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Inventing the **21st-century** purchasing organization

To get the most out of the purchasing function, top-performing companies redefine its role and ensure that its goals align with corporate strategy.

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A decade of globalization-fueled competition has opened the eyes of executives everywhere to the strategic benefits that can be achieved through the intelligent use of purchasing and supply management. These include more competitive supply chains, improved product development, and faster times to market—in addition to the significant cost advantages associated with sourcing from low-cost countries. Often, however, evolution in the way executives think about purchasing hasn't translated into results. A dearth of talent derails the improvement efforts of many companies, while others suffer from a misalignment between purchasing and the broader company strategy or from low or misguided aspirations.

Our global survey of chief procurement officers (CPOs) suggests that the role of purchasing at many companies hasn't evolved much beyond the function's narrow, transactional roots as a buyer of materials, components, and services.[1] But some purchasing and supply-management organizations are attracting the attention of CEOs by taking the function to the next level. By integrating their activities more closely with those of their internal customers, some purchasing units have gained sustainable cost reductions in nontraditional areas (marketing or health benefits,

[1] Nicolas Reinecke, Peter Spiller, and Drew Ungerman, "The talent factor in purchasing," *The McKinsey Quarterly*, 2007 Number 1, pp. 6–9.

for example) where previous optimization efforts have fizzled. Others go further still, using their insights to challenge and enhance manufacturing or administration activities. Finally, some use purchasing as a springboard for innovation, leveraging a broader supply base of tangible and intangible goods to enhance product-development efforts.

While no single company we've studied has reached its full potential in purchasing and supply management, a look at the practices of high performers can shed light on what it will take to get there. First, top purchasers adopt a more rigorous approach to talent by simultaneously upgrading their procurement skills and exploring clever ways to connect employees across the organization in a common purpose. Second, these companies set high aspirations and establish goals that balance their vision of the future with a clear-eyed focus on how to achieve it. Finally, top purchasers place a special emphasis on aligning their sourcing efforts more closely with corporate strategic goals, making more of today's cost-savings opportunities while positioning themselves for greater gains as globalization intensifies. These pioneering organizations are laying the foundation for a better approach to procurement—an approach that average performers shouldn't ignore.

The problem with purchasing

Procurement's tactical potential as a cost killer is no secret. After all, spending on purchased goods and services can represent 70 percent of a company's costs, so business leaders have long known that purchasing improvements can directly improve the bottom line.[2] Consequently, the role of purchasing has evolved around the idea of cost containment—say, squeezing external suppliers for price reductions or creating processes to restrain wasteful "maverick" spending. Today such fundamental practices remain indispensable across a range of supply- and demand-side circumstances (the former largely through controlling prices, the latter through better management of what is purchased). Companies that fail to master these basics typically struggle to reap substantial savings, let alone see additional benefits.

For many companies, however, average proficiency in purchasing and supply management masks a troubling problem: purchasing hasn't grown beyond its transactional origins. Talent shortfalls are the largest factor in this problem. Most companies consistently overlook the role of talent in purchasing. At one consumer-driven European company, for instance, the purchasers' lack of marketing savvy prevented any meaningful and

[2] In our survey, for example, we found that the overall sourcing efforts of high-performing purchasing groups generated annual cost savings that were nearly six times greater than those of the low performers.

productive dialogue with marketers as the two groups attempted to define a new sourcing strategy. Indeed, senior executives found that constructive conversations between the parties were impossible until the company hired several purchasing managers with backgrounds that gave them a better understanding of their internal customer's needs.

Low aspirations and a transactional mind-set are another problem. At one consumer product manufacturer, for example, procurement's historical emphasis on transactional activities (mainly handling purchase orders) contributed to management's unwillingness to entrust purchasers with the wider set of centralized outsourcing opportunities they might otherwise have "owned." These responsibilities were instead left scattered inefficiently among several business units until a broad reorganization effort eventually addressed the problem.

An interrelated difficulty occurs when purchasers' activities are misaligned with company strategy. Among poor performers this problem starts when companies fail to involve purchasing in the early stages of strategic planning. The ill effects appear throughout the organization. One large European company, for instance, was more than two years behind in its efforts to incorporate a product innovation that had been widely adopted by rivals. For the most part the problem was that the company's purchasers had a single-minded focus on price, which created tensions with the supplier responsible for the innovation, making collaboration impossible. At another company an absence of English-language skills among purchasers had, over time, made the group organize its activities according to the nationality of its suppliers rather than by the type of goods being purchased. This structure prevented the company from optimizing its supply base to reduce costs—a goal that had become strategically important—while also making it hard for purchasers to gain category-specific expertise, and thus credibility, with internal customers. Likewise, at a company where a major restructuring called for lower costs, purchasers saved money on a business unit's IT spending only to find that poor alignment with the finance group's priorities prevented the savings from reaching the company's bottom line. The business unit's IT budget remained unchanged, though it should have been reduced to reflect the savings.

Value beyond the core

Some companies, though, are escaping such pitfalls and getting more from their sourcing operations. These high performers tend to extend the influence of purchasing within their organizations by closely linking its activities to those of its internal customers, product developers, and other functional groups in order to discover new ways of adding value.

Enter nontraditional categories

Top sourcing organizations excel, first, by extending their activities into areas that have gone unnoticed in the past or areas that have proved too difficult to optimize. Consider a government agency where purchasers helped the HR staff benchmark the agency's benefits plans against alternatives. After analyzing the historical costs of the existing plans, the agency's sourcing group teamed with HR to develop and assess various options jointly and to test their appeal with employees before adopting a new plan. Purchasers brought to the project their analytical expertise and their skills in assessing suppliers and negotiating with them, while HR formalized the design. The resulting plan was approximately 7 percent cheaper than its predecessor and received a 25 percent higher satisfaction rating from employees.

At another company the intelligent use of purchasing helped rein in rising legal costs by separating legal services into commoditized segments (including paralegal and research needs) and creating sourcing strategies for each individual segment. Meanwhile, the company introduced systematic performance metrics—such as indemnity averages—and created an independent general-counsel office staffed with lawyers trained in purchasing basics. Through these measures the company consolidated its provider base to 9, from 900, capturing significant savings in the process.

Challenge the business system

In addition to uncovering hidden value, some purchasers work closely with others within their organizations to challenge and improve the way they deliver products or services to market. At a European conglomerate, for example, purchasers drove a push to outsource more manufacturing activities. By benchmarking the company's capabilities against those of outsiders to identify outsourcing partners and by managing the resulting relationships, the company reduced the level of in-house manufacturing by 30 percent and significantly improved its times to market. Moreover, in one case the company found that sharing a supplier improved a historically thorny relationship between two business units.

Purchasers can also directly support the goals of other functional groups. Some companies already use sourcing hubs in low-cost countries as beachheads to generate additional sales in those markets. Top purchasers take such collaborative efforts much further. At one casual restaurant chain, for instance, purchasers teamed up with the sales unit to devise a way to manipulate dynamically the menu items consumers see. If shrimp became relatively cheaper to source than beef in a given week, for example, the sales staff could quickly position menu items featuring the former

more prominently, and vice versa, thus directly influencing customer demand in response to changing conditions. This approach allowed the chain to maximize profits and minimize the risk of supply disruptions associated with key ingredients.

The ability of high performers to expand their horizons can have strategic implications as well. For example, spiking fuel prices prompted one airline to initiate a procurement-led review of its jet fuel usage. The airline's sourcing unit partnered with engineers to form a team whose analysis subsequently persuaded senior managers to invest in fuel-saving winglet extensions for the company's fleet of older aircraft. This move shaved annual fuel consumption by 3 to 5 percent and extended the operating range of the company's aircraft by more than 125 miles (200 kilometers), making new routes possible.

Stoke the innovation engine

Suppliers have always provided critical fuel for innovation—serving, for example, as a potential source of valuable insights and technologies that support product and process improvements. Purchasers serve as a fundamental link between a company's supply base and the rest of its value chain. Some companies exploit this connection quite effectively. P&G, for instance, has made notable progress on its ambitious target to source a high percentage of its products from outside the company. Its purchasers played an important role in nurturing the early development of the company's popular SpinBrush—an inexpensive, battery-powered toothbrush brought to P&G by outside inventors who had modeled the product on technology they'd used earlier to create a battery-operated, spinning lollipop. Apple, for its part, harnessed its supply base to outsource much of the development of the iPod's hardware and software. Even the idea for the device was brought to Apple by an outside entrepreneur, Tony Fadell.

Certainly, few companies have extended their innovation models so radically, and in many cases they would not be wise to do so—a company's approach to innovation must reflect its industry, its unique strategy, and its competitive position. Still, forward-looking purchasers can work closely with suppliers to spur product and process innovations that save money and even offer strategic advantages. At one high-tech company, for example, purchasers worked intensively with a supplier to adapt the software menus that governed a key piece of capital equipment used in manufacturing. This effort, part of a broader lean-manufacturing initiative, ultimately freed the valuable time of the equipment's operators, who could then support an important expansion of the plant.

Getting there

Although several organizations are making considerable strides along the lines discussed above, none has reached its full potential in any one area, let alone all of them. Still, a look at how these purchasing standouts are distancing themselves from the pack can offer insights into the skills and approaches necessary for achieving wider success in purchasing.

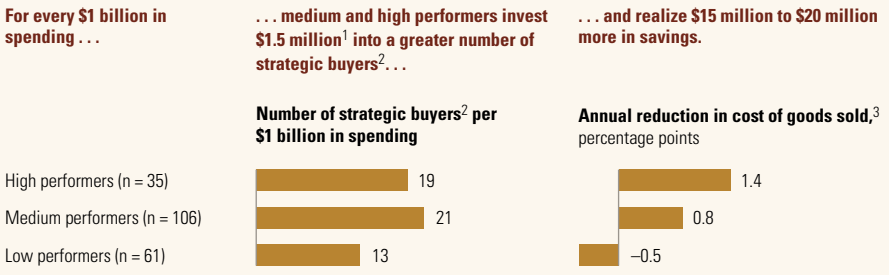
Connect purchasers to the business

The role that talent plays in successful sourcing cannot be overemphasized. In most industries the application of commercial negotiation tactics accounts for as little as 20 to 30 percent of the impact available from purchasing improvements. The rest comes from managing product specifications and demand—practices that purchasers learn as a result of deep functional and category expertise, their ability to apply it across a broad range of circumstances, and their understanding of the company's wider aims. Recognizing this reality, top companies start by filling key purchasing positions with people who have a deep understanding of vital spending categories—for example, carbon composites for an aerospace company or marketing for a telecommunications company. By exhibiting a strong hiring bias toward experts, these companies improve procurement's credibility among internal business units and create an environment that nourishes collaboration. The best purchasing groups aggressively recruit such professionals from within the ranks of their own companies, by finding, for example, a talented development engineer to manage the company's sourcing of electrical components or a senior IT professional to develop strategies for sourcing the company's technology. No matter where companies find these experts, our evidence suggests that the benefits of hiring them are significant (Exhibit 1).

Top sourcing groups also use systematic talent-development programs that help purchasers beef up their commercial acumen and establish relationships with internal customers. For promising university recruits, this training might take the form of a rotation program offering a variety of operational experiences. For long-term staff, some companies create special training programs. One large logistics conglomerate, for instance, suspected that a lack of relevant skills in the central purchasing group was hampering its interactions with an important business unit. The conglomerate therefore created a two-year "training academy" that offered high-potential candidates classroom training, workshops focused on specific product categories, and individualized development plans. The company also established strict criteria to ensure that purchasers running sourcing projects had appropriate functional knowledge in addition to skills in project management, communication, and leadership.

EXHIBIT 1

Better people, better results



[1]Assumes $0.2 million in costs per strategic buyer.

[2]Strategic buyers lead cross-functional sourcing teams that develop sourcing strategy, while transactional buyers take care of subsequent purchase order processing.

[3]Averages over 3 most recent fiscal years; for companies operating in Africa, Asia, Europe, and North and South America in the following industries: automotive and assembly, chemicals, consumer packaged goods, energy and utilities, financial services, high tech and telecommunications, materials and construction, pharmaceuticals, retailing, transportation, travel and logistics.

Source: 2006 McKinsey and Supply Management Institute (European Business School) survey of purchasing executives at >200 companies

Today the company's purchasers are seen as peers by the business unit (indeed, purchasing employees have been poached to fill some of its leadership roles), and cooperation between purchasing and internal customers has improved dramatically.

Top companies also actively link purchasers with other groups in their businesses. Some rotate key personnel through engineering, manufacturing, marketing, or quality-management roles, while all forge partnerships between purchasers and these areas by creating standing cross-functional teams. These teams, led by purchasers and organized along spending category lines, form the backbone of a company's sourcing activities. They could, for example, define the specifications of necessary products and services, create sourcing strategies, and conduct supply and market analyses. Following this approach, one large European manufacturer created more than 50 such teams, charging them with uncovering savings opportunities and developing new sourcing strategies. Within nine months the insights, analysis, and commercial thinking these teams generated were responsible for €100 million in savings—and such results aren't atypical. Indeed, we estimate that employing cross-functional teams can nearly double the impact of a savings initiative (Exhibit 2).

The US state of Illinois jump-started its recent purchasing transformation by hiring a group of experts in areas such as health care, employee benefits,

the contracting of services, IT, and knowledge management. After receiving intensive, "boot camp"–style training in purchasing, these experts led teams that helped save nearly $300 million over two years. To share information across agencies and departments, one of these groups, the new knowledge-management team, created a Web-based tool to bring together data on supplier capabilities, industry performance, and purchasing tools.

Shoot for the moon, but start on the ground

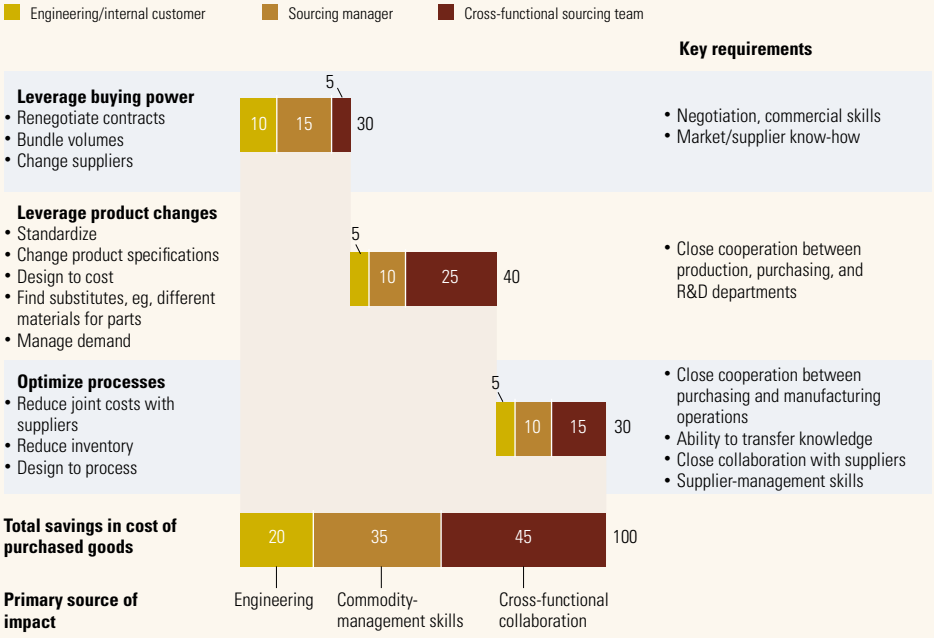
The best sourcing groups strive to transform their roles within the organization, and this effort starts with high aspirations. Within high-performing sourcing groups, for example, employees are far more likely to view cost reductions as a vital (though not sufficient) stepping-stone to a wider impact than are their counterparts in low-performing groups. Top performers view purchasing not only as the commercial conscience of the organization but also as its competitive eyes and ears.

However, these groups back such lofty aspirations with a pragmatic approach to achieving them. Typically, the transition to achieving such a mind-set begins when a CPO works closely with the CEO and other senior executives to set (and subsequently meet) aggressive, organization-wide savings targets. While it may seem counterintuitive to start with

EXHIBIT 2

The power of teamwork

Distribution of potential savings by source, %



costs only to move beyond them, it's important to recognize that many low- and even average-performing purchasing units either don't set such targets or else create uncoordinated ones—for example, applying goals across a smattering of spending categories or business units. This mind-set often results in blurred accountabilities, a diminished sense of urgency, and, consequently, unrealized or unsustainable results.

By contrast, when CPOs collaborate with other senior managers to champion goals that cross organizational and product line boundaries, the savings potential not only is greater but also creates an opportunity for purchasers to establish credibility with other business units. The large European manufacturer mentioned previously, for example, is following this path. After setting a goal to reduce spending on purchased goods by 13 percent, and supporting that goal with a robust, cross-functional initiative, the CPO observed that the purchasing group's relationships with business units improved and that its broader aspirations gained traction. As the initiative proceeded, the benefits of working more closely with suppliers early in the design and manufacturing process became clear, and senior engineers who had initially resisted the changes began to come around. Indeed, less than a year into the change, the CPO found that several top engineers from key business units had actually applied to join the new purchasing group.

For one mobile-telecom company, heightened aspirations arrived along with a new CPO, who immediately and publicly assumed responsibility for the lion's share of cost reductions identified in a new restructuring program. After meeting the target, the unit set about transforming its role from the company's buyer into a cross-functional partner and has, along the way, gained responsibilities that would have been unthinkable just four years before—including decision rights for the company's handset portfolio.

Align purchasing with strategy

As the mobile-telecom company's experience suggests, once high-performing sourcing groups establish a track record of value creation and become collaborative peers within an organization, they can begin to realize their broader strategic potential. This new role must be codified by the CPO and other senior managers and communicated throughout the company so that the responsibilities and decision rights of the group are understood and embraced by the business units. Of course, the details of the sourcing unit's new responsibilities will vary with the company's strategic aims—for instance, is the company pursuing innovation-led growth or outsourcing its manufacturing to compete with low-cost competitors? The answer to such questions will determine how purchasers identify, manage, and interact with suppliers.

Once the sourcing group's mandate is clear, CPOs can actively engage with other senior executives in the early stages of strategic-planning activities to properly align purchasing with company strategy—and begin applying sourcing expertise in a variety of circumstances. For one North American retailer, for instance, a major purchasing initiative gave the company the financial leeway to pursue a broader restructuring plan that included revamping the appearance of its stores and enhancing its marketing approach. One aerospace company's purchasers supported a divisional spin-off by managing the difficult contractual issues involved in disentangling the unit from the company while also protecting the purchasing synergies that the new entity represented as a supplier.[3]

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Finally, given a high-performing sourcing unit's role as a bridge connecting different groups within the company, it can even support organizational change. The European manufacturer, for example, had suffered heavy losses in a core business area as a result of the dot-com collapse and subsequently needed to instill a stronger commercial mind-set among its engineers to cut costs. The CEO found that the procurement-led cross-functional teams provided an excellent mechanism for successfully communicating management's new message throughout the company while simultaneously preparing it to compete in the new environment.

A few companies are making major strides in creating a better approach to procurement. By emulating these practices, other companies might begin the process of transforming their purchasing organizations from mere corporate buyers into a powerful, competitive weapon that adds value far beyond cost savings. Q

[3] For more about the role of purchasing in mergers and acquisitions, see Timothy L. Chapman, Jack J. Dempsey, Glenn Ramsdell, and Trudy E. Bell, "Purchasing's big moment—after a merger," *The McKinsey Quarterly*, 1998 Number 1, pp. 56–65.

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