

**Strategic Sourcing: Building a foundation for success – understanding the difference between sourcing and strategic sourcing and its impact**



UPS Supply Chain Solutions<sup>SM</sup>

**Our Insight.**

A UPS Supply Chain Solutions  
White Paper

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With the increase of on line buying and sourcing of goods and services, educators, consultants, writers, and industry leaders have spent a great deal of time and resources attempting to improve the identification and selection of suppliers and the associated purchasing processes.

Today, some of the most commonly heard terms for buying include:

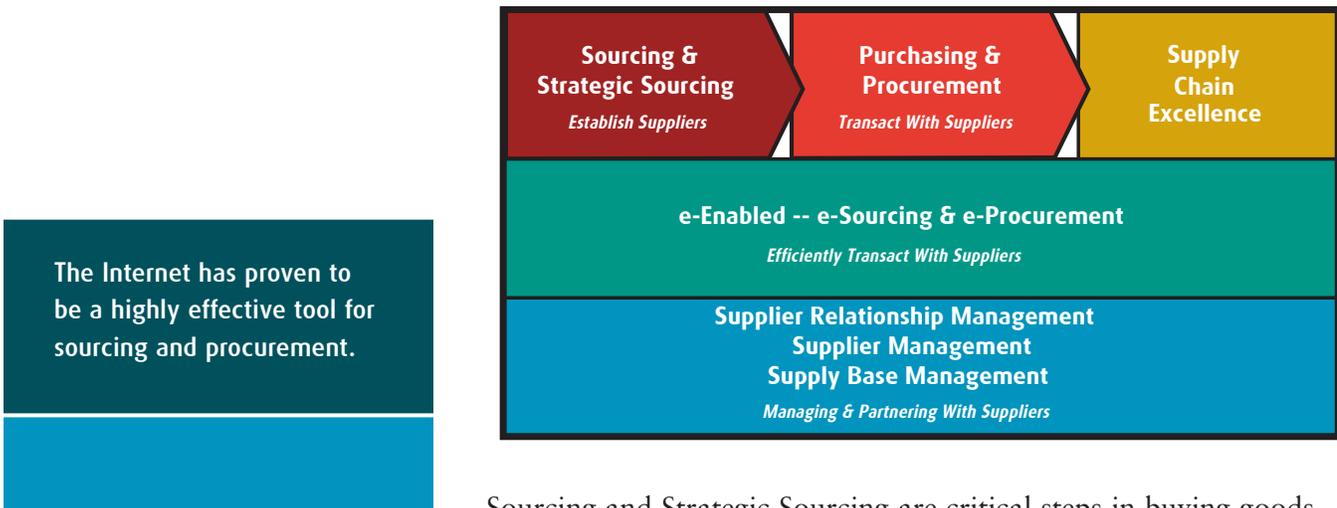
- Sourcing
- Strategic Sourcing
- e-Sourcing
- Purchasing
- Procurement
- e-Procurement
- Supplier Management
- Supplier Relationship Management
- Supply Base Management

Sourcing by identifying and locating suppliers is relatively simple, but it becomes more complex as the amount of unique raw materials, ingredients, parts, components, connectors, apparatus, products, equipment, supplies, and services increase and the numbers of buyers involved in the decisions expand. In a global enterprise, it is possible for one purchasing decision to impact numerous business processes or departments including manufacturing, receiving, distribution, marketing, sales or customer support.

The risks of buying the wrong items, services or from the wrong supplier can have major impacts and ripple throughout a business. Consequences can range from late delivery to total service failure liability and can even affect market competitiveness. In addition, if the selected suppliers cannot provide opportunities to reduce costs, improve and upgrade product/service offerings or provide other market-facing advantages, then an organization can quickly find itself losing market share.

To help clarify the confusion, UPS Supply Chain Solutions is offering insights into the optimum approach to buying. Often known as Strategic Sourcing, it begins the critical process and lays the foundation for creating value through the purchasing process.

Figure 1: The required foundation



Sourcing and Strategic Sourcing are critical steps in buying goods and services (see Figure 1). In this stage, individuals or groups analyze, assess, and select vendors and their goods and services based on certain specifications and requirements. This relationship is typically documented in a contract with terms and conditions regarding products, services, prices, and service levels.

The next steps are Purchasing and Procurement Management which are established after Sourcing and Strategic Sourcing to execute upon the contract and to supply the enterprise with required goods and services at the negotiated price and agreed-upon times. These actions are typically represented in purchase orders (POs) or release orders/instructions on master POs. POs are communicated via phone, fax, mail, EDI, etc.

The Internet has proven to be a highly effective tool for sourcing and procurement. Strategic Sourcing has been e-enabled through web applications, marketplaces and portals that support auctions, reverse auctions, etc. Procurement has also been e-enabled through web applications, marketplaces, and portals that support requests for information (RFIs), requests for quotes (RFQs), purchase orders, logistics arrangements, payment, etc.

The final building block is Supplier Relationship Management (SRM). Managing and partnering with suppliers is important from sourcing through procurement. Integrating operations and establishing mutually beneficial programs are essential to a successful company.

## Why Sourcing and Strategic Sourcing are important

### What is Strategic Sourcing?

...Strategic Sourcing can go well beyond cutting costs.

Defining Strategic Sourcing should be fairly simple. Most companies are already involved with some form of Strategic Sourcing initiative. Typically, when professionals define Strategic Sourcing they limit the scope and therefore the impact of a Strategic Sourcing initiative. However, Strategic Sourcing can go well beyond cutting costs. It can have a profound impact on a company's financials and can strongly influence the purchasing and procurement processes.

For purposes of this paper, Strategic Sourcing will be defined as the process of evaluating, selecting and aligning with suppliers or consortiums of suppliers to achieve operational improvements in support of an organization's strategic objectives. The phrase Strategic Sourcing was coined and is used when the activities of sourcing are directly tied to a sourcing strategy.

Figure 2: Strategic sourcing platform



What does it mean to have a sourcing strategy and why does an organization need it? First, a sourcing strategy aligns an organization's overall business strategy with the sourcing objectives. For example, it does not benefit an organization to select a supplier for a multiple-year agreement based on superior manufacturing capabilities and local presence if the organization is evaluating global outsourcing operations in support of business growth and cost competitive objectives. Second, when properly defined, a sourcing strategy assists an organization by gaining a true understanding of its requirements, knowing how it must map to the existing supply market, and then develop a plan for both short and

Cost reduction is typically the primary goal of most Strategic Sourcing initiatives.

long-term sourcing objectives. Having a clearly defined sourcing strategy will significantly improve both the quality of the results and the speed required to achieve an organization's sourcing objectives.

Because Strategic Sourcing is so comprehensive, there is a high probability that the criticality and scope of Strategic Sourcing ends up involving much more. It can result in a cross-functional/cross-enterprise effort intended to optimize the "concept-to-cash" supply chain performance. It is an ongoing endeavor to evolve both internal and external processes to obtain the highest level of strategic benefit for a business. When done correctly, the results are immense and ultimately position an organization to achieve a competitive advantage in the marketplace through its suppliers.

## Results that can be achieved

### Know thyself

One advantage attributed to a well-coordinated Strategic Sourcing initiative is gaining an understanding of how competencies and processes support a clearly defined business strategy. Obviously, it's impractical to meet the requirements of a business without first understanding them. A Strategic Sourcing initiative presents the opportunity to clarify and communicate corporate goals and objectives. It also is a means to define and document what an organization's competencies are and what they should be. Non-value-add functions that waste critical time, resources and require financial support can be identified and outsourced or eliminated.

As companies grow, many redundancies tend to occur. These redundancies can be in the form of distributed activities that mirror each other, or they may take the form of similar products being itemized and purchased separately. After these redundancies are identified, aggregation of similar products or consolidation of activities can occur. The processes and workflows can also be redesigned to eliminate the non-value-added work.

Ultimately, an organization will select its suppliers based on their ability to support and assist in improving a process, providing a product/service at a lower total cost, or offering a better product/service that helps to differentiate. For example, computer manufacturers differentiate their computers' capabilities by using specific suppliers and noting the suppliers' technology on their computers and marketing materials.

## Realize the benefits

Executives are beginning to understand that procurement is a key part of the business or supply chain process. It is typical for businesses to spend more than 60 percent of revenue purchasing goods and services; and it is estimated that approximately 70 percent of all potential savings from purchasing can only be achieved through the Strategic Sourcing process. The results of a well-managed Strategic Sourcing initiative can be impressive and the benefits can be extended well beyond cost reduction.

## Impact the Bottom-line

Cost reduction is typically the primary goal of most Strategic Sourcing initiatives, because savings in cost of goods sold (COGS) fall directly to the bottom-line. For example, let's assume that a business reduces COGS by \$1 million. If that business has a 10% margin on sales, it must sell \$10 million worth of products to achieve the same \$1 million in reductions or savings. Again, every dollar from reducing COGS comes directly off of the bottom-line. This is critical in a business environment where it is more difficult to increase revenues.

When properly executed, Strategic Sourcing focuses on total costs and not just the purchase price. Often, procurement professionals consider the "sticker price" versus the price of the complete lifecycle. However, other costs should also be taken into account such as carrying costs, service and repair expenses, and end-of-life/disposal costs.

### Best Practice Case Study — Dial Corporation<sup>1</sup>

Recently Dial Corp., the Scottsdale, AZ, based manufacturer of soaps and detergent products and consumer goods, split from Viad Corp., its parent company, and became an independent entity to better focus on its core competencies.

Accompanying that change was a restructuring of Dial's corporate functions into a business-unit approach, which included an overhaul of the purchasing function from a decentralized organization operating at the site level, to a central body headed by a chief procurement officer (CPO).

The move not only changed the structure of the company but it also changed the way its employees viewed total costs. By simplifying its supply base, working closely with its key suppliers, leveraging its buying power with key suppliers across the different business units, and developing a system for implementing innovative cost-savings

<sup>1</sup> Reilly, Christopher, Purchasing Magazine, "Central Sourcing Strategy Saves Dial \$100 Million," January 15, 2002

ideas, purchasing was able to drive \$100 million in total costs from the system in five years, including \$10 million in 2001.

### **From local to central**

Prior to the split of Dial Corp., purchasing had a decidedly local flavor. Purchasing managers at each of the Dial sites were responsible for all purchases from surfactants and other detergent raw materials, to computer systems and ancillary services. It was typical for buyers at one facility to buy the same raw material as a buyer at another Dial plant from two different suppliers and at different prices. While a decentralized purchasing structure can have its advantages, it was ineffective in taking advantage of Dial's volume requirements and corporate-wide buying power.

Early on corporate management realized the need for a smaller, more strategic purchasing function featuring a corporate buying group and led by a corporate officer. Dial's CPO and senior vice president, Michael H. Hillman explains:

"When we centralized the purchasing function, we combined all of our purchases and developed a strategy in which commodity experts would purchase those items in their area of expertise across all of the business units," Hillman says. "For example, there are purchasing managers who deal in chemical buying, plastics buying and paper buying, respectively," Hillman says.

### **Purchasing takes the lead**

The fact that top management at Dial saw the need for corporate leadership for its purchasing practices speaks volumes to the importance it places on controlling its costs and generating significant savings through leveraged buying and supply chain management.

Cost reduction goals are outlined in the corporate-wide strategic plan and are based on a number of variable factors. In 2001, the company's annual cost reduction goal was \$10 million.

Coming up with cost-savings ideas is a formal process at Dial, and involves every employee as well as every link of its supply chain. As part of the design, a formal procedure was introduced to get people thinking about cost reduction. Every employee within Dial is ultimately responsible for a budget, and is charged to save money in their area by identifying and implementing innovations and cost-reduction ideas to the central purchasing group.

Strategic Sourcing is applicable to almost every procurement activity.

### **Extend the enterprise to improve your competitive position**

In 1624 John Donne wrote “No man is an island,” which is to say that each of us is an extension of the individuals who surround us. This concept is relevant and applicable to business partners. Today, the performance of an operation often extends beyond its four walls to the performance of its business partners. Taking a critical view of suppliers and their capabilities and operations is important. This is also where the brand of a business partner can directly influence customers’ experiences and expectations. However, if problems or quality issues arise, customers generally do not blame business partners and suppliers. They hold one entity responsible. Think of this in terms of cars. Although parts are sourced from numerous different suppliers, the car manufacturer – Ford, Chevrolet, Mitsubishi, Toyota, etc.— is held responsible for all the parts.

Many suppliers have competencies in performing strategic value-added functions and prefer a strategic relationship or business partner that allows them to use their full complement of competencies. However, some companies elect to by-pass these value-added functions and hire their own in-house expertise. The danger is that by-passing suppliers’ expertise makes it easier for suppliers to partner with competitors who are willing to collaborate in joint strategies. Tighter relationships with suppliers can result in supplier integration which can result in shorter lead-times (cycle-times can be reduced by as much as 50 percent), higher quality and more reliable fulfillment. Even if a contract is firmly in place, revisiting supplier relationships and renegotiating contracts can be extremely important based on market conditions. This is especially true if suppliers have an abundance of capacity.

### **Take advantage of supplier services**

Executives are discovering that suppliers can be untapped resources in a number of areas because they often have more to offer than a specific product or service. As expert providers to specific industries, suppliers have insights, competencies and expertise in areas that the companies which employ them may not have. Companies have begun to rely heavily on this input. In the case of product design, relying on suppliers can have two primary results: improved product offerings that are more manufacturable and serviceable, and using suppliers disposed to providing parts for a quick launch. Other contributions from suppliers may include marketing concepts, technology pursuits, or creative financing. Company executives should meet frequently with executives from strategic suppliers to discuss possible new products or markets and other mutually

beneficial strategies. Suppliers may also offer valuable input to corporate objectives and issues.

### Apply to direct/indirect goods and services

Strategic Sourcing is applicable to almost every procurement activity even though it is usually more relevant to direct materials because of the inflexible nature of price. However, companies need to consider all purchases as candidates for Strategic Sourcing. Factors such as quality, shortened and reliable cycle times, technological capabilities, and services become key negotiation items.

Figure 3: Direct/Indirect goods & services

<p><b>Direct</b></p> <ul style="list-style-type: none"> <li>• Raw Materials</li> <li>• Ingredients</li> <li>• Packaging</li> <li>• Paperboard</li> <li>• Components</li> <li>• Parts</li> <li>• Assemblies</li> <li>• Cables &amp; Fasteners</li> </ul>	<p><b>In-Direct</b></p> <ul style="list-style-type: none"> <li>• MRO</li> <li>• Office Supplies</li> <li>• Lab Supplies/Equipment</li> <li>• Safety Supplies</li> <li>• IT/Computers</li> <li>• Furniture</li> <li>• Signs</li> <li>• Forms</li> </ul>
<p><b>Services</b></p> <ul style="list-style-type: none"> <li>• Transportation</li> <li>• Legal</li> <li>• Insurance</li> <li>• Janitorial</li> <li>• Lawn Care</li> <li>• Construction</li> <li>• Real Estate</li> <li>• Consulting</li> </ul>	<p><b>Utilities</b></p> <ul style="list-style-type: none"> <li>• Electric</li> <li>• Gas</li> <li>• Water</li> <li>• Telecommunications</li> <li>• Cellular</li> <li>• Internet Access</li> </ul>
<p><b>Capital Equipment</b></p> <ul style="list-style-type: none"> <li>• Machines</li> <li>• Plant Equipment</li> <li>• Materials Handling</li> <li>• Computers</li> </ul>	

Because Strategic Sourcing is so critical and can have such a strong affect on the bottom line, some buyers prefer managing and developing incumbent suppliers by aligning strategies and working towards common goals for the procurement of direct materials only. Other companies utilize their highly skilled procurement staff to manage and source other purchases including indirect resources, services, utilities, and capital equipment purchases.

### Develop the required organization

As executives acknowledge the strategic role of procurement, the skills employed by procurement professionals should be broadened. Negotiation and management skills are increasingly important as the procurement role evolves from transaction-based into more of a strategic partnership with suppliers. This means less time is spent

administering and more is invested in understanding the suppliers/vendors, commodity groups and supply chains that must be evaluated and balanced to attain a company's strategic goals (see Figure 4).

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### **Best Practice Case Study -- Baker Hughes<sup>2</sup>**

Baker Hughes, an oil-field services company headquartered in Houston, has integrated strategic sourcing and e-procurement with good initial success.

In designing its strategic sourcing initiative, Baker Hughes recognized its traditional approaches failed to deliver the promised benefits. Historical approaches ranged from individual divisions developing supplier agreements to several divisions collaborating on the development of supplier agreements. In most cases, use of these agreements was voluntary from the end-user's perspective, and most used the ordering and payment process of their choice. There was little consistency in the approach to working with the supply base, no real commitment to suppliers in terms of compliance with agreements, and little use of common processes. The resulting agreements may have been well thought out and negotiated, but the required level of buy-in from the organization was just not present.

#### **Focusing Properly**

To address these issues, Baker Hughes first focused on properly structuring the strategic sourcing initiative. The company setup full-time sourcing teams for each commodity and assigned leadership and accountability for the overall effort within the Executive Leadership Team. Divisional participation was made mandatory with each division being represented on a Commodity Advisory Board. With this structure in place, each commodity team then received responsibility for simultaneously executing along two separate but integrated work threads -- sourcing and infrastructure.

- Sourcing – assess opportunity, assess internal supply chain, assess supply market, develop sourcing strategy, implement sourcing strategy, and institutionalize strategy
- Infrastructure – as-is assessment, visioning, to-be design, organization/technology design and implement

While the sourcing activities focused ultimately on delivering a supplier agreement, the infrastructure thread sought to put in place the necessary process, technology, and organization elements to ensure realization of the negotiated benefits.

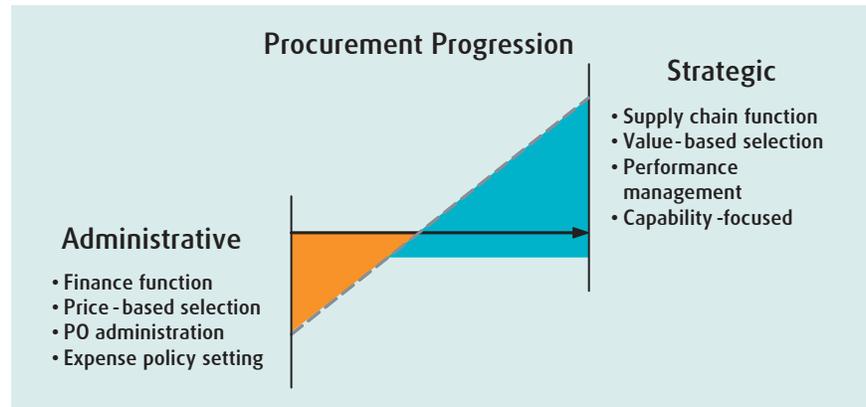
<sup>2</sup> Corini, John, Supply Chain Management Review, "Integrating e-Procurement and Strategic Sourcing," March/April 2000

## The progression from a procurement focus to strategic sourcing focus

The diagram below demonstrates that as procurement functions mature, the time spent on strategic functions increases significantly with a corresponding drop in administrative responsibilities.

Figure 4: Procurement progression

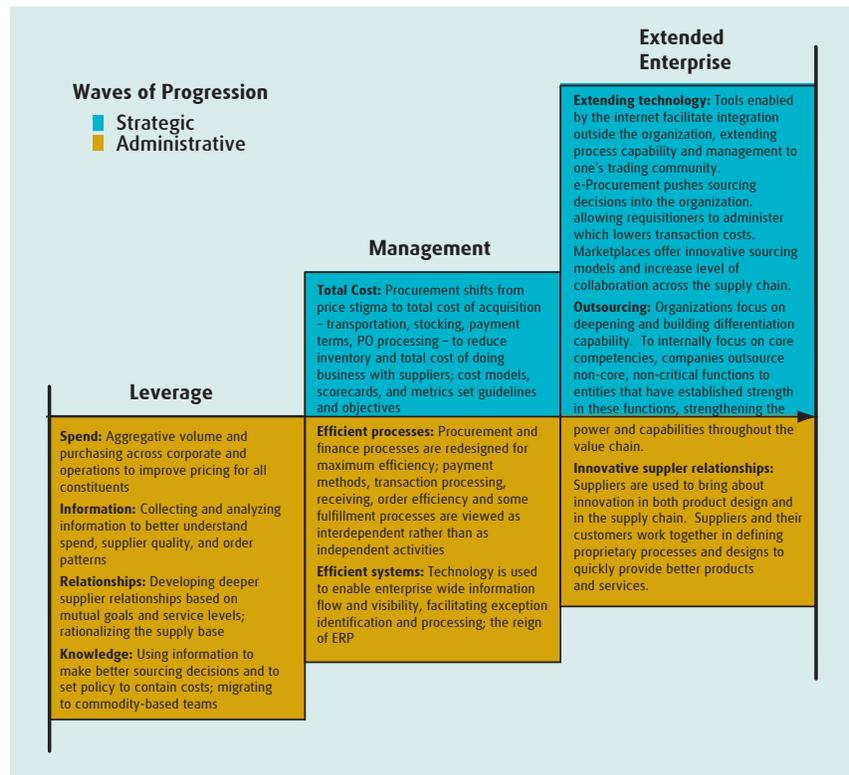
An organizational commitment is required to implement and support Strategic Sourcing.



This progression towards Strategic Sourcing is not a fluid evolution. Rather, cycles of thought leadership and technology advancements typically lead to three distinct waves in progression (see Figure 5):

- **Leverage** wave-organizations leverage information, knowledge, volume/spend, and relationships to optimize price by consolidating suppliers to ultimately achieve cost reductions
- **Total Cost Management** wave-processes, technology, and suppliers are evaluated, selected, or redefined to push costs out of an organization's supply chain
- **Extended Enterprise** wave-two focal points are pursued: bringing about tighter process integration through collaborative technology and innovation in supplier and partner relationships, and building or entrenching core capabilities by outsourcing non-core functions.

Figure 5: Waves of progression



## What it takes to achieve results

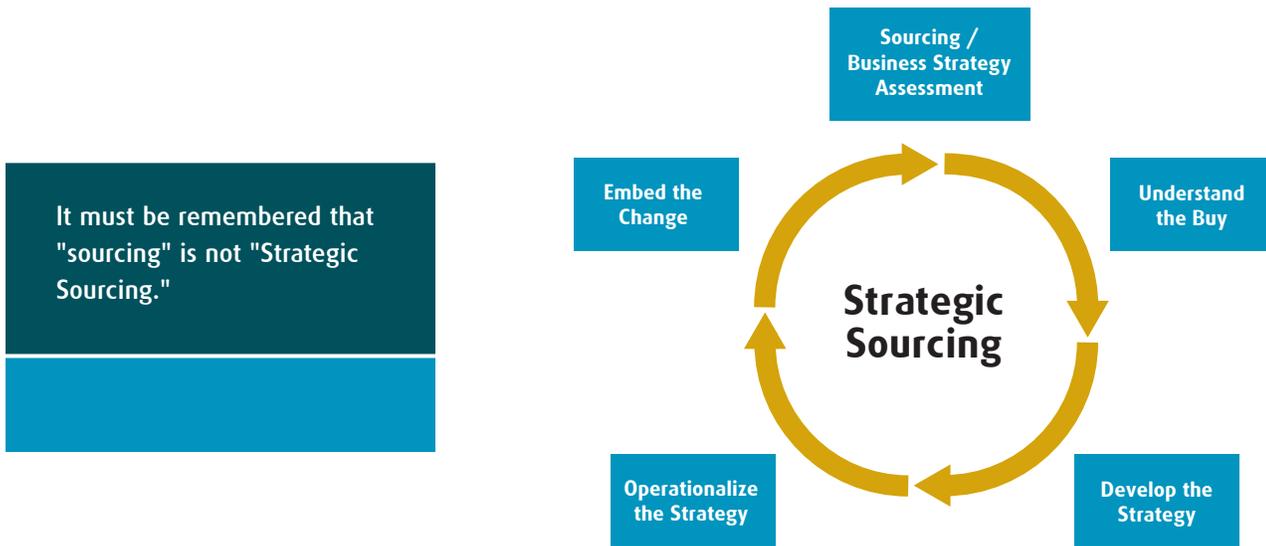
### The reality

As stated earlier, Strategic Sourcing is defined as:

**The process for evaluating, selecting and aligning with suppliers, or consortiums of suppliers, to achieve operational improvements and support an organization's strategic objectives**

Given this definition, the high-level approach to Strategic Sourcing shown in Figure 5 may look very similar to what your organization is doing today in sourcing its requirements.

Figure 6: Strategic sourcing approach



It must be remembered that “sourcing” is not “Strategic Sourcing.” From an approach perspective, what separates the two is the ability to address the following critical success factors while executing against the approach. These factors are shown in the order an organization would encounter them in the process and are not indicative of the order of priority:

### Strategic Sourcing approach to critical success factors

- Information Availability
- Organizational Commitment
- Supply Market Understanding
- Total Cost Evaluation
- Modifying Approach Towards Suppliers
- Organizational Role Changes
- Culture / Processes for Continuous Improvement

#### Information Availability

When a sourcing professional is the “first-to-know” rather than the “last-to-know,” the sourcing function becomes proactive, instead of reactive, which significantly improves results. Consider the possible differences in costs, availability, and selection when a professional has six months to outsource a printed circuit board assembly versus three months or less because manufacturing failed to communicate capacity issues which required changes to purchasing. Consider the possible benefits when a sourcing professional has the opportunity to recognize there will be a shortage of a particular product in six months and can proactively source alternate suppliers;

instead of the organization having to scramble because of missed deliveries leading to product backlogs. When executed correctly, Strategic Sourcing enables the company to constantly evaluate information about the business' strategy, overall market conditions, suppliers' performances, internal needs and expectations, and upcoming engineering changes and to adjust accordingly.

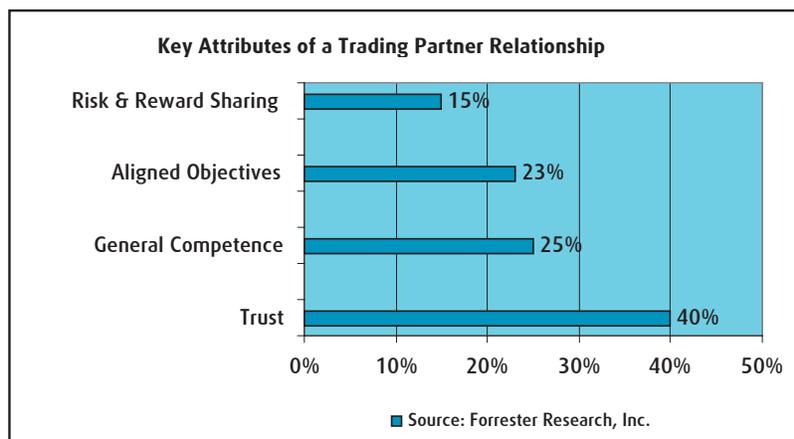
### Organizational Commitment

For a number of reasons, executive commitment to Strategic Sourcing is imperative. First, executives are the source of the information (business strategy objectives/operational improvement goals) and they must ensure the information is filtered to the purchasing organization. Second, the level of integration between an organization and its suppliers and the investment needed to achieve competitive advantages can be substantial and require executive commitment from all the organizations involved. Third, resources (human and financial) will have to be allocated to achieve sourcing results. Finally, and most importantly, organizational commitment is required to address the changes, management issues. For example, compliance to sourcing decisions often needs executive support and communications in order to drive adoption throughout the organization.

An organizational commitment is required to implement and support Strategic Sourcing.

An organizational commitment is required to implement and support Strategic Sourcing. A recent Forrester Research survey (see Figure 7) demonstrates the critical factors in a trading partner relationship. The expectations for a successful trading partnership will only be achieved with organizational commitment from both parties.

Figure 7: Forrester Research Survey



Strategic Sourcing has traditionally been associated with consolidation opportunities.

### **Supply Market Understanding**

Successful Strategic Sourcing professionals will develop an understanding of their position in the marketplace: how important purchasing is relative to the whole market demand; the position or importance of suppliers in the marketplace; the balance of demand and supply, cost drivers, i.e., raw materials, manufacturing processes; new entrants into the marketplace or consolidation trends; substitutes or alternatives; and finally, suppliers' or alternate suppliers' capabilities and overall strategies. Having this understanding will help an organization be proactive to changes in the marketplace, understand ways to leverage suppliers' capabilities for lowest total cost solutions, and finally better prepare for negotiation opportunities.

### **Total Cost Evaluation**

Total cost analysis will indicate the types and magnitude of savings opportunities outside of traditional negotiations around price, delivery and payment terms. By understanding the impact of inventory costs, how specifications drive costs, true life-cycle costs (including warranty, repairs, and disposal), transactional costs and others, the Strategic Sourcing process can increase the value through the traditional approach and identify sources of savings when suppliers are unable or unwilling to provide price concessions.

### **Modifying Approach towards Suppliers**

Strategic Sourcing has traditionally been associated with consolidation opportunities. Although increased business opportunities for suppliers and perceived competition will result in delivered savings, these are typically one-time savings opportunities. However, when an organization approaches suppliers talking about strategic opportunities, looking for ways to integrate that improves the performance of both organizations, and discussing/evaluating the savings opportunities from a total cost perspective, the process becomes less contentious. Now, both parties are talking about creating value, not shifting profit from one organization to another.

Likewise, technology advances such as the Internet and on-line proposal/bid processes have created competitive environments that may not previously have existed, but have caused current suppliers to be more responsive to an organization's financial objectives. However, before conducting an on-line event, it is important to understand the market characteristics to mitigate risks and prevent undesirable results. Through an understanding of strategic objectives and the marketplace, sourcing professionals can evaluate and modify supplier relationships to achieve the desired results.

One of the keys will be to separate the sourcing function from the procurement function.

### **Organizational Role Changes**

One of the keys will be to separate the sourcing function from the procurement function. Individuals responsible for sourcing typically spend over 50-60 percent of their days addressing transactional responsibilities (placing orders, rescheduling orders, resolving shortages, resolving invoice discrepancies) and have little time available to focus on higher value activities. Examples of higher value activities include supplier management, market research, and meeting with internal customers to understand how their needs are currently being met and/or are potentially changing.

In addition, since information is required from internal customers, e.g., engineering, manufacturing, sales and marketing, potentially these individuals will be required to provide part-time support resulting in a roll change to the Strategic Sourcing process and develop an understanding of the overall business goals.

### **Culture/Process for Continuous Improvement**

Change management will be instrumental to delivering the results and more importantly sustaining the results. Change is hard. UPS Supply Chain Solutions consulting services describes this as converting from a “project” to a “process.” In addition to the critical success factors mentioned above, organizational commitment, organizational role changes, and measurements (both internal and external) need to be addressed to drive the corresponding behavioral changes.

### **Best Practice Case Study -- Donnelly Corporation<sup>3</sup>**

Donnelly Corporation, a global company based in Holland, MI manufactures a diverse range of products and is focused on developing, designing and producing the sophisticated electronics hardware and software, and exterior systems that will shape the car of the new millennium.

After a study of its global structure, Donnelly determined that it was significantly increasing its presence in the Tier One automotive world and it needed to address its sourcing and purchasing operations. It began the task of centralizing its three independent US-based purchasing operations in an effort to leverage opportunities resulting from increased industry sales. Under the decentralized structure, the material costs typically were rising at the rate of inflation and some limited savings were being realized.

#### **The Strategic Plan**

After centralizing Sourcing and Purchasing, Donnelly created its first strategic plan, the “Donnelly Procurement Plan”. After one year, Donnelly was able to see a 5.2 percent swing in projected materials cost, a 25 percent improvement in supplier quality measures, and was on target for a 50 percent reduction in the size of its production supply base.

<sup>3</sup> Wincel, Jeffrey, Supply Chain Management Review, “A Practitioner’s View of Strategic Procurement,” Summer 1998

## In Summary

When looking at the macro or top-level view of the approach to Strategic Sourcing, it is difficult to assess what is different from the traditional sourcing approach. However, when looking at the definition of Strategic Sourcing and then evaluating what needs to be addressed from a critical success factor perspective and why, the differences should become apparent. The critical success factors previously discussed will vary slightly depending on an organization's current situation. They are not meant to be all-inclusive nor imply that if addressed, success is guaranteed. However, they do represent a solid checklist for determining how likely an organization will be in achieving and adapting to the objectives of Strategic Sourcing.

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By aligning a client's business strategies with its operating processes, UPS Supply Chain Solutions consulting services can create high-performance supply chains that from inception to implementation generate real, hard-number values and quick benefit realization. This distinguishing capability, our experience in solving real-world challenges, and the resources of UPS enable us to set strategies, design and build solutions as well as implement, operate, manage and synchronize your world of commerce.