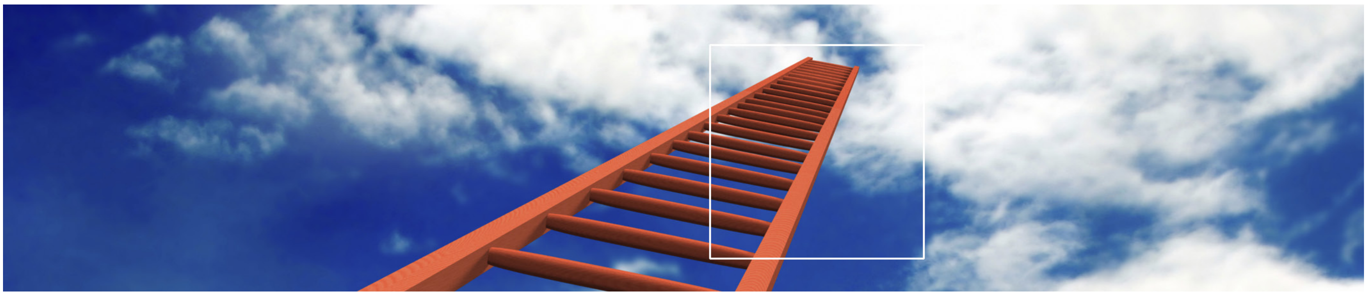
Worldclass Purchasing

Central results from the "Purchasing Value Excellence" (PVE) study



The global financial and economic crisis appears to have pulled out of its low point. Now is when the decision is made as to who will capitalize on the opportunities of the recovery phase and who can lay the foundation for the years of future success. This can only happen with a methodical, optimally structured and staffed purchasing department functioning as the backbone of a successful company. By lowering costs, the purchasing department significantly contributes to increased value. However, this is not the case for all companies. Oftentimes, the purchasing department operates purely as an order processor and in doing so inadequately performs its strategic functions. What these types of purchasing departments can learn from the very successful purchasing organizations, including which best practices they can purposefully adopt and how they can benefit from the implementation and regular utilization of these best practices, was identified in detail by Arthur D. Little in cooperation with the University of St. Gallen and the German Federal Association of Materials Management, Purchasing and Logistics (BME) with the 2010 PVE Study.

Arthur D. Little has been conducting an extensive purchasing benchmarking study entitled "Purchasing Value Excellence" (PVE) in regular intervals since 2002. To date, over 600 purchasing organizations have taken part in this study. Since 2005, this study has been conducted in cooperation with the University of St. Gallen. The objective is to identify the services profile of a best practice purchasing organization fit for the future. Thus answers are sought to the following questions:

- What are the central drivers of successful purchasing organizations?
- Which best practices can less successful companies adopt and implement?

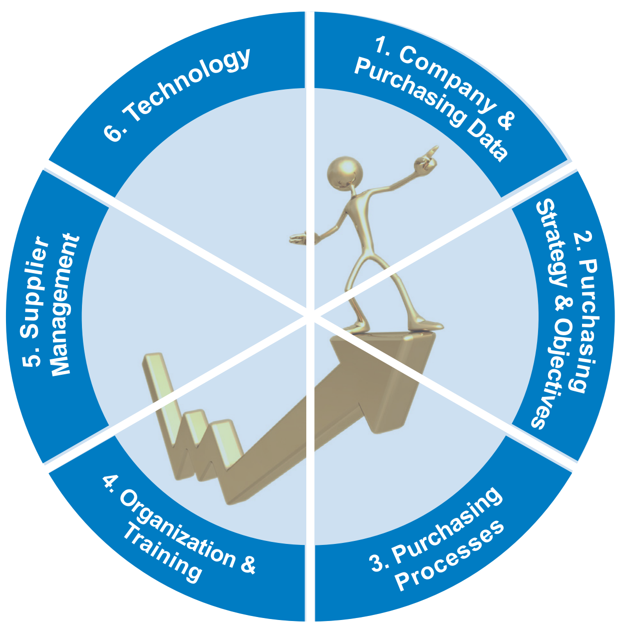
The existing findings are based on two datasets from different time periods. The first group of participants took part in the years 2006/2007, and the second group in 2009/2010. The study participants were primarily from large and mid-sized companies.

Six PVE fields to measure purchasing performance

We grouped the purchasing service parameters into six performance fields (figure 1). Within each performance field, parameters that characterize a best practice purchasing organization were identified. These determining factors could be precisely identified by directly comparing the best 25% of all purchasing organizations (top quartile according to overall performance pursuant to PVE point total) with the worst 25% (bottom quartile).

Out of the maximum attainable point total of 1,750, the overall winner was able to achieve about 1,500. When considering all industries, the average mean was identified to be 725 points. The following section presents several of the most interesting findings and also contains specific recommended courses of action for achieving "excellence in purchasing".

Figure 1. Performance fields of Purchasing Value Excellence (PVE)



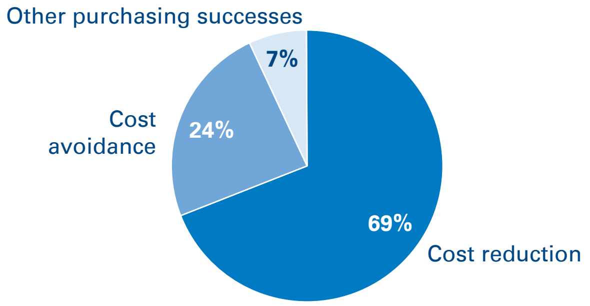
Source: Arthur D. Little

Price rate separates the wheat from the chaff

Price rate is one of the most important purchasing indices. It presents the inflation-adjusted trend of purchasing prices during the course of the year and is thus an index for the performance of the purchasing department. The surveyed companies reported a current average price rate of about –1.5% p.a. as opposed to the –2% p.a. during the 2006/2007 time period. The top quartile achieved a price rate of nearly –4%, while that of the bottom quartile was +0.2%. The most successful purchasing organizations were apparently able to achieve very low price rates, while the bottom quartile recorded price increases. The composition of both quartiles by industry is relatively similar such that the price rate can't be explained purely on the basis of which industry the particular company falls under. This confirms the assumption that a lower price rate is an indicator for a successful purchasing organization.

The participants in the study further indicate that cost reduction accounted for about 70% of the cost savings. That means that in a good two-thirds of the cases, the purchasing department can actually lower the purchasing prices. Cost avoidance (negotiating with a supplier to "talk them out of" their desired price increase) has about a 25% impact. With 5%, additional factors only play a minimal role in explaining the purchasing success (figure 2).

Figure 2. Composition of purchasing success



Taking of the sample in the 3rd and 4th Quarter of 2009
Source: Arthur D. Little

Long-term cooperation before short-term cost reduction

Today's purchasing strategies and objectives are focused on long-term and integrated approaches with cooperative basic principles. 90% of the participants indicated that long-term supplier relationships are "important" or "very important" to them. A focus purely driven by price and short-term gain has lost its significance.

However, this is where considerable differences can be observed between the top and bottom quartiles of the study participants: for example, the successful purchasing departments nearly universally indicate that they take a total cost of ownership approach with their suppliers (top quartile: "important" to "very important": about 70%). Whereas over 80% of the study participants in the bottom quartile report they follow this approach "somewhat" or "not at all".

These strategies formulated by the majority of the participants also carries over into the structure. The identification of key suppliers, with which a large percentage of purchasing volume is maintained, is preferred over the price-driven practice of "cherry picking". However, an optimum key supplier quota cannot be identified. The ideal number of large suppliers with which a company covers 80% of their purchasing volume varies sharply by industry.

From supplier assessment to supplier development

Long-term successful partnerships with suppliers are based on two important pillars: supplier assessment/selection and supplier development. A standardized supplier assessment has become the norm these days and as such is practiced by the top and bottom quartiles of the participants. Even though the bottom quartile actually spends a larger percentage of time available for the supplier management on the assessment (about 50%) compared to the top quartile (about 40%), the larger investment of time does not necessarily guarantee more success. Conversely, the top quartile spends about 25% of the time on supplier development, whereas the bottom quartile only invests around 10% of the time. This means that long-term, successful supplier partnerships are only possible if the relationship is intensively developed and is not just evaluated as per the status quo.

Global sourcing opportunities already maxed out?

With respect to global sourcing, most of the participants think the ideal level has already been attained. About two-thirds of the purchasing volume is purchased domestically, nearly 20% comes from the home continent and only about 15% of the volume stems from suppliers from other continents. The companies do not anticipate a further expansion of non-domestic volume; however, there is no evidence of a trend reversal back to near-sourcing either. 40% of the participants record net savings resulting from global sourcing to be ≥5% (TCO observation). Thus, in spite of the higher logistic costs, global sourcing continues to be one of the most effective ways to reduce purchasing costs.

Purchasing in the planning process: The earlier, the better

Many purchasing organizations consider themselves to be limited in their options because they are not included early enough in the requirements planning. However, this is essential for purchasing success. Only if the purchasing department is also included in the requirements phase and can suggest early on, for example, possible substitutes (suppliers or supplied parts), will the overall optimum balance be effectively achieved between the conflict of objectives that often exists between complete satisfaction of all functional requirements on the one hand and an economically adequate price on the other hand. This development of the purchasing department away from a reactive company function ("ordering office") towards a unit proactively functioning throughout the requirements planning and procurement process, still poses a significant challenge to many companies even today. This observation applied to nearly all participants in the study. For example, the purchasing departments of the bottom quartile are involved early on in the product specification process in only about 10% of the cases. Even though this percentage is higher in the most successful purchasing departments, the percentage is still only around 60%.

Maverick buying: large companies lead the way

There are also opportunities for improvement in the percentage of the purchasing volume that is processed directly by the respective departments and does not flow through purchasing. This so-called "Maverick buying" averages out to be 44% for the bottom quartile, but in comparison only 5% for the top quartile. It is particularly noteworthy that the lower the Maverick buying rate tends to be, the higher the purchasing volume of a company is. Large companies often react with strict purchasing policies ("No procurement allowed without the involvement of the purchasing department.") in order to prohibit maverick buying. Mid-sized companies that tighten their purchasing policies with regard to Maverick buying could achieve potential savings in this area.

Automation and IT utilization hold promise for additional improvement potential

There is considerable room for improvement within the field of "technology" for most of the study participants. Many administrative tasks are still being performed manually although there are adequate IT systems available on the market. Large companies indicate a higher technology usage than the mid-sized companies. For example, the percentage of electronic requisition requests is around 60% for large companies, while in the other companies it is only 35%. On the one hand this is the result of economies of scale – many IT investments exhibit a return on investment only after they reach a certain frequency of the repetitive task – on the other hand, in many cases large companies are also subjected to higher standardization pressure in order to maintain uniform processes throughout the entire company. The utilization of IT systems is thus often the means to satisfy this requirement.

As before, there continues to be room for improvement with respect to online inquiries and online auctions. On average about 20% of all inquiries are currently processed online, and for auctions it is actually only 5%.

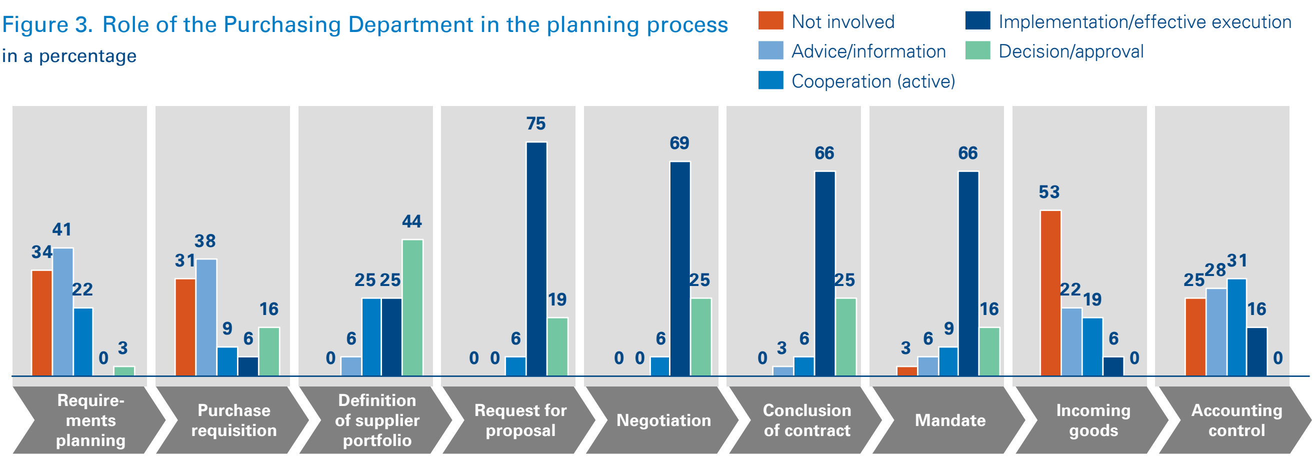
Your way to achieve purchasing value excellence

The most successful companies of 2009/2010 were characterized by

- the building of long-term, partnership supplier relationships coupled with an intensive supplier development process,
- the further integration of the purchasing organization into the requirements planning process as well as
- the utilization of innovative IT systems to optimize processes, to keep administration and repetitive, operational tasks to a minimum, and to invest the time gained in strategic functions.

How can your purchasing organization benefit from the findings of the study? Basically, the first step should be to identify the most important action points for your company. To this end, all participants in the study (participating at a future date is also still possible) receive a customized PVE benchmarking report that can be used to easily identify the areas of weakness specific to the company. This report shows the individual company's purchasing performance in comparison to the average performers within the industry as well as to the performance of all study participants across the industries. Arthur D. Little would be happy to provide support in the detailed identification of opportunities for optimization. This is accomplished by way of a workshop involving all relevant departments to be conducted

Figure 3. Role of the Purchasing Department in the planning process
in a percentage



Taking of the sample in the 3rd and 4th Quarter of 2009
Source: Arthur D. Little

directly on-site by a consultant with extensive experience. In this workshop we can discuss optimization approaches, run through scenarios of a successful implementation and present the potential results.

Operational Performance Excellence framework (OPE)

Under the title of "Supply Chain Performance Excellence" and "Manufacturing Performance Excellence", Arthur D. Little offers comparably designed studies for logistics and production. With the benchmarking studies "Marketing & Sales Excellence", "Customer Services Performance Excellence", and "Innovation Excellence", the operational excellence area is completely covered.

The Operational Performance Excellence framework (OPE) ensures that the proper drivers are addressed within the company. Strong areas are improved and positioned so that they can carry the company to the top. In the weak areas, the problems are identified and effective optimization initiatives are conducted. The Operational Performance Excellence framework propels the entire value added chain to performance excellence by way of proven best practices. Increasing the efficiency and effectiveness of the value added chain as well as synchronizing the individual elements in an overarching manner can significantly improve the profitability of a company.

Companies interested in participating in the studies can do so at any time and request the respective benchmarking questionnaire free of charge. The written assessment of the results will then be sent to them by mail or alternatively presented on-site. Comparing the company's own methods and approaches with the best practice methods provides a starting point for achieving Operational Performance Excellence.

Figure 4. Operational Performance Excellence of Arthur D. Little

Source: Arthur D. Little

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The study of Purchasing Value Excellence was conducted in cooperation with the University of St. Gallen, Chair of Logistics Management, and the German Federal Association of Materials Management, Purchasing and Logistics (BME).

Chair of Logistics Management
University of St.Gallen

BME

Arthur D. Little

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