# Strategic Sourcing in the Mid-Market Benchmark

*The Echo Boom in Supply Management*

December 2005

# Executive Summary

## Key Business Value Findings

Continued pressures to reduce costs and improve spending visibility and control are fueling a strategic sourcing revolution among mid-size enterprises. Aberdeen-*Group*'s latest benchmark of more than 130 procurement and supply chain executives found that more than half of mid-size companies have either launched initiatives to formalize and improve strategic sourcing capabilities within the past 12 months or will embark on such programs within the next year.

## Implications & Analysis

It's easy to understand the motivation for strategic sourcing improvements.

Aberdeen's benchmark study found that the typical mid-size enterprise applies disciplined sourcing methods to only a third of total spending. Most rely on ineffective, fragmented, and largely manual procedures to analyze spending, negotiate, collaborate, and manage suppliers. Such inadequacies limit the ability of mid-size enterprises to leverage already diminutive spending volumes, assess supply market opportunities and costs, and drive continuous improvements in supply costs and performance.

> Inadequate sourcing competencies are costing mid-size firms more than $134 billion in missed supply savings opportunities annually.

These factors lead Aberdeen to estimate that inadequate sourcing competencies are costing mid-size firms in the U.S. more than $134 billion in missed supply savings opportunities annually. With global economic instability and inflation on the horizon, improving sourcing competencies will be a necessity for mid-size enterprises.

## Recommendations for Action

Mid-size enterprises yielding the greatest spend coverage and returns from their strategic sourcing initiatives enforce standard and written sourcing procedures company-wide and utilize commercial sourcing automation and analytics software. Such practices accelerate sourcing cycles, improve supplier collaboration and market transparency, improve spend visibility and compliance, and derive optimal sourcing award allocation decisions. They also yield competitive advantages in supply costs, performance, and profits (Figure 1).

**Figure 1: Strategic Sourcing Performance Gap among Mid-Size Enterprises**
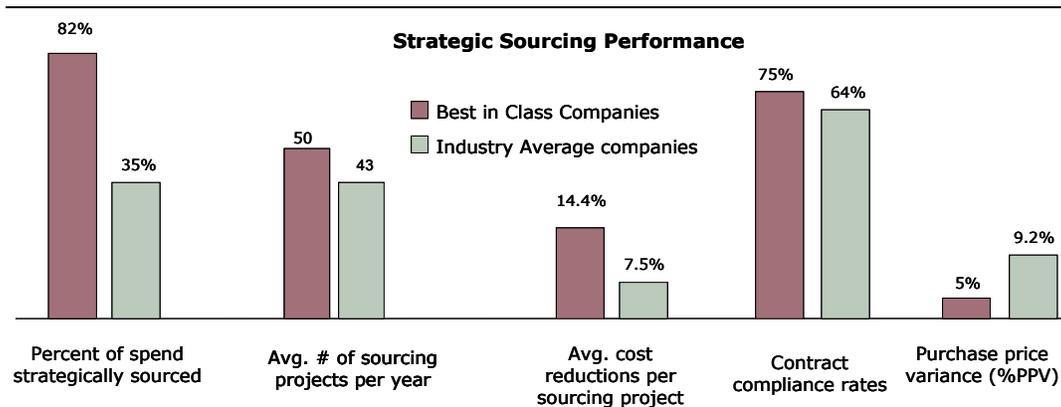


Source: Aberdeen*Group*, December 2005

Recognizing mid-size enterprises' resource and budget constraints, Aberdeen recommends that they employ the following practices to formalize and improve strategic sourcing operations and performance:

- Develop and enforce standard sourcing procedures company-wide;

- Hire sourcing and commodity expertise, including consultants;

- Improve access, quality, and analysis of corporate spending;

- Enlist executive support for resources and policy changes; and

- Leverage sourcing management automation to reinforce process standards, improve productivity, and increase negotiation and knowledge sharing capabilities

Mid-size enterprises employing these strategic sourcing techniques report more than four times greater procurement cost savings, better supply performance, and greater profitability than industry peers.

This report benchmarks the current strategic sourcing processes, competencies, and systems infrastructures of mid-size enterprises. The report identifies the practices and attributes of top-performing sourcing programs and provides a framework for estimating the operational and financial impact of adopting such practices.

# Table of Contents

# Figures

# Tables

# Chapter One:
## Issue at Hand

Most mid-size enterprises missed out on (and bore the brunt of) the first wave of supply management automation and improvements, being forced to compete as suppliers in price-based reverse auctions and drive year-over-year cost reductions in the face of rising energy and commodity prices. With continued pressure to reduce costs and compete in global markets, many mid-size companies view strategic sourcing improvements not just as a priority, but as a necessity for survival.

Evidence: Aberdeen's benchmark of procurement and supply chain executives from 133 mid-size companies (with annual revenues between $50 million and $999 million) revealed that more than half have either launched initiatives to formalize and improve strategic sourcing capabilities within the past 12 months or will embark on such programs within the next year. Factors driving the surge in strategic sourcing among mid-size firms include:

- *Cost pressures.* Mid-size enterprises report sustained pressure from competitors, customers, and executives to reduce costs. In certain industries, such as automotive and high-tech, some customers are requiring mid-size firms to adopt and document sourcing and supply management procedures and competencies.

- *New regulatory requirements.* New regulatory (e.g., Sarbanes Oxley) and executive requirements demand that mid-size companies improve visibility and control of corporate spending and supply chains.

- *Rising energy and commodities prices.* Increases in oil prices alone have added $400 billion to the cost of doing business over the past year. Energy price increases are beginning to drive inflation for other commodities.

- *Globalization.* Pressures to source from emerging markets such as China and Eastern Europe demand improved sourcing and supply management skills.

- *Supply market instability.* Rising energy and commodity prices, competing demand from emerging markets, changing tariffs, and supplier bankruptcies require mid-size firms to vigilantly source and ensure supply continuity (Figure 2).

**Figure 2: Mid-Size Firms Prioritize Sourcing in Response to Cost Pressures**

**Longevity of formal sourcing program**

**Factors driving sourcing improvement plans**
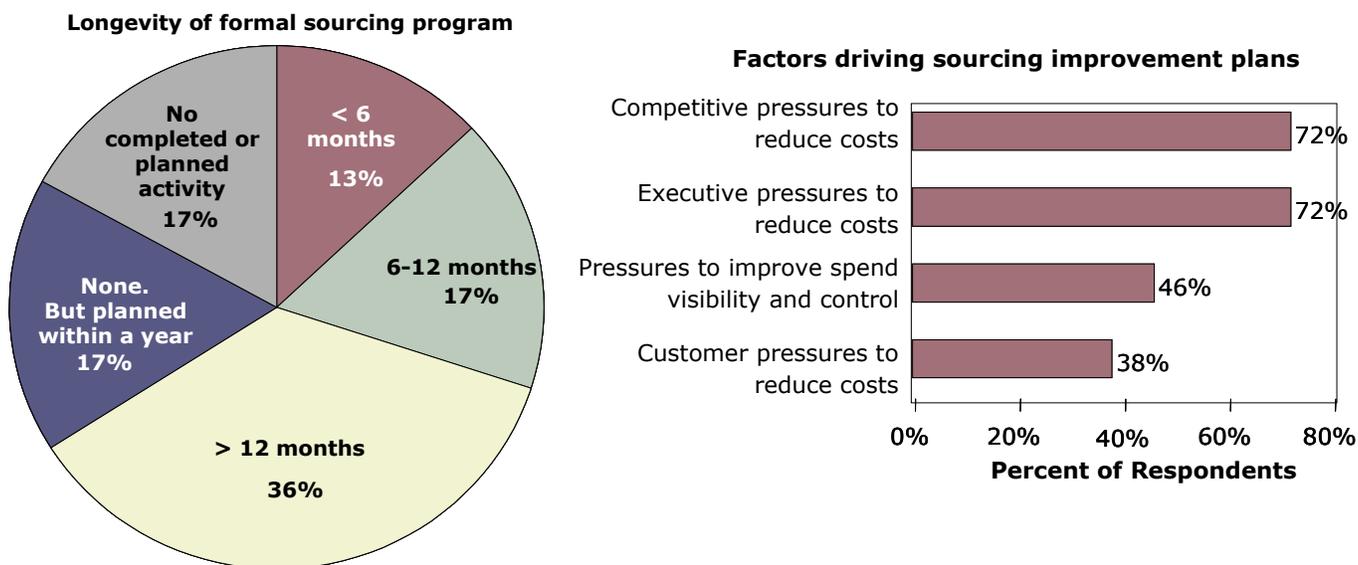


Source: Aberdeen*Group*, December 2005

## Strategic Sourcing: A Necessity for Survival

Strategic sourcing offers the largest and most direct opportunity to address these challenges. Aberdeen defines strategic sourcing as the process of identifying, evaluating, negotiating, and configuring the optimal mix of products, suppliers, and services to support supply chain and other business objectives at the lowest total cost.[1]

While there are a myriad of strategic sourcing approaches, the primary goals are similar:

- *Select the combination of products, services, and suppliers that offers the lowest total cost solution.* Total cost is the sum of multiple price and non-price factors, such as quality, delivery, and warranty terms. Modeling and understanding the total cost of a supplier bid, product, or program is fundamental to effective sourcing. Such insights can determine the true cost of a bid. They also help identify opportunities for further negotiation and for elimination of non-value-added processes.

- *Ensure sourcing decisions support supply chain and business objectives.* Sourcing decisions made without regard to how they will impact other areas of the enterprise or supply chain are at risk of not achieving intended results, or failing altogether. Sourcing strategies must be aligned with supply chain and business initiatives to ensure sufficient supply to support requirements and optimize cost and performance.

- *Enhance and institutionalize knowledge and proven sourcing methodologies across the enterprise.* To be successful, a strategic sourcing program must incorporate standard procedures and metrics. It must also provide an environment that fosters continuous improvement. Such an environment requires supply management profession-

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[1] *Strategic e-Sourcing: A Framework for Competitive Advantage* (Aberdeen Group, 2001)

als to have timely access to spending, commodity, and market information and to utilize (and continually enhance) standard sourcing methodologies.

When managed effectively, strategic sourcing can dramatically improve cost structures, operational performance, and product quality. It can also shrink time-to-market cycles and improve an enterprise's ability to exploit market changes and respond more efficiently to global customer demand.

## Pressures, Actions, Capabilities, Enablers (PACE)

Unfortunately, Aberdeen's benchmark indicated that traditional, fragmented, and uninformed sourcing practices that most mid-size firms use will not deliver the supply cost and performance improvements required to remain competitive and profitable. This point is best summarized by a procurement director at a mid-size manufacturer:

> *"The 'three bids and a cloud of dust' mentality of old*
> *will not sustain us in today's global market. We must be*
> *more disciplined and knowledgeable in our sourcing*
> *methods if we are to achieve savings and to improve, or*
> *even sustain, the current cost line."*

The above findings indicate continued pressures to reduce costs and more requirements to improve spending visibility and control are the leading pressures fueling strategic sourcing improvements among mid-size enterprises. Table 1 illustrates the *actions*, internal *capabilities*, and technology *enablers* mid-size enterprises have prioritized to address these pressures and accelerate improvements in strategic sourcing competencies and performance.

These prioritized actions, capabilities, and enablers are examined in more detail in the next chapter. In addition, Chapter Four compares the strategic sourcing approaches and resulting performance of average and best-in-class performers among mid-size enterprises.

**Table 1: PACE (Pressures, Actions, Capabilities, Enablers) for Strategic Sourcing**

| | Actions | Capabilities | Enablers |
|---|---|---|---|
| **Upper Mid-Market: $500M - $999M in revenue** | Standardize sourcing methods | Hire sourcing process | Adopt technologies to improve supplier management |
| | Establish formal sourcing group | Hire proven expert to head sourcing and procurement group | Adopt technologies to improve contract management |
| **Middle Mid-Market: $250M - $499M in revenue** | Adopt sourcing and negotiation technologies | Hire spend category and supply market experts | Adopt full online sourcing platform |
| **Lower Mid-Market: $50M - $249M in revenue** | Use consultants to establish sourcing program and competence | Secure executive support for sourcing and compliance initiatives | Adopt sourcing consulting services |

Source: Aberdeen*Group*, December 2005

# *Chapter Two:*
# **Key Business Value Findings**

**Key Takeaways**

- Most mid-size firms lack the process and commodity expertise and supporting organizational and technology infrastructure to transform sourcing operations.
- Sourcing deficiencies put mid-size firms at a cost and competitive disadvantage.
- Improvement strategies include making sourcing a corporate initiative, hiring procurement leaders and talent, adopting sourcing automation, and using consultants.

Most mid-size enterprises continue to rely on inadequate, fragmented, and largely manual procedures to analyze spending, and negotiate, collaborate, and manage suppliers. Aberdeen's benchmark identified the following hindrances to sourcing effectiveness at most mid-size firms:

- *Lack of formal sourcing procedures*: More than a third of mid-size enterprises lack formal and written strategic sourcing processes that are used consistently across the company. Another third only use disciplined and formal sourcing methods for their most critical or strategic spend categories (Figure 3).

- *Lack of sourcing and commodity skills*: Mid-size enterprises rated the lack of strategic sourcing process expertise among the top challenges to sourcing transformation at their companies. Respondents reported that their companies lack general strategic sourcing principles as well as domain expertise for key spend categories and supply markets.

- *Insufficient systems infrastructures*: More than 80% of mid-market enterprises use a hodgepodge of homegrown sourcing automation "solutions" and offline communications to facilitate negotiations and manage sourcing projects. Most supplier negotiations occur either face-to-face or via e-mail or phone. The homegrown solutions primarily consist of word-processing or spreadsheet-based RFx templates and analytics. Such inadequate and dissociated "systems" limit the feasible number of suppliers evaluated, diminish productivity, elongate sourcing cycles, and stifle knowledge transfer.

Adding to these challenges, mid-size enterprises often lack the spending clout to aggressively negotiate the best pricing and terms with suppliers, making it even more imperative that mid-size firms capitalize on every dollar and advantage. Such inadequate sourcing competencies limit the ability of mid-size enterprises to leverage already diminutive spending volumes, assess supply market opportunities and costs, and drive continuous improvements in supply costs and performance.

**Figure 3: Mid-Size Firms Prioritize Sourcing in Response to Cost Pressures**

**Sourcing efforts fragmented and limited at most mid-sized firms**
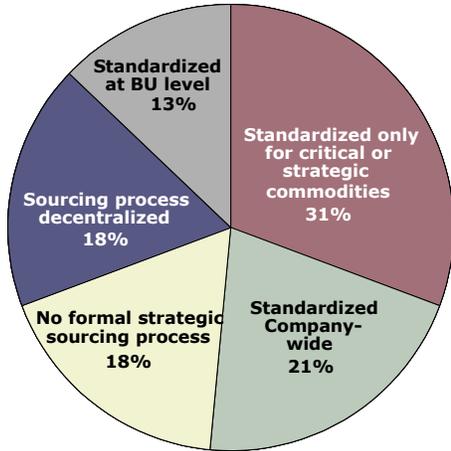
**...and most lack the skills and support to get started**
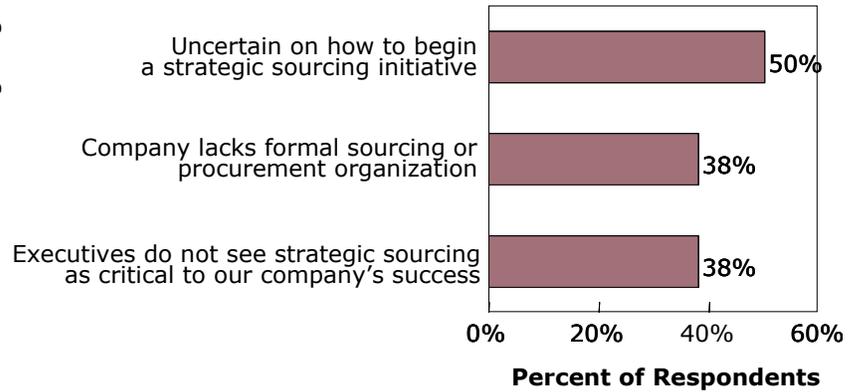
Source: Aberdeen*Group*, December 2005

Evidence of the negative impact sourcing deficiencies are having on mid-size enterprises: The typical mid-size company only applies disciplined sourcing methods to 35% of total spending. (Not surprisingly, as Figure 4 indicates, manufacturers demonstrated greater strategic sourcing competency and coverage; but lacked a disciplined sourcing approach beyond their most critical production spending. Service companies lag manufacturers in sourcing competency; but are more aggressive in their plans for improvement.)

These factors lead Aberdeen to estimate that *inadequate sourcing competencies are costing U.S.-based mid-size firms more than $134 billion in missed supply savings opportunities annually.*

**Figure 4: Categories Strategically Sourced by Major Industry Sector**
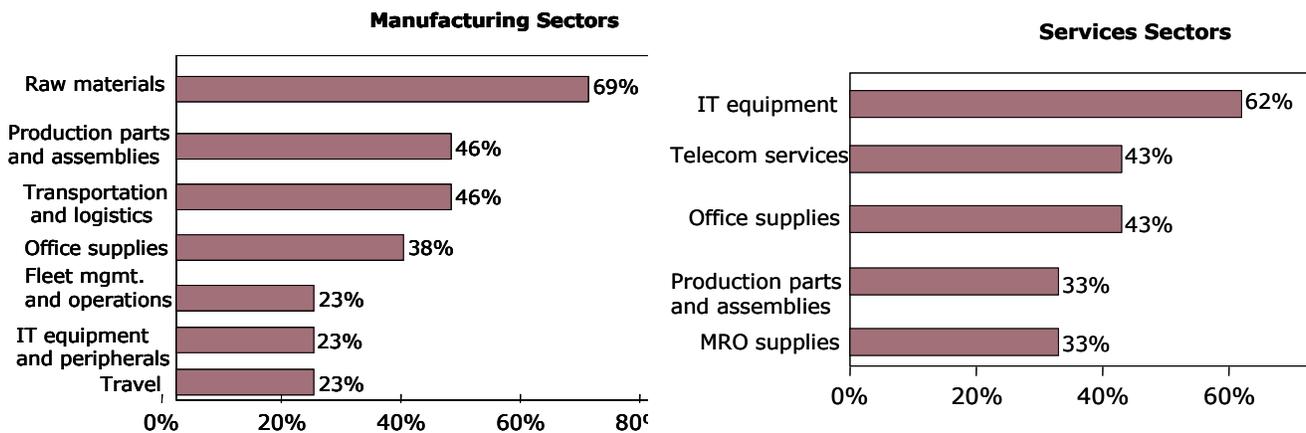
Source: Aberdeen*Group*, December 2005

## Planned Responses to Strategic Sourcing Challenges

While the motivation for strategic sourcing improvements is clear, the roadway to success will be long and arduous. In fact, more than half of mid-size firms are "uncertain how to begin a strategic sourcing initiative," and nearly 40% of benchmark participants lack any formal sourcing or procurement organizations.

Challenges to improvements include internal resistance to standardizing and centralizing sourcing procedures, poor visibility into spending data, and a general lack of strategic sourcing and category management competence within the enterprise. Many mid-size firms also report difficulties in securing sufficient budget and resources to acquire and deploy sourcing automation (Table 2).

Mid-size firms have prioritized the following strategies to overcome these challenges:

- *Secure executive support for strategic sourcing and automation investments*.

- *Recruit a proven procurement executive to lead the development of a strategic sourcing organization and program*.

- *Upskill the procurement team by hiring sourcing, process, and category experts*. Mid-size firms are also looking for technical skills and experience with sourcing and procurement automation. These findings echo a previous Aberdeen study, which found that procurement executives planned to add commodity experts and technology managers to their teams. Manufacturers plan to hire engineers as commodity experts to control costs and specifications in product development.

- *Adopt sourcing automation to improve negotiation leverage, sourcing process standardization, buyer skills and productivity, and spend visibility and control*.

- *Use consultants to develop and accelerate sourcing competence and programs*.

**Table 2: Strategic Sourcing Challenges and Responses for Mid-Size Enterprises**

| Challenges | % Selected | Responses to Challenges | % Selected |
|---|---|---|---|
| 1. Reluctance of business units or sites to adopt standard sourcing procedures | 41% | 1. Secure executive support for strategic sourcing initiative | 68% |
| 2. Insufficient visibility into timely and accurate spending data | 38% | 2. Hire experienced procurement executive to develop and lead strategic sourcing organization | 50% |
| 3. Lack of internal strategic sourcing process and category expertise | 36% | 3. Hire sourcing, process, category, or technical experts | 39% |
| 4. Insufficient spending volumes to negotiate favorable pricing terms | 33% | 4. Adopt commercial sourcing automation tools | 34% |
| 5. Reluctance of business units or sites to comply with negotiated agreements | 31% | 5. Use consultants to develop strategic sourcing processes and programs | 29% |
| 6. Limited resources to implement, support an e-sourcing deployment | 31% | | |

Source: Aberdeen*Group*, December 2005

## Sourcing Automation Usage and Investment Plans

Looking to leapfrog and avoid the mistakes of early adopters, mid-size enterprises have prioritized investments in sourcing and supply management automation solutions that are broader, better integrated, and more strategic than those employed by early adopters. Mid-size firms have the added benefit of new, flexible shared delivery and usage-based pricing models that can help accelerate deployment, reduce total cost of ownership (TCO), and circumvent internal budgeting and resource requirements.

Example: Telecommunications power equipment manufacturer Eltek recently launched an initiative to improve its strategic sourcing competencies and performance ─ including the adoption of sourcing automation tools ─ in response to being forced by some of its customers to participate in reverse auctions as a supplier. With annual revenue of $1.6 billion Norway Kroner (about $241 million), Eltek could not justify a large capital investment in sourcing automation software. Instead, the firm opted for an online negotiation platform that offered a shared delivery model and flexible pricing. In a few sourcing events, the investment paid for itself and is helping offset Eltek's margin pressures.

As a group, mid-size firms had prioritized supplier performance measurement, contract management, and broad e-sourcing platforms for investment within the next 12 to 24 months (Table 3). Upper-mid-size enterprises (annual revenues between $500 million and $900 million) prioritized e-sourcing and spending analysis solutions for investment. Companies in this segment have had greater experience and maturing results from initial investments in online negotiations and related procurement technologies. These firms are now looking to adopt more advanced sourcing capabilities that can help identify new savings opportunities, enable collaborative, total-cost based negotiations, and support sourcing process standardization, project management, and knowledge transfer.

Consider Simmons Foods. The Arkansas-based poultry producer with $600 million in annual revenue launched an effort to standardize on a single ERP system and automate procurement execution activities companywide. Part of a lean operating initiative, this implementation effort improved visibility into corporate spending data and uncovered opportunities for sourcing improvements. Simmons' procurement team is now beginning to cleanse and mine spending data to track and control purchase price variance (PPV) and uncover new opportunities to leverage spending and renegotiate with suppliers.

**Table 3: Sourcing Technology Investments in Next 12-24 Months**

| Technology Solution Area | % Selected |
|---|---|
| Supplier performance measurement | 58% |
| Contract management | 57% |
| Full e-sourcing platform | 41% |
| Optimization-based sourcing analytics | 41% |
| e-RFx | 38% |
| Strategic sourcing consulting services | 31% |

Source: Aberdeen*Group*, December 2005

Mid-size enterprises' planned approaches for sourcing automation adoption vary greatly from those used by early adopters, most of which were larger enterprises. Key sourcing automation adoption plans for mid-size enterprises include:

- *Greater interest in broader sourcing project management and collaborative and optimization-based negotiation capabilities*, rather than the priced-based reverse auctions that fueled the first wave of online sourcing. Part of this motivation can be attributed to the fact that many mid-size firms lack the buying clout to mandate and capitalize on reverse auctions, particularly in tightening supply markets.

- *Broader adoption of a new shared application delivery model* that provides sourcing functionality to multiple clients from a single and centrally hosted application instance. Mid-size firms will mostly use this model for online negotiation capabilities (Figure 5). Aberdeen's March 2005 report, *On Demand Supply Management Benchmark* found that more than 50% of mid-market firms will deploy sourcing and procurement solutions in this shared mode (a.k.a., On Demand or Software as a Service (SaaS)) within the next 24 months. The study also found that sourcing automation deployed in a shared mode can be implemented within weeks, deliver full payback within six months, and offer solution and maintenance costs half those of installed software.

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### Sourcing Automation Overview

Sourcing automation, or "e-sourcing," is the use of Web-based applications, decision support tools, and associated services to streamline and enhance strategic sourcing processes and knowledge management. Distinguishing components of sourcing solutions include:

- *Online negotiations,* enabled by electronic request for information/proposals/quotes (e-RFx) and reverse auctions. Advanced functionality includes BOM-driven negotiations, multi-line-item negotiations, bundling/unbundling of bids, complex price negotiations, flexible bidding, and internationalization support.

- *Collaboration tools* support cross-functional sourcing and interaction with suppliers.

- *Project management* capabilities establish and monitor sourcing projects.

- *Document management* capabilities support the exchange, modification, and recovery of sourcing-related documents and schematics.

- *Knowledge management* capabilities provide a central repository for supplier, material, component, part, and market intelligence and support management and reuse of sourcing strategies, RFx templates, and processes.

- *Analytical tools* support spending, bid, and cost modeling and analyses. Advanced capabilities include optimization-based analytics.

Providers are further differentiated by their ability to provide commodity, supplier, and market intelligence and to deliver sourcing expertise and services. Many sourcing solution providers have extended platform capabilities to include spend data cleansing and classification, contract management, and performance measurement capabilities.

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- *Prioritization for sourcing application to effectively integrate with execution, and compliance solutions.* Having learned from the compliance challenges of early adopters, mid-size firms list the ability to integrate with or deliver contract management and procurement execution (as well as ERP systems) as critical criteria they will use to select their sourcing solution providers.

- *Increased reliance on third-party consultants* to help define strategic sourcing processes and train internal employees on commodity costing models, sourcing automation tactics, and category and supply market assessments.

**Figure 5: Sourcing Automation Adoption Methods and Plans**



**Current Deployment Methods**

**Future Deployment Methods (Planned)**

Legend:
- ■ e-RFx
- ■ Reverse auctions
- □ Full e-sourcing platform

**"Critical" Criteria for Sourcing Solution Selection**

| Capability | Percent |
|---|---|
| Integrated sourcing and spending analysis | 74% |
| Integrated sourcing and procurement execution | 63% |
| Integrated sourcing and performance measurement | 61% |
| Integrated sourcing and contract management | 56% |
| Integration to back office and ERP systems | 55% |

**Type of Solution Provider (Planned for use)**

Source: Aberdeen*Group*, December 2005

## Sourcing Automation Accelerates and Improves Results

While more flexible delivery and usage-based pricing models are making sourcing auto-mation more accessible to mid-size enterprises, a more straightforward reason for the uptick in solution adoption is that sourcing automation delivers rapid, measurable bene-fits in the form of material cost savings, process efficiencies, and performance enhance-ments when incorporated into a well-designed sourcing program. Aberdeen has examined more than 200 sourcing automation deployments. Table 4 summarizes the average bene-fits these companies have achieved from using e-sourcing technologies.

Many enterprises have achieved full ROI from their solution investments after a single sourcing event. Such returns can make sourcing automation self-funding investments. New low-cost, shared-tenant (On Demand), flexible pricing, and rapid deployment deliv-ery models have made sourcing automation more accessible to mid-size enterprises.

**Table 4: Sourcing Automation Benefits**

| Sourcing Challenge | Average Improvement or Savings through E-sourcing |
|---|---|
| High material costs | 14.3% cost savings |
| Sourcing cycles average 3.3 to 4.2 months | Cut sourcing cycles in half |
| High sourcing transaction and administration costs | Reduce sourcing administration costs 60% |
| Long time-to-market cycles for new products | Shrink time-to-market cycles 10% to 15% |
| Inconsistent sourcing procedures and skills | * Helps identify and standardize on sourcing best practices.<br>* Enhanced knowledge capture and transfer |
| Inability to effectively exploit market changes | Enhanced market knowledge and improved market transparency |
| Unable to effectively exploit low-cost country supply sources | Dramatically improve ability to identify and negotiate with new sources of supply on a global basis |
| Transactional and combative supply relationships | * Detailed e-RFx and enhanced collaboration clarifies expecta-tions and improves supply relations.<br>* Productivity improvements free up buyers to develop supply base. |
| Inadequate spend under management | Process efficiencies empower application of strategic sourcing to spend more. |

Source: Aberdeen*Group*, December 2005

# *Chapter Three:*
# **Implications & Analysis**

**Key Takeaways**

- Best-in-class strategic sourcing performers among mid-size firms have employed the following strategies:
    - Development and enforcement of standard sourcing procedures company-wide.
    - Hiring of sourcing and commodity expertise, including consultants.
    - Improved access, quality and analysis of corporate spending.
    - Enlistment of executive support for resources and policy changes.
- These competencies have enabled best-in-class firms to outperform peers in every key area of sourcing performance and effectiveness.
- Strategic sourcing competence can deliver four times the improvements in supply costs, enhance performance, and improve profits and market value.

As shown in Table 3, benchmark participants fell into one of three categories — Laggard, Industry Norm, or Best in Class — based on their characteristics in four key categories: (1) process (efficiency, effectiveness, and scope of sourcing process standardization); (2) organization (sourcing organizational and decision-making structure); (3) knowledge (visibility into spending, compliance, and supply market data); and (4) technology (level of sourcing automation and integration across the enterprise).

In each of these categories, benchmark results show that the mid-size firms exhibiting best-in-class strategic sourcing characteristics are also enjoying best-in-class supply and financial performance (Table 5).

## Best-in-Class Strategies

Aberdeen uncovered the following common characteristics among the mid-size enterprises that demonstrated the greatest return from their strategic sourcing initiatives:

- Development and enforcement of standard sourcing procedures;
- Hiring of sourcing and commodity expertise, including consultants;
- Improved access, quality, and analysis of corporate spending;
- Enlistment of executive support for resources and policy changes; and
- Leveraging of sourcing management and automation.

**Competitive Framework Key**

The Aberdeen Competitive Framework defines enterprises as falling into one of the following three levels of practices and performance:

*Laggards (30%)* —practices that are significantly behind the average of the industry

*Industry norm (50%)* — practices that represent the average or norm

*Best in class (20%)* — practices that are the best currently being employed and significantly superior to the industry norm

**Table 5: Strategic Sourcing Competitive Framework for Mid-Size Enterprises**

|  | Laggards | Industry Norm | Best in Class |
|---|---|---|---|
| **Process** | Sourcing approaches and decisions vary by business unit and site. | Sourcing standards used only for most critical or strategic spend categories | Standard sourcing procedures used and enforced company wide. |
| **Organization** | No formal sourcing organization. | Sourcing teams organized at the business unit or regional level. Some coordination across units and regions. | Formal group for managing and aligning sourcing processes and decisions across the enterprise |
| **Knowledge** | • Limited visibility into corporate spending and contract compliance<br><br>• Little sourcing or commodity expertise | • Ad hoc and high-level reporting on spending and contract compliance<br><br>• Some sourcing process standards; expertise on critical commodities | • Standard and repeatable reporting on spending and contract compliance<br><br>• Standardized sourcing procedures; expertise across multiple commodities |
| **Technology** | • Use mix of manual processes augmented with home-grown sourcing "tools" (e.g., Word-processing based RFx templates, spreadsheet-based pivot tables, etc.)<br><br>• No integration with other systems | • Use fragmented mix of home-grown sourcing "tools" and some commercially available negotiation solutions<br><br>• Limited integration into other systems | • Use commercially available e-sourcing platform to automate all aspects of sourcing projects from negotiation, knowledge management, analysis<br><br>• Integration into other business systems, such as contracts, spend analysis, and procurement execution |
| **Performance** | • Spend and compliance analyzed on ad hoc basis<br><br>• Strategic sourcing principles applied to less than 25% of total spend | • Spend and compliance analyzed on annual basis.<br><br>• Strategic sourcing principles applied to 35% of total spend | • Spend and compliance analyzed on quarterly or more frequent basis.<br><br>• Strategic sourcing principles applied to 82% of total spend |

Source: Aberdeen*Group*, December 2005

### *Development and enforcement of standard sourcing procedures*

Not surprisingly, mid-size enterprises recording the greatest strategic sourcing effectiveness and returns have been at it the longest. Nearly 90% of top-performers have had formal and written sourcing policies and procedures for more than a year. By comparison, less than half of remaining benchmark participants reported such tenured programs.

Eighty-percent of best-in-class performers use a formal sourcing and supply management organization or shared services organization for all company-wide sourcing efforts. Only half of the remaining mid-size firms have similar organizational models, aligning sourcing organizations at the business-unit level or lacking any formal sourcing group.

Similarly, 93% of best-in-class performers have standardized sourcing processes company-wide, including 40% of this group that use disciplined sourcing procedures for all categories of spending. The remaining best-in-class firms have standard procedures at least for their companies' most critical and strategic spending categories.

Standard procedures ensure consistent results, minimize regulatory and supply risks, foster knowledge transfer, and elevate the skill set of the entire procurement organization.

### *Hiring sourcing and commodity expertise, including consultants*

Best-in-class companies have aggressively hired sourcing and commodity experts, including procurement executives, to build the right procurement operating model, define best-practice processes, and recruit talent. Having ample staffing is critical, but sourcing excellence cannot be achieved by just adding new talent.

On the contrary, best-in-class companies are managing more spending and sourcing projects and returning greater results with fewer resources and average and below-average performers. These firms are focused on results, both in terms of cost savings and supply quality and continuity.

Case in point: Best-in-class firms augment recruitment efforts with consultants and sourcing services. More than half of the top-performers have used, currently use, or plan to use outside consultants to help define and improve their sourcing processes and performance. Best-in-class companies are using consultants to improve sourcing processes and organizational structures, increase the portion of spending that is strategically sourced, and attack categories of spending where internal expertise is deficient.

For example, feeling competitive pressures to reduce costs, one mid-size publishing company knew there were savings opportunities in its purchased print, marketing, and promotional items, which was one of its largest areas of spending. However, the $300 million company lacked internal expertise to develop an RFP, determine and assess cost models, and identify and assess suppliers. The publisher tapped a procurement consultancy and outsourcer for assistance, then worked with the consultant to assess requirements, develop detailed specifications, and identify the optimal lotting structure and sourcing strategy. Qualified suppliers were invited to participate in an online reverse auction, resulting in more than 20% cost savings. The publisher plans to eventually develop this category and online sourcing talent internally.

### *Improving access, quality, and analysis of corporate spending*

With their initial sourcing improvement and automation initiatives maturing and with supply markets tightening, best-in-class mid-size enterprises are looking to improve their ability to aggregate, cleanse, classify, and analyze spending data. Related Aberdeen benchmarks revealed that access to timely, accurate, complete, and detailed spend data offers invaluable intelligence on spending patterns, compliance and performance ratings, inventory status, and part attributes. Such insight is critical for identifying hard-dollar savings opportunities and developing sourcing, budgeting, planning, and product strategies.

However, our research also revealed that spend data is typically stored in multiple, disparate systems within and outside the enterprise. We also found that spend data is rife with errors and often incomplete or lacking key attributes ─ such as detailed part descriptions or service descriptions ─ that are required for accurate classification and detailed analysis. Correcting these anomalies across thousands of line items and purchases can be a time-consuming and daunting task for most companies, let alone resource-strapped mid-size enterprises. (See *Spending Analysis Benchmark*, December 2003)

Due to these factors, best-in-class performers have prioritized not only improving spend data accuracy and analysis, they will also utilize commercially available solutions and services to aggregate, classify, and cleanse spend data for analysis.

One example: In the cost-competitive aerospace industry, Vought Aircraft Industries Inc. was extremely successful at sourcing and controlling direct manufacturing costs. The $1 billion manufacturer wanted to apply the same rigor to indirect expenses like maintenance, repair, operations (MRO), but it lacked insight into this spend data, which was distributed among five different financial systems.

To gain centralized and meaningful visibility into its indirect expense commitments, Vought adopted a turnkey spend data cleansing and classification service to categorize and normalize its indirect spending from its varied financial systems. Within two months, Vought had a single view of its indirect purchase history. Its sourcing managers now use a Web-based analytical and reporting tool to analyze spend by multiple dimensions, track compliance, and identify opportunities for vendor aggregation and savings.

Today, the company is analyzing 100% of indirect spend (except complex and services categories like benefits) and refreshes spend data twice annually. Armed with detailed spend data, Vought has been able to renegotiate a number of supplier relationships, gaining price concessions by leveraging spend volumes and consolidating business with fewer suppliers. It has also cut-off non-preferred payment methods for specific suppliers and categories to deter maverick spending and reduce payment processing costs. (See *Best Practices in Spending Analysis,* September 2004)

### *Enlisting executive support for resources and policy changes*

Best-in-class performers cited garnering the support of top brass ─ particularly the CFO and SVP of supply chain ─ as the leading contributor to their success. Executive support is critical for securing the requisite budget and resources to augment staff and fund sourcing automation investments. Executive backing is also critical to drive mandates and policy changes to ensure business unit support and accountability for strategic sourcing and cost savings, as well as compliance goals and guidelines.

In fact, a recent Aberdeen benchmark of 100 CFOs (See *The CFO's View of Procurement*, September 2005) found that companies with the best-performing procurement operations shared the following attributes:

- The finance organization provides dedicated resources to procurement or participates as a core member of sourcing teams.

- The companies use formal, preferably multi-year, procurement plans to project, audit, and validate procurement savings.

- Financial systems are positioned to complement purchasing applications to improve visibility and compliance.

### *Leveraging of sourcing management automation*

All top performers utilize some form of sourcing management automation to accelerate and support their strategic sourcing improvement initiatives. More than 80% of this top-performing group has been using sourcing automation for more than a year. Best-in-class companies use souring automation to reinforce process standards, improve productivity, and increase negotiation and knowledge sharing capabilities. But what truly differentiates top-performers is their approach to sourcing automation:

- *Use of commercial sourcing solutions*: Nearly all best-in-class firms use commercially available sourcing automation solutions. By comparison, nearly half of industry norm and laggard companies using automation have attempted to internally develop e-RFx, sourcing, and related supply management systems, primarily using basic word-processing, spreadsheet, and database tools. Such home-grown solutions offer limited functionality (primarily data store and retrieval), lack scalability, security, and audit trail capabilities, and are often custom-built for specific sites or groups. In fact, half of mid-size companies report that their sourcing process is only "partially automated" and uses "disparate" systems that are neither integrated across the sourcing process or the company. In addition, standard database and reporting tools are limited in their ability to support the analysis of multiple-line items or complex pricing and sourcing scenarios.

- *Leveraging of dedicated hosting or shared hosting delivery models*: 67% of best-in-class companies have deployed sourcing automation in either a dedicated hosting environment or a shared, multi-tenant (On Demand) model. As noted above, previous Aberdeen benchmarks indicate that such models accelerate implementation cycles, improve TCO, and reduce burdens on internal IT resources. In addition, shared, multi-tenant models offer flexible, usage-based pricing models that are more affordable and pose a lower deployment risk for mid-size firms.

Enterprises employing these methods, structures, and technologies outperformed their peers in every major category of sourcing performance and effectiveness (Figure 6). In fact, best-in-class performers are able to apply strategic sourcing to more spending and derive greater cost and performance results with fewer resources than their peers.

**Figure 6: Sourcing Key Performance Indicators (Average versus Best-in-Class)**



Best in Class Companies

Industry Average companies
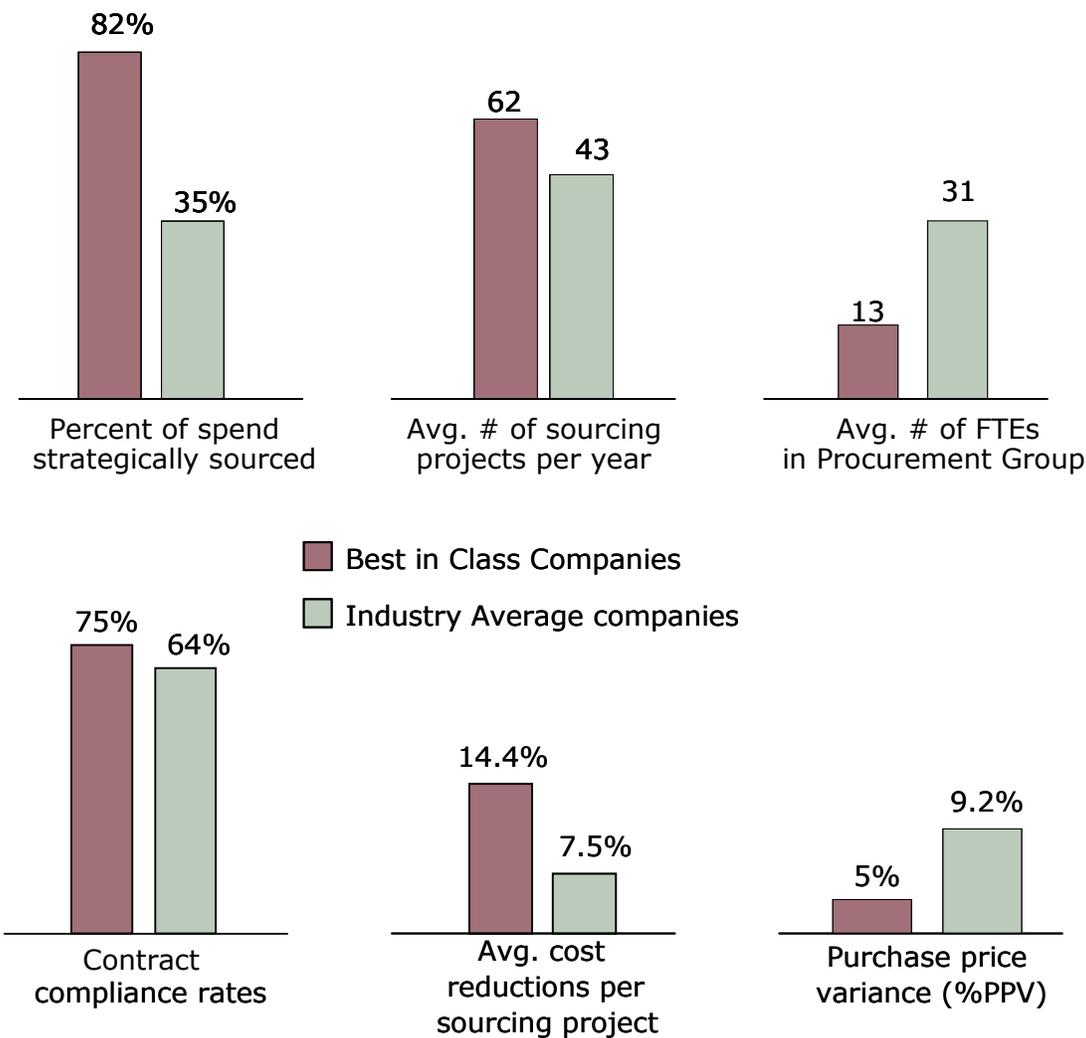
## Building the Case for Strategic Sourcing Improvements

As mid-size enterprises weigh the relative impact and costs of various methods to increase profitability, the value of cost reduction through improvements in strategic sourcing and procurement become self-evident. At most companies, half of revenues are spent on the procurement of external goods and services. And, unlike other functional areas, procurement savings translate into bottom-line savings.

Table 6 illustrates the financial impact strategic sourcing can have when applied to a company with $250 million in annual revenue, a 15% operating margin, and a typical expense profile. It also compares the performance differential of the same company operating at industry norm and best-in-class sourcing performance levels:

- *Industry norm* companies apply strategic sourcing to only 35% of total spending and negotiate only 7.5% cost reductions, on average.

- *Best-in-class* companies apply strategic sourcing to 82% of total spending and negotiate 14.4% cost reductions, on average.

In the example in Table 6, improvements in strategic sourcing alone return more than four times the procurement cost savings and a 6% improvement in earnings per share. This example is conservative, only examining the impact of improved strategic sourcing. It does *not* incorporate advantages best-in-class companies demonstrate in spending compliance.

**Table 6: Strategic Sourcing Impact on Costs, Income, and Market Value**

| | Industry Norm Performer | Best-in-Class Performer |
|---|---|---|
| Revenues | $ 250,000,000 | $ 250,000,000 |
| Starting Spend Position | $ 125,000,000 | $ 125,000,000 |
| Spend strategically sourced | $ 43,750,000 | $ 102,500,000 |
| Annual sourcing savings | $ 3,281,250 | $ 14,760,000 |
| Annual implemented savings | $ 2,460,938 | $ 11,070,000 |
| *Implemented Cost Savings Delta* | *$8,609,062.500* | |
| Operating Income | $ 127,460,938 | $ 136,070,000 |
| Interest and Other Income | $ 13,000,000 | $ 13,000,000 |
| Taxes (@ 38%) | $ (48,435,156) | $ (51,706,600) |
| Net Income | $ 92,025,781 | $ 97,363,400 |
| Net Shares Outstanding (M) | 15,000,000 | 15,000,000 |
| Earnings Per Share | $6.14 | $6.49 |
| P/E Ratio | 10 | 10 |
| Market Value per Share | $61.35 | $64.91 |
| *Improvement* | *6%* | |

Source: Aberdeen*Group*, December 2005

# Chapter Four:
# Recommendations for Action

These benchmark findings clearly indicate that continued cost pressures and tightening supply market dynamics are fueling an echo boom in strategic sourcing improvement initiatives among mid-size enterprises. Recommended improvement activities depend in large part on the maturity of a company's procurement operating model, strategic sourcing competence, and performance.

Whether a company is trying to gradually move its strategic sourcing capabilities and performance, as well as its sourcing and procurement organization, from "Laggard" to "Industry Average," or "Industry Average" to "Best in Class," the following actions will help spur necessary improvements:

## Laggard Steps to Success

1. *Hire outside consultants to learn sourcing principles and best practices*

   The quickest way to develop sourcing process competence is to learn from proven experts. While fees from large, global consultants may be too costly for many mid-size enterprises, there are numerous regional and boutique consultants that specialize in strategic sourcing and commodity management. Several leading sourcing automation solution providers also have deep sourcing and category expertise that is packaged and priced for mid-size firms.

2. *Trial online negotiation tools for quick wins and to gain consensus and funding*

   Mid-size firms just launching formal strategic sourcing organizations and initiatives should expect resistance from suppliers and internal stakeholders. One of the most effective methods to counter this is to prove the positive impact of strategic sourcing. One of the quickest ways to do this is to trial an online negotiation solution (preferably in a low-risk, shared hosted environment) to run competitive negotiation events for spend categories ─i.e., considerable spend that's easily specified and in a competitive supply market. Early savings can help win support and funding for future sourcing program and automation investments.

## Industry Norm Steps to Success

1. *Formalize sourcing methods*

Lessons from early sourcing projects and consulting engagements should be documented and incorporated into standard procedures that are clearly defined and enforced across the organization. Standard procedures ensure consistent results, minimize risks, foster knowledge transfer, and elevate the skill set of the procurement organization.

2.  *Fill skills gaps*

Be prepared for the fact that traditional buyers accustomed to processing purchase orders may lack the requisite skills to transition to strategic sourcing and supplier management activities. Training and education programs can help, but it's likely that mid-size firms will need to hire outside strategic sourcing and commodity expertise. When necessary, continue using consultants to learn new skills and garner commodity and costing expertise.

3.  *Adopt a broader online sourcing automation platform*

Move beyond basic online negotiation capabilities to a broader sourcing automation platform that supports project and knowledge management capabilities. Establish project, category sourcing, and negotiation templates that can be reused and modified to target additional categories. Such functionality will foster transfer of process and supplier knowledge across the enterprise.

## Best in Class Next Steps

1.  *Improve spend visibility*

Having picked much of the low-hanging-fruit sourcing opportunities, best-in-class performers must identify new areas to improve supply costs and performance. The next wave of savings opportunities likely lies in your spend data. Adopt technologies or services to make spend data cleansing, classification, and analysis a largely automated and repeatable process. Access to timely, accurate, and detailed spend data can uncover opportunities for supplier rationalization, spend leverage, and specification management.

2.  *Add financial, engineering, and commodity skills to the team*

Traits required for effective strategic sourcing and supply management go beyond good negotiating skills. As procurement becomes more involved with strategic business initiatives ─ such as product development, low-cost country sourcing, and capital equipment and real estate spend ─ mid-size enterprises will need to add new skills to the procurement team. Procurement executives at top firms are now recruiting new talent with graduate degrees in supply chain, logistics, procurement, and finance. Half of manufacturers are recruiting buyers with engineering degrees to advance product costing and specification control.

3.  *Adopt extended supply modules and advanced analytics*

Unless a company is diligent, the value of strategic sourcing can diminish over time due to a tactical focus on price reductions and insufficient procedures and systems to monitor contract and supplier performance. (In fact, Aberdeen benchmarks affirm that only 75% of sourcing savings ever get implemented, on average.) Best-in-class companies can protect against such savings leakage by adopt-

ing contract management and performance measurement solutions. Companies can achieve additional cost savings through the use of advanced optimization-based sourcing analytics that support evaluation of a multitude of complex sourcing scenarios within the overall constraints and objectives of the business.

4. *Improve low-cost-country sourcing competence*

   Globalization and cost pressures are forcing mid-size enterprises to source from and sell into emerging markets. Proof: A recent Aberdeen benchmark found that mid-size enterprises source 20% of total spending from low-cost country sources today. Low-cost sources are expected to account for 40% of spending at the typical mid-size company by 2008. (See *Low-Cost Country Sourcing Benchmark*, June 2005) The attraction to LCCS is simple: Low-cost sources offer costs 30% lower than those of suppliers in more established regions. However, LCCS introduces new challenges, including cultural and language differences, longer lead-times, complex tariffs and logistics issues, and the need to develop and manage supplier relationships from the other side of the world. Most mid-size firms will rely initially on external service providers and local agents to support supplier vetting, development, and management issues. However, as LCCS increases, mid-size firms will need to develop and nurture such competencies on their own.

# Author Profile

**Tim A. Minahan,**
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Tim Minahan is senior vice president of global supply management research for AberdeenGroup. In this role, Minahan provides analysis and assessment of software and services that automate and streamline procurement, sourcing, design, and supply chain management operations.

Minahan specifically focuses on total cost management (TCM), which is an organizational and technological framework for managing the total cost of ownership of supply relationships. Within TCM, Minahan tracks spending analysis, sourcing, procurement execution, contract management, and supplier performance measurement technologies. Minahan also covers the convergence of strategic sourcing and product development. He continually consults with early implementers of these applications to identify world-class supply management strategies and determine the strengths and weaknesses of technology solutions and services that are competing in this market.

His current research efforts include benchmarking contract management performance and an examination of advanced direct materials sourcing approaches and systems.

# *Appendix A:*
# Research Methodology

Between October and December 2005, Aberdeen*Group* benchmarked the sourcing and supply management organizational alignment, procedures, systems, and competencies of 133 mid-size enterprises across a wide range of manufacturing and service industries and geographical segments.

Responding procurement, supply chain, logistics, and operations executives completed an online survey that included questions designed to determine the following:

- Pressures forcing their organizations to implement or improve strategic sourcing operations and results;

- The organizational, process, and systems structures and effectiveness of existing sourcing management programs;

- Current and planned use of automation, supplier intelligence, and consulting services to aid these activities;

- Emerging best practices for supply risk management; and

- The performance, cost, and competitive benefits, if any, that have been derived from effective supply risk management initiatives.

Aberdeen supplemented this online survey effort with telephone interviews with select survey respondents, gathering additional information on sourcing strategies and results.

Responding enterprises included the following:

- *Job title/function:* The benchmark sample included respondents with the following functional roles: procurement (42%), supply chain and logistics (30%); information technology (9%); manufacturing/operations (7%); finance (5%); business process (5%); and sales (2%). Eighty-six percent of participants held titles of manager and above.

- *Industry:* The benchmark group included respondents from manufacturing industries, including high tech (25%), industrial (22%), consumer products (4%), and process (4%). Remaining participants were from the service sectors, including retail and distribution (12%), construction (7%), telecom (2%), media (2%) as well as the education and public sectors (4%).

- *Geography:* Nearly half (47%) of benchmark participants were from North America. Remaining respondents were from Europe (28%), Asia-Pacific (19%), South and Central America (4%), and Middle East/Africa (2%).

- *Company size:* 60% of benchmark participants were from mid-size firms, including 27% in the upper segment (annual revenues between $500 million and $5 billion); 14% from the middle segment (revenues between $250 million and $499 million); and 17% from the small segment ($50 million to $249 million).

**Table 7: PACE Framework**

| PACE Key |
| --- |
| Aberdeen applies a methodology to benchmark research that evaluates the business pressures, actions, capabilities, and enablers (PACE) that indicate corporate behavior in specific business processes. These terms are defined as follows: |

*Pressures* — external forces that impact an organization's market position, competitiveness, or business operations (e.g., economic, political and regulatory, technology, changing customer preferences, competitive)

*Actions* — the strategic approaches an organization takes in response to industry pressures (e.g., align the corporate business model to leverage industry opportunities, such as product/service strategy, target markets, financial strategy, go-to-market, and sales strategy)

*Capabilities* — the business process competencies required to execute corporate strategy (e.g., skilled people, brand, market positioning, viable products/services, ecosystem partners, financing)

*Enablers* — the key functionality of technology solutions required to support the organization's enabling business practices (e.g., development platform, applications, network connectivity, user interface, training and support, partner interfaces, data cleansing, and management)

Source: Aberdeen*Group*, December 2005

**Table 8: Relationship between PACE and Competitive Framework**

| PACE and Competitive Framework How They Interact |
| --- |
| Aberdeen research indicates that companies that identify the most impactful pressures and take the most transformational and effective actions are most likely to achieve superior performance. The level of competitive performance a company achieves is strongly determined by the PACE choices it makes and how well it executes. |

Source: Aberdeen*Group*, December 2005

## *Appendix B:*
## Related Aberdeen Research & Tools

Related Aberdeen research that forms a companion or reference to this report include:

- *The CFO's View of Procurement* (September 2005)
- *Low-Cost Country Sourcing Success Strategies* (June 2005)
- *The CPO's Agenda* (March 2005)
- *Best Practices in Spending Analysis* (September 2004)
- *Best Practices in e-Sourcing* (September 2004)
- *The Spending Analysis Benchmark Report* (December 2003)

Information on these and any other Aberdeen publications can be found at www.Aberdeen.com.

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# Aberdeen*Group*

## Our Mission

To be the trusted advisor and business value research destination of choice for the Global Business Executive.

## Our Approach

Aberdeen delivers unbiased, primary research that helps enterprises derive tangible business value from technology-enabled solutions. Through continuous benchmarking and analysis of value chain practices, Aberdeen offers a unique mix of research, tools, and services to help Global Business Executives accomplish the following:

- IMPROVE the financial and competitive position of their business now

- PRIORITIZE operational improvement areas to drive immediate, tangible value to their business

- LEVERAGE information technology for tangible business value.

Aberdeen also offers selected solution providers fact-based tools and services to empower and equip them to accomplish the following:

- CREATE DEMAND, by reaching the right level of executives in companies where their solutions can deliver differentiated results

- ACCELERATE SALES, by accessing executive decision-makers who need a solution and arming the sales team with fact-based differentiation around business impact

- EXPAND CUSTOMERS, by fortifying their value proposition with independent fact-based research and demonstrating installed base proof points

## Our History of Integrity

Aberdeen was founded in 1988 to conduct fact-based, unbiased research that delivers tangible value to executives trying to advance their businesses with technology-enabled solutions.

Aberdeen's integrity has always been and always will be beyond reproach. We provide independent research and analysis of the dynamics underlying specific technology-enabled business strategies, market trends, and technology solutions. While some reports or portions of reports may be underwritten by corporate sponsors, these sponsors do not influence Aberdeen's research findings.

Founded in 1988, Aberdeen*Group* is the technology-driven research destination of choice for the global business executive. Aberdeen*Group* has over 100,000 research members in over 36 countries around the world that both participate in and direct the most comprehensive technology-driven value chain research in the market. Through its continued fact-based research, benchmarking, and actionable analysis, Aberdeen*Group* offers global business and technology executives a unique mix of actionable research, KPIs, tools, and services.

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