

Procurement Outsourcing

Navigating the risks to reap the rewards

Procurement outsourcing has long been expected to become “the next big thing” in outsourcing. As far back as 1999, in A.T. Kearney’s Assessment of Excellence in Procurement study, executives said they expected to increase their outsourcing of day-to-day procurement activities significantly, and deploy more strategically managed consortia. Yet more than a decade later, procurement outsourcing continues to trail outsourcing in other functions. Why aren’t more companies outsourcing procurement? Because it’s not that easy to do.



Procurement is not as easily outsourced as other functions—that’s because procurement results tie directly into the cost of goods sold (COGS) and the business’s profit-and-loss statements. Companies are careful not to lose their grip on this important function. Despite a substantial growth in outsourcing in the past several years, procurement outsourcing is less than 2 percent of all outsourcing activities. Figure 1 on the following page illustrates the gap between procurement outsourcing projections and the reality three years later among leading practitioners, according to a comparison of A.T. Kearney indirect procurement studies (2007-2010).

Only a handful of companies are considered experts at outsourcing procurement and, to date, most procurement outsourcing is limited to select portions of indirect spend. It is difficult to envision it expanding to all indirect spend areas across companies, let alone into direct spend. Expectations that

procurement outsourcing will achieve high growth over the next several years may need to be tamped down. Figure 2 on the following page highlights the expected growth rates to 2012.

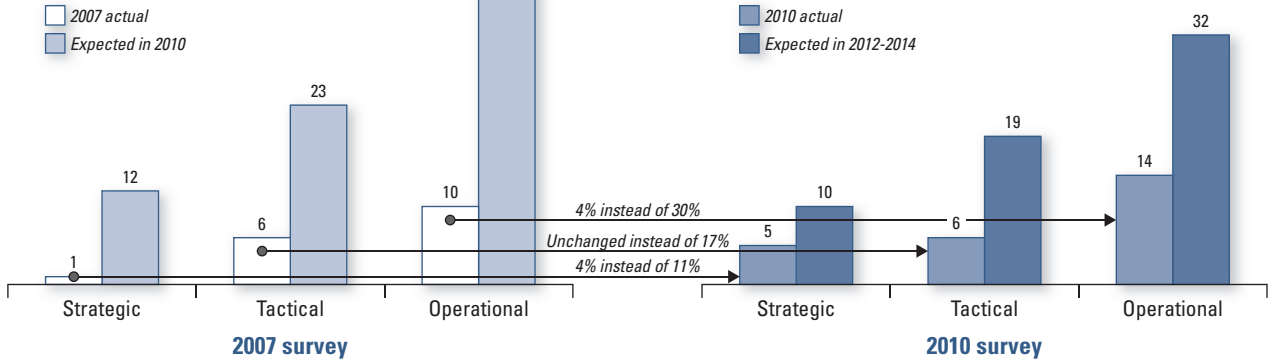
In fact, a few companies recently began the process of backing out of or renegotiating procurement outsourcing deals they signed just a few years ago. One large multinational retailer that considered all indirect sourcing categories to be “nonstrategic” undertook a sizeable outsourcing deal that did not result in ample benefits in several categories. Another global telecommunications company that “mixed” procurement into a broad outsourcing contract concluded that it was paying too much for average results. Both companies now recognize that their due diligence efforts during the vendor selection and contracting processes were less than adequate.

These experiences exemplify why companies planning to begin procurement outsourcing efforts, or intensify

Procurement is not as easily outsourced as many other transactional or non-strategic functions—that’s because it ties directly into a company’s profit-and-loss statements.

FIGURE 1: Level of procurement outsourcing lags expectations

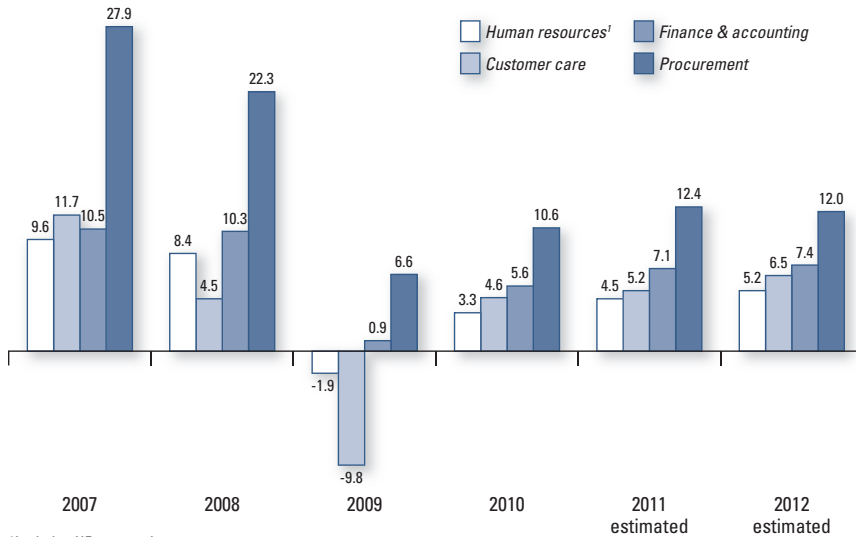
Outsourcing activities—actual versus expected
(% of respondents)



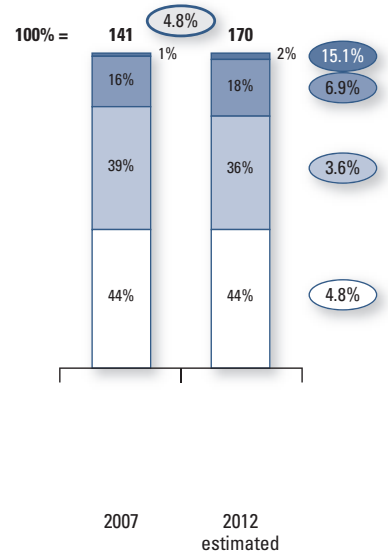
Source: A.T. Kearney Indirect Procurement studies, comparison 2007 and 2010

FIGURE 2: Procurement outsourcing is expected to remain a small portion of overall outsourcing

Outsourcing growth rates—2007-2012 (% by business function)



Revenue breakdown (\$ billion)



¹Includes HR processing

Source: IDC "Worldwide and U.S. Business Process Outsourcing Services 2010-2014 Forecast"; A.T. Kearney analysis

already started initiatives, should do so cautiously. There are certain characteristics that leaders in procurement outsourcing share. For example, the most successful companies in procurement outsourcing were not nota-

bly proficient in procurement before outsourcing it. Others are succeeding by starting with requests for proposals (RFPs) that are smaller in scope and more specific; encompassing a relative handful of procurement

processes or sourcing categories and expanding only if these "pilot" efforts succeed. This latter approach reflects the type of caution that is warranted when outsourcing any key corporate function.

Outsourcing Procurement: What You Need To Know

A thorough analysis is a must when considering procurement outsourcing. You must be honest about your current capabilities when determining what facets of procurement you might outsource. For instance, do you outsource strategic sourcing? Category management? All procurement operations from buying through payments?

Strategic sourcing or category management should not be outsourced in isolation, in most cases. Yes, an external provider can perform strategic sourcing alone to cut costs quickly with minimal transformation or change management. But the benefits will be short lived unless you subsequently develop a sound category management capability. This process will help acquire skills and know-how that were not already available and build discipline in the procure-to-pay chain. But doing so requires substantial change management efforts that vendors are challenged to drive, especially when they are not in control of the purchasing operations. Outsourced category management brings fees for service that can exceed the cost of bringing this expertise in-house, especially where there is scale to leverage.

A preferred operating model involves outsourcing some transactional procurement operations as a first step, or combining end-to-end solutions for specific categories. The former arrangement helps to realize savings in labor arbitrage and improve efficiency by outsourcing non-core activities, coupled with data transparency that can result in further savings due to improved spend management. It also provides a solid starting point for

incremental outsourcing. A combined end-to-end category solution allows for maximum savings potential from a non-core business area and encourages vendors to “put some skin in the game” by committing to specific savings targets. Of course, agreeing to this model requires ceding control over decisions

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in the selected categories, combined with significant change management and collaboration to realize savings.

Clearly, if you are considering procurement outsourcing you must be open to change, and willing to let the outsourcing vendor be the driving force behind it in order to promote long-term savings. You must also understand all potential costs—both upfront and ongoing—before engaging vendors.

Contract Cautiously

Deciding to pursue procurement outsourcing also means undertaking a formal strategic sourcing process to select the right vendor, as vendor solutions and contracting methods vary

widely in this relatively immature outsourcing field. While today’s customer service leader can engage a call center vendor and feel secure about the outcome, the same cannot yet be said about the procurement leader who is considering outsourcing strategic sourcing or category management. Each service provider’s specific capabilities, solutions and service offerings are different (and, in some cases, still under development), as is the category-specific know-how each possesses. Most importantly, a full understanding of the value proposition in terms of costs weighed against potential savings and other benefits is needed.

Determining which aspects of procurement to outsource and which vendor solution to adopt are the basic first steps toward successful procurement outsourcing. Yet the ultimate success or failure of such a deal can very well lie in the contracting process. At this time, there are too many ways to land a procurement outsourcing contract, and the variety of options are actually a negative. You need to have a very clear picture of the fees that you will pay for the service and the benefits you should expect in exchange.

When charging for services, vendors may charge a fee as percentage of managed spend, charge a fixed price per full-time equivalent (FTE), charge a percent of savings achieved or even offer to negotiate a gain-sharing agreement. Deals built around percentage of managed spend bring clear costs and invoicing, but can result in high ongoing fees and the risk of operating losses if savings are not committed.

Price per FTE deals, which we endorse for procure-to-pay outsourcing,

present a clear picture around costs that make them easy to audit. The downside of FTE deals is that when contracts include category management, what is in fact a high-value-added service is treated like any other type of transactional outsourcing, thus blurring the value of the spend management skills incurred, which actually go beyond that FTE.

Contracts that include one-time charges upfront typically result in negative cash flow in the first year or two of the arrangement, but they are fairly transparent and help to incur a real cost in the right category rather than realizing it later through high long-term fees. Although gain-sharing agreements create the appearance of a partnership and potential upside, the concept tends to be blurry in execution. Because gain-sharing relies on trust, disputes may arise around how much in savings were realized should the signatories of these multiyear contracts move on—thus, we rarely favor this type of arrangement.

Delivering Results: Deal After Deal

Procurement outsourcing is an emerging practice, and certainly is not an arrangement to be entered into lightly. For several companies, it has not yielded the expected results. Companies with the most to gain tend to be those with annual revenues between \$1 billion and \$5 billion, as they rarely invest heavily in procurement capabilities and are keenly focused on growth. Companies in this range lack the scale to make significant headway by pooling their own spend across the business, but can outsource indirect categories to a vendor that can in turn bundle this spend with that of other companies to obtain favorable terms. Consumer products and financial services companies have been leading the inquiries about procurement outsourcing based on a combination of their familiarity with outsourcing other functions and their sizable (but often undermanaged) indirect spend.

Procurement outsourcing is also unique when compared to the many other types of business process outsourcing (BPO), as it does not come with the baked-in guarantees that vendors usually deliver in other functions. An early willingness to share spend data and an honest assessment of present-day capabilities is a must during the vendor selection process. Where a capability is found to be lacking, the question then is whether it can be improved through an internally focused effort or by outsourcing.

The pilot approach discussed earlier offers a cautious on-ramp, with the potential to expand efforts by adding more categories or moving up the chain to more tactical aspects such as strategic sourcing and category management. As it happened with the now more popular outsourced functions, the best way to eliminate “buyer’s caution” in procurement outsourcing is for a group of vendors to deliver sustainable results and operational efficiencies—and do so deal after deal.

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