MRO Demystified Part III
The Role of Strategic Sourcing in Spend Management

SourceOne
A Corcentric Company
Strategic Sourcing

The Ins and the Outs

Without Strategic Sourcing at the forefront of the spend management cycle, organizations will struggle to maximize the potential value of their workflows. One of the goals of Strategic Sourcing is to formally leverage organizational purchasing power with the help of historic or projected spend data. The process makes it possible to survey a market, identify and implement best-in-class pricing for products and services, establish competitive supplier relationships, and ultimately support the organization’s broader strategic vision. To better understand what makes Strategic Sourcing so critical in an effective spend management program, let’s take a look at the typical inputs and outputs of a Strategic Sourcing event.

**Inputs**

Each Strategic Sourcing initiative begins with the identification of a need or opportunity. These discoveries must be supported by detailed, accurate spend data. While specific inputs will vary based on the nature of the project, every type of project will require a number of them.

If the opportunity relates to an existing purchasing category, Procurement must analyze the current supply base, service levels, product specifications, and spend to establish a baseline for measuring future improvements. For identified needs that represent new or CapEx purchases, on the other hand, Procurement has to capture the budget and specifications for the project.

To understand its level of spend under management, Procurement requires access to all the data supporting its baseline analyses. Conducting periodic reviews of each category’s current state is an important step in maintaining this awareness. The process will also prove helpful in assessing a category’s *actual* purchasing profile in comparison to a stakeholder’s perception of the category, and ensuring that efforts are directed to high-impact areas.

Once a Strategic Sourcing opportunity has been identified, the next step is conducting in-depth market research to understand the current state of the marketplace. Analyzing major suppliers, emerging technologies, and pricing trends will help determine which suppliers to engage as well as the particular questions to ask when surveying the market. An active approach to understanding market trends helps ensure supplier relationships do not become stagnant and contributes to the value of managed spend.

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Outputs

Strategic Sourcing events built upon detailed, historic purchasing data result in an accurate representation of the Total Cost of Ownership (TCO) of a particular product or service. Understanding not only products purchased, but frequency and seasonality of purchases, freight and ancillary costs, and any available value-added incentives allows for a comprehensive view of what the total cost of purchasing will equal year-over-year under a contract.

Understanding the TCO empowers Procurement to manage spend beyond the unit cost price and at the conclusion of a Strategic Sourcing initiative easily identify the most competitive suppliers. More tactical purchasing practices often limit information sharing, leaving the door open for suppliers to offer a competitive unit price while delivering weak service levels and high ancillary costs. Taking a TCO approach helps Procurement avoid these situations.

Strategic Sourcing gives suppliers insight into an organization’s holistic purchasing patterns and goals, enabling them to propose solutions that will better support an overall program instead of focusing on direct unit cost price reduction alone. Suppliers with creative solutions for product substitutions, inventory management programs, reporting integrations, or other value-added activities are able to bring these ideas to the table during a sourcing event while providing accurate pricing estimates and scopes of work.

The Strategic Sourcing process inherently facilitates knowledge-sharing between companies and suppliers – allowing suppliers to directly transfer their competitive advantage to their customers. Ultimately, they establish a mutually beneficial partnership that drives down costs while maintaining high quality and delivery standards.

An organization can only be as strong as the suppliers supporting them. If suppliers are not effective in influencing their own spend, those inefficiencies are often reflected in their pricing and service levels. Strategic Sourcing should be used as an opportunity to understand a supplier’s pricing structures, their level of influence across their own supply chains, and how these factor into the final costs proposed. Often, suppliers maintain their own strategic partnerships to gain access to specialized pricing and other benefits. Visibility into these partnerships could lead Procurement to discover additional value-adds of their own. Increased transparency combined with regular knowledge transfers and solid communication allows for better spend management.

At the conclusion of a Strategic Sourcing event, Procurement will have reviewed the category through the lenses of both internal spend data and external market intelligence. Their results will have captured the product or service’s TCO as well as the available competitive advantages - generating a 360-degree view of the current and potential state of managed spend. Additionally, these efforts eliminate the risk of cost inefficiencies going unnoticed and impacting the bottom line.

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Developing a Market Basket

Best Practices

Without accurate data, suppliers cannot provide the information necessary for assessing TCO.

In MRO categories - with thousands of SKUs purchased annually - requiring a supplier to quote on all historic items is inefficient for both parties. A supplier is less likely to participate in an initiative that will require a massive resource overhaul to complete. The buyer, for their part, will waste resources preparing and analyzing extensive pricing lists for products that they may never purchase again. To combat this, a best practice in Strategic Sourcing is developing a Market Basket to use as a representative sample of an organization’s purchasing profile within a competitive environment.

A market basket is defined as a recurring set of goods or services purchased by an organization that are generally unchanging year-over-year. This is the list of items that make up the “core” purchases in a particular category. The strategy behind market basket development can vary from category to category, however, there are general best practices that can be applied universally to conduct an initiative that results in an accurate representation of the cost of doing business.

The 80/20 Rule

A common tactic in market basket development is the use of an 80/20 split in spend data, which consists of:

- Identifying the top 80% of products purchased in terms of annual extended cost
- Selecting those items to be quoted by suppliers
- Isolating the most frequently purchased items and eliminating any one-off goods from the list of products to be quoted.

This makes it easier for participating suppliers to focus their efforts on quoting the most appealing high-volume products where the most impact can be made.
Balancing Product Mix
In addition to selecting the highest-volume items, a market basket should also represent all critical product lines that are included within the category. If any niche or custom fabricated items critical to operations fall below the top 80% of spend, a representative sample of those line items should be added. Doing so will ensure the selected supplier can support that line of business in conjunction with the high-volume items. Failure to survey the category comprehensively can lead to partial award scenarios, which can create additional tail spend, administrative costs, and other risks.

Limiting SKUs Based on Complexity
When developing a market basket, Procurement should consider the complexity of the products or services included when determining the overall scope of the core list. For custom items with extensive drawings and Bills of Material (BOMs) that suppliers will need to evaluate, consolidating the market basket will lead to better supplier engagement and adherence to timelines. For off-the-shelf distributor products that are found standard within the category, extensive lists of 300+ SKUs are not uncommon. Due to the tactical nature of matching items and establishing prices, these are more likely to be completed in full by a supplier. Additionally, grouping similar products into categories and subcategories enables suppliers who may not be able to support the full scope of the initiative to more easily identify the areas which apply to them.

Securing Discount Structures
Once a market basket is established for a sourcing event, Procurement should not neglect the remaining items that did not make the core list. For anything that is considered an ad-hoc or “non-core” purchase, discount structures can be negotiated to avoid paying list price. To achieve this, Procurement should group the remaining purchases into categories and communicate volumes to the participating suppliers. They should also request that suppliers provide discounts structures that are applicable to each of these categories. For example, in a general industrial supplies and hardware sourcing event, categories such as Lab Supplies, Fasteners, Abrasives, and Machining may be established. Suppliers should propose discount structures to apply to ad-hoc purchases that fall under each category.

These can be established as a general discount percentage off of a published list price, or a cap on the markup for a cost plus structure. Either way, this ensures that tail spend does not go uninfluenced under a particular contract. An additional discount structure can be secured for the most common manufacturers purchased by a customer. This simply replicates the category discount style but applies them to individual manufacturers.

The market basket approach combined with securing discount structures to cover low-volume purchases leads to a category of spend that is almost completely under management. All pricing and concessions should be explicitly stated within the contract. Periodically, items on the core purchase list should be reviewed and updated to ensure that unit pricing remains locked under contract for the most frequently purchased items.

Getting spend under management is only half the battle. Maintaining long-term control over MRO spend requires ongoing programs and processes that continue to challenge status quo and drive value within the category. Effective MRO spend management means proactively and strategically approaching purchases, price points, and supplier relationships.
About Source One, a Corcentric company

Source One is a top provider of spend management solutions ranging from spend analysis and strategic sourcing through category management and Procurement Transformation. Since 1992, Source One has helped industry leading enterprises optimize their approach to countless indirect spend categories including MRO, Facilities Management, IT & Telecom, Professional Services, and more. Serving as an extension of client resources, Source One’s category subject matter experts deliver best practices, market insights, tools that drive greater value out of the bottom line. To learn more about Source One, a Corcentric company, visit us online at: www.sourceoneinc.com.