


# **PROCUREMENT:**

## **A Strategic Lever for Bottom Line Improvement**



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## A Time for Impact

With continued softness in the economy and increased competitive pressures, companies are finding themselves besieged by investors and corporate boards demanding stronger financial results. This escalating demand for enhanced performance, coupled with the rising scrutiny and skepticism of the financial markets, indicates that fresh and creative approaches are needed to improve bottom line performance and maintain year-over-year corporate growth.

How can companies most significantly impact their bottom line in the shortest amount of time? In a phrase: Hard Dollar Cost Reductions. For a company enjoying 10% profit margins, an overall cost reduction of as little as 5% can impact top line growth by 20%. While specific corporate results vary, the principle remains constant; *saving* money has a greater effect and requires fewer resources than making money. While companies are targeting long-term growth, internal changes can be made to generate near-term benefits. Further, these cost reductions can become a competitive differentiator, supporting progress and providing flexibility in an unpredictable market. As a result, many companies are looking with a strategic eye toward what has historically been a tactical function: Corporate Procurement.

***Hard dollar cost reductions are the shortest path to bottom line improvements***

## Procurement: A High Reward, Low Risk Opportunity

As companies weigh the relative costs of various methods to increase profitability, the value of cost reduction, through a more strategic focus on procurement, becomes self-evident. Companies typically spend between 50% and 80% of revenues on the procurement of external goods and services (see *Figure 1*). Even small cost improvements to these expenditures can quickly yield significant bottom line benefits. And when correctly executed, these improvements can create sustainable year-over-year cost reductions to support continued profitability and growth.

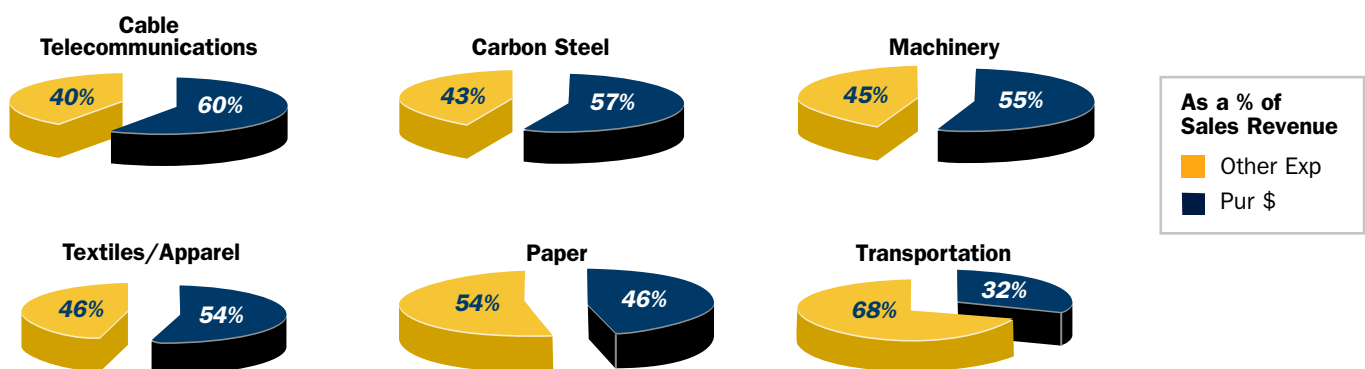


Figure 1. Typical Procurement Expense Profiles for Service and Manufacturing Companies

Figure 2 illustrates this point by showing the financial impact of a conservative cost reduction when applied to a company with a 15% operating margin and a typical expense profile (65% of revenues are spent on direct and indirect materials). In this example, a 5% reduction in indirect expenses alone generates a 34% improvement in earnings per share for a company with a 10% operating margin.

	As Reported	With 5% Procurement Savings
Revenue	\$10,000	\$10,000
COGS	(\$9,010)	(\$8,560)
Indirect	(\$2,208)	(\$1,758)
Direct	(\$4,793)	(\$4,793)
Other	(\$2,009)	(\$2,009)
Operating Income	\$990	\$1,440
Interest and Other Income	\$213	\$213
Taxes (@ 38%)	(\$376)	(\$547)
Net Income	\$827	\$1,106
Net Shares Outstanding (M)	213	213
Earnings Per Share	\$3.88	\$5.19
P/E Ratio	10	10
Market Value Per Share	\$38.82	\$51.92
	<b>Improvement</b>	<b>34%</b>

Figure 2. Example of Procurement Impact on Earnings per Share

While the financial impact of procurement is dramatic, the associated risks and costs are relatively low, especially when compared to other cost reduction initiatives such as decommissioning plants or layoffs. Rather than contending with the negative impact created by more drastic cost-cutting measures, procurement initiatives generate the best kind of results: positive reports of improved profitability.

### High-value Opportunities to Drive Immediate Savings

So how can a company identify the highest impact cost reduction opportunities? To begin, they must understand what they buy and from whom they buy it. Thoroughly reviewing accounts payable history and mapping expenditures can provide tremendous insight into corporate savings opportunities. In-depth analysis and classification of more than \$80 billion in spend reveals the following common issues and findings:

**Procurement savings are a low risk, positive impact alternative**

**Begin by understanding spend**

- Companies buy the same or similar products from many different suppliers, which means they are not leveraging total company buying power and they are managing more suppliers than necessary.
- Companies have not fully defined product requirements or established standard SKUs for many items. In such cases, companies may be buying items that exceed their needs when a less expensive item is perfectly suitable.
- Companies have not established formal supplier agreements for a large number of product categories or optimized their sourcing efforts by engaging a broad supply base and creating a competitive negotiation environment.
- Even in cases where companies have implemented a formal sourcing process, compliance against negotiated contracts is often low, resulting in increased costs and supplier proliferation.

While these problems may appear overwhelming, there are a variety of solutions to address them and drive bottom line savings.

#### **Increase customer leverage and buying power through intra- and inter-company aggregation and supplier rationalization**

All too often, companies do not take advantage of their own buying power due to a simple lack of information. Many companies have grown through acquisition, resulting in disparate systems and unique site level processes that limit their ability to track company-wide spend. By harnessing intra-company expenditures and selecting fewer suppliers in each buying category, companies can gain significant leverage. They can also deepen their advantage through inter-company aggregation and supplier rationalization.

#### **Drive further cost savings by rationalizing product specifications and establishing standard buying practices**

Companies should ensure that they only purchase the products they need. Due to a focus on quality or a reliance on historical buying, buyers may inadvertently select products that exceed the requirements of the overall finished good. By developing processes that clearly define the need before translating that to a specification, companies can avoid unnecessary costs. A simple example would be paper. The paper used to print investor relations and marketing collateral, such as an annual report, needs to accurately display company colors, reflect quality, be durable and support the chosen printing method. These needs should be defined before determining the exact type and grade of paper used, otherwise companies may select a higher grade and cost of paper than actually required.

***Leverage existing  
buying power***

***Rationalize  
product  
specifications***

## **Source more effectively by**

### **Engaging a larger number of qualified suppliers during supplier selection**

When the time comes to renew a contract, companies now have access to eSourcing tools that allow them to expand the number of suppliers included in the initial selection process. The Internet, readily available supplier databases, and automated RFI tools have all significantly reduced the time required to identify and qualify suppliers, thereby enabling companies to engage hundreds of suppliers from around the globe in their initial evaluation, in hours rather than weeks.

### **Creating a more competitive negotiating environment**

When applied properly, additional e-sourcing tools, such as online auctions, help companies create a more competitive negotiating environment. Real time bidding and price transparency provided through e-auction tools give companies control of the buying process and drive major overall cost savings.

### **Improve financial controls and contract compliance**

Even after selecting the best suppliers, negotiating the optimal contract, and improving supplier information, companies can still miss the opportunity to realize hard dollar savings. To fully achieve bottom line benefits, buyers need to buy against contracts quickly and easily and companies need to control spend activity through a procurement tool. These steps allow greater visibility into contract compliance and purchasing patterns.

### **Doing Procurement Right: A Comprehensive Approach for Immediate and Sustained Savings**

To extract the maximum value from procurement, companies need to understand their spend, select the best approach to source and procure each set of goods and services, and continuously monitor performance. By focusing on these steps, companies can create the highest overall return with the greatest immediate benefit. Companies often skip the spend analysis step and start with the familiar, neglecting potentially large areas of cost reductions. Today's sourcing and procurement solutions can help companies begin saving in a matter of months, providing significant early returns that can fund longer term initiatives. Closing the loop with compliance and performance management secures cost reductions and creates opportunities for additional savings.

***Maximize the number of qualified suppliers during sourcing***

***Use competition to drive savings***

***Ensure compliance and control***

Unfortunately, too many companies have acted on only a *portion* of a procurement strategy. For instance, low quality spend data can cause companies to minimize their own buying power. Some companies conduct strategic sourcing initiatives but may fail to implement a procurement system to facilitate compliance. While other companies may be leveraging the latest procurement technology only to realize that they don't have the tools or resources to enable suppliers and manage catalog content. A comprehensive approach focused on the highest value opportunities will have the largest benefit on a company's overall bottom line.

So how can a company effectively achieve measurable and sustainable cost savings? They must address the entire procurement value chain from savings identification, to negotiation, and most importantly, realization. The five essential steps are described below:

### **1. ASSESS for insight and opportunities.**

Any savings initiative should start with a thorough understanding of what a company buys, and from whom they buy it. A complete spend assessment will provide immense visibility into a company's needs, their total buying power, and the degree to which they are leveraging that power. While this process may appear complicated, there are many solutions to help companies conduct a spend analysis—from custom data warehouses to spot consulting support to existing supplier databases and tools that can quickly categorize data up to 80% in weeks.

### **2. SOURCE for savings.**

Equipped with an understanding of needs and opportunities, companies discover a majority of savings through effective sourcing. An effective sourcing methodology will address product specification rationalization, recommend standard buying practices, use the most appropriate sourcing and negotiation strategy for the category, and achieve the lowest total cost. To maximize sourcing results companies need to obtain category specific expertise, deploy the right sourcing strategy, and apply today's available technologies.

### **3. ENABLE buyers and suppliers to turn contracts into commerce.**

The end result of even the best sourcing efforts is a piece of paper—a negotiated contract that defines pricing and service terms. In order for companies to realize negotiated savings they must enable end-users to easily

***Doing procurement right requires an approach that addresses all areas of cost reduction opportunities***

buy off these contracts while also driving compliance. To truly enable companies to realize savings they must not only connect users to contracts, but also ensure that users can accurately and confidently buy against those contracts.

#### **4. TRANSACT through management tools in order to capture savings.**

Once buyers have easy access to sourcing savings they will need an efficient means of placing requisitions, routing them for approval, and processing payments. By utilizing ERP, legacy or procurement solutions to transact requisitions, orders, invoices and payments, companies not only drive compliance against contracts but also streamline processes and increase control and visibility of spending.

#### **5. MANAGE continuous improvements in order to maximize procurement performance.**

Finally, in order to maximize and sustain savings, companies need to aggressively drive compliance improvements and leverage category experts to manage suppliers.

Each of these activities is vital to attaining real, measurable hard dollar savings. Skip any one step, and some or all of the savings potential will never hit the bottom line. Each step requires the appropriate technology and category specific expertise. Companies should carefully develop their approach to include each step in the procurement value chain and apply the right combination of expertise and tools.

#### **A Time for Hard Savings**

Companies that have successfully realized benefits from their procurement initiatives view procurement as an integral part of their overall corporate strategy. They no longer perceive procurement as a cost center, but rather as a strategic lever for improving profits or funding new initiatives. Procurement opportunities are significant—translating directly, with no dilution, into measurable, hard dollar profit increases. The risk is low and the savings can begin in months not years. By quickly mobilizing a well executed, procurement initiative, organizations can drive significant bottom line cost reductions that provide the resources necessary to meet the next competitive challenge, maximize profitability and fuel growth.

## **ICG Commerce Executive White Paper Series**

### **PROCUREMENT:**

#### **A Strategic Lever for Bottom Line Improvement**

*How procurement can significantly impact company performance*

### **ASSESS:**

#### **Analyzing Spend for Insight and Opportunities**

*An overview of spend analysis best practices, insights and common savings opportunities.*

### **SOURCE:**

#### **Driving Savings Through Leverage and Structured Negotiations**

*Sourcing benefits and strategies for maximizing results*

### **ENABLE:**

#### **Turning Contracts Into Commerce Through Buyer and Supplier Enablement**

*Key enablement challenges and solutions to overcome them*

### **TRANSACT:**

#### **Driving Compliance and Process Efficiencies Through Procurement and Transaction Management**

*Leveraging procurement solutions to streamline procurement and drive compliance*

### **MANAGE:**

#### **Driving Continuous Improvements**

*Maximizing benefits through supplier, procurement and category management.*

### **TOTAL PROCUREMENT OUTSOURCING:**

#### **Focusing Corporate Assets on Core-Competencies**

*Expanding procurement's bottom line impact through outsourcing*





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