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Turning indirect sourcing into a multimillion-dollar profit center

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Turning indirect sourcing into a multimillion-dollar profit center

Retailers usually have a long list of business boosting ideas, but are often limited in cash to fund them all. Focusing on not-for-resale spend is the single largest incremental funding mechanism and the secret lies in doing it “business-backed”

Retailing is a cutthroat business. Even the largest and most successful retailers operate in an environment of fickle customers, tough competition, and razor-thin margins. These industry factors can impede the strategic investments needed to drive growth, from network expansion or store upgrades to the use of new formats and new technologies. As a result, different parts of the organization frequently compete fiercely for scarce resources.

Indirect sourcing –the purchase of goods and services not for resale– represents a largely underexploited opportunity for retailers to save money and generate much-needed cash to finance those growth opportunities. In our experience, indirect spend is typically around 10 percent of total revenues, depending on the retailer’s sub-sector and format. While other industries have successfully optimized their indirect sourcing activities, retailers are significantly behind in their sourcing maturity due to several challenges, some of which are unique to the retail industry. Our experience shows that implementing a world-class indirect sourcing process can yield 100-150 basis points of incremental profit within 12 to 24 months, plus year-over-year profit improvements of 20 to 30 basis points.

To extract the full potential from gains in indirect sourcing, retailers must pursue several steps to evolve the role of not-for-resale (NFR) sourcing from traditional procurement all the way to business-backed NFR sourcing (Exhibit 1).

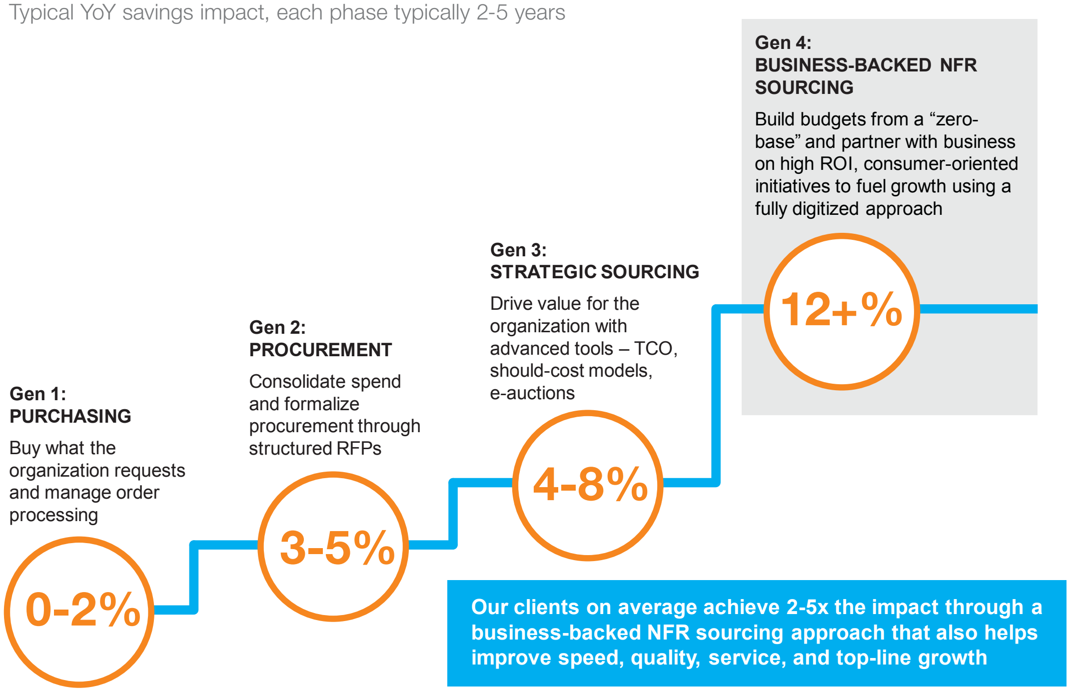
This journey, depending on your starting point, can take between one to two years. A retailer’s starting point depends both on the initial maturity of the NFR function and the organization’s commitment and ability to drive change. First, indirect sourcing must establish a ‘peer-like’ relationship to manage and influence the spend categories across departments and locations to capture savings. Next, the function must develop a comprehensive, strategy that includes a shift to a true total cost of ownership (TCO) approach1. This includes building budgets from a “zero-base” and partnering with the business on high ROI, consumer-oriented initiatives to fuel growth using a fully digitized approach to strategic sourcing. By building initial momentum, retailers can capture cost savings that demonstrate its value, leading to additional resources to manage this spend category. When done successfully, retailers can achieve a 12-15 times return on the people and operating expense investment for an indirect sourcing team and gain the resources to expand both its capabilities and reach.

1 TCO is an exhaustive look at all of the costs a retailer would incur, both directly and indirectly, from a transaction. It starts with the specific price paid directly to the vendor for the product or service and also includes any internal retailer costs resulting from the transaction, such as installation or removal labor, inventory management, and the actual sourcing process cost. The TCO approach looks at all the ways a retailer can reduce the TCO—for example, by paying a better price, changing specifications, or transforming the procurement process.

Exhibit 1 To capture the full indirect spend opportunity, the role of NFR sourcing in retail has to evolve

Maturity of the sourcing approach

Typical YoY savings impact, each phase typically 2-5 years



What is the matter with retail?

Our experience of more than 1,800 procurement transformations across many industries in the past five years shows that a focused, cross-functional multi-year program with a TCO approach encompassing supply, demand, and process management can sustainably reduce indirect costs by an incremental 10 to 15 percent. In many industries, those priority programs have then become common place and tend to lead to average run-rate savings of 3% per year after the incremental business-backed NFR transformation. However, the retail industry has substantial ground to make up if it hopes to get similar gains. McKinsey's proprietary Global Purchasing Excellence benchmarking survey of more than 800 global companies (respondents were primarily from the Fortune 1000), reveals that retail performance scores trail its consumer industry peers and the cross-industry average score (Exhibit 2).

Similarly, according to the McKinsey's Capability Building Assessment (MCBA), an online tool to assess the purchasing personnel knowledge of core procurement tools and processes, the sourcing capabilities of retail practitioners are among the lowest third across industries (Exhibit 3).

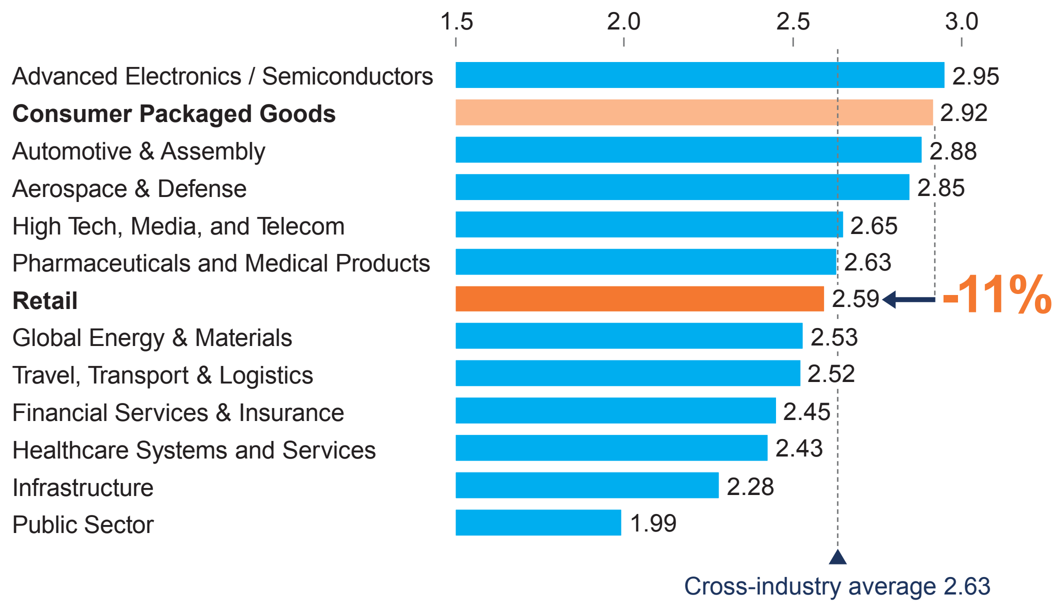
A hidden opportunity

The magnitude of the opportunity in indirect sourcing reinforces the imperative for retailers to pursue cost savings in this area. Furthermore, retailers that seek to enhance their indirect sourcing function stand to add substantially to their bottom line in the near term. In addition, the majority of the savings –in many cases, as much as 80 percent– are captured in the first twelve to 24 months. Therefore, for a hypothetical $10 billion retailer with indirect spend equal to 10 percent of revenue, i.e., $1 billion spend, a program started today could deliver a total of $80 million to $120 million in run-rate savings by mid 2019. If the value at stake is so large, why has the retail industry been slow to go after it? The reasons stem first from some universal challenges associated with indirect sourcing that are not unique to retailers, but common across industries.

Exhibit 2 Despite tremendous opportunity, retailers lag behind their consumer peers and cross-industry average in purchasing excellence

The Retail industry lags behind consumer peers and cross-industry average in McKinsey's Global Procurement Excellence survey across more than 800 global companies

Average score of industry group

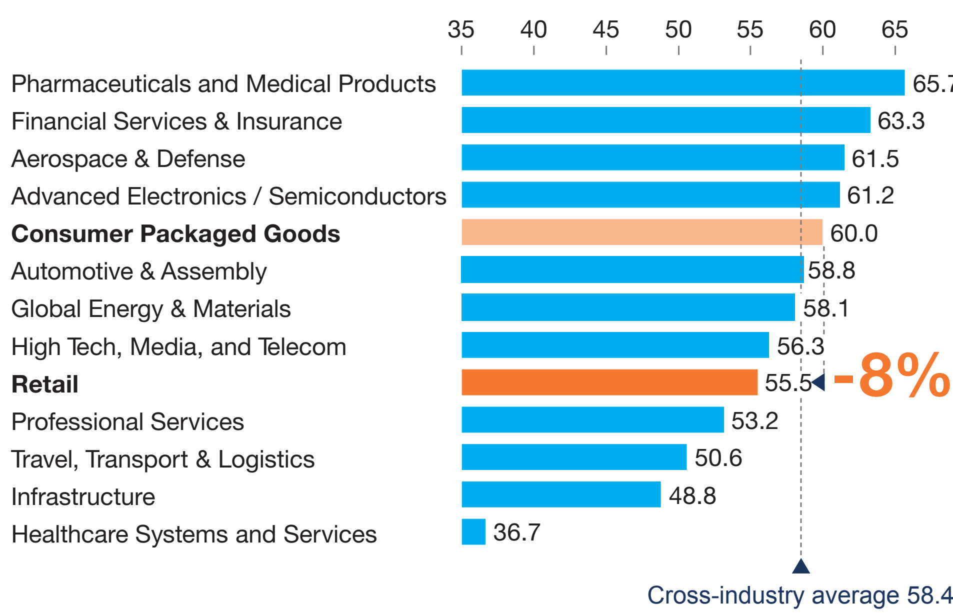


SOURCE: McKinsey Procurement GPE benchmarking 2016

Exhibit 3 Of more than 3,000 surveyed purchasing professionals, retail participants score, on average, in bottom third across industries

Retail procurement practitioners rank in bottom third across industries and lag behind their consumer peers for individual procurement capabilities among 3,000+ sampled

Average capability score of all participants by industry



SOURCE: McKinsey Procurement MCBA benchmarking 2016

- *Distributed spend authority*. Companies in all sectors can struggle to control indirect spend because responsibility for it is often widely distributed across the business. For example, the technology function often controls the majority of IT spend, while marketing makes primary sourcing decisions on advertising space and creative services—all without the participation of sourcing professionals. These functions can resist collaborating with indirect sourcing because they believe sourcing does not have the required knowledge to meet their specific needs.

- *Limited incentives to manage spend*. The departments responsible for indirect spend categories often focus solely on securing the right good or service for the organization as expeditiously as possible. Issues arise only if they fail to stay within their set budget. So, it is common for departments to select the lower price among a few quotes to move quickly without fully understanding what a service or good should cost. Further, the absence of incentives to control spend can encourage a "use it or lose it" budget management mentality that can result in inefficient sourcing.

- *"Sacred cow" spend*. Other indirect categories, such as employee benefits or even travel, may be considered too sensitive for sourcing to tackle. As a result, businesses often completely avoid any opportunities for cost savings for fear of damaging staff morale and productivity.

- *Single-minded emphasis on pricing*. In this case, procurement functions tend to focus almost exclusively on price reduction levers (*at what price we buy*), if they get involved at all. However, more than half the potential value typically comes from another set of levers: demand and specification management (*what and how much we buy*).

At retailers, many of these issues are magnified: indirect spend is highly fragmented, with almost half of all indirect spend typically managed at the store level. Meanwhile, key categories from rent to media are considered the domain of other functions and therefore "nonaddressable". Moreover, the indirect sourcing function often has a lower overall status in the organization at retailers compared with other sectors. At most retailers, the head of indirect sourcing sits within the finance function, while in other industries the equivalent position usually reports directly to a board-level chief procurement officer.

The indirect sourcing function at retailers can face additional challenges due to its relative purchasing strength compared with merchandise (direct) sourcing. The merchandising function in large retailers prides itself on excellent sourcing capabilities, alongside a host of other skills. Unfortunately, this focus on merchandising can leave indirect sourcing without the resources to increase its results and impact on the organization. For a given level of spend, retailers typically have around one-eighth the number of people devoted to true indirect sourcing than the cross-industry average. Worse, indirect sourcing can struggle to hold onto its best people: merchandising's high profile makes direct sourcing a magnet for higher-performing and more ambitious sourcing specialists.

An indirect route to higher performance

While these challenges may seem daunting, they are surmountable. The great strides high-performing companies in other industries have made in delivering sustainable year-on-year savings in indirect spend demonstrate that the common issues can be overcome. Our experience with a growing number of top retail players demonstrates that the industry-specific ones can be beaten too. In order to boost their indirect sourcing performance and position to capture significant savings, retailers need to launch a transformation of their NFR sourcing organization. Such a transformation will require implementing six strategic pillars.

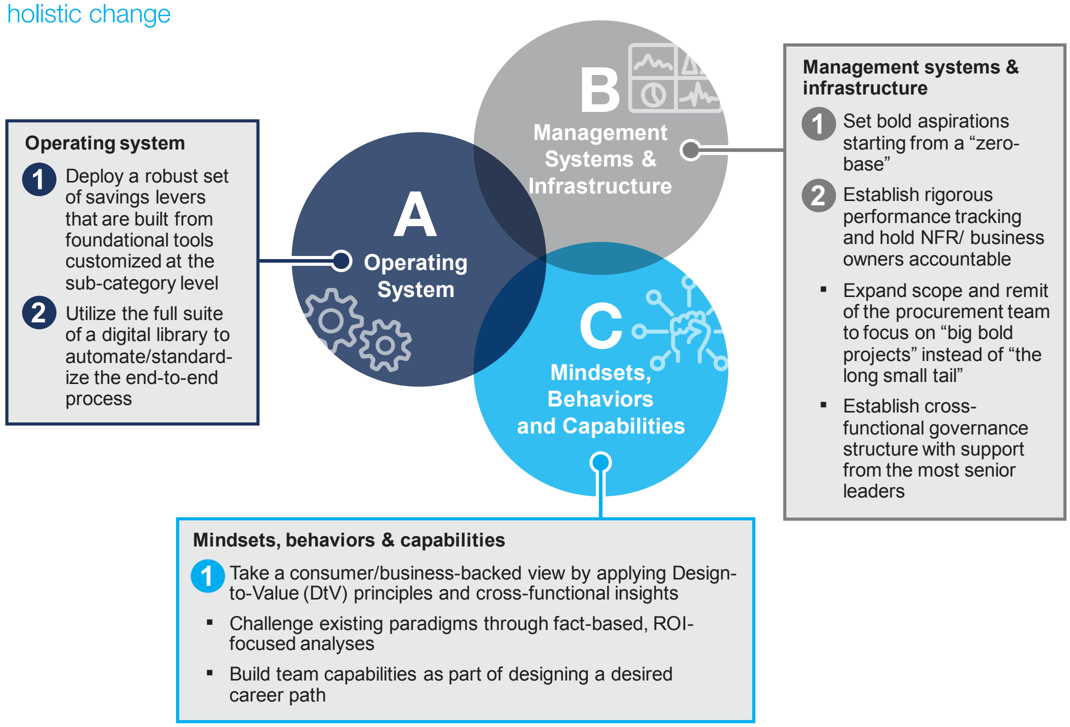
1. Redefine the vision for indirect sourcing

Ultimately, a strong and vigorous indirect sourcing function deserves a different strategic role in most retail organizations. Instead of engaging only at the back end of commercial processes –for example, by negotiating contracts and tweaking specifications– indirect sourcing teams can deliver even more value through upfront involvement in shaping commercial strategies, evaluating the broadest possible range of supply partners, and exploring ways those partners can work more efficiently or deliver additional services.

This strategic shift from the traditional role of procurement to a strategic, business-backed NFR sourcing function, is rooted in three core elements coming together to drive holistic change: (A) a robust, digitized operating system for NFR, (B) strong management systems and an infrastructure built to track performance, prioritize strategic projects and established cross functional governance, and (B) consumer/business-backed mindsets, behaviors and capabilities that challenge existing paradigms (Exhibit 4).

Exhibit 4 Core elements of business-backed NFR sourcing

Business-backed NFR sourcing is rooted in 3 core elements coming together to drive holistic change



To do this, the procurement function has to demonstrate its capabilities in category management and execution and generate significant value in some high spend categories. These efforts should be made visible to the executive leadership, as it will foster understanding of the value of elevating the indirect sourcing function and giving it the authority over spend that currently resides in specific departments or locations. In many cases, the CFO plays a key role in setting up regular cross-functional external spend reviews to enable collaboration between sourcing and the functional owners. Furthermore, many sourcing leaders monitor compliance to explicit procurement policies, which requires end-to-end NFR sourcing engagement for the procurement of any indirect spend above certain thresholds. In addition, the CFO can encourage collaboration between sourcing and other functions through setting joint spend targets that are directly linked to incentive pay. At one retail client, the NFR sourcing leadership reviewed progress against the initial savings targets with the CFO in a bi-weekly face-to-face meeting until formal Sourcing Councils were stood up. These councils replaced the CFO report outs as they were chaired by the VP for the category cluster, e.g. the head of HR for categories such as travel and temp labor, and co-chaired by Finance.

2. Introduce a TCO focus

One of the most powerful ways retailers can squeeze more value out of their indirect purchasing activities is by modifying product and service specifications and demand to meet needs more effectively. In our experience, better demand and specification management can deliver twice the savings as those achieved by even the best price negotiations.

One North American retailer, for example, originally used a single specification for the cleaning and housekeeping contracts across all its stores, from a busy branch in the snowy Northeast to a quiet one in the dry and dusty Southwest. Worse, the checklist used by store managers to evaluate housekeeping yielded little information that could be used to compare the performance of different suppliers. When we helped the company adopt a TCO approach, we introduced different housekeeping requirements depending on footfall, location, and time of year. This change enabled our client to reduce costs by more than 10 percent. A more detailed checklist and data collection approach also enabled it to compare the relative price and performance of different contractors, drop underperforming suppliers, and step in earlier to address poor performance in specific stores or regions.

Taking it a step further, this retailer used its consumer insights to understand which areas of the store consumers valued to be "clean," how to differentiate between "clean" and "neat," and ways to compare variance in performance with competing retailers. For example, if customers perceive a store as neat –meaning merchandise is properly sorted and stored on the shelves– and the store is structured so that customers can easily find what they are looking for, then they also perceive it as cleaner than other stores that are less neat (Exhibit 5).

Exhibit 5 Consumer insights allow differentiated approaches to cleaning services, focusing on those aspects that consumers value most

RETAIL DEPARTMENT STORE EXAMPLE

Consumer insights show focus on "neat" drivers allows Retailer 4 to outperform average on customers' perception of "clean"

Statistically significant lead over average
Statistically significant gap under average

Top 2 box, % Agree or Strongly Agree

Significant drivers of neat

		CLIENT	Retailer 1	Retailer 2	Retailer 3	Retailer 4	Retailer 5	Retailer 6
Overall Store	Merchandise is folded neatly or hanging on racks	63	-6	12	5	12	-38	4
	The store is not crowded and cluttered with product	56	-11	-9	8	22	-30	7
	I can easily find the products I am looking for	71	1	-3	-8	15	-32	2
	There is enough space to shop and navigate around the store	62	-12	0	4	16	-18	0
	The cashier counter is uncluttered	71	6	-24	-13	20	-24	-15
	The sales associates have a neat and polished appearance	75	4	13	1	-5	-14	4
	The store does not have overflowing trash cans	72	3	-1	-2	2	-7	-8
Fixtures/ Displays	The displays in this store are tidy and organized	70	-3	4	8	9	-31	1
	There is never any dust on the fixtures	44	-2	4	-6	5	-19	38
Floors/ Carpets	The carpet is vacuumed well	67	7	5	2	2	-26	-6
	The floors are clean	79	2	1	0	3	-13	-4
	The carpet has no noticeable stains	63	2	-2	-2	7	-17	-4

12. Still thinking about the same two stores, please indicate how much you agree or disagree that each statement describes each store. Please use the scale from strongly disagree, disagree, somewhat disagree, somewhat agree, agree, and strongly agree.

SOURCE: Disguised client example

This finding contradicted the conventional wisdom that customers would always value and seek out stores with stain and dust-free floors and fixtures. Ultimately, the retailer redistributed hours to where gaps existed and pulled hours from areas that were not noticed or valued by consumers. The net result was an optimized cleaning specification that not only came at a 6 percent lower cost but also had higher consumer satisfaction. This fact base became a differentiator in capturing added value.

3. Create visibility into indirect spend to allow fact-based decision making

Since so much indirect purchasing activity is distributed across retail businesses, simply creating an understanding of what is being bought, and from whom, can reveal significant savings opportunities. By rigorously analyzing their purchase order books and accounts payable systems, retailers can build a more complete picture of spend by supplier and category, allowing them to simplify their supplier bases and ensure they are making the best use of their volume purchasing power.

When we conducted such an exercise at one retailer, for example, we discovered its purchases included more than 6,000 different types of wrap and packaging, with 80 percent of the SKUs unique to one region and only 1 percent of them common across all regions. By standardizing SKUs across regions, the retailer expected to capture savings of 6 to 9 percent through the elimination of variation in features (for example, the color of foam trays) that did not affect the customer experience but drove additional volume discounts from vendors.

Gaining visibility around spend and specifications can be a time-consuming and cumbersome process. Typically, it involves not just pulling data from various ERP systems (which often are not able to provide the same data in the same format) but also extensive data cleaning, since accounts payable data, for example, needs to be translated into sourcing data. The next level of insights then comes from marrying that data with other factors such as customer demand or specifications. That information can reside in contracts or spec sheets, but more often than not it requires conducting surveys of the business units, stores, or consumers for this information. Therefore, the sourcing function requires three elements: the technological capabilities to gather and analyze such varied data sources; the time and capacity to complete this task prior to executing a category strategy; and the support from the functional leaders to receive the information and data in a timely fashion. Deploying the right digital tools can significantly improve the efficiency and effectiveness of creating the required spend visibility. For example, applying advanced spend intelligence and automated sourcing insights help to not only shorten the time to insights, but also improves the depth of insights generated.

4. Build capabilities systematically

Our research into purchasing practices in many industries has demonstrated that a purchasing staff's capabilities are the factor most closely correlated with higher average sourcing savings. Specifically, building sourcing capabilities drives twice the impact that improving procurement's integration and alignment with company strategy would and 1.5 times the impact of the implementation of functional tools. The resulting improved performance in turn translates directly into improved EBITDA and higher sales growth (Exhibit 6).

High-performing procurement personnel typically have a mix of sourcing-specific skills (such as the ability to reverse-engineer a supplier's cost structure) and general business capabilities (including the ability to manage negotiations and push for appropriate trade-offs with both suppliers and internal stakeholders). To build those capabilities, the best companies balance the use of classroom training and e-learning tools with extensive field experience, giving their people the opportunity to learn on-the-job by working alongside experienced coaches and mentors. Successful capability-building programs need to be tailored to indirect sourcing so that purchasing personnel receive training in the skills that will help them in their specific roles. When we supported one retailer in its procurement transformation, we ran a pilot training program during the first few months of the transformation to explain the key concepts. In these initial trainings, we trained a majority of the new sourcing team. A subset of the participants then applied these learning to the initial set of categories addressed in this phase. These category managers then became trainers for the second round of trainings. We also helped the organization think through the technologies and tools that they needed to introduce, such as should cost modeling, RFX templates, and competitive event management tools.

Exhibit 6 Capabilities are the most critical financial impact driver and crucial to sustain performance

Capabilities are critical for driving performance …
which delivers tangible financial benefits

Building capabilities is critical to driving performance

2.2x the impact of integrating and aligning with strategy

1.8x the impact of addressing structure and processes

1.5x the impact of implementing functional tools

Companies with superior capabilities are likely to perform better

2.2x as likely to have a higher EBITDA margin

2.0x as likely to have higher growth in EV/book value

1.5x as likely to have higher sales growth

SOURCE: McKinsey Global Procurement Excellence benchmarking; Bloomberg; Factiva; Beer & Nohria (2000); Conference Board report (Fortune 500 interviews)

5. Prioritize opportunities and build momentum

The biggest indirect savings opportunities may not be the most accessible. In the early stages of transformation efforts, retailers are better to focus on significant savings they can achieve immediately. Early wins generate momentum and the organizational excitement that enables indirect sourcing to gain access to the more complex, larger categories. At one retailer, we started the process with categories that were already under the control of the purchasing function, such as office supplies. The success cases in these categories helped the team build credibility with their stakeholders. Then the team addressed categories that did not fall under their control but also did not directly affect the consumer experience, such as telecom or some IT expenditures.

Delivering rapid savings offers benefits that go far beyond the cash they liberate. Early projects help purchasing staff to gain experience and confidence with new tools and techniques, and success can provide a clear signal about the capabilities of the function, which can open the eyes of the wider organization to savings potential elsewhere. Since 75 percent of operational improvement programs fail to meet targets in the first two years, and 15 percent are not able to sustain initial gains after two years, building momentum and getting the organization on board are crucial to meeting long-term goals.

6. Establish stretch targets and a robust tracking and transformation plan.

Big savings need bold yet achievable ambitions, and the best indirect spend optimization programs establish challenging savings targets per category. When working with one retailer, we helped the sourcing team set itself the goal of reducing spend by 15 percent on all addressable indirect categories within two years. This was a very aggressive target for the organization. Hence, we helped build a communication plan to ensure that everyone understood it was an aspiration, meant to encourage people to think about their sourcing strategies more boldly and come up with out-of-the-box ideas to create value. It was clear that some spend areas might not achieve the 15 percent, but the difficult targets encouraged purchasing staff to look for more creative ways of reducing expenditures. During the sourcing work with this client, most categories achieved their targets, and this sent a strong signal about the power of the approach to the wider purchasing organization and beyond.

In some cases, there is real value in integrating zero-based budgeting (ZBB) into the business-backed NFR approach. Through a repeatable, rigorous process, retailers are able to challenge every dollar in the annual budget, manage financial performance throughout the year and drive accountability and ownership.

The size of the prize for indirect sourcing

A structured, well-resourced initiative to expand the reach of indirect sourcing can make a substantial and immediate impact. Overall project costs are typically recouped through savings in six to nine months, and the majority of the savings –in many cases up to 80 percent– are captured in the first two years.

More broadly, after the initial transformation a best-in-class retail indirect sourcing organization will continually address 80 percent of spend and generate 2 to 3 percent in annual cost savings, with each sourcing full-time equivalent delivering $1.3 million to $1.5 million in savings. Sourcing can use an analysis of key performance indicators to prioritize areas that could deliver the greatest return. So once this function is up and running with the right strategic alignment, approach, team, and systems, it will represent the single biggest ROI opportunity in the organization, delivering savings in areas that have more limited overall business risk.

As retailers face tougher competition from their traditional rivals and from cost-advantaged online players, they will not find a more effective way of rapidly delivering value than by transforming their approach to indirect sourcing. With overall average savings opportunities of as much as 18 percent across all categories, a transformation program can add 80 to 180 basis points to operating margins in as little as two years. Moreover, such success positions the indirect sourcing team to continue capturing further savings on an annual basis. An indirect sourcing organization can generate up to a 15–fold return on investment (Exhibit 7).

Exhibit 7 Best-in-class indirect sourcing's impact in retail

Best in class retailers average…

100-150 basis points of incremental profit

2-3% savings per year

$1.3-1.5M savings per procurement FTE

12-15:1 ROI on their indirect organization

SOURCE: McKinsey Retail Procurement

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Retailers that have built an effective business-backed NFR sourcing function have created a major source of funding to enhance their top line and to invest in strategic priorities to expand their business. No other function can achieve that level of return. If a retail organization is not realizing similar numbers, it is often because a company has not equipped its indirect sourcing team with the full suite of capabilities and tools as well as access to all relevant spend categories.

Few retail sourcing functions are in a position to demand such a role today, but they can certainly earn one over time. By delivering surprising value across an ever-increasing range of categories, indirect sourcing can gradually build its reputation, credibility, and reach in the organization.

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