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BENNETT E. MCCLELLAN WITH JOHN DOMOKOS

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How Can You Make Strategic Sourcing Strategic?

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OVERVIEW

Strategic sourcing is not just another term for "beat up your suppliers." In fact, when fully and properly deployed, the goal of strategic sourcing is competitive advantage first, cost considerations second. Yet in many corporations, strategic sourcing simply equates to getting the best price at any cost. An unrelenting focus on numbers sidelines the pursuit of strategic advantage. This kind of misguided strategic sourcing preempts taking advantage of a true strategic approach.

In industries where knowledge is king, squeezing suppliers generally becomes counterproductive. Suppliers squeeze back, or they go elsewhere. Further, if your profits depend on the use of intellectual capital, then beating up your suppliers is a sure way to help the competition beat you.

One of the root problems seems to be that sourcing is not typically seen as a board level concern. Those applying strategic sourcing concepts generally have little to do with setting overall corporate strategy. Sourcing is a function to be performed, not a key factor for success. As a result, the practice of thinking strategically about sourcing is either ignored or deemphasized, and in either case disappears over time.

Is forfeiting strategy an inevitable outcome of applying strategic sourcing concepts?

John Domokos, an expert in strategic sourcing, says it does not have to be that way. His view is that you can take a strategic approach to sourcing and get the best prices from your suppliers. As the former head of sourcing for Roche Diagnostics and a long-time strategic sourcing consultant, John emphasizes understanding sourcing as a way for companies to differentiate themselves from their competitors and as a key component of competitive advantage. In this article, John shares his views on how to put the strategic elements back into strategic sourcing.

WHAT IS STRATEGIC SOURCING?

According to Domokos, strategic sourcing is best defined as consciously and selectively applying business strategy and relationship management skills to what you purchase in a way that optimizes the results of your total business. Strategic sourcing is buying what you need in a way that helps you grow and sustain your business. Strategic sourcing is not just getting the best prices for the goods you use.

Only a limited number of a company's overall purchases fit the strategic goods or services category. "In a strategic sourcing approach, you might have 5% to 10% of suppliers that are considered strategic, but they may represent 80% to 90% of total spending," says Domokos. You therefore have to segment what you buy. Is it a strategic good or is it more like a commodity? You need to tailor your purchasing approach to fit each purchasing segment and each supplier.

How do you distinguish strategic items from non-strategic items?

Domokos says, "A strategic purchase is a good or service that contributes significantly to the company's revenue or cost position in its industry. The firms that make these goods or services are typically specialized. The goods and services from a strategic supplier are generally not easily substituted." In other words, strategic goods provide unique value to the purchaser.

Domokos gives the example of a pharmaceutical company making a variety of purchases. "When the company buys lab supplies, those are non-strategic. You specify a certain set of requirements and get the best price you can for the quality of goods you need. Those are transactional commodities. One substitutes pretty well for another. And there are several suppliers that can meet the service requirements to provide lab supplies."

That same pharmaceutical company may source an active ingredient for a major drug from a limited number of suppliers. In contrast to lab equipment, an active ingredient would likely be a strategic buy as it plays a central role in the company's products, has limited availability, may be patent protected, and must meet FDA requirements. It is not a commodity. It's a strategic good. It has the potential to enhance the company's revenue and cost positions.

Domokos further advises that making strategic sourcing decisions involves analyzing your requirements into the future on a more holistic basis. In addition to looking at the total cost of acquiring the good or service, you need to consider how the supplier can help your company differentiate itself and grow.

Domokos explains, "Your decision should not be driven by price alone. Rather, you need to assess the other benefits from integrating the supplier into your business. You are looking for more than a company to provide an ingredient. You are looking for the potential to cultivate the relationship and materially add to the value that the supplier provides to your company."

John elaborates on what it means to integrate a supplier into your business. "You clearly identify the strategic importance of what they provide. You would typically enter into a long-term agreement with them. Such agreements should define the supplier's obligations to help the company be successful through the goods and services provided. Once you have such an agreement, you continually look for new ways to integrate them into your business. You look to them for solutions for your business problems."

In other words, strategic sourcing involves leveraging your suppliers' best brains. That sounds pretty clever. Does it really work?

Domokos is adamant. "Absolutely!" he says. "Remember, strategic sourcing occurs in the context of an overall sourcing program. You have to be clear about not only the specifications for what you are buying, but also what you are looking for in terms of longer-term supplier relationships. You need to do both of these things before you get into negotiations to put a purchase agreement in place."

John notes that purchasing officers are typically under a lot of pressure to hit their targets. He suggests, "For non-strategic commodities, identify the best source to fulfill your needs, with a heavier emphasis on pricing and cost savings, while assuring that you meet your quality and delivery requirements. For strategic purchases, you are looking at the total cost and value creation from the partnership with the supplier."

Summarizing, strategic purchases make a major and direct contribution to the competitiveness and bottom line of your business. Strategic goods and services help differentiate a company's offerings from those of their competitors. Such strategic suppliers are typically integrated into the company's business processes as partners. Their value contribution grows over time.

WHO NEEDS STRATEGIC SOURCING?

The potential advantages of strategic sourcing are compelling. The question is how do you know if your company is a candidate for a strategic sourcing review?

First, companies that have not implemented a robust strategic sourcing process should do so. Most Fortune 500 companies do not fit this profile. However, whether their strategic sourcing programs currently reflect best practices in sourcing and whether they are being managed effectively are open questions. People slip into bad habits. Domokos advises major corporations that have allowed their sourcing to slide into routine purchasing to reboot their strategic efforts.

Second, mid-sized companies that have implemented strategic sourcing, but have not done a review in the past 3 to 5 years, are typically good candidates for improvement. Five years is a long time between checkups, especially in highly competitive industries. New sourcing opportunities arise as the nature of what companies produce changes. Domokos estimates that these companies typically find they have a 15% to 25% total cost reduction opportunity.

The third kind of company that is ripe for strategic sourcing is one that has experienced high growth, generates high profitability and is situated in a technology-dependent industry.

High growth? High profits? High technology? Why?

Ironically, needing to implement strategic sourcing can be a sign of success. This is especially true for fast growing companies generating between $500 million and $1 billion in sales. Success itself can create strategic sourcing opportunities.

Domokos relates an experience he had recently with a high-tech company in Southern California. The company had quickly grown to nearly a billion dollars in sales. The people running the company were marketing and development oriented, and viewed purchasing as a commodity trading activity. They had never considered how a supplier might help them grow even faster or improve their profit margins.

Exploring the situation further, John discovered that the company had never done a strategic sourcing analysis. The vast majority of their purchases were purely transactional. Yet some of their key purchases were clearly of a strategic nature.

Such high growth, high profit profiles are not limited to independent companies. John provides the example of a division within a major medical products company. The division had experienced rapid growth. They had gone through a large number of product iterations in a short number of years. The divisional executives had not considered strategic sourcing as a tool for helping them differentiate their products.

John describes the management of this division as product development driven. Implementing strategic sourcing in this division involved a major procedural shift in product development. Instead of introducing suppliers after they had developed the designs, they shifted to having supplier engineers on their product development teams. Their engineering people were not used to having outsiders present during product development. The change brought up many issues of trust, protection of trade secrets, and job security.

The success of the effort was confirmed during the development of a medical testing device. The development team realized they needed to include an electronic alarm in the device to provide failure warnings. The team deployed an off-the-shelf alarm that fit the spec. Given their past method of operations, this seemed like a good solution.

When the supplier's electrical engineers saw the design, they asked, "Why did you put this particular alarm into this device?" As it turned out, the technology in that alarm was at the end of its lifecycle. The alarm was being discontinued. The supplier's engineers came up with a superior alarm using newer, less expensive technology.

John emphasizes the message: "The suppliers were able to bring unique solutions to fulfill the product design requirements. Having their engineers on the design team made the design team aware of issues and opportunities they could not have imagined."

WHAT DOES IT TAKE TO IMPLEMENT STRATEGIC SOURING?

Let's say you've decided your company is a candidate for a strategic sourcing review. How painful is it going to be?

Domokos explains that to realize the benefits of strategic sourcing the approach has to become a way of life.

John says, "If I'm a CEO, I need to look at strategic sourcing as a long-term business process change. It needs to be built into the way people do business in my company. It involves education, typically beginning with the senior staff. It involves training at all levels. It involves the implementation of business controls. Metrics are needed to assure that the targets are realized. And once those policies are put in place, such as competitive bidding, there has to be discipline exerted to make sure those policies are followed."

In other words, strategic sourcing is not a quick fix for lagging profits. It's a long-term approach for optimizing the purchase of goods and services along multiple dimensions and integrating key suppliers as business partners that can help the company grow.

The good news is you don't have to do everything involved with strategic sourcing at one time. John describes how one major client adopted strategic sourcing as a multi-step process. An initial review showed that the company spent some $4 billion on purchases of various kinds. The spending was further categorized as to whether it involved major or minor business process changes.

One of the first areas John's team tackled was telecommunications. At that time, there were 8 client companies, 12 locations, and 4 or 5 different suppliers of telecom services. His team put together a bid package for the total spend, and they discovered the company could save $2.5 million a year.

Domokos comments, "In a case like that, there's not too much business process involved. Most people won't have to do anything differently. Of course, the heads of IT will all want to stick with their own telecom service providers. But if you get the CFOs together, they are going to love the number. They are going to help you make the tough decisions."

He further suggests that, "Business process changes can be implemented by something as simple as putting a policy in place. For example, you could decide to require three competitive bids whenever anyone spends more than $50,000."

Such policy statements sound simple, but can actually be nightmarish to enforce. John tells the following story to illustrate.

"One client had 3,000 people who could generate a purchase order. You can imagine the difficulty of reining that in. Not to mention the pressure put on the individual. The individual would have to tell their longtime suppliers, 'I can't give you the PO until I get some bids.' Suppliers would threaten, 'Unless you give me the PO now, you are not going to get the goods and services on time.' It took us some time to get everybody on board."

Different groups are also oriented differently toward purchasing. John notes that those in production and materials handling are typically cost focused and regularly do competitive bidding. But then there are the groups that see themselves out of bounds for strategic sourcing initiatives. "If you look at marketing, sales, and legal, 90% of the time they are not thinking about sourcing in a strategic way."

WHAT DO YOU DO IN SUCH SITUATIONS?

John responds, "As head of sourcing, you have to come with a strategy to work with everybody. Here's how one of these situations worked out. I ran into the CEO at a social event. He said to me, 'John, I have a $4 million purchase order on my desk for the annual marketing meeting. Should I sign it?'"

"I told him that was one area strategic sourcing had not been able to touch. To make a long story short, on Monday, I got a call from the head of marketing. He said, 'The CEO said I'm not signing this PO until you can prove this is the best deal. Can you help me?' I assured him I could support him in this effort and we went to work."

Domokos uses these stories to illustrate key points about implementing strategic sourcing. Here are the main takeaways:

First, strategic sourcing has to be a policy that is driven from the top. It must be signed off by the senior staff and endorsed by all management.

Second, strategic sourcing policies have to be applied consistently across the company, but with the recognition that business practices differ among departments or divisions. Strategic sourcing, like strategy, must be adapted to the function.

Third, implementation takes persistence and commitment. It's not a memo writing exercise. It's a long-term change management challenge.

Fourth, you can smooth the path for change by focusing initially on areas where business processes will be least altered. Major process changes gain momentum once you start generating success stories.

Fifth, the boss has to be behind the philosophy as well as the process. Power players will avoid the process if it is not enforced at the top.

WHERE DOES STRATEGIC SOURCING GO WRONG?

Domokos says, "It's the human elements. Strategic sourcing is a significant change management challenge. The companies that have been successful with it have recognized that fact."

The following are some pitfalls Domokos has witnessed in helping companies implement strategic sourcing:

- The board adopts strategic sourcing as a policy, but does not adjust senior management's objectives. If top management's MBOs are focused only on new products and hitting sales targets, then that's what they are going to do. MBOs must include strategic sourcing targets.
- The executives at the top don't come from a background where they understand the importance of purchased inputs to their processes. If you have a CEO with an operations background, or an engineering background, it's more likely they will understand and appreciate and pursue the benefits of strategic sourcing.
- There is arrogance about what the company does that precludes input from outsiders. Some companies, particularly at the director level, just believe they are the smartest people around. They cannot conceive of other people having anything to add to their competence.
- The consultants over-promise the short-term benefits. One of the first things you need to check on is whether the short-term benefits promised are realistic. Often times they are not.
- People down the line fear for their jobs or their positions in the hierarchy. Letting other people into your department or area is hard. They might point out your mistakes. They might make your job unnecessary. You lose that sense of control over your area of expertise. It's just not comfortable.
- The program is introduced in a way that generates resentment and backlash. Managers who shove any kind of change program into the organization run the risk of creating a backlash. You can conceivably set up enough resentment in the organization to make sure the gains are not sustained.
- Humans resist change. You have to address people's fears. Change involves an education process. Change involves testing and seeing that different things can work.

COMPETITIVE ADVANTAGE FROM THE MASTERY OF COMPLEXITY?

Strategic sourcing sounds simple, but is really quite complex. Ironically, it is the complexity of implementing strategic sourcing that gives it an enduring strategic quality. Companies that master this complexity gain an advantage over those that are not able to master the skills required. Strategic sourcing, when well implemented, becomes one of those rare and inimitable capabilities that distinguishes one company from another. Such companies not only buy better, they are also better able to coordinate a range of strategically important activities across their boundaries.

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JOHN DOKOMOS is a senior consultant and former industry executive with over 30 years of experience in strategic sourcing, manufacturing operations, and new product development. He has been an independent consultant for the past six years, serving clients in the pharmaceutical and medical device sectors. Prior to this, he was Vice President of Sourcing and Vice President of Purchasing & Site Management at Roche Diagnostics. Before this, he spent 16 years in senior executive positions with Boehringer Mannheim. In his early career, John held various manufacturing and production positions with Hycel Incorporated, Lypho-Med Pharmaceutical, and Armour Pharmaceutical. John holds an MBA from Indiana University and a BS from University of Illinois.

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