processes effectively at scale, such as through an internal shared-services organization, and has established appropriate governance structures to sustain the operation over time.

Consider outsourcing nonstrategic indirect procurement
If an organization lacks the capability, capacity, or scale to invest in sourcing, or if a category is of lower strategic importance, outsourcing the corresponding element of indirect procurement

may be the right move. For example, travel and entertainment is not a strategic activity or part of the core capabilities for most organizations. Because many third-party firms specialize in the function, outsourcing this category can be cost effective.

Assess in- versus outsourcing cost–benefit tradeoff

In some instances, organizations may have internal capabilities even for nonstrategic or subscale indirect-procurement categories or processes. The organization can then assess the costs and benefits of outsourcing the work or keeping it in-house, often a balance that looks primarily at the relative costs of the internal organization and the outsourcing contract.

But other factors enter into the equation as well. For example, an organization might have internal expertise in facilities management. Even if the category doesn't have immediate strategic value for the organization, the business might nevertheless determine that retaining the expertise is sufficiently important for future flexibility and retain it. Conversely, it might decide that the expertise would be better deployed elsewhere in the organization, and opt for outsourcing.

Indirect procurement is a critical business function for any company and can unlock significant value while providing competitive advantages. While outsourcing a portion of indirect procurement can offer considerable short-term benefits, such as access to category expertise and market intelligence, long-term value erosion is a serious risk. Companies can achieve a better balance by thoughtfully examining indirect procurement to focus on what matters strategically. Once those decisions have been made, organizations can invest in the people, processes, and tools to capture the savings achieved by next-generation procurement.

Chetan Ghatge is a an associate partner in McKinsey's Boston office, **Patricio Ibáñez** is a partner in the Cleveland office, **Samir Khushalani** is a partner in the Houston office, **Peter Spiller** is partner in the Frankfurt office, and **Henrique Teixeira** is a partner in the Sao Paulo office.

The authors wish to thank Saurabh Garg and Pete Kimball for their contributions to this article.