The Four Phases of Continuous Sourcing

Purchasing can deliver ongoing benefits, but only if it cycles through a series of linked disciplines.

by Hugh Baker and Tim Laseter

The *Wall Street Journal* gave purchasing front-page play in 1992 when the newspaper featured J. Ignacio Lopez de Arriortua. His aggressive tactics had delivered a desperately needed $1 billion to the bottom line of the General Motors Corporation, and that was big news. Thomas Stallkamp ascended to the presidency of the Chrysler Corporation after he'd introduced a collaborative approach to purchasing at a time when the company badly needed more support from its suppliers to compensate for its size disadvantage relative to GM and Ford Motor Company. Before he retired last year, Gene Richter led a string of top companies — Black & Decker, Hewlett-Packard, and IBM — to "world class" procurement practices.

Although each man focused on a different aspect of performance, all three destroyed the notion that purchasing was some kind of backwater for failed executives. In fact, these executives led a sea change in CEO perceptions of purchasing. Now CEOs have become addicted to the fast bottom-line savings purchasing delivers, and they have come to expect continuous performance improvement.

Unfortunately, every technique in the purchasing tool kit generates diminishing returns when applied in a static environment. Squeezing supplier margins the way Mr. Lopez did works for a while, but eventually leads to financially unstable suppliers who no longer invest in innovation. Even the collaborative design efforts championed by Mr. Stallkamp can lead to a dysfunctional cycle in which suppliers accept design waste up front to leave room for annual improvements. Buyers and engineers feeling the enormous pressure from above become coconspirators with suppliers in this new game of "meet the target or else."

Our work with leading companies across a host of industries has shown that a static model focusing on a single performance lever simply won't work. Instead, success comes from a Continuous Sourcing Cycle to capture margin, reduce cost, manage demand, and create value. (See Exhibit 1.) Rotating through all four of these phases produces a dynamic of change — a new supply base, newly specified parts, a recent-

Illustration by Lars Leetaru

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ly merged enterprise — that creates an environment ripe, once again, with opportunity.

Savings Waves

The Continuous Sourcing Cycle offers a systematic approach to driving bottom-line improvement through purchasing. The approach produces wave after wave of savings by cycling through four distinct methods of extracting value from the supply base.

Readers familiar with *Balanced Sourcing: Cooperation and Competition in Supplier Relationships* (Jossey-Bass Inc., 1998) might see this articulating of the Continuous Sourcing Cycle as a contradiction. We don't agree, and we can explain.

Balanced Sourcing defines a philosophy of cooperative supplier relationships coexisting with a comparable commitment to competitive sourcing strategies; building and sustaining supplier relationships; integrating the supply web; leveraging supplier innovation; and evolving a global supply base.

The Continuous Sourcing Cycle isn't a new, alternative philosophy to the concept of Balanced Sourcing, but simply an approach for achieving its desired equilibrium. As one strategist described it, "A playground teeter-totter offers a good metaphor about balance. But don't imagine yourself straddling the pivot point with hands extended making slight adjustments to keep both ends in the air at the same time. It feels more like continuously running back and forth from one end to the other at lightning speed to lift the end most at risk of touching the ground at any given time!"

That sort of balancing act can be achieved more systematically

Insight into specifications employed by competitors often provides a clear road map for managing demand.

pricing. In fact, focusing on the relationship alone can generate supplier "partnerships" built on blind trust — not a wise basis for a long-term commitment. Equally damaging, a single-minded focus on competitive pricing independent of supplier relationships can produce a Darwinian rivalry that keeps suppliers on their toes, but fails to capture the value of innovative solutions possible from a more balanced model.

Achieving the balance between price negotiation and partnership requires six organizational capabilities: modeling total cost; creating

with the Continuous Sourcing Cycle, which draws on the foundational capabilities required by Balanced Sourcing. A close look at Exhibit 1 shows two types of critical insight throughout the cycle. "Cost insight" resides at the center of the circle. Such insight derives from modeling total cost — the foundational organizational capability highlighted in *Balanced Sourcing.* Similarly, the "competitive insight" in the outer circle derives from the organizational capability for creating sourcing strategies, the second of the model's six core capabilities. A little reflection will prove that each of the other six capabilities naturally supports the four methods within the Continuous Sourcing Cycle.

The Four Phases

Capture margin, the first phase of the cycle, addresses the effective use of competitive threat in negotiations to reduce supplier prices. It is the bread-and-butter way for most purchasing functions to meet short-term targets. Negotiation to reduce margins ranks as the oldest and most fundamental purchasing tactic. But, despite its longevity, new wrinkles such as online auctions continue to appear on the old cloth. Regardless of the current technology applied, pressure imposed from competitive tension among a broad, potentially global supply base undoubtedly delivers money to the bottom line.

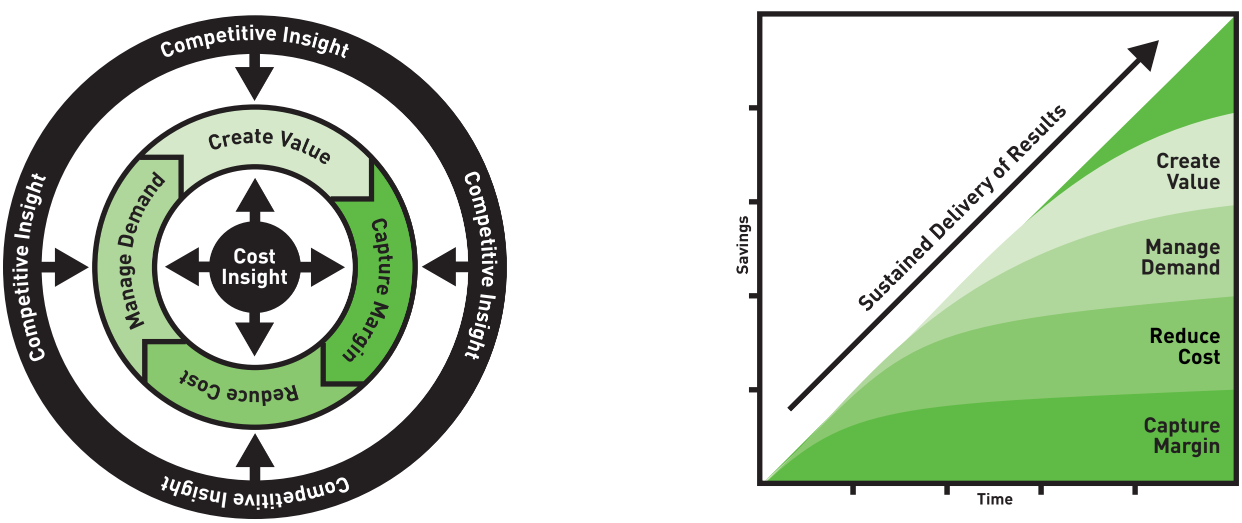
Better still, cost understanding provides the insight to uncover excessive margins where suppliers have the most room to give. For example, a manufacturer sourcing metal bakeware from Asia analyzed the price trends for Asian flat-rolled steel and discovered a 30 percent drop over the prior year. With this information in hand, the company then negotiated a near-term price reduction to decrease the excessive margins the suppliers had enjoyed from the deflation in their primary raw material.

A merger of two companies with common spend categories offers an opportune time to capture supplier margin by comparing prices between the prior entities. Once again, cost modeling provides a better insight than simple price comparison. Understanding the scale impact of the combined volumes of the merged companies often supports a negotiation to achieve prices lower than those achieved by either company previously.

Reduce cost, the second phase of the Continuous Sourcing Cycle, impacts supplier cost, not just margins. For example, a company can reduce cost by switching supply to countries with low labor costs. Alternatively, it can change the role of a supplier to simplify the value chain, or it can move products to a manufacturing technology better suited to the company's specifications. An automotive manufacturer in the U.K. transitioning to strategic sourcing uncovered a pattern quite common among companies employing a transactional approach to sourcing decisions. The company found that many of the rubber seals purchased from outside suppliers were running on compression molding machines designed for low-volume production, although annual volumes had grown to a level that would make high-volume injection molding more economical.

Honda of America provides a classic example of reducing cost by working with existing suppliers through its "BP" program. BP — which stands for "best practice," "best process," and "best price," among other things — employs a team trained in the Japanese method for continuous improvement, or *kaizen*. These manufactur-

Exhibit 1: **The Continuous Sourcing Cycle**



ing process specialists help suppliers uncover and eliminate waste. Again, the combination of competitive insight and cost understanding drives efforts to reduce costs.

Both of the first two phases — capture margins and reduce cost — fall cleanly within the domain of purchasing and require limited support and involvement from other business functions.

Manage demand, however, requires compliance from the rest of the organization, as purchasing executives challenge the quantity, quality, or service levels required by their internal customers. In the mid-1990s, for example, Ford created a dedicated facility for conducting hundreds of Value Analysis Workshops with engineers, buyers, program managers, and suppliers to identify different ways to reduce cost in a vehicle. The teams focused on eliminating features customers did not desire — or were not willing to pay for — such as a black paint coating for a part not normally visible to the consumer.

Demand management proves equally valuable for nonproduction spending. Many companies have dramatically reduced travel costs by imposing more restrictive travel policies, such as enforcing advanced ticket purchases, mandating economy class on all but the longest flights, and tightening constraints on the use of nonpreferred airlines.

Insight into specifications employed by competitors or "best practice" policies often provides a clear road map to potential tools for managing demand. In addition, deep cost understanding ensures that the customer captures its full share of the benefits.

The **create value** phase of the cycle logically comes after the other three phases. Once the company has proven its capabilities in capturing margin, reducing cost, and managing demand, creating value becomes a priority. Ideas, such as supplier-recommended features intended to increase margins, create value for the company even if the costs of the materials go up. Convincing the organization — especially the CEO — to accept these recommendations, however, proves far tougher than in the other three phases, in which the results can be immediately measured in lower purchasing costs. The credibility developed through rigorous quantification of the bottom-line impact from the prior three phases makes the organization more willing to accept such ideas on faith — further underscoring the logic for approaching this phase only after successfully completing the prior three.

Blockbuster Inc. offers an excellent example of creating value through a creative pricing agreement with its suppliers. Prior to 1997, Blockbuster paid movie studios up to $80 per videotape — though the marginal cost of making a copy was a mere fraction of that total. Such pricing made it cost prohibitive for Blockbuster to adequately serve the initial surge of demand for new releases because it would have been left with a huge inventory of expensive tapes once the initial demand tapered off. However, the studios producing the tapes worked with Blockbuster to develop a creative pricing arrangement, reducing the up-front cost to only $7 to $8 per tape and sharing the revenue stream that followed. This pricing structure aligned incentives for Blockbuster and the studios to flood the stores with copies of newly released videos to tap the demand surge, resulting in far more video rentals, which helped drive Blockbuster's market share from 26 percent in 1997 to 36 percent in 2000. More important, revenues increased 62 percent and EBITDA rocketed 180 percent during the same time period.

Such effective value-creation strategies build on cost understanding — in this case, for example, the true production cost of a videotape — as well as competitive insight into overall demand patterns. But value creation requires even more: an understanding of the overall business economics, the creativity to envision new paradigms, and the credibility to convince others to accept the risk.

Sourcing Dynamics

Though this conceptual model may be intellectually appealing, a hardened purchasing executive may remain dubious. Most find themselves trapped in the corporate equivalent of Lewis Carroll's "Wonderland" — facing a CEO and lamenting, like the Queen of Hearts in *Through the Looking-Glass*, "it takes all the running you can do, to keep in the same place." Others might cite Rita Mae Brown, the American writer and playwright who observed, "Insanity is doing the same thing over and over again, but expecting different results."

Through our frontline experience with many purchasing executives, we've heard mandates from CEOs who expect miracles. Though it may feel like a fantasy, expectations for ongoing improvement have unfortunately become a corporate norm not likely to go away. For those arguing against the insanity of doing the same thing over and over again — frankly, we agree.

In fact, those observations spurred our development of the Continuous Sourcing Cycle. Companies must continuously drive performance improvement but recognize that doing the same thing over and over again won't work. We are not proposing the mythical perpetual-motion machine that runs forever after an initial charge of energy. The Continuous Sourcing Cycle, like a generator in a hydroelectric plant, requires sustained effort and a dynamic environment: Take either away and the generator fails.

A new supply base or a merger may provide new energy. For example, companies can introduce a business discontinuity by oscillating between reducing the supplier base to gain leverage and expanding the supply base to introduce new blood. Online auctions — currently in vogue in fragmented supply industries like packaging, transportation, and metal fabrication — try to push both simultaneously. The most effective online auctions invite a large number of new participants beyond the incumbents — and promise to award business to a small number of winners to gain the maximum leverage.

Horizontal mergers — in which companies acquire competitors — create another discontinuity, forcing a renewed look at the supply base of each company. The merger of the Chrysler Corporation and Daimler-Benz AG forced the combined entity to rethink each supply base. Arguably, Chrysler suffered from some "blind trust" partnerships that needed a renewed focus on competitive pricing. The more aggressive negotiation tactics of Daimler-Benz — mandating a 5 percent price reduction across the board — may have been a somewhat crude process for altering the balance, but it did get the attention of the suppliers. DaimlerChrysler AG is now seeking a more collaborative approach to capture an additional 10 percent reduction over the next few years.

Changing scope boundaries — for example, combining services and product — introduces a dynamic likely to reduce cost, manage demand, and create value. For instance, Dow Chemical Company and Nibco Inc., a $400 million maker of valves and pipe fittings, collaborated by expanding the supplier's role beyond the traditional scope of mere physical product. The tighter operational integration between the two companies allowed Nibco to incorporate a wider variety of resins and thereby expand its product line, ultimately increasing its overall market share by attracting customers seeking greater product breadth.

Blockbuster and Hollywood studios worked together to tap the demand surge for newly released movie videos.

Like the operators of a hydroelectric dam, a top-notch purchasing function adjusts the water flow of discontinuities and maintains the equipment by applying new tools as they become available. For example, Deere & Company, following the direction of R. David Nelson, developed new cost-modeling tools. Adding to a strong tool kit for bottoms-up cost modeling, Deere now applies parametric modeling to address parts like fasteners that might not warrant the investment of a detailed cost model.

On March 1, Mr. Nelson took the top purchasing job at Delphi Automotive Systems, the GM spin-off and now the world's largest automotive supplier. His charter? Shift the company beyond the margin-focused tactics of the Lopez era to focus on supplier development and "should cost" modeling. Or in other words, pursue the next set of phases in the Continuous Sourcing Cycle.

The Whirlpool Corporation has prospered under the leadership of Roy Armes, corporate vice president of global procurement operations. The company builds long-term forecasts of supply and demand in spend areas exhibiting commodity pricing dynamics like flat-rolled steel and integrated circuits. After all, having a bottoms-up cost model for Intel's Pentium processor likely will not provide significant negotiating leverage, but knowing supply-and-demand curves for Intel and its competitors could.

In the end, CEOs and their chief procurement officers might dream of a perpetual purchasing machine — despite the constraints of business "physics." The Continuous Sourcing Cycle, coupled with business discontinuities and good old hard work, can deliver ongoing improvements to the bottom line of any company. +

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