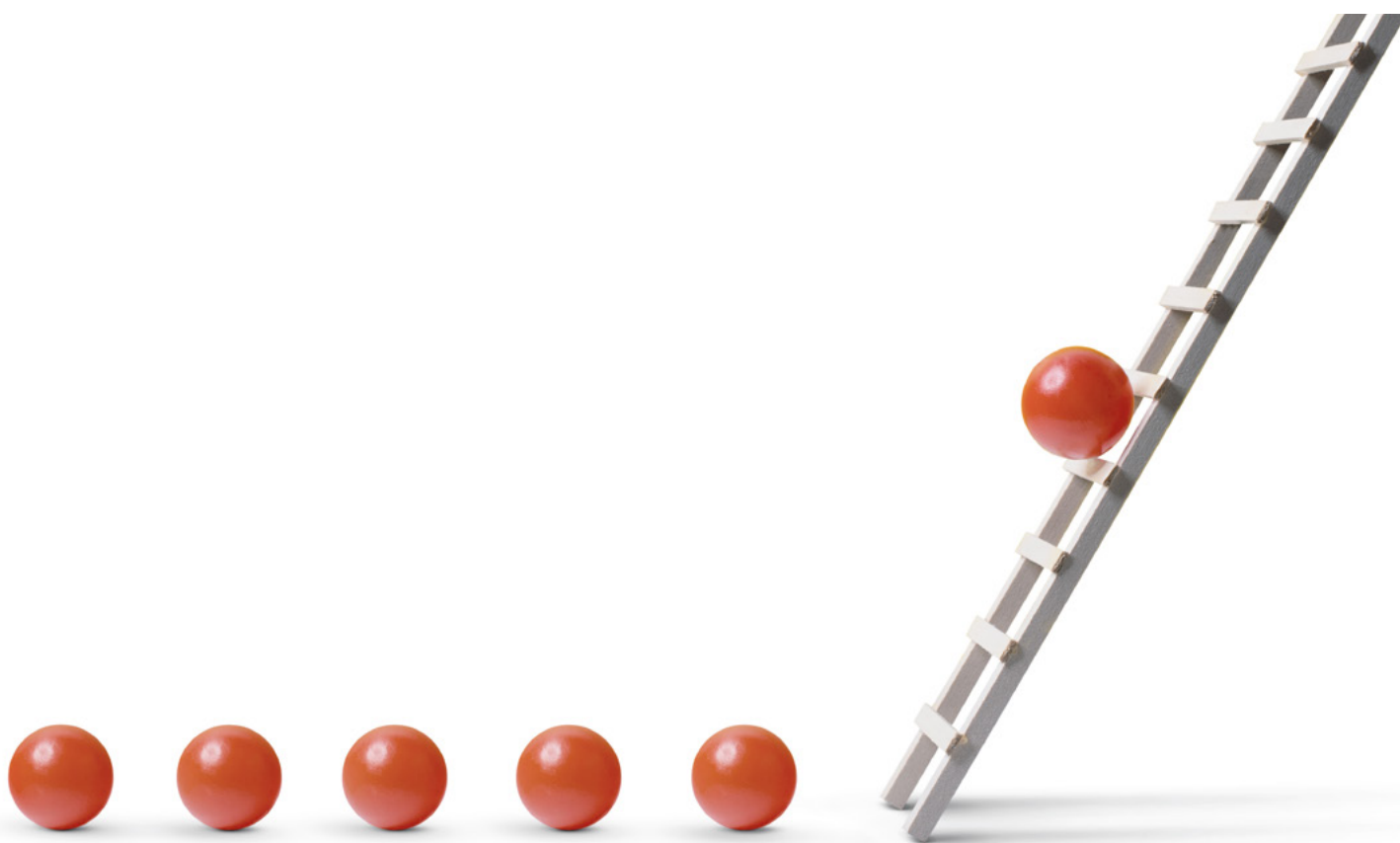


Operations Practice

Now is the time for procurement to lead value capture

With companies facing more pressure than ever to deliver savings, procurement teams can offer not only short-term relief, but also long-term rewards.

by Nancy Busellato, Riccardo Drentin, and Sunil Kishore



Faced with significant price erosion, companies in industries with increasingly commoditized products are under pressure to better manage their costs and cash positions. The need for action is particularly strong in technology and advanced industries (such as semiconductors), which have experienced price erosion of 5 to 20 percent annually in recent years. At the same time, shocks arising from the pandemic and international trade tensions have placed stresses on liquidity that companies are looking to ease.

Where to find relief? An often-underappreciated source is the procurement organization, which can play a leading role in efforts to address these issues and capture value. But many procurement organizations have not devoted enough time and resources to effectively pursue operational improvements and strategic priorities. They typically focus on short-term activities, such as “category waves,” that generate in-year impact. But too many neglect longer-term, strategic initiatives—such as

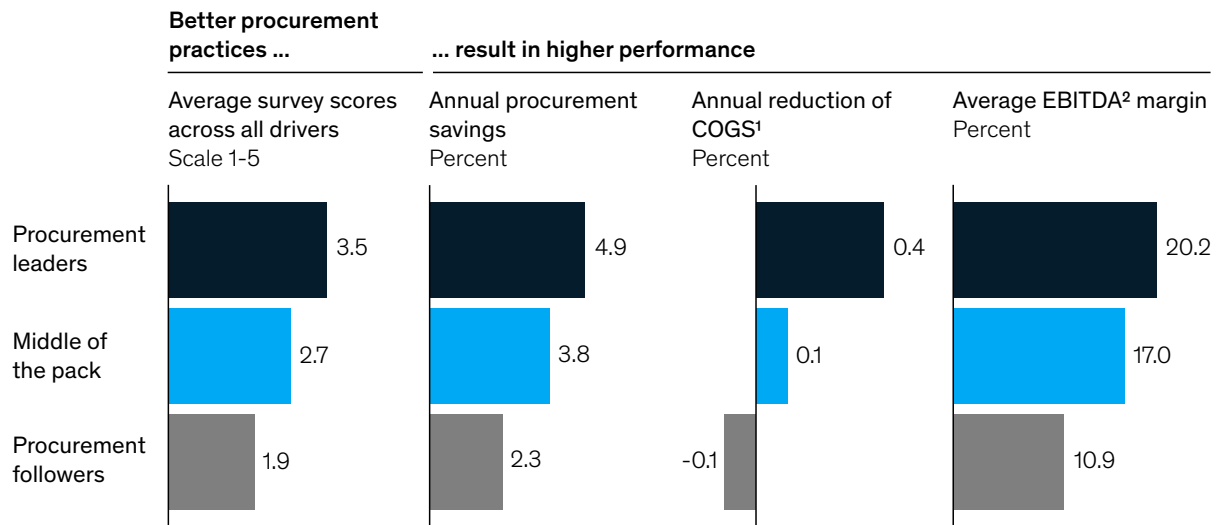
capability building, digitization, and stress testing the supply base—that promote resilience.

The returns from longer-term initiatives are significant. For example, our benchmarking research has found a 99 percent correlation between investing time and resources in capability building and achieving better results in procurement. Procurement functions in the top quartile in terms of the health of their practices generate twice the annual savings of those in the lowest quartile, allowing them to improve earnings performance (exhibit).

Success therefore means taking a holistic approach that balances short-term activities to boost P&L with longer-term initiatives that build resilience. Moreover, by rethinking their approach to short-term procurement efforts—such as through applying digital solutions and the right incentives and mind-sets—companies can rapidly generate sustained savings across virtually all categories.

Exhibit

Global Purchasing Excellence: Procurement health shows a strong correlation to corporate performance.



Confidence level of correlation > 99%

¹Cost of goods sold
²Earnings before interest, taxes, depreciation, and amortization
 Source: McKinsey Global Purchasing Excellence

Tackling operational and strategic imperatives

Achieving the right mix between short- and long-term is not only a matter of taking actions, but of stepping back and adopting a different perspective on how procurement engages with the business.

Take a full-scale approach to spend optimization

The first change reexamines the scope of the procurement function's ambition. The traditional category-wave approach, in which a company assesses only a few categories at a time, results in slow, incremental improvements relative to the full-scale opportunity. To accelerate impact, procurement can take a full-scale approach to generate savings across all categories in a shorter timeframe.

A full-scale approach helps companies move up to the first quartile in terms of achieved in-year savings. The financial rewards are substantial: our benchmarking has found that moving from the mid- to top-quartile boosts annual savings by more than 1 percent, so for a company with \$10 billion in annual spending, the savings amounts to \$100 million.

A supplier-negotiation event can be an effective way to identify the full scope of savings opportunities. Such an event, which can be held in-person or remotely, includes top strategic suppliers and increases cost competitiveness through preparation, group pressure, the presence of senior executives, and intense negotiation execution. A high-tech company, for example, conducted several negotiation rounds over a 1.5-day event, which generated concrete offers achieving savings of more than 3 percent. Larger-scale events, including selected mid-size suppliers, can potentially achieve even more.

For the long tail of small suppliers, harmonizing contract conditions based on a savings-reduction target (for example, between 2 and 5 percent) can be effective. Cash-optimization levers, such as uniform payment terms, are another potential source of longer-term savings.

Use digital to accelerate decision making

Although companies have implemented digital solutions to support spend optimization, the impact has often fallen short of expectations. To capture tangible value, procurement needs a digital solution that generates actionable insights and provides transparency into the savings opportunities.

A well-designed solution helps buyers identify and prioritize opportunities across all categories, accelerates their decision making, and allows them to focus on value-adding activities. In addition to tools that run analyses, the solution should provide visualizations, such as dashboards, that give users easy access to regularly refreshed data and insights. Key topics to cover in dashboards include how spending has evolved over time for each supplier, the gap between actual and theoretical spending based on should-cost prices for specific suppliers, and the impact of single sourcing on total spending.

A global technology company with more than \$5 billion in direct spending uses analytics and dashboards to optimize spending on components, including for the long tail. The company had struggled to optimize long-tail spending because of the need for significant manual effort in analyses and the fragmentation of data across different platforms, owners, and business units. Using a digital solution, the company has now automated the analyses of costs for its tens of thousands of components, including the long tail. The analyses are provided to procurement specialists on dashboards that can be refreshed with a mouse click.

A multinational healthcare company applied digital and analytics (DnA) to deliver 40 percent of the value it achieved in a transformation. The new DnA-enabled engine and operating model allowed the company to reach best-in-class performance by year three of the transformation, and to sustain the impact going forward. The company implemented the transformation through a procurement-data

platform that serves as a single source of truth— together with a series of use cases scaled up via an agile approach, and an intuitive “buyer cockpit” that delivers actionable recommendations and prescriptive analytics. The new operating model enabled by these improvements shifted more than half of category managers’ time to value-added tasks—and accelerated the sourcing process by more than 30 percent.

Build digital capabilities across the organization

Capturing the benefits from digital is, at heart, a question of empowering people to use digital solutions, through capability-building programs that are tailored to the needs of procurement teams. To design an effective learning journey, an organization starts by assessing the team’s talent and identifying capability gaps. Throughout the journey, the organization tracks its progress and benchmarks the capabilities it is building against those of other players in the industry.

These steps become especially important—and difficult—during a crisis. One telco with several hundred procurement professionals recently faced the challenge of building their people’s capabilities to conduct negotiations in a virtual setting. As a first step, the company assessed current virtual-negotiation skills across the organization, pinpointing a very basic problem: because buyers were not accustomed to working in a virtual setting, many did not initially turn on their computer’s camera. This is not a trivial question in negotiations: seeing facial expressions and body language, even in a virtual setting, is highly valuable.

To address this and other identified gaps, the company provided a training program that included exercises on advanced negotiation skills and tactics, remote communications, crisis-specific communications, and practice negotiation. Participants slowly eased into turning on their cameras and getting comfortable with new tactics and ways of communication.

Address structural issues

To lay the foundation for savings over the long term, companies will likely need to solve structural issues in procurement, such as lead times, payment terms,

and claims. These often go unaddressed because companies lack the specialized knowledge and resources required to tackle the challenges.

One company optimized lead times to improve the flexibility of its operations and the value of its inventory, as well as to enhance the business’s ability to serve unexpected orders. The company had recently seen lead times increase significantly for many essential components, for reasons including existing agreements, shortages, and the COVID-19 pandemic.

As a first step, the company prioritized critical components with respect to lead time on the basis of volume and strategic importance. It also prioritized commodities with high volumes of components having long lead times. It then engaged with suppliers to renegotiate lead times for the prioritized components based on the current market dynamics. Additionally, it identified and aligned lead-time discrepancies across systems to increase transparency and improve monitoring of lead-time performance. Over a two-month period, the optimization effort reduced lead times by 35 percent across the prioritized categories.

Companies can relieve stress on cash by harmonizing payment terms across all suppliers. A quick, integrated review of current payment terms can have a substantial impact on cash flow. For example, a company can improve days payable outstanding (DPO) through three levers: increasing payment terms days; postponing the start of payment terms (for example, moving from invoice issue date to invoice receipt date); and reducing frequency of payments. DPO optimization from median to top performance can increase cash flow by a 25 percent. And by building up the organization’s related capabilities and skills, a company can enable continuous monitoring and improvement of payment terms over time.

Some structural issues have significant strategic implications, such as single-supplier dependency, which has been a cause of many of the most significant business disruptions. The pandemic has increased the urgency to break these dependencies in order to derisk the supply chain and make it less

vulnerable to disruption. Additionally, introducing alternative suppliers and accelerating their qualification generates new savings opportunities. One company determined that fully half of its single-source spending could be redirected to multiple sources.

Build trust with the business and with suppliers

Developing joint projects at scale is often an effective way to build trust-based partnerships. For suppliers, this means co-investing in the design of new products in order to achieve sustainable costs and optimize the goods supplied. Enhancements to supplier-relationship management and ways of working enable the procurement function and suppliers to collaborate more effectively. A negotiation event, as described above, is one approach to enhancing collaboration.

At same time, the procurement function can deepen its engagement with the business—to raise awareness of how additional savings can be generated through collaborative approaches, and of how these savings are reflected in the P&L. For example, procurement and business teams can collaborate more closely during product development to minimize single-source dependency.

Because of different reporting methodologies in accounting for savings, there can be a large difference (up to about 20 percent) between procurement savings and P&L impact. However, even if all of the savings are not reflected in the P&L, the collaboration is still valuable for incentivizing productive behavior by stakeholders.

To address collaboration challenges comprehensively, procurement organizations can adopt agile methodologies. Building on successful applications in IT and software development, agile

helps procurement organizations to work eye-to-eye with their business stakeholders. Together, they can capture value by injecting expertise into projects and solving fixed-cost challenges through a pool of procurement talent.

Agile methodologies are most effective when supplementing existing category management rather than replacing it, because it relies on a stable backbone of specialists to maintain supplier relationships and transactional procurement activities. For example, one large telecom player has successfully transformed from a central, pyramid-structured procurement organization with different category teams to an agile network model with a single pool of strategic-sourcing professionals.

People work in small, flexible teams for specific sourcing projects, leveraging their individual strengths and competencies in the best way, while having greater responsibility to run those projects from end to end. Key elements of the transformation included mind-sets changes, strength- and interest-based focus for roles, and a visual scheduling (or “kanban”) system to allocate projects.

In the current crisis, companies can rethink and reshape the procurement function. The first step to building next-generation procurement is to identify the highest-priority business needs as well as the digital tools that will support the efforts to address them. Now is the time for each organization to define those priorities and begin leveraging the related digital tools. Companies that do this effectively will be well positioned to ensure value capture and accelerate their recovery out of these challenging times.

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