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Creating value through procurement outsourcing

Before they outsource strategic procurement, companies must look hard at the true value drivers and long-term benefits of using third parties

by Peter Spiller and Martina Tokic

The rise of business process outsourcing (BPO) has transformed the structure of many industries in the last two decades. Companies now routinely hand over activities, processes, or whole operations to third parties. The BPO industry, in turn, has evolved to offer an ever-broader range of services, including many strategically important ones like manufacturing or R&D.

In procurement, the outsourcing process has followed the same trajectory, albeit more slowly. Outsourcing transactional procurement, like order processing or the management of invoices, is now relatively common. Only in the past ten years, however, has the outsourcing of strategic procurement activities, like supplier selection, contract negotiation or specification management, become more widespread (Exhibit 1).

Exhibit 1

Procurement outsourcing can span a number of activities, from strategic to transactional.

NOT EXHAUSTIVE

Purchasing process							
Strategic (sourcing) activities				Transactional (procure-to-pay) activities			
Demand and specification management	**Strategic sourcing**	**Supplier management**	**Sourcing support**	**Operational purchasing**	**Procurement admin**	**Accounts payable processing**	**Technology and support systems**[1]
• Specification development • Policies/ processes development and implementation • Change management	• Developing and implementing category strategy • Supplier selection • RFx • Negotiations • Contracting	• Supplier performance management • Contract management • Supplier relationship management • Supplier development	• Spend analytics • Market analysis • Supplier profiling • Contract administration • Risk management • Spot buy • Auction support	• Requisition processing • Purchase orders processing and expediting • Materials and services receipt recording	• Performance monitoring (supplier, financial) • Compliance monitoring (policies, contracts) • Reporting	• Supplier master file set-up and administration • Invoice processing and payment • Bill auditing • Time & expense (T&E) auditing	• Help desk • Catalog management • eProcurement • Solution hosting

[1]Managed/sourced separately or as a part of procurement outsourcing (PO) agreement (PO provider utilizes own or third-party technology).

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Providers say that outsourcing these activities offers their customers a host of benefits. By aggregating demand from multiple customers, they aim to secure lower prices. In addition, large facilities in cost-efficient locations help them to reduce the cost of executing time-consuming activities like supplier assessment or processing RFQs. The providers' scale also gives their customers access to expertise, especially in categories where low spend makes it hard for customers to keep the right sourcing expertise in house. Finally, outsourcing smaller or less important categories to a third party leaves in-house purchasers with more time to spend optimizing the procurement of strategically critical ones.

Some companies have certainly been successful in outsourcing some or all of their strategic procurement activities. One European utility outsourced its entire purchasing function to an external provider on a five-year contract, for example. The outsourcing provider was able to apply proven commercial levers as part of their strategic sourcing activities—like volume-bundling, introducing new suppliers and renegotiation with existing ones—and it was also able to use low-cost processing operations to save money on transactional activities. These changes helped the company to cut its overall operating costs by 19 percent, and improved its customer service.

Not every outsourcing agreement runs smoothly however. One large mining company entered a contract with a procurement outsourcing (PO) provider in which the provider received a percentage of the value of every transaction it managed. This arrangement gave the provider little incentive to reduce purchasing spend and the company captured far lower savings than it had hoped.

In another case, an electricity distributor decided to reverse a previous outsourcing decision due to frustration with its provider's poor cost control and lack of focus on savings. The company set up a new central purchasing function with world-class processes and was able to capture average savings of almost a third in the first three major categories it tackled. That company wasn't alone in reversing a decision to outsource strategic procurement. One European bank did just that after a multi-million Euro deal with an external provider failed to deliver the savings, or the service, it had promised. Another manufacturer disentangled its relationship with a major procurement outsourcing provider because the company did not manage to connect with, or influence, its fragmented internal user base, resulting in little impact.

We believe that the failure of many outsourcing deals was built into these agreements from start. A lack of understanding of the underlying drivers of value in the categories they outsource leads companies to pick the wrong partners, outsource the wrong activities and agree to the wrong incentives that will ensure sustainable long-term savings. To make strategic procurement outsourcing a success, companies need to take a highly systematic approach with three basic steps:

1. They outsource strategic buying only in categories where doing so offers clear value.
2. They have a precise understanding of the sources of that value and how to unlock them.

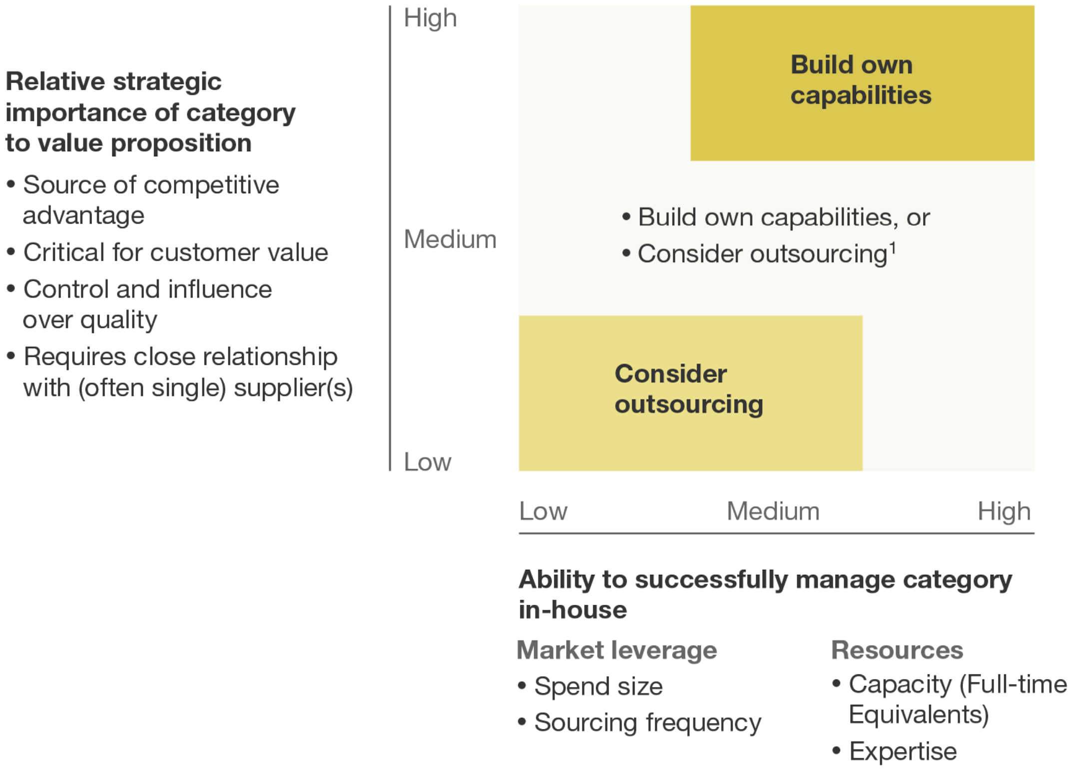
3. They choose outsourcing partners that have the capabilities to address those sources of value, then define and implement agreements that maximize the chance of capturing potential savings

Picking the right categories

Deciding whether to outsource strategic buying in a particular category requires the same thought and analysis as any other make-or-buy decision. The right decision rests on two factors (Exhibit 2).

Exhibit 2

High-level approach for strategic segmentation of categories.



[1]Decision based on whether internal or external party can generate more value.

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What is the strategic importance of the category? Some categories may be a distinctive source of competitive advantage for the company, or of such significance to quality requirements or customer value proposition that outsourcing them would create unacceptable risks to the business.

Can the company manage the category effectively in-house? A company's ability to capture the maximum possible value from a category depends on a host of factors, including the size and complexity of the supply market, the organization's relative influence in that market, the existence of appropriate in-house expertise, and the availability of sufficient capacity to manage the sourcing process. In the case of non-critical categories, companies should ask themselves if another organization might be in a better position than them to manage that category. In general, therefore, outsourcing is a more appealing option for categories where companies spend less or buy less frequently, or where they lack the skills or resources to do a good job in-house.

As they undertake this analysis, companies need to consider the medium- and long-term implications of their decisions as well as the short-term effects. For example, one global food processing company deliberately retained the management of a number of non-core categories in-house. It used those categories to develop junior members of the purchasing function, helping to ensure succession within the organization.

Where is the value?

Once an organization has drawn up a shortlist of potential categories for outsourcing, it needs to decide whether it should. To do that it needs to understand exactly how outsourcing might deliver value in the category, then pick the right provider and the right deal that capture that value. The value levers available to strategic buyers—whether in-house our outsourced—fall into four main categories.

Volume aggregation. By bundling demands from multiple clients, outsourcing providers can often negotiate better prices, especially in areas where the company's own spend is too small or infrequent to give it a strong position in the market. To capture the benefits of volume aggregation, however, companies must be sure that their own specifications and delivery requirements are sufficiently similar to those of the outsourcing provider's other clients, and that they are willing to accept the provider's sourcing decisions, such as in moving to lower cost suppliers. It is also worth checking whether volume deals always make sense. We have seen examples where small organizations were in fact getting better prices than much bigger companies because, as niche players, they were not as prominently on the supplier's "radar screen." By selling more cheaply to these customers, the supplier would not endanger overall market price levels, but would still capture the additional volumes.

Expertise. Their scale allows outsourcing providers to offer deep expertise and real-time market insights across a broad range of categories. Access to leading expertise doesn't just provide direct benefits in categories where companies don't have their own expertise. It can also help them to "learn from the best" and improve their own capabilities in other categories.

Labor arbitrage. Outsourcing providers offer a combination of scale, standardized processes and low-cost locations designed to reduce the labor cost of sourcing activities. While labor arbitrage often delivers significant benefits in transactional sourcing activities, however, the nature of strategic buying can limit the savings achieved. Many strategic activities—from negotiations around specifications, to drawing up contracts or managing on-going supply—require close cooperation with, and often physical proximity to internal customer departments in the company. As a result, it’s usually lower-paid internal positions that are outsourced, and savings are often offset by the increased costs of managing the external provider.

Demand and specification management. In the most successful purchasing organizations, 40 to 50 percent of the total savings achieved come from changes in internal factors, like optimizing specifications to minimize total cost of ownership or controlling demand. Such savings also tend to be the most sustainable over the long term. Capturing the benefits of demand and specification management requires close and on-going collaboration between the purchasing function and other parts of the business, however, which can be harder for an outsourced provider.

The potential power of these various levers varies for different organizations and different categories. It also varies over time. Commercial levers, like volume aggregation, can often deliver rapid savings, for example, while demand and specification changes, while ultimately more valuable, often take longer. If outsourcing contracts fail to target demand and specifications, savings rates can flatten out over time. This can lead to customer dissatisfaction and ultimately to the termination of outsourcing arrangements.

Companies also need to be sure that outsourcing really is the best way for them to access the value they seek. Scale is only one factor when seeking price reductions, for example. Many companies achieve significant savings through smarter negotiations of strategic importance to their suppliers. Similarly, a company might be able to access favorable prices by joining a purchasing consortium, or reduce labor costs by opening its own service center in a low-cost region.

Designing and executing effective agreements

Once they know how the outsourcing of strategic buying can deliver value, companies must take the appropriate steps to see that it does. Ultimately, the success of any outsourcing arrangement is determined by the preparation and implementation of the underlying agreement. That, in turn, depends on selecting an appropriate provider, on establishing strong relationships between the provider and the wider organization, and on tight management of the process once it is underway.

To select the right partner, companies need to thoroughly assess the market, including the supplier’s experience, expertise, scale and existing customer relationships. Different players in the procurement outsourcing space have very different value propositions (see sidebar, “Picking the right partner”). Companies must also ensure that the provider’s geographic reach and culture fit with their needs. When one global mining company entered a procurement outsourcing agreement, for example, its internal purchasing department was forced to provide extensive support as the provider’s employees were perceived within the organization to be inflexible and difficult to work with.

To build an effective relationship between the provider and the wider organization, the company must ensure that the proposed agreement meets internal requirements. Resistance from top management or from business units can scupper an outsourcing agreement from the outset. Stakeholders across the business need to be satisfied with the reasoning behind outsourcing effort, and compliance with internal sourcing policies must be enforced. Most companies find it essential to appoint an outsourcing manager to monitor the performance of the provider and address issues in the relationship. Companies also need to ensure they are treating their outsourcing provider as a strategic partner—clearly communicating strategic direction and giving the provider sufficient control of categories and suppliers to work effectively.

The right incentives are vital to keep the interests provider's and company's interests aligned. Strong agreements focus on metrics that drive long-term savings, like continuous improvement targets. The associated targets must be clearly defined and measurable, and all parties in the agreement must understand the goals and expectations and how they are calculated. Misaligned incentives can result in failed relationships: by encouraging the outsourcing provider to focus on quick wins or on lowest-cost suppliers, for example, quality, service and total cost of ownership may be compromised.

Finally, companies need to thoroughly prepare the transition and implementation phases of the agreement. They need to back the implementation with a strong internal team that can support users through the transition, resolve issues as they emerge, and guide on-going refinement and improvement of the relationship. One global telecommunication equipment provider involved stakeholders in early pilots of a new outsourced e-procurement system, for example. Fine-tuning the system based on user feedback helped ensure high compliance when the system was eventually rolled out across the organization.

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Outsourcing strategic procurement activities can give companies access to scale, expertise and capabilities they don't have in-house. But it also carries significant risk. To make these agreements work, companies must ensure that the benefits BPO providers offer is clear, and that the scope and incentive structure of the arrangement is designed to capture value over the long term■

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Sidebar: Picking the right partner

Different players in the procurement outsourcing space have different skills and different propositions for their customers. In selecting a partner, companies need to understand whether the capabilities and geographic scope they offer are the right ones to capture the value they need. Players in the market today fall into three broad groups:

- **Multi-tower business process outsourcing (BPO) generalists** are large global players that provide end-to-end services for procurement and other functions. Their key value propositions are volume aggregation and price negotiation. They can usually take on a wider range of categories, but often offer standardized solutions across companies and focus less on demand and specification management. In fact, many multi-tower BPO generalists see procurement as an entry ticket to addtional BPO and IT outsourcing activities.
- **Procurement specialists** are smaller players with regional or category expertise. They provide end-to-end services, and typically work closely with stakeholders. Their key source of value is thorough demand, specification and supplier management with internal customers, i.e., changing companies' purchasing behavior. However, they usually lack global presence and have less ability to aggregate spend.
- **Offshore service providers** are large providers that offer cost savings from labor arbitrage through offshore resources, mostly for transactional and sourcing support activities. Hence, their ability to tap all available value drivers is often limited.