"Best Practices" Newsletter

About This Issue

This March 2002 edition of our newsletter contains more techniques to help our clients & colleagues accomplish their strategic procurement objectives.

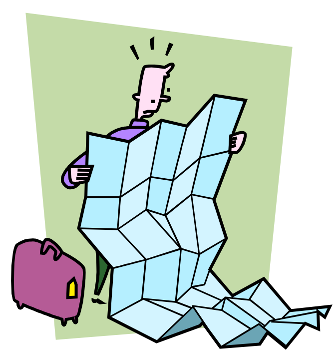
Strategic Procurement Solutions is a consulting firm specializing in Strategic Sourcing, Training, and Organizational issues related to procurement & supply-chain management. Robert Dunn, C.P.M. & Mark Trowbridge, C.P.M. are senior partners in the firm, and lead teams of professionals in supporting our clients.

Visit our web site at **www.StrategicProcurementSolutions.com** for more information or to contact us about our consulting & training services.

Our team will be at the San Francisco I.S.M. International Conference. If you have time, please drop by the Exhibit Hall (Booth #914) to meet us...

Myths About Consortium Purchasing …

by Mark Trowbridge, C.P.M.



Great benefits can be attained by synergistically leveraging combined volumes with other buying entities. This practice is referred to as "Consortium" procurement. Consortiums can be led by participant members, or by a third-party who spearheads the consortium.

Our partners have worked with, and on behalf of, many consortiums. We've achieved impressive efficiencies for the members, and provided suppliers with access to qualified customers. On a recent airline flight, I was seated next to the VP of Sales for a large pharmaceutical firm who works with several leading consortiums. He confirmed the following "myths" that are held today:

Consortium Myth #1 – Prices offered by a supplier to a consortium always represent the combined volume of consortium member purchases. Actually, suppliers quote consortium pricing at levels slightly lower than the level justified for the *average consortium member alone.* This is because suppliers need to have an acceptable profit margin for all sales to a particular consortium. Suppliers who operate in “consortium rich” industries may even standardize the price levels offered to various consortium groups (irrespective of volume).

Consortium Myth #2 – All members of a consortium receive more beneficial pricing than they can qualify for individually. Actually, larger members of a consortium can usually directly negotiate better prices & terms with suppliers based upon the lower cost of doing business with them. Some consortiums are even beginning to negotiate “tiered” pricing levels on behalf of their members to reflect varying member volume.

Consortium Myth #3 – All of a buyer’s volume should be focused through consortium relationships. Actually, the optimal mixture may be to have direct provider relationships for a buying firm’s high volume commodities, coupled with consortium pricing for lower volume acquisitions.

Consortium Myth #4 – Visible pricing represents all transactional value. Actually, in non-member operated consortiums it is not unusual for the consortium sponsor to be receiving a “commission” or “revenue share” from the enrolled suppliers. This can be in addition to membership fees paid by the member firms. Member companies should be aware of all transactional costs before they enter into a consortium. We recommend that a direct question be asked of the consortium coordinator, “Do you receive any revenue from consortium suppliers?” All pricing factors should be fully available to member companies.

Consortium Myth #5 – Lower unit prices represent lowest total cost. Actually, members should always be aware that although a consortium has negotiated discounted prices with key suppliers, those suppliers do not always represent the best value. Revenue factors discussed in “Myth #4” above can influence the selection of consortium suppliers. To ensure they personally receive the best total value, members should continually educate themselves about other suppliers not represented in their consortium. Moreover, pricing on identical SKU’s can vary between suppliers selling to the same consortium.

Consortium groups represent a wonderful value for many buyers. Their benefits are especially available to small & medium sized buyers, or large firms needing niche supplier support. Care should be taken in selecting a consortium, and in leveraging volume with the other members. Be willing to strategically check the marketplace and enter into direct relationships when warranted.

<u>Formal vs. Informal Inventories… the "Shell Game"</u>…by Robert Dunn, C.P.M.

The supply-chain profession has utilized many "best practice" tools to reduce costs surrounding management of our employers' internal inventories.

The economic model that defines the "Total Cost of Ownership" for any given commodity, consists of three major elements:

- **"Acquisition Cost"** - All costs associated with processing an order, from request through payment (including procurement & accounts payable personnel factors, procurement systems, etc).

- **"Carrying Cost"** - The costs associated with stocking & maintaining inventory (including premises expense, cost of funds, materials personnel factors, inventory management systems, capital equipment, etc).

- **"Commodity Cost"** - The actual total cost of the products & services used within the enterprise (including product price, freight cost, financing factors, etc).

- **"Total Cost of Ownership"** = Acquisition Cost + Carrying Cost + Commodity Cost.

Leading procurement professionals can often reduce these various cost elements, however, one area of cost reduction opportunity is often overlooked or hidden (especially within the service sector). With the advent of e-commerce, stockless programs and outsourcing, many procurement groups will claim that they have "all but eliminated" carrying cost by keeping little or no inventory on hand. They fail to understand that poor inventory management by their outsourced suppliers still negatively impacts their own "Total Cost of Ownership".

Their claim may be a true statement when referring to "formal inventory", *i.e. that, which is identified, managed & measured*. If we re-define inventory to apply to all the direct materials, and indirect supplies, equipment and furniture owned, leased or rented which is not in use within the enterprise…then failure to exercise sound inventory management "Best Practices" can have a significant negative financial impact.

Unfortunately the failure to apply solid inventory management techniques to "Informal Inventories" is not industry specific. Our experience from various sourcing projects has identified millions of dollars of informal inventories held by suppliers to financial institutions, hospitals, transportation companies, utilities, health care organizations, and technology providers. Direct manufacturers are good at monitoring their own production inventories, but notoriously ineffective in monitoring their external inventories under …for example…printed inventories, furniture inventories, HR benefits materials, collateral marketing materials, fleet vehicles, photocopiers, PC hardware/software, etc.

Failure to manage informal inventories can impact the opportunity cost of invested funds and can be detrimental to the overall financial health of any organization. Instead of relaxing our inventory management diligence, it may be appropriate to assess the value of applying these tools to our informal inventory cost reduction opportunities.

Consider the following…In any RFP that involves the provision of a commodity, seek to determine the following about each bidders' ability to manage your "Informal Inventory":

- What computer system(s) do they use to manage their inventories? What techniques, information, and reports are utilized by their application? Is inventory tracking uniform throughout their company? Will you have access to their reports?

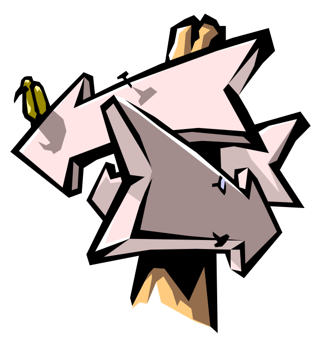
- Where will the inventories be located that will eventually impact your account? Understand freight cost factors & lead time impact.

- How many inventory "turns" does each bidder have? It can be eye-opening to compare "turns" for several competitors from a particular industry. Low "turns" may negatively impact their carrying cost & also expose your firm to potentially high obsolescence exposure.

- Do bidders have "JIT" (Just-In-Time) or "BIT" (we call this Barely-In-Time) relationships with their own key suppliers? How do these relationships impact their own inventory management costs?

- What parameters does each bidder use to determine "Make or Buy" decisions? In other words, do they have a formula for deciding what part of their own supply-chain process to perform themselves or using external resources?

Factors in Opportunity Profiling…by Patrick Soller



Creating an opportunity profile can help you "Size the Prize" and also "Seize the Prize." Commodity candidates for strategic sourcing initiatives can be identified throughout the organization, using this technique.

Finding these opportunities requires inspection from a variety of views. Each takes a different approach from the procurement team to properly understand, perform strategic sourcing, gain organizational consensus, communicate change, implement new programs, and capture savings.

One important factor in creating an opportunity profile is to understand the scope of fragmentation across user organizations. From this perspective, there are basically three types of opportunities:

- **Single group purchases ("SGP")** – Those acquisitions made by one group/unit only. Examples of commodities primarily falling into SGP groupings might include: Custom Application Software, Special Processing Equipment, Specialty Services, etc.

- **Multiple group purchases ("MGP")** – Those acquisitions made by multiple groups/units through independent buying processes. Examples of MGP acquisitions might include PC's and Peripherals, Travel & Entertainment, Courier Services, etc.

- **Maverick Spend ("MS")** – Those acquisitions where significant dollar volume of purchases are made around the approved processes.   Common examples might include Specialty Printing, Office Supplies, Temporary Labor, Consulting Services, etc.

It requires progressively more effort to impact SGP, MGP, then MS opportunities. Many organizations tend to pursue SGP, due to the reduced complexity, organizational risk, and straightforward project management of those opportunities. As procurement become more influential and centralized, however, a greater amount of MGP opportunities are captured through a consolidated supply-chain approach, too.

Maverick Spending, however, is a further opportunity for almost all organizations. Here is a formula that represents the ongoing tendency of users to spend company funds outside of leveraged programs:

$$\mathbf{MS = i^2}$$

Maverick Spending occurs primarily is due to two factors, ***inconvenience*** and ***ignorance***. If a purchase is inconvenient for the end user, they will find an easier way to make that purchase. In addition, the end user may not understand that this action is counterproductive to the corporate goals.

Education of the end user and user-friendly & streamlined procurement processes are essential to minimize the adverse affects of Maverick Spending.

Key benchmarks to quantify and qualify any potential opportunity are:

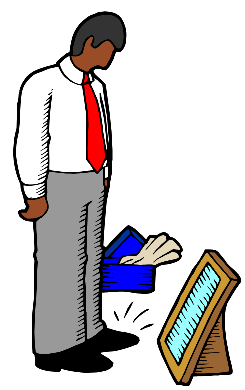
- Total corporate expenditure
- Total expenditure controlled by the procurement organization
- Purchase order volume
- How is the order being transmitted (i.e. eProcurement, P-Card, purchase order, manual ordering, etc)
- Total number of suppliers being used (fragmentation of spending)
- Total percentage of time being spent purchasing the commodity
- Quality of service being provided by the supply chain

When developing your opportunity profile consider the following to determine your ability to succeed:

- Total Savings Potential
- Soft vs. Hard Dollar Savings
- Savings Audit Credibility
- Anticipated Barriers
- Risk of Failure
- Unique Client Requirements
- Available Supplier Base
- Timeline Requirements
- Resource Availability
- Project Complexity
- Degree of Difficulty to Complete

Remember, the goal is to make your organization more efficient. Improving the process, reducing costs, and improving quality and service are ways to increase efficiency. Strategic sourcing is a great way to approach a problem, once the opportunity is understood. The opportunity profile is an important tool to identify the areas of improvement.

Putting On Their Shoes…
by Mark Trowbridge, C.P.M.



Sophisticated negotiators are experts in understanding the psychology of their counterparts. They do this by perceiving the needs, desires, and challenges faced by the opposing party.

Unsophisticated buyers often fail to maximize their negotiating influence, by incorrectly "assuming" what motivates sellers. For example, it may be a mistake to assume a sales executive is losing by not gaining a new high volume account. If you'll sit down with that sales person, you may discover that their senior management is more concerned with corporate profit margins than with increasing gross revenue. In fact you can read several leading corporation's annual reports, and discover they have a stated corporate goal of "spinning off" low margin accounts.

Or the opposite may be true…Several years ago, as a supply-chain director for a large financial institution, I learned one of the finalists in a strategic sourcing initiative for office supplies strongly desired to expand their company's distribution network further into the Northwest U.S…an area where my firm had several-hundred branch locations. Equipped with that inside knowledge, my team was able to negotiate a company-wide pricing level very close to the supplier's cost for product…but one that enabled them to justify daily deliveries into cities they previously couldn't serve cost-efficiently. The net result of our arrangement provided my company with outstanding price levels…and the supplier with a profitable basis for selling to higher-margin accounts in an expanded service area.

How can you try on other people's shoes? Take time to learn about companies and their negotiating teams before you enter negotiations. Do they have regionalized profit centers? Are salespeople incented on a transactional basis…and when? What are their corporate objectives? What are the team members' personal objectives?

It has been observed that in negotiations, "Knowledge is Power". Take time to try on the shoes of the other party…trying on shoes is always better than guessing they'll fit.

Editor's Note: **Strategic Procurement Solutions**' objective is to provide top quality supply-chain consulting & training services to corporate clients in the private & public sector, and to enable those clients to exceed their internal users' expectations regarding promptness, price, and quality. One means of doing this is through this periodic educational newsletter, which provides quarterly articles about "Best Practices" in procurement. Contact us at **www.StrategicProcurementSolutions.com** for more information about our services, or if you do not wish to receive this newsletter in the future.