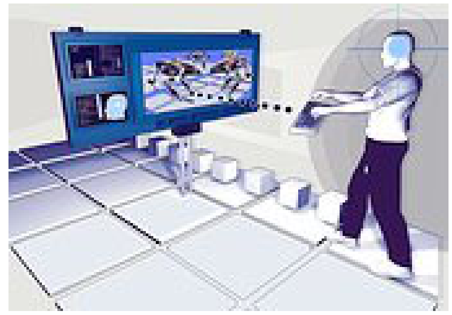
Procurement -- The Strategic Perspective

Published: May 28, 2008 in Knowledge@Wharton



The Importance of Procurement in a Global Environment

Until recently, procurement was a necessary, but seldom celebrated, component of multinational corporations. But times have changed: These days, procurement organizations within companies are playing pivotal roles in the success of global firms in ways that old-fashioned purchasing managers could never have imagined. In this special report, Wharton faculty and procurement experts at The Boston Consulting Group discuss why the procurement function has risen to such prominence in a highly competitive global environment, and how, as supplies of critical commodities tighten and prices rise, companies can strategize to mitigate these and other risks.

Part 1: Procurement -- The Strategic Perspective

Procurement has taken on greater strategic importance in multinational companies in recent years -- and it will assume even greater significance in the years to come, according to Hal Sirkin, senior partner and managing director at The Boston Consulting Group and global leader of BCG's operations practice. In an interview with Knowledge@Wharton, Sirkin discusses procurement in the context of global business, and the ways in which companies from rapidly developing economies are challenging traditional multinationals.

Knowledge@Wharton: Companies have been sourcing from China and other low-cost locations for years now. What level of expertise and cost savings are you seeing?

Sirkin: We've seen cost savings in the range of 20% to 40%, depending on what the product is. On the other hand, we've also seen examples where there were no cost savings when companies tried it. There are a lot of advantages to going to low-cost countries to source, but it has to be done right. I think the biggest mistake that companies make is that they try to source things and forget it -- and you can't forget it.

There are really three things that you have to get right: the product, the process, and the location. First, you have to think about what the product is. Are you sourcing the right part or the right product? That really means that the company you're buying from needs to have the technical capability to produce it well and the practical capability to execute it well. But you also need to see if it even makes sense to source it from China or other low-cost locations. If a part requires 50% labor, it makes a lot of sense to go to countries that have low-cost for labor. But if it only has 10% labor content, then it makes more sense to buy closer to home and save on the transportation costs.

The second thing is having the right process with regard to the supply chain and quality. From a supply chain perspective, you have to make sure that the costs don't eat up the savings. So, items that are difficult to transfer -- such as large, bulky or perishable products -- become an issue. Or, if you have a fashion product or something with a lot of variable demand, sourcing it far away means that you'll have to hold a lot more inventory. That means higher costs and a greater risk of obsolescence. We've seen people trying to offshore and outsource parts and products with 300% variation in demand, and when that happens, the value goes down.

In addition to the right supply chain, you have to have a quality process in place. Now, we've seen a lot of examples recently where companies have had problems with the quality of the products that are coming in. Some products were unsafe and others were unusable. Whenever you outsource, you have to invest your time and people to make sure that the quality process is in place, because your brand is on that product, whether you make it in Chicago or China. And because your brand is on that product, you have to make sure that you defend it and whatever you produce. Saying that it was "Made in China" or "Made in India" does not defend you against a quality problem. In fact, it may make it worse in the public's mind.

The third thing is to outsource to the right location. The absolute lowest direct cost is not always the best thing to do. Back to supply chain issues, if you're thinking about bringing something to China, you'll also probably -- if you're in the U.S. -- want to consider Mexico. Or if you're in Western Europe, you'll want to consider Eastern Europe because you may have a much better balance there [even though the direct cost may be higher] of avoiding supply chain problems, such as large variability and inventories, and the hidden costs of other things.

In the U.S., with increasing port constraints, we may be seeing delays over time. And Mexico, which of course does not require importing through ports, may be a good alternative. So, get it right [and] you can see a lot of savings. Get it wrong and your costs actually go up.

Knowledge@Wharton: So then, would you say that the level of expertise that you are seeing amongst the companies that are sourcing globally is pretty good -- or do they have a way to go?

Sirkin: Well, some companies do it well. They've got a lot of experience and their expertise is extremely good. They avoid a lot of the problems and they are making the right decisions. Other companies, normally the ones that are starting, are going in sometimes way too fast without the right level of expertise and they are making a lot of mistakes. It's fine to make mistakes as you learn, but it's better to make them on small things than big things.

Some companies spend billions of dollars building plants and then recognize that they've made mistakes. The biggest mistake that they often make is to duplicate a plant that they have either in Europe or in the U.S. And because in low-cost countries the value is in the low wages, you don't necessarily want to put in a lot of automation. If you've put in a lot of automation, of course, you haven't taken advantage of the fact that the wages are lower.

Knowledge@Wharton: Can you think of any specific examples of things companies should be doing differently, if they haven't quite yet done everything perfectly, so to speak?

Sirkin: Three things come to mind. One is to rethink what you do. Again, if you move to an environment with a much lower labor cost, you need to think about things differently. Fundamentality, there is what we call the capital/labor trade-off. If you're in an environment of $25- or $50-an-hour wages fully loaded, you think about the trade-off between capital and labor very differently than if you're in an environment like China where wages are $1 to $2 an hour.

At that point in time, you may say, "I want to produce things. I don't want to spend as much money on capital assets because wages are so low." I want to think about how to set up my factory, but I also want to think about the design of my product. If I want to avoid high-cost labor, I'll design a simpler product with fewer screws and other small parts, something that can be made with an automated production process. But if wages are only about 4% of what I would pay in the West, the capital/labor trade-off is different. I may design a product with a much more manual production process with things like screws rather than more fancy welding because it's fundamentality cheaper.

Many automotive factories fall into this trap. U.S. and European companies copied their plants and then sent them to China. In doing so, they actually ended up with a higher cost position, because they put in lots of automation and they were sub-scale. To succeed at low-cost sourcing, companies first need to rethink what they do.

Second, they need to rethink the whole opportunity and that doesn't mean just sourcing. If you're going to produce in China and India -- where there is a combined population of about 2.5 billion people -- you may want to think about using your production facilities as a platform to start selling in those markets or expanding sales in those markets. Or [you may want to] use your plants for more than just that single part or that single product or that single division of your company. Use them as a lever to do even more sourcing there for the right products.

Third -- and this is the most controversial [and] people worry about it tremendously -- you have to find ways to protect your intellectual property. You need to be explicit about the trade-off between the cost savings and the risk of losing your intellectual property and make some real decisions. We've seen companies lose intellectual products because they sent them to countries with lower protection.

But we've also seen companies make some very smart decisions. I'm thinking about a French company that makes a tri-metal alloy for which the end part of the production process is the important part of the intellectual property. They made a decision not to bring that technology to a low-cost country, but to keep it in France even though it costs them more. They put all of the complex assembly in China, but ship the tri-metal from France to protect their intellectual property.

Knowledge@Wharton: Can you take a minute or two to talk about your forthcoming book called *Globality*?What does it entail?

Sirkin: *Globality* is a book that we believe takes a very different perspective on how all of the competition between companies will go forward in the future. Its subtitle says a lot about what it is, which is "Competing with Everyone from Everywhere for Everything." And by that we mean that your competition will change and you will be competing with *everyone* -- not just your traditional competitors -- [including] new companies from countries like China, India, Brazil, Russia, Eastern Europe, Southeast Asia and just about everywhere.

The second point is that competition will come "from everywhere." Your competitors will no longer look a lot like you. It may be a small company in Indonesia. It may be a large company in China. It may be a big-sized company in India. But, competition will be coming from everywhere and competing for everything. By "everything," we mean for resources, for people, for customers, for distribution systems and for supply chains.

We're expecting a wealth of competition to spring up because companies from low-cost countries are moving from being outsourcing vehicles for the traditional Western multi-nationals, to becoming companies in their own right that are growing and growing rapidly. So you see companies like Tata Steel and Mahindra that are starting to take roles on the global stage, with their own brands and their own products. They should not be ignored.

Globality looks at not just the Western companies, the traditional multi-nationals, but the new emerging companies that are starting to become large and that are challenging those multi-nationals, and what the lessons are both for emerging companies and, more importantly, for the multi-nationals.

Knowledge@Wharton: The book has been written by folks at BCG?

Sirkin: Yes, myself, a colleague from China, and a colleague from India.

Knowledge@Wharton: Before we wrap up the interview today, is there anything that you would like to add that we have not talked about, any important points that you think our listeners should take away from our conversation, and that we haven't gotten to yet?

Sirkin: Yes, the most important point is to seriously consider your procurement on a global basis. Some companies have jumped in too quickly and too fast and haven't thought it through, whereas others are sitting back and saying, "This is a lot of work, and I don't really want to do it." For that last group, I would caution them and say, "If you can get a 20% cost savings in a business that might have a 10% or 15% margin, that creates a massive competitive advantage."

You can forego that competitive advantage, but if you do, one of your competitors will eventually figure it out, and you'll be at a competitive disadvantage. There's a value to going early, and there's a value to making sure that you go slowly enough that you get it right, but quickly enough that your competitors don't get ahead.

