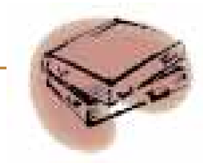

HOW TO CAPTURE HIDDEN VALUE

Non-Product-Related sourcing can cost the equivalent of 20 percent or more of a company's sales. Yet, it is frequently overlooked as a potential source of significant savings and efficiency gains. Managed rigorously, the hidden value of such sourcing can be substantial.

by John Houlihan

WHEN THE INTERNATIONAL Business Machines Corporation in Europe changed from country-centered to business-centered operations, the reorganization produced some unforeseen results. One was that budgets for employee travel among European countries mushroomed 20 percent a year over the following three years. In Britain the bill grew to $48 million; in the rest of Europe, to $300 million.

What happened? Where was the money going? It was not so easy to answer those questions, the company discovered.

The company had been dealing with 40 to 50 travel agents who booked business with a myriad of airlines and hotels throughout Europe, making a daunting task of pinpointing the details of the surging expenditures. The only possible way to retrieve the figures was to go through the records of each travel agent. Cooler heads prevailed and decided it was better to concentrate on building a system for the future. I.B.M. now uses a single agent for Europe, one for North America and another for Asia.

A simple solution to a thorny

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Illustrations by Stephen Schudlich

operational problem? The reality is more complex. When I.B.M. first attempted to sort out the problem, it faced the same geographic barriers it was trying to dismantle. Country units wanted to keep the local agents with whom they had long and amicable relationships. In the end, the company formed a multinational team that took 18 months to select a single agency.

Capturing hidden value in the sourcing of travel services, I.B.M. discovered, was a long, complex and troublesome process — but one with substantial dividends. For example, I.B.M. can now show individual airlines in detail what would happen if it moved its business elsewhere. This highly persuasive data had previously been buried in the corporate mire.

OUTSOURCING CHALLENGE

Companies typically spend the equivalent of 20 percent to 25 percent of sales with third-party suppliers for goods and services not directly related to the end product or services of the business. In some businesses, these Non-Product Related (N.P.R.) expenditures even exceed those spent directly for the end product. As a result, N.P.R. sourcing offers increasingly attractive opportunities to unlock hidden value.

The amount of the savings can be significant: an estimated 15 percent to 25 percent, or the equivalent of 2 percent to 4 percent of sales, or more.

The European Institute of Purchasing Management, in Archamps, France, near Geneva, was founded a decade ago by 10 multinational companies to provide advanced training and education in purchasing. In explaining why a company would invest in purchasing training, the institute's Web page says, "Purchasing remains one of the major areas available to industry where overall competitive ability can be significantly improved. From its previous role as simple 'mail box' passing on order forms, purchasing has become a potential area for increased profitability. A gain of 2 percent at the purchasing stage can prove to be more profitable than a 10 percent increase in sales."

The issues are far from academic, however. Booz-Allen & Hamilton's client experience, for instance, demonstrates that significant savings are available across a wide range of N.P.R. categories. (See Exhibit I.)

Here are some examples: A major Dutch bank saved 21 percent on its printed material; a large British government agency, 23 percent on cleaning services; a German electronics

EXHIBIT I
POTENTIAL SAVINGS FROM N.P.R. SOURCING

Cluster	Category	Cost Savings* (Percent)
Accommodation/ Facilities	Building services	8-31
	Real estate	5-10
	Security	10-20
	Mail handling	8-13
	Property management	5-10
	Utilities	15-25
Personnel	Temporary labor	10-20
	Payroll	15-30
	Food service	5-17
	Travel	15-30
Marketing & Sales	Advertising & promotion	10-30
Distribution	Printing	10-20
Automation/ Communications	Road transportation	15-30
	Telecommunications	10-15
	Software services	15-25
	Management information systems (MIS)	8-13
Office	Office supplies	15-40
Professional Services	Outside legal counsel	8-13
Production/ Development	Maintenance repair & overhaul (MRO)	10-25
	Maintenance contracting	10-15

*Note: Savings percentages represent typical first-wave reductions.

Source: Booz-Allen & Hamilton

company, 30 percent to 40 percent on telecommunications expenditures; a French electronics company, 20 percent on software services bills, and a United States electronics company, between 11 percent and 14 percent on temporary labor costs.

NEGLECTED STEPCHILD

The hidden value of rigorous management of N.P.R. sourcing does not lie simply in cost reduction. When there is tighter control of goods and services — including advertising, transportation, research and information systems — the result can be greatly enhanced capabilities, more effective organization and stronger strategic performance.

Getting companies to focus on N.P.R. sourcing, however, can be difficult for a number of reasons:

- A great deal of attention is directed to sourcing for products or services, but to most executives, N.P.R. sourcing is peripheral and unimportant. (It should be noted that in some cases the dividing line between product and non-product-related goods and services is difficult to determine. For example, packaging materials may or may not be regarded as integral to the product.)
- N.P.R. sourcing expenditures tend to be spread across hundreds of commodities and thousands of suppliers in global operations. Though some may have been brought under the corporate umbrella, such N.P.R. goods and services as professional services, banking, security, energy, travel, media, rent and transportation tend to be locally sourced. A company operating in 10 countries will commonly source N.P.R. goods and services from 10 suppliers. (Witness I.B.M.'s profusion of travel agents.)

- Booz-Allen's experience suggests that 10 percent to 15 percent of N.P.R. expenditures are unrecorded and disappear in a corporate vacuum. They are either hidden from view or simply inaccessible, lost amid the complex array of goods and services that any large organization purchases.
- The lack of any clear structure to N.P.R. sourcing expenditures adds to the tangle. Budgets are dispersed and fragmented. If, for example, you attempted to clarify the travel budgets of a large company, you would find yourself wrestling with a plethora of categories and various levels of decision-making authority.

BENIGN NEGLECT

This self-perpetuating cycle of neglect casts N.P.R. sourcing into the corporate wilderness, with consequences.

N.P.R. sourcing is not regarded as an area of great importance to the organization and can attract low-caliber personnel. Purchasing professionals with a more strategic and systematic approach are directed to product-related purchasing, and even here, purchasing is often not granted the importance its organizational role justifies. For instance, the Center for Advanced Purchasing Studies in the United States, an independent research organization that provides companies and purchasing professionals with research and data, found that in the largest United States banks there was only one purchasing employee for every 676 company employees and that each purchasing employee in the top 18 banks handled almost $25 million of purchases every year.

Because N.P.R. sourcing is regarded as unimportant, it is also one of the easiest areas in which numbers may be reduced. It is a striking fact that less than half of N.P.R. purchases are handled by the formal purchasing organization. As a result, a $500 million business unit might have only two purchasing people assigned to

N.P.R. expenditures. The exception for some companies seems to be the purchase of information technology, which is increasingly seen as critical to future business success and receives a high priority.

By and large, it is little wonder that N.P.R. sourcing expenditures in some organizations have risen year after year through inattention. At the same time, direct product expenditures have often been driven down by as much as 8 percent to 10 percent a year for three or four consecutive years. The startling consequence is that N.P.R. expenditures for many large corporations are now almost on a par with those for the direct product. For instance, Booz-Allen has estimated that totally integrated supply chain management can produce savings equivalent to between 2 percent and 4 percent of sales — the same level of opportunity as for N.P.R. sourcing.

CHOOSING THE PROVIDERS

The debate about N.P.R. sourcing often centers on whether certain activities, including purchasing itself, should be handled internally or be outsourced. A sensible and informed decision on outsourcing can only be reached, however, when an organization fully understands the costs as well as the resource and operational implications of its N.P.R. expenditures. Because sourcing is concerned with extracting value, blindly following an outsourcing route with fully exploring the costs involved in N.P.R. goods and services leaves the company a hostage to fortune.

This is most evident in the current flurry of information technology outsourcing arrangements. In the fall, the Bank One Corporation and the Boeing Company signed multimillion-dollar outsourcing deals for computing services. These followed the BellSouth Corporation's $4 billion contract with the Electronic Data Systems Corporation. Such deals have encouraged others to outsource I.T., though some companies have little real appreciation of what they hope to achieve or how to measure their achievements.

Gartner Group Inc. in the United States, which provides research and analysis of the information technology industry, has found that about 70 percent of the companies it studied that outsourced information technology were unhappy enough with the results to renegotiate contracts and 20 percent terminated their contracts. Similarly, research by the American Management Association showed that there was a 40 percent spurt in information echnology outsourcing between 1994 and 1997, yet less than a quarte of the c tracting compa nies reached their goals through outsourcing.

Outsourcing is an important tool. It can — and does — work. But it requires understanding and analysis before committing to huge contracts.

CREATIVE SOLUTIONS

Exploring N.P.R. sourcing often unearths a variety of means by which genuine improvements can be made.

In the area of office materials, for example, one company achieved savings of 40 percent by restructuring its supplier base and increasing volume with preferred suppliers. It established a standard service agreement, simplified the procurement process and provided the chosen suppliers with predictable volumes.

In another example, a company renegotiated its agreement with its supplier of cleaning services to delineate the amount of space to be cleaned per person, redefine certain specifications and spell out the frequency of cleaning. The result was a

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savings of 31 percent.

Similarly, another client focused on temporary labor. It consolidated its suppliers; automated the time reporting and payment processes, and harmonized purchasing guidelines across sites. It then established a joint team with the suppliers to improve job descriptions and personnel specifications. The result was a savings of 20 percent.

Indeed, Booz-Allen research suggests that typically a 15 percent annual savings rate across the board is achievable within two years of addressing the issue.

While producing impressive savings, none of these individual initiatives was particularly innovative or imaginative. Even so, capturing the value of N.P.R. sourcing rapidly requires some approaches that are fundamentally different from past practices. In the process, management should not prematurely bank the savings and should pay enough attention to organizing the fundamentals of an effective program.

In general, the best programs involve sourcing specific capabilities from advantaged suppliers, lowering the total costs of ownership and efficiently capturing the opportunity. To achieve this, there are six key actions to take:

1. Clearly define the project, select the approaches to be used and organize the resources.
2. Obtain broad and visible sponsorship of the changes from the chief executive officer on down.
3. Drive early wins, wave by wave.
4. Apply new rules to avoid the strong danger that improvements will quickly be forgotten and that old habits and practices will return.
5. Utilize predefined processes and knowledge.
6. Enlist the early help and involvement of suppliers, who are vital in supporting any program of change.

Indeed, suppliers are often not leveraged as resources for saving time and increasing savings levels in major N.P.R. programs. They can often provide data, market information, resources and insights into opportunities. They can, for example, play an important role in defining more cost-effective procedures for product and service specifications and compliance with agreed-upon contracts.

MAKING IT HAPPEN

Realizing savings requires a programmatic approach. Savings programs are best organized in waves, with initial emphasis on budgets, compliance and speed. It is important that these quick wins be seen in the context of a continuing multi-year effort to extract value through N.P.R. sourcing.

The process should begin with a savings estimate from top to bottom. The estimate can be used to influence budgets, allocate resources and determine the priority of the areas to be addressed. During the process, commitments should be sought from budget holders and those who have N.P.R. purchasing responsibilities. (It is worth noting that segmenting core N.P.R. expenditures can enable the rate of savings in the first wave of the program to be accelerated.)

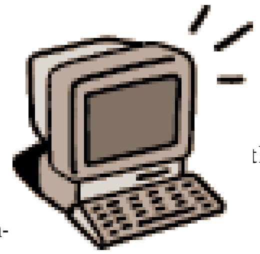
After a period of data collection and analysis, the process can move on to an examination of the details of potential savings from the bottom up. This can define the actions required and their likely impact. Agreements can then be reached with suppliers that will lead to new contracts. Both the demand and the supply aspects of the expenditures need to be addressed; focusing on a single side is likely to be self-defeating.

On the demand side, the key issues are the product/service, specifications and volumes. Related issues include reducing the expenditures, adopting standardization and insuring compliance. On the supply side, the key issues are prices and suppliers. Related issues are consolidation of the supply base, volume expansion and contract renegotiation.

Finally, the program can move on to implementation and compliance. Then, start with the next wave of savings and improvements. Opportunities on the supply and demand sides vary from wave to wave as the program is rolled out.

IDENTIFYING OPPORTUNITIES

In the first wave of the program, short-term opportunities need to be identified. On the supply side these typically include: consolidating purchases and increasing leverage and coverage of contracts; changing to a new source within a known market; improving the introduction of new suppliers; introducing or encouraging competitive bidding, and leveraging the insights of key suppliers.



On the demand side, the short-term opportunities often include: improvements to specifications, contract structuring, the negotiating process and compliance to contracts.

The first wave introduces the first steps toward a more rigorous budgeting and performance measurement for N.P.R. expenditures. In the second and third waves of the program, further opportunities will emerge. These typically include:

- Improved efficiency in purchasing the many low-value items that typically constitute the large tail-end of the spend. Here the application of purchasing cards, agents and distributors serves to concentrate the many suppliers and remove the inefficiencies of traditional ordering.
- Wider access to information and specialist service providers through the Internet gives benefits in benchmarking prices and selecting more advantaged suppliers.
- Deeper strategic analysis for the more expensive and complex categories of the spend. An example in buying services would be using a structured analytical framework that assesses the value-for-cost. This segments the various components of the service, costs them, allows the buyer to reconfigure the package from the elements and shares total visibility of the economics between buyer and supplier.
- Qualifying new suppliers.
- Outsourcing more activities.
- Changing the level of bundling or unbundling of the products or services acquired.

By this stage the organization will have adopted new and improved processes, policies and standards for purchasing N.P.R. categories. The complementary roles of purchasing and the other formal disciplines of the organization will be clarified, proven in value and accepted in cooperation. These fundamental changes and extensive efforts require deployment of substantial resources in order to achieve rapid results. This is one of the main barriers to successful initiatives in N.P.R. sourcing.

To mobilize resources and insure that progress is rapid, it is sometimes useful to introduce a number of other measures. For example, cluster teams can be formed around groupings of categories in order to concentrate knowledge and specialized skills. They can also support an organization that is dispersed through many geographic locations of the business and may even be vested with the power to cancel or amend contracts. Demand councils can be established to improve decision-making by users, to commit to targets for savings and to provide incentives to achieve quick and lasting savings. Specialist resources can be recruited from outside the organization to meet the temporary demands of the program.

These resources can serve differentiated roles according to the specialized needs of an N.P.R. program. Some projects, such as shared services across divisions, may involve strategic decisions that will require deep analytical skills. Others may be more process-intensive and require gathering information and securing widespread agreements for compliance. Still others require more specialized information on best practices regarding how to buy the specific categories, and require access to insights that are often available in the marketplace.

Perhaps the most critical factor in this entire process is that N.P.R. sourcing be set in the context of the strategy for managing the enterprise as a whole. Instead of being regarded in isolation, N.P.R. sourcing must be regarded in relation to issues such as global sourcing, outsourcing and supply-chain management. The efforts to extract greater value have to be seen as continuous, as having strategic value and as requiring the correspondingly high level of attention of the chief executive officer and the management team as a whole. The rewards in competitive strength and bottom-line performance are clearly attractive.

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