

# From Good to Great Procurement

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## The Drivers of Sustainable Procurement Performance

Does my procurement organization already employ best-in-class practices, sophisticated tools with the right talent, and the necessary formal and informal cross-functional linkages?

Some 50 to 90 percent of the companies that answer this question will respond “no.” On the one hand, this realization is a good indication of readiness for change and the acceptance that development is needed. On the other hand, though, these organizations should realize not only that they are missing an opportunity today but also that they will not have the basic building blocks in place to be ready for the challenges that the next decade will bring.

How do we know that the gap is so large? Over the past five years, McKinsey & Company has conducted more than 1,500 global procurement studies. And we have also examined more than 700 procurement organizations in detail and spent more than 2,000 hours interviewing chief procurement officers (CPOs) and their staff members. The result of this Global Purchasing Excellence (GPE) research is an in-depth examination of the links between procurement health and corporate performance.

The findings confirm that procurement pays: Companies with high-performing procurement functions consistently outperform their rivals on a range of financial indicators, and the best companies are building advanced talent-management strategies into the very heart of their procurement organizations.

So why is not everyone capturing the value at hand? Often, the reasons are quite trivial: lack of talent, overhead cost pressures, unclear governance, and insufficient systems and data. The research we conducted clearly shows that not paying attention to procurement is a significant lapse of judgment. While many reasons are indeed significant

management challenges, the impact achieved with good procurement far outweighs the efforts needed to overcome them.

In this chapter, we discuss how procurement pays across all industries, and we detail the key drivers for procurement success.

## Procurement Pays

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High-performing procurement functions deliver huge value to their companies. This is the case regardless of industry. In addition to the U.S. \$84 billion (cumulative) in yearly cost savings cited earlier, procurement leaders deliver superior returns from their operations, as well as lower cost of goods sold.

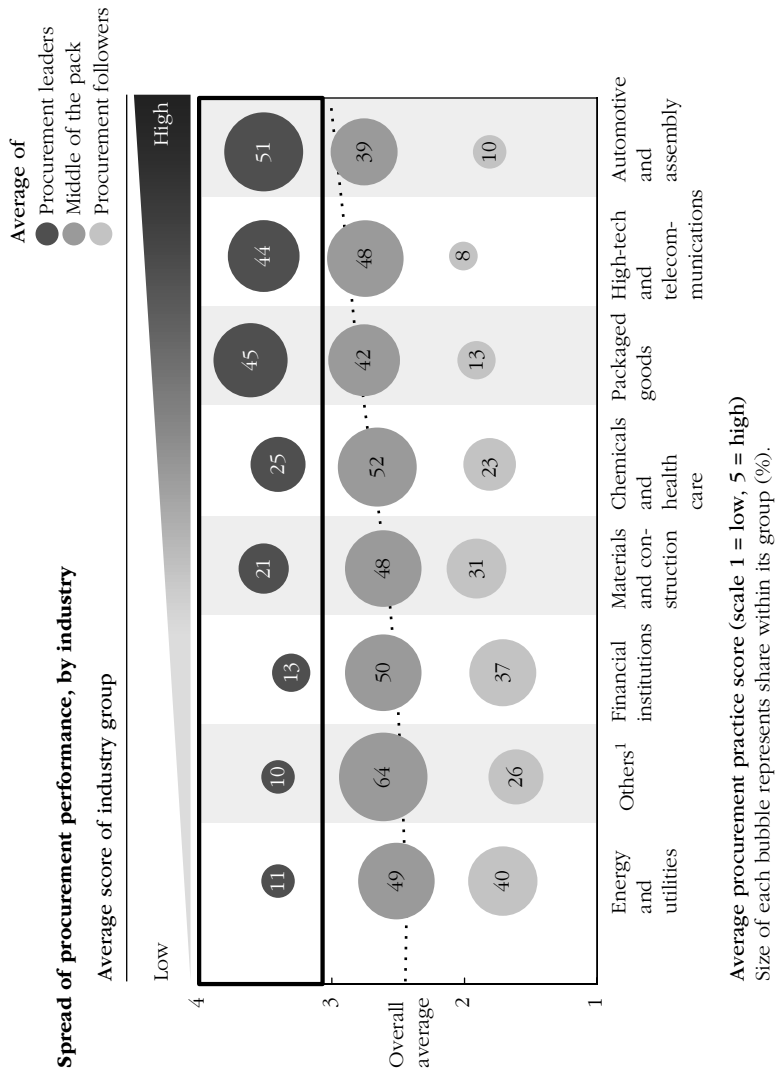
Our research confirms that every industry has its high performers in procurement. But we also find significant variations in performance among companies within an industry—much wider, in fact, than the performance differences between industries.

Of those companies surveyed in the energy and utilities industry, for example, only 11 percent were considered to be procurement leaders, delivering a GPE score greater than 3 (1 = low, 5 = high), while a whopping 40 percent were rated as procurement followers—that is, those whose performance was below the average for the total sample (see Exhibit 1.1). Even in the automotive and assembly industry, long considered a model of advanced procurement performance, only 51 percent were ranked as procurement leaders. It's clear that there is plenty of room for improvement across all industries.

Our data on the spread of procurement performance across industries provide compelling evidence that an effective corporate procurement function generates significant and sustainable value. As one CEO we interviewed put it, echoing the views of many others, “The profit lies in purchasing now—and even more so in the future.”

The same GPE research points to four key dimensions that enable best-practice procurement organizations to stand apart:

1. **Capabilities and culture**—defined as the way that procurement professionals think, plan, conduct themselves in the workplace, and communicate, individually and collectively.
2. **Category management and execution**—that is, the procurement strategies and processes that the company follows in order to create value.
3. **Structures and systems**—meaning how the organization manages the procurement function's resources through formal and informal structures and how the function interacts with other company functions.



**EXHIBIT 1.1 There Are Procurement Leaders in Every Industry**

<sup>1</sup> Including retail, travel and logistics, services, entertainment, and public sector.

Source: McKinsey Global Purchasing Excellence.

4. **Integration and alignment**—defined as procurement’s alignment with and support of the overall business strategy.

The best procurement organizations excel along each of these four core dimensions. But it is essential to point out that one dimension in particular—capabilities and culture—is the key to driving procurement health and the strength of the bottom line. It correlates 1.5 to 2.2 times more strongly with the health of a company’s procurement function than does any other dimension.

At the same time, capabilities and culture have an important, two-way relationship with the other three dimensions: a procurement function needs the right talent to achieve its key objectives, but it also adopts an approach to each of the core dimensions that optimizes the use of that talent. Category management and execution are much more effective if executed by excellent people. Structure and systems cater to excellent people by creating leverage and exposure. And integration and alignment are much easier to achieve with outstanding talent than with mediocre personnel.

In one case, the CPO of a global logistics and transportation company set out to improve his procurement organization’s performance, focusing exclusively on talent for the first three years. He spent his time “recruiting the right people, developing the right skills, and building an appetite for real impact,” he recalled. “Everything else came a distant second.” The result? Double-digit percentage cost reductions in each of the following three years!

## Capabilities and Culture—Recognizing Talent as the Key Asset in Procurement and Investing Accordingly

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The most effective procurement practices make enormous demands on the people whose job it is to implement them. Of all those on procurement leaders’ staff, 40 percent are educated to the postgraduate level, compared with only 14 percent of those on the staff of companies rated as followers. But procurement leaders don’t look only for high educational attainment. They also look for attitude and ability, recognizing how much harder it is to change an employee’s hardwired attitudes than it is to develop function-specific capabilities. The best organizations select “supply entrepreneurs”—high-performing individuals who are ready and willing to take full ownership for their categories and to push boundaries as if they were spending their own money.

These profiles are business-oriented and aligned with the requirements that were articulated by other business functions, such as sales and marketing and business development, several decades ago. The CPO of a global conglomerate summarized it this way: “I hire for attitude and train for skill.”

The training programs used by procurement leaders are both broader and deeper than those of the others. While nearly all companies in our research train their people in core procurement skills such as negotiation, the procurement leaders also offer training in more advanced skills such as sourcing-strategy development, advanced analytics, and the structured identification of category-specific improvement levers. Furthermore, they build more general business, leadership, and intercultural skills among their strategic procurement personnel.

That is just the start. Procurement leaders build on these training programs by building experience: They deliberately rotate staff both within procurement and across functions. For example, 70 percent of the procurement leaders run internal job-rotation programs (with the majority of program participants moving into higher-level positions), whereas only 29 percent of the average performers do so. In many cases, these rotation programs keep category managers in their positions for only three years and have them rotate to other functions after five or six years.

During their job-rotation programs, the leaders work hard to balance the outflow and inflow of talent by earmarking capable individuals to return to the purchasing functions. In this way, they avoid excessive brain drain. All in all, their efforts make procurement an important career stepping-stone.

Talented people are also rewarded for outstanding performance. The bonuses offered by procurement leaders are both higher and harder to get than those offered by followers. For example, high-level strategic procurement staff at leading procurement organizations have a maximum potential bonus of approximately 45 percent of their base salary, while at procurement’s average performers, the comparable figure is only 30 percent.

## **Category Management and Execution—Improving Effectiveness through Advanced Procurement Tools and Approaches**

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Category management is the fundamental driver of procurement value, and the best organizations ensure that their category management machinery is both powerful and effective. Power comes from

high-caliber staff: Procurement leaders invest 29 strategic full-time equivalent (FTE) employees per U.S. \$1 billion in spending, compared with just 17 FTEs at purchasing followers. The return on these investments is typically between 15 and 25 times the cost. (That is, they earn their salary by mid-January or, in dollar equivalents, there is a \$20 million to \$30 million impact created by 12 additional FTEs.) Purchasing leaders also extend the influence of the procurement function to ensure that more of the company's overall spend is controlled by procurement. At procurement leaders, the average figure is 82 percent compared with 65 percent for procurement followers. The leaders are heavily involved in procurement of nontraditional categories such as marketing and capital expenditure.

Effectiveness is ensured through excellence in execution. Strong procurement organizations share an unflinching focus on process standardization, but they are careful not to let a dogmatic adherence to standards detract from performance. They develop standards for building a procurement function in which everyone works as one team, speaks the same business language, rotates freely among roles and categories, and measures success in common terms. But at the same time, staff members in these organizations have the freedom to adapt to the specific needs of particular categories, markets, and projects, tweaking or creating new standards to ensure that the most effective approaches are absorbed into the fabric of the organization.

Great tools matter, too. Procurement leaders exploit the explosion in data digitalization and improved analytics to make extensive use of selected e-procurement tools such as electronic purchasing catalogs and spend analysis software. However, contrary to common belief, they tend to do this for efficiency and not for effectiveness—another indication of the value and scarcity of talent.

At the same time, information technology (IT) is important in high-performing organizations, and it will become even more important. Among procurement leaders, almost three-quarters scored “very good” or better in e-literacy. They consistently use their IT solutions to speed and simplify transactional and administrative work, freeing up their staff to add more value.

The leading companies participating in our GPE research also encourage their staff to pursue value beyond basic commercial levers, through demand and specification management. Hence, procurement leaders make widespread use of the total-cost-of-ownership methodology, best-cost country sourcing, and design-to-value management. It was, for example, the new CPO, not the head of engineering, at one of our globally leading high-tech clients who launched a comprehensive design-to-cost-and-value



program addressing all global businesses and product lines over a two-year period. Financial impact from redesigning products and supply chains, defeaturing, and managing sourcing demand down reached 20 percent in the majority of the businesses touched—a very significant value creation attributed to the procurement leadership. Approaches like this help buoy the entrepreneurial attitude that procurement leaders have consciously cultivated among their staff members, creating much more impact across the organization.

## **Structure and Systems—Organizing for Economies of Skill**

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The significance of a center-led procurement function is clear from the research data. Of the procurement leaders, 95 percent have a fully centrally coordinated procurement organization or a hybrid model that combines a center-led structure with some decentralized elements. Contrast this with procurement followers: 25 percent have no centrally coordinated procurement function. This seems surprising to most observers, given that the economies of scale are often small and balanced with the proximity to the internal customer. However, economies of scale are less relevant because only 25 percent of the impact is commercial, while specification and demand management drive 75 percent of impact. For specification and demand management, economies of skill—not economies of scale—are relevant, another indication of the value of talent.

In fact, the top-performing companies participating in the research most often choose organizational structures that build on economies of skill. They centralize strategically important tasks and delegate many of their tactical procurement activities. Their best staff members are given the most important work—tasks such as defining the overall sourcing strategy and negotiating framework agreements.

Leading companies also excel at internal collaboration—with procurement at the center of the action. Their procurement organizations regularly extend their efforts beyond cost reduction and supply chain performance, measuring a combination of price, quality, and supply chain performance and striving for other strategic goals—for example, access to intellectual property. None of this happens without a cross-functional, collaborative approach. Almost all procurement leaders report extensive collaborative activities with internal customers, whereas less than one-third of followers say that is the case. The collaboration can be as simple as closely and early on aligning on the specific

internal customer sourcing needs that procurement has to act upon or as complex as jointly developing extensive category strategies that may explore make-or-buy and outsourcing matters or new supplier development opportunities. In any case, there is a clear link between cross-functional collaboration and procurement excellence, as most procurement levers explicitly require the engagement of functions outside procurement.

Another way to maximize economies of skill is to ensure that best practices, once established, are shared widely across the organization. Our research revealed that procurement leaders have effective knowledge-management processes in place to capture, codify, and communicate the best practices. Siemens, for example, centrally collects and maintains clearly defined procurement practices, processes, and methods and facilitates extensive sharing and application in all global businesses. This starts with a uniform definition of spend baselines, targets, and savings types across businesses as diverse as power plants and hearing aids, and extends to the joint pursuit of supplier development or efficiency initiatives.

## **Integration and Alignment—Using Success in Cost Management to Advance toward a Truly Strategic Role for Procurement**

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The proverbial seat at the executive table? The heads of top-performing procurement organizations have been there for years. They talk business all the time, and they are entirely familiar with the overall company strategy.

Among procurement leaders, the CPO is twice as likely to report to the CEO and to be a member of the top management team as is the case at the average performers. These CPOs had the highest possible exposure to the company's most important business decisions; they are perfectly placed to enable swift cross-functional collaboration with peers, demonstrate procurement's position as a strategic role rather than a support function, and ensure that procurement projects have the right support from senior management. After all, they do "own" 60 to 80 percent of the productivity opportunity of the company. Of course, it takes time to get to this position, and it should go without saying that achieving the position does not happen without sustained, demonstrable performance. The CPO of a manufactured-goods company put it this way: "Only after we had spent three years delivering undisputed cost improvements of triple-digit millions to impress the board did they start taking us seriously in other

areas. Now, we play a vital role in supporting product development, marketing, and manufacturing, too.”

The top-performing companies in our GPE research also excel at aligning procurement strategy with the business strategy. As the procurement function becomes more sophisticated, it evolves from playing a defensive role (for instance, supporting cost control) to actively contributing to value creation. The research results show that 92 percent of leaders managed this close alignment with company strategy compared with only 67 percent of average performers and 27 percent of followers.

## **Practical Tips for Improving Category Management Performance**

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What if your organization is not performing as well as you would like with respect to the four basic dimensions of procurement excellence? What if the first change-management effort you have to undertake is to reach sophistication in classical category management? Here are some practical tips on how to build an effective category-management engine that can form the foundation for your procurement organization’s enhanced value creation. With the impact of sophisticated category management providing the tailwinds, your overall transformation toward Procurement 20/20 will gain the support it needs from both management and the wider organization to pursue the much larger vision.

Every successful category-management improvement program comprises three key elements—cross-functional teams and governance, a stringent modular category management approach, and rigid performance management—all embedded in a proper communication and change plan.

### **Cross-Functional Category Team and Steering Governance**

Successful category programs follow a total-cost approach rather than focusing solely on price. To do this, a program must involve cross-functional category teams comprising, for example, procurement, engineering, and finance. Ideally, these teams are collocated in a “war room” for at least 50 percent of the time for three to four months, and, during this period, they focus solely on generating ideas for cost reduction and execution. To develop these savings ideas, teams should use the entire procurement toolbox—for example, spend and price variance analyses, clean sheets, delta costing, tail analyses, linear performance pricing, best of

benchmarking, life cycle and target costing, and specification and service-level definition. They should also conduct cross-site benchmarking and include suppliers in the idea-generation process, as appropriate.

Category teams should present and get sign-off on their comprehensive category strategies from a strategic sourcing council. Frequent steering meetings enable fast decision making, ensure that difficult topics are escalated and resolved, and identify necessary cross-functional paradigm shifts, such as an earlier involvement of procurement in the development process and tightening the supplier performance-management system.

### **Rigorous and Modular Category Management Approach**

Successful programs start with an up-front definition of an ambitious yet realistic savings target. The target should be linked to a larger program or business need to create a sense of urgency and momentum, but it should also be broken down into teams, products, and divisions. Procurement and cross-functional partners need to share the same target. Establishing a rigid approach to category strategy development—one that entails mandatory sourcing analyses, templates, and frequent cross-functional problem solving—helps guide the teams toward their targets in a consistent way. The approach should also balance quick wins with sustainable impact.

### **Performance Management**

Category teams require continuous tracking of results, a savings ramp-up curve, and standardized definitions of idea maturity levels to ensure progress that becomes visible on a granular level. A tracking tool should contain all savings ideas with their associated maturity level, measuring idea implementation against the savings target and simulating the savings ramp-up across all categories over time. The program management team should also develop a set of standard reports—ideally, generated automatically by the tracking tool—that communicate the progress to leaders and team members, creating a positive competitive spirit among the teams.

Any category transformation requires contributions from various stakeholders in procurement and internal customers such as finance, engineering, and legal. Consequently, every category transformation requires consistent communication and embedding of the program into a broader change plan.



Now that we have discussed what the key dimensions of a world-class procurement organization look like today, you may be wondering how you should advance your organization so that it will still be a leader in the future. What are the major trends that will affect businesses over the next decade, and how will they affect the procurement function? How should you prepare?

