
Abstract

To successfully implement strategic sourcing, companies must know their most important goods and services and determine how vital they are to day-to-day operations, as well as to achieving longer-term business goals. Strategic sourcing takes on a new approach of collaboration of constituents across supply chain to better serve downstream customers that would result in enhancing longer-term profit enhancement. This chapter outlines strategic sourcing concepts, principles and methodology for executing the sourcing strategy.

Keywords

Sourcing methodology • Procurement operations • Collaborative approach • Expenditure category • Total cost of ownership

2.1 Strategic Sourcing Concepts

Strategic sourcing is the process of developing channels of supply at the *lowest total cost*, not just the lowest purchase price. It expands upon traditional purchasing activities to embrace all activities within the procurement cycle, from specification to receipt and payment of goods and services (see Fig. 2.1). Although strategic sourcing focuses primarily on reducing costs, its foundation is building longer term, win-win relationships with key suppliers to give buyers a competitive advantage.¹ The nature of the relationship underscores the success of strategic sourcing initiatives. It is critical that both buyer and supplier work together and share information to identify opportunities that will significantly increase savings over time.

¹Douglas A. Smock, Robert A. Rudzki, and Stephen C. Rogers, Sourcing Strategy: The Brains Behind the Game, Supply Chain Management Review, May/June 2007.

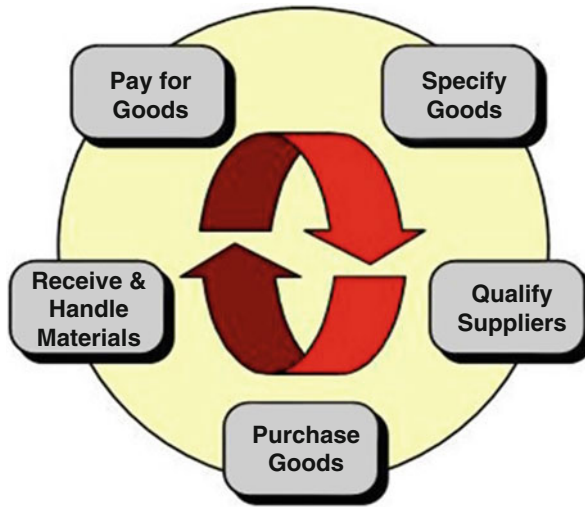


Fig. 2.1 Procurement cycle

In most companies, procurement operations are loosely coordinated. It's common to find different units within the same firm buying the same product with a different buying method that results in a different price and service level. The challenge facing a company is to obtain an optimally integrated enterprise-wide strategic procurement that allows it to leverage the purchase to achieve the most cost-effective strategic procurement of quality products at the highest level of customer service.

The transformation from traditional purchasing methods to a strategic-sourcing focus requires three fundamental philosophies that drive the strategic elements and also the infrastructure required to support the procurement process. These include:

- Focus on the total delivered value, not the purchase price
- Collaborative approach to dealing with suppliers, rather than oversight
- Focus on enhancing profitability, rather than cost savings

The above fundamental philosophies (as shown in Fig. 2.2) often result in fewer supplies. This creates economies of scale and long-standing relationships with suppliers.² Both the supplier and purchaser gain an advantage: they can both leverage core competencies to focus on increasing market share and improving market position.

The move from purchasing to strategic sourcing developed amid the far-reaching market changes during the 1980s. New production models based on just-in-time delivery and total quality management—as well as outsourcing, commoditization and globalization—had a profound impact on the way goods should be sourced, and

²Doug Smock, Deere Takes a Giant Leap, *Purchasing*, September 6, 2006.

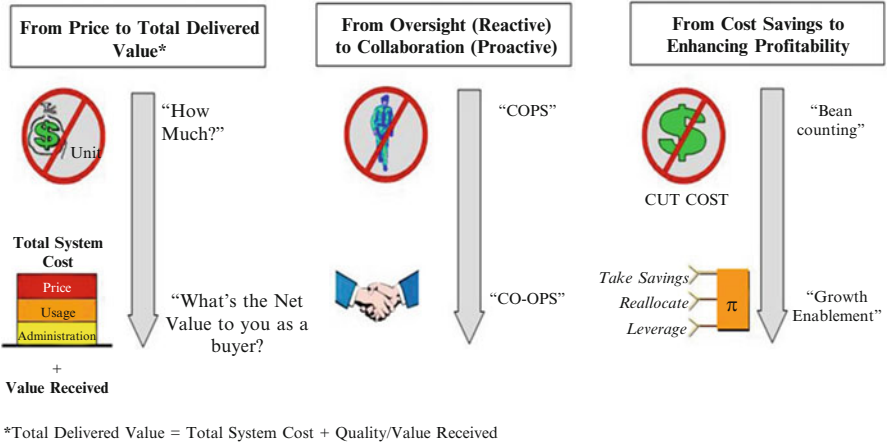


Fig. 2.2 Fundamental philosophies of strategic sourcing

on the relationship between suppliers and customers. Companies that wished to remain competitive had to shift their focus from a narrow transaction-based view of purchasing to a wider, more strategic view of how the supply chain could be configured to achieve broader corporate goals.

2.2 Strategic Sourcing Principles

A procurement strategy’s overall objective is to support the ultimate goal of achieving and sustaining a company’s competitive advantage. Hence, any procurement strategic initiative must be designed to support profit growth targets. This means a firm must seek ways to maximize the return on total delivered value of purchased materials, which is different from ensuring that the needed material is available at the lowest possible purchase price. The three prevailing principles in formulating and executing strategic sourcing are as follows:

Expenditure Category Strategy Formulation A product or service’s strategic importance is determined by whether it has an impact on a company’s core business and future competitiveness. Certain expenditure categories contribute differently to a company’s success, so different strategies should be deployed depending on the goods or services that are procured. Formulating an expenditure category strategy requires a company to assess how important a resource is to the company’s competitive position. However, critical resources may not be instrumental to running a company. They may be necessary, but they provide no competitive advantage in the marketplace and may have very little to do with a company’s goals or mission. A good example is office supply. A business needs photocopying paper, pens and folders each day, but sourcing them is unlikely to affect a company’s competitive position. On the other hand, strategic sourcing of important products will impact a

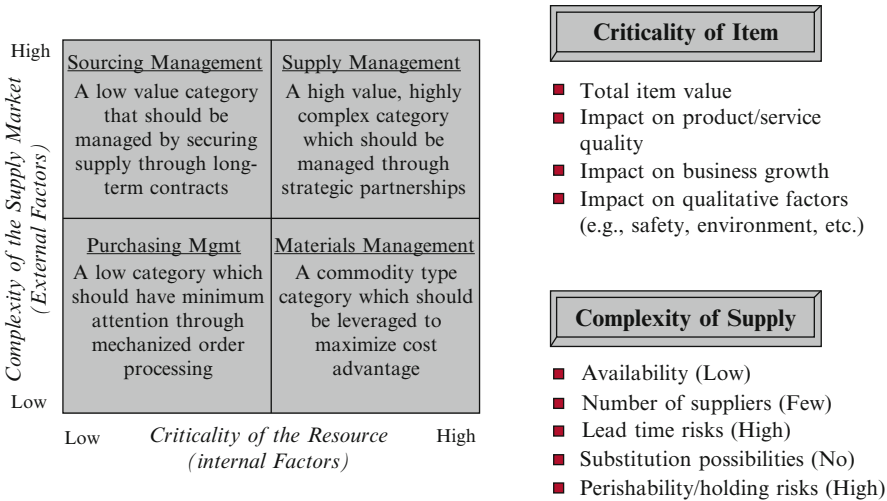


Fig. 2.3 Expenditure category strategic approach

company’s position in the market. Silicon, for instance, is the key product for a microchip manufacturer as it adds value and differentiates the product from competitors. Thus, purchasing silicon is crucial to the overall product value and the company’s future. If a problem occurs with silicon supply, such as poor availability or a price increase, the whole supply chain is affected, from the microchip manufacturer to the electronics manufacturer. Therefore, silicon is strategically important to a microchip manufacturer, and the purchasing process should reflect that.

In addition to understanding the strategic importance of purchasing key products, a company must also pay attention to the supply side. This will act as a guideline for specific strategies to use and the amount of time and effort that should be spent purchasing any particular item. Items with a simple supply market (high availability, large number of suppliers and plenty of substitution possibilities) are easy to purchase. Therefore, a company should devote minimal time and effort to buy them. Items with high market complexity are most likely to be high value goods or recurring needs. As the dollars spent in the long term can be significant, companies should spend the necessary time to reduce the total cost of these purchases.

A supply market’s complexity is determined by how difficult it is to buy a certain item. Buying becomes difficult when a small number of suppliers are dominant and very little competition exists; buyers encounter high switching costs and lack negotiating power due to small purchase volume; suppliers have more power due to their ability to provide inputs that are important to the industry; and the supply market has high entry barriers due to, for example, major capital requirements for a startup (see Fig. 2.3). The strategic formulation for each expenditure category depends on its importance and complexity. Hence, appropriate arrangements (procurement options) must be assigned to sourcing items in each category (see Fig. 2.4 for

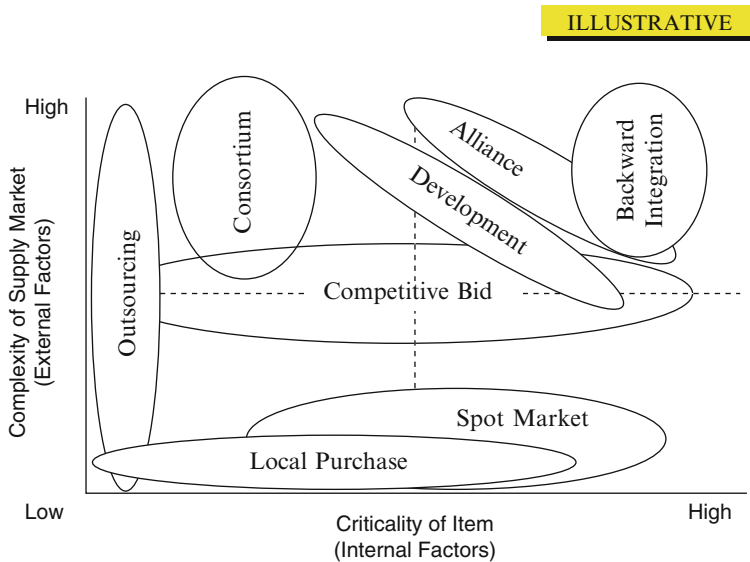


Fig. 2.4 Procurement options

arrangement of sourcing techniques). A more detailed methodology for determining the importance and complexity of an expenditure category are illustrated in later sections.

Total Supply Cost The Strategic Sourcing concept considers the *total cost of supply*. This concept unveils the total cost incurred by the buyer when purchasing materials and services. The Total Supply Cost (TSC) is an assessment of all costs—both direct and indirect—involved with an item over the product life.³ Most frequently, TSC is used in the purchase process to determine the most cost-effective choice. When TSC is calculated at the time a decision is made, many of the included costs are estimated because they are incurred in the future. Calculating the TSC can give buyers more detailed information to make decisions on suppliers and purchasing. It is important to know that the quoted purchase price is not the only cost involved in obtaining and using an item. An example of the TSC framework is shown in Fig. 2.5. The inclusion of all other known cost factors allows for a more complete picture to emerge. The benefits⁴ of using TSC include:

- Helps focus on total value, core business, quality, yields and cycle time reduction
- Helps in understanding technical issues beyond price

³Lisa M. Ellram, Total Cost of Ownership—An Analysis Approach for Purchasing, International Journal of Physical Distribution & Logistics Management, Vol. 25 No. 8, 1995.

⁴Total Cost Modeling in Purchasing, Center for Advanced Purchasing Studies, 1994.



Fig. 2.5 Total supply cost

- Makes it easy to negotiate and communicate based on facts
- Drives suppliers to work on the right issues
- Pinpoints and promotes continuous supplier performance improvement
- Provides in-depth knowledge of key costs and aids in quantifying actual savings⁵
- Aids in supplier development
- Improves internal and external communications

⁵Zeger Degraeve and Filip Roadhooft, A Smarter Way to Buy, HBR, 2002.

- Reduces subjectivity
- Allows purchasers to determine if “something is missing”

To calculate TSC, one must first establish a framework and assumptions that will guide the work. This includes defining the needed item (or service) and determining who will use it, estimating how long the item will be in use, calculating quantities and usage rates and determining the scope of process and areas that will incur costs from using the item. Early in the process, one should define the degree to which a company is using relative vs absolute cost data. In general, three costs categories are involved in calculating the TSC. They are:

- *Incurred costs*: These are either known or can be estimated to a reasonable degree of accuracy. Incurred costs include a quoted price, transportation costs, spare parts and supplies, brokerage fees and customs duties.
- *Performance factors*: These include areas such as delivery performance, quality and requirements for service or maintenance. Performance factors are relative data. As long as the data is valid for relative comparison, it doesn't need to be an absolute cost figure.
- *Policy factors*: These encompass all issues the buying company chooses to incorporate to reflect business or social policy directives. Typically a supplier or product either meets or does not meet the policy criteria, and a firm's policymakers must establish a dollar value for it. These policies can include recycled content of materials and minority and women-owned suppliers.

For social policy factors, and other so-called “soft issues,” a company must ask itself: “How much more would we be willing to pay for the privilege (or issue) being considered?” The buyer may include any soft issue in TSC as long as the company is willing to put a value on it. The buyer's value can be arbitrary, as long as it is consistent across suppliers and its relative weight makes sense to the buyer.

Several other factors must be considered in determining TSC that can affect the absolute cost comparisons between supplier A and supplier B, as well as item X and item Y. Estimates of these factors are acceptable as long as they provide a valid basis for comparison. These additional factors are:

- *Attributes of Performance*: To select suppliers that can make strategic contributions to a buyer's business, buyers need to sort out the performance variables. However, buyers should also be concerned about a supplier's respect for recycling, handling hazardous materials, safety and demographics. For example, a buyer may have a commitment to do business with minority and female-owned businesses, and we must factor these demographics into a supplier's performance.
- *Total Processing Cost*: Historically, the purchase price may have served the buyer well. But TSC takes into account many other elements that may require a more detailed methodology for calculating costs. For example, order processing costs are not the same from supplier to supplier. Importing/exporting costs and

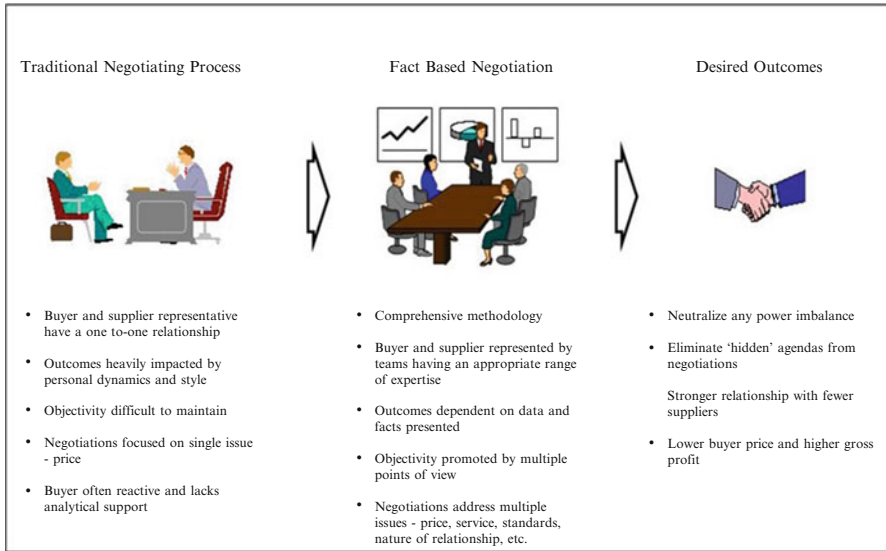


Fig. 2.6 Negotiation philosophy

correction costs can also vary. Inventory costs depend on whether the supplier carries the costs or if the buyer takes ownership of the goods.

- *Weighting and Method:* After establishing the attributes of performance and cost ownership, the buyer needs to create a weighting system that converts all supplier data into a structure for making richer, better informed decisions.

The TSC can be applied to the cost of any purchase. In a manufacturing environment, it is most commonly applied to the purchase of inventory, services and Maintenance, Repair and Operating (MRO) materials.⁶

Negotiating Philosophy The successful implementation of strategic sourcing relies largely on the ability to undertake fact-based negotiations. These use a structured analytical framework based upon rigorous analysis to achieve a lower total system cost. This method, illustrated in Fig. 2.6, takes a total-cost-of-ownership (or TSC) approach to selecting suppliers rather than focusing on the purchasing price alone. This technique is suitable for high-need, high-value relationships belonging to the strategic partnership zone of the strategic sourcing model.

In contrast to a traditional negotiation process where outcomes often hinge on one-to-one personal dynamics and style, fact-based negotiation relies on comprehensive methodology. To carry out fact-based negotiation, a team of executives experienced in a range of business functions is formed. Buyers and suppliers come to the table with experts in everything from procurement, engineering and finance,

⁶Doug Smock, DeereTakes a Giant Leap, Purchasing, September 6, 2006.

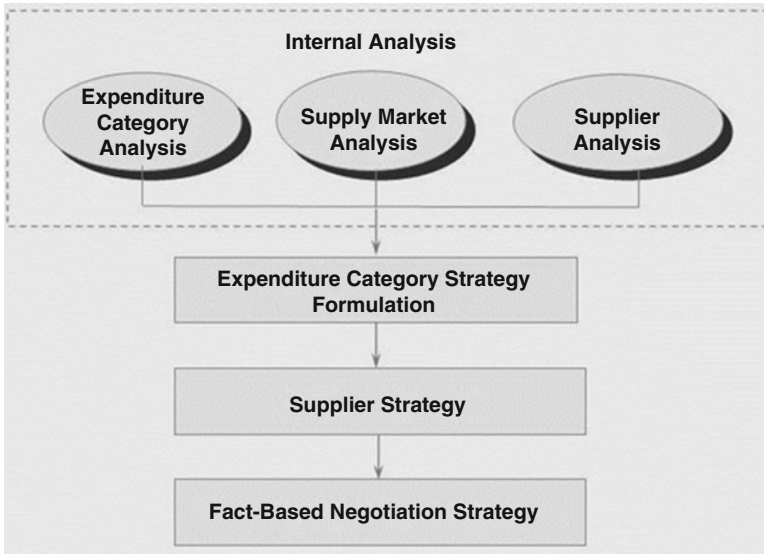


Fig. 2.7 Strategic sourcing methodology

to maintenance and research and development. The objective of the negotiation is to rely on analytical support of data and facts to address multiple issues that will develop a long and lasting relationship between the buyer and supplier. If carried out correctly, a fact-based negotiation process should produce win-win outcomes for both buyer and supplier that can ultimately lead to stronger relationships with fewer suppliers.⁷

Strategic sourcing represents a major shift from a win-lose to a win-win negotiating philosophy. It is important for both parties to negotiate with a win-win philosophy that will successfully form the basis of a long-term relationship. This approach shows that a company can lower purchasing costs without *browbeating* suppliers.

2.3 The Strategic Sourcing Methodology

Under traditional procurement methods, a purchasing department used similar methods for buying a wide variety of products and services. The chief focus was on buying items at the cheapest possible price. For example, when a company purchased large capital items, managers with technical expertise, such as engineering or information technology, often handled the decision-making and purchasing process. Managers discarded the negotiating and buying skills of purchasers in favor of so-called expertise in a product's function. In contrast, strategic sourcing recognizes

⁷Mark Gottfredson, Rudy Puryear, and Stephen Phillips, *Strategic Sourcing—From Periphery to the Core*, Harvard Business Review, February 2005.

that the skills of purchasing professionals are necessary not only for purchasing but also for decisions in other areas—product design, direction of research and development and technology uptake. All of these functions have purchasing implications and all have an impact on a company's overall profitability.⁸ Rather than taking a blanket approach to securing products and services, strategic sourcing differentiates between items so that products with the highest priority command the most time and effort.

Strategic sourcing methodology consists of the following four distinct stages (see Fig. 2.7):

- **Internal analysis:** Analyses to understand the roles each purchased category plays in meeting strategic business objectives. If done properly, internal analyses should produce immediate short-term cost savings benefits to buyers.
- **Expenditure category strategy:** This stage involves determining the strategic approach, portfolio of buying options and tactics for each buying category.
- **Supplier strategy:** Unique category characteristics and market conditions will drive different approaches to sourcing a given expenditure category. Supplier strategy determines the overall approach for dealing with suppliers; this includes the number of suppliers, the focus of a Request for Proposal (RFP) and negotiations.
- **Fact-based negotiation strategy and execution:** A structured analytical framework arms the negotiating team with all facts necessary to reach the desired outcome. These stages consist of the following:
 - **Negotiation strategy and case building:** Defines the leverage points of buyers and suppliers and formulates strategies for countering a supplier's leverage points.
 - **Supplier response and positioning:** Involves anticipating supplier responses and mapping out negotiation tactics for countering a supplier's responses.
 - **Negotiation planning, discussion and resolution:** This process prepares a company for the actual negotiations by mapping out the logistics of engagements.
 - **RFP/RFQ (Request for Quotation) preparations:** RFP/RFQ provides a formatted vehicle for collecting competitive information from suppliers to aid in the negotiations.
 - **Supplier selection and evaluation:** This stage involves developing processes and criteria for evaluating individual suppliers. This requires a complete understanding of value received from purchasing.

Details of strategic sourcing methodology are presented in the following chapters.

⁸Robert B. Handfield and Samuel L. Straight, What Sourcing Channel is Right for You? Supply Chain Management Review, July/August 2003.

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Strategic Sourcing

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