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Supplier Empowerment and the Bottom Line

by Tim Laseter and Greg Fairchild

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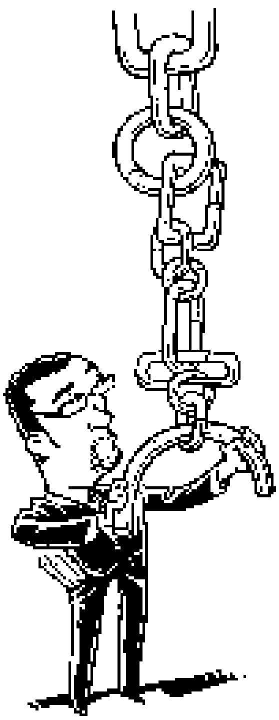
When you adapt your sourcing strategy to a more diverse world, everybody benefits.

by Tim Laseter and Greg Fairchild

Illustration by Lars Leetaru



Steve Reinemund, former chairman and CEO of PepsiCo Inc., said it best in March 2007: "The responsibility of leadership for diversity…is now in the hands of business…. That's where the entrepreneurs are; they're in diversity-led businesses." His comment, in a speech to the Kentuckiana Minority Business Council in Louisville, Ky., reflects an emerging recognition of the impact of corporate leadership in promoting ethnic and gender diversity in business today, especially in the face of less-effective government efforts. Reinemund's comments also reflect the increasing emphasis on integrating supplier diversity practices into overall supply chain strategy.

The strategic imperative of supplier diversity is not immediately obvious to many businesspeople, because the most compelling argument starts at the broadest macroeconomic level. Companies succeed best in a flourishing economic climate, and small-business entrepreneurship provides critical engines for innovation and job growth. For example, research has demonstrated that in the United States, new firms and small businesses consistently produce more innovations and create more jobs than large enterprises throughout the full business cycle. In fact, a team of economists led by renowned entrepreneurship professor William J. Baumol argue that this form of "entrepreneurial capitalism" produces growth superior to that brought by the large-firm, oligarchic, or government-led capitalism found in many other countries. Without the creative destruction of entrepreneurship, even dominant economies grow stagnant — as has been demonstrated by the tepid growth of much of western Europe over the past decade. As they become more dependent on the low wages of developing countries in addition to foreign oil, developed nations must tap the entrepreneurial innovation of smaller businesses to ensure a healthy economy.

The entrepreneurial world in turn increasingly reflects the diversity of the general population. In the U.S., minority-owned and women-owned businesses have grown in number and capacity, expanding at twice the national average rate in recent decades. They now account for 20 and 30 percent of all U.S. firms, respectively. This expansion has been fueled by demographic and macroeconomic phenomena, including increases in population diversity, improvements in educational attainment, and rising household incomes. According to recently released U.S. census data, minority groups — Hispanics, blacks, Asians, and Native peoples — now account for 43 percent of Americans under 20. Current demographic trends suggest that the white majority will drop to less than half of the total U.S. population by 2042. Asian-Americans now hold college degrees in greater proportion than the white population, and black educational attainment rates have risen faster than those of the white population. One in six adult blacks now holds a college degree.

In short, whereas large firms reflect the demographics of the past, the small firms at the heart of an innovative economy almost certainly reflect the ethnic and gender diversity of the current population. Thus, one of the most effective ways for a larger company to help foster a more vibrant economy is to build supplier relationships with the growing base of businesses led by women and minorities. At the same time, promoting supplier diversity can yield direct business benefits for corporations. It can be an effective strategy, for example, to find and support local entrepreneurs, and to develop them into top-tier suppliers that are more cost effective and committed than physically distant firms. In some industries, especially consumer products, dealing with diverse suppliers can provide a company with important insights into current and growing markets that are themselves diverse in culture and language.

Improvements in supplier diversity, however, require a change in the mind-sets of many corporate leaders. Unfortunately, few companies have a clear sense of the potential range of diverse businesses around them. Not surprisingly, few have engaged in the development of their minority supplier network with more than a “compliance” or symbolic mind-set. There have been many efforts to encourage women- or minority-owned business development in the U.S. over the past four decades, often sponsored by public–private partnerships, but they have yielded disappointing results. Research shows that they often suffered from ill-defined goals and objectives. Those programs that tracked results tended to focus on the percentage of budget spent rather than areas of benefit. Some procurement officers resisted programs designed to promote social welfare, and tried to change them to simply expand the base of small suppliers, whether or not they were owned by minorities or women. Other causes of failure included a lack of innovation in developing suppliers’ capacity, poor understanding of the requirements of major corporate customers, and a lack of familiarity within procurement departments of the proven methods of minority business development.

But experience suggests that corporations can develop innovative, firm-appropriate approaches to supplier diversity. The first step is to understand the history — and limitations — of past efforts to promote supplier diversity. The second is to change the corporate mind-set to consider supplier diversity as a strategic imperative rather than a

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vaguely defined moral obligation. The final step is to make a few key changes in sourcing processes to recognize and overcome the challenges inherent in working with diverse suppliers. These include identifying and focusing on the most promising potential suppliers, providing financing for undercapitalized women- and minority-owned businesses, and investing in building those suppliers' management capabilities.

Beyond Social Responsibility

The U.S. policy experience with encouraging diverse business ownership is particularly evocative because it represents more than 40 years of intensive trial and error. Although U.S. government policy designed to aid small business dates back to the Great Depression — the era when economist Joseph Schumpeter began highlighting the importance of entrepreneurial creative destruction — the federal government's focus on increasing the base of diverse business owners began during the Civil Rights movement as a response to discrimination in hiring. Just after taking office, President Richard Nixon in 1969 established the Office of Minority Business Enterprise through executive order. By increasing the base of diverse business owners, the reasoning went, the government could ensure that minority workers would fare better in the labor market. Related policies were initiated that spurred many corporations, especially those with government contracts, to develop their own supplier diversity programs. It was through these (and similar) programs that the phrase "corporate social responsibility" first came to the attention of many businesspeople.

Unfortunately, in this crucible, many supplier diversity programs were formed with a compliance, rather than a strategic, mind-set, and accordingly were susceptible to the criticism that they were meddling with free-market processes. Defenders argued that market intervention and incentives were needed to overcome high levels of racial discrimination among many sources of capital and customers. The stigma resulting from the political debate discouraged many managers from considering strategic reasons to pursue supplier diversity.

Nonetheless, some corporations joined forces in support of organizations such as the National Minority Supplier Development Council (chartered in 1972 as the National Minority Purchasing Council), which now includes 3,500 corporate members. In 2001, a group of large companies formed the Billion Dollar Roundtable to commemorate annual spending of US$1 billion or more with women- and minority-owned businesses, and to share best practices. Thirteen companies, including well-known corporations such as Procter & Gamble, IBM, Toyota, Johnson Controls, Verizon, and Wal-Mart now rank as Roundtable members.

> **One of the most effective ways to foster a vibrant economy is to promote suppliers led by women and minorities.**

However, because these programs were poorly understood, even by those implementing them, they experienced a continuing tension between being "socially responsible" and improving efficacy and value through the supply chain. Efforts to build supplier diversity that never addressed these contradictions were well-intentioned but ineffective. For example, some programs took a broad-based approach, often focusing on percentage of spending, that would allow firms to report large expenditures with a diversity of business owners. These programs, based on social equity considerations, often set a common target for buyers across all purchase categories. Unfortunately, a sole focus on ends (percentage or magnitude of spending) may have the unintended consequence of obscuring careful thinking about the means (which entrepreneurs to target for development and why). Such one-size-fits-all guidelines oversimplify the challenges of strategic investment in diverse suppliers, leading to mixed results that in turn can exacerbate negative stereotypes about such programs. Proportional goals may be necessary to encourage action, but are insufficient in the competitive marketplace.

Certain companies — particularly those that deliberately stay close to consumers, such as PepsiCo and Wal-Mart — have been at the forefront of strategic efforts to grow their share of total purchases. These companies understand that supplier diversity is not a social cause but a strategic necessity. Unless a company can make this critical shift in mind-set, its efforts will likely be ineffective, at best, or value destroying, at worst. If purchases from small and disadvantaged businesses merely represent a necessary evil to meet customer-imposed or government-mandated targets, the programs will inevitably focus on damage control rather than value creation.

A Tight-knit Supply Base

A truly strategic approach to building a diverse supplier base requires a fundamentally different perspective that looks beyond both the corporate social responsibility movement and the tactical focus of most current corporate practices. The best example of this kind of perspective comes from our observation of the way that the best Japanese companies, such as Toyota and Honda, built local supplier bases when they began manufacturing in the United States. Although their goal was geographic rather than demographic diversity, they employed the requisite strategic mind-set and pursued their goal with disciplined, pragmatic focus. Their efforts were all the more significant because traditionally, Japanese companies, with their highly homogeneous culture, have not focused on diversity. More importantly, their example demonstrates how supplier development fosters broad-based economic growth, in this case reinvigorating the U.S. automotive supply base to achieve world-class performance.

When Honda and Toyota built their U.S. assembly plants in the 1980s in Ohio and Kentucky, respectively, each already possessed a highly capable base of *keiretsu* suppliers. The Japanese manufacturers could have simply imported parts from these suppliers or asked them to build plants in the United States. But the Japanese recognized the need for a strong U.S. supply base to support their long-term growth plans. So they invested in finding capable suppliers and encouraged their existing suppliers to form joint ventures with U.S.-based suppliers to help build domestic capabilities.

The best Japanese companies know how to build a tight-knit supply base through intensive interaction and a methodical approach to expanding scope and responsibility over time. Thus, in the early 1980s, the purchasing team from Honda of America visited thousands of metal stampers as Honda set up operations in Ohio. Suppliers were examined against world-class cost standards and selected largely on the strength of their commitment to meet that benchmark. Initially, new suppliers were given a few simple parts that were also sourced from a Japanese *keiretsu* supplier. Honda's engineers then worked with the companies to improve their operations. Over time, a given supplier graduated to more complex parts and assemblies, but Honda remained ready to help the supplier when needed. This suggests a long-term and developmental approach that contrasts with most supplier diversity models in the field today.

Dave Nelson, former head of purchasing for Honda of America, enjoys telling the story of one supplier that began suffering from quality problems after years of solid performance. The supplier had nearly doubled its labor force over a short period of time to accommodate Honda's growth, pushing it beyond the limits of the current management team. Honda dispatched four staff members to work with the supplier full-time for 10 months to build the necessary management capability.

Today, many of the best automotive suppliers in the world, such as Johnson Controls and Borg-Warner Inc., are headquartered in the United States. Thanks to mentorship from Honda and Toyota, these manufacturers are not dependent on the now-struggling Detroit Three but instead serve vehicle manufacturers all over the world. And Honda and Toyota now have a much larger portfolio of capable suppliers to draw on to support their long-term strategic plans. More companies need a similar outlook today to build a top-quality, diverse supply base that will help ensure economic success in an increasingly diverse world where costs, quality, and collaboration can provide competitive advantage.

How to Choose Carefully

The Japanese analogy highlights the criticality of selecting the right partners. In addition to a mind-set change, effective supplier diversity must build on a deeper understanding of the size, scope, and challenges that characterize diverse suppliers. A truly strategic sourcing effort focuses investment in areas offering the potential for significant impact. The view that "any diverse supplier will do" obscures the dramatic differences across firms.

Firms led by women or ethnic minorities tend to be smaller and less well capitalized than the average business, inhibiting their ability to compete on an equal footing across all industries. In many industries, the minimum efficient scale (the company size required to compete effectively on cost) may be far beyond the capacity of most minority-owned firms. For example, the chemical industry, with its large capital expenditure requirements, tends to have fewer and larger competitors.

In the U.S., across the full spectrum of industries, the average firm has around $1 million in annual sales (according to the 2002 Economic Census, the most recent data available). Recognizing that this average includes goliaths like $379 billion Wal-Mart highlights how many extremely small firms must also be in the mix. Minority-owned firms averaged only $163,000 in annual sales in 2002, and the average woman-owned firm garnered $145,000.

In addition to the variance between publicly traded and majority-owned firms, there are significant differences by sector due to capital requirements and economies of scale. For example, the average utility achieved $22.6 million in sales, whereas the average construction company had sales of only $477,000. Strategically, a company is more likely to find a cost-competitive diverse supplier in an industry with more small players, such as apparel, and a higher concentration of minority owners.

Consider the transportation and warehousing industry, another industry with small-scale competitors. Black-owned businesses in the U.S. account for 10.2 percent of the industry, despite representing only 5.2 percent of all U.S. firms. There are nearly 39,000 black-owned trucking companies and more than 16,000 black-owned courier companies. Similarly, Asian entrepreneurs own only 4.8 percent of all U.S. firms, but they own 15.5 percent of accommodation and food-service firms, another industry with many small players. With average sales of $313,000, even the average Asian-owned company in this segment faces only limited scale disadvantages; the overall industry average sales are just $692,000.

Of course, companies that limit their diversity sourcing to small-scale service businesses may miss the opportunity to tap into manufacturing innovations. Although manufacturing in total has greater scale economies — as indicated by the average annual sales of $6.7 million across all U.S. firms — certain manufacturing segments demonstrate lower-scale economies. Take the textile industry as an example. The average textile mill achieved annual sales of more than $9 million, but the average apparel manufacturing firm achieved only $1.1 million. Furthermore, although women own just 28 percent of businesses across all industries and 18 percent of manufacturing firms, they own 50 percent of apparel manufacturing firms and even 28 percent of the more capital-intensive textile mills.

Companies can strategically source a majority of their purchases from minority owners in particular segments, chosen through detailed understanding of the industry economics, rather than simply trying to achieve "reasonable" targets of "5 to 10 percent diversity sourcing" in all purchasing categories. Benchmarks are helpful to gauge progress, but should not become goals in and of themselves. Though most women-owned and minority-owned businesses are very small concerns, many represent diamonds in the rough that can grow to be strategic suppliers with the right type of mentoring and support. Over time, they can then grow into publicly traded companies that can expand into related industry segments.

IBM's mentoring program sends each supplier through a process facilitated by a professor from a leading business school.

Crossing the Capital Gap

Even in industries with low minimum efficient scale, entrepreneurs need access to money in order to fund inventory and receivables. The need for funds can be particularly acute in high-growth firms: Solid profit margins cannot provide the working capital needed to support rapidly expanding sales. Minority businesses, in particular, face a dramatic capital gap.

For example, in the U.S., most black and Hispanic business owners originally capitalized their business using personal financing of a few thousand dollars. Small-business owners typically supplement the initial investment with commercial loans. Whereas 22.5 percent of majority-owned firms are able to fund 25 to 100 percent of their business with commercial loans, only 12.5 percent and 14.9 percent of black-owned and Hispanic-owned businesses, respectively, can do so.

Venture-capital money can play a dual role in supporting minority-owned and women-owned entrepreneurial suppliers. Such equity funding removes the cash-flow problem of debt financing during initial growth stages when money is best reinvested in the company. But even more importantly, venture money brings managerial expertise, because venture investors typically take lead positions on the board of directors; in some cases, they become active advisors in the day-to-day management of the business. Unfortunately, fewer than 4 percent of private equity firms actively invest in minority-owned businesses, and, accordingly, venture money represents an insignificant source of capital for minority firms.

Wal-Mart has led the way among corporations to address this capital gap. In 2005 it formed a $25 million private equity fund specifically to invest in helping build the businesses of diverse suppliers. Targeting nine women-owned or minority-owned businesses, the fund has a five-year life. At the time of its inception, Jay Fitzsimmons, then Wal-Mart's treasurer and senior vice president of finance, explained the rationale: "Even though small businesses are one of the fastest-growing sectors of the economy, access to capital remains a key barrier to growth for women- and minority-owned businesses. By creating this fund, we help fill a significant void and can have a positive impact on those businesses that are ready and able to move to that next level of national and international distribution for retailers."

Creating a de novo investment fund may not be possible for most companies. Yet collaborating with local and national venture-capital firms focused on domestic emerging markets may be a particularly cost-effective strategy. With this new type of venture capital, experts in investing in and advising this unique segment manage the business risks. In addition to building relationships with venture firms, companies can make the contractual commitments to their minority-owned suppliers that help attract the "smart money" available from such firms.

Time for Talent

Not every company may be able to tap the resources of private equity funds for diverse suppliers, but all companies can invest time in building a supplier's management talent like an active fund manager. Most venture capitalists will say that the competence and passion of a start-up's management team ranks as high in their investment decisions as the technology, market, or other business strategy element. Companies that seek to develop supplier diversity for true competitive advantage need to select suppliers with potential and then invest to build the management capability.

This is an area in which we see a huge range of effort among even leading corporations. Some simply encourage managers from their minority- and women-owned supplier businesses to attend programs such as the Advanced Management Education Program offered by the National Minority Supplier Development Council. Others encourage such suppliers to attend company-sponsored training, but the training is typically open to all suppliers.

Mentoring programs that match women and minority suppliers with an executive sponsor have achieved mixed results. Not surprisingly, the level of the executive and his or her willingness to invest the necessary time to truly coach the supplier largely determine the degree of success. IBM set the high-water mark for mentoring with a program that was launched in 2003 and now encompasses seven minority businesses, of which two are high-potential suppliers rather than active ones. Each supplier in the program goes through a structured process facilitated by a management professor from a leading business school. The program begins with a one-day kickoff meeting in which the supplier meets the executive mentor. A two-day retreat follows shortly thereafter, and another one-day session is scheduled within a year to ensure follow-up on the agreed-upon action items.

Another innovative option is for companies to encourage two or more high-potential firms to merge. For example, one supplier may have attractive capacity in light manufacturing but may lack skills in technology management. Another may have complementary strengths and weaknesses. Astute and thoughtful supplier diversity managers may be able to convince the prospective suppliers that the sum is superior to the constituent parts.

All these recommendations have been proven effective, showing that managers today are more willing to reexamine their assumptions about supplier diversity programs. Taking the kind of strategic approach that Japanese automakers used to build their U.S. supplier bases and adapting supply chain processes tailored to minority- and women-owned businesses would result in clear economic and business benefits. It would create qualified suppliers of enough scale and scope to produce jobs, foster innovations that lower costs and raise quality, and broaden the base of business leadership. Such a focus represents good business — not just businesses trying to be good. +

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