# 15 ROUTES TO VALUE

**Keith Crichton** challenges procurement leaders to look at potentially untapped ways they can make cost savings, improve productivity, boost the efficiency of working capital or help achieve revenue

## 1 AVOID INEFFECTIVE SPEND

This first lever offers 100 per cent potential savings. By treating discretionary spend, such as travel, marketing, consulting, training, product development, as if it were an investment only costs that offer a clear return should be considered. Spend reduction can be realised by effective zero-based budgeting, tight financial controls, and, for larger spend, business case approval. Of course, productive discretionary spend should be welcomed, not eliminated.

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## 2 DEFINE THE RIGHT 'BOUNDARIES OF THE FIRM'

Choosing correctly between insourcing and outsourcing, and then implementing the decision, is critical to a firm's strategy, financial performance and reputation. Key questions include: Is is a core activity? Does the firm have internal capability to carry it out or does that exist externally? Can a capable supplier be appointed/managed without them being opportunistic? Are there key risks associated with the activity and where/how should these be managed? Can the requirements for outsourcing be clearly specified and performance effectively measured/managed? Outsourcing a problem without a clearly defined requirement is doomed to failure.

## 3 BALANCE FLEXIBILITY AND COMMITMENT

Flexibility from a clients' perspective sounds ideal but can come at a cost in terms of foregoing further discounts. Some examples:

- The capital investment budget for a convenience store was set as part of the annual planning cycle and could fluctuate from year-to-year. The business sourced equipment by ad hoc call-offs against frame agreements that contained no binding volume commitments. The suppliers said they could offer discounts if the client would make commitments to enable more efficient production runs.

- Prior to 2010, polysilicon, the primary feedstock to the solar module manufacturing industry, was in tight supply so manufacturers locked themselves into long-term take-or-pay contracts. There was a sustained period of over-capacity from 2011 to 2013 resulting in prices dropping, so some contracts appeared expensive. Prices have since recovered with increased demand, but this only encourages future investment in additional capacity resulting in the prospect of continued price volatility. There is no right or wrong answer, but it is worth considering the optimum balance between the premium for complete flexibility and the risk of making commitments.

## 4 OPTIMISE SPECIFICATIONS

A traditional approach has been for a stakeholder like marketing to set the specification, and for procurement to manage the sourcing. However, this does not allow for evaluating different options on specification. While the stakeholder should make the final decision, procurement should bring insights about the cost of different options. For example, a technical product may be specified by the brand name of the OEM, but other suppliers may be acceptable. Or a non-critical item of equipment may be specified in terms of bespoke design, but an industry standard may be sufficient. A cross-functional approach should be taken to meet the required functionality at lowest cost.

## 5 EXTEND MARKET REACH

How deep is your firm's supply market intelligence capability? Are you proactively identifying emerging potential suppliers? Is your thinking limited to tried and tested regional/local suppliers even though the potential supply market may be global? Do you have the due diligence and quality assurance capability to source with confidence from developing markets? By seriously considering the whole market, a more effective option may be discovered.

## 6 DRIVE COMPETITION

This remains one of the most effective ways of capturing value and is a core part of procurement. Specifications and selection criteria need to be clearly defined and sufficient time spent developing a qualified shortlist of suppliers. Sometimes reverse auctions may be appropriate at the near commodity end of the spectrum, provided the supply market is competitive. Competition may be the most obvious commercial lever, but it is often not applied with frequently enough. There are many examples where incumbents have been unchallenged for 10 years or more, even though supply markets have changed.

## PROBE FINANCIAL STATEMENTS FOR UNTAPPED SOURCES OF VALUE

| | |
|---|---|
| Sales revenue | Unit price X **volume** |
| Cost of product | **Unit cost** X volume |
| **GROSS MARGIN** | |
| Variable costs | **Unit cost** X volume |
| Fixed cash costs | **Internal staff**<br>**Third party** |
| Depreciation | |
| **NET PROFIT** | (pre interest, tax) |
| Reverse depreciation | |
| Change in working capital | Accounts receivable<br>**Accounts payable**<br>**Inventory** |
| Capital expenditure | **Mainly third party** |
| **CASH FLOW** | (pre interest, tax, dividends) |

**VALUE LEVERS**
**REVENUE** **COST** **PRODUCTIVITY** **WORKING CAPITAL**

> *"Buying cheap can cost more over the long term and is not always the best solution"*

## 7 SCRUTINISE SUPPLY CHAINS

Do you truly understand your supply chains?

For example, you may be using a regional distributor for spare parts but be unaware they are manufactured in low cost countries. Are you obtaining necessary assurance on social compliance? Can you estimate the ex factory and shipping costs and the consequent distributor margin? Are you aware of the trends in input costs (such as energy, labour) for the finished products? Can you produce a high-level cost model? Knowing what something 'should cost' enables an effective fact-based approach to negotiation.

## 8 MINIMISE TOTAL COST OF OWNERSHIP

Buying cheap can cost more over the long term and is not always the best solution. For example, a parcel delivery company needs to take several factors into account in selecting the most effective vehicle for its fleet against defined functional specifications. As well as price, ongoing costs such as maintenance and tax need to be considered, offset by any residual value. The only way of effectively evaluating each option requires application of discounted cash flow analysis to derive a total cost of ownership.

## 9 LEVERAGE FINANCIAL INSTRUMENTS

Developing a close relationship between procurement and finance can identify unconsidered sources of value. For example, the optimum currency to source goods and services will depend on differences between the client and its supplier in terms of their functional currencies, approaches to forex risk and hedging capabilities (which requires a fixed volume). Other financial factors to consider include insurance levels, lease versus buy, use of guarantees, and so on. The evaluation approach will vary according to the respective financial circumstances between the parties. Engagement of finance is essential.

## 10 GROW REVENUE THROUGH SUPPLY INNOVATION

Procurement is key in identifying innovation within supply markets and bringing it to the attention of stakeholders. This can lead to improvements in a company's products and services resulting in more sales. Or to sales revenue from new products or services (e.g. transparent, light-weight gas cylinders).

## 11 GOVERN SUPPLIER PERFORMANCE

While a robust sourcing process, culminating in contract award, results in potential value being identified, such economic benefits can only be realised through effective implementation. In particular, the Kraljic Matrix should be applied to identify strategic suppliers that contribute most to financial performance and operate in supply markets with greatest risk (due to HSE concerns, for example). Governance processes should be put in place with such suppliers (e.g. relationship owners) to ensure the capture of potential value identified within the contract as well as further continuous improvement.

## 12 DRIVE COMPLIANCE

Do your financial controls, including separation of duties, ensure that users only utilise approved suppliers? Are purchase orders, including call-offs, always raised and issued before any commitment to the supplier? Use of non-approved suppliers can result in loss of economies of scale and higher risk. Do your systems enable suppliers' invoices to be accurately checked against contract terms? Do you carry out spot audits to check invoices? External research suggests around 10 per cent of suppliers' invoices are inaccurate. This varies according to the complexity of the purchase (such as the number of line items).

*"Procurement is key in identifying innovation within supply markets and bringing it to the attention of stakeholders"*

## 13 MANAGE WORKING CAPITAL

There may be opportunities to effectively release working capital by optimising trigger points for re-ordering inventory items, only holding stock for critical items, gaining economies of scale by centralising warehousing, or outsourcing inventory management to your supplier (subject to defined service levels). While standard industry trading terms for a particular category/geography should be the norm, sometimes a mutually beneficial variation could be agreed due to significant differences in the cost of overall capital (and more specifically debt) between a client and its supplier.

## 14 IMPROVE PROCESSES AND PRODUCTIVITY

Asset productivity can be improved by applying 'work activity norms' to services spend (e.g. maintenance). Clearly defining and integrating your procure-to-pay process with financial delegations, and enabling workflows can improve transactions. Are budget holders, end users, order placers and accounts payable staff trained in your processes and system? Is there a continuous improvement mechanism for identifying errors and eliminating root causes? How do you prioritise and assign sourcing and supplier management activity given resource constraints? There will be core activities – such as risk mitigation. But have you considered linear programming to optimally allocate remaining resource capacity?

## 15 MITIGATE RISK

Effectively mitigating risk ensures there is less chance of an adverse event occurring or that its impact is lessened, should it occur. A systematic approach will ensure that the full benefits from reducing financial (and other) loss are realised. This should ensure that the complete scope of supply chain risks are identified and prioritised according to likelihood and impact, and appropriate mitigations and governance are in place. Examples of mitigating actions include robust supplier pre-qualification and alternative qualified suppliers.

Of course, you may be putting some of these levers into practice. But, others may have provided some ideas. Prepare your own story on the full scope of sources of value for your organisation. Take a stand and engage your bosses, colleagues and team to do the same. SM

## Article published in September 2015 issue of Supply Management

## About the Author

**Keith Crichton** is Managing Director of Chainge Consulting Limited. He is a business-to-business professional with over 30 years procurement, trading and marketing experience. Before establishing CHAINGE in 2011, he was Head of Procurement of BP's Alternative Energy and Shipping divisions, following 12 years leading various aspects of procurement transformation within BP.

Keith has worked for several international clients across a diverse range of sectors - manufacturing, marketing, construction, utilities, alternative energy, banking, legal and professional services.

Previous articles include "Optimising R&D Spend", published in the July 2013 issue of Supply Business. Recognitions include winning the People Category of the 2006 ISM Richter Awards for leadership of the innovative "Capability Accelerator" programme.

Keith has an MBA (Distinction) from INSEAD and an MA (Hons) in Mathematics/ Management Science from Cambridge University. He is a full Member of the Chartered Institute of Procurement and Supply and a Certified Professional in Supply Management.

## About Chainge

**CHAINGE** is focused on accelerating value and mitigating risk by transforming functional capability in Procurement and Supply Chain Management. Such support can be at the assessment, planning or implementation stages. Our people have multiple years of practical experience across diverse sectors and disciplines. This enables a rapid understanding of a client's needs that can be matched to the right resource leading to more effective outcomes. We pride ourselves on being delivery focused and highly flexible in tailoring our service to specific requirements. All this can be competitively offered due to minimal overheads within our Associate based model.

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